



# Expanding Trade Financing Opportunities Through Islamic Finance

By Scott Schmith

The growth of alternative financial markets, such as those that adhere to the principles of Islamic finance, provides substantial opportunities for U.S. exporters and financial institutions. This paper provides an overview of Islamic financial tools, trade trends with Muslim-majority countries, and how U.S. financial institutions can use Islamic finance to increase U.S. exports.

## *What is Islamic finance?*

Islamic financial services are essentially financial services that comply with Islamic principles on interest, non-Islamic investments, and speculation. Islamic financial services apply Islamic teachings in the creation of trade, savings, and credit instruments that resemble the same instruments that are common in conventional finance. The biggest impact for most financial institutions that use Islamic-compliant products is that their Islamic compliant products are structured to avoid the payment of fixed interest through mark-ups, leasing, and etcetera.

## *How large is the market?*

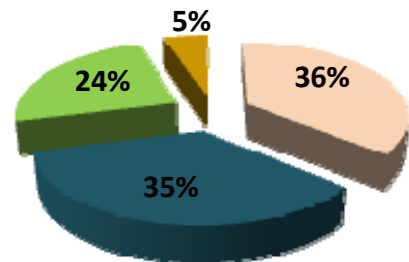
According to the Islamic Financial Services Board, an industry body, Islamic assets under management stand at around \$700 billion and are growing faster than conventional financial assets. Muslims account for around 21 percent of total world population, yet the economies of Muslim countries account for only 8 percent of global GDP. Islamic finance, despite its rapid growth, currently represents only a small portion of total financial products used in countries with large Muslim populations. The convergence of growing populations in

Muslim countries and upward trends in Islamic finance presents many opportunities for both providers of Islamic finance and for U.S. exporters.

## *Where are the markets?*

Islamic finance includes trade, deposits, leasing, real estate, and business lending and is concentrated in the Middle East and South Asia but is spreading rapidly to other developing and developed markets. The Gulf Cooperation Council (GCC) states (Saudi Arabia, Kuwait, the United Arab Emirates, Bahrain, Oman, and Qatar) account for almost 36 percent of the total market of \$500 billion as measured by the Banker. The non-GCC Middle East and North Africa region (35 percent

**Percent of Global Islamic-Finance Market by Region**



■ Gulf Cooperation Council (GCC) states  
■ Non GCC Middle East and North Africa  
■ Asia: Malaysia, Pakistan and Indonesia  
■ Other

Source: The American Banker

of the total), is dominated by Iran (not open to U.S. investment), with Lebanon, Egypt and Turkey acting at significantly lower levels. Asia represents 24 percent of the total and is

dominated by Malaysia, Pakistan and Indonesia.

### ***Why is Islamic-finance important for conventional financial institutions?***

Trade finance and leasing trends follow overall trends in international trade. As a result, U.S. finance and leasing companies have increasingly focused on emerging markets, including those most promising for Islamic-finance. According to Moody's Islamic finance has grown at a 15 percent annual rate in the last three years, significantly more rapidly than the growth rate of conventional financial markets. Exports to Muslim countries have also grown much more rapidly than conventional finance and exports to other regions. Exporters can benefit from both these trends by adapting their trade-financing to the specific needs of their customers.

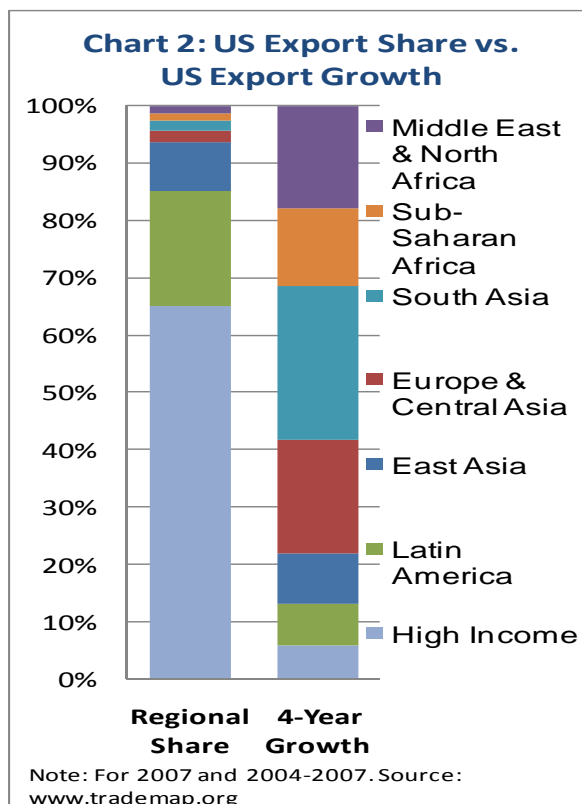


Chart 2 shows that as expected, high income countries continued to receive the biggest share of U.S. exports from 2003-2007. However, opportunities for U.S. exporters appear much different when comparing growth rather than the absolute share. Column 2 was calculated by indexing the four year growth rates for each global region and highlights U.S. exporters' substantially higher growth rates to developing regions. Significantly, trade to regions with large Muslim populations has experienced much higher growth rates than to Latin America and the developed countries.

### ***What does Islamic-finance look like in practice?***

There were only limited financial instruments and potential markets for Islamic-finance in the early stages of this market's development. These options, however, have greatly expanded to include the bond, equity, and venture capital markets. Some of the most relevant Islamic financial product structures for exporters and lessors include the following:

- **Murabaha** - a bank buys an item for a client and the client agrees to later repay the bank the price and an agreed profit.
- **Ijara (Lease)** – alternatively, a bank buys an item for a client and leases it back for an agreed period. At the end of that period the lessee pays the balance on the price agreed and becomes the owner of the item. The varieties of *ijara* allow for different treatment of the residual value of the leased item
- **Sell-and-buy-back** – a client sells one of his or her properties to the bank for an agreed price payable now on condition that the client will buy the property back after a certain time for an agreed price.
- **Letter of credit** – a bank guarantees import payments using its own funds for a client based on sharing the profit from the sale of this item or on a mark-up basis.

