International Review of Business Research Papers
Vol. 3 No.5 November 2007 Pp.241-265

Integration of Islamic and Conventional Finance

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Fast growth of Islamic finance in recent years has created a huge opportunity for cooperation between the Islamic and the conventional financial institutions. Such cooperation to date has been most frequently observed in financing large development projects, like real estate and natural resource explorations, mainly in the Muslim countries. Even though active research efforts have been put into Islamization of conventional financial products, little research on the potential for cooperation between the Islamic and the conventional financial systems has been published. In this paper, we develop several deal structures that could help to expand cooperation between the two financial systems. We show several variations of the project financing structure that may provide conduits for the Islamic money to flow into non-Muslim countries, where potentially lucrative investment opportunities are currently not fully utilized either due to a gap in risk characteristics between entrepreneurs and bankers or simply due to shortage of capital.

Field of Research: Islamic Finance; International Cooperation

1. Introduction and Literature Review

The principles of Islamic financial system are about 1400 years old[1], but the modern, institutionalized form of such principles first appeared only about 4 decades ago, when the first Islamic bank was established in Egypt in 1963[2]. Islamic Finance has been exhibiting rapid growth worldwide since then. Presently, it is estimated that Islamic financial institutions (IFIs) possess some US$300[3] billions (Fig. 1) of assets all over the world, with worldwide existence of about 300[4] institutions. Some researchers even predicted that Islamic finance would attract 40% of the total savings of the Muslim population worldwide within the next few years.[5]

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Islamic finance has emerged from a myth to an unavoidable phenomenon in the global financial system, and has become a strong counterpart of the conventional financial system. The portion of financial assets managed by IFIs is, however, still very small as compared to the total assets of the conventional financial institutions (CFIs). Today IFIs actively operate not only in Muslim countries but also in many of the non-Muslim countries (Table. 1), but Islamic finance has not yet dominated conventional finance even in the Islamic countries. Some researchers claim that it has not been very easy for islamic banks to correctly apply the islamic law to banking transactions because of the dominance of the conventional financial system.[vi]

Recent growth in Islamic finance initially coincided with the current account surpluses of oil-exporting Islamic countries, but its continued growth reflects the influence of other factors such as the desire for sociopolitical and economic systems based on Islamic principles and a stronger Islamic identity. In addition, introduction of broad macroeconomic and structural reforms in financial systems, liberalization of capital movements, privatization, and global integration of financial markets have paved the way for the expansion of Islamic finance.[vii] Given that the Islamic financial industry has grown to an extent that cannot be ignored anymore and that the Islamic and the conventional financial institutions coexist in many countries, there appears an ample need for cooperation between the two systems. We have recently seen some fascinating developments in this regard. For example, Citibank, Hong HSBC, Goldman Sachs, BNP-Paribas and UBS have already established Shariah compatible services.[viii]

Transactions of Islamic and conventional banks are fundamentally different in their nature, however, and differences in the basic principles have critically hindered further expansion of cooperation between the two financial systems.[ix] For example, income-sharing, not interest-taking, is a salient feature of the Islamic financial system, but profit-sharing banking is a relatively new concept to most CFIs.[x] As a result, income-sharing banks are found mostly in Islamic countries or in countries where OPEC oil revenues have been invested.[xi] In a typical IFI, sale and lease-based transactions dominate the asset portfolios and can exceed 80%, with the remainder allocated to profit-sharing arrangements.[xii] In such banks, the relationships between depositors and the bank and between the bank and bank-investee can best be described as agency relationships.[xiii]

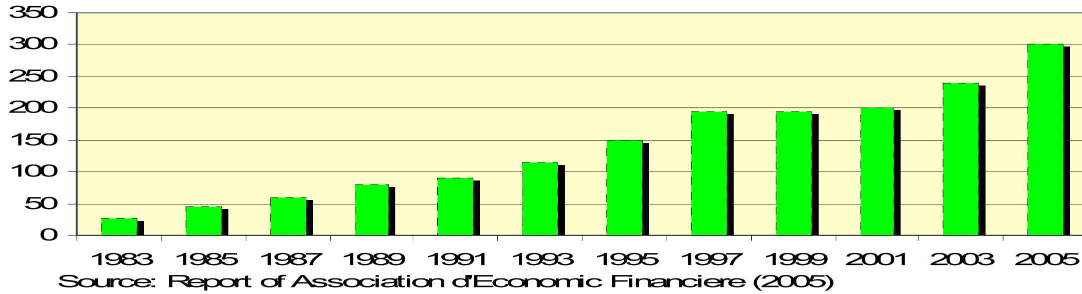
Due to such fundamental differences in the basic principles, cooperation between the two financial systems have been limited mostly to financing large projects conducted in Islamic countries for which CFIs – most of which are based in western countries - invite Islamic money for the purpose of risk sharing or simply to facilitate negotiations with host countries. There may exist, however, plenty of good investment opportunities for Islamic money in non-Muslim countries - especially in those countries that do not currently host any IFIs.[xiv] There are abundant opportunities for productive investment in the fast-industrializing

countries in Asia, but many of their FIs are either too risk-averse or suffering from short supply of money to fully utilize such opportunities. In these countries, the fact that Islam presents its own macro-economic system which is different from the capitalist and socialist systems may create incentives for corporations to seek funding from IFIs rather than CFIs.[xv] For example, young companies which focus on new technologies can easily face prohibitive costs in obtaining external capital from CFIs because they operate in a highly uncertain environment. For such companies, getting capital from IFIs on profit-sharing basis could become the best option.[xvi] Likewise, corporate restructuring with a non-interest-based funding from IFIs may turn out to be a good opportunity for financially-troubled young companies.[xvii]

Although Islamic finance is gaining acceptance worldwide and extensive research work is being carried out, much of the research is concentrated on developing Sharia-compliant products for IFIs. There has not been much research on the integration of Islamic and conventional financial system that can facilitate the flow of funds form Islamic to conventional banks and vice versa. This paper attempts to develop several deal mechanisms that may facilitate such capital flows. Section 2 provides a general overview of the current trends in the Islamic finance industry, and Section 3 compares the conventional and Islamic finance. Section 4 looks into possible ways of making a bridge between them and develops several deal structure models. Section 5 provides a brief conclusion of the paper.

2. Trends in Islamic Finance

In the Muslim world, there have been regulatory changes towards the Islamizaton of the financial system in the past few years[xviii]. Especially, Malaysia and Bahrain have been intensively competing with each other to become the hub for Islamic finance, and thus



have played a key role in the development of present day global Islamic finance industry.[xix] The kingdom of Bahrain is also expected to take steps on macro economic level to transform the economy into a purely Islamic economy[xx]. As a result of such developments, IFIs have developed a vast range of products designed to serve the growing market. These products cater for housing and consumer finance, business loans and project funding (table 2).

