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Global Islamic Finance Report

GIFR 2011

Editor in Chief: Professor Humayon Dar
Associate Editor: Mufti Talha Ahmad Azami

A BMB Islamic Publication
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Editors’ Profiles

Professor Humayon Dar
Editor in Chief

Dr Humayon Dar is the Chief Executive Officer of BMB Islamic UK Ltd, a Shari’a advisory and structuring firm. He is a leading player in the Shari’a advisory business and has been associated with the most recent innovative developments in Islamic banking and finance including: structuring Islamic put options, developing Shari’a-compliant short-selling techniques and engineering an Islamic financial futures contract. His most recent contribution to the Islamic financial industry is the first-ever Islamic Socially Responsible Investing – SRI – screening methodology. Dr Dar holds a BSc (Hons) and MSc (both in Islamic Economics) from International Islamic University in Islamabad, where he studied with a number of top Islamic jurists and Muslim thinkers. He also has an MPhil and PhD (both in Economics) from Cambridge University, where he conducted research on Islamic Finance. His post-doctoral research has focused exclusively on Islamic economics, banking and finance.

Mufti Talha Ahmad Azami
Associate Editor

Mufti Talha Ahmad Azami is the Associate Shari’a Manager at BMB Islamic. A seasoned and dynamic UK based Shari’a scholar with a specialization in Islamic Commercial Law, Mufti Talha serves as the in-house Shari’a scholar for BMB Islamic and plays an instrumental role in the management of the firm’s Shari’a advisory services. Mufti Talha is responsible for Shari’a structuring, screening & monitoring, research and publications. Prior to BMB Islamic, he worked in Islamic Academia with prominent scholars from India for more than ten years. Mufti Talha holds a BA in Arabic and Quranic Sciences and an MA in Islamic law from Nadwa University in Lucknow, where he studied under a number of leading Islamic jurists and Muslim thinkers. He also has an MA in Hadith Sciences from Islamic University in Deoband and an MA in Islamic Banking and Finance Management from Loughborough University in the UK.
Preface

In the Name of Allah, the Most Beneficient, the Most Merciful

An indicator that one’s work has been beneficial is praise. So it was with a humble delight that the groundbreaking Global Islamic Finance Report 2010 (GIFR 2010) received such admiration for its depth of coverage, incisive commentary and quality of analysis of the Islamic finance industry. There is compelling reason to continue with this path breaking trend which has benefited so many around the world. Hence, we are pleased to once again work with old colleagues and new friends in producing the GIFR 2011.

Not wishing to rest on the laurels of its predecessor, the GIFR 2011 builds further on the comprehensive and robust analysis of GIFR 2010 bringing in three important additions. Firstly, a major theme of GIFR 2011 will be the regulation of Islamic financial services industry and the role different regulatory bodies and industry-wide institutions (e.g., AAOIFI, IFSB and IDB etc.) have played in the development of Islamic banking and finance. Secondly, with the growing international interest in Islamic finance, it is expedient to analyse the state of the Islamic finance industry in various countries around the world. It provides a comprehensive overview and allows readers to see the tangible growth of Islamic finance in one country vis-à-vis another. Finally, the introduction of an innovative index (IFCI); a composite statistic encompassing a range of variables will provide an immediate evaluation of the integration of Islamic finance into a country’s financial system.

In a constantly changing financial world, it is imperative to be aware, to extol the virtues, convey new developments and highlight the challenges Islamic finance faces so that those can be resolved. The GIFR 2011 intends to bring issues to the foreground, to provide an accurate and comprehensive account of the industry and to continue positive discussion and ignite new ideas. It is an ambitious objective but one which needs to be continually fulfilled.

Edited by two of the foremost advocates of Islamic banking and finance, Professor Humayon Dar and Mufti Talha Ahmad Azami, GIFR 2011 promises to be yet another ground breaking initiative of BMB Islamic – winner of the Islamic Finance News – IFN – ‘Best Islamic Shari’a Advisory Firm’ 2008.
Dr Adnan Aziz
BMB Islamic

A formally trained Islamic banking and finance expert, Adnan is best known in the industry for his valuable contribution in expanding the frontiers of Islamic banking and finance as part of the world’s best Shari’a structuring team. He has pioneered several innovative Shari’a financial engineering techniques. Adnan possesses a wealth of academic and research experience from Pakistan, UAE and UK. He received formal academic training in the field of Islamic economics, banking and finance from the International Islamic University (IIU) in Pakistan and a PhD from Loughborough University in UK. Previously Senior Manager at a Shari’a Advisory firm (majority held by Deutsche Bank) and Head of Shari’a Advisory and Structuring for BMB Islamic, Adnan is currently heading business development at BMB Islamic. He is primarily involved in exploring new business ideas and relationship management of senior executives across the industry. His deep understanding of Shari’a, hands-on experience of working on some of the most innovative Islamic financial products, excellent relationships with most of the top industry Shari’a scholars, and high standards in academia and research have positioned Adnan amongst the handful of those unique professionals who are just the right fit for the evolving Islamic finance industry. He has authored several research articles and is a frequent speaker at industry conferences.

Dr Akram Laldin
International Shari’a Research Academy (ISRA)

Dr Mohamad Akram is currently the Executive Director of International Shari’a Research Academy for Islamic Finance (ISRA). Prior to joining ISRA he was an Assistant Professor at the Kulliyah of Islamic Revealed Knowledge and Human Sciences, International Islamic University, Malaysia (IIUM). At present, he is a member of a number of Shari’a Advisory Boards including Bank Negara Malaysia, HSBC Amanah, and the International Islamic Financial Market (IIFM). He is the Chairman of Islamic Advisory Board of HSBC Insurance, Singapore, and is Committee member of AAOIFI Shari’a Standards, Bahrain. He is a registered Shari’a Advisor for the Islamic Securities with the Securities Commission of Malaysia and has acted as Shari’a advisor in the issuance of several sukuk’s. Dr. Akram holds a B.A. Honours degree in Islamic Jurisprudence and Legislation from the University of Jordan, Amman, Jordan and a Ph.D. in Principles of Islamic Jurisprudence from the University of Edinburgh, United Kingdom. He has presented many papers related to Islamic banking and finance and other fiqh topics at national and international level and has conducted many training sessions particularly on Islamic banking and finance for different sectors since 1999. In addition he is also prolific author of academic works specifically in the areas of Islamic banking and finance. He is the recipient of Zaki Badawi Award 2010 for Excellence in Shari’a Advisory and Research.

Adrian Woodcock
Norton Rose (Middle East) LLP

Adrian is a Corporate Finance Of Counsel based in Bahrain. Adrian has been active in the region for over 8 years and his main areas of focus are equity capital markets, joint ventures and mergers & acquisitions covering a broad cross-section of industry sectors including financial institutions, manufacturing and technology. Adrian advises a variety of companies from the UK, US, Russia, Western Europe, Middle East and Asia.

Amman Mohammad
Amman Muhammad was appointed Managing Director of Absa Islamic Banking in mid 2009, three years after its launch. His task is to increase the footprint, customer base and product offering. Nine months after his appointment, Islamic Banking was launched in Tanzania, though the National Bank of Commerce (NBC) of which Absa is the majority shareholder. Absa Islamic Banking was also chosen Best Islamic Bank in Africa & the Middle East (non-GCC) for 2009 & 2010 by the analysts associated with Global Finance magazine. Prior to joining Absa, Amman headed up the Deloitte South Africa Islamic Financial Services practice. He is an active member of the Banking Association committee on Islamic Banking and the National Treasury Working Group looking at levelling the playing field for Islamic banks in South Africa.

Andrew Henderson
Clifford Chance LLP

Andrew Henderson is a senior associate in the financial services regulation group in Clifford Chance’s London office. He lead Clifford Chance’s Middle East financial services regulation group from 2006 until late 2010. He has advised banks, investment banks, brokedealers, fund managers, exchanges and clearing houses in the UK and Middle East. This has included advice on establishment of Shari’a based businesses and the regulatory aspects of Shari’a based products and services.

Anouar Hassoune
Moody’s

Anouar Hassoune, 33, is a Senior Credit Officer based in the Paris office of Moody’s Investors Service, one of the leading rating agencies globally. Before this position, Anouar used to be a credit analyst at another well-known rating agency, namely Standard & Poor’s. Anouar is responsible for the rating coverage of banks in the Middle East and North Africa, and also handles the global coordination of Moody’s initiatives in the field of Islamic finance. Anouar’s academic background includes a master’s degree in Business Administration from Paris-based HEC Business School, a master’s degree in Political Science from the Paris Institute for Political Studies, a post-graduate degree in Economics from the University of Paris, as well as the “Agrégation” certification in Business and Finance earned at the French “Ecole Normale Supérieure”.

Asim Anwar Kamal
BMB Islamic

Asim Anwar Kamal graduated from the International Islamic University Malaysia (IIUM) with a 1st class honours degree in Economics, specialising in Islamic Economics & Finance. Throughout his time at IIUM he excelled and was awarded the IIUM scholarship for academic excellence. He graduated as the top ranked student and was also awarded the Best Student in Islamic Economics prize. After completing the degree, Asim was awarded a scholarship from Bank Negara Malaysia (BNM) to pursue their Chartered Islamic Finance Professional Programme (CIFP), which he recently completed. Asim is currently at BMB Islamic London, where he has been involved in Shari’a Structuring & screening and has contributed extensively to the Global Islamic Finance Report 2011.

Dr Asmadi bin Mohamed Naim
University Utara Malaysia (UUM)

Dr Asmadi Mohamed Naim, born in Kelantan, Malaysia in 1970, is an Associate Professor of Islamic Finance & Banking at the College of Business, University Utara Malaysia (UUM). Previously, he was appointed as Deputy Dean of Academic Affairs and Student Development at the Faculty of Finance and Banking from 2006 to 2007. Prior to that, he was assigned as Deputy Director of the Islamic Centre, UUM and Coordinator for Islamic bank courses with private higher institutions. Since 2008, he has been attached as a Shari’a Consultant with Hong Leong Islamic Bank Malaysia (HLISB). He obtained a Shari’a degree from the University of Jordan, and a masters and PhD in Fiqh and Usul Fiqh from the International Islamic University, Malaysia (IIUM), specializing in Islamic financial contracts. He recently completed the Chartered Islamic Finance Professional from INCEIF in 2010. He has authored several books and numerous articles in reputable national and international journals, magazines and newspapers. He is actively involved in producing research funded by the UUM as well as other institutions such as CAGAMAS, ISRA, OUM and Asia e-University. He has received a number of awards including the Award for Best Writer for Consumer (magazine criteria) by the Ministry of Internal Trade and Consumer Affairs and Institut Akhbar Malaysia (AIM) in 2003;
Don Brownlow
International Banking Systems

Through his work at IBS Publishing and his 30 years experience of banking IT, Don is regarded as an authority on the banking systems market and its participants, authoring numerous white papers, specialist publications and articles on banking systems and their application within the industry. He has worked in senior bank-IT management roles, in banks’ user operations departments and in consultancy roles. He has been employed in banks in the City of London and overseas, often specialising in systems selection projects and project managing the resulting systems implementations. Don has also been extensively involved in Islamic banking and finance – taking a specialist interest in the systems implications of Shari’a-compliance. As an Associate Fellow of the London-based Institute of Islamic Banking and Insurance (IBI) and the holder of a Post-Graduate Diploma in Islamic Banking, Don has conducted consultancy assignments relating to this growing industry. He has provided advice to vendors looking for potential compliance of their systems and examined the requirements of banks looking to select or migrate to Shari’a-compliant systems. He has been variously commissioned to produce white papers and specialist market reviews on the international market for Islamic banking systems, the specialist needs of Islamic bank users, and the particular risks assumed by the Islamic banking industry.

Ayman Abdel Khaleq
Vinson & Elkins LLP

Ayman Khaleq is a partner at Vinson & Elkins based in Dubai. His practice focuses on advising clients on corporate and structured finance transactions with a particular emphasis on the structuring and documentation of Islamic finance and investment products (including sukuk offerings backed by pools of global assets). In addition, he advises clients on the structuring and formation of innovative Shari’a-compliant real estate, infrastructure and private equity funds and investments. Ayman has been involved in a number of privatization and deregulation transactions across a number of Middle East countries such as Bahrain, Saudi Arabia, Qatar, and Jordan, and has been advising foreign investors on doing business in the Middle East for more than ten years. Some of the key sectors in which Ayman practices include infrastructure, telecommunications, media, technology, and energy (including renewable energy). Ayman is qualified in New York State and Jordan and is fluent in Arabic and English. He holds LL.M (honors) from the George Washington University and an LLB (highest honors) from the University of Jordan Faculty of Law.

Datuk Noripah Kamso
CIMB Principal

Datuk Noripah Kamso is the Chief Executive of CIMB-Principal Islamic Asset Management Sdn Bhd. Since 2008, she has successfully established a platform for the firm to extend its reach across the globe. The firm acts as a global partner to institutional investors, providing a range of Shari’a investment portfolios to suit differing investment needs. She was previously Chief Executive of CIMB-Principal Asset Management Berhad from September 2004 to October 2008, after bringing more than 23 years experience, combining Commercial Banking and Investment Banking. During that period, she has managed a Derivatives Broking Outfit via CIMB Futures Sdn Bhd for 9 years. Deemed a two-time winner of the “Marketing Personality of the Year” award (for 2006 & 2005) by Asia Asset Management for the Asia Pacific region and CEO of The Year for Malaysia (2007), Datuk Noripah has successfully overseen CIMB-Principal’s further expansion into new markets and institutional mandates. Besides serving as a Council Member of the Federation of Investment Managers Malaysia (FIMM), she was the Past President of the Malaysian Futures Brokers Association (MFBA).

Etsuaki Yoshida
Japan Bank for International Cooperation (JBIC)

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Fadzlan Sufian is currently associated with Khazanah Nasional Berhad and the Department of Economics, Faculty of Economics and Management, Universiti Putra Malaysia. His research concerns performance measurement, efficiency, and productivity analysis.

Dr Hatim Tahir

Dr Tahir is a Director at Deloitte ME Islamic Finance Group, and Leader of Deloitte ME Thought Leadership in Islamic Finance. He has over 27 years of experience in business finance and spent 20 years in Islamic financial services focussing on Islamic Finance and Takaful regulation, risk management and compliance. His other core expertise included business advisory, financial education, and applied research. Prior to joining Deloitte, Dr Tahir worked for Dubai International Financial Centre in a senior role and led a competency-based capital market education initiative for the NASDAQ Dubai. Dr Tahir has extensive knowledge and expertise in the Gulf financial marketplace and worked closely with several GCC regulators in regulatory assignments, training and education, research and advisory. His most recent applied research examined “the Securitised Sukuk Instruments in the Gulf Region”, published by Harvard University Forum on Islamic Finance, Harvard Law School. He is a Member of the AAOIFI’s Auditing and Governance Standards Committee and Visiting Research Fellow at ICMA, University of Reading, UK.

Dr Jarmo Kotilaine

Jarmo Kotilaine joined NCB Capital, a Riyadh-headquartered investment bank, as Chief Economist in 2008. He previously advised the Spanish stock exchange, Bolsas y Mercados Españoles (BME), and oversaw financial services consultancy at Control Risks Group (CRG), a London-based international business risk consultancy firm. Prior to that he headed the Financial Services practice area of Oxford Analytica where much of his work focused on emerging capital markets. His main clientele has consisted of banks, stock exchanges and financial regulators, some of which he has continued to serve as an external advisor. He is a frequent columnist and commentator on Middle Eastern and global financial and economic issues. Jarmo studied economics and economic history at Oxford (BA/MA), Cambridge (MPhil), and Harvard (AM, PhD). He subsequently joined the faculty at Harvard where his primary research focus was the long-term economic and institutional development of Eurasia as well as on international trade and finance. Jarmo’s languages include Russian, German, French and Polish.

Isam Salah

Isam Salah is a senior finance partner in King & Spalding’s New York and Dubai offices and heads up the firm’s Middle East & Islamic Finance Practice Group. His practice covers a broad range of international and domestic finance and investment matters, with particular emphasis for the past fifteen years on the structuring of Shari’ah-compliant finance and investment transactions. His work in this area has included the first and more than a dozen, Shari’ah-compliant financings for private equity investments, the utilization of a Rule 144A high-yield note offering to fund the Shari’ah-compliant financing of private equity investment, several billion dollars worth of Shari’ah-compliant property investments, the implementation of the first Euro-Sukuk transaction on behalf of a corporate issuer, the structuring of mezzanine and junior secured property financings (securitized and rated), and the structuring of a home mortgage product. He is a frequent writer and speaker on the topic of Islamic finance and investment. He is a former President of the Arab Bankers Association of North America. A graduate of Case Western Reserve University, Mr. Salah received his law degree from Cleveland State University, where he served as Editor-in-Chief of the Cleveland State Law Review. He received his LLM from Georgetown University, where he held a fellowship at that University’s International Law Center.

