CHAPTER 1

The Islamic banking and finance industry

Islamic banking and finance has so far been in bed with capitalistic conventional financial institutions, and has indeed emerged as a torch-bearer of Islamic capitalism. While the phenomenal growth of Islamic banking and finance has pleased many of its advocates, it has increasingly attracted a lot of criticism for paying less attention to social responsibility. In fact, one prominent Islamic economist, Professor Nejatullah Siddiqui, once said:

> "Whatever the legal opinion, the economic role of the [tawarruq-based] transaction can hardly be different from that of lending and borrowing money. As the credit price on which the client buys the asset is invariably higher than the cash price on which the asset is sold, tawarruq (as the method is called) is functionally identical to interest based lending and borrowing. Islamic economic analysis has shown that, even in the case of a loan for business purposes, exchange of money now with more money later is unfair because of the uncertainty that accompanies the passage of time. Money needs being converted into goods and services before it can enter the process of production---the source of possible growth/value increase. The results of the process of production have to be reconverted into money before money can be paid back to the one who gave it in the first instance. This amount of money, resulting from conversion of the product into money, may be more than, equal to or less than the original amount of money" (Islamic Economic Studies, Volume 13, No. 2, p. 16).

Other economists who have been involved in Islamic banking and finance for decades tend to argue that the recent trends in the industry are more in line with the conventionalisation of Islamic banking and finance and less on Islamisation of conventional banking and finance (Professor Volker Neinhaus).

Many industry observers opine that for Islamic banking & finance to survive and sustain as a distinct model of banking and finance, it must commit itself to social responsibility. This can be done by redefining its objectives away from a pure shareholder-centric approach to a wider stakeholder-oriented model. This necessarily involves re-defining the objectives and scope of Islamic banking and finance. The development of Islamic banking and finance so far represents what is known as an example of process innovation, i.e., Islamic banking and finance attempts to employ different processes and contracts to achieve economic effects of the conventional products in a Shari'a compliant way. It has indeed been a worthwhile approach that has at least provided Shari'a compliant solutions to the Muslim users of financial services. This is certainly a building block of an Islamic financial services industry that must now diverge from its conventional counterparts in its objectives and scope.

Now that the size of the global Islamic financial industry has reached USD1.357 trillion (see Table 1), it is indeed the right time to develop Islamic banking and finance as an example of model innovation. It should be developed as a new model of financial intermediation that should attempt to differentiate itself not only in the processes it employs to develop products but also in the final outcomes of the products and the system.

For example, for Islamic banking to remain true to the trading nature of the contracts it employs for product development, it must enhance its trading capacity. Instead of products based on tawarruq, 'ina and similar practices that are cash-oriented, Islamic banks should further enhance the products based on genuine murabahas.

Country	2007	2008	2009	2010	2011
Iran	235	**293**	**369**	**406**	**413**
Saudi Arabia	92	**128**	**161**	**177**	**205**
Malaysia	67	**87**	**109**	**120**	**131**
UAE	49	**84**	**106**	**116**	**118**
Kuwait	63	**68**	**85**	**94**	**95**
Bahrain	37	**46**	**58**	**64**	**65**
Qatar	21	**28**	**35**	**38**	**47**
UK	18	**19**	**24**	**27**	**33**
Turkey	16	**18**	**22**	**25**	**35**
Bangladesh	6	**8**	**9**	**10**	**13**
Sudan	5	**7**	**9**	**10**	**11**
Egypt	6	**6**	**8**	**9**	**12**
Pakistan	6	**5**	**6**	**7**	**12**
Jordan	3	**5**	**6**	**6**	**11**
Syria	1	**4**	**5**	**5**	**5**
Iraq	---	**4**	**5**	**5**	**9**
Indonesia	3	**3**	**4**	**5**	**9**
Brunei	3	**3**	**4**	**4**	**8**
Other countries	7	**7**	**9**	**10**	**125**
Total	**639**	**822**	**1036**	**1139**	**1357**

Table 1: Size of the Global Islamic Financial Services Industry

On a systemic level, there is a need to develop a system of Islamic foundations that should work side by side with Islamic banks for a period of 15-20 years, after which it should completely replace Islamic banks (see the Box below for further details on Islamic foundations).

Report Layout

GIFR 2012 focuses on the issue of social responsibility and Islamic philanthropy (Part 3), in addition to the discussion on industry segments (Part 2) and country sketches (Part 4).

Part 2 – Review of Industry segments

Chapter 2 will discuss the basic parameters of the profit distribution mechanism in the mudaraba pool of an Islamic Bank, and highlight some of the issues that need Shari'a solutions or refinement of existing practices. A proper understanding of the profit distribution mechanism in an Islamic bank's Common Mudaraba Pool is not possible unless the nature of the investment deposits in the Islamic banks, vis a vis those of conventional banks, is properly understood. To safeguard the benefit of depositors and stop misuse of the weightage system, appropriate adjustments need to be made to profit allocations.