Table 2: List of the standard Islamic banking products

Product	Meaning	Description
Murabaha	Intermediation	Buying goods needed by clients and then selling them on later at a profit
Mudharaba	Sponsorship	Financial institution provides funds and the company manages the funds with no financial liability on the company in case of losses
Musharaka	Partnership	A joint venture where the business owner and financial institution, both, provide funds and bear losses
Ijara	Capital Leasing	Similar to conventional leasing but calculations are made on rental bases
Wakala	Agency	An agency contract which generally includes expert's fees for the financial institution
Salam	Forward Selling	A short-term agreement under which a financial institution pays, in advance, amounts corresponding to the future delivery of a defined quantity of goods
Istisna	Contracting Agreement	A variation of Salam under which a financial institution pays, in advance, amounts corresponding to the future delivery of a defined quantity of goods

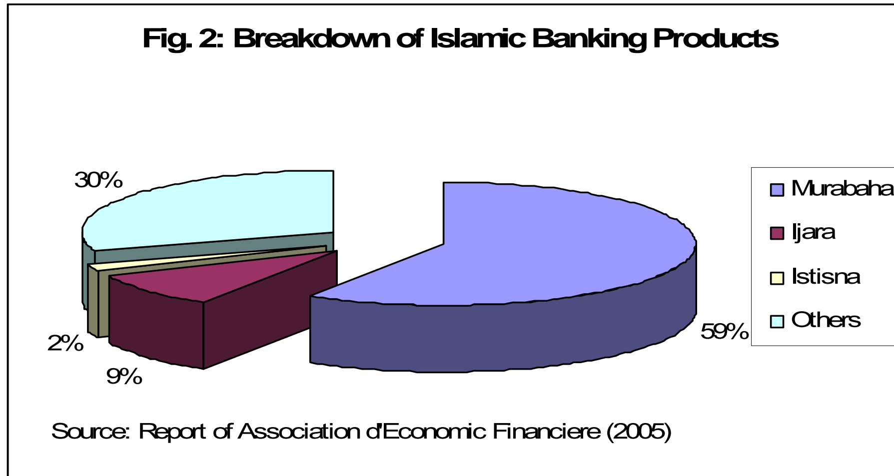
Currently, banking is the most developed part of the Islamic financial system. In Egypt, Iran, Indonesia, Malaysia, Pakistan, Sudan, and the Gulf Cooperation Council (GCC) countries, Islamic banking exists alongside conventional banking.

There are two main channels for Islamic banking these days; 1) Full Islamic Banks and 2) Islamic banking windows of conventional banks (Table 3).

Table 3: Examples of Full Islamic Banks and Islamic Window operations of conventional banks.

Examples of Full Islamic Financial Institutions	Examples of International Financial Institutions having Islamic Window Operations
1. 1st Ethical (United Kingdom)	1. Citybank
2. Al Aman Takaful Insurance (SAL) (الأمان للتأمين التكافلي) (Lebanon)	2. HSBC
3. A'Yan Leasing & Investment Co (شركة أعيان للتجارة و الإستثمار) (Kuwait)	3. Standard Chartered Bank
4. Al Baraka Banking Group – ABG (مجموعة البركة المصرفية) (Bahrain)	4. ABN Amro
5. American Finance House (LaRiba) (United States)	5. Goldman Sachs
6. Bank AlJazira (بنك الجزيرة) (Saudi Arabia)	6. BNP Paribas
7. Bank Eghtesad-e-Novin (Bank Eghtesad-e-Novin) (Iran)	7. UBS
8. Bank Albilad (بنك البلاد) (Saudi Arabia)	8. Chase

The major Islamic finance product is Murabaha that captures about 59% of all the value of Islamic banking products (Fig. 2). Ijara, the second largest in volume among banking products, has only 9% market share. Dominance of banking products has caused shortage of liquidity-enhancing instruments, thus eliminating a large segment of potential investors in the Islamic financial markets. More liquid instruments are fast emerging in recent years through securitization, however, and Malaysia and Bahrain have been instrumental in launching tradable securities that have created much needed liquidity and a secondary market for institutional investors in the Islamic financial market. Islamic funds, with a current market size of USD16 billion, represent the initial application of securitization [xxi]. Several "Islamic equity" investment funds have also been launched, with both FTSE[xxii] and Dow Jones[xxiii] providing indices to monitor this growing market.



Equity funds, the largest share of the Islamic funds market, are the same as conventional mutual funds but with an Islamic touch that requires a unique "filtration" process[xxiv] to select appropriate shares. The future of Islamic equity funds is bright in part because of a new wave of privatization under way in Muslim countries such as Egypt and Jordan, and in high-growth Islamic countries such as Indonesia, Malaysia and Pakistan, where the demand for Islamic financial products is growing rapidly. Sukkuk (Islamic Bond) is the fastest growing product of Islamic finance. Sukkuk has become a global product with both issuers and investors from all around the word.

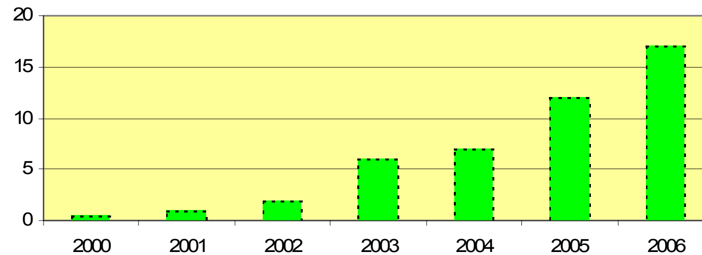
Table 1: Examples of Countries Providing Islamic Financial Services

Muslim Countries		Non-Muslim Countries	
Albania	Malaysia	Australia	The Philippines
Algeria	Mauritania	Bahamas	Russia
Bangladesh	Morocco	British Virgin Islands	Singapore
Brunei	Niger	Canada	South Africa
Djibouti	Pakistan	Cayman Islands	Sri Lanka
Egypt	Palestine	China	Switzerland
Gambia	Qatar	France	Thailand
Guinea	Saudi Arabia	Germany	Trinidad and Tobago
Indonesia	Senegal	India	UK
Ivorey Coast	Sudan	Ireland	USA
Jordan	Turkey	Luxembourg	New Zealand
Kuwait	UAE	The Netherlands	

Source: Council for Islamic Banks and Financial Institutions

Sukkuk is similar to asset-backed bonds, but instead of a fixed annual interest rate, payouts to investors over the life of the bond are derived from leases, profits or sales of tangible assets such as property, equipment or a joint-venture business.[xxv] According to London's Islamic Finance Information Service, $16.9 billion in sukkuk was issued between January and October 2006 - 43% more than the total in 2005 (Fig. 3).

