JOINT-VENTURE FINANCING FOR ISLAMIC BANKS

The banking sector is poised to face new challenges from high interest rates environment in the coming years. With higher cost of borrowing, the public may postpone their purchases. Not only that, current concern with inflation is making many banks worried about interest-rate risk. Floating rate loans can easily absorb any increase in the overnight offer rate (OPR) but fixed-rate loans such as car loans may not. The same applies to Islamic banks. Those offering fixed *al-bai-bithaman ajil* (BBA) and *al-ijarah thuma al-bay* (AITAB) may soon face difficulties, unless they have a floating-rate option to work with.

But Islamic banks can do better by offering products with equity features so as to lessen tying up their business with credit and interest-related parameters for performance of equity products are based on real economic activities with the bank taking an active role. They will not demand upfront profits as readily evident in bank loans. In this way, equity products with *musyarakah* (general partnership) and *mudarabah* (trustee partnership) features will not impute inflation premiums into the business agreement.

Conducting joint-ventures via share-ownership is not new in the banking business. Before the Great Depression, banks in the United States were free to purchase land and housing assets and they did so by using depositors' money. They were also allowed to underwrite stocks and insurance. There were no walls then separating commercial and investment banks and insurance.

But speculative purchases leading to land scandals have eroded much of the US banking assets. When land prices dropped, banks were left holding assets with relatively no market value. Likewise, they bought bad stocks and were unable to sell them at profitable prices. Moral hazards, conflict of interest and bad governance have caused severe bank runs and put more than 3,000 banks across the United States into bankruptcies.

Through the Glass-Steagall Act 1933, the US government further tightened banking activities by enacting a firewall between commercial and investment banking. To prevent bank failure, commercial banks are no longer allowed to buy properties and stocks. They can only lend and borrow. Like the Glass-Steagall Act, the Malaysian banking law (ie. BAFIA 1989) to some extent serves to protect depositors. It does not allow commercial banks to use deposits to buy real assets and shares for profits. In this way, it prohibits banks from engaging in joint-ventures with non-banking companies. BAFIA however allows commercial banks to own shares as a result bonds conversion into stocks arising from debt restructuring activities. Bank equity holdings in 2004 amounted to RM1.7 billion which on average made up 2.3% of the capital base. Equity risk remained insignificant with equity investments representing only 0.4% of the banking system's total asset as at end-2004.

The Islamic Banking Act 1983, however, does not put explicit restrictions on asset and share purchases. This is because both transactions constitute the foundations of Islamic banking business. Application of *murabahah* and *ijarah* requires Islamic banks to secure ownership of assets before sale and leasing activities. Likewise, Islamic banks are expected to buy and own equity shares of companies they invest under the *musyarakah* and *mudarabah* principles.

Equity contracts may well become the next generation products for Islamic banks in Malaysia. With the emphasis on small and medium scale industry (SMI) in the 9th Malaysian Plan, Islamic banks can play an important role in stimulating contract and entrepreneurship financing. But, using equity may not be a walk in the park for Islamic banks as they are not too familiar with the partnership financing system.

Contract financing is not new in Malaysia. Usually, banks provides a package of trade-financing facilities such as letter of credit, trust receipt, letter of guarantee, export-credit refinancing and overdraft to prospective customers. Companies will come with a contract note (i.e., contract to manufacture and supply goods to the buyer), company accounts and track records. When all requirements are met, funds will be released according to the agreed schedules.

But, financing small and medium scale enterprises is prone to problems especially in monitoring and repayments. In 2004, SME non-performing loans (NPLs) accounted for 30.6% of the total NPLs for the business sector. NPLs of SMEs were highest in the manufacturing, construction and the wholesale and retail trade sectors, accounting for 58.7% of total NPLs of SMEs.

Islamic banks can find more ease in *murabahah* and BBA markets, as the gross NPLs for the household sector account for 7% of total outstanding household loans. Venturing from a comfort zone into a sector with disproportionately high NPLs can be scary. However, one must understand that SMEs financing are largely based on loans where control and monitoring are minimal. With ample collaterals and guarantees, banks that acts as money lenders and debt collectors tend to isolate themselves from day-to-day SME operations and their problems.

The same may not apply for Islamic banking. Shariah legitimacy on share purchases via IBA 1983 would mean an opportunity to gain control over the project and company as well. An Islamic bank can either use *mudarabah* deposits or shareholders' capital to gain some voting power over the running of the SME companies. It can readily learn this control mechanism from the German and Japanese universal banks where, by virtue of share ownership, these banks secure board membership and actively participate in company decisions. In this manner, they can veto any move that may prove detrimental to the investment project.

The control mechanism from the universal banking experience is however limited to one where the mode of financing is still running on debt and not equity. Thus, universal banks make loans to their clients using deposits but acquire control out of shareholders capital. This may not be possible under BAFIA 1983 but likely for the Islamic banks. IBA 1983 does not prohibit share-purchases using shareholders capital. An Islamic bank can acquire the shares of, say ABC Sdn., Bhd., if it has injected capital into one of ABC project, say housing development.

IBA 1983 is silent on whether the bank can use depositors fund or shareholders fund to buy ABC stocks. In Islamic law everything is permissible (*halal*) except those that are explicitly defined otherwise (i.e., prohibited). By extension, the same applies for IBA 1983. It can help Islamic banks reduce moral hazards in SME Islamic financing through minority shareholding power. Serving as a control mechanism and governance, the board membership formula is vital for Islamic banks. Otherwise it must look for alternatives as a controlling mechanism. One option is to outsource the risk management function to a venture capital company. Outsourcing is not new within financial institutions. For example, unit trust companies outsource investment functions to the fund management companies.

However, one must see that the success of *musyarakah* financing does not rest on the control mechanism alone, but also on project viability. Exposure of the *musyarakah* project to market risks is a law in nature that all parties concerned must dutifully observe under the principle of “no pain no gain” (*al-ghorm bil ghonm*) which also reject *riba* (interest) as a legitimate gain. If an Islamic bank can take the economy to another level, it must come from *musyarakah* financing, a profit-sharing contract where parties contributed capital into the business. It is new to banking but not to general business.

The writer is Director of Research with the Malaysian Institute of Economic Research (MIER).