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Financial Instruments: Islamic Versus Conventional

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Additional information is available at the end of the chapter

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Abstract

The financial system of any economy is made up of its financial institution, financial instruments and financial regulators. However, the nature of the instruments, institutions and regulations depend on the economic system and philosophy prevailing in that economy. This chapter presents a simple and precise narrations on the meaning of financial instruments, their forms and characteristics, fundamental principles of Islamic finance as well as the similarities and differences between convention and Islamic financial instruments. A case study reflecting the core merits and pitfalls of financial instruments is presented to further press home the understanding of the topic. This piece is intended to provide readers with the basic understanding of issues raised.

Keywords: conventional, Islamic, financial instruments

1. Introduction

All businesses irrespective of their sizes, ownership structure or economic system they operate within require some form of financial intermediation. Cash savings from the surplus components of the economy (both individuals and households) are channeled to the deficit units in the economy to finance various investment projects, business expansions, managing working capital and creation of new lines of products or services. To achieve these extensive business needs, banks, finance houses and capital market operators play a key and pivot role of financial intermediation by allowing corporate and individuals to save and invest profitably.

The financial system of an economy is made up of the various financial regulators, financial instruments and financial institutions responsible for bridging the gap between surplus and deficit businesses. While the institutions are established in corporate forms to provide for

intermediation in an economy, the regulators such as the Central Banks and the Securities and Exchange Commission exist to ensure fair dealings among the institutions as well as protect the interests of investors. Financial instruments (FIs) on the other hands are the vehicles through which the financial institutions deliver values to both the deficit and surplus units in such a manner that is economically beneficial to the parties.

2. Financial instruments

In order to provide a precise and carefully structured meaning, financial instruments (FIs) is defined as 'any contract that gives rise to a financial assets of one entity and a financial liability or equity of another entity' [1]. This definition explains the fact that a financial instrument issued has two forms of effect in Accounting. To an issuer of a financial instrument, it is a liability because an obligation for future cash outflow is created. An investor on financial instruments consider the instrument acquired as assets because it creates future economic benefit in form of cash inflow.

Aside the need for using FIs to generate funds for investments, expansion and day-to-day operational issues, financial instruments are also used in hedging against risks and uncertainties that prevail in business environment. Several uses of FIs has been documented in finance literature.

Financial Instruments can be grouped into bank-based instruments and capital market-based instruments. In order to avoid the risk of capital mismatch, businesses often look at their funding needs and chose a suitable financial instruments that meets their finance objectives based on the timing of funding, expected returns and funds' gestation period. It is therefore sufficing to maintain that financial instruments of short term nature are issued by banks, while the medium and long terms instruments are capital/ stock market-based instruments.

3. Principles of Islamic finance

Before elaborating further on the major similarities and differences between Islamic Financial Instruments (IFIs) and Conventional Financial Instruments (CFIs), it is important to highlight the fundamental principles of Islamic finance. The knowledge of the principles provides a clear basis of understanding the peculiarities of IFIs. The principles are presented below.

3.1. Prohibition of interest (RIBA)

At the very heart of Islamic Finance is the prohibition of collection and issuance of interest/riba. The ban on interest in all economic activities is so explicitly define and remains non-compromising in Islamic literature as it is divinely forbidden by Allah. Therefore, businesses can be operated and managed on basis consistent with sharing profit or losses, not on a fixed determined outcome or expected returns. Riba/Interest in all forms and types are prohibited

based on Qur'anic Injunctions and prophetic traditions (Hadiths). It is the absence of Interest that provides Islamic finance with its uniqueness and distinct flavor.

3.2. Fair dealings

This principle underscores the need for businesses, professions and people in employments to be conscious of Shariah provisions (Qur'an & Sunnah) in determining what is halal or haram in their dealings. Businesses that include sinful products in their products portfolio should be avoided, profits earned should be moderate and products or services should be harmful or misleading to consumers/ buyers especially where inappropriate products' promotion is used.

3.3. Zakkat

Zakkat is one of the five pillars of Islam. Qur'an enjoined all believers to appropriate 2.5% or 1/40 of qualified zakatable assets based on conditions prescribed by Shariah. Zakat's proceeds are assessed, charged, collected and distributed by an appropriate state authority. Some of the benefits of zakat to its payers include the fact that it reduces poverty, creates new entrepreneurs, wealth re-distribution, reduces envy and promotes social harmony and cohesion among people.