Fig. 3: Total Issued Sukkuk from 2000 to 2006 (In Billions of US Dollars)



Source: Islamic Finance Information Service

3. The Islamic versus the Conventional Financial Systems

The Islamic financial system is not limited to banking but covers capital formation, capital markets, and all types of financial intermediation. The Islamic economic principles that govern the Islamic financial system form a branch of Sharia - a set of rules that governs every aspect of Islamic life. Many of the conventional financial products have their Islamic counterparts these days - although not fully Islamic in their true sense, they are quite close. Research in Islamic finance is going on at a good pace and we will see much improvement towards true Islamization of all the conventional financial practices.

Sharia has a well-established backbone of a sound financial system including government taxation, banking, international finance, etc. It prohibits some of the common practices in the conventional finance. For example, interest on loan is prohibited, and this is the major and significant difference between the Islamic and the conventional financial systems. The rationale is that money is just a medium of exchange and has no intrinsic value, and hence it should not be traded like other commodities but should be used to facilitate the trade of commodities. As a result, a large part of Islamic banking involves profit and loss sharing or equity participation in the forms of Murabaha, Mudaraba and Musharaka, where there is no pre-determined interest and the investor is liable to lose his/her invested capital if the borrower loses.

Although ban on the receipt and payment of interest is the nucleus of the Islamic financial system, the system is also supported by other principles of Islamic doctrine advocating risk sharing, individuals' rights and duties, property rights, sanctity of contracts, and great emphasis on ethical business practices. There are six basic principals of Islamic Finance;

First, transactions have to be trade related - i.e., there should be some underlying commercial need.

Second, the flow of funds should create value to the economy and add to the social welfare of the society.

Third, contractual obligations and the disclosure of information are upheld as a sacred duty. This feature is intended to reduce the risk of asymmetric information and moral hazard. Sanctity of contracts is a very important feature of Islamic financial and social system.

Fourth, investments in businesses that create social evils or destroy social norms are not allowed.[xxvi]

Fifth, Gharar, which means excessive uncertainty, is not allowed. Sharia allows reasonable level of uncertainty embedded in most investment opportunities, but prohibits investments if the degree of uncertainty is unusually high[xxvii]. The prohibition of Gharar is often used to justify prohibition of such conventional financial practices as speculation and financial derivatives.

Sixth, exploitation of any party due to weak position or weak bargaining power is prohibited. Sharia emphasizes that every transaction should be just to all the participating parties. One party should not be benefited at the expense of the other. Both parties should be happy and satisfied after the transaction.[xxviii] Similarly, unjust distribution of income between the depositor and the financial institution is also prohibited.

Sharia allows all those transactions that do not violate its rules, but there are no such restrictions on conventional banks. Almost all of the deposits and loan extensions of conventional banks are based on interest, and CFIs are not required to look as deeper into the investment opportunities from an ethical point of view as the IFIs are required to do. It is not surprising that IFIs are at great disadvantage against their conventional competitors.

4. Bridging the Two Financial Systems

Although there are fundamental differences between the Islamic and the conventional banking systems, one may still be able to find some slots for

cooperation between them. There have been active efforts to connect the two systems. For example, some large development projects have been funded jointly by international investment banks and IFIs. Citibank, HSBC and such other international banks have been actively working with Islamic banks to fund Sharia-complaint projects. A recent example is the Petro-Rabigh project (the "Rabigh Project"), jointly financed by APICORP, Bank Al Bilad, Calyon, Citibank, Islamic Development Bank, Gulf International Bank, Riyad Bank and SABB.[xxix] Similar cases flourish where projects have been jointly financed by Islamic and conventional banks (Table 4).

Table 4: Examples of Sharia-complaint projects Jointly Financed by Islamic and Conventional Banks

Country	Project Financier	Total Amount (USD M)	Year	Original Currency	Project Manager
Europe	Heitman; UBS Real Estate, Arcapita	814.90	2004	EUR	NA
UAE	Arcapita; HSBC	500.00	2004	USD	Dubai Sports City LLC
Bahrain	Arcapita; HSBC	300.00	2004	USD	Bahrain International Golf Course Company
Europe	Arcapita; Bank of Scotland	281.90	2003	Euro	Shurgard Self Storage
USA	Arcapita; Fannie Mae, Bank of America, N.A., Bank One, N.A. and GMACCM	417.40	2002	USD	Sunrise Third Senior Living Holdings LLC
USA	Arcapita; Prudential Insurance Company of America	222.40	2002	USD	Sunrise Second Assisted Living Holdings LLC
USA	Arcapita; Freddie Mac	143.70	2000	USD	Second Multifamily Properties LLC

*Arcapita is the first Islamic Investment Bank

Source: IFIS (Islamic Finance Information Services)

As one can easily see, cooperation between Islamic and conventional systems has been achieved mostly for the purpose of funding large-size development projects. We strongly believe, however, that there are other areas of potential cooperation between the two systems in countries where currently IFIs do not exist. Many IFIs today have a lot of funds because of the petro-dollars and the increasing demand for Islamic banking products from Muslim depositors, but their investment opportunities in home countries are rather limited as compared to those in non-Muslim countries served mainly by CFIs. Most IFIs may lack the market acquaintances to serve such countries, but there may exist local CFIs that come across some good investment opportunities which, even though the risk-return characteristics are not particularly suitable for the CFI's risk appetite, may be acceptable to the IFIs. It may turn out that the two institutions belonging to different financial systems can work together to avail those opportunities.

It is the differences between the two systems that may provide ample opportunity for cooperation: Due to Sharia's prohibition on interest, Islamic IFIs become more tolerant to equity-type risk than their conventional counterparts with fixed-income-type funding. For example, a conventional bank may not be willingly to invest in equity-type claims if it has to pay a fixed rate interest to the depositors, because the mismatch in risk types between its assets and liabilities would create huge burden on the management. There are many investment opportunities, however, where the entrepreneurs prefer equity-type funding in order to avoid hard commitments of cash outflows. An Islamic bank may not face a problem similar to a conventional bank because the nature of an Islamic deposit is more like a partnership contract than credit relationship. Hence there is an opportunity for the CFI working as an agent to intermediate equity investment of IFI in the enterprise. In some cases, the entrepreneur and the Islamic bank may find it better to leverage the funding in order to increase the expected return of the investment. In this case, the two FIs may agree on a deal structure similar to project financing. In what follows, we explore some of the promising deal structures that may facilitate the cooperation and the flow of funds between the Islamic and the conventional financial systems.

4.1. Project Financing Model:

Project financing is probably the most significant investment activity of the present-day Islamic finance industry. Cooperation between Islamic and conventional banks is already quite active in this area. This paper presents a special case of Project Financing Model (Fig. 3). The various steps of the model are described here.