Chapter 3 and 4 focuses on takaful, the 'cinderella of the Islamic finance industry'. Chapter 3 provides a general overview of the industry as of 2012. The chapter looks at the geographical expansion of the industry, product developments in general and family takaful, bankatakaful and takes a look at individual financial planning. Chapter 4 delves into innovation in the takaful industry. For the continued success of this segment, healthy cooperation between customers and companies is necessary. The stakeholders of takaful need to have a good understanding of what is meant by cooperation and cooperative principles as this underpins the ethics of takaful.

Chapter 5 moves to the capital markets. The economic crisis took its toll on the industry but there are now positive developments for the Islamic debt and equity markets. The sukuk market has made impressive headway and 2011 is already an all-time record year. Encouragingly, innovation in sukuk parallels the spread of the industry to new markets. In spite of the progress being made, the market still faces some potential stress points, which needs to be addressed. However, the Islamic finance industry is constantly evolving and times of turmoil offer glimpses of opportunity. In 1999, the creation of the Dow Jones Islamic Index represented a milestone for the industry. Since then, Islamic finance indexes and stock screening methodologies have undoubtedly progressed and become widespread. The Shari'a screens offer a macro perspective to investment, bringing issues of social responsibility and corporate stability to the fore in combination with profit maximisation. Cumulatively, it leads to more robust methodologies and indexes, which are outperforming conventional indexes. **Chapter 6** explores this further and provides some positive conclusions about this segment.

Chapter 7 focuses on Islamic asset management industry in the Asia Pacific, ex Japan. It highlights general developments in region before concentrating upon several countries within the Asia Pacific. These countries can truly have a seismic effect on the Islamic finance industry as a whole. Moreover, with regulatory changes in Malaysia, Indonesia, Brunei, the potential for Islamic asset management to outperform conventional is a real possibility.

Chapter 8 narrows the geographical focus to the UK and looks at Islamic real estate management in the country. The UK was once a darling for Islamic finance but given the economic crisis, and reduced government attention, Islamic finance is faltering. However, as a financial centre, the UK will always offer ample opportunities, especially in real estate. Commercial real estate remains a popular asset class for Shari'a compliant investors, particularly from the Middle East, either indirectly through a real estate fund or directly as a standalone investment. However, it is becoming more and more difficult for Shari'a sensitive Investors to access Shari'a compliant financing to acquire UK commercial real estate.

Chapter 9 proffers a highly technical discussion on Islamic hedging and in particular, Profit Rate Swaps (PRS). The chapter looks at the ways in which the proposed standardised PRS documentation will enable a PRS to be structured, and provides a worked example of using a PRS to hedge sukuk. **Chapter 10** delves into the controversial Goldman Sachs sukuk. At first glance, the sukuk appears to be a step forward for the Islamic finance industry but real questions are being posed as to the Shari'a compliancy of the sukuk. Concerns about the intention of the parties are being raised with regards to the legal structuring of sukuk. The ongoing substance v form debate continues and this sukuk undoubtedly embodies the contentions which arise from this dialectic.

Chapter 11- 14 looks at legal and regulatory issues in four countries: Russia Turkey, Pakistan and Indonesia. **Chapter 11** looks at tax laws in Russia and finds that current tax laws are conducive to structuring Islamic finance products such as Shari'a compliant REPOs, mutual funds and sukuk. **Chapter 12** provides a general overview of Participation banking in Turkey. The chapter looks at a range of industry segments from Islamic retail banking to the capital markets. Turkey is undoubtedly a rising star in Islamic finance and coupled with a strong economy, it has the potential to determine the trends in the industry. **Chapter 13** addresses the accommodation of AAOIFI standards in the guidelines to Islamic banks by the State Bank of Pakistan. The chapter looks at the amendments made by the central bank and their work provides an example of a bank utilising the directives of an Islamic finance multi-lateral organisation in building the domestic market. It highlights the importance of the work of AAOIFI in bolstering the Islamic finance industry. **Chapter 14** focuses on Indonesia and the issues that arise with regards to product development. The chapter scrutinises the unique characteristics of the regulatory framework for Islamic banks in Indonesia, and its impact on the product suite.

Chapter 15 – 18 attends to the legal and contentious aspects of the industry. **Chapter 15** looks at risk management in the industry. It will look at the risks that are facing the industry and the actions that need to be taken to ensure its long term survival. Attention is paid to liquidity issues and the impact that a failure of an Islamic bank would have on the industry as a whole. **Chapter 16** then looks at dispute resolution in the industry, specifically litigation and arbitration in Islamic finance. The industry is young, thankfully reducing disputes between parties. However, as the industry grows in size, it would be naïve to assume the incidence of disputes will not increase. Thus, it is necessary to ensure the right dispute resolution framework is in place.