3.4. Others

Other principles of Islamic not captured include prevention of private monopoly as well as the development of suitable platform for the selection of Halal compliant investment. Here, businesses consider what is acceptable (Halal) and unacceptable (Haram) in deciding what to invest on and the extent of returns to be negotiated in a manner that is fair and equitable to all parties.

4. Major differences between CFIs and IFIs

Apart from the fundamental principles governing Islamic discussed, there are some sets of factors that distinctively distinguish conventional financial instruments from Islamic financial instruments. These areas of differences include.

4.1. Nature of assets backing an instrument

Conventional financial instruments (CFIs) are mere paper assets. The value of such assets are based on their intrinsic value usually determined by the availability of information, issuers performance and ratings, targeted returns and the extent of trade-ability of a given instruments.

According to [2], CFIs deal mainly on intangible assets, that is, not backed by tangible assets or commodities and other assets of physical existence and substance. Under this condition, the value of an instrument is normally a function of the future economic benefits it attracts. Islamic

financial instruments (IFIs) on the other hand do not consider money as an instrument of trade or commodity. As such, it does not have intrinsic value, but a mere medium of exchange. Therefore, the use of money as commodity is prohibited by Shariah especially where make gains without effort or any form of risk. IFIs are basically financial instruments essentially supported by assets of different forms especially the tangible ones.

4.2. Relationship between investors and issuers

CFIs considers the relationship subsisting between instruments' investors and issuers as that of borrowers and lenders. For instance, if an institution issues a 10 year bond through the capital market, he becomes the borrower. An investor who subscribed to and acquire the bond issued is seen as the lender.

IFIs on the other hand look at the relationship between investors and issuers as a mutually beneficial relationship in form of either joint venture, partnership or a buyer and seller just to mention few. A case in point here is in Musharakah financing, the financier and his client are technically deemed as partners while in Murabaha, the parties are seen as seller (financier) and the buyer (client) form of arrangement as against the lender and borrower perspectives in conventional finance [3].

4.3. Risk taking

Risk taking is a major underpinning difference between the CFIs and IFIs. Under the CFIs, financiers or investors do not share the associated risk of the investment. This risk aversion is premised on the belief that a borrower must produce returns to cover for the principal and interests without any contemplation of risk to his investment. The conventional arrangement entirely transfers the risk to the client or borrower. IFIs however is built essentially of risk sharing arrangements. The instruments are built with fairness having in mind that whoever is entitle to returns, he/she must equally partake in sharing the risk associated with such returns.

4.4. Existence of divine regulations

IFIs are governed and control by divine laws (Shariah) sourced from the Qur'an, Hadeeths and Ijma (Consensus of Scholars). Coherent policies and regulations are usually drawn from divine laws as mentioned. Unfair business dealings like an exaggerated adverts and promo, cheating in products and prices, abnormal profiting, hoarding, private monopoly and deceits have been outlawed by Shariah. However, these restrictions derived from the divine books are non-existent under the CFIs [4].

4.5. Extent of contractual conditions

Apart from the basic elements of a valid contract as contain in the common English laws such as offer, acceptance and the payment of considerations etc. The CFIs have limited contractual rules and principles. IFIs embody several fundamental principles as enshrined by Shariah. These principles include provisions that IFIs must be from Gharar (i.e., uncertainty). Transactions

conditioned around the occurrence or non-occurrence of uncertain events is prohibited. Such uncertainties also cover transactions beclouded with enormous ambiguity especially those that could potentially lead to disputes and change of terms are considered voidable.

5. Forms of financial instruments

Both the CFIs and IFIs have been classified either based on monetary system instruments or the capital market instruments. Other finance scholars used short, medium and long term basis of classification which pays attention to the duration or life-span of instruments. [5] groups financial instruments into two, i.e. instruments for mobilizing funds and the instruments for utilizing funds.

5.1. Instruments for mobilizing funds

This group is made up of instruments used by banks and other financial intermediators in mobilizing or soliciting deposits from the economic surplus units of an economy. The resources mobilization is achieved through the deposit money banks' instruments like the savings accounts, current accounts, investment accounts and Sukuk (Islamic Bond).

