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An approach to Islamic Finance in Spain

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Abstract Islamic finance systems are a new way of raising funds for families, companies and public institutions. This kind of system has its origin in the Middle East and Asia, but it is gaining customers all over the world due to the growth of Islamic economies and the problems of traditional financial systems in Western countries. Therefore, having into account the problems to get credit by SMEs in Spain Islamic Finance is a new open way for entrepreneurs, as well as for corporations and the whole society. This new financial resource has strict principles based on the *Sharia'a*, the Muslim law that regulates the transactions in Arab society. This fact could be a key point in order to develop a business structure in Spain, as a consequence of the spoiled reputation of traditional banks.

Keywords: Islamic Finance, SME, Spain, Banking

1 Introduction

The Financial crisis, developed after the Lehman Brothers' collapse in 2008, has reduced the instruments and opportunities for funding in most Western countries. Obtaining money by credit is one of the main problems in countries of the Eurozone. This is one of the principle reasons why many SMEs in Spain had to leave their business once liquidity in their statements started to disappear. However, the European Parliament and governments in the European Union have applied different measures in order to expand the credit. These measures have always followed

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a path in which banks were the connection between the financial sources and the final customer. Those stimuli did not get at the same magnitude from the banks to the customers as it did from the governments to the banks because some of the banks needed liquidity in order to increase their capital ratio due to the Basel 2 treaty. Thereby, the result is that European banks are stronger than before the crisis because of those reforms, but SMEs still have difficulties to obtain funds according to the Basel 2 treaty rating system, in which SMEs show a riskier profile due their shorter history, lack of information and high elasticity to market condictions, comparing them to big corporations, (Shiyab, 2014).

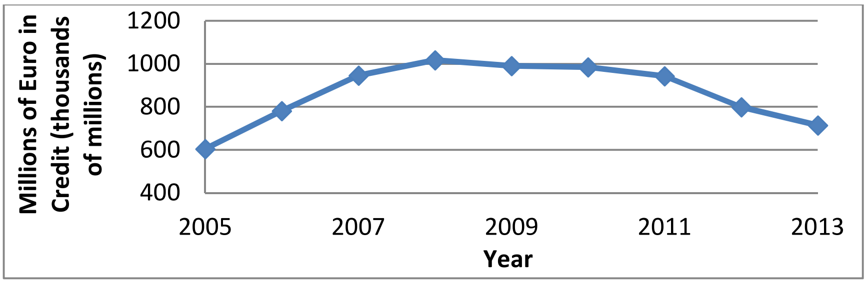

Fig. 1 Evolution of Credit in Spain. Source: Bank of Spain (BdE)

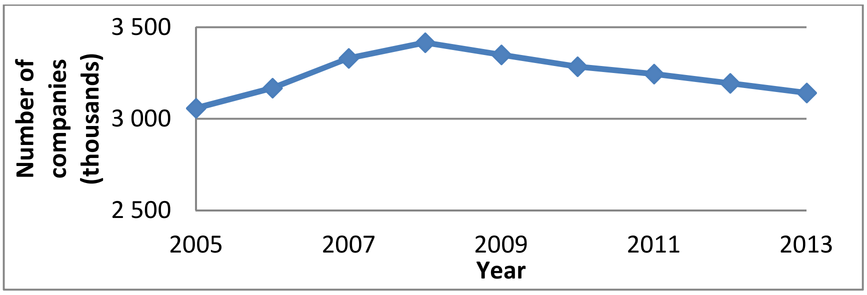

Fig. 2 Evolution of the number of companies with less than 200 employees in Spain. Source: Spanish Statistical Office (INE)

As it has been already mentioned, one of the main problems for SMEs is the access for external financial resources (Lehmann & Neuberger, 2001), even when they play a key role for growth and employment creation across any country of the world (Wagenvoort, 2003). The principal source for obtaining funds for SMEs is banking financial products (Montoriol, 2006), however, actually they face credit rationing when trying to develop their operations. This credit rationing is the existence of any kind of restriction on the access to financing sources, without taking into account the real risk of the project, being directly related to the size of the company, the previous relationship with the financing institution or other characteristics of the company that seeks for credit sources (Larrán, et al., 2008).

In Europe, the problem has been bigger than in any other part of the world. The Euro currency avoids the countries of the Euro-zone to apply monetary policies and national exchange rates. In the special case of Spain, the credit from financial institutions has been historically focused on real estate and construction sector. Furthermore, real productivity was not competitive comparing to other economies of the world. These facts made Spanish economy very vulnerable to external monetary flux restrictions. Thereby, when this happened in 2008, Spanish economy was hardly hit, what implied a credit restriction and a lag on public sector payment (Mendizabal Zubeldia, et al., 2011). That is why all kind of companies in Spain were forced to stop their business and to reduce their personnel.

Facing this credit restriction, SMEs in Spain tend to increase the relative weight of commercial credit in contract to banking credit (Fischer, 2005). To sum up, commercial credit is the natural substitutive for banking credit when the latter is restricted, being higher the cost of the former when not using discounts for prompt payment discount. Here is where Islamic Finance methods can offer Spanish SMEs a new method for external source for finance.