Jasani Abdullah

Jasani Abdullah joined Hong Leong Islamic Bank (HLISB) in June 2007. Prior to joining HLISB, he was with the RHBank Banking Group for over 24 years where he was involved in branch operations, regional credit and marketing, Islamic consumer, commercial and corporate banking business. At RHBank, he was instrumental in bringing up its Islamic banking business from a window based environment right up to the Islamic subsidiary level. When he left RHBank, he was Vice President and Head of Product Development Division, RHBank Islamic Bank. At HLISB, he spearheads banking operations activities which covers amongst others Shari’a & product
John A. Sandwick has been a private banker in Geneva, Switzerland, since 1993, and an investment and banking professional since 1989. He has built as cornerstones of his profession an expertise in Islamic asset management, Islamic asset securitization and Islamic real estate financing. From 1984 to 1989, John was a director at the Washington-based Middle East Policy Council, where he led numerous programs on U.S.-Arab economic, commercial and investment policy management issues. During 1989-93 he worked at REM Capital Corporation in Washington, followed by joining Deutsche Bank (Suisse) S.A. in 1993, and later Banque Leu S.A. (a division of Credit Suisse Private Banking), both in Geneva. John was managing director of Encore Management S.A. in Geneva from 1999 through 2009. He is now an independent consultant specializing in Islamic wealth and asset management. Mr. Sandwick is one of the most active innovators in Islamic banking, having created several first-ever investment products such as a sukuk fund, a sukuk basket participation note, and soon a Real Estate Investment Trust (REIT) in Saudi Arabia. He is currently developing other long-term fixed-asset Islamic funds for individual and institutional investors. In private banking, he directed traditional and Islamic wealth management for several high net-worth families, particularly in Saudi Arabia, and managed large volumes of both financial and real estate assets. John was one of the first Islamic bankers anywhere to develop practical Islamic wealth management solutions for the private banking industry, including creating Islamic model portfolios for all major investment strategies. John Sandwick did undergraduate studies in International Finance & Commerce at Georgetown University, and a Master’s with honors in Development Banking at The American University, both in Washington. Chapter 7 is based on studies undertaken by this contributor.

John Yip
Islamic Bank of Asia

John Yip is the senior vice president of the capital markets department at the Islamic Bank of Asia in Singapore. He works upon sukuk, buy side mergers and acquisitions and general Shari'a related mandates. He has advised on major sukuk issuances including the Monetary Authority of Singapore SGD sukuk al-jara reversed inquiry programme and the largest ever SGD sukuk issuance for Khazanah Nasional, Malaysia’s sovereign development fund. John has held senior posts at The International Investor, a Kuwait based Islamic investment bank, and at RHB Securities, where he was the youngest ever team leader. He worked for UOB Asia and was instrumental in the structuring and arrangement of the first sukuk issuance out of Singapore. In recognition of John’s contribution to the field of Islamic finance, he had been invited to join the esteemed ranks of the Islamic Finance Committee of Labuan Offshore Financial Services Authority of Malaysia. John graduated with a LL.B(Hons) from the National University of Singapore. He has a postgraduate qualification in Islamic Banking & Finance from the International Islamic University Malaysia and a Masters in finance from the University of Hull. John is a member of the Society of Technical Analysts of the United Kingdom. John’s study on the profitability of Islamic banks is reproduced for Chapter 11.

Dr. M. Kabir Hassan is a financial economist with consulting, research and teaching experiences in development finance, money and capital markets, Islamic finance, corporate finance, investments, monetary economics, macroeconomics and international trade and finance. He provided consulting services to the World Bank (WB), International Monetary Fund (IMF), Islamic Development Bank (IDB), African Development Bank (AfDB), USAID, Government of Bangladesh, Organization of Islamic Conferences (OIC), and many private organizations and universities around the world. Dr. Hassan received his BA in Economics and Mathematics from Gustavus Adolphus College, Minnesota, USA, and M.A. in Economics and Ph.D. in Finance from the University of Nebraska-Lincoln, USA. He is now a tenured Professor in the Department of Economics and Finance at the University of New Orleans, Louisiana, USA. He has more than 100 papers published in refereed academic journals to his credit. Dr. Hassan supervised 27 doctoral theses, and many of his students are now well placed in the academia, government and private sectors. He is editor of The Global Journal of Finance and Economics and Journal of Islamic Economics.
Banking and Finance, and Co-Editor of Journal of Economic Cooperation and Development. Dr. Hassan has edited and published many books along with articles in refereed academic journals. Dr. Hassan is co-editor (with M.K. Lewis) of Handbook of Islamic Banking and Islamic Finance, The International Library of Critical Writings in Economics (Edward Elgar: 2007), and co-editor (with Michael Mahlknecht) Islamic Capital Market: Products and Strategies (John Wiley and Sons, forthcoming 2010). He is co-author Islamic Entrepreneurship (Routledge UK, forthcoming 2010), and co-author (with Rasem N Kayed and Umar Oseni) of Islamic Finance (Pearson Publishing Company, 2012 Forthcoming). A frequent traveller, Dr. Hassan gives lectures and workshops in the US and abroad, and has presented over 100 research papers at professional conferences.

Kamran Khalid Sherwani
Dar Al Shari'a

Kamran is currently working with Dar Al Shari'a, Dubai Islamic Bank as AVP (Senior Consultant – Sharia and Legal). Previously he worked with Emirates Islamic Bank’s Sharia Structuring and Coordination Department as an in-house counsel from 2006 to 2008. He studied Islamic Shari’a and law at International Islamic University Islamabad, Pakistan. He has been actively involved in transactions such as Sukuk, Syndications and project finance apart from other corporate and retail Shari’a-compliant finance products. He is involved in structuring of products, drafting of agreements, submission of the same to the Shari’a Board and getting them approved by the Board. Most recently, he played a pivotal role in development, structuring, documentation, and Sharia approval of recently launched personal finance product (launched by Dubai Islamic Bank) based on Salam. In the process of all the aforementioned activities, he works very closely with Dr. Hussein Hamid Hassan, who is one of the leading Shari’a scholars in the world. Kamran has also participated in quite a few training workshops and conferences in relation to Islamic finance, banking and insurance as speaker or trainer. He worked with PTCL and Ufone, major telecom companies in Pakistan, as in-house lawyer.

Kashif Jahangiri
KPMG

Kashif is a Tax Director with KPMG in Ireland since October 2006 and is mainly involved in Islamic finance practice of KPMG. Prior to that, he headed up KPMG’s tax practice in Islamabad, Pakistan where Islamic finance transactions are taxed on the same basis as conventional finance transactions. Kashif has a deep understanding of Islamic finance products and transactions. Being a practicing Muslim, he is well aware of the religious principles underpinning Islamic finance products. Kashif is an active member of KPMG’s Global Islamic Finance Group. He has authored articles on Islamic finance and has also spoken on the subject at international seminars. Kashif is a fellow member of the Institute of Chartered Accountants of Pakistan. Besides, he holds graduation degrees in commerce, business administration and law. Kashif has also co-authored a book on Pakistan’s income and corporation tax law which has been adopted by the Institute of Chartered Accountants of Pakistan as recommended reading for professional students.

Madzlan Bin Mohamad Hussain
Zaid Ibrahim and Co

Madzlan Mohamad Hussain is a Partner of the Islamic Banking and Finance Practice for Zaid Ibrahim & Co. (ZICO), a regional law firm with presence in Indonesia, Malaysia, Singapore, Thailand, Vietnam, the UAE and most recently, Australia. He started his career with the firm in 1998 as a trainee associate. Madzlan’s engagements include advising government authorities on Islamic finance prudential framework; advising financial institutions on the legal and regulatory compliances for their Islamic finance operations; standardisation of Islamic finance documentation; structuring and designing Shari’ah-compliant financial products; Islamic corporate financing facilities; and issuance of Islamic securities. In 2004, Madzlan joined the Islamic Financial Services Board (IFSB), an international standard-setting organisation for the Islamic financial services industry, based in Kuala Lumpur. During his 6-year stint at the IFSB, he was particularly responsible in overseeing the development of prudential framework for corporate governance practices for all segments of Islamic financial services and was instrumental in spearheading IFSB’s initiatives in addressing legal issues in Islamic finance. He returned to ZICO as a partner in February 2010. Madzlan holds a law degree from International Islamic University Malaysia and a master degree in Islamic finance from Loughborough University, United Kingdom. He was admitted as an Advocate and Solicitor, High Court of Malaya since 1999 and is an Associate, Chartered Islamic Finance Professional since 2009.
Mehreen Mahmood Awan
Agha & Co

Mehreen Mahmood Awan is an associate in the Islamic Finance Practice group at Agha & Co, Dubai. Mehreen’s primary area of practice is corporate finance, including mergers and acquisitions, company formation and cross border transactions. Mehreen specializes in Islamic finance transactions and has represented various clients in the GCC in the development and implementation of Shari’a-compliant financing and investment structures, including lease finance (Ijara), acquisition finance (Ijara wa-iqtinah), construction finance (Istisn’a - Ijara), joint ventures (Musharaka), capital and services partnership (Mudaraba) and safe-keeping arrangements (Adel), contract of construction or manufacture (Istisn’a). Mehreen regularly advises clients on matters of compliance with Shari’a and Saudi laws. Prior to joining Agha & Co, Mehreen worked at a large reputable UAE law firm, assisting on a range of matters. Mehreen is a graduate of Lahore University of Management Sciences (LUMS), Pakistan, where she studied Shari’a and Islamic Banking & Finance as part of the curriculum towards attaining her degree in B.A-LL.B. Mehreen also holds the Real Estate Authority (RERA) certification from the Land Department, Government of Dubai.

Mian Muhammad Nazir
Dar Al Shari’a

Mian Nazir is Senior Vice President of the Shari’a Coordination Department (Dar Al Shari’a) at Dubai Islamic Bank. Previously Mian Nazir was a legal advisor to Dallah Al Baraka and the Director of Law and Regulatory Affairs, Pakistan Telecommunication Authority where he advised on telecommunication regulations and investments in addition to assisting Government of Pakistan in drafting the Electronic Transactions Ordinance (2000). Nazir’s educational background in both English commercial law and the Shari’a, along with his extensive experience in advising high end clients on the full portfolio of Shari’a-compliant products has acclaimed him as an expert and trusted advisor on product development and the drafting of legal documentation. He is regularly invited to speak on issues relating to Islamic finance and has conducted training workshops for organisations such as Redmoney and the Institute of Islamic Banking and Insurance. Mian Nazir is a BSc graduate of International Islamic University, Pakistan and a holder of an LLM from the University of Cambridge.

Dr Muhammad Qaseem
Dubai Islamic Bank (Pakistan)

Dr Muhammad Qaseem received his PhD in Tafseer and Qur’anic Sciences from the Faculty of Usul ud Din, International Islamic University, Islamabad. He also holds degrees in Tafseer & Hadith and has over ten years of experience in contributing to academic topics on Islamic finance. He is the author of numerous articles and books on Islamic finance and notably translated a sizeable part of the verdict of the Supreme Court of Pakistan, banning interest. He also has 18 years of University teaching experience in the Islamic sciences in various programmes. A member of numerous Shari’a boards in the UAE and Pakistan he has notably worked on many landmark Islamic sukukas and innovative structures. Currently the Country Head of Shari’a Affairs in Pakistan for the Dubai Islamic Bank, Dr Qaseem is the foremost representative of a younger emerging cadre of Shari’a scholars continuing to expand the frontiers of Islamic finance. Fully conversant in five languages, he has notable civil commitments in being amongst the chief translators for the President of Pakistan. Some of his current appointments as member of a Shari’a Board include: National Mudaraba Sukuk of NBC, UAE; Dubai Financial Markets, UAE; Dubai Islamic Bank-Pakistan; Dubai International Financial Centre Sukuk, UAE; and BMB Islamic. He also sits on the Shari’a Board for the Sukuk Al-Watiniyah.

Dr Mian Farooq Haq
State Bank of Pakistan

Dr. Mian Farooq Haq is a PhD holder from London School of Economics and Political Science and is working as a Senior Joint Director at the central bank of Pakistan. He is currently heading Prices and Socioeconomic Division in the Economic Analysis Department. His areas of interest include Islamic finance and various banking practices, development policies, cultural context at national and organizational level, social construction of technology etc. At the central bank, he regular contributes to the Monthly Inflation Monitor, Global Commodity Watch, Annual Report and quarterly reports. His recent research at the central bank includes a project quantifying the demand for Islamic finance in Pakistan and a KAP (Knowledge, Aptitude and Practice) based study of Islamic finance.
Mohammed Paracha  
Norton Rose (Middle East) LLP

Mohammed is a Banking Partner based in the Bahrain office of Norton Rose (Middle East) LLP where he is also the Deputy Head of the Global Islamic Finance Practice. Mohammed specialises in Islamic financial and banking transactions and has a broad range of transactional experience. Mohammed trained and qualified with Norton Rose Group and has spent time recently as in-house counsel at a large bank before returning to Norton Rose Group. Mohammed is a regular speaker at Islamic finance conferences and seminars on wide range of topics. The IFLR describe Mohammed as “a talented lawyer”. Mohammed is fluent in Urdu and Punjabi.

Neil Miller  
Norton Rose (Middle East) LLP

Neil D Miller is a Finance lawyer based in Dubai where he is Head of Banking and Islamic finance. He specialises in Islamic products covering different asset types, investment classes and industry sectors creating Shari’a-compliant instruments for general, banking, asset and project finance transactions, asset and wealth management purposes and hedging and risk management solutions. He regularly advises on Shari’a governance and related issues concerning compliance and governing law). He has also advised on a number of Sukuk (including restructurings). In 2008 Legal 500 described Neil as “the most proactive, client friendly Islamic finance lawyer, with a can-do attitude that ensures deadlines are met.” The recently published Chambers 2000 said: “The arrival in the Dubai office of the firm’s global head of Islamic finance, Neil Miller, surely spells good things for the team”. Miller was “one of the first Western lawyers to pay serious attention to Islamic finance” and, consequently, has excellent experience in structuring transactions and advising on regulatory matters. Neil spent five years running the Group’s office in Bahrain and was the founder in 2000 of Norton Rose’s Global Islamic Finance Group. He is a member of the Islamic Finance Experts Group (advisers to the Government) a regular commentator and thought leader on the subject.

Noeleen Goes-Farrell  
Trident Fund Services Luxembourg S.A.

Noeleen Goes-Farrell is a Director of Trident Fund Services Luxembourg S.A. and worked in the financial services industry in both Luxembourg and the Netherlands for over 18 years in private banking and retail brokerage for Merrill Lynch, Prudential Securities and JP Morgan before joining the Trident Group in 2008.

Oliver Agha  
Agha & Co

Oliver Agha is a founding partner of Agha & Co and Agha & Shamsi boutique law firms believed to be the first Shari’ah compliant law firms. The law firms were established to put principles before profit and their representations is limited pursuant to an express ethical code. The Firm’s members provide world-class transactional skills seamlessly coupled with comprehensive Shari’ah knowledge and backed by one of the leading Shari’ah Advisory board that include Sheikh Mohamed El Gari, Abdul Sattar Abu Ghuddah and Esam Ishaq. Mr. Agha, is a New York licensed attorney, formerly with leading international (top 50 Am Law) firms. He has extensive experience in corporate (M&A), project finance, banking and cross-border structured financings, including for the International Finance Corporation (IFC) in Asia (Japan, China, South Korea, Thailand, Indonesia, Vietnam, India, Pakistan, Nepal and Sri Lanka) and as a lead lawyer in many of the leading and award winning deals in the Gulf Cooperation Council (GCC) region. Mr. Agha is also on the board of the leading supra-national Islamic finance standard-setting body - Accounting and Auditing Organization of Islamic Finance Institutions (“AAOIFI”) and is recognized as a top Islamic finance lawyer by numerous publications. He is the author of various notable published papers, articles and presentations regarding salient Islamic finance topics and is regularly invited to speak at numerous Islamic conferences and as a guest on television (e.g., CNBC) and radio. Mr. Agha has been involved in regional deals that aggregate over US$40 billion, including those that have been financed according to Shari’ah. Mr. Agha has developed innovative, but genuine, Islamic structures that are also commercially viable. Mr. Agha’s practice encompasses project finance (petrochemicals, power, and infrastructure), Islamic banking (Islamic product development), Islamic capital markets (sukuk), Islamic private equity, Islamic real estate financing and Islamic insurance (takaful) as well as advising governments in developing the regulatory infrastructure to house Islamic finance. Mr. Agha is a member of the State Bars of New York and Connecticut and, previous to his current roles in the Middle East, practiced as a...
Omar Shaikh
Islamic Finance Council

Omar sits on the UK Treasury and UKTI Islamic Finance Advisory Sub-Committees and is a Board Member of the Islamic Finance Council UK (‘IFC’), a not-for-profit body established to promote the Islamic finance industry. The IFC is actively involved internationally in education of scholars and assists various universities and provides strategy advisory to private sector bodies. In addition Omar currently holds select Islamic finance related Board Advisory roles for private sector institutions, including a Gulf based private equity investment manager, RHT Partners. Omar’s background includes working with Ernst & Young UK firm where he was recognised as the firms Subject Matter Expert for Islamic finance and successfully lead the build out of the UK Islamic financial services across multiple sector teams. He has worked with the EY UK Private Equity team providing financial due diligence and the multi-award winning EY Islamic Financial Services Group in Bahrain. Working in EY Bahrain he worked on creating operational frameworks for new Islamic banks and managing the conversion of existing conventional banks into Islamic financial institutions. Omar has trained as an auditor and received his CA qualification from ICAS, and a Bachelor in Accounting and Finance from the University of Glasgow, UK. He has presented on Islamic finance at various international conferences in the Gulf, Europe, Asia and Africa.

Peter Casey
DFSA

Peter Casey joined the DFSA in 2002 as Director, Insurance. In 2004, his responsibilities were extended to other areas with the authority. In 2007, he was appointed Director, Policy and in 2009 he also became Head of Islamic Finance. In 2010, his responsibilities were further extended to include Strategy. Before joining the DFSA, Mr Casey was Head of the Non-Life Insurance Department of the UK Financial Services Authority. Before that, he held senior regulatory posts in the Treasury, the Department of Trade and Industry and the Office of Fair Trading. He has wide experience of UK Government, having also served in the Cabinet Office and Science Research Council, and having worked in areas ranging from export promotion to the creation of computer misuse legislation. Mr Casey was educated at Cambridge University.