Both the savings and current accounts under the CFIs and IFIs are similar in terms of resources withdrawal and deposit terms and conditions viz. a viz., the payment of deposit on demand. However, for IFIs, there is no interest on any amount save and there is no predetermined returns expected on the deposit. With regards to savings accounts, only profit sharing is permissible under Islamic finance, whereas interest is paid to depositors under conventional finance.

Investment account under the IF is a replica of the fixed deposit account under the CF. Money in such account are meant to generate returns in form of profit or loss which depends on the money is used for. Therefore, the investment outlets and associated risk determine the extent of returns expected. Under the CFIs, a fixed interest is fixed on the deposit irrespective of the returns it intends fetch. The investment account under the IF has a variation of Investment Account with or without authorization. In the latter arrangement, the depositor specifies where his deposit should be invested while in the former, the bank is at liberty to invest in any business deemed profitable by the bank.

Sukuk is another instrument of mobilizing funds. Under this arrangement, the issuer of a sukuk sales it to investors and issued certificates and later rent it for a fee. Issuer also undertakes to buy-back the certificate in the future at the par value of the instrument. The sukuk that confers partial stake in debt is called Sukuk- Murabaha, stake in assets is called sukuk al-Ijarah, in normal business is called sukuk al-musharakah and in investment is called sukuk al-istithmar [6, 10].

5.2. Instruments for utilizing funds

In order to effectively utilize the funds generated by instruments of resource mobilization, four instruments of utilization under IF are clearly identified for discussion, they are: The

Musharakah—Equity participation; Mudaraba—Partnership; Murabaha—Mark-up/Losses and Finally the Ijarah or Leasing [7, 12].

Under Mudaraba (Partnership), the bank and the entrepreneur go into voluntary business association which allows the bank to contribute capital while the client contribute his entrepreneurial skills. If profit is made, the parties share the profit and where the case of loss exist, only the bank suffers it. Arrangement could also be made to gradually reducing the capital as the business progresses to permit for payment of returns based on unpaid capital balance [9].

Musharakah or equity participation is also another utilization instrument where in both the bank and client contribute to the working capital, managerial capabilities, regular assets and technical experience needed to run a business. At the end, profits and losses are shared according to negotiated terms.

Mudaraba is an instrument which allows bank to purchase assets, machinery or domestic appliances. The customer agrees to take up assets and pays back at a mutually agreed mark-up on the costs acquired by bank.

Ijarah is also a form of assets financing, an asset owned by a client could be sold and lease back to seller. Here, the seller gets proceeds on sales and have the right to continue the use of such asset at a rental fee, not interests predetermined.

6. Case study

Alheri Integrated Farm was founded in January, 2000 by Dr. Usman Abubakar. Usman, a retired University researcher had been practicing small scale farming over two decades and then decided to establish a modern farm. His present interest in the business was not more than a pastime. In order to give the business a sound footing in terms of business substance, Usman liquidated his real-estate assets and invested handsomely on the new business which became incorporated as a private limited company under the Company Law. Usman's wife and three children namely—Abubakar, Ibrahim and Aisha, were name as directors.

Professional and unskilled workers were trained and placed on the job. The farms operates a centralized management structure with unit managers handling direct supervision of staff and resources in their care. Overall, the business had been profitable in areas of grains production, animal husbandry and product processing and exportation. Since the business by its ownership make-up is a family business, the company witnessed phenomenal growth due to high retention of earnings, premium working commitment of the owner and the pool of skilled power handling various specialty areas of operations.

Up to January, 2012, the company had been relying on short term loan and sometimes overdraft from it bankers in financing its working capital needs. But the management led by Usman had issues with the growing finance costs of utilizing the facilities in face of poor pricing of unprocessed agricultural output. The finance cost often takes about a third of the normal margin which the owner found as outrageous. During a refresher course in the

summer of 2012, Dr. Usman was introduced to various Islamic banking products and services which in his reckoning are fair, just and Shariah compliant. Upon returning to Nigeria, he quickly open account with Jaiz Bank, the only non-interest banking institution in Nigeria. Since then, the business blossom and became more profitable as the chosen banking products did not only make economic sense, but also morally amenable to his Islamic values and norms.