2 Islamic Finance

The Islamic world has lived a great development during the second half of the twentieth century. The discovery of vast oil reservoirs in Middle East together with the huge demand of petroleum from the Western countries, enhance the rapid growth of countries such as Qatar, United Arab Emirates, Saudi Arabia, etc. Due to this fact, these countries have millions of dollars per capita. However, crude oil reservoirs will not last forever, and that is why Middle East countries started to invest in other type of industries in order to diversify their economy. Therefore, the rapid growth of the economy, the population growth in Islamic countries, and the restrictions imposed by the Islamic culture on economic and social aspects of life, encouraged to create what is known as Islamic Finance.

Islamic Finance is based on the Sharia, the law the Islamic world is ruled by. This fact is the one that makes this industry quite different to Western Traditional Banking. The objectives and the activity is basically the same in both industries, but in the Islamic Finance every operation must follow the Sharia. There are five main differences that Sharia introduces to Islamic Banking (Beck, et al., 2013):

- The investment purposes must not be related to gambling, alcohol, porn, sale of pork or weaponry.
- The assets exchanged in the contract must be tangible.
- Speculation and uncertainty are not allowed.
- The contracts must not be charged with interests, or riba in Arab.
- The operations must be based on risk sharing.

Interest is the basic tool for western banking industry. However, Islamic Banking does not allow using interest as it is considered to be unethical. It is seen as an unjustified capital growth, avoiding any effort to earn that money. Apart from those facts, there cannot be a fixed return for the lender coming from the operations, which is the reason why the risks are shared. The returns come from the profits that the wealth growth created by the operation gives (Castro, 2013).

3 Main Islamic Financial Products

In Order to give the reader a general view of how products look like in Islamic Finance, this part of this paper deals with the main products that any customer can find in the market. The first type of products is the ones that give a fixed income to the banks (Castro, 2013).

- *Sukuk*: This product is the so called Islamic bond. This term means participation certificate. They are rather liquid bonds. *Sukuk* generally cannot be tradable in secondary markets, although if they are, liquidity level is increased. At the expiry date, the seller pays a donation, or *hiba*, that represents a nearly fixed productivity of the *sukuk*, and buys again the asset. However, the *sukuk* cannot represent debt, as it is forbidden to trade with debt, so they have to represent a property of an asset, thereby, connecting *sukuk* value to the underlying asset value.
- *Ijara*: In this product the bank leases an asset to the customer. This contract fixes a rent and a period for the leasing operation. All the costs associated to the use of the asset are responsibility of the client. When this contract comes to an end, there is a possibility for the customer of purchasing the asset. This must be done on a separate contract. When the asset is shared by different banks or investors, the rentals are shared according to the percentage of property of each owner.
- *Murabaha*: This is the form that Islamic banking uses to credit asset buying operations of their customers. Under this kind of contracts, the bank buys the asset the customer needs. The customer is given a price with a surplus, according to the profit that the bank estimates as fair. Once the contract is signed, the bank delivers the asset to the customer, who pays in a fixed period of time by instalments. All the income from the penalties given in deferred payment of the instalments by the customer must be spent on charity, according to sharia.
- *Salam*: This contract is used to finance activities related to commodities. The bank buys the commodity in advanced to the producer, whoobtains liquidity in order to produce the goods. Then, when production is finished goods are sold to the bank at pre-fixed price. As a regular practice, the bank usually enter into a parallel Salam contract in which another party buys the assets.

- *Istisna*: Similar to Salam. One difference is about the asset underlying the contract. These assets are manufacturing goods. The second difference is that the payment can be in advanced or in a future moment. This type of contract is used for building houses, plants, projects or public infrastructure.

Apart from the previous, there are two other widely used products which do not guarantee any income to the financial institution.

- *Musharaka*: This kind of product works as a joint enterprise. The customer and the bank enter in this contract where they prefix a share of the profits earned, while the losses are shared according to the capital contribution of each party. This capital can be either cash or assets, and the financial institution can help with its expertise on the sector by giving managing advice.
- *Mudaraba*: Similar to *Musharaka* but in this case the losses are only supported by the capital provider. This product is very useful for high skilled people with a weak economic situation, where capital provider has no managing rights over the business.

4 Opportunities and Challenges for Spain and Islamic Finance

As already seen in the second part of this paper, one of the main problems for the development of SMEs in Spain is the access to external financing sources. Thereby, in order to fill this gap, one of the solutions is to seek for finance from other countries where liquidity can be found easily. In table 1 there is a brief summary in which one of the main indicators for excess of liquidity is shown, the current account balance, BoP. As it can be observed in the table, Islamic economies are the ones that reached the best positon according to their BoP. The main countries in this group are Saudi Arabia, Kuwait, Qatar, Iraq, Libya, Malaysia and Algeria. These countries account for almost the 28% of the positive BoP of the whole world, making them one of the main possible sources for financing.