Step 1: Either the conventional or Islamic bank finds an investment opportunity that needs equity as well as bond financing[xxx]. The two banks negotiate with each other to establish an SPV. [xxxi]

Step 2: The two banks invest their funds in the SPV. The conventional bank has a bond-type investment in the SPV and the Islamic bank becomes the major shareholder of the SPV.

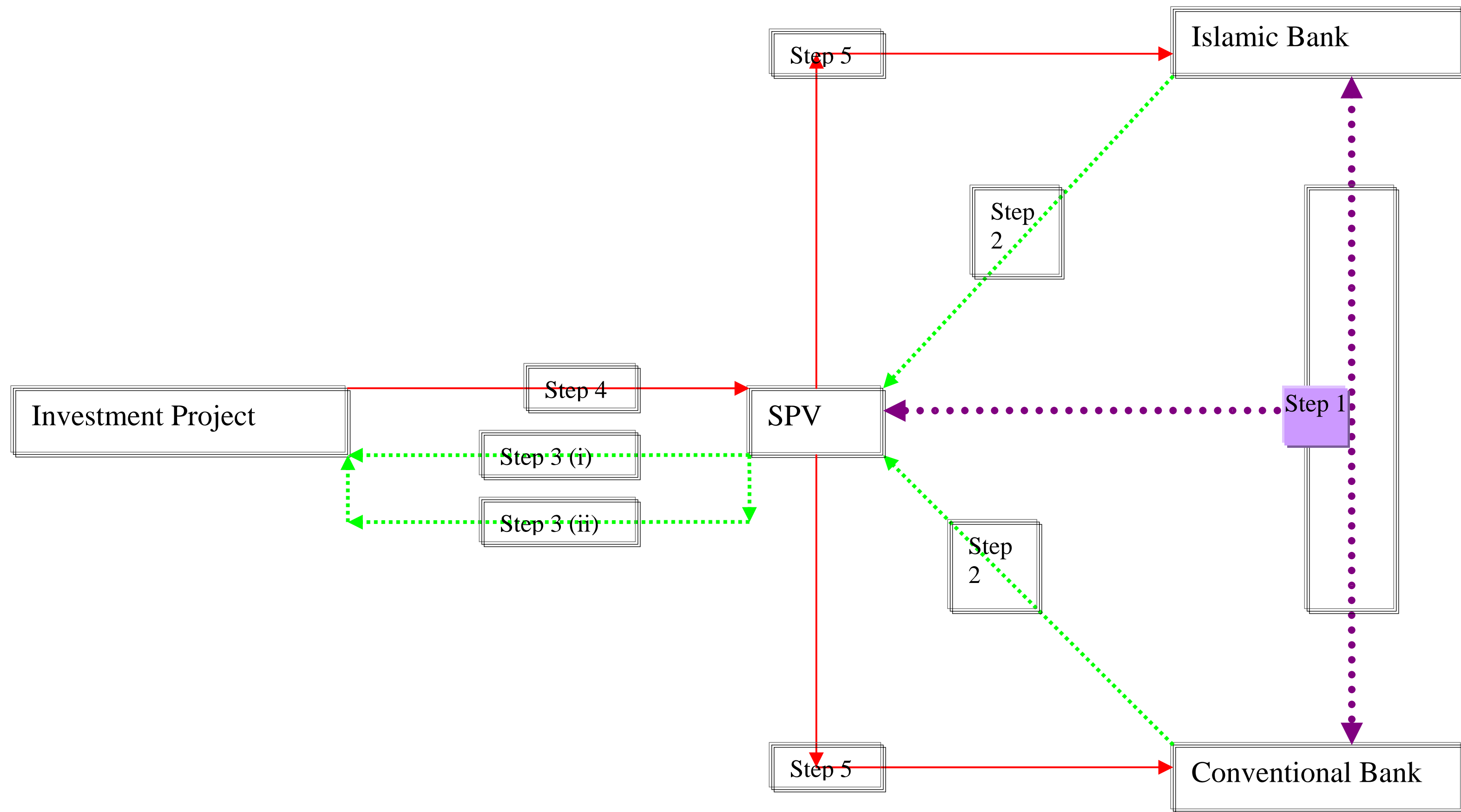
Step 3: The SPV invests funds in the project in two different modes of financing - equity and bond. The equity part of the project is financed by the Islamic bank while the bond part is financed by the conventional bank.

Step 4: Profit of the project comes to the SPV. This profit includes two kind of income; bond income and equity income.

Step 5: The SPV pays the fixed income to the conventional bank and the remaining profit is given to the Islamic Bank.[xxxii]

Project financing has been a key area of investment for Islamic banks. Many Islamic banks have already been very active in working with conventional banks in this field. It is important, however, to note that the interactions between the two systems have been limited only to a narrow area of project financing. It is worth trying to find alternative channels of cooperation. The following deal structures, which are variations of the project financing model, may serve such purposes.

Fig. 3: Project Financing Model



4.2. Joint Equity Fund Model

A Joint Equity Fund (JIF) can be established by the conventional and Islamic bank as a separate legal entity that may serve the role of the SPV. The difference is that the JIF should be a going-concern and a multi-purpose entity. It will have a longer life and the ability to invest in diversified areas. The operational objective is to find and take advantage of promising equity investment opportunities. The mechanism of the model is explained in steps as follows (Fig. 4).

Step 1: The Islamic and the conventional bank establish a JEF which can be an independent body governed by both the banks or it can work under the control of any of the two institutions. The two banks can agree on any ratio of investment and profit and loss will be shared according to the ratio of their investments. The ratio of the profit and loss can be based on the ratio of investment.

Step 2: The JIF invests the money in Sharia-compliant businesses. This fund can invest the money in projects, stocks or it can start joint ventures with other companies provided the businesses are compliant with the Islamic Economics principles. It is also possible for the fund to start its own conglomerate businesses and invest the money over there.

Step 3: The business where the JIF invests money makes profit or loss. This profit or loss goes to the Income Statement of the fund.

Step 4: If the income statement of the JIF shows a positive income, it can be divided into 3 parts; share of the Islamic bank, share of the conventional bank and some surplus that can be reinvested in the JIF as retained earnings. There should be a pre-agreed ratio of how much of the profit can be retained in the fund. If the income statement of the fund shows a loss, it is deducted from the fund that will decrease its net balance of assets.

It is important for this structure to work that the conventional bank is able to find depositors who are willing to expose their money to equity-type risk. There are several alternatives that the bank can employ to convince potential depositors.

First, the conventional bank can create near-risk-free or very low risk profitable investment opportunities for their depositors via negotiation with its Islamic partner. For example, the SPV may provide a preferred-dividend-like cashflows to the conventional bank. Depositors of the conventional bank receive fixed income as long as the fund generates enough cashflows, while the Islamic depositors receive dividend-like cashflows. If the fund fails to generate enough cashflows, the depositors of the conventional bank have the first claim.