The final two chapters, **chapter 17 and 18** pertain to the interpretations of scholars and the application of fatwas to product development. **Chapter 17** adopts a cautious and critical stance, highlighting certain inconsistencies in the fatwa methodology. The chapter scrutinises current methodological practices adopted for product development, and suggests a new one which upholds neglected Shari'a requirements. **Chapter 18** then looks at takaful products, especially the role of tabarru in the structuring of takaful products. Serious questions are once again posed as to the classical understanding of how tabarru should operate and how it currently operates. The chapter concludes with highlighting the need to incorporate hiba principles into the structuring on takaful products.

Part 3 – Social Responsibility and philanthropy

The core theme of this year's report is Social Responsibility and Philanthropy. Islamic finance and Islamic finance institutions are recognising the crucial importance of societal wellbeing in ensuring the sustainability and traction of Islamic finance. If Islamic finance institutions focus on solely profit maximisation, it is a recipe for failure. Saudi Arabia's National Commercial Bank (NCB) understand the importance of Corporate Social Responsibility (CSR). NCB have provided their CSR report and this is produced in **Part 3.** The reader will hopefully be impressed by their commitment to CSR and the number of projects in this field. NCB offer a model which other Islamic finance institutions should attempt to employ in some form.

Chapter 19 is a theoretical chapter that explores the epistemology of Islamic and conventional finance. The chapter argues that the present Islamic finance industry evolved from conventional finance to address a market failure in conventional finance in terms of unmet market demand for Islamic finance products. However, since most practitioners in Islamic finance were bankers and market players from the conventional background, they developed, more often than not, products that were similar to conventional ones albeit with Shari'a compatibility. **Chapter 20** continues this philosophical vein, looking at Islamic finance and ethics. It explores the relationship between the value proposition inherent in the Islamic view of economic behaviour and financial intermediation, notions of ethical behaviour embedded in the growing movement towards corporate social responsibility and the role of law in enforcing such behaviour. The chapter helps define what ethics and ethical behaviour are by reference to the work of corporate philosopher Roger Steare and seeks to explain why, even in an Islamic financial scenario, ensuring ethical behaviour requires help from laws and regulations. **Chapter 21** transitions into more practical territory. A comparison of ethical approaches in contemporary Islamic and secular ethical finance shows significant similarities and differences between the two. In both Islamic and secular ethical finance, pursuing profits while pursuing ethics in for-profit limited liability companies remains a divisive issue. The main challenge that faces both Islamic finance and secular ethical finance, however, is the gap that is often observed between expectations that are created by using such labels as "ethical," "Islamic," "sustainable," and "responsible" and the actual practice.

Chapter 22 investigates the current state of Muslim Philanthropy. Muslim philanthropy is at a crossroad, challenged to build new models of giving while simultaneously refining old methods embedded in the vibrant Islamic tradition. Muslim giving needs to be reexamined and allied with the newly developing era of prosperity and social awakening in some parts of today's Muslim world. The foremost challenge in the field is to promote strategic and accountable philanthropy that complements and enhances the generations-old conventional charity, which is often personal and spontaneous. The chapter examines the current state of Muslim philanthropy in both Muslim majority and minority countries and sheds light on its promising future. **Chapter 23** then looks at the specific problem of poverty alleviation. A blight on the Muslim conscience, poverty is pressing concern for far too many Muslim countries. More needs to be done to change the current ignominious situation. Islamic economics as an intellectual field and Islamic finance as a practical field can grow, but needs to address the challenge of poverty. **Chapter 24** then looks at the problems faced by international Muslim charities such as Islamic Relief. There are many challenges for Islamic charities in procuring the funds and disbursing it to the loci of need. Efficient use of funds is expedient but surrounding issues can often affect efficiency. While charitable works and Islamic finance institutions are in different industry segments, a much more synergistic relationship can only be beneficial for both segments.

Chapter 25 is an in-depth expose of Islamic microfinance. With the global success of the Grameen model, there is much hope for Islamic microfinance. Islamic finance has now expanded in terms of product range and geographical reach but the number of Islamic financial institutions offering microfinance products in compliance with Islamic principles and serving the un-bankable Muslims continues to lag behind. Islamic microfinance has the potential of providing financial access to the poor Muslims who currently reject microfinance products that do not comply with Islamic law. The chapter provides case studies in MENA, Pakistan, Bangladesh, Malaysia, and an in-depth look into Indonesia.

