



BANK OF ENGLAND



Islamic Finance Task Force (IFTT) Statistical Treatment of Islamic Finance

Classification of Islamic financial instruments

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Islamic financial instruments: scope and process

• Scope

- Review Islamic financial instruments previously considered in existing studies...:
 - Information Note on Islamic Finance by the Advisory Expert Group (AEG) on National Accounts, 2020.
- Existing examples
 - Qard, Wadiah, Amanah / Mudaraba / Sukkuk, etc.
 - Around 28 financial instrument categories listed
 - See: Annex B (tables); Annex C (diagrams).
- New examples:
 - Waqf Funds; Hajj Funds...

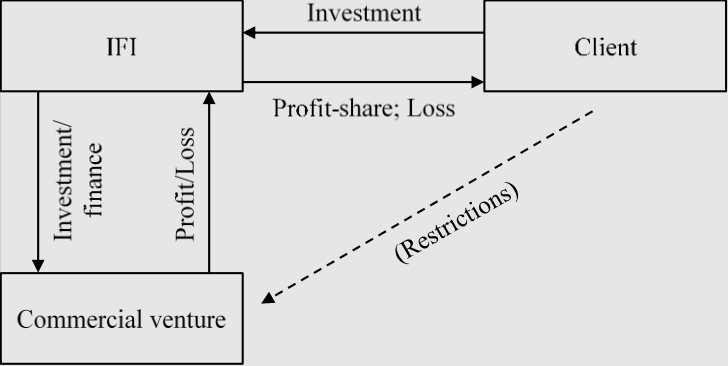
• Process

- Understand the financial instrument. See:
 - AAOIFI, IFSB, AEG, IMF, online search, published documentation...
- Analyse its economic substance...:
 - ...in terms of the SNA 2008 and BPM 6 Manuals
 - ...type of property income
 - ...economic sector of institutions and counterparties
 - ...expected properties
 - ...transferability
- Recommend the appropriate financial asset or financial liability classification.
 - This will depend on the detailed properties.
 - 'Slotting-in'.

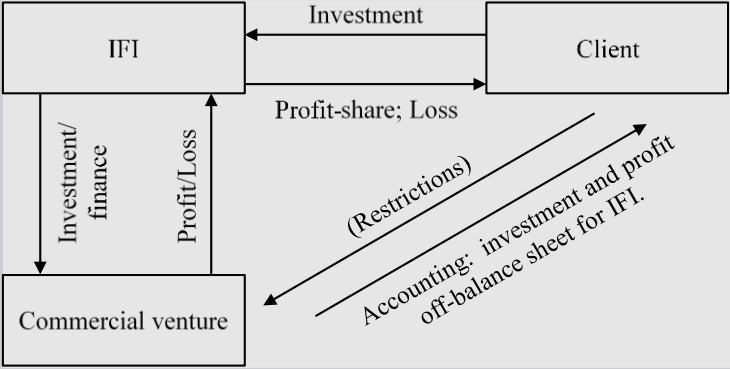
Islamic financial instruments: two examples

1. Restricted Mudaraba
2. Wakalah deposits
 - These are existing financial instruments, so are covered in Annex B (tables) and Annex C (diagrams).

Example 1: Restricted Mudaraba, on balance sheet (Annex C)

Instrument	3) Mudaraba, or Profit-Sharing Investment Account (PSIA); on-balance sheet for IFI
Descriptive diagram	 <p>The diagram illustrates the relationships between three entities: IFI (International Financial Institution), Client, and Commercial venture. <ul style="list-style-type: none"> An arrow labeled 'Investment' points from the Client to the IFI. An arrow labeled 'Profit-share; Loss' points from the IFI to the Client. An arrow labeled 'Investment/finance' points from the IFI to the Commercial venture. An arrow labeled 'Profit/Loss' points from the Commercial venture to the IFI. A dashed arrow labeled '(Restrictions)' points from the Client to the Commercial venture, indicating that the Client imposes restrictions on the investment. </p>
Notes	<ul style="list-style-type: none"> • Restricted Mudaraba: Client restricts where, how or for what purpose funds are invested. • IFI: on-balance sheet; maintains Statement of Restricted Investment.
National accounts	<ul style="list-style-type: none"> • FA: Other deposits (F29) • Income: Interest and similar returns (D41)
External sector statistics	<ul style="list-style-type: none"> • FA/IIP: Other investment: Currency and deposits: Other deposits • Income: Primary income: Investment income: Other investment: Interest and similar returns (D410)

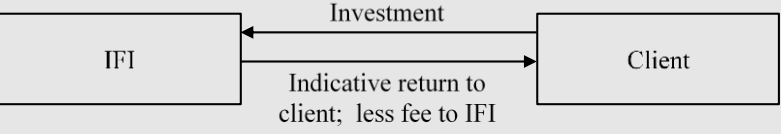
Example 1: Restricted Mudaraba, off balance sheet (Annex C)

Instrument	3) Mudaraba, or Profit-Sharing Investment Account (PSIA); off-balance sheet for IFI
Descriptive diagram	 <p>The diagram illustrates the relationships between three entities: IFI (International Financial Institution), Client, and Commercial venture. <ul style="list-style-type: none"> An arrow labeled 'Investment' points from the Client to the IFI. An arrow labeled 'Profit-share; Loss' points from the IFI to the Client. An arrow labeled 'Investment/finance' points from the IFI to the Commercial venture. An arrow labeled 'Profit/Loss' points from the Commercial venture to the IFI. A diagonal arrow labeled '(Restrictions)' points from the Client to the Commercial venture. A diagonal arrow labeled 'Accounting: investment and profit off-balance sheet for IFI.' points from the Client to the Commercial venture. </p>
Notes	<ul style="list-style-type: none"> • Restricted Mudaraba: Client restricts where, how or for what purpose funds are invested. • IFI: off-balance sheet.
National accounts	<ul style="list-style-type: none"> • FA: Equity (F51) (or F519?), if imputed to a non-banking sector counterparty. • Income: Dividends (D421)
External sector statistics	<ul style="list-style-type: none"> • FA/IIP: Portfolio investment: Equity • Income: Portfolio investment: Dividends (D42P)