Philippe Neefs
KPMG

Philippe is a partner with KPMG Tax Luxembourg since 2007, mainly in charge of Commercial & Industrial clients and specialised in the Luxembourg tax aspects of interposing Luxembourg vehicles to structure holdings, IP and finance structures in various European and non-European countries. Philippe’s professional experience includes Merger & Acquisitions and cross-border tax planning (holding, financing, Intellectual Property structures, private equity, real estate structures, and distribution channels). He is a member of the International Corporate Tax, the Merger & Acquisition and the Global Information Communication and Entertainment tax networks of KPMG. He has successfully carried out significant restructuring and merger projects for US and Continental European investors and multinationals. He also advised on restructurings for principal steelmakers in Russia.

Qudeer Latif
Clifford Chance LLP

Qudeer Latif is Head of Islamic Finance for Clifford Chance. He has worked in London, Dubai and Riyadh with Clifford Chance and his practice covers structuring and implementing Islamic instruments across a number of asset classes including the capital markets, project finance, acquisition finance, structured finance and asset finance fields. Clifford Chance has advised on more than US$30 billion worth of Islamic finance transactions in 2008 to date across a number of asset classes including a number of deals in which Qudeer has been actively involved including the US$1 billion sukuk-al-mudaraba for Sourouh (the largest Shari'a-compliant securitisation to date) the US$2 billion Islamic facilities for the Ma'aden Phosco project financing and the US$425 million bai salam acquisition financing of EFC in Egypt. Qudeer was also instrumental in the finalisation of the first standardised Islamic finance contract, the master agreement for treasury placement earlier this year. Qudeer is recognised as a leading global Islamic finance lawyer by a number of independent journals and directories.

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Rehan Pathan
NCB Capital

Rehan Pathan is the Head of International Sales at NCB Capital covering Asset Management, Brokerage and Investment Banking sales outside Saudi Arabia. NCB Capital is among the leading regional investment managers as well as the world’s largest Shari’a-compliant Asset Management Company. NCBC ranks among the top 3 brokers in Saudi Arabia and is a leading player in the domestic Investment Banking arena. Rehan and his team focus on growing NCBC’s presence in international markets and help the firm achieve its vision of becoming a leading provider of Shari’a-compliant and regional investment management solutions and funds, regional securities trading and access to Saudi Investment Banking opportunities globally. Rehan joined NCB Capital in September 2008 after 6 years with Deutsche Bank, first in Bahrain and then in Dubai. In his last role with DB, Rehan was with Deutsche Asset Management, based out of the DIFC, Dubai where he was Vice President, DWS Sales and Distribution for the MENA region. In this role he helped build and develop the fund business for DB Asset Management across multiple regional and international distribution channels. One of his key areas of focus was the distribution of the DWS NOOR range of Sharia compliant funds. Prior to his role with the asset management group, Rehan worked for Deutsche Bank’s Global Transaction Banking division, where he managed Institutional Sales, again in the MENA region, including Pakistan. He began his career in 1997 with ABN AMRO, Bahrain, working in the Private Banking and Corporate Banking Divisions. Rehan is a graduate of the University of Bahrain with a B.Sc. in Business Administration and holds an Executive MBA in Islamic Finance from Cass Business School of City University, London.

Rizwan Malik
BMB Islamic

Rizwan Malik is part of the new crop of talented and dedicated professionals within the Islamic finance industry. He holds a BA and an MSc in Banking and Finance. His Masters dissertation on ‘Performance of mutual funds in the Islamic finance industry’ compared and contrasted the risk/return profile of Islamic, ethical and conventional mutual funds. Since leaving higher education, Rizwan has worked at BMB Islamic as an Associate. He has worked on an array of projects including stock screening of equity funds, structuring of Shari’a-compliant products and editing documentation. Rizwan has been a key part of the team responsible for the creation of the groundbreaking Islamic Finance Country Index (IFCI).

Rizwan Rahmad
BMB Islamic

Rizwan has enjoyed a short but diverse career embarking on a path that has seen him work in several sectors. Having completed his Masters in economics, he worked at the World Bank in Bangladesh, acting as a researcher for the Senior Economist. After returning to the UK, Rizwan has pursued his legal studies while working at leading law firms and has completed the LPC. His interest in Islamic finance began in earnest in 2008 after undertaking an internship at European Finance House (EFH). Rizwan has since worked at the Islamic Finance Council and is currently a Research Associate at BMB Islamic. He has assisted in the drafting of legal documentation and has written a number of articles.

Robert Rilk
Robert Rilk is a Manager at Pricewaterhouse Coopers working in the field of financial services regulation. He advises on financial services / regulatory matters from a Swiss and cross-border perspective. He has gained considerable experience in the Middle East, notably GCC countries while working as a Legal Counsel/Senior Advisor with BNP Paribas Najmah. He conducts and supports research in the field of Islamic banking, most recently by presenting a research paper at the 9th Harvard University Forum on Islamic Finance, “Building bridges across financial communities”. Furthermore, he lectures regularly at Durham University’s Islamic Finance Summer School Being a trained lawyer, Robert Rilk worked more than 5 years as an Associate with a Swiss law firm, specializing in cross-border economic law and banking laws. Robert Rilk has earned Master degrees in law from Albert-Ludwigs-University Freiburg i. Br., Germany, and UT I Toulouse, France, and has been admitted to the bars of Germany (Freiburg Bar) and Switzerland (Zurich Bar Association). He is a member of GAIR e.V. (German Society of Arabic and Islamic Law) and speaks German, French and some Arabic.
Dr. Shariq Nisar earned his PhD in Economics specializing in Islamic Finance from AMU, Aligarh. Today, he is among the senior most professionals of Islamic Finance in India. He has pioneered Shari’a screening of stocks in India and has been associated with some of the landmark Shari’a-compliant deals in India. He is also closely associated with academic activities wherein he focuses on Islamic finance education, research and training. He has structured Islamic finance courses for various universities and has been invited by Harvard Law School, Islamic Development Bank and various other prestigious institutions for Islamic finance and investment conferences. Currently Dr. Shariq is founding Director of India’s premier Shari’a advisory firm TASIS.

Simon joined the DFSA in 2006 as Director, Supervision covering asset management, banking and insurance with his remit including the supervision of Islamic Financial Institutions as well as Conventional Firms offering Islamic Windows. Simon has spent much of his working life in the private sector with senior roles at Baring Asset Management, New Star Asset Management and, most recently, as Head of Asset Management Compliance at Barclays Wealth. He has previously worked at IMRO, a predecessor organisation of the UK FSA and on the successful BCCI investigation for the Serious Fraud Office. Simon is a Fellow of the Securities and Investments Institute, as well as a Fellow of the Institute of Financial Services.

Dr. Sofiza Azmi is a Senior Research Fellow at the Asian Institute of Finance (AIF), an organisation jointly set up by the Central Bank of Malaysia and Securities Commission Malaysia. Prior to her current post, she was the Head of the Director General’s Office at Labuan Financial Services Authority (Labuan FSA), Malaysia and a Research Fellow at the International Centre for Education in Islamic Finance (INCEIF). She holds a PhD in Corporate Fi-
Mr. Jaffer is a Partner and the Head of International Business Development for “white label” Bancassurance and SRI within FWU Group. His main achievements are his success in developing a sustainable business in the five emerging markets FWU Group has a presence in, understanding the intricacies of those local markets, while having a global experience of the industry. Since working at FWU Group, Mr. Jaffer has gathered a lot of experience in dealing with the Middle East in particular and has helped acquire 13 bank distribution partners in the region, as well as two in South East Asia. Before joining FWU Group in 1999, he was Senior VP within the International Mutual Funds Group of Scudder, responsible for international product development from June 1998 until June 1999. From January 1989 until 1995, he was VP with Citibank London with the Financial Institutions Group responsible for structured products including alternative investments then in 1996 joined Citibank’s Alternative Investment Strategies (AIS) Group as Director and was also a member of Citibank’s Hedge Funds Policy and Strategy Committee. Mr. Jaffer was an Audit Partner with the Price Waterhouse practice in Africa from July 1984 until September 1988. He is a UK qualified Certified accountant (FCCA). He is currently Regional Advisory Council Member (EMEA) of the Alternative Investment Management Association (AIMA), was a Council member of AIMA for the period 2001 to September 2008 and past Chairman for the period 1997 to 2000. He is also a member of ALFI’s Asset Management Advisory Committee and of their Hedge Fund Committee. ALFI is the Association of the Luxembourg Funds Industry. He is also an active member of the Working Group of Luxembourg For Finance, commissioned by the Luxembourg Finance Minister and designed to promote SRI in the Grand Duchy. Mr. Jaffer has also edited several Euromoney publications including five on Hedge Funds and Alternative Investments (“Funds of Hedge Funds”, “Hedge Funds: Crossing the International Frontier”, “Multi-managers Funds: Long only strategies for Managers and Investors”, “Evaluating and Implementing Hedge Funds Strategies” and “The new generation of risk management for Hedge Funds and Private Equity Investments”) as well as a book on investment opportunities in the GCC published by CPI Financials. In 2009, he received the “Best Business Leader in Europe” accolade given by World Finance magazine.

Tricia’s primary area of practice is corporate finance, mergers and acquisitions, private equity, and securities and capital markets. Tricia provides cross-office support to the firm’s Middle East and North Africa practice on a variety of corporate transactions involving Islamic finance, mergers and acquisitions, divestitures, and public and private securities offerings. Tricia maintains an active cross-border transactional practice, and has spent time in the firm’s London, Dubai, and Shanghai offices, assisting on matters involving Islamic finance, mergers and acquisitions, private equity, and securities and capital markets. Tricia provides cross-office support to the firm’s Middle East and North Africa practice on a variety of corporate transactional matters involving Islamic finance, securities, and fund formation. Tricia also provides regulatory corporate and securities advice to clients in the Dubai International Financial Center (DIFC) and the Dubai International Financial Exchange (DIFX).

Umar F. Moghul practices in the realm of banking & finance, private equity and real estate. Mr. Moghul has represented an array of financial institutions, businesses, joint ventures and high net worth individuals (many of which operate per Islamic principles), in a variety of cutting-edge financing and investment transactions. His legal practice also encompasses counseling financial institutions with respect to their obligations under the USA Patriot Act. In the realm of...
of real estate. Mr. Moghul’s practice has included the establishment of real estate investment funds (both onshore and offshore), joint ventures and one-off financing transactions; novel Islamic warehouse and table funding financing transactions; and the design and documentation of novel Islamic residential and commercial financing products. Mr. Moghul’s corporate and private equity practice includes the establishment of a variety of onshore and offshore investment fund structures and advising on leveraged buyouts and growth equity transactions with targets in the services, healthcare, technology and energy sectors. Mr. Moghul has published several articles and has spoken at numerous forums regarding Islamic law and Islamic finance. He is a lecturer in law at the University of Connecticut School of Law where he teaches Islamic law. Mr. Moghul earned his J.D. from Temple University and his B.A. and M.A. from the University of Pennsylvania.

Prof Dr Volker Nienhaus

Dr. Volker Nienhaus was professor of economics at the German universities of Trier and Bochum (1989-2004) and president of the University of Marburg (2004-2010). He holds an honorary professorship at the faculty of economics and business administration of the University of Bochum since 2004. He is a member of several academic advisory committees and boards, including the Governing Council of the International Centre for Education in Islamic Finance (INCEIF) in Kuala Lumpur and the International Advisory Board of FVU, Munich and Dubai. He is also a consultant to the Islamic Financial Services Board (IFSB) in Kuala Lumpur and was a Visiting Scholar at the University of Malaya (under the Securities Commission Malaysia Islamic Capital Market programme). Currently, he is a Visiting Professor at the ICMA Centre, Henley Business School, University of Reading. He has published numerous articles, essays and books on Islamic economics and finance since the 1980s.

Yerlan Baidaulet

Yerlan Baidaulet graduated in 1992 with a Bachelor’s Degree in History and World Economy (with Honours) at Kazakh National University. In 1993-1994, he completed the post-graduate program MAPOW at St.Gallen University, Switzerland, and in 1997 received an MBA in Banking & Finance at Kazakhstan Institute of Management, Economy and Forecasting (KIMEP). His highly distinguished career commenced in 1993, as an Assistant to the Governor of Talgar district, Kazakhstan before undertaking a 6 month Internship at Credit Suisse Group, Switzerland. Since then, Mr Baidaulet has held various managerial positions at several banks and consulting firms in Kazakhstan including Alemysystem, Eximbank, Swiss-Kazakhstan Centre for Economic Development, Impex International, Profit Invest Ltd and JSC Engineering and Technology Transfer. His extensive experience led to appointments as Field Representative in Astana for the IDB Group (2001-2005) following which he was Head of the Representative Office in Astana for Eurasian Development Bank (2006-2010). Since October 2010, Mr. Baidaulet has been the Chief Economic Advisor to the Deputy PM-Minister of Industry and New Technologies. He is also Chairman of the Kazakh Association for Development of Islamic Finance.

Dr Zamir Iqbal

Dr. Zamir Iqbal is the Lead Investment Officer with the Quantitative Strategies, Risk and Analytics department in the Treasury of the World Bank in Washington, D.C. He earned his Ph.D. in international finance from the George Washington University. He has written extensively in the area of Islamic finance and has published articles in reputed academic journals and presented papers at international conferences. His areas of interest are financial engineering, risk management, and corporate governance in Islamic finance. He is co-author of several books on Islamic finance including “An Introduction to Islamic Finance: Theory and Practice,” “Risk Analysis for Islamic Banks,” “New Issues in Islamic Finance and Economics: Progress and Challenges,” “Globalization and Islamic Finance,” and “Stability of Islamic Finance.” He has also served as adjunct faculty of at the Johns Hopkins University and the George Washington University.

Dr Zeid Ayer

Dr. Zeid Ayer is the Chief Investment Officer of CIMB-Principal Islamic Asset Management Sdn Bhd. He is responsible for establishing and implementing investment strategies for the firm’s clients and overseeing the performance of both global Islamic equity and global sukuk portfolios. He is also the lead portfolio manager for all global sukuk portfolios. A specialist in various fixed income instruments, Zeid was previously a Senior Portfolio Manager co-managing all multi-sector short duration portfolios and the Global Head of asset-backed and mortgage-backed credit with Principal Global Investors (PGI). Prior to this he was an Assistant Vice President...
(Computational Risk Modeling Analyst) in Asset-Liability Risk Management with PNC Financial Services Group from 1996 to 2001. Dr. Ayer is a Chartered Financial Analyst (CFA) charterholder. He obtained his Ph.D. in Physics from the University of Notre Dame, USA and M.S in Computational Finance from Carnegie Mellon University, USA.
# TABLE OF ACRONYMS

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<tr>
<td>AAOIFI</td>
<td>Accounting and Auditing Organisation for Islamic Financial Institutions</td>
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<td>Arab Banking Corporation</td>
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<td>Association of Banks in Malaysia</td>
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<td>Association for Innovation and Economic Development and Real Estate</td>
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<td>Authorité des Marché Financiers</td>
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<td>ASA</td>
<td>Association of Sharia Advisors</td>
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<td>ASEAN</td>
<td>Association of South East Asian Nations</td>
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<td>ASIC</td>
<td>Australian Securities and Investment Commission</td>
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<td>ARMM</td>
<td>Autonomous Region of Muslim Mindanao</td>
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<td>AUI</td>
<td>Assets Under Intermediation</td>
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<td>AUM</td>
<td>Assets under Management</td>
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<td>BAB</td>
<td>Bahrain Association of Banks</td>
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<td>Acronym</td>
<td>Full Form</td>
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<td>WTO</td>
<td>World Trade Organisation</td>
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PART 1
Introduction
CHAPTER 1

The global Islamic financial services industry

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| Potential global size of the Islamic financial services industry | USD 4.4 trillion growing at 10% per annum |
| Actual global size of the Islamic financial services industry | USD 1.13 trillion |
| The size gap | USD 3.27 trillion |
| Global growth rate (2010) | 10% |
| Catch up parameter (with 25% annual growth rate in the actual size of the industry) | 9 years |

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Introduction

It is true that the current global financial crisis did not directly affect Islamic banking and finance but it certainly did slow its pace and progress. One possible reason for the relative lack of activity in Islamic finance is the decrease in enthusiasm shown by many western financial institutions. The likes of Credit Suisse, Deutsche, UBS and many of the iconic American banks now seem less interested in getting their share of the USD 1.1 trillion pie. The Qatar Central Bank issued an instruction to banks operating in Qatar which effectively requires conventional banks to cease providing Islamic financial services in Qatar by 31 December 2011. This type of move by a central authority in an influential Muslim country makes conventional banks even more nervous to start activities in the Islamic space.

This proves the point made by some industry analysts that western institutions offering Islamic financial services cannot offer sustainability nor stability to Islamic finance, as their involvement in this sector is purely opportunistic. Islamic windows of conventional institutions are like prayer mats which can be rolled up at any time, if for any reason these institutions have to close down their Islamic operations. Full fledged Islamic banks, on the other hand side, are like mosques, which cannot be undone easily once they have set up, except in circumstances of bankruptcy or financial distress.

However it is important to acknowledge that western banks have played a tremendously important role in the development of Islamic finance globally, as well as in local markets. ABSA, a subsidiary of Barclays Bank, for example, has been instrumental in opening up Islamic financial services to the Muslim masses in South Africa. HSBC Amanah and Standard Chartered Saadiq offer Islamic financial services in a number of Muslim countries, and indeed compete with full-fledged Islamic banks.

As the table above suggests, UK-based banks have shown more interest in Islamic finance than US banks. An increasing number of European banks are however showing interest in this new field, with the likes of Commerzbank and Deutsche Bank getting involved. Other important new players include Bank Sarasin and Dexia Bank, which offer a number of products for wealth and risk management.

