Mozambique and the Islamic Finance, the Alternative in the Post-Covid 19 Situation.

By:

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May 17, 2021

With the looming post-Covid 19 crisis and the potential loss of liquidity in the banking market, the Islamic financial system (internationally known as "Islamic Finance") may provide an alternative to the African banking model for customers and could provide additional ways for domestic banks to finance themselves.

There has been a growth of Islamic banking in African countries with a non-Muslim majority, such as Botswana, Kenya, Gambia, Nigeria and South Africa, thus making it imperative to contribute to the demystification of this financial system in Mozambique. This includes emphasizing that its financial products are not: (i) solely restricted to the Muslim community; (ii) complex and not subject to banking supervision; (iii) investments with lower returns than conventional products; (iv) and integral part of terrorism and/or linked to money laundering.

Through training and promotion mechanisms on Islamic banking and Islamic law (the Shariah), the foundations of Islamic Finance could be laid in Mozambique as an option in the post-Covid 19 times.

There are a number of basic principles that are fundamental to take into account when one envisions structuring an operation/transaction based on Islamic Finance, namely: the prohibition of *riba* (the payment of a fixed or determinable interest on funds); any type of interest is totally prohibited because in the context of Islam, money in itself does not have an intrinsic value and as such, the creation of value cannot pass only through a loan.

All value creation must reflect human effort, initiative and risk in a productive activity. Transactions which involve receiving or paying back capital with a delay period and which generate interest are completely forbidden in Islamic Law. Economic practices involving *gharar* (deceptive uncertainty) and *maysir* (gambling/speculation) are also prohibited.

The motivation behind these prohibitions is to ensure a fair match between the expected benefits and the benefits obtained by both parties to a contract. All activities that contain elements of uncertainty, such as commercial transactions where there is uncertainty about an asset or its price, fall under the prohibition of *gharar* (uncertainty) and *maysir* (gambling) because legally *gharar* and *maysir* render a contract null and void. Shariah further prohibits *bay*'*al-aayn* (literally the sale/transfer of debt) and no sale or transfer of bonds or debts is permitted, even if those debts are structured by Islamic rules. Also included in the prohibitions under Shariah are haram (forbidden) activities, i.e. those related to tobacco, pornography, weapons, alcohol, pork, and gambling.

To ensure that financial products comply with these Shariah specifications, model contracts acceptable under Islamic legal doctrine are used and conventional financial contracts are also adapted to comply with the Shariah principles described above.

Thus, there are two main types of structures: the profit and loss sharing instruments / contracts (Islamic "partnership" contracts); and the bond-like financial certificates, which are known as the "*sukuk*" or Islamic bonds.

Profit and loss sharing contracts are not only halal (Shariah compliant), but also preferable to other types of contracts. The most used contracts are those called *mudarabah* and *musharakah*.

Under a *mudarabah* contract, the owner of the capital (the *rabb al-mal*; the bank or the client) contributes the capital to the applicant who contributes the specific work or expertise in the transaction in question (the *mudarib*; the entrepreneur or the bank in the case of indirect financing), who undertakes to manage the amount of the down payment with a view to making a profit. This in turn will be divided between the parties on a percentage basis, as specified in the contract. Such a contract cannot guarantee deliveries of capital, but only a portion of the total income, and as such can never guarantee a lump sum.

The same operation can also be used for indirect financing: the agent who received the capital can enter a *mudarabah* contract with a third party who will invest it in productive activities (two-tier *mudarabah*). *Mudarabah* contracts are commonly used for fund management and for structuring sukuk (Islamic bonds).

In turn, the *musharakah* contract is also an investment instrument very similar to the *mudarabah* contract. Both parties are involved in the implementation and management of the project, and profits are divided according to the terms agreed upon in the contract. However, losses are allocated in proportion to the capital contributed.

The difference between the two types of contracts is that under a *mudarabah* contract, the capital is fully delivered by the bank, which also bears the losses by itself, while with a *musharakah* contract, both parties participate financially in the project.

Moreover, in the first case, the project management is the sole responsibility of the *mudarib*, however in the second case it is shared. The assets acquired with the investment remain the property of the bank under a *mudarabah* contract, while their ownership is shared in the case of a *musharakah* contract. Both instruments are suitable for financing joint ventures and for financing projects and infrastructure.

There are other forms of financing but of a non-participatory nature that are more frequently used in consumer credit and short- and medium-term financing: the most popular involve *murabahah* contracts (purchase of assets with deferred payment) and *ijarah* contracts (hybrid contract of a leasing and an operating lease). These involve charging a commission or a margin on the price of the goods that are purchased with the funds provided.

In this case, the remuneration obtained does not explicitly refer to the time dimension and is thus considered compensation for a commercial service (in the case of a *murabahah* contract) or for the use of an asset (in the case of an *ijarah* contract).

These transactions are usually associated with indirect forms of collateral, such as ownership of the assets underlying the transaction. The *murabahah* contract is the most used. Under this, one party buys an asset and sells it to the other party at a higher price, which is agreed upon when the contract is made and is paid at the end. On the other hand, the *ijarah* (leasing) contract, one party (usually the bank) buys an asset and leases/rent such asset to the customer.

In these *ijarah* contracts, ownership of the underlying asset remains with the bank as it bears the risk associated with the borrowed assets for the duration of the contract. Some types of *ijarah* contract (for example, the *waiqtina ijarah* contract) include the ultimate purchase right and allow for the transfer of ownership of the product.

In conclusion, and having summarized the legal framework, it cannot be overemphasized that, like any conventional financial system, the Islamic financial system also presents various legal risks such as those concerning the potential loss that may be incurred by an Islamic bank as a result of insufficient, poorly applied, or simply unfavorable legal procedure in the country in which it operates, namely in Mozambique.

The lack of a Mozambican legal framework to support the products and services that Islamic banking offers hinders the growth of the Islamic financial sector and reduces stakeholder confidence in the viability of Islamic financial solutions.

Specific measures that can be taken to mitigate this risk would include seriously engaging banking and capital market supervisors (the Central Bank of

Mozambique), amending the Mozambican banking legislation, appointing *Shariah* experts to provide advice on Islamic banking operations, preparing legal documentation that complies with existing laws and *Shariah* itself, and ensuring that the talent behind Islamic financial operations is well advised in Islamic contracting.

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