Some Notes on Islamic Finance in the National Accounts

Russell C Krueger
(International Monetary Fund – Retired)

Discussion by Celestino Girón
(European Central Bank)

34th IARIW General Conference. Dresden. August 2016
Content

1. Islamic Finance

2. Debt and Equity

3. Comments and questions
Islamic Finance: main features

- No fixed cash-flows allowed: no interest payments. Remuneration based on profitability of activity financed
- Investment in real assets and productive activities
- Bank activity:
  - Profit sharing investment accounts (PSIA)
  - Returns smoothen across time
  - Specific instruments exist to meet Sharī`ah requirements
Islamic Finance: main SNA challenges and statistical treatment

• Restricted PSIA: segregated accounts where the bank provides management services
  ➢ Investment fund income (D443)

• Unrestricted PSIA: similar to conventional deposits, but returns paid come from bank profits after a complicated allocation of net profits between depositors and shareholders
  ➢ Interest (D41), but recommended to be called “interest and other returns on deposits”
Islamic Finance: main SNA challenges and statistical treatment

• Specific reserves, in particular

  – Profit Equalization Reserve (PER), allocated before assigning profits to depositors and shareholders
    ➢ Part of “interest and other returns on deposits”, reinvested

  – Investment Return Reserve (IRR), allocated after calculating the shareholder profit share
    ➢ Standard reserve to absorb shareholder losses; part of bank capital
Islamic Finance: main SNA challenges and statistical treatment

• Specific deposits, in particular:
  – Murabahah (Tawarruq, Inah), simultaneous purchases and reselling with deferred payment
    ➢ “interest and other returns on deposits”, by the difference between buying and selling prices
Islamic Finance: main SNA challenges and statistical treatment

• FISIM, SNA approach:

\[
\text{FISIM} = \text{Implicit services to borrowers} + \text{Implicit services to depositors} \\
= (rL - rr) \times \text{Loans} + (rr - rD) \times \text{Deposits}
\]

– What is rL, RD and rr in Islamic finance?

• Broad approach: from all bank income statement: “revenue from jointly funded assets” - “Income distributed to IAH” - “Income available to PER” – \( rr \times (\text{assets} - \text{liabilities}) \); \( rr \), midpoint return yield on assets and liabilities?

• Instrument-by.instrument approach: more precise in pinpointing type of return and fee payments, but... feasible?
A digression: debt and equity equivalence

Corporate structure:

Merton, 1974 (“On the pricing of corporate debt: the risk structure of interest rates”):

☑ Shareholders hold a call option against debt holders, on the value of assets with strike price equal to the debt value

☑ Islamic finance liabilities to be modelled via re-engineered call option
Questions/ comments

• The distinction debt instruments / equity instruments is still an issue. Are leverage measures equivalent to those of SNA banking? Do Islamic bank enjoy an additional layer of risk protection?

• FISIM calculation (broad measure, rr at mid-point) seems (unavoidably) simple: \[ FISIM = (r_L - r_D) \times (A + L) / 2 \]
How does this affect comparability of financial service value added and GDP?