Despite the claims of many of its enthusiastic proponents, the practice of Islamic finance has so far failed to provide a superior alternative to conventional finance. Critics would argue, how could Islamic finance be superior to conventional banking, if the former merely
The global Islamic financial services industry

Is Islamic finance all about profit or is there something more to it? Whilst the profit motive is important, most advocates and supporters of Islamic finance insist that it should be for the wider benefit of the communities it attempts to serve. In the wake of the current financial crisis, the conventional financial services industry and its wider influence has come under greater scrutiny than ever before. Its very morality or perceived lack of it, in pursuit of profit at all costs is being questioned by financial analysts, governments and regulators. Now is the right time to highlight the Islamic stance; that banking practices should benefit all stakeholders not just shareholders alone, and made relevant to policymaking in countries where Islamic finance represents a significant chunk of financial activity.

Islamic banking and finance in the wake of the financial crisis

There is not a single Islamic bank anywhere in the world that needed to be bailed out by tax payer’s cash, during the recent financial crisis. This of course was not the case for their conventional counterparts. However, it must be noted that some IFIs were in actual fact caught up in the crisis, for a variety of reasons that were both related to the crisis and unrelated.

Dubai Islamic Bank was one such institution which went through a management overhaul, after evidence emerged of unusual patterns in its financials. This report does not attempt to analyse what went wrong or what were the causes and consequence of the irregularities, but it must highlight the need for a robust corporate governance system for the functioning of Islamic financial institutions.

Real estate developers such as Nakheel and property finance companies such as Amlak and Tamweel were badly caught up in the problems faced by the real estate sector in Dubai. This also points out the need for diversification in the Islamic financial services industry.

Whilst it is true that Islamic finance emerged from the crisis stronger and more resilient, there is a need being felt that it should be reformed to make it more socially responsible, committed to community development and poverty alleviation, in addition to the continued emphasis on compliance with Shari’a.

“The recent global financial crisis seems to be a blessing in disguise for Islamic finance,” opines, Dato’ Dr Nik Norzul Thani, Chairman of the Malaysian law firm, Zaid Ibrahim & Co. According to him, one of the impacts of the crisis has been an increasingly enormous interest around the world with regards to the soundness and resilience of the Islamic financial model.

What helped Islamic banking & finance in the current financial crisis?

The small size of the Islamic banking and finance industry prevented its exposure to so-called toxic assets in the west, which ruined the balance sheet of most of conventional banks. Islamic banking and finance has yet to attain a certain degree of sophistication and in many cases remains primitive and conservative in its product offerings and investments. For example, despite the huge emphasis put forward by the likes of John Sandwick on the need for setting up a comprehensive Islamic mutual funds business, the emphasis has so far been on other areas such as private equity and real estate be-

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<td>Total</td>
<td>639</td>
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<td>1,036</td>
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Table 1: Size of the Islamic financial services industry (in USD billions)
cause they offer quick and lucrative returns.

What else has helped Islamic finance in the current financial crisis?

Malaysia. Yes, Malaysia has helped Islamic finance to come out of the financial crisis. This is the country that has fully committed itself to developing Islamic banking and finance in its own country, the Asian region and the world at large. The government of Malaysia plans to use Islamic banking and finance as a tool to create a financial link between Malaysia and the rest of the countries in the Organisation of Islamic Conference (OIC).

There are also a number of Middle Eastern-backed banks operating in the country. These include Al Rajhi Bank, Kuwait Finance House, Asian Finance Bank and Unicom International Islamic Bank. Furthermore, Dubai Islamic Investment Group has a 40 percent stake in Bank Islam Malaysia.

Islamic finance as a genuinely ethical business

Whatever the case is in terms of success or otherwise of Islamic finance during the crisis, it is about time that the global practices of the industry are brought in line with the development agenda of multilateral institutions such as the World Bank, IMF, United Nations and other similar organisations. While imitating conventional financial products has certainly helped Islamic banking in terms of acquisition of financial technology, it has nevertheless taken it further away from its objectives of achieving social justice and fairness for all the stakeholders in the financial business.

This is also the time for financial regulators to set up ‘objectives of Shari’a boards’, to ensure that Islamic financial practices are not only in compliance with Islamic legal requirements, but are also in line with the objectives of Shari’a in terms of social responsibility, community development and poverty alleviation.

Changing leadership in Islamic banking & finance

There is no doubt that Prince Mohamed Al Faisal, a son of the late Saudi King Faisal Bin Abdulaziz Al Saud, played a pioneering role in the development of Islamic banking and finance. Faisal Banks, set up by Dar Al Mal Al Isami Trust – the financial conglomerate created by Prince Mohamed Al Faisal – are now only small players in the fast growing Islamic financial services industry. Although Sheikh Saleh Kamel (and his Dallah Al Baraka Group) is still an important global Islamic financial player, other new players are assuming even greater importance on a global scale. Al Rajhi Bank of Saudi Arabia – the largest Islamic bank in the world outside Iran – is emerging as an important global player.

Similarly, intellectual leadership of the industry has over the last four decades seen a dilution of the influence of Islamic economists in favour of a very powerful role played by Shari’a scholars. During the recent financial crisis, the role of Shari’a scholars has come under greater scrutiny and it seems as if strong institutions and regulatory bodies will dominate the future intellectual leadership of the industry.

Report layout

This report is divided into four parts. The specific focus of this year’s report is regulation of the Islamic financial services industry, with a thorough analysis of the global regulatory infrastructure and a detailed review of the regulation of Shari’a advisory, covered in PART 3, after a broad study of all the different market segments and asset classes covered in PART 2. PART 1 gives an exposition of the global Islamic financial services industry. Part 4 presents country sketches, a coveted section of the GIFR brand which reports and analyses Islamic financial activity in over 50 countries. This study forms the basis for the creation of the Islamic Finance Country Index, which ranks countries accord-
ing to their activity and development in the Islamic financial services industry.

Part 2

Chapter 2 starts the substantive side of the report by discussing Islamic retail market operations specifically referring to the consumer and SME markets. Besides giving description of certain retail products, it spells out the distinctive features of Islamic retail banking and its intermediation roles. It also focuses on wealth management and bancatakaful products in Islamic retail banking. Chapters 3 and 4 discuss the structuring of Islamic finance products. Chapter 3 highlights innovations in creating banking products to serve the array of customer needs in retail banking. Chapter 4 builds on this by focusing on legal issues in the USA that arise when structuring Islamic finance products and services. The chapter’s focus is on the financing of equity investments, the offering of Shari’a-compliant financing and finally investment products. Chapter 5 provides market insights and perspectives on bancatakaful, a fast growing segment of the Islamic finance industry. The reader will have the opportunity to review the best practices of corporate governance as well as the evolving landscape for tactical players and the competitive distribution edge of the bancatakaful channel. Chapter 6 looks into the Islamic capital markets paying close attention to the growth of the equity and sukuk market in the GCC and Malaysia over the last few years.

Chapter’s 7 and 8 take a closer look into Islamic asset management. Chapter 7 looks at the modern portfolio theory and how this fundamental approach to asset management has never been applied in the world of Islamic finance. While many banks offer Islamic asset management services, the reality is they most often randomly sell Sharia-compliant products. Little or no effort is made to link the professional tools of asset management with the needs of the Muslim investor. This chapter presents a thoroughly researched and tested approach to solve this problem. Globally accepted investment standards were thoroughly researched and tested approach to solve this problem. Global banks have been successful in creating investment products and services. The chapter’s focus is on the financing of equity investments, the offering of Shari’a-compliant financing and finally investment products. Chapter 5 provides market insights and perspectives on bancatakaful, a fast growing segment of the Islamic finance industry. The reader will have the opportunity to review the best practices of corporate governance as well as the evolving landscape for tactical players and the competitive distribution edge of the bancatakaful channel. Chapter 6 looks into the Islamic capital markets paying close attention to the growth of the equity and sukuk market in the GCC and Malaysia over the last few years.

The mechanisms and systems of conventional finance offer much for Islamic finance to learn from. Collaboration has undoubtedly strengthened Islamic finance services provision. But with competition, IFIs are evolving and gradually becoming viable competitors for market share. Chapter 9 analyses the comparative performance of Shari’a equity indices vis-à-vis conventional equity indices. Results show that both are capable of achieving similar investment performances, thereby strengthening the proposition that the Shari’a investment approach provides a real, profitable alternative. Chapter 10 provides an overview of key features and developments in the Shari’a-compliant derivatives market. Market size and standardization remain the prominent challenges. Market practice constitutes an important driver for standardization along with industry initiatives on standard documentation. Yet, the markets have to gain more experience with the use of these instruments and structures and their documentation.

Chapter 11 studies the efficiency and profitability performance of banks. A common concern has been the lack of rigorous empirical studies undertaken on Islamic finance. This chapter seeks to address these shortcomings. The growing size of Islamic banks and the entrance of foreign players will have an effect on institutional efficiency, the number of players in the market, product offerings and socioeconomic conditions. The chapter progresses into an empirical study on the profitability of Islamic banks. Results from the research conducted suggest profitability and fee based income generation do not depend on the type of banking system used.

Chapter 12 looks at the role of Shari’a boards in Islamic finance. The term Shari’a-compliance is defined and its importance highlighted. Furthermore, the challenges and issues with regards to Shari’a-compliance are discussed in some detail. The chapter also shows that an IFI cannot be fully Shari’a-compliant unless it is supervised and guided by a qualified and fully empowered Shari’a board, comprised of Shari’a scholars who are well versed in both Shari’a knowledge and banking practices. Chapter 13 highlights the increasing demand for highly qualified and skilled finance professionals who combine knowledge of Shari’a and technical financial skills. It looks at the importance of developing the necessary human talent pool together with the best methods for achieving this so that the barriers currently causing a shortage can be removed in order for the industry to progress. Chapter 14 looks at the market for Islamic banking IT systems. The emergence of Shari’a-compliant banking systems which are capable of accommodating the nuances of Shari’a. The solutions together with the main vendors are discussed in detail.

Part 3

Part 3 looks at the regulatory framework of the global Islamic finance industry and is divided into three distinct parts. The first part comprises of Chapters 15 – 18 which deal with the Islamic finance infrastructure. Chapter 15 looks at the regulatory stance adopted by countries and industry bodies with respect to Islamic finance. Chapter 16 provides a more incisive look into the challenges of regulating Islamic financial services. Chapter 17 focuses on two topical aspects of the Islamic finance industry which has garnered much debate: risk management and Shari’a governance. Many banks still struggle with the implementation of Basel II rules regarding risk management, transparency and market discipline. With regards to Shari’a governance, high concentration and clustering has not resulted in consistency or legal certainty. Chapter 18 assesses the repercussions of the financial crisis on the regulatory framework. The regulatory and supervisory environment going forward will be very different and will pose serious challenges to both the conventional and Islamic finance industry. Changes in the areas
of capital adequacy, liquidity, quality of information will pose challenges for the Islamic financial industry. At the same time, these changes offer an opportunity for the Islamic financial industry to take bold steps in enhancing the regulatory and supervisory framework and make serious efforts to implement the framework with the help of all stakeholders.

Chapter 19 – 27 embarks on a review of the regulatory models adopted by specific countries. One can see similarities and variance in their respective approaches. Chapters 19 and 20 assess two of the most dynamic regulatory models in accommodating and promulgating Islamic finance: Malaysia and Bahrain respectively. Chapter 21 looks at the stance taken by the DFSA to Islamic financial institutions in the DIFC, an onshore financial free zone that bridges the east and the west. The report then moves onto regulatory approaches adopted by the UK in Chapter 22. The UK has a more mature regulatory system having been a supporter of Islamic finance for over 15 years. Chapter 23 highlights Pakistan’s regulatory infrastructure and the important role played by the State Bank of Pakistan and the Securities and Exchange Commission of Pakistan. Chapter 24 moves onto the thorny issue of regulating Islamic finance in the USA. The USA has had to adopt a more subtle approach predicating the economic substance of an Islamic finance product and reconciling it with conventional counterparts. Chapters 25 and 26 take an alternative slant to regulation, focusing on taxation regimes of Ireland and Luxembourg respectively. Both countries have ambitions of becoming domiciles for Islamic funds and a flexible and unencumbered taxation regime will be important in achieving this.

The remaining three chapters encapsulate the problems arising from governance. Chapter 27 commences with a holistic look at Shari’a governance, the issues that arise, the approaches which have been undertaken and the improvements that need to be made to create an efficient system. However, even with (or without) a robust governance system, there will be occasions where courts will get involved. Chapter 28 explores this in greater depth. Through the discussion and analysis of various disputes arising within the Islamic finance industry, one can conclude that the leading cause of disputes involving Islamic finance transactions are rooted in failure of the market structures to accord with genuine Shari’a-compliance. These problems are exacerbated by governing law clauses and the choice of court in hearing disputes. These are incongruous with the subject matter of the dispute and therefore may well lead to serious enforceability issues in spite and at times because of the election of foreign laws. Chapter 29 narrows the focus by delving into a topical issue at present: the restructuring of sukuk in the event of a default. The chapter looks at the legal issues that arise and the rights of investors and creditors under such circumstances. Chapter 30 then attempts to reconcile the governing law and choice of court conundrum by suggesting the creation of an international Shari’a court which encompasses the manifold viewpoints in Islamic law.

Part 4

Part 4 contains a detailed analysis of the state of the Islamic finance industry in 55 countries. Each country sketch carefully analyses the current state of the industry in that particular country, looking at history, regulatory frameworks, capacity, institutional presence as well as future challenges. The sketches complement the unique and pioneering Islamic Finance Country Index (IFCI) included in the report. The IFCI is a unique path-breaking one of its kind study that has ranked countries according to how receptive they are to Islamic finance. Rigorous statistical analysis has been applied to create a composite set of statistics, which provide an immediate and unbiased assessment of the state of the Islamic finance industry across the globe.
ISLAMIC FINANCE ACCESS PROGRAMME (IFAP)

- Developed by Professor Humayun Dar in collaboration with leading practitioners and organizations around the industry.
- Globally recognised, affordable Islamic financial intelligence programme.
- Bringing the highest quality of Islamic financial intelligence to the top executives and decision-makers in the Islamic financial services industry.
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WHAT THE INDUSTRY LEADERS SAY ABOUT IFAP

"The Islamic Finance Access Programme is an excellent forum from an informative, educational and networking perspective. Professor Dar is a true expert in his field and Fidomes are proud to be associated with the IFAP."
(Nades Goos-Farrell, Director, Trident Fund Services (Luxembourg) and Fidomes).

"The Islamic Finance Access Programme run by Edbiz is extremely informative, focused and well run. They partner with carefully selected industry players, bringing to bear a variety of perspectives and a wealth of knowledge about the Islamic finance market."
(Rosali Pretorius, Partner, SNR Denton).

"The Islamic Finance Access Programme on Structuring Islamic Investment Funds was insightful, interesting and relevant. The speakers were knowledgeable and instructive and the programme proved not only to be educational but also a great forum for networking with other professionals in interested in the Islamic finance market."
(Lawrence and Graham LLP).

For information on future events, please email: Rizwan Malik on rmalik@edbizconsulting.com or call on (0044) 7791762047
PART 2
Review of Industry Segments
CHAPTER 2
Islamic retail banking operations

2.1 Introduction

This chapter focuses on operational aspects of Islamic retail banking. Although retail banking practices cover a host of areas such as payment services/remittances, e-banking and fee based products, our concern will be on products offered to the consumer and small and medium enterprises (SME) i.e. businesses which have not yet reached the status of a limited public listed company (PLC). There are other criteria to consider when defining an SME such as assets under management (AUM) and labour force; but this differs from country to country.

Islamic banking distinguishes itself from its conventional counterpart in the following way:

i. Islamic banks play multiple roles in assisting individuals and enterprises such as acting as partner, agent, guarantor, etc.

ii. Under a partnership contract such as mudaraba and musharaka, Islamic banks jointly share any risk with their clients. However, the risks in musharaka differ from the risks in mudaraba. In a musharaka contract, the bank and entrepreneur both contribute capital and they jointly share the risk on their capital & effort. However, in mudaraba, the bank may lose its capital and the entrepreneur faces the risk of wasting his efforts.

iii. In a few jurisdictions, Islamic banks participate in true trading activities (asset backed transactions).

iv. mortgagor and mortgagee

Conventional banks earn profit through interest and fee based incomes. According to Shelagh Heffernan (1998), all modern banks act as intermediaries between borrowers and lenders, but they may do so in a variety of ways: from the traditional function of taking deposits and lending a percentage of these deposits to fee-based financial services. In contrast, Islamic retail banking activity capitalises on profit rate differentials.

2.2 Accounts

Islamic retail banks offer various products to individuals in order to mobilize deposits. Specifically, there are three main underlying contracts that have been applied by Islamic banks to collect deposits from their customers. Those concepts are wadia, mudaraba and qard.

2.2.1 Current accounts

In general, any Islamic bank which obtains its license under commercial banking law has a right to offer current accounts allowing the customer to withdraw his/her money. The withdrawals can be made either in person or by a third party designated by the customer through, for example, cheque payment.

