Oil

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FONDAZIONE ENI ENRICO MATTEI

GILLIAN WALMSLEY of LSE Describes New Opportunities offered by Islamic finance

When Bonds Comply with Sharia

The growth in Muslim financial structures in the West is of decisive importance for the development of Islamic companies and the creation of links with the global community. But no system is perfect or immune from problems

by DANIEL ATHZORI

The transformation of oil into a financial asset contributed to increase the volatility of oil prices. The boom in the energy commodities market appears to be driven not only by geopolitical factors, but also by the fact that energy commodities are growingly seen simply as an instrument to diversify investment portfolios, as an asset class like any other.

Gilliam Walmsley, Product Manager at the London Stock Exchange, helps us to understand new investment vehicles, such as the Exchange Traded Commodities, through which commodities are traded like shares. Moreover, she gives us an insight into Islamic finance, whose importance for the oil market is two-folded.

On the one hand, Islamic finance emerged in the wake of the 1970s oil bonanza, and still enjoys significant relations with the energy market. On the other hand, it claims to promote an economic system based on tangible assets, that is to say, in our case, more on the "physical barrels" than on the "paper barrels" of oil.

What are Exchange Traded Commodities? And what is their importance in relation to the oil market?

Exchange Traded Commodities (ETCs) offer exposure to either a single commodity or a basket of commodities. They are simple and transparent open-ended securities which trade intraday, like equities, on regulated exchanges. Investors can use ETCs to gain exposure to the price of oil, or more broadly to a basket or index of natural resources which may also include oil. Since their launch on the London Stock Exchange four years ago, ETCs have provided investors with a straightforward way of tracking the price of oil, which may have often been too complicated previously.

What is the advantage of investing in Exchange Traded Commodities in comparison with futures trading or oil companies share trading?

London is the international financial center as well as the Islamic financial center despite events in the last few years. At the beginning of 2010, the United Kingdom introduced measures to facilitate the issuance of Sukuk

The trading of futures can be complex and often requires a high level of expertise in specific types of financial instruments. Buying oil directly can carry extra logistical charges, such as delivery and storage costs. Investing in oil companies offers investors exposure to the performance of that particular company, which by no means necessarily correlates with the price of oil.
ETCs on the other hand are simple and accessible. They offer pure exposure to the price of oil, not oil companies, and do not incur delivery or storage costs. Investors can get in and out of their positions with ETCs in the same way they would with liquid shares – quickly and easily.

Several Muslim economists believe that the moral economy of Islam can positively contribute to prevent speculative behaviours, in particular through the eradication of the culture of interest and debt. Do you think that Islamic finance can really promote an ethical reform of the economic system, or do you simply consider it another way of doing finance?

No financial system is perfect. We need markets which are efficient, transparent and properly regulated. The crisis was caused by an excess of overly leveraged debt, and equity markets have remained open, allowing companies to shore up their balance sheets, and raise funds in other ways. Equity markets are an important part of the solution to the crisis. That said, companies and governments do need to be able to borrow capital to operate and flourish and on the other side of the coin long term fixed income investment in bonds is a crucial part of many portfolios (most pension funds for example). An appropriately balanced funding strategy is key.
The growth and prevalence of Islamic financial structures in the west, and globally, opens up huge opportunities for new types of investors, companies and regions. It would be unfair to say that the Islamic Finance is 'simply another way of doing finance'. It has been instrumental in the development of companies and regions with an Islamic foundation, and has helped connect them, as well as Muslim investors, with the global investment community.

The emergence of Islamic finance in the 1970s is often read in relation with the oil bonanza and the cash flow of petrodollars. What is the relationship between Islamic finance and the oil market nowadays?

It is certainly true that from the economic development of countries with majority Muslim populations, some of which enjoy burgeoning oil industries, a large and influential new investor base has emerged. This has created new opportunities and new demands for issuers, for legal firms and for financial services generally, and they are not restricted to oil.

The London Stock Exchange aims to become the global hub of Islamic finance. Do you think that the international financial crisis has weakened the potential of London seizing a larger market share in this sector?

