Debt is debt, even if it's Shariah-compliant

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The heavy reliance on such debt financing is due to the ease for bankers in originating debt-based products and the regulatory bias for debt instruments, even within the Islamic regulatory framework

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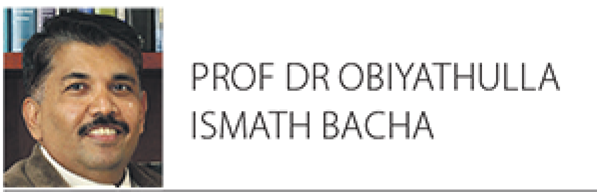

In A book aptly titled "This Time Is Different", Rogoff and Reinhart, two prominent economists, show that every single financial crisis over the last 800 years has had a single root cause — excessive debt. It appears that what begins as borrowing for the funding of development infrastructure can, as it builds, lead to a spiralling of debt and financial crisis. There is a circular and reciprocal relationship between debt, leverage, vulnerability and financial distress. This applies to all borrowers, governments, corporations or other entities.

Collectively known as the leverage effect, debt increases break-even points, requires obligatory cash outflows to service the debt and magnifies profits/losses. A leveraged entity is a riskier one, vulnerable to even small changes in external dynamics. Just as a nation that has accumulated too much debt would be highly vulnerable to external shocks, a highly leveraged firm would be easily susceptible to financial distress arising from even a small weakening in market conditions.

Seen from this economic viewpoint, the Shariah position on debt is not just prescient, but highly rational. The Shariah provides little room for debt. In fact, debt as in interest-based borrowing does not exist.

The only two "debt" contracts are qardh hasan which is a charitable loan with only the principal being compulsory and no fixed repayment schedule and murabahah which is really trade financing. Here, a manufacturer may offer his products to a retailer on a deferred payment basis. This is goods murabahah, where the underlying real asset is the object of the transaction.

Shariah allows for a profit markup on the deferred price above that of the cash or spot price. The prohibition of riba (interest) is reflective of an overall abhorrence of debt and the encouragement of trade/investment.

In building one's wealth, one should not put their money to work by lending, but by participating in trade and investment. By participating in trade and investment, one shares the risk, whereas in providing debt financing, the underlying business risk is transferred to the borrower.

In enabling the former and avoiding the latter, Shariah provides for risk-sharing contracts like mudarabah and musharakah. These are quasi-equity contracts. Mudarabah, for example, can provide the flexibility of conventional equity without its dilution and the terminal feature of debt without the leverage. These are important advantages and one that is truly needed today by a world that has gorged itself on debt.

They Seem Oblivious

Yet, Islamic banking and its practitioners seem oblivious to these. Both Islamic banking and Islamic capital markets are now characterised by their heavy reliance on debt-based contracts.

For example, Islamic banks in Malaysia — the nation that has been in forefront of Islamic finance — depend heavily on commodity murabahah to finance their customers. As of end-2018, close to 45% of all Islamic bank financing was under murabahah. Ijarah accounted for about 15%, while bai bithaman ajil another 10%. Thus, at least 70% of total financing were based on debt contracts.

The majority of the murabahah financing would have been under commodity murabahah programmes where a commodity like crude palm oil is bought and sold on electronic platforms in order to transfer the funds from the bank to the customer. Though heavily criticised as organised tawwaruq, commodity murabahah transactions have nevertheless kept increasing. Risk-sharing contracts like mudarabah and musharakah barely account for 10% of total financing.

The picture is similar in Islamic capital markets. Going by Bahrain-based International Islamic Financial Market's numbers, some 71% of all short-term sukuk issued between 2001 and 2017 were murabahah-based. For all tenors of domestic issuances for 2010-2015, 63% and 16% respectively were murabahah and ijarah. However, mudarabah- and musharakah-based sukuk were a mere 11%.

Heavy Reliance on Debt Financing

Financing provided under debt-based contracts like commodity murabahah is invariably fixed-rate contracts with no physical underlying asset, thus, uncollateralised debt.

The heavy reliance on such debt financing has to do with two factors, first, the obvious familiarity and ease for bankers in originating debt-based products. For them, debt-based financing and sukuk offer the path of least resistance. A murabahah or ijarah sukuk can be designed to mimic the cashflows of a coupon bond, making their credit assessment (rating) and placement that much easier. Furthermore, since market acceptance of such instruments is high, there is little incentive for them to innovate other structures.

A second and perhaps more compelling reason is the regulatory bias for debt instruments, even within the ambit of the Islamic regulatory framework. For example, the Islamic Financial Services Board (IFSB), which sets standards for Islamic banks, has a standards framework that largely follows the Basel requirements for conventional banks.

As a result, going by IFSB standards, an Islamic bank that finances customers using debt contracts like murabahah needs to set aside a much lower capital adequacy ratio (CAR) than one that uses risk-sharing mudarabah.

If IFSB standards encourage the reliance of Islamic banks on debt, the revised Shariah stock screening methodology used in Malaysia may enhance that reliance. Recent revision to the Malaysian methodology includes the use of the leverage ratio (debt-to-total-assets), used in other screening methodologies such as the Dow Jones. A 33% threshold is used. However, only conventional debt is counted in the leverage ratio, not the likes of murabahah or ijarah. Thus, a firm with a leverage ratio currently exceeding 33% needs to only replace a portion of the conventional debt with murabahah financing to remain Shariah-compliant.

The fact that murabahah would have the same leverage inducing effect as a conventional loan on a company's balance sheet and cashflows is ignored. The rationale for a 33% threshold is to weed out firms with too much leverage.

As is well established in the capital structure theory, a firm's overall risk increases as the proportion of debt in its capital structure increases. Yet, given the regulatory bias, a firm could have 80% of its capital structure consisting of debt and still be Shariah-compliant if most of its debt is murabahah.

It is hard to see how a change in labels can have any impact on the firm's risk. The use of these revised stock screening standards has given Islamic banks in Malaysia some easy pickings. Some listed firms have opted to simply replace conventional debt with murabahah and the likes, in order to maintain their Shariah status.

This is the kind of activity that critics of Islamic finance have described as "Shariah arbitrage", replacing a deemed non-halal item with another that is effectively the same, making it profitable to some, but bringing no net benefit to society at large.

If the last global financial crisis of 2007/8 has taught us anything, it is the dangers of perverse incentives leading to the layering of debt upon debt. Such pyramiding is possible when the Shariah requirement for an underlying asset to be the object of financing is ignored. The increasing popularity and reliance on commodity murabahah type financing has all the makings of an accident waiting to happen.

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