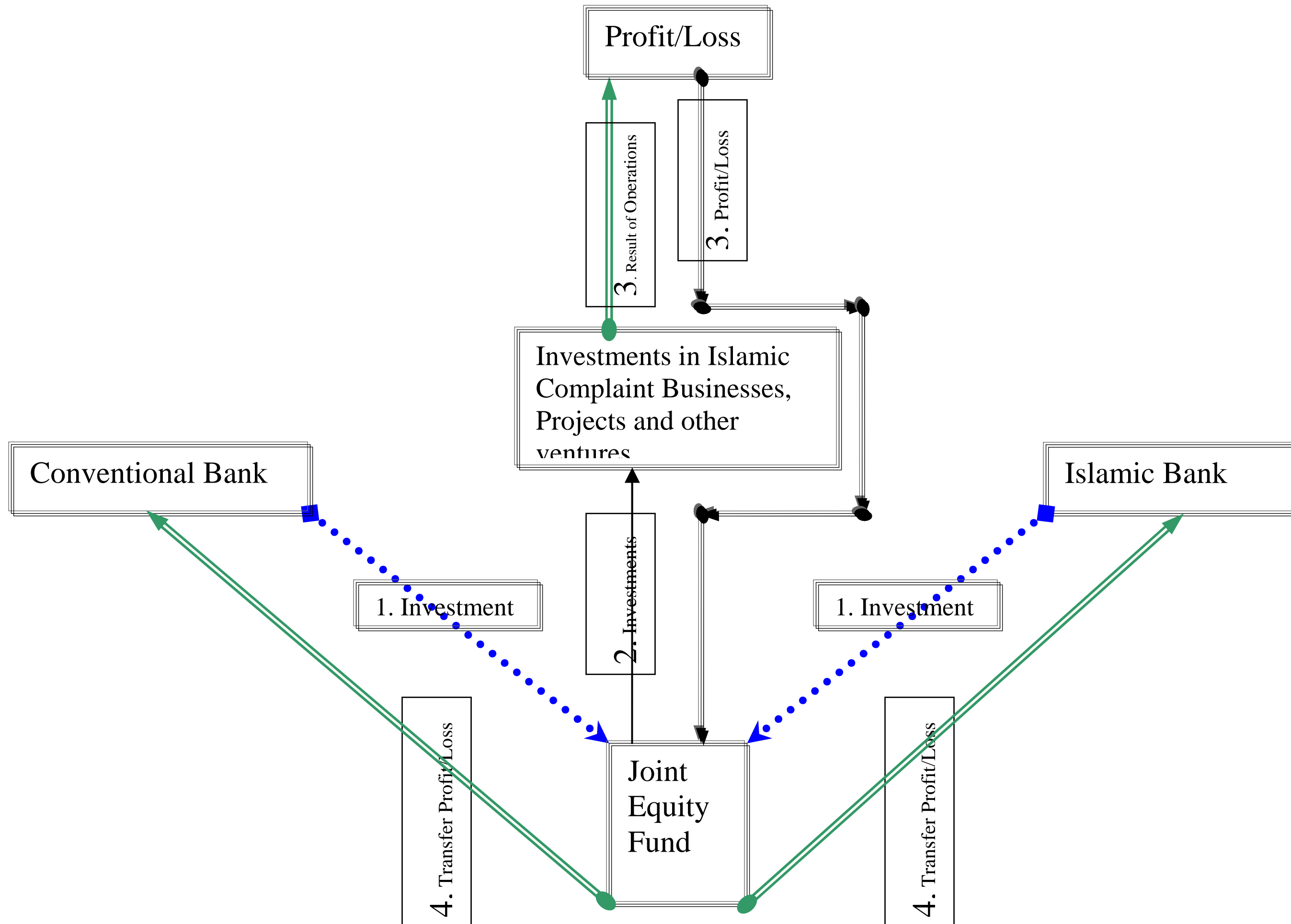
Second, the conventional bank may issue profit-sharing certificate to its depositors. Hence the investors are actually investing their money in mutual funds

managed by the bank, not deposits. If the return prospects are good, it may not be very difficult to find willing investors.

Third, instead of soliciting depositors, the conventional bank may issue collateralized bond with the bank's share of the fund as collateral. In many countries, the conventional bank may still have to guarantee the bond by its own credit.

Many emerging economies like China and India have a lot of opportunities for new businesses. All of the multinational conglomerates are setting up subsidiaries or expanding their operations in such markets and are actively seeking financing. Many conventional banks, in contrast, still find it too risky to assume large credit risk in those economies. Equity-type investment may not be a reasonable alternative because banking regulations in many countries restrict equity exposures of commercial banks. When such restrictions apply, a joint equity fund of the Islamic and the conventional banks can become a good alternative.

Fig. 4: Joint Equity Fund Model



4.3. Agency Model:

There may exist, in a non-Muslim country like Korea, some attractive Sharia-complaint investments opportunities that the Islamic bank many want to invest in but lacks necessary competencies. For example, an Islamic bank in the Middle East may wants to invest in the Korean M&A market but finds it lacks proper market acquaintance. It may find it better to find a Korean partner. Similarly, a lot of potential Sharia-compliant investment opportunities may exist in the Chinese market where Islamic banks have little or no experience[xxxiii]. In these cases, an agency relationship between an Islamic bank and a local conventional bank can be established whereby the conventional bank acts as an agent of the Islamic bank. A simple model is given in Figure 5. The step by step explanation of the model is as follows:

Step 1: A Sharia-compliant investment opportunity approaches the conventional bank for financing. The bank may have the expertise to manage this investment opportunity but does not have enough capital to finance the project, or it finds the risk characteristics of the investment opportunity is not properly aligned with its risk-averse nature and therefore it does not want to grasp it at its own risk. The conventional bank then approaches an Islamic bank for financing the business whereby it agrees to work as an agent of the Islamic bank. Detailed terms and conditions are set at this stage. The most appropriate approach is to have a profit sharing ratio[xxxiv.]

Step 2: The conventional bank establishes an SPV which is a kind of temporary asset management company setup only for the execution of the specific investment project. The SPV vanishes as soon as the investment is wrapped up.

Step 3: The Islamic bank provides funding according to the terms and conditions of the contract.

Step 4: The SPV invests the funds in the business and supervises it throughout the course of the investment term. The SPV is managed by the conventional bank by providing its management expertise.

Step 5: The profit/loss from the business comes to the SPV.

Step 6: If the income of the SPV is positive, it is shared between the Islamic and the conventional banks according to the terms and conditions of the contract. The residual value of the SPV will be returned to the Islamic bank or shared between the two institutions if it is agreed upon in the contract. In case of losses, the monetary loss will be born by the Islamic bank and the conventional bank gets no reward for its services.