The current economic crunch in Nigeria which many analysts believe to have emanated from the decline in the global oil prices expectedly led to inflationary situation. Government's intention to diversify the economy provided the basis for increased attention given to the Agricultural sector. The ban on importation of rice and wheat provided a great opportunity for Alheri Farm to invest in Rice and Wheat production premised on good product price and huge products demand.

The farm requires huge capital outlay estimated to \$12 million and \$3 million in corporate and human resource expenses as per **Table 1**. During the management board meeting, Unit managers who were excluded from previous meetings were brought in to air their views due to the significance of the issue at hand. The subject matter of the meeting was to discuss the various alternatives of raising \$13 million in order to tap in and benefit from the emerging window of opportunity in rice and wheat production, milling and sales.

The meeting came up with the following suggestions:

- i. The company should go public by Initial Public Offer. The offer could be used to raise the required fund for financing the project
- ii. To issue debenture with floating charge at the rate of 12% redeemable after 5 years
- iii. Secure a long term bond for the project finance
- iv. Raise the required sum through conventional or Jaiz Banking window
- v. Considered using long term finance provided by Islamic Finance Instruments

Dr. Usman seem uncomfortable with the options i-iii because of various risks of take over as well as dilution of interest which he found unnerving. Option 'iv' in his reckoning may be too exorbitant to handle considering the high gestation period of the project and the short term nature of the finance option. Since he envisaged mismatch, his interest on long-term finance

Project items	Costs \$
Machinery and plants	2,500,000
Freehold land	4,500,000
Buildings and warehousing	3,800,000
Light tools and implements	1200,000
Staffing, training and technology	3,000,000
Total	15,000,000

Table 1. Breakdown of project's costs.

Income statement for the year ended 31 December 2015				
		2015	2014	2013
		\$'000	\$'000	\$'000
Revenue	1	10,564	9018	8107
Cost of sales	2	(3413)	(3374)	(2762)
Gross Profit		7151	6644	5345
Overheads/administrative costs	3	(1881)	(1367)	(1046)
Operating profit		5270	5277	4299
Finance expense		(420)	(640)	(560)
Profit before taxation		4850	4637	3739
Taxation		(1213)	(1160)	(935)
Profit for the year after taxation		3637	3477	2807

Table 2. Alheri Integrated farm: 3 year financial summary.

based on Islamic Finance sufficiently attracted his interest. But he has limited knowledge on the instruments as well as their merits and pitfall. The management resolved to seek the services of consultants in Islamic Finance. The firm is interested in briefing on the way out using instruments conforming to Shariah (**Tables 2 and 3**).

Alheri Integrated Farms Limited.

10th July, 2017

The Managing Consultant

Halal Consulting Limited

Abuja-Nigeria

Sir

Appointment as Consultant on Islamic Finance.

Following the resolution of the management board of this company to seek for your service on Long term Islamic Financial Instruments, we write to appoint you as our consultants in the aforementioned capacity for the period of two years in the first instance. The appointment is subject to the content of the engagement agreement already signed today.

The scope of the professional engagement has an urgent requirement for the submission of clear and feasible report on:

- i. Assess the viability of the project with focus on discounted pay-back period and the overall business performance outlook given a six year loan offer from Citizen Bank PLC.
- ii. Suggest the appropriate instrument considered more suitable to the situation at hand. Discuss the various long-term financial options available to the company from Islamic Finance view point

		2013	2012	2011
		\$'000	\$'000	\$'000
Non-current assets				
Property, plant and equipment	4	11,739	10,067	9269
		11,739	10,067	9269
Current assets				
Inventories	5	1492	1328	1249
Accounts receivables	6	1436	963	671
Cash and cash equivalents		428	396	336
		3356	2687	2256
Total assets		15,095	12,754	11,525
Shareholders' equity				
Ordinary share capital		1000	1000	1000
Retained earnings		8967	7696	6536
Total shareholders' equity		9967	8696	7536
Non-current liabilities				
Loan	7	1490	1200	1100
		1490	1200	1100
Current liabilities				
Accounts payable	8	1606	1285	1789
Loan	9	1432	1288	1100
Bank overdraft		600	285	–
Total current liabilities		3638	2858	2889
Total shareholders' equity and liabilities		15,095	12,758	11,525

Table 3. Alheri integrated farm: statement of financial position notes as at 31 December.