Table 1 Positive **c**urrent account balance (BoP, current US$). Source: IMF

Country or Zone	Millions of US Dollars
Main Islamic Economies	403,645.76
Germany	240,743.21
China	193,139.15
The Netherlands	72,732.98
Norway	72,609.01
Russian Federation	72,015.71
Japan	60,859.46
Switzerland	53,913.74

Singapore	51,437.24
South Korea	43,335.10
Others	181,940.88
Total	1,446,372.25

Following this reason, European countries like the United Kingdom, The Netherlands, France, Luxembourg or Germany have applied different measures in order to attract Islamic investment. The UK was one of the first countries to introduce fiscal and legal reforms in order to diminish natural walls against Islamic finance. In fact, the UK is the ninth country in the world according to the amount of assets. In France, in 2010 under the sign of Christine Lagarde as Minister of Economy and Finance, some regulatory changes took place in order to develop different Islamic products such as *murahabah, sukuk or ijara*.

Thereby, Spain should adapt their fiscal structure to let Islamic financial products to be competitive enough. Indirect taxes like VAT or tax on patrimony transfer should be modified in order to avoid the penalty it implies to Islamic products. Furthermore, direct taxes on *sukuk* revenues should be equal to the taxes for revenues from fixed-income products like traditional bonds, as well as recognizing *sukuk* as debt for companies in order to be deductible facing the corporation taxes (Kessler Rodríguez, 2012).

Apart from this, the reputation of traditional banks in Spain has decreased due to different situations in which some managers abused of their positions or there was a lack of ethical business operations (Hedgecoe, 2014). There are several theories establishing that reputation, especially on banks, has a great influence on situations where a customer has to decide whether to sign a contract with a bank or a different financial institution (de Obesso Grivalvo, et al., 2012). The strict principles that rules financial contracts on Islamic Financial Systems make this new financing source in Spain a strong possibility for gaining an important market share.

What is more, several non-Muslim like the UK decided to enter in the sukuk market. Other governments like Hong Kong, South Africa and Luxembourg did the same, in order to fed the bond-hungry situation of Islamic investors who were looking for products where they could find a good return. For example, the UK sold £200m sukuk when investors demanded £2bn, and Luxembourg's 60% of its €200m sukuks went to Middle East investors (Wigglesworth, 2014). Seeing this investment-appetite from Islamic investors, governments set a benchmark for other companies to enter the sukuk market. Therefore, this could be a new approach for Spanish government and SME's to get liquidity in a different way.

Finally, products like *musharaka* and *mudaraba* can allow SMEs to solve their funding problems, especially to those at the very beginning of their life. The key advantages of venture capital in business development are (Nisar, 2010):

1. It is more attractive for companies in their early stage, too small to raise funds in public markets or from conventional banks;

2. Technology advancement;
3. Increase in job creation and innovation, like some years ago did Google, Amazon, Apple and Intel among many others.

The Islamic commercial principles, that is profit and loss sharing, prohibition of interest-baring loans and transactions, and avoidance of speculative transactions, will enhance equity financing rather than debt-based financing (Hj. Nawawi, 2009). In order to regulate venture capital financing for SMEs the *Guidelines and Best Practises on Islamic Venture Capital* of the Securities Commission Malaysia would serve as a good model (Oseni, et al., 2013).

6 Conclusions

Giving the actual environment in which financing sources are difficult to achieve by SMEs and big corporations, both from banks and in the markets, the Islamic Finance Systems offer a new alternative for raising funds.

In order to introduce Islamic Finance in Spain, a first approach would be to enter into a niche market at this time. Previous experience shows that if focused on a niche market, like SMEs could be in this country, the yield is higher than a full-scale introduction for an alternative financing system (Salavou & Avlonitis, 2008).

Countries like the UK, Germany and France, due to the high number of immigrants from Islamic countries, have taken the lead in reforming their fiscal and legal systems. However, only the UK has made a real difference. Thereby, Spain has a great opportunity to make a difference in the Euro-Zone, apart from the fact that Spain has an important influence from the Arab culture, it has a numerous population of Muslim people, especially in places like Ceuta and Melilla.

Anyway, reforms in both fiscal and legal systems are the further steps to be taken in order to make Islamic Finance attractive by eliminating double taxation situations. Transparency and accountability, added up to fairness should guide the development of Islamic financial products in Spain, something that already underlies in Spanish legal and fiscal systems. In fact in the last months some important events related to Islamic Finance have taken place in Spain, due to the great interest that has aroused in entrepreneurs, like the International Halal Congress in the city of Cordoba. In this Congress, José María Fuentes, Investment Director of Kernel Investment Group in the USA said that “Because of our strategic location, good relationship with Arab countries and our tradition, Spain has to become the hub for Islamic Finance in Latin America (…) and Mediterranean countries, (Abascal, 2015). Also in this conference, Ángel José del Río, Aresbank Commercial Division, highlighted that his bank did not offered Islamic products in Spain because its legal framework did not allow financial entities to do it.

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