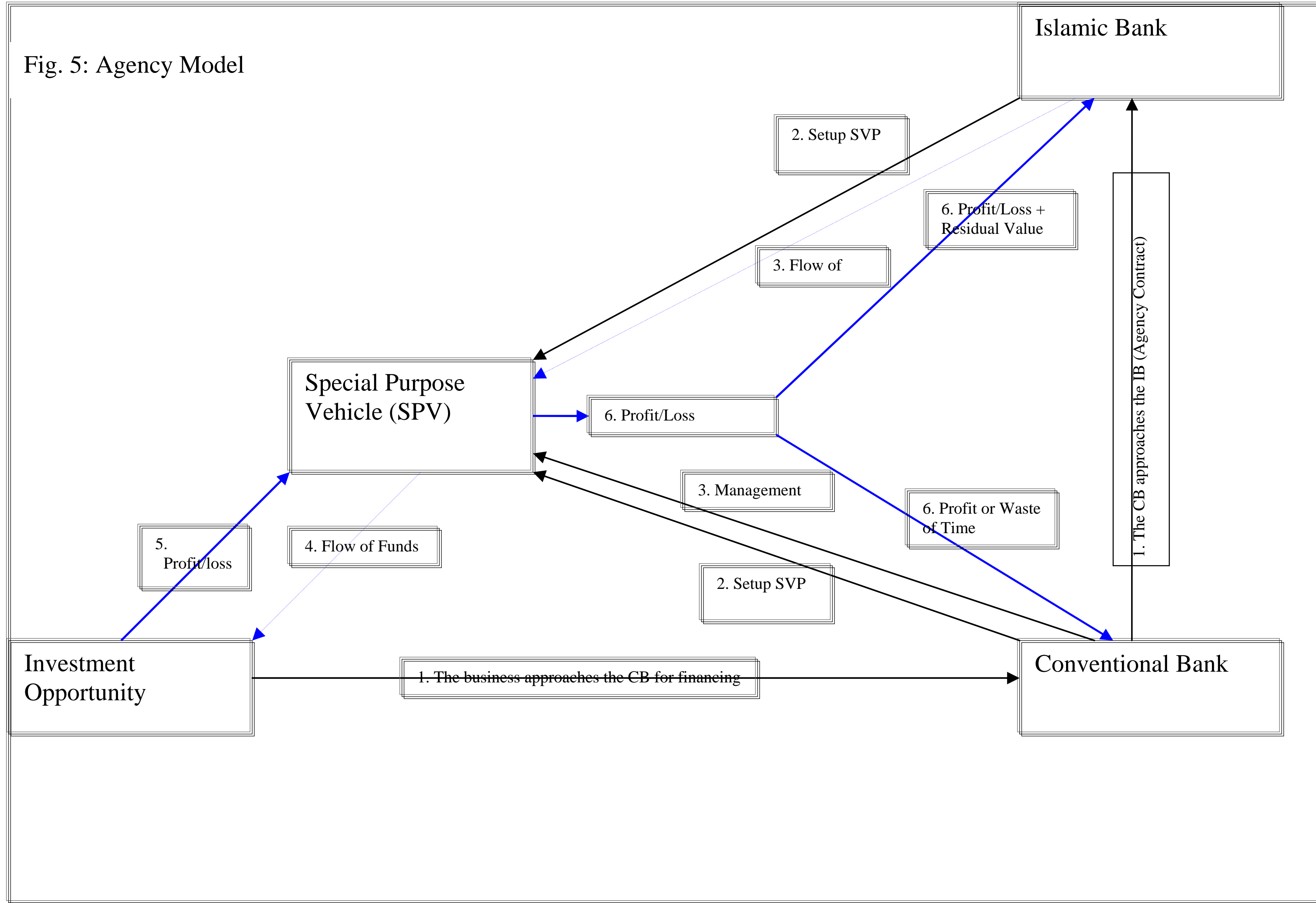


Fig. 5: Agency Model

4.4. Loan Restructuring Model:

Acquisition of existing loans from conventional banks or of securities backed by such loan contracts may not be a good investment alternative for an IFI because an interest-bearing loan is strictly prohibited by Sharia. This means that the growing market for loan restructuring is not accessible to Islamic finance.[xxxv] The Loan Restructuring Model (Fig. 6), presented in this paper, can well be applied by a conventional bank suffering from too much below-investment-grade loans to restructure their existing loan portfolio into an equity-like contract and thus attracts Sharia-complaint funding from Islamic banks.

Step 1: A company that a conventional bank had already advanced loan to, begins suffering badly from shortage of cashflows due to the interest payment. The bank believes that the company would generate enough cashflows in the long run, but is not willing to sit on a non-performing asset for an extended period.

Step 2: The conventional bank approaches the Islamic bank for sharing the company's long-term cashflows.

Step 3: The conventional and the Islamic banks form an SPV[xxxvi]. The SPV and the management of the target company sit together to discuss the terms and conditions of loan restructuring. When they reach to a consensus, the previously advanced loan to the company is restructured into two parts; equity and debt. The equity portion is taken by the Islamic bank or shared by the two banks, and the conventional bank takes only the debt part.

Step 4: The conventional bank gets fixed interest out of the cashflows that the company generates. The interest should be much smaller than had been specified in the original loan contract.[xxxvii] If the company declares profit after paying the debt off, the Islamic bank takes its share in the equity profit according to the terms and conditions of the contract.[xxxviii]

In many countries in Asia including Korea, commercial banks have ample experience in loan restructuring due to the financial crisis in the late 1990s. It is expected that the market for loan restructuring in China would grow very fast. Even though many Korean banks and other specialized institutions such as KAMCO (Korea Asset Management Corporation) plan to enter this market, they either do not have enough financial resources or fear the high credit risk in the Chinese market. Some Islamic banks which do not have to receive a minimum level of interest may find the opportunity worth the risk and thus a mood of cooperation can be found.