2.2.1.1 Wadia based saving account

In classical Islamic law, wadia was a voluntary contract in which an individual deposits their valuable property with another person for the purpose of security and safekeeping. As it was considered to be a voluntary act, the custodian or safekeeper is not entitled to any fees. Furthermore, the custodian is not obliged to provide a
2.2 Investment accounts

As the development in introducing Islamic banking products is a continuous process, most banks are offering a variety of Islamic banking products using various underlying contracts. The mudaraba based investment account is normally open to customers who are ready to face a slightly higher risk in order to gain higher profit. In contrast, there are customers who are inclined towards a fixed rate of return. Bay al-inah is a sale and buy back product, in which the bank would purchase an asset from the client on a cash basis and then immediately resell the asset to the customer at a marked up price on a deferred payment basis. The two contracts must be executed separately from each other and be independent of each other. Tawarruq on the other hand is more acceptable to the scholars as it involves a third party so it does not indicate a clear nuse to the prohibition of riba. In tawarruq, the person seeking liquidity would buy an asset from a person for a higher price than its cash value on deferred payment terms. The individual would then go and sell the asset in the market to a third party for its cash market price in order to achieve the desired liquidity. Islamic banks prefer to use the tawarruq concept with minor modifications to ensure compliance with contract requirements of the Shari'a and avoid any controversial matters in the concept. The commodity murabaha trade via a commodity murabaha platform has become the enabler for the organized tawarruq.

2.2.2 Commodity murabaha based account

Many Islamic banks opt to use the tawarruq concept as an alternative to bay al-inah to cater to the demand of investors who are familiar and inclined towards a fixed rate of return on investments. Bay al-inah is a sale and buy back product, in which the bank would purchase an asset from the client on a cash basis and then immediately resell the asset to the customer at a marked up price on a deferred payment basis. The two contracts must be executed separately from each other and be independent of each other. Tawarruq on the other hand is more acceptable to the scholars as it involves a third party so it does not indicate a clear nuse to the prohibition of riba. In tawarruq, the person seeking liquidity would buy an asset from a person for a higher price than its cash value on deferred payment terms. The individual would then go and sell the asset in the market to a third party for its cash market price in order to achieve the desired liquidity. Islamic banks prefer to use the tawarruq concept with minor modifications to ensure compliance with contract requirements of the Shari'a and avoid any controversial matters in the concept. The commodity murabaha trade via a commodity murabaha platform has become the enabler for the organized tawarruq.

2.3 Financing

Retail banking operations especially that of consumer banking is highly voluminous and transactional in nature and its mass market focused. Depending on the volume involved, a great deal of effort is required in building up the overall business and operational infrastructure. The key established and basic products for the retail consumer market are:

1. Home financing
2. Car/vehicle financing
3. Personal financing

There are differences in the operational infrastructure and the Shari'a governance procedures to support these products. The manner that the Shari'a concepts are being used to facilitate product offerings is something that is most interesting and intriguing at times, as one bank may market and package the same home financing products differently from that of another bank.

2.3.1 Home financing

In the Malaysian Islamic retail market, home financing is being packaged mainly via the following structures; the commonality being that the products are structured to enable clients in purchasing a house via deferred installment payments.

i. Bai bithaman ajil (BBA)
ii. Tawarruq (commodity murabaha)
iii. Musharakah mutanaqisa (diminishing partnership)
iv. Ijara

2.3.1.1 Bai bithaman ajil or deferred payment sale
Bai bithaman ajil or BBA is a deferred payment sale which requires the bank and customer to undertake a number of contracts between themselves, each independent of one another. The customer approaches the Islamic bank specifying a property that he wants the bank to purchase, and subsequently gives a binding promise to repurchase the same house from the bank at a pre-agreed mark-up price consisting of cost plus profit, in instalments or a lump sum payment in the future.

BBA, as defined operationally above, is accepted by almost all Islamic banks worldwide; however, the practices of BBA in South East Asia differ from the above definition.

Under the Malaysian practice of BBA, the customer will normally purchase the property directly from the developer by paying, for instance, ten percent of the price and paying the balance after securing finance from the bank. To secure the finance, the customer will sell the property to the bank at example 90% of its original price in cash to be paid directly to the developer. Subsequently, the bank will resell the property to the customer at cost plus profit to be paid in instalments.

2.3.1.2 Tawarruq concept

The concept of tawarruq is an extension of the BBA concept but involves a third party to the transaction. The original BBA concept (ie murabaha) applied when the bank purchased the asset from the supplier at cost price and sold the asset to the customer at credit.

However in tawarruq, the customer sells the asset again to a third party, which can be the original supplier or another person. Hence, the customer can get cash through the sale that he made to the third party and use the cash to pay for the property in house financing. In a normal tawarruq transaction, the commodity, such as iron and crude palm oil, has been used as an enabler for the tawarruq concept.

As discussed previously, the issue of pre-arrangement exists in tawarruq which made the concept somewhat similar to the al-ina structure. In addition, the legal documentation must sufficiently cover the transfer of ownership of commodity between the bank, commodity trader and the customer as the end user.

Under the Malaysian context, Bursa Malaysia has initiated a Shari’a-compliant tawarruq commodity market platform named Bursa Suq al-sila’. Crude palm oil has been chosen as the underlying commodity in commodity murabaha transactions through registered participants as an enabler for the tawarruq concept.

2.3.1.3 Musharaka mutanaqisa

Operationally, musharaka mutanaqisa or diminishing musharaka financing is a partnership between the customer and bank to jointly purchase a property. For instance, the customer pays ten percent of the property price and the bank pays ninety percent. The customer undertakes to purchase the bank's share on a monthly basis at a specific duration at a pre-determined price. Thus the ownership of the bank will reduce from month to month.

Most scholars agree that the price can be pre-determined if the musharaka contract falls under the shirkat al-milk concept (jointly owning an asset, but not for commercial purposes). Here, a criticism of the practice is that the bank definitely enters the contract for commercial purposes; hence it is not permissible to determine the price of the bank’s portion as it will constitute a guarantee.

Beside this point, Islamic banking needs an exception from the prohibition of pre-determined price for the property in this product as it is among matters which may be volatile in terms of price and may burden the customer if the property price increases continuously.

2.3.1.4 Ijara

Ijara is a contract enabling the user to benefit from usufruct or benefits of a tangible item, or services provided by individuals in return for compensation. In order to ensure the validity of contract, the type of benefit, duration and price must be pre-determined and the subject matter which is related to the benefits must be in existence. The human services and the fee or ujr must also be pre-determined to avoid gharar (uncertainty) in the contract.

Generally, Islamic banks do not practice the plain ijara as mentioned above. They enter into a number of contracts and agreements (all independent of each other), such as for example sale-purchase and then ijara. Here, the bank purchases the property from the developer and subsequently leases the asset to the customer. Under a separate agreement, the bank undertakes to sell the asset to the customer at the end of the tenure for a token price.

In practice, this is not normally the case as the bank purchases the house from the customer and then leases it back to the customer under a sale and lease back structure. Due to the nature of an ijara transaction, banks normally offer the product for completed property whereas for a property under construction, it is structured under an istisna (contract to build) during the construction phase and ends with an ijara structure. Thus, several contracts will have to be devised to operationalise the transaction. Another alternative structure is via an ijara mawsufa fi zimma structure (forward lease) between the client and the bank with an embedded istisna contract. Due to the long term nature of house financing, the ijara structure is highly suitable as it can be structured as a variable rate financing product.

Another version of ijara is the ijara thumma al bai (AITAB), which is a popular product in Malaysia, to cater for car/vehicle financing. This contract is similar to the conventional hire purchase product supported by a standard set of legal documents in place to support the operations of the product, thus ensuring mass appeal to clients. Under this structure, the bank will purchase the
vehicle and thereon lease it back to the client. At maturi-
ty, the bank will sell the car to the client at a nominal fee.

2.4 Islamic banking for the SME

A lot is being said about sukuk and less is said about financing the SME market even though it is the back-
bone of the business sector in most countries. The requirements of SMEs in the Malaysian context are as follows:

1. Working capital
2. Term financing
3. Trade financing
4. Guarantee facility

In financing the SME, there is a need to set up an ef-
effective Shari’a screening methodology so as to ensure that the core business and the business set up is gener-
ally Shari’a-compliant and in most cases greater care must be put in to ensure that the SMEs with mixed businesses are being screened and evaluated accord-
ingly. The process should be ongoing specifically when the facilities are of the working capital/trade financing type and to a certain degree when ijara structures are being used.

The most common requirement is working capital. Some banks offer products such as murabaha or com-
modity murabaha working capital financing facilities. Such facilities are vital for an SME to procure raw materials as working capital for production and sales purposes. To a certain extent, some banks do offer products such as al-ina based overdraft/cashline, but the more globally focused banks have started to offer an alternative over-
draft product via mudaraba contracts.

For an SME, term financing products are crucial as it ena-
bles them to purchase office space, factories and fixed assets. Similar to consumer financing the more popular contracts are murabaha, BBa and the ijara contracts with deferred instalments payments.

Islamic trade finance products are a popular option in view of the standardized nature of the products. Islamic banks normally offer a Letter of Credit facility and it is normally structured using the wakala structure or mur-
abaha structure for the purchase/import of raw materials or intermediate goods. To finance purchases, clients can opt for murabaha working capital financing, more popu-
larly known as Islamic Trust Receipts (TR-i), or alternati-
vatively in Malaysia there is the standard Islamic bankers’ acceptance (a combination of al-inah/murabaha and bai al dayn (debt discounting)).

To offer a holistic product, banks will package the above facility together with a guarantee facility in the form of kafala guarantee and kafala shipping guarantee. The fi-
calised product will be a fee based product. The main issue here is the acceptance of such products as some banks charge flat fees and some charge a percentage over the amount guaranteed. At the end of the day, banks will adopt the pricing structure sufficing the banks’ requirements.

2.5 Wealth management

Wealth is measured in many countries by accessibility to essential services such as health care, or the possession of crops and livestock. In economics, wealth refers to the value of assets owned minus the value of liabilities owed at a point in time (See: INCEIF, 2006).

In order to accumulate wealth and to maintain it, wealth management should be an essential part of achieving his or her financial goals. Therefore, for many individuals, wealth planning is the map that lays out the road to reach their financial goals.

In Islamic retail banking practices, it is an effort to pro-
 vide professional services to individuals, their families and their businesses; to offer impartial assistance in analyzing and organizing financial affairs in order to achieve the desired financial and lifestyle goals, as long as the lifestyle is not prohibited in Islam (INCEIF, 2006).

2.6 Retail wealth management products

The wealth management products in the Islamic space are still in their infancy. They appeal to medium to high net worth individuals who wish to expand their investment horizon. Historically, the simplest form of an Islamic wealth management product is the Islamic unit trust, followed by the more complex structured products and banca assurance.

One of the main challenges in offering products is the clients’ risk appetite: a balance between a high return and risk of loss. Capital guarantee in conventional products seems to be a requirement, but there is still business risk prevalent with the products.

On the Islamic side, the offering of such products is a challenging one where the Shari’a scholar may have to look at the issue of “capital protection”. Structures such as commodity murabaha/tawarruq are being used to create this effect and linkages to Islamic indices en-
deavour to ensure extra returns for the clients. There is a need to be competitive with conventional products, thus research and development has to be continuously undertaken to come out with hedging mechanisms to reduce risk as well as account for foreign exchange dif-
fentials in some of these products.

2.7 Bancatakaful

Bancatakaful refers to the marketing of takaful prod-
ucts through a bank’s established distribution channel. Normally, takaful companies leverage an existing bank’s distribution channels under one group to market its products. In Malaysia, takaful operators are required to observe the regulatory requirements relating to ban-
catakaful as set out in the Bank Negara Guidelines on bancatakaful, so as to ensure that the consumers ben-
According to Bank Negara Malaysia, bancatakaful has made noticeable headway albeit from a very low base, to account for 7% of the general takaful distribution share in 2005. The trend of increasing bancatakaful penetration is set to continue, owing to the ability of takaful operators to leverage on existing group structures and closer strategic affiliations with other financial institutions.

As bancatakaful in Malaysia is a new subsection of Islamic banking and finance, there are at this juncture only a few products such as will writing, structured products with takaful protection, deposit accounts with takaful protection and family takaful linked plans.

Table 1 below summarizes the operational aspects of Islamic retail banking.

### Description on the roles and products

<table>
<thead>
<tr>
<th>Islamic banks role</th>
<th>A. Intermediation role by Islamic bank</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>i. Mobilization</td>
</tr>
<tr>
<td></td>
<td>ii. Investment</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Islamic banks mobilize deposits through offering various deposit products consisting of various underlying contracts such as wadia, qard, mudaraba and tawarruq.</th>
<th>B. Wealth Management</th>
</tr>
</thead>
<tbody>
<tr>
<td>Islamic banks offer investment opportunities by offering various investment products using mainly mudaraba and wakala contracts and tawarruq concepts.</td>
<td>i. Unit trust-i</td>
</tr>
<tr>
<td>Underlying contracts are murabaha or BBA, musharaka mutanaqisa or ijarah.</td>
<td>ii. Structured products</td>
</tr>
<tr>
<td>Underlying concepts are BBA and ijarah.</td>
<td>C. Bancatakaful</td>
</tr>
<tr>
<td>Tawarruq and al-ina</td>
<td>i. Will writing</td>
</tr>
<tr>
<td>BBA, Murabaha, Ijarah, Ina</td>
<td>ii. Family takaful/General takaful</td>
</tr>
<tr>
<td>Murabaha, Ad Dayn, Wakala, Kafala</td>
<td></td>
</tr>
<tr>
<td>Wealth planning and management is a service by Islamic retail banks to individuals, their families and their businesses, in analyzing and organizing financial affairs in order to achieve the desired financial goals as long as it does not contradict with the teaching of Islam.</td>
<td></td>
</tr>
<tr>
<td>Normal structured products have been structured under the tawarruq concept. However, few have been structured under mudaraba, musharaka and wakala contracts.</td>
<td></td>
</tr>
<tr>
<td>Bancatakaful is a marketing of takaful products through a bank’s established distribution channel.</td>
<td></td>
</tr>
</tbody>
</table>

### 2.8 Challenges for Islamic retail banking

Notwithstanding the salutary developments in Islamic retail banking, there are few challenges that Islamic banks have to overcome:

#### 2.8.1 Marketing of Islamic retail financing products

There are real challenges in the marketing of Islamic products are that Islamic banks need to first identify their target market. There is still a misconception that these products are only for Muslims. Islamic banks have to dispel this myth and gear its marketing approach towards the universal appeal of Islamic banking products. With respect to Islamic home financing products, the most common approach is to align the similarities with that of a conventional home loan and identify some
key differences thereby reducing the need to undertake massive customer education programs. The product concepts that fall within this category are BBA and tawarruq. This approach is not liked by some purists as it suggests a resemblance between Islamic and conventional products.

The other approach is differentiating the features of the underlying concepts of musharaka and ijara which create a form of partnership and usufruct respectively and a right of use as opposed to pure lending under a conventional home loan. As mentioned earlier, these products require a substantial amount of marketing expenditure, not to mention massive consumer education.

2.8.2 Legal documentation

The legal documentation for each of the retail products differs in relation to the concepts used. For example, both the BBA and tawarruq concepts have an underlying sale contract with a selling price that encapsulates the financing amount plus the profit. The underlying asset for a BBA is the house to be financed, which is eventually charged to the bank as collateral whereas under a tawarruq, the client has to undertake a separate commodity transaction via brokers/agents to extract the financing amount and the house is used as collateral. These differences need to be reflected clearly in the legal documentation.

Operationally, it is necessary to ensure that the said transaction documents flow are being carried out in proper sequence so as to comply with the Islamic tenet that someone cannot sell something that he does not own, therefore the bank or customers must ensure that they possess ownership of the asset/house prior to selling it.

When we compare musharaka mutanaqisa and ijara concepts, the legal documentation requirements differ considerably as much emphasis is undertaken to define musharaka and ijara. Moreover, there are supplementary contracts that need to be drafted to operationalise the whole transaction. For example, under a diminishing musharaka, the core underlying contract is the partnership agreement between the bank and the customer in joint ownership of the house with an underlying ijara contract for the rental of the house from the customer. Under ijara, the core contract contains information regarding the rental of the house from the lessor (bank) to lessee (customer), which is supplemented by an agency agreement between lessor and lessee for the maintenance of the property.

2.8.3 IT support infrastructure

Ideally to support the business operations of an Islamic bank, an Islamic core system must be in place. This scenario is only prevalent in the new greenfield Islamic bank setup and is not the case for Islamic windows or subsidiary based Islamic banks where the Islamic IT infrastructure is being outsourced to the parent bank.

IT support infrastructure is definitely a key enabler in the Islamic retail banking business. From the outset, the Islamic bank will have to decide and undertake a strategy as to whether to buy an expensive new system to support the distinct features of the Islamic products or upgrade the existing conventional system. At the end of the day, banks will need to assess the business viability in this area as the cost benefit analysis will have to be carried out extensively before deciding on which IT system infrastructure to embark upon.

2.8.4 Risk management aspect of retail financing products

Shari’a-compliance risk is a major category under operational risks. It needs to be managed effectively so as to mitigate the non Shari’a-compliance risk. The mass market nature of these products requires an integrated risk management approach which encapsulates Shari’a requirements as well as ensuring effective marketing strategies, comprehensive legal documentation, robust IT infrastructure and appropriate review mechanisms.

There is similarity with conventional retail banking when it comes to credit risk, whether the counterparty is able to service the financing or not. Furthermore, depending on how the product is structured, elements of market risk may be prevalent thus there is a need to mitigate those risks.

A good example is in the musharaka mutanaqisa home financing where the bank, as a partner, shares the risk of co-owning a house as opposed to just being a financier under a BBA/tawarruq home financing product. Thus the bank has to assess the market risk for each product.

2.9 Conclusion

In conclusion, it is crystal clear that Islamic retail banking is on the right path to providing a good alternative to conventional banking consumers. From its edifying philosophy right through to its holistic approach, Islamic retail banking has the ability to penetrate consumer and SME markets step by step. However, Islamic retail banks should not ignore the need to strengthen themselves and overcome the challenges that they currently face.