## ***What are the largest exports to Muslim countries?***

Table 1 (below) shows 2008 U.S. exports to the largest Muslim markets. Although each country's market is different, there was generally a large demand for construction equipment and transportation items, due to growth in public infrastructure projects. Countries with large Muslim populations are not always the largest markets for Islamic finance, as evidenced by Turkey, the 4<sup>th</sup> largest Muslim country for U.S. exporters but proportionally a much smaller market for Islamic finance.

## ***Importance of regulation and official finance***

Standard setters, both governmental and non-governmental, play a key role in shaping the rules within Islamic-finance markets. Non-government organizations such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB) ensure the convergence of product standards and the development and improvement of ac-

counting and management standards.

## ***Case study: The aircraft industry***

Already some U.S. exporters are taking advantage of these changes in the trade-finance sector to create opportunities for additional exports. For example, a U.S. aircraft manufacturer has used Islamic compliant leasing to increase aircraft sales and leases to the Middle East. According to AME Info, a Middle East business resource, the Middle East aircraft market is valued at \$260 billion in the next two decades which translates into an expected need for an additional 1,580 commercial jets.

Islamic finance's emphasis on asset-based sales is well-suited to aircraft and other equipment manufacturers. U.S. exporters that provide Islamic financing options might also gain a competitive edge on companies that do not provide these services but are otherwise competitive in a given product sector.

According to the *AirFinance Journal*, one of the main benefits of Islamic financing for airlines and lessors is the diversification of funding sources. Fewer banks are lending to sup-

**Table 1: 2008 U.S Exports by 1-digit Commodity Groupings (\$millions)**

<b>Industry</b>	<b>U.A.E</b>	<b>Malaysia</b>	<b>Saudi Arabia</b>	<b>Turkey</b>	<b>Egypt</b>	<b>Indonesia</b>	<b>Qatar</b>	<b>Kuwait</b>	<b>Oman</b>	<b>Bahrain</b>
Food and live animals	517	440	660	681	1,570	1,029	28	141	49	55
Beverages and tobacco	20	35	23	53	5	39	2	4	1	3
Crude materials	95	782	226	3,011	894	1,687	6	28	8	2
Mineral fuels	68	34	40	1,300	509	96	1	4	13	2
Animal & vegetable oils	34	7	137	217	69	1	0	24	26	0
Chemicals	670	791	796	766	415	761	114	201	64	29
Manufactured goods	1,087	496	764	496	223	222	144	212	54	39
Machinery & transport.	11,049	9,297	8,833	3,380	1,768	1,822	2,426	1,789	1,067	496
Misc. manufactured	1,252	807	759	392	448	177	290	232	85	77
Commodities	957	274	240	144	130	79	66	84	47	128
<b>Total</b>	<b>15,749</b>	<b>12,963</b>	<b>12,478</b>	<b>10,440</b>	<b>6,031</b>	<b>5,913</b>	<b>3,077</b>	<b>2,719</b>	<b>1,415</b>	<b>830</b>

Source: U.S. Census Bureau

port trade transactions. Islamic finance can help bridge this shortfall by widening financing sources and tapping into some of the relatively more liquid banking sectors in the Middle East. For aircraft and other equipment manufacturers the key structure is the *ijara*, or Islamic lease. The return is in the form of rent rather than interest, and the lease structure can be adapted into an operating or finance lease.

One of the main difficulties of expanding Islamic finance to the aircraft segment, however, is a reluctance to finance aircraft for their entire operating lives. For other equipment, with much shorter operating lives, however, this is not an issue. Another important consideration for aircraft and other exporters is the difference between transaction costs for Islamic-finance and conventional instruments. In some instances, Islamic-compliant transaction costs may be higher than for conventional finance. As demand for these transactions increases these differences could diminish.

Emirates Airlines, the international airline of United Arab Emirates, has made frequent use of the *ijara* to finance its fleet expansion. The advantage of Islamic-compatible trade finance is clear to the management of Emirates Airlines. According to the *Middle East Economic Digest*, Islamic financing is an integral part of Emirates Airlines' history. Emirates Airlines had earlier raised US\$1.3 billion from the Islamic market, including a *sukuk*, or Islamic bond, issuance. Emirates Airlines' management said that they will continue to rely heavily on Islamic-compatible financing to support its aircraft purchases.

Some export credit agencies (ECA) and development banks are also using Islamic-finance to increase exports of aircraft and other products and services to the Middle East. Finland's Finnvera and Germany's Euler Hermes, for example, have recently begun to cover export credits to finance new power plants. The Islamic Development Bank (IDB), a multilateral financial institution, focuses on advancing the development of Muslim-majority countries. The IDB has adopted its lending-practices to conform to the demand for Islamic-compatible financing. In the next few years the IDB plans to increase Islamic-compatible lending by 15 percent a year. Although it is not yet clear to what extent ECAs and multilateral financial institutions will support Islamic trade-finance for the aircraft and other industries, their increasing involvement suggests that the use of this trade-finance option will continue to grow.

The renewed interest of airlines and lessors in Islamic financing has not yet transferred into a significant number of Islamic-finance deals, but that may only reflect the emerging characteristics of the market. If current difficulties in the traditional loan market continue, then Islamic financing could become more than an alternative form of funding for those U.S. exporters seeking to increase their competitiveness by broadening their trade-finance horizons.

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