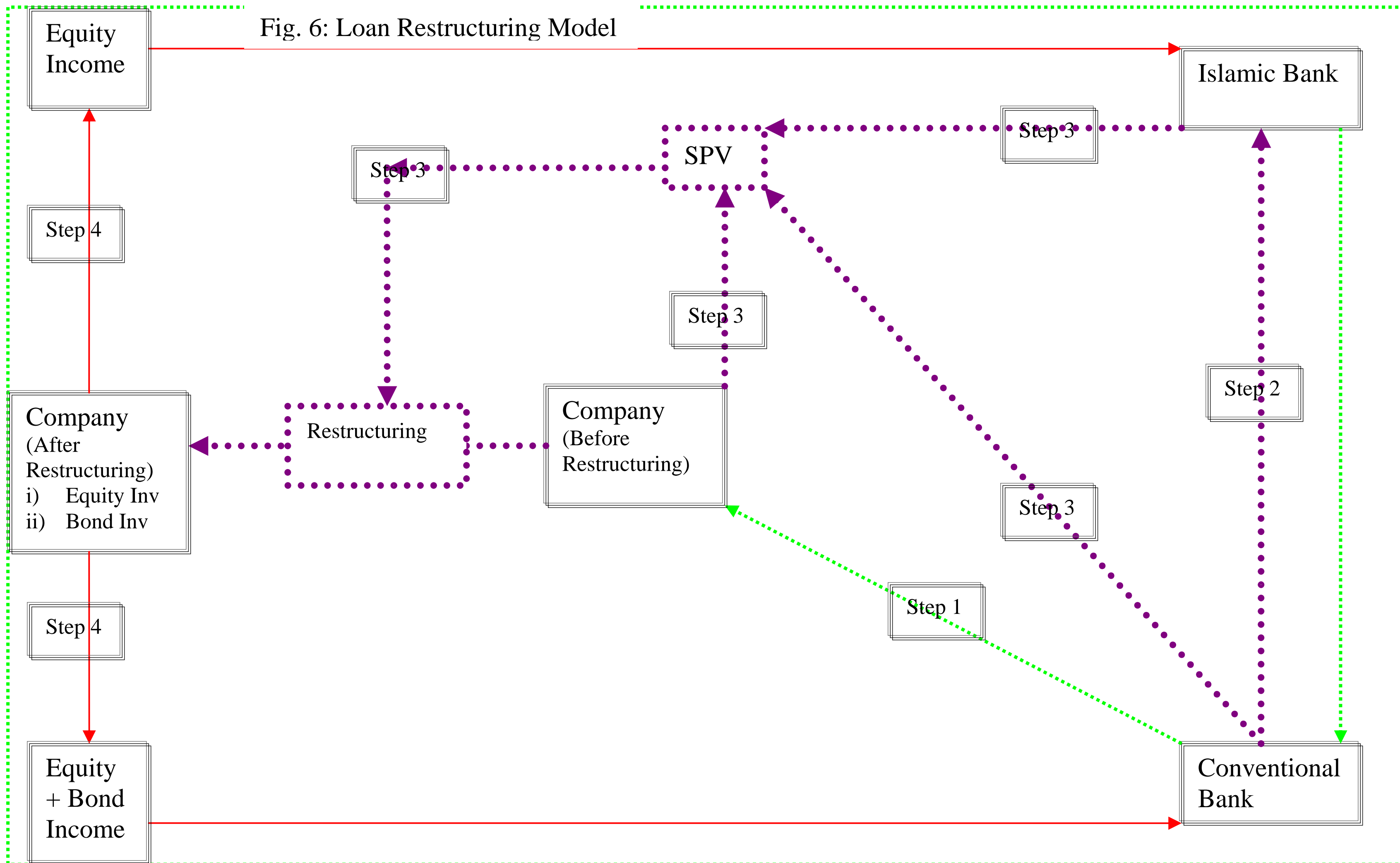


Fig. 6: Loan Restructuring Model

5. Summary and Conclusion

Islamic Finance has become a very significant part of the global financial industry. It has come a long way and is there to stay. Although it is still much smaller than the conventional financial industry, it is significant enough not be ignored anymore. Keeping in view the growing Islamic finance industry and its attractive market potential, the conventional banking institutions have also established ties with Islamic banks to finance large development projects. This cooperation between Islamic and conventional banks till today is mostly limited to a narrow area mainly because of the fundamental differences between the two systems. But there exist a number of other potential ways that can make this cooperation possible in a broader sense.

Project financing is the area where the cooperation already exists and is very active. In this paper, we have developed several variations of such deal structures which, we believe, would create ample opportunities for cooperation between the Islamic and the conventional financial systems, especially in countries whose economies are growing too fast for the domestic CFIs to find enough creditors that are willing to expose their money to riskier-than-deposit investment opportunities. The JEF model can be used to setup equity investment entities by both the Islamic and the conventional banks, and the Loan Restructuring model can be used by both the banks for sharing the long-term cashflows of a company that are experiencing difficulties in servicing existing loans from the conventional bank. The Agency model can be used for establishing an agency relationship between the Islamic and the conventional banks where the conventional bank will have to work as an agent of the Islamic bank. There is a huge market potential for such joint cooperation models both in established economies like Japan and Korea and in growing economies like China and India.

While much research efforts have been devoted to Islamization of conventional financial products or to introducing such products to non-Muslim investors, potential for cooperation between the Islamic and the conventional financial systems has not been actively studied. It is almost surprising that little about the potential of cooperation between the Islamic and the conventional financial system is known to senior management of financial institutions in many non-Muslim countries where Islamic financial institutions do not exist. One such example is Korea, where many entrepreneurs claim that funding mismatch arising from the gap in risk appetites between the financial and the non-financial industries has seriously deterred the economy's growth potential.[xxxix] We believe that many of the deal structures can easily be adopted in order to fill the gap in risk tolerance between entrepreneurs and domestic bankers. Further research effort in this direction will prove valuable for the expansion of the Islamic financial systems to the non-Muslim world.

6. Acknowledgements

The authors are thankful to Mufti Muhammad Mushtaq Ahmad, The Bank of Khyber, for his cooperation in reviewing the paper for Sharia compliance. The authors also acknowledge the financial support provided by the KDI School of Public Policy and Management, Korea for this research study.

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[1] Islam is the guiding source of Islamic Finance and the history of Islam is about 1400 years old when this religion came into existence in early 7th century. Interest on loan was prohibited in those days by the Prophet Mohammad (PBUH). The system of Zakat was introduced and an ethical base was setup for businesses in Islamic perspective.

[2] There are different views about the first IFI in recent history but references are often made to Mitghamr Egypt Savings Association that was founded in 1963. See Ali (2002) and Archer and Ahmed (2003).

[3] For the growth trends in Islamic Finance Industry since the past three decades, please see the 2005 report of the Association de'Financiere

[4] There are different reports about the number of IFIs and the size of the Islamic Financial Market. A 2006 report of Moody's states that there are 300 IFIs with more than US$ 250 billion assets and growth rate of 10–15% a year (see Moody's Report, April 2006). Also the General Council for Islamic Banks and Financial Institutions reports that there is a total of 284 businesses offering Islamic financial services and managing US$ 178.5 billion (General Council for Islamic Banks and Financial Institutions (GCIBAFI), 2005). A recent paper shows that there are 200 IFI today (Dahlia El-Hawary, Wafik Grais and Zamir Iqbal, 2006)

[5] See Zaher & Hassan (2001).

[vi] See Bahgat Bahgat Khalil El Sharif (1990).

[vii] The Middle Eastern Muslims countries have exhibited strong financial growth since their liberalization from western colonialism. This growth led to demand for sound banking and financial services that are also complaint with Sharia. Moreover, the privatization in some Muslim countries like Pakistan has added to the development of the Islamic Financial Industry. Also countries like Pakistan, Iran, Malaysia etc have adopted Islamic Financial regulations in order to support the industry on macro economic level.