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CHAPTER 3
Islamic retail banking products

3.1 Introduction

Innovation, which is considered to be an essential requirement for the sustainable development of the Islamic banking and finance industry, has not been amongst the top few items on the agenda for most IFIs. Different IFIs, depending on the scholars sitting on their Shari’a supervisory boards, are following different ways and means to achieve their targets. They are often successful in achieving such targets as whatever they do is somehow unique to what others are doing, therefore, they are gaining a competitive edge over other institutions, without any need for innovation. As we know the Islamic banking and finance industry is currently passing through the most challenging period of its short history. According to Shari’a scholars, the reasons are mostly attributable to the global recession and competition amongst providers of Islamic financial services operating in different parts of the world. Less regulation, lack of standardisation and increasing controversy are further adding to the situation. The result is less innovation and sluggish development of the industry on the whole.

Increasing defaults at the retail level and restructuring at the corporate level has forced many institutions to follow a policy of playing safe and to remain conservative. In this chapter, we will discuss the significance and the prospects for innovation in structuring different Islamic retail banking products in the context of the GCC, with particular reference to the UAE.

3.2 Liability products

Islamic liability products, such as current accounts, saving accounts and term investment deposits, offer almost the same features as their conventional counterparts. Due to certain Shari’a restrictions, marketing of such products faces challenges; however, as a result of certain innovations, offering Shari’a-compliant liability products has been successful in the past few years.

The successful launch of Mashreq Millionaire (a conventional savings product with a chance of winning cash prizes) followed by a Shari’a-compliant product launched by the National Bonds Corporation (a mudaraba-based Islamic savings product which offers the chance to win cash prizes out of the mudarib’s own funds), became the driving force towards innovation, resulting in the efflorescence of many Shari’a-compliant liability products which offer cash prizes in addition to the profit payable to the depositors. The Bank, on the one hand pays the profit to the customers in its capacity as the mudarib and on the other hand pays out certain periodic cash (or in-kind) prizes (from its own funds) to customers on the basis of a computerized lucky draw in its personal capacity. The institutions offering such products include, among others, Abu Dhabi Islamic Bank and ADCB-Meethaq (Islamic widow of Abu Dhabi Commercial Bank).

Most recently, the issue of giving Islamic current account customers certain privileges, as is the case of current accounts operated within a conventional bank, was raised to the Shari’a boards of different IFIs. However, all such structures and proposals failed to convince Shari’a scholars who consider this as riba as current accounts is looked upon as a ‘Qard’ (loan) for the bank, for which the bank cannot offer any additional benefits to the depositors of the current account. Many customers, in order to avail such benefits and privileges, opt for a conventional current account instead of opening and operating an Islamic account. Hence there is a gap for further development and innovation with respect to liability products in the Islamic retail space.
3.3 Asset products: Home finance – istsina, ijara and forward lease

The recent growth in the housing industry, especially in the GCC, resulted in the active involvement of IFIs in the home financing business. Shari’a scholars provided different Shari’a structures for home financing such as ijara and murabaha for ready properties and istsina – forward lease and istsina – parallel istsina in the case of the off-plan properties. Under the structure, the IRI becomes the actual buyer (both in cases of simple purchase and/or istsina) and thereafter leases (on a normal lease basis or on a forward lease basis, as the case may be) to the customers. Such ijara is (or in the case of forward lease becomes) ijara mutana bitamleek (lease to own).

The lease-to-own model has proven to be an innovative idea and has resulted in great commercial success. Unlike murabaha, which does not allow a floating rate and diminishing musharaka, which has its own limitations and issues, ijara based products, provided more flexibility and variation. Home finance is the only area where the innovation has played an important role and has resulted in certain innovative products such as the forward lease structure with its multiple variations such as step-up and easy start. Such variations allow the customers the flexibility of paying small instalments in future or in some cases provided a way of making upfront payments, easing the financing at a later stage. Once the recession is over, further innovation and development in home financing products can be expected.

3.3.1 Murabaha

Murabaha is accepted by most Shari’a scholars as a permissible mode of financing for retail banking. Deferred price payment facilitated the financing of assets such as motor vehicles, white goods and even real estate assets. Murabaha financing of motor vehicles and white goods has been successful due to the short financing periods and small financing amounts. Both the aforementioned products have been successful in the GCC region.

The development of real estate murabaha financing was more challenging due to the Shari’a restriction of fixing the price upfront and due to the longer tenures and larger amounts involved in the transactions.

3.3.2 Tawarruq

Shari’a Standard number 30 i.e. Monetization (Tawarruq) published by AAOIFI refers to tawarruq, which is not approved by many Shari’a scholars due to strong similarities with bai al ina. The Islamic Fiqh Academy of the OIC further strengthened their opposition to tawarruq through its announcement of tawarruq as a Shari’a repugnant product.

However, after having been published in the Sharia Standards, Shari’a scholars may allow such transactions which follow the standard in letter and spirit. After a few transactions being approved on the aforementioned basis, tawarruq may also find its way to the remaining institutions where it is not permitted as a mode of personal finance. Standardisation as well as effective regulation may be the key to resolve the issues pertaining to products like tawarruq.

Tawarruq has been widely used for many years, as an Islamic product for the purposes of fulfilling the cash requirements of customers. Furthermore, even if the Shari’a boards of certain institutions do not permit tawarruq as a Shari’a-compliant product, they do allow tawarruq to be used for customers who want to pay their conventional debts through this mode of finance.

3.3.4 Services ijara

Islamic personal finance has witnessed consistent development and innovation especially in the GCC. Many Islamic banks have been using commodity murabaha as the basic tool for personal finance products. Due to certain controversies and debates on the Shari’a-compliance of tawarruq, an institution, which are led by those Shari’a scholars who do not favour tawarruq, have used innovation to structure certain personal finance products which are based on the Shari’a concepts of murabaha and ijara. Ijara which aimed to provide certain service packages such as rent finance, travel finance, event finance, medical finance and education finance, could not achieve the same results as tawarruq, as in the majority of cases, the basic requirement is immediate and the service provider cannot wait for documentation and other requirements to be fulfilled.

In many institutions, the service ijara product with all its variations, only attracted the attention of a few customers and has remained almost akin to a dead product from a commercial viability perspective. Due to the limited number of transactions, most of the institutions offering such products have also started to look for alternatives. The main concept of the ijara based product was to acquire certain services from the suppliers/service providers and then provide the same to the customers on an ijara basis. For example, if a customer planned to travel to Europe with his family and is inclined towards getting the travel package financed by some institutions, then the customer will bring the quotation to the bank with a request for financing the same package. The customer promises the bank that once the bank has acquired the travel services package from the travel agency/service provider, then the customer will lease such services from the bank on agreed terms.

Shari’a allows for the lease rental to be paid as per the payment terms agreed between the customer and the bank. Then the bank acquires the package from the travel agency and leases it to the customer under a lease agreement. An almost identical mechanism is used in the case of other variations of the services ijara product such as medical finance, education finance, rent finance and event finance. A well regulated environment would have been ideal for the success of such a product; however, it could not achieve the expected results.

3.3.5 Salam finance

One of the leading Shari’a scholars of the contemporary world, Dr Husain Hamid Hassan floated the idea
Apart from the theoretical approach of the above structure, it has some practical issues due to which it has been very difficult to implement. One of the main problems was the issuance of the sale undertaking in favour of the customer. In most cases, the customers are common members of society who are not involved in the sale and purchase of commodities. In addition to this, they do not have any relationship with suppliers and brokers. On top of this, suppliers and brokers only deal with huge transactions and are not involved in small transactions, which posed yet another problem. In tawarruq based transactions, the customer normally appoints the bank or a third party related to or arranged by the bank as their agent to sell the commodity in the market.

Dubai Islamic Bank (DIB), which had planned to launch a salam based cash financing product to retail customers, was advised to remove the agency element from the structure and to use any commodity which is locally available, so that the customer and/or the bank are able to take actual possession and control over the commodity. Further adding to the innovative structure, the bank’s retail team brought in the idea of using refined sugar as the subject matter of salam, as millions of tons of raw sugar is brought into the country and sold to distributors after refinement.

In order to overcome this problem, another leg of the transaction was devised, whereby the customer would appoint a third party as its agent to purchase the commodity from the suppliers as per the delivery schedule. Such a third party will be available for all the customers of the bank to act as their agent at a specified fee.

After having solved the problem of the relationship between the customers and the suppliers, the next challenge was the restrictions from the Shari’a scholars that the salam goods/commodity must be locally available and the customer, if it requires to do so, may take the actual delivery of the salam goods/commodity. As mentioned earlier, the institutions practicing personal finance on a tawarruq basis do not have any such restriction. As a result of the aforementioned restriction, it was a challenge to find a locally available commodity, or brokers and suppliers dealing in the trading of the same. DIB started working with certain producers and importers involved in the import and production of certain fungible commodities. Finally, they made arrangements with suppliers and distributors involved in the import of raw sugar, processing and distribution.

Although the product has been launched and has successfully attracted a large clientele, it still faces challenges as far as procedures and dealings with the suppliers and brokers are concerned. Some of the retail bankers are still of the view that if using the London Metal Exchange (LME) platform becomes permissible from a Shari’a perspective, salam personal finance will become a more viable product for institutions providing Islamic finance solutions. Moreover, locking the price for the salam finance period will become easier, as the fluctuation seen in LME commodities is much less than the other fungible commodities.

Innovative structures of salam still face a lot of challenges and do not enjoy a level playing field with its counterpart – tawarruq (monetization) based products.
Proper regulation as well as standardisation are definite solutions to the aforementioned problems.

### 3.4 Credit cards

Credit card is an area where the Islamic banking and finance industry needs to focus vis-à-vis innovation and development. The models currently used are subject to strong criticism and controversies by Shari’a scholars. Business experts also do not consider the models used currently as enough to provide a basis for a successful and profitable retail product. Opinions of the scholars vary from using similar conventional credit card models to service based cards, however, this product has not been as successful as the conventional credit cards.

Both Islamic and conventional credit cards are dependent on global players such as Master, Visa, American Express and Japan Credit Bureau. The business of such players is mainly based on the conventional system. Due to the unavailability of an alternative, IFIs don’t have any choice other than to interact with the same global players on terms and conditions acceptable to such players. Many scholars and experts have time and again raised their voice for better interface and introduction of at least one new player which provides the basis for Shari’a-compliant credit cards. However, based on the size of the industry and the potential for credit cards, it is not feasible to incur huge costs on such a venture. Innovation is required to introduce a model which on the one hand is capable to cater for public needs and requirements and on the other hand proves to be a successful business proposition. Shari’a experts have been discussing certain structures based on ijara, murabaha as well as salam. However, none have been considered appropriate to replace the current models in vogue. A model which involves takaful is also undergoing a litmus test in Bahrain. Its success will depend on the wider acceptability amongst the Shari’a scholars, commercial viability and effective structure and product development.

### 3.5 Conclusion

Standardisation at the level of international bodies such as AAOIFI, International Islamic Fiqh Academy, IFSB and the Islamic Fiqh Academy of the OIC may help innovation, as institutions will be forced to differentiate themselves from their competitors, and this may result in the sustainable development of the industry. Regulation at the government level may also play an important role for more innovation in the field of Islamic banking, finance and insurance. The current loose regulatory regime allows institutions to do pretty much anything which is permitted by their respective Shari’a boards. The regulator’s involvement with standardisation at the local level, will provide all institutions with a level playing field, and encourage innovation and development amongst them.
CHAPTER 4
Islamic financial products under US Law

4.1 Introduction

The United States is not sufficiently recognized for its openness to Islamic financial products and investments. Part of that openness is derived from a legal and regulatory framework that generally takes a substantive and flexible approach to issues and developments, rather than an approach that is tied to labels and formalities. The regulatory authorities, in recognition of constitutional protections, have also sought to treat financial products and instruments that are based on Islamic principles in a manner that would not discriminate on the basis of religion. The traditional willingness of the U.S. business community to undertake new transactions is also a positive factor.

Two important trends have characterized the growth of Islamic finance in the United States. The first has been the development of consumer Islamic financing and investment products and the regulatory approvals required for the introduction of such products. Those regulatory approvals have come from federal and state bank regulators and have included the rulings of local tax authorities. The focus of the approval process has been on determining how closely the legal and economic substance of the proposed products satisfy the criteria designed with interest-based products in mind. In addition to obtaining required regulatory approvals, applicants have also had to consider the application of consumer protection and disclosure laws. Those laws often force a characterization of Shari'a-compliant transactions in a manner that is often inconsistent with the Islamic view of such transactions.

The second important trend has been the significant level of equity investment, structured and financed on a Shari'a-compliant basis, which has flowed into the United States from the GCC since the mid-1990s. This wholesale investment flow has been led by GCC-based financial institutions and investment companies that have made investments in property, companies and leased equipment, often using fund or fund-type structures. The equity capital for such investments has generally come from the local, high net worth clients of those institutions. Most of the legal issues arising in such investments have related to the way in which they have been financed. These issues have been resolved by the parties in the manner in which they have structured the ownership and financing of such investments and have not required the involvement of regulatory authorities.

This chapter will provide an overview of some of the key legal issues that arise in the financing of wholesale equity investments in the United States and with the offering of Shari'a-compliant financing and investment products to U.S. consumers. The focus will be on the key structures that are used in these transactions-those being murabaha, ijarah and ijarah waiqafa.

4.2 Equity investment

4.2.1 Acquisition and financing structure

The structure most commonly used to finance property or corporate acquisitions in the United States on a Shari'a-compliant basis is an ijarah waiqafa, which is a lease and purchase arrangement. The structure is popular because it provides financing flexibility and it is similar to other conventional financing structures regularly used in the United States.

To structure an ijarah waiqafa, it is necessary to create a special purpose company (SPC). The purpose of the SPC would be to hold title to the property and to lease it to the Shari'a-compliant investor entity (Inves-
The SPC would be established and maintained by a corporate service company that would maintain the company in good standing, supply the directors and officers of the SPC, maintain the books and records of the SPC, and file the SPC’s tax returns. The corporate service company would be paid a nominal annual fee for performing these services. The use of an SPC is necessary in the United States if the ultimate finance provider is a bank, because banks are generally prohibited from owning real property. Even if that regulatory prohibition did not exist, most conventional banks would probably be reluctant to own real property assets directly because of the potential liabilities that flow from such assets.

The contract under which the property is to be acquired (the purchase contract) is generally entered into by one of the investment sponsors prior to the establishment of the various entities, including the SPC and the Investor, that will be used in the acquisition and financing structure. The purchase contract needs to provide the buyer with flexibility either to assign the purchase contract to the SPC or to direct that the property be conveyed directly to the SPC. The approach that is taken to convey title to the property to the SPC should be carefully analyzed to make sure that it does not result in the double application of any local property transfer tax - for example, once for the deemed conveyance of the property to the buyer and a second time for the deemed conveyance from the buyer to the SPC.

The SPC will generally be obligated to pay the purchase price of the property at the closing. The SPC will fund its payment of the purchase price from two sources - the proceeds of a conventional loan from a financial institution and an initial payment from the Investor under the ijara wa’iqtiha documentation that is entered into on the closing date. This payment by the Investor under the ijara wa’iqtiha documentation may be identified as an initial payment of rent, but it represents the equity investment made by the Investor in the property. Under the ijara wa’iqtiha documentation, the Investor will lease the property from the SPC, and the SPC will assign to it any existing tenant leases. As a result of this assignment, the Investor will become the landlord in relation to the end user tenants of the property. The rent payments to be made by the Investor to the SPC will be substantially equal to the debt service payments to be made by the SPC to the financial institution, and the method of computation and dates of payment will be matched. Any default by the Investor under the ijara wa’iqtiha will result in a default under the lease documentation: first, because the terms of the ijara wa’iqtiha are substantially the same as the terms of the conventional financing provided by the financial institution to the SPC, and, second, because the conventional financing will typically contain a cross default provision linking to defaults by the Investor under the ijara wa’iqtiha documentation. A corresponding cross default in the ijara wa’iqtiha documentation to a default under the mortgage loan documentation is typically not acceptable, however, because it requires an explicit recognition of the existence of the conventional financing being obtained by the SPC.

As part of the ijara wa’iqtiha documentation, the Investor would grant to the SPC, the right to “put” the property to the Investor and require the Investor to purchase the property and pay the unpaid “acquisition cost” of the property; the acquisition cost corresponds to the unpaid principal amount of the loan provided by the financial institution to the SPC. The put option would be exercisable upon an event of default and it is intended to provide an equivalent acceleration mechanism under the ijara wa’iqtiha documentation. The ijara wa’iqtiha documentation would also provide for the SPC to grant to the Investor a “call” right to purchase the property for an amount equal to the acquisition cost. The dates on which the call right may be exercised would correspond to the dates under the conventional financing on which the SPC may prepay that financing.

To satisfy Shari’a considerations relating to the sharing of risk, it will be necessary for the lease document to assign to the SPC, as the owner of the property, certain major responsibilities relating to the property. The SPC will then typically seek to retain the Investor (or an affiliate of the Investor) under a separate supplemental agreement to handle the performance of those responsibilities on behalf of the SPC. An amount equal to the amount required to be paid by the SPC to the Investor (or its affiliate) under the supplemental agreement would be included as part of the rent calculation, with the result that these two amounts are offset against each other. The final document comprising the ijara wa’iqtiha documentation would typically be a tax agreement in which the SPC and the Investor would agree that for U.S. federal income tax purposes, the ijara wa’iqtiha is to be treated as a financing, that the Investor is to be treated as the owner of the property for U.S. tax purposes (notwithstanding that title to the property is held by the SPC), and that the SPC and the Investor are to prepare and file their tax returns in a manner consistent with this treatment. As noted above, this type of structure, with minor modifications, can be used to finance corporate acquisitions in addition to property acquisitions.