Islamic microfinance is niche segment but it combines the three pillars of Islamic finance: profitability, ethics and Shari'a. Venture philanthropy is similar but is more concerned with macrofinance. **Chapter 26** highlights how the venture philanthropy approach allows ethical investing with a charitable impact that could be of interest to religious institutions of all three Abrahamic Faiths. The chapter takes a focused look at the work of one institution, LGT Venture Philanthropy Foundation, who are an impact investor supporting organisations with outstanding social and environmental impact. The Foundation strives to increase the sustainable quality of life of less advantaged people by inspiring clients to active philanthropy, providing individualised philanthropic advice and investment implementation.

Chapter 27 returns to Corporate Social Responsibility, effectively tying all the disparate elements of social responsibility and philanthropy; and more importantly all the challenges that arise in the industry. The chapter addresses social responsibility, divergent Shari'a viewpoints, ethical finance, social responsible investing, standardised documentation, responsibility of scholars, governments, standard setters and regulators.

Part 4 – Islamic Finance Country Index and country sketches.

GIFR 2012 continues its assessment of the state of the Islamic finance industry in over 40 countries. The Report provides bitesize review of significant developments in the industry, granting the reader an update of any major changes. In addition, the Islamic Finance Country Index (IFCI) offers a ranking of countries with regards to their work in Islamic finance. This is the second year of the IFCI and already we can see changes in the ranking showing how certain countries are pushing forward in Islamic finance, and how other countries are lagging behind.

ISLAMIC FOUNDATION

It would be beneficial to move past the current "banking" based model of Islamic finance intermediation and create a new model or innovate upon an old one. There are already examples where pioneering work has been done: the mudaraba model, as developed and implemented in Pakistan, is an innovative example of a new model of Islamic investment banking. Another model worth considering is the Islamic foundation.

An Islamic foundation would be a collective saving and investment programme that allows its members to save and collaborate together upon a commercial enterprise. An Islamic foundation could take several forms: it could be a deposit taking institution or may have a deposit taking institution as part of its overall operations.

The foundation model would be completely different from a banking based Islamic financial model. It may be based on the waqf so that the assets are locked into a structure that creates socially responsible assets. Principally, the foundation should ensure that its ultimate goal is to promote socioeconomic welfare for its members and for the wider society, through trickle down effects. An Islamic foundation must attempt to promote good economic agents in terms of efficiency, ethics, social responsibility and charitable giving. Examples of such objectives could be welfare of the elderly, welfare of women, animal sanctuaries and investing in children in need, etc.

The members of the Islamic foundation must demonstrate that they are efficient, ethical, responsible and charitable people. By way of example, each member would have a logbook containing a monthly account of at least one project conducted efficiently, ethically, responsibly and in a charitable way. The goods and services it produces must be sold in the market for competitive prices to make profit for the Islamic foundation. The profits would be reinvested within the foundation structure with members enjoying participatory benefits. For example, if the Islamic foundation runs a school, the members' children attending would benefit through paying a subsidised rate. Similarly, they must have easy and affordable access to healthcare and other social services. If the Islamic foundation runs a finance programme, it must give preferential treatment to its members. The Islamic foundation must provide interest-free loans to its members for home purchases and the financing of other durables like cars and other household items. By being a member of the foundation, saving and creating commercial enterprises, it engenders communal linkages, a sharing of resources and ideas and a pool of willing workers.

Commercial activity in the premodern Islamic world relied heavily on trust between market players and this built strong relationships, fostering commercial linkages between principals and agents in different cities. Bonds of trust amongst foundation members will ensure success of the foundation. There are unfortunately examples throughout the world where there has been an abuse of trust creating corruption within the foundation. However, these are examples of bad governance and a lack of regulation. As with any communal endeavour, the Islamic foundation has to be underpinned by a strong, enforceable rule of law.

As the examples of such social projects abound in the West as well as in the Muslim world, there is a need to study these different models to develop a new model of Islamic financial intermediation. An example of a conventional foundation is Fauji Foundation in Pakistan, which was set up in 1954 as a charitable organisation, and now is one of the largest industrial conglomerates in the country with total assets over 250 billion Pakistani rupees (USD3.5 billion), serving over 7% of the beneficiary population in Pakistan. It has investments in industrial production (e.g., cement, fertilizers, and oil & gas etc.), education, healthcare and financial services.

It is proposed that special arrangements be made to list such Islamic foundations on a stock exchange to ensure that those who invest in Islamic foundations must be able to redeem their investments if they wish to do so. However, to remain within the spirit of a foundation model, the listed stocks must be non-dividend paying and that the investors should have a choice of donating their capital gains, if any, back to the Islamic foundation. The efficacy of the Islamic foundation will be dependent on values and commitment of its participants, just as with any endeavour. Unity of focus coupled with a clear sense of community development and an attainable goal, will be key ingredients.