[viii] See Sundararajan & Errico (2002).

[ix] Conventional financial systems are based on interest which is completely banned in Islamic finance. Further, conventional financial system focuses primarily on the economic and financial aspects of transactions, while the Islamic system places equal emphasis on the ethical, moral, social, and religious dimensions to enhance equality and fairness for the good of society as a whole. The system can be fully appreciated only in the context of Islam's teachings on the work-ethics, wealth distribution, social and economic justice and the role of the state. For detailed discussion on the topic, see the article "*Islamic Financial System*" by Zamir Iqbal on World Bank's website.

[x] See Khalid Mohammed Boodai (1980).

[xi] See Fredrick Vernon Iffert (1989).

[xii] See Iqbal and Mirakhor (2002).

[xiii] See Archer, S. and Abdel Karim, R. (1997).

[xiv] The IFIs have sufficient funds but there are not much productive investment opportunities in the oil-rich Islamic countries. Countries like Korea and Japan, however, do not have any IFI but still there is a market for Islamic complaint business opportunities. Recently, The Bank of Tokyo-Mitsubishi with CIMB Malaysia issued Islamic bonds for Japanese companies in Malaysia (Anatara, 5 October, 2006).

[xv] See Chapra (1992 and 2000).

[xvi] See Sami Al-Suwailem (1995).

[xvii] See Muhammad Mazhar Iqbal (1995)

[xviii] Pakistan, Iran, Lebanon, Malaysia and some other islamic countries have developed Islamic financeial regulations in order to regulate the growing trend of the industry in these countries. The governments of these countries are also committed to gradually transform the financial system into an Islamic one

[xix] Bahrain is leading in terms of volume of Islamic financial transactions while Malaysia is leading in terms of a sound regulatory system for Islamic finance. According to the Global Sukkuk Table, Bharain has the greatest concentration of Islamic real estate projects

[xx] Professor Awan, Head of the Faculty of Sharia at INCEIF, expects that Bahrain can play a leadership role in adopting new monetary policy tools for macro economy management as the share of Islamic finance grows in size. The precedents set in Bahrain will be followed by other Muslim countries just as the co-existence model of Islamic and conventional finance perfected in Bahrain has been followed by other countries (World Islamic Banking Conference 2006).
[xxi] For recent values of and updates on securitization and issued Sukkuk, visit Liquidity Management Center, Bahrain at http://www.lmcbahrain.com/global-table.asp
[xxii] http://www.factset.com/www_607.aspx
[xxiii] The Dow Jones Islamic Market Indexes were introduced in 1999 as the first benchmarks to represent Islamic-compliant portfolios. Today the series encompasses more than 60 indexes and remains a comprehensive family of Islamic market measures.
[xxiv] The Islamic equity funds invest in Sharia-complaint companies. According to the filtration process of Dow Jones Islamic Index, companies with a debt financing of not more than 33% are selected, provided that the debt does not remain a permanent feature of the capital structure. Also, the companies should not have businesses related alcoholic beverages, pork etc.
[xxv] Karen Lane, Islamic-Bond Market Becomes Global By Attracting Non-Muslim Borrowers, Wall Street Journal, *November 16, 2006; Page C1*
[xxvi] For example; investment in pornographic, tobacco, alcohol and weapons (which is not in the control of the state) is prohibited. These businesses harm the society and create social disorders. Investment in pork related businesses is also prohibited because of its ban in Quran.
[xxvii] The sale or purchase of something that does not exist at the time of contract and whose expected quality and quantity cannot be guaranteed is included in the category of Gharar e.g. a transaction on crops (grown in a specified field) next year. Financial options are considered as Gharar by Sharia scholars. Bai Salam is a transaction on goods that do not exist at the time of contract but it is not included in the category of Gharar because its expected quality and quantity can be assured.
[xxviii] In the case of many derivatives contracts, for example, one party gains only when the other party loses, and therefore they are prohibited in Sharia. Similarly, gambling is also included in this category because of this reason.
[xxix] For a detailed description of the Rabigh Project, see the article "*Islamic Project Finance in the Kingdom of Saudi Arabia*" by Craig, Al Sheikh, Kamal and Al Sudairy (White & Case, September 2006). Also see the Q & A with White & Case´s Craig Nethercott, Mohammed Al-Sheikh and Christopher on "*Islamic Financing Spreads in the Middle East* " (White & Case, March 28, 2006)

[xxx] According to Mufti Mushtaq, the funds of the conventional are mostly what we call the prohibited money except the money that comes form the current accounts. In the case of an SPV or any other joint venture, the portion of the prohibited money must not exceed 50% of the total financing of the SPV.
[xxxi] SPV (Special Purpose Company) is a temporary legal company created for a specific purpose - e.g. carrying out a project. The SPV is dismantled as soon as the purpose is achieved or the task is abandoned. According to Mufti Muhammad Mushtaq Ahmad, The formation of SPV is not necessary in the case of project financing but it is a nice tool if the two institutions want to pursue different project financing on going-concern bases.
[xxxii] It is more desirable that the two financial institutions share the profit and loss of the SPV.
[xxxiii] Kuwait Finance House Malaysia started to sell Islamic bonds worth US$ 200 million for a Chinese firm in November 2006. This is said to be the first Islamic Bond issued for a Chinese company (See Islamic Finance News, 22nd November, 2006)
[xxxiv] A fee-based contract can also be signed whereby the conventional bank gets fees for its services as an agent.

[xxxv] After the Asian financial crisis of the late 1990s, the market for loan restructuring grew very fast in certain countries, especially countries like Korea. It is said that many western financial institutions that participated in that market at the early stages had achieved a very high level of return on investment.
[xxxvi] According to Mufti Mushtaq, the loan restructuring model can also be structured without establishing an SPV.
[xxxvii] When a loan is restructured due to the issuing company's financial distress, interest burden of the company is lightened in two ways: The principal of the debt portion is reduced to only a portion of the original loan, and the interest rate may also be reduced. The original lender usually accepts a lower interest rate because small loss in interest is better than sitting on a bad loan.
[xxxviii] In many loan restructuring schemes equity investors receives payoffs only after the debt is paid off. It is possible, however, to allow dividends before the principal is paid off as long as the company generates enough cashflows to convince the debtholders that the debt would ultimately be paid in full.
[xxxix] This observation is from in depth interviews conducted by one of the authors with many of the entrepreneurs and bankers in Korea. Most of the Korean banks have been very reluctant in extending corporate loans in recent years while dramatic increase in housing loans during the same period have created potential financial market instabilities. Many of the interviewees agreed that credit risk of most corporate lending is either too risky for Korean banks to assume or providing only inadequate return for corresponding risk.

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