4.2.2 Key legal issues relating to transaction structure

There are several key legal issues inherent in the ownership and financing structure described above. The Investor, including its equity owners, will want to be treated as the owners of the property to obtain the U.S. federal tax benefits of property ownership. To achieve that tax treatment, the Investor must be entitled to all of the benefits, and must suffer all of the burdens, of property ownership, notwithstanding that the Investor is the lessee of the property and not the title holder. As will be discussed below, achieving that tax treatment while respecting Shari’a principles can be challenging, but is achievable, through the inter-play of the ijara wa’iqtiha documentation. Another key legal issue relates to the Lender’s recognition that, while its mortgage loan is to the SPC, which is the title owner of the property, its true “borrower” is the Investor, which is leasing the property from the SPC. The Lender will want to be certain that this structure - in which a special purpose company is interposed between it and its true borrower - will not negatively impact the Lender’s rights or the enforcement of its remedies. Although all of the rights of the Lender should flow from its mortgage loan documentation, through the SPC and reach the Investor.
through the ijara wa‘iqtina documentation, there can be occasional gaps in the structure if the documentation is not properly drafted or structured.

The use of the SPC presents the additional issue of control. Although the property is generally controlled through the ijara wa‘iqtina documentation, representatives of the corporate service company will be serving as directors of the SPC, and those individuals will be obligated to respect their director fiduciary obligations to the SPC, when they are called on to make decisions. For example, if a default has occurred and a foreclosure action is being threatened, the Investor may seek to have the SPC file for bankruptcy as a defensive measure to force the lender to negotiate a restructuring of the financing. In such circumstances, directors of the SPC may take a more conservative approach to the question of a bankruptcy filing than would directors who are employees of the Investor.

4.2.3 Tax issues and property ownership

To pass Shari‘a scrutiny, the lease that is part of the ijara wa‘iqtina documentation must provide that certain responsibilities that are generally thought of as being attributable to property ownership be retained by the property lessor. The consensus among Shari‘a scholars is that the property owner should retain the obligation to make major or structural repairs to the property and to maintain damage insurance on the property. As a consequence, the lease agreement must provide that such responsibilities are the obligation of the SPC. This allocation of responsibilities, however, is inconsistent with the tax approach which requires that these burdens, which are correctly attributable to ownership, be the responsibility of the Investor if the Investor is seeking to be treated as tax owner of the property. This conflict is resolved through the supplemental agreement, by which the SPC retains the Investor, or a consolidated affiliate of the Investor, to undertake on behalf of the SPC the responsibilities for major repairs and property insurance allocated to the SPC under the lease document. The payment by the SPC to the Investor under the supplemental agreement and a corresponding rent payment by the Investor to the SPC under the lease, are in practice netted off against each other.

Another point of conflict pertains to the consequences of damage resulting in a total loss. Under Shari‘a principles, once an asset has been destroyed and can no longer be used, it cannot be the subject of a lease; and any existing lease of that asset must terminate. As the lease essentially represents the continuation of the financing provided by Lender to the SPC and from the SPC on to the Investor, one can appreciate that, from the Lender’s perspective, it would be unacceptable for a borrower to be relieved of its payment obligation under a loan upon the destruction of the collateral for the loan. Moreover, such a result would be inconsistent with the tax position that all risks and rewards of property ownership must fall on the Investor if it is seeking to be treated as the owner of the property for federal tax purposes. This conflict is also typically resolved in a supplemental agreement, which may provide that the Investor (as the contractor under the supplemental agreement) is responsible for maintaining insurance and that upon damage resulting in a total loss of the property, will pay out insurance proceeds equal to the outstanding obligations under the ijara wa‘iqtina documentation (those obligations being substantively identical to the obligations of the SPC under the mortgage loan). The consequence of this arrangement is to reallocate back to the Investor the risks associated with a total loss arising from damage, thereby preserving the tax treatment of the ijara wa‘iqtina transaction as a financing.

4.2.4 Foreclosure and subordination

Before entering into a property financing transaction using an ijara wa‘iqtina structure, the lender will want to determine that if a default occurs there will be no material impediment to the exercise of its remedies, in particular foreclosure. In addition, the lender will want to be assured that it will be able to sell the property free of the Investor’s rights under the ijara wa‘iqtina documentation. We are not aware of court decisions dealing specifically with ijara structures of the type described above, but we would expect that the lender would be able to consolidate the foreclosure proceeding under the mortgage loan documentation with the foreclosure proceeding under the ijara wa‘iqtina transaction so that both foreclosures proceed together in one consolidated proceeding. We would also expect that if a foreclosure proceeding is initiated by the lender against the SPC, but the Investor is not included in that proceeding, it should be possible for the Investor, as the party in interest, to intervene in that foreclosure proceeding.

The termination of the ijara wa‘iqtina documentation requires that such arrangement be subordinate to the mortgage granted by the SPC to the Lender. Subordination may be achieved through a direct agreement between the Lender and the Investor; but most Shari‘a scholars are reluctant to permit the investor to enter into a direct contractual arrangement with the lender. The solution most commonly used has been to place the requested subordination provisions directly in the ijara wa‘iqtina documentation between the SPC and the Investor. In these unilateral provisions, the Investor acknowledges that the ijara wa‘iqtina documentation is subordinate to the mortgage of the Lender and may be terminated by the Lender upon the completion of a foreclosure of the mortgage (and not merely upon a default under the mortgage loan).

4.2.5 Governing law

Although the ijara wa‘iqtina documentation is intended to comply with Shari‘a principles, the agreements are generally stated to be governed by New York law (except for the mortgage and related security documentation, which are typically governed by the law in which the property is located). The occasional suggestion that the documentation should be governed by Shari‘a principles (in addition to the local secular law), has been generally resisted on the basis that such provisions conflict with the selection of local law as the governing law of the transaction and are likely to create confusion in an enforcement scenario. Instead, the goal should be to have the legal effects of the documents be consistent with Shari‘a principles, while looking to the local secular law to achieve such effects in a predictable manner.
The issue of governing law has recently received special attention as a result of legislative initiatives that would prohibit judges from applying Shari’a law in court decisions. These initiatives are partially in response to a misguided court decision that sought to apply principles of Shari’a in a family law context; and perhaps influenced by the anti-Islam agenda of some. Legislation in the State of Oklahoma that would prohibit judges from applying Shari’a law or international law in their decisions was passed in a voter referendum, but its application was enjoined by a federal judge. In the State of Georgia, recently introduced legislation did not single out Shari’a law, but instead prohibited the application of foreign law by judges in Georgia courts if to do so would deprive litigants of their constitutional protections. These initiatives are all the more reason to approach Shari’a-compliant transactions with the objective of implementing a structure that will be enforceable under a designated local secular law.

4.3 Consumer investment products

The offering of retail investment products to U.S. consumers is still in its early stages. The United States bank regulatory framework does not contemplate investment accounts of the type offered by Islamic institutions in the Middle East, because those investment accounts require a sharing of profits and losses between the depository bank and the consumer. Such losses are not limited to the loss of profits, but also to a loss of all or part of the amount deposited with the bank. A loss of the amount deposited by a customer with a bank is inconsistent with the U.S. regulatory framework, which does not permit the invested amount to be at risk, and backs that arrangement with federal deposit insurance up to specified limits.

The United Kingdom’s approach to the same issue might indicate a possible course of action for U.S. regulatory authorities that would enable them to reconcile the requirements for Shari’a-compliance with the principles of the U.S. regulatory system. The U.K.’s FSA, which follows a regulatory approach similar to the approach taken by the United States, has required the continuation of the guarantee of the investment amount, but has permitted the bank’s customer to waive the guarantee and its benefit if the depository institution suffers a loss that would otherwise have been shared by the customer U.S. regulators have not yet been asked to approve such an arrangement, and there has been no indication whether such an approach would be acceptable. The depository arrangements currently targeted to the Muslim community in the U.S. permit the customer to share in the profits of the depository bank, but not in any of the bank’s losses. Although this arrangement protects the customer against the bank’s losses, it is not in compliance with Shari’a principles, because the customer is not required to share in the bank’s loss. It remains to be seen whether a U.S. financial institution will seek regulatory approval of a deposit product that would pass on the financial institution’s losses to the depositor under a UK-style waiver approach or some other arrangement that has the same substantive effect. In considering a solution to this problem, one approach that has been suggested would be to treat a profit and loss sharing deposit as an investment product regulated by the Securities and Exchange Commission, rather than a banking product regulated by the federal and state banking regulators.

4.4 Consumer financing products

4.4.1 Regulatory issues

U.S. regulatory authorities began to address the issues relating to Shari’a-compliant consumer products in the mid-1980s. The regulator that took these initial steps was the Board of Governors of the Federal Reserve (Federal Reserve). During this period and continuing until the late 1990s, the Federal Reserve approved the offering of Shari’a-compliant consumer financing products by the foreign subsidiaries and branches of U.S. banks. The initial approvals permitted some of the leading U.S. financial institutions to offer murabaha and ijara products in countries, such as Pakistan and the Sudan, that had mandated that all financing activities in those countries be provided on an Islamic basis. The Federal Reserve next expanded this authority by permitting foreign subsidiaries of certain U.S. banks to offer such products in countries that had a strong and increasing demand for Shari’a-compliant products, even though such products were not legally mandated in those countries.

Embedded in these approvals was the Federal Reserve’s implicit determination that the risks associated with offering the specified murabaha and ijara products - in particular taking title to the product for a short period of time (as in a murabaha transaction) or for an extended period of time (as in an ijara transaction) were substantively no different than the risks associated with comparable conventional financial instruments. One of the keys to a murabaha transaction is that the financial institution must take title to the goods in question before they are resold to the financial institution’s client, with such resale at cost plus an agreed profit and with payment typically at an agreed future date or dates. In an ijara or ijara wa’iqtina structure, the financial institution will hold title to the leased assets until the end of the lease term. Taking title to goods and then reselling those goods is not a typical or generally permitted activity for a U.S. financial institution. Nevertheless, in its approvals the Federal Reserve chose to look to the substance of the transactions rather than the form. In doing so, the Federal Reserve reached the conclusion that the risks posed to U.S. financial institutions engaged in such transactions were essentially credit risks of the type regularly managed by those institutions in their traditional banking operations. This flexible approach of the Federal Reserve -to look to the substance of the transaction in making a regulatory determination- is one of the strengths of the U.S. regulatory system and will benefit the Islamic finance industry as it submits additional products for review and approval.

This focus on the substance of the proposed financing transaction rather than its form was also essential to the regulatory approvals that were next granted from 1997.
to 2001, but this time by the Office of the Comptroller of the Currency (OCC), which is the federal bank licensing authority. During this period, the OCC approved the offering of ijara wa’iqtina and murabaha financing products on a case-by-case basis to finance consumer home purchases. As part of its approval, the OCC concluded that the transactions were essentially credit transactions that could be effectively identified and managed by U.S. financial institutions, and that the applicant U.S. financial institutions did have the appropriate expertise to identify and manage those credit risks.

In addition, the OCC addressed the restrictions placed on ownership of real estate by U.S. financial institutions. U.S. banks are not permitted to own real estate, other than to house the operations of the bank, or real estate acquired as a result of a foreclosure. These depression-era restrictions were intended to prevent banks from engaging in speculative real estate investment activities. In its approvals, the OCC again took a substantive view of the transactions in question and determined that the risks associated with the ownership of real estate in these situations, were credit risks rather than the types of risks intended to be prevented by the regulatory restrictions. Its approvals were granted on that basis. The New York State Banking Department, which has taken an active interest in the regulatory issues posed by Islamic financial products and issues, also approved similar home mortgage financing products during the same period.

4.4.2 Tax issues

The regulatory approval of ijara and murabaha financing products was a significant step forward, but it did not resolve all of the legal issues associated with the use of such products to provide consumer finance in the United States. A key issue with almost every Shari’a-compliant product in the United States is its tax treatment, both on a federal and on a state and local level. For example, most states have property transfer taxes that apply to every transfer of real estate or every recording of a real estate deed. These taxes can be significant in some jurisdictions and can materially affect the profitability of a transaction. If the Shari’a-compliant product proposed by the bank is a murabaha financing of real estate, a tax could potentially be payable on the sale of the home from the seller to the bank and again on the resale of the home by the bank to its customer. The same result would apply in an ijara financing, except that the second tax would be payable when title to the property is transferred to the bank’s customer at the end of the lease term. This double taxation of common home finance products would make such products disadvantageous in comparison with conventional home finance products. The tax authorities in New York State have recognized the inequity of imposing a second tax payment on a Shari’a-compliant structure when the substance of the transaction has equivalence to conventional financing. Rulings have been issued on a case-by-case basis to eliminate this double tax burden.

In addition to transfer tax issues, Islamic consumer finance products also present potential federal tax issues. For example, under current U.S. tax law, an individual tax payer is permitted to deduct mortgage interest payments in determining the tax payer’s total taxable income. As the Shari’a-compliant structures are substantially equivalent to the conventional structure, these embedded finance (or “interest”) charges should also be deductible. The financial institution that developed the Islamic financial product may have obtained such approval to facilitate the marketing of such product, but if it did not, the consumer would be left with the choice of either not deducting the embedded financing charges or deducting such charges and defending its position if challenged by the tax authorities.

4.4.3 Risks of property ownership

U.S. law imposes various responsibilities and liabilities on the current and prior owners of real property. If a bank provides financing to a consumer with a Shari’a-compliant product, it will generally take title to the property for only a moment (in a murabaha financing) or for an extended period of time (in an ijara wa’iqtina financing). The mere fact that the bank entered the chain of title (even if, in the case of a murabaha transaction, for only a brief moment) is sufficient to make the bank potentially liable for risks associated with the property. Risks of this type are generally not applicable to banks providing conventional mortgage finance, so a bank providing a Shari’a-compliant financial product will need to understand and take steps to mitigate such risks. If, for example, environmental problems are identified at a property that is currently or was previously owned by the bank, that bank would potentially have the obligation to bear the expense of any environmental remediation that may ensue. Risks of this type can be mitigated by having environmental experts conduct thorough due diligence prior to undertaking the transaction. Indemnities from the bank’s customer may also be sought, but such indemnities may be insufficient. Structurally, the bank’s other assets can be protected from these risks by using a separate subsidiary for each financing transaction, but the creation and maintenance of a new entity for each transaction will drive up the cost of the transaction and may put the financing product at a competitive disadvantage in comparison with a conventional mortgage financing product.

The ownership of property also carries with it the risk of liability for injuries occurring on the property. A financial institution financing the acquisition of property through an ijara wa’iqtina structure needs to be mindful of those risks and should obtain an indemnification undertaking from its customer, which is the party that is occupying the property, or insurance, protecting it against the risks associated with its ownership of the property.

4.4.4 Other risks

Murabaha and ijara wa’iqtina structures can be used by U.S. financial institutions to finance the purchase of goods or equipment in addition to real estate. When these structures are used to finance the purchase of goods or equipment, the financial institution will seek to address some of the risks unique to those transactions. A customer in a murabaha transaction will want to have the benefit of the supplier’s express and implied warranties relating to the goods or equipment, and the financial institution will want to be sure that its customer is look-
ing to the supplier, rather than to the financial institution, should the customer seek to make claims under those warranties. It is generally possible to transfer contractually the benefit of the supplier’s warranties from the financial institution to the customer, and this issue should be addressed during the customer’s preliminary dealings with the supplier, and in the purchase contract that is eventually signed between the financial institution and the supplier; otherwise the warranties will end up benefiting only the financial institution.

Similarly, the financial institution will seek to eliminate any warranty claims that might be made against it by its customer. Although it is generally possible to disclaim warranties, such disclaimers, especially in a consumer context, are generally not favoured and would probably be strictly construed against the financial institution. In most states, any disclaimer of warranties must be conspicuous and the language used must clearly call the customer’s attention to the exclusion. In addition, the disclaimer of certain implied warranties, such as merchantability and fitness for a particular purpose requires specific language to be enforceable. Warranty disclaimers that fail to meet those requirements may be held to be invalid.

The nature of a murabaha transaction is such that the purchase price to be paid by the customer does not change if the customer is required to make early payment, for example in a default situation, or if the customer seeks to prepay the purchase price voluntarily. This feature of a murabaha transaction can create problems under U.S. laws that aim to protect consumers by limiting the interest or finance charges that may be imposed in a consumer transaction; that impose a limit on penalties resulting from mandatory or voluntary prepayments or that require full disclosure of all interest and finance charges applicable in a consumer transaction. Under U.S. laws, the profit element of a murabaha purchase price would be treated as interest. The general practice of IFIs in voluntary prepayment situations is to provide the customer with a compensatory payment that is intended to offset the financial institution’s receipt of the portion of the profit embedded in the murabaha price that is “unearned” as a result of the early payment. This approach is not documented, and the IFI has no legally enforceable obligation to make such compensatory payment to its customer. Nevertheless, making such compensatory payments is generally expected by participants in murabaha transactions.

Such an approach, however, does not work in the regulated field of consumer finance in the United States. What we have seen in this situation in which U.S. legal requirements and Shari’a requirements come into conflict is that the Shari’a scholars, recognizing the utility of providing Shari’a-compliant financing products to the Muslim community, have permitted the financial institutions providing such financial products to rebate the “unearned” profit back to the customer so that the financial institution may avoid violating U.S. laws concerning the receipt of usurious interest charges or what might be considered to be impermissible prepayment penalties.