Attached with this letter are the company's three years income statement, statement of financial position, and the new project's projected returns and capital outlay. Submit your report to our corporate headquarters not later than two weeks from the undersigned date.

Accept the compliment of our esteemed regards, please.

Signed

Nabila Haruna

Manager, Corporate Services

6.1. Estimates and assumptions concerning the new it project

The operational projections are:

- i. When fully operational in about 10 months' time the new rice and wheat fields will allow Alheri Integrated Farm to increase its total output in value by more than ten times its

current capacities. The projected level of output is adjudged to be sufficient new capacity for the foreseeable future of the company's operation.

- ii. The new project will also allow the company to integrate its current grains production with the proposed line of activity which may significantly increase the current storage capacity of the farm.
- iii. The new line of activities will allow the Farm to improve raw materials and finished goods inventory control and identify in a much easier timeline the farm's inventory needs.
- iv. The investment will also identify an improved re-ordering or re-stocking system which is adjudged as efficient by hiring new inventory managers with new computer applications to be deployed for that purpose.

The financial projections are:

1. Initial outlay will be \$12 million plus additional incidental costs of \$3 million.
2. Market research earlier conducted indicates that the proposed investment will allow Alheri to shore up its annual revenue by between \$3 million (minimum) and \$4 million (maximum) for the foreseeable future.
3. The Gross Profit while factoring out depreciation on the additional annual revenue is expected to be at least 40%.
4. There will also be an annual rise in overheads estimated at about \$500,000 as a result of the proposed investment.

Additional information on the rice and wheat investments cannot be easily quantified or monetized. They include:

- i. The new product line will increase the current market position of the farm which has put the company in major production and processing business.
- ii. It will also attract government financial intervention especially from the Federal Ministry of Agriculture, the Central Bank of Nigeria and Small and Medium Scale Enterprises Investment Scheme operated by deposit money banks.

6.2. Suggested solution

HALAL CONSULTING LIMITED

24th July 2017.

The Management.

Alheri Integrated Farm Limited.

Sir

Re: Appointment as Consultant on Islamic Finance.

Reference to your appointment letter dated 10th July 2016 requesting an initial report on Funding alternative available for your new projects. We are writing to communicate our findings based on the information you made available to us on the said date.

Having regard to your first requirement wherein the minimum repayment period was made and viability of the project in terms of returns. The analyses made after factoring out finance charges while ignoring depreciation that the project's initial outlay is recoverable in six year period. The computation as per **Table 1** used a simple traditional undiscounted pay back analysis for its simplicity of assumptions. In year six, the cumulative cash-flow stands at \$15,960,000.

Regarding the business viability of the projects, the revenue, gross profit, overhead and finance charges' effect of the new project was incorporated into the computation as per Tables II and III in the appendix. While the bank's facility at 24% rate yields the total \$5,040,000 to the bank represent one third of the loan value, the benefiting company only gains annual increase of 11% holding other business earnings constant. This implies that the company could only benefit from the gains of \$2,160,000 over the period. The figure will increase steadily when the loan is completely paid and the earning capacity of the asset is sustained. Based on present estimation, the bank would gain 233% higher than the company during the normal repayment period.

Given the analyses above, it suffices to maintain that the bank stands to gain more during the most productive period of the project. As the company witnesses rise of sales, finance and overhead costs incidental to the project, their aggregate earnings reduces while the bank enjoys consistent stream of cash inflow of \$840,000 annually.

Given the obvious pitfall in conventional finance where the productivity of capital is fixed irrespective of the outcome of investment as well as the incidents where the finance providers take the largest chunk of the returns, Islamic Finance provides the best way out [11]. Islamic finance is a form of business and corporate financing designed on bases consistent with the principles of Islamic law (Shariah). As such, several Islamic finance products have been used locally and internationally (NSE-Rules, 2012).