London is undoubtedly the global western hub for Islamic Finance. Its status as an international financial centre, and as an Islamic financial centre, remains unmatched despite the events of recent years. This is thanks to an infrastructure that has been built over the years: it has one of the largest pools of investors in the world. It has a long history of market making and on top of this it has an unparalleled pool of expertise in economics, in law and in specialist sectors, having pioneered Islamic financial education and the establishment of the first Islamic banks outside of majority Muslim population countries. It also has a legislative and regulatory regime which is extremely complementary to Islamic finance. At the beginning of 2010 for example the UK government introduced measures to encourage and facilitate the issuance of corporate sukuk in the UK. For the London Stock Exchange's part, we have facilitated and responded to the rise in Islamic finance by hosting a range of Shariah-compliant financial products such as ETFs, as well as being the listing venue for several Shariah-compliant firms.

There is much debate about the resilience of Islamic finance against the financial crisis. Do you think that Islamic finance has really been resilient to the financial crisis, or does it suffer from the very same flaws of conventional finance, such as reckless behaviours and lack of regulation?

As mentioned, no financial system is perfect, and we need to be very careful not to assume any sector or structure is immune to problems the likes of which we have witnessed over the last few years. That includes Islamic finance. It does not necessarily enjoy more or better regulation than other types of finance and it is certainly not impervious to reckless behaviour. Islamic finance has rightly become an important part of the global financial system and as such needs to be monitored and regulated as effectively as everything else. We need globally coordinated, effective regulation of all financial markets, and we need to make sure they are as transparent as possible.

Asset: Action to take

SUKUK, defined by many as Islamic bonds, are financial instruments that include the features of both traditional debt securities as well as securitized instruments. They represent participation certificates for the ownership of several assets that enable investors to obtain periodic financial flows (similar, from a Western perspective, to an interest rate) deriving, for example, from the leasing of commercial real estate that is part of a pool of assets and is managed in compliance with Sharia (which prohibits interest, equating it with usury).
The issuance of Islamic obligations has reached 47 billion dollars worldwide and, despite the financial crisis, according to some estimates, the sukuk market should reach 100 billion dollars in the next three years. The main sukuk are: Mudaraba, Musharaka, Murabaha, Istisna, Ijara, and the convertible instruments.
The **MUDARABA SUKUK** are agreements between two parties where the first provides the capital and the others contribute to the management and operation of the business. The one contributing the capital is the only one liable for losses while in the event of profits both parties benefit on the basis of predetermined shares.
The **MUSHARAKA SUKUK** is a partnership between a bank and client, both making capital contributions (assets and liquidity). The parties agree in advance on profits by means of a contract, while losses vary based on the shares held.
The **MURABAHA SUKUK** is a contract where the client asks the bank to acquire an asset on its behalf, committing to repurchase it by installments after a certain period at an augmented price.
The **ISTISNA SUKUK**, on the other hand, is a contract for the purchase of assets produced by contracting (manufacturing and construction) where payment is made progressively to the builder as the work advances.
The **IJARA** is the most typical contract in Islamic finance. It functions like leasing. The bank or financer buys the assets and leases them to the entrepreneur in exchange for the payment of a remuneration. **SUKUK** which are **CONVERTIBLE** into shares were created in 2006.

Gillian Walmsley

She is Head of Fixed Income Products at the London Stock Exchange and covers the Group's London markets for ETFs, ETCs and ETNs in addition to Fixed Income & Securitised Derivatives.
Before joining the Exchange in 2008, Gillian was part of the Interest Rate product development team at Liffe, the derivatives arm of NYSE Euronext, where she worked on the design and launch of various short-term interest rate, bond index and government bond futures and options contracts and on the structuring of exchange credit derivatives.
Previously she was part of the Equity Derivatives team and worked on the launch of stock futures, the development of the UK equity options market and the introduction of flexible equity and index contracts.
Gillian began her career in the City on the Liffe trading floor as an Exchange Official overseeing open-outcry trading activity in the fixed income option pits.