SYNTHETIC DEBT IN ISLAMIC BANKING AND FINANCE?

Islamic religious law (Shariah) forbids usury, which traditional Sunni Islam interprets as a ban on receipt of interest from loans. Although some exceptions occur in Islamic countries, prominent Islamic financial institutions on the whole view the ban as a guiding principle.

This creates a competitive disadvantage for Islamic financial institutions in providing corporate financial services outside of Islamic societies. Corporations in the United States, the European Union and the Far East are comfortable with corporate debt as a low-cost form of finance. Such corporations generally conduct financial business only with financial institutions that are capable of servicing the entire spectrum of corporate capital needs.

In an effort to redress the imbalance, Islamic financiers began to experiment in the late 1990s with leasing bonds (*Sukook Al-Ijara,* in Arabic). These financial instruments are asset-backed fixed-income securities that pass through rent from leases. Sunni religious authorities have ruled that leasing bonds are Shariah-compliant because bondholders receive rent in lieu of principal and interest.

In mid-2002 the Malaysian Bank Negara (Malaysian central bank) began a program to win acceptance of the Sukook Al-Ijara by the international banking community. The first step was issuance of a US$600 million Malaysian Global Sukook with the Malaysian government as the lessee-obligor and a portfolio of prime real estate backing the securities.

The Sukook structure implemented by Malaysia satisfies the requirements of international bankers in the case of fixed-income government securities, but it suffers from drawbacks that are likely to limit its use in corporate finance. For example, the temporary transfer of assets from the obligor to a Special Purpose Trust for the term of the Sukook creates accounting problems under International Accounting Standards (IAS) and Financial Accounting Standards (FAS) as well as tax concerns.

The Malaysian Sukook also suffers from the economic drawback that the bond issue is overly secured, particularly in the case of amortizing bonds. Corporations are unlikely to be content with securing lease-backed bonds by tying up ownership of hard assets worth considerably more than the bonds.

The *lease-based synthetic debt* developed by Electrum Partners in the early 1990s is an alternative that better suits the needs of Islamic finance. It avoids the shortcomings of the Malaysian Sukook that would deter the spread of the Sukook Al-Ijara to non-Islamic countries. It is better than debt from an economics perspective because synthetic debt creates an all-equity capital structure with less risk for all financing participants than debt-based capital structures used by non-Islamic financial institutions.

Synthetic debt finance avoids accounting problems that arise from temporary transfers by creating a permanent ownership structure for the leased assets that secure synthetic debt. The all-equity capital structure avoids additional accounting problems under IAS and FAS as well as problems with U.S. federal tax law. The ownership structure avoids over-collateralization of the securities by reducing pledged ownership rights to the leased property in tandem with amortization of the synthetic debt.

Innovative technology is often not implemented by the society that invented it, due in part to competition from entrenched technology. In such cases, history frequently identifies the technology with the society that makes the technological benefits available to the world. For example, the history of automotive technology is identified with early 20th Century America because the U.S. developed mass-production for automobiles, although the automobile was invented in France. Similarly, the steam engine is identified with 18th Century England because the English harnessed the steam engine to start the Industrial Revolution, although the steam engine was invented in ancient Rome.

Islamic financial institutions have an opportunity to bypass the current fixed-income technology of financial institutions in non-Islamic countries by implementing synthetic debt finance on a large scale. This would not only provide an efficient instrument for allocating low-cost fixed-income investment capital within Islamic countries, it would also elevate the Islamic institutions to competitive status in international finance by enabling them to offer economically diversified investment banking services to corporations in non-Islamic societies.