Restricted Mudaraba (Annex B)

Instrument	Description	National Accounts	External Sector Statistics
Restricted Mudaraba	<p>Restricted mudaraba is where an investor restricts the manner as to where, how, or for what purpose the funds are invested. No mixing of funds is allowed from other sources to ensure proper management and accountability of the funds. The IFI manages the restricted mudaraba either as mudarib who engages in risk-sharing or as wakil who acts purely as intermediary for a fixed fee and not participate in the investment results. (...)</p> <p>Restricted Mudaraba that are held on-balance sheet of the IFI should be classified as Other Deposits (F29). Restricted Mudaraba that are held off-balance sheet should be treated as equity.</p>	<p>FA: Other deposits (F29) or Equity (F51)</p> <p>Income: Interest and similar returns (D41) or dividends (D421)</p>	<p>FA/IIP: Other investment: Currency and deposits: Other deposits or Portfolio investment: Equity</p> <p>Income: Primary income: Investment income: Other investment: Interest and similar returns (D410) or Portfolio investment: Dividends (D42P)</p>

Example 2. Wakalah deposit (Annex C)

Instrument	Wakalah deposit
Descriptive diagram	 <pre> graph LR Client[Client] -- Investment --> IFI[IFI] IFI -- "Indicative return to client; less fee to IFI" --> Client </pre>
Notes	<ul style="list-style-type: none"> • Bank acts as agent for depositor, charging a fee, e.g. 1.5% to 2%. • Investors are offered an indicative return; actual return may differ. IFI can retain excess of profits over indicative return; has incentive to cancel fee.
National accounts	<ul style="list-style-type: none"> • FA: Transferable deposits (F22), if applicable; or Other deposits (F29) • Income: Property income: Interest and similar returns (D41).
External sector statistics	<ul style="list-style-type: none"> • FA/IIP: Other investment: currency and deposits: Transferable deposits or other deposits. • Income: Primary income: Investment income: Other investment: Interest and similar returns (D410).

Wakalah deposits (Annex B)

Instrument	Description	National Accounts	External Sector Statistics
Wakalah deposits	<p>In wakalah, the bank acts as an agent for investment of depositor's funds in exchange for a fee, usually in the 1½ to 2 per cent range. Potential depositors are offered an indicative return, but if the actual return is lower the depositor will receive only the actual return. Conversely, if the actual return is higher, the bank pays only the indicative return and keeps any excess as an "incentive fee." Because of the possibility of the bank earning this incentive, it will often not charge a fee.</p>	<p>FA: Transferable deposits (F22) or Other deposits (F29)</p> <p>Income: Interest and similar returns (D41)</p>	<p>FA/IIP: Other investment: Currency and deposits: Transferable deposits or other deposits</p> <p>Income: Primary income: Investment income: Other investment: Interest and similar returns (D410)</p>

Islamic financial instruments: conclusions (i)

- It is usually possible to propose a satisfactory SNA / BPM classification for the considered Islamic financial instruments.
 - But sometimes it is more difficult.
 - There is not always an exact relationship between the Islamic financial instrument and the standard SNA / BoP classifications.
 - The appropriate classification will depend on the actual characteristics of the financial instrument, not simply its formal terminology.
 - New financial instruments will arise as Islamic finance evolves. Future recommendations may change.
- Notes
 - Debt is defined in SNA / BPM as zero residual economic claim: it is extinguished when it is repaid.
 - In SNA / BPM, property income that arises from deposit, loan and debt securities is D.41 'interest'.
 - GN proposes that D.41 be renamed, 'interest and similar returns'.

Islamic financial instruments: conclusions (ii)

- The GN recommends a decision tree for classification. Possible criteria:
 - What form of institutional unit is represented by the recipient of the finance? An equity classification will only be possible for an entity that is a corporation.
 - Is the financial instrument designed to provide a profit that has a comparatively high reliability as to its magnitude?
 - Whether or not the financial instrument is recorded on the balance sheet of the Islamic Financial Institution.
 - Whether or not the investment account holder has an investment-like claim on ventures or funds offered by the issuing institution (and hence the venture/fund has institutional unit type behaviour).
 - Whether or not the investment account holder has a claim on the residual value of the issuing institution.
 - Whether the lender is the supplier of the goods or services being financed, which would determine a trade credit or loan classification.
 - Whether the financial instrument provides negotiable securities, for example in the form of participation term certificates.
 - Whether equity holdings exceed the 10 per cent threshold for foreign direct investment.
 - Whether an existing foreign direct investment relationship already exists.

Questions for Global Consultation and outcomes

- Classification of Islamic financial instruments and corresponding investment income
 - Q.9 Do you agree with the suggested classification of Islamic financial instruments contained in annex B using the slotting-in approach from an economic statistics perspective and that this approach is capable of future application if and as Islamic finance evolves (issue 4.1)?
 - Outcome: Yes – 32; No – 2; Undecided – 8.
 - Q.10 Do you agree with the recommendation to construct a “decision tree” for inclusion in a compilation guide that would help facilitate future classification decisions (issue 4.2)?
 - Outcome: Yes – 25; No – 2; Undecided – 6.



Thank you.