The component can use a portfolio of Islamic Finance products in addressing its diverse needs as stated in **Table 1**. The first four items on the table are fundamentally assets which could be used for the creation of additional wealth as described in the case. The following financing options can be applied as suggested by Albaity and Ahmad [2]

- i. Murabaha—This product will enables Alheri Farms to make a purchase of the identified assets like Machineries and tools without securing an interest-bearing loan as the case discussed. Instead, the bank undertakes buying the items and subsequently sells it to the Alheri Farms on a deferred payment basis on carefully and mutually agreed terms.
- ii. Ijarah—Alheri Farm cap opt for lease agreement in which a bank buys any item of assets as par **Table 1** for a company and then leases it out to it over an agreed period of time with the bank earning a profit from the rentals payment instead of the exorbitant finance charges often paid as interests.

These instruments provide short and medium terms financing options. Normally when such instrument are used in financing long term investment, the consequence of financing mismatch would become pronounced in terms of cost and inflexibility.

The long term funding need of the company can be met using any of the following long term instruments:

- i. Sukuk is defined as certificates of equal value representing undivided shares in the ownership of tangible or fixed assets and services or in the ownership of a particular assets of a projects or special investments as the case of your company. In its simplest terms, Sukuk can best be called trust certificates. The relevant local financing guide based on the Nigerian Securities and Exchange Commission's rule 2013, Sukuk refers to an undivided in ownership of an assets, investment or project based on Shariah principles and concepts and approved by the SEC. Under a sukuk arrangement, returns to Sukuk holders (certificates), represent rights to receive payments from a trade transaction or ownership of a particular asset or business venture. However, the returns to conventional bondholders represent the right to receive interest for borrowed monies [8, 13–15].
- ii. According to [6, 7], Issues of ordinary shares are Initial Public Offer (IPO) are permissible source of long term finance subject to certain screenings associated with the rights and benefits of the shareholders. For instance, benefits like cash dividends, bonus issues, right issues and perquisites given to equity holders are permissible in Shariah.
- iii. Preference shares which confers on its owner fixed rate of returns and priority of settlement during winding-up is not legally acceptable in Islamic finance. As such the company may not consider it as viable option, [3, 4].
- iv. Convertible loan stock are preference shares or bonds that can be converted into ordinary shares after a predetermined period. Value of the future conversion is not certain, although the future conversion ratio of the number of ordinary shares that will be given upon conversion, is fixed bond or preference share is unknown. There has not been an official consensus or scholarly decree given, however, most Shariah scholars express concerned over the element of gharar therein.

Overall, the short term source of funding has been less optimal on two grounds. One is its sub-optimality based on timing since the repayment period is beyond short term threshold. The second misnomer which the facility provided conferred more benefits to banks with less risk exposure, but more certain and higher returns.

A more plausible option available to the company is to secure plants, machinery and equipment using short-term Sukuk Structure like Ijarah and other forms of Sukuk in bond's form. 20% equity may be raised to finance the operational components of human resource and Information Technology requirements. These options suggested may not dilute ownership structure materially while financial risks exposure remains low.

Signed

Managing Consultant

7. Conclusion

In the context of conceptual discussion on the topic of discourse, the meaning and principle of Islamic and conventional financial instruments were discussed. The latter is more amenable to business and personal financing needs due to relative low risk, profit sharing arrangements and the existence of multiple products financing options ranging from assets acquisition, working capital and non-current assets.

The chapter also reviewed two major classification of Islamic financial instruments (IFIs) which are (i) the instruments of mobilizing funds and (2) the instruments of utilizing funds. The former includes the current accounts, savings account, investment account and the sukuk while the latter is made up of Mudaraba, musharakah and Ijarah. Few differences were identified between the CFIs and IFIs under the instruments of mobilizing funds. However, the absence of riba, risk and partnership instead of lender borrower relationships have found to differentiate the instruments utilizing funds.

Based on the case material presented and analyzed, the company's used short term fund from conventional sources to finance long term project. This approach is referred to financing mismatch. The conventional funding sourced conferred huge portion of the corporate returns to the lender, not the borrower. If the IFIs like Sukuk are utilized, capital assets may be acquired in more favorable terms and raising further equity would provide working and operating capital.

The pitfall of the conventional instruments include the use of interests which is not so sensitive to the productivity of capital as well as lender borrower relationship as against partnership in which the parties are out for mutually benefiting ventures. Drawing from literature and case study, it is safe an inference that IFIs are cheaper, less exploitative and creates limited credit risk exposure. While the CFIs have been used overtime, IFIs are emerging, more dynamic and has strong potential for improvement through research and sponsored studies.

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