Some Notes on Islamic Finance in the National Accounts

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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*(assets –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:

Corporations			
Assets	100	40	Debt
		60	Equity

Dedbt holders			
Debt	40		

Shareholders			
Equity	60		

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

Corporations			
Assets	100	100	Equity

Dedbt holders			
Equity	100	60	Call option

Shareholders			
Call option	60		

- ✓ 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: $FISIM = (rL - rD) * (A+L)/2$ How does this affect comparability of financial service value added and GDP?