4.5 Conclusion

The United States maintains an open attitude to Shari’a-compliant equity investments and financial products, and the regulators have demonstrated their willingness to address the issues raised by such consumer products in a constructive manner. A number of issues have yet to be addressed, however, and that will not occur until we begin to witness more robust entry of IFIs into the United States.
CHAPTER 5
Bancataful

5.1 Introduction

With Generali International choosing Takaful International as their representative in Bahrain, there is no denying that takaful continues its ascension to success. For both organisations, this agreement means that all Generali customers in Bahrain will benefit from Takaful International’s services in health insurance and similarly, takaful family policy holders will benefit from Generali’s expertise in the field of insurance and reinsurance. This example is just one of many showing how takaful is quickly being embraced by international insurance companies. With assets over USD 1000 billion, Islamic finance has shown amazing resilience over a turbulent 2009 and great promise so far for 2010. More particularly, growth has been noticeable in the field of Islamic insurance or takaful. Indeed, an increasing number of favourable factors contribute to this growth in the GCC (Gulf Cooperation Council made of the UAE, Kuwait, Saudi Arabia, Bahrain, Oman and Qatar) region as well as in Asia, amongst these, the emergence of a young, affluent and educated Muslim population. As demand increases, it makes sense to optimize product distribution and seek the best way of doing so.

5.2 The GCC

According to a report issued by Alpen Capital in January 2010,1 life insurance premiums in the Middle East and Central Asia grew at a CAGR of 9.3% in 2008, well above the global average of 4.1% and -3.5% for conventional insurance respectively.

In the Middle East, life insurance accounted for about 26% of all insurance products sold in 2008. If we look at patterns from developed economies, non-life insurance grows faster at the early stages of the insurance industry development, whereas the life insurance does so later. Consequently, there is significant room for growth for family takaful, as penetration is still low (1.5% compared to a global average of 7.1%). Analysts at Alpen Capital have identified several key drivers of life takaful in the GCC: besides demographics and greater affluence bringing on a change in consumer habits, there is also a wider choice of takaful products available and the fact that they are far better regulated as the industry gains momentum and learns from experience.

There are several ways to distribute takaful products. The popularity of each channel depends on the level of maturity of the industry in the country those products are sold. By optimizing their distribution networks and including takaful in their product range, banks open themselves to cross-selling opportunities, therefore generating annuity fee income. It also allows banks to achieve valuable economies of scale in areas such as marketing, IT and back-office processes. The compelling economics of the bancataful business model has proven a real success for joint ventures in the region.

The GCC has caught on that trend, as the industry is slowly gaining momentum there and as a consequence, similar initiatives have been launched in the Middle East. In November 2008, Zurich Financial Services signed an agreement to establish a joint venture with Abu Dhabi National Takaful. In June 2009, AXA announced its partnership with one of the world’s largest takaful and retakaful group, Salama in the UAE. In November 2009, Allianz Takaful and Standard Chartered Bank have announced a five-year sales agreement to promote insurance products from Allianz Takaful in Bahrain. In Saudi Arabia, FWU Group, the global takaful provider, has a stake in Al Ahli Takaful Company and has forged successful distribution partnerships, such as with National Commercial Bank (NCB). FWU Group also enjoys a
very successful partnership with AMAN, based in Dubai. If we take the example of Saudi Arabia, in many cases, banks have shareholding links with insurance companies and while they have not developed specific insurance schemes, they have influenced the placement of insurance through referrals. Some of the new joint-stock companies have major banks as leading shareholders, and these companies use the bank’s distribution network to market takaful and simple personal lines insurance products. Al Ahli Takaful Company co-operates with NCB to distribute its products. There is no question that bancassurance is becoming an increasingly more important distribution channel in respect of individual and credit life business. For instance, one major majority bank owned takaful company acquires about 90% of its business through the bank. According to the GCC Takaful Report, there are still some opportunities to be explored in the bancatakaful arena to maximize the use of this promising channel of distribution. Developing dedicated sales teams offering takaful products, offering them sales incentives at par with conventional products, designing customized long-term investment-linked savings and pension products for as well as investing in technology to deliver high customer service standards are some of the areas to be improved on to widen outreach and increase customer retention.

5.3 The case of takaful in Asia

According to the recently-issued World Takaful Report by Ernst & Young, the global takaful contributions grew 29% in 2008 to reach USD 5.3 billion. Experts forecast those contributions at USD 8.9 billion in 2010 and at USD 15 billion in 2015. While the GCC (Gulf Cooperation Countries) are leading in terms of volume, Asia comes second with contributions reaching USD 1.146 billion and registering a CAGR (Compound Annual Growth Rate) of 28%, in line with the global trend of the industry. The forecast for the region shows great promise: according to Ernst & Young, Asia should post results of USD 1.847 billion for the takaful industry in 2010. Malaysia remains the largest takaful market in South East Asia, with contributions nearing USD 0.8 billion in 2008, while Indonesia is the country knowing the fastest growth (35%). In terms of insurance penetration, Brunei makes an entrance in this year’s statistics, with the fastest growth (35%). In terms of insurance penetration, Brunei is the country knowing the latest news in insurance in Southeast Asia, with contributions nearing USD 0.8 billion in 2008, while Indonesia is the country knowing the fastest growth (35%). In terms of insurance penetration, Brunei makes an entrance in this year’s statistics, with the fastest growth (35%).

<table>
<thead>
<tr>
<th>Distribution channel</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct and telemarketing</td>
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<td>44.3</td>
<td>38.0</td>
<td>32.0</td>
<td>30.0</td>
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<tr>
<td>Bancatakaful</td>
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<td>20.4</td>
<td>25.0</td>
<td>30.0</td>
<td>32.0</td>
</tr>
<tr>
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<td>19.3</td>
<td>20.0</td>
<td>20.0</td>
<td>22.0</td>
</tr>
<tr>
<td>Brokers</td>
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<td>14.2</td>
<td>15.0</td>
<td>15.0</td>
<td>14.0</td>
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<tr>
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<td>1.8</td>
<td>3.0</td>
<td>3.0</td>
<td>2.0</td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
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0.23% achieved in a single year (as a reference, Malaysia’s rate is 0.40%).

Takaful has been popular since it was introduced in Brunei with the setting up of two takaful operators, Insurans Islam TAIB and Takaful IBB. Currently, Brunei counts three takaful operators and the industry will see another development with the coming merger of Takaful IBB and Takaful BIBD.

In order to further strengthen the industry, Insurans Islam TAIB is currently tapping its own capital to meet the capitalization needed under a government order. Indeed, the firm will have to restructure its general takaful and family takaful units so that the two bodies will have a capital of USD 5.8 million each.

In Southeast Asia, Malaysia holds the strongest position in terms of takaful contributions volume, which stood at USD 889 million in 2008. According to the World Takaful Report, Malaysian takaful operators have fared better than their Middle East counterparts in terms of returns on equity since 2007, when world economies underwent the global financial crisis stress. Malaysian takaful companies also came out better in terms of risk retention; an indication that Malaysia has a more sophisticated operational capability. On retention, Bank Negara Malaysia’s (BNM) Financial Stability and Payment Systems Report 2009 released in March 2010, had noted that the ‘consistently high’ net retention level of 72.3% for Malaysian general and general takaful business enabled counterparty reinsurance risks to be kept at ‘manageable level’.

It added that as a majority of the offshore and foreign reinsurers were reputable companies with high ratings, it further reduced the extent of counterparty risk during the challenging financial climate in 2009. Indeed, the Malaysian landscape is made of global powerhouses such as...
Swiss Re, Hannover Re and Munich Re, but also of local operators such as MNRB Retakaful and ARIL, increasing the underwriting capabilities of the national insurance industry.

The country is a glowing example of how takaful is part of the financial awareness of customers: some banks report a share of non-Muslim takaful customers of over 50% and in some cases, over 70%, a sign of the successful integration of takaful in Malaysia.

BNM has recently approved the inclusion of takaful products and services within the scope of business which can be distributed by financial advisers. The inclusion of takaful products is a significant initiative as it will allow financial advisers to capitalise on the potential for growth of the takaful sector, given that the market penetration rate for takaful products is low at 7.7% and given the largely untapped Muslim population in Malaysia, who are usually more inclined towards Sharia-compliant products.

BNM however recognises that it will be essential for all financial advisers to be trained correctly and have the necessary knowledge in takaful, to understand the Sharia requirements and the differences between takaful and conventional products. It will therefore be necessary for financial advisers to obtain certain specific qualifications prior to being able to distribute takaful products. Distribution through bancatakaful has been increasing annually. In 2005, it represented 20.4% which is estimated to have increased to 32% by the end of 2008. This is due largely to competitive pricing and strong agency-driven distribution. BNM is playing an important role in the promotion of takaful in the country and has recently issued four new family takaful licenses. Already present in Malaysia, financial giants such as HSBC, Barclays and Standard Chartered are raising the bar for others to follow. The main Malaysian players are CIMB Aviva Takaful Bhd, Etika, Hong Leong Tokio Marine Takaful Bhd, Prudential BSN Takaful Bhd, Takaful Ikhlas Sdn Bhd, AIA Takaful International Bhd and Syarikat Takaful Malaysia Bhd, all having greatly contributed to the success of takaful in the country. Also, Bank Negara Malaysia has launched an initiative called “insuranceinfo” which is a joint effort between the Bank and takaful industry to provide educational information enabling consumers to make well-informed decisions when purchasing insurance or takaful products from their banks.

Hot on Malaysia’s steps is Indonesia, which has shown impressive growth levels in 2008. The takaful sector in Indonesia continues to grow steadily, due mainly to the popularity of unit-linked products. Today, takaful contributions amount to USD 150 million (1.5% of total insurance premiums of the country) and the whole activity is shared between three takaful operators and 39 takaful windows. A glowing example of bancatakaful success in Indonesia is provided by PT Bank Mandiri, who, in 2003, joined forces with AXA, the French insurance giant. Together, through their combined distribution channels, they reach an impressive 72 million customers who have exposure to their unit-linked takaful products (Mandiri Investasi Seajaherta and Mandiri Rencana Seajaherta). Another way to make the wider audience aware of the takaful offering in Indonesia is through advertising. This is the case for PT Prudential, who, since launching its takaful operations in September 2007, saw takaful contributions reach USD 85 million in 2008 – accounting for nearly 25% of its total business in Indonesia.

In Singapore, the Islamic insurance or takaful market is expected to see strong growth this year according to Daud Vicary Abdullah of Deloitte, quoting a 15% increase for this market.

In Pakistan, the agent-oriented network is the dominant distribution channel. Agents are also known as salesmen or development staff according to the insurers’ particular practice. Whatever denomination is used, the channel of distribution is exclusive to one insurer. A minority of agents operate on an independent basis, working with a number of companies. These are known colloquially as “cash and carry” agents. EPU Life, for example, has links with Faysal Islamic Bank and Barclays Bank for the purposes of distributing life and related products. New Jubilee Life Insurance is a subsidiary of the Aga Khan Fund for Economic Development based in Switzerland (AKFED), which also has management control of the Habib Bank Ltd, the largest commercial bank in the private sector. The newly established Adamjee Life has a distribution agreement with Muslim Commercial (MCB) Bank, one of its shareholders. Standard Chartered Bank is a leader in bancassurance.

5.4 Good governance and best practice

However, some developments in the industry will need to take place. According to the Alpen Capital report, one of the solutions would be mergers and acquisitions: that way, takaful operators would not see their profit margins decrease. Some takaful operators in the GCC and Asia have already chosen to combine forces with large international players by creating joint-ventures with them. For takaful to truly flourish, it seems that partnership in the sector is essential to achieve economies of scale as well as enable cross-border distribution of takaful. According to Dato Hj Syed Mohibb innovation is key, as are the following: a new approach to product and process development (such as dynamic equity principal protection strategy), new distribution models to reach an evolving consumer base (optimised bancatakaful) as well as exploring new investment avenues. Measures such as these will help drive growth by focusing on consumer needs. Again, the involvement of global players will facilitate implementation of innovation, as their internal operational infrastructure and better budget allocation are more conducive to introducing beneficial changes.

For Ernst & Young, one of the growth factors identified, is a consistent governance and risk management policy for takaful operators globally. Currently, there are as many codes of conduct and ethics as there are Sharia interpretations, that is to say, too many. According to Professor Rodney Wilson of the Faculty of Islamic Studies in Qatar, good governance could impact the takaful industry in more positive ways than one: not only would it enhance public confidence that the operator they are...
dealing with is conforming to appropriate sets of rules, but it also would provide useful and relevant information to participants or potential consumers. There are indeed some best practices that could help takaful players operate more efficiently and have a more transparent infrastructure: clear definition of strategic and operational roles for each decision-making body and implementation of Shari'a-compliance at every investment and underwriting stages. Indeed, the IFSB, based in Malaysia, has issued an exposure draft on “Standard on Solvency requirements for takaful undertakings”, in which it identifies the components necessary for an Islamic insurer to operate efficiently from a governance and risk management perspective. According to the IFSB, an essential part of good governance is the existence of an appropriate mechanism for sustaining a takaful undertaking’s solvency and adherence to sound risk management. In view of their importance and in particular of their effects on systemic stability – so crucial and relevant these days - takaful operators should always bear these in mind while planning and mapping their governance strategies, whatever the strength of the solvency regime imposed by the supervisory authority. Another consideration to take into account is the retakaful capacity: global brands such as Munich Re, Hannover Re and Swiss Re, together with regional players like Takafal Re and MNRB Retakaful have contributed to enhancing the Islamic reinsurance capabilities. Today, there are nine fully-fledged retakaful operators and most have operations in Malaysia. It is a well-known fact that Malaysia has always been at the forefront of regulations for the industry, Indeed, it is widely acknowledged that the South East Asian model is at the forefront of regulations for the industry. Indeed, it is widely acknowledged that the South East Asian model should be a blueprint for all insurers who have the desire to explore takaful, whether local operators or international players.

5.5 A changing landscape for all takaful players

However, there is unanimous agreement among experts that the global markets for takaful remain largely under-penetrated. Consequently, for takaful to have a fair share of the USD 4 trillion-worth global insurance pie, it is essential consumers become aware of its advantages. Again, Malaysia is at the forefront of consumer education with its education programme launched by its central bank, Bank Negara Malaysia. Information and education are especially crucial in the aftermath of the global financial crisis, as consumers tend to choose safety above risk taking. Takaful can provide this sense of security for consumers as investments are asset-based and its principles based on solidarity and sharing of risk and profits. For example, the dynamic principal protected equity strategy - like the one offered by FWU Group - is one of the most significant innovations that will certainly have a great impact on takaful consumers as well as on takaful operator’s growth. The main benefit for the customer is that the new technology secures capital growth at maturity by locking in the highest net asset value (NAV) of the strategy measured on a monthly basis during the complete term of the investment. The new technology is used in FWU’s family takaful investment-linked programmes. But the global crisis also had repercussions on banks distributing takaful: increasingly, banks have seen increased terminations for non payments and high lapsation rates. Again, in this instance, the role of good governance and the implementation of best practices are essential: assessing consumers’ appetite for the products as well as conducting the appropriate risk profiling will ensure consumers are offered the products which are most suited to their needs. Also, the lack of investment opportunities for takaful operators is having a negative impact on consumer choice. Diversifying the investment opportunities would not only dilute the risk and increase the range of products available but also would be more in line with the risk management direction the takaful industry needs to take.

5.6 Bancatakaful

In the majority of cases, takaful remains deeply embedded within the overall wealth management operations of global financial institutions which typically offer the full range of conventional as well as Islamic banking services. It inevitably results in potential internal conflicts of interest between the Shari’a-compliant technicians within the bank who are responsible for product design and development and the retail network responsible for delivering the product to the customer. The conflict arises because very few of the leaders in the bancatakaful sector have stand-alone sales forces able or willing to dedicate all their resources to the promotion and distribution of takaful.

This issue creates a “shelf space management” challenge whereby takaful has to jostle its way amongst other conventional insurance and banking products. Those are introduced on the market on a regular basis, whereas takaful is a life cycle savings and protection solution in its nature. It means that although takaful knows dynamic innovation, products are not launched with the same frequency. Consequently, takaful’s challenge is to stand out from credit cards, personal finance and other retail banking products. To remedy this, senior management should offer a level playing field where the sales incentives are similar to other banking products. Alternatively, distribution could be achieved through an investment team responsible for the sale of products with longer shelf life, such as mutual funds and structured instruments alongside takaful-linked products. This is the case for DIB – one of the most successful distributors of takaful in the UAE - with their AlIslami Takaful Programme, the latest addition to their suite of wealth management solutions, which include Shari’a-compliant savings schemes, mutual funds and other structured products.

Another way to alleviate that challenge is through white labeling, the benefits of which for the banks are numerous, as they can give their own name to the products, integrate their own mutual funds to the mix and avoid heavy investment in research and development, while still diversifying their range of products.

Another related challenge for more generalist players with a background in conventional products is to ensure that their staff has access to constantly updated and practical training programs on takaful. Providing staff with access to thorough and ideally web-based
educational programs will give specialist sales teams the knowledge and confidence they need to distribute takaful products more effectively. Indeed, big major international banks tend to have dedicated on-line training departments, such as Barclays, HSBC and Standard Chartered, who all have entered the market of Islamic insurance by opening dedicated windows in the GCC.

The fourth edition of the World Islamic Insurance Directory published jointly by Takaful Re and Middle East Insurance Review also showed an increase in the number of operators in the takaful market. According to both organisations, the Gulf Cooperation Council has 77 takaful operators, Iran 18, the Far East, 37 and Africa, 29. It begs the question: if all those companies were abiding by the same rules and regulations, would it mean the industry would finally gain the impetus and credibility it needs to move forward?

Bancatakaful can only be described as a win-win situation for all stakeholders: for the takaful operator (by having access to the bank’s wide customer base and benefiting from lower costs than those charged by agencies for example), the banks as distributors (by enabling them to increase their product offering and revenue generating capabilities) and the customers (by having access to a wider range of financial products from a trusted source.) However, though the first signs of improvement are certainly very clear due to the foreign players visibly and increasingly investing in takaful, there is still much to be done if bancatakaful is to realise its very rich potential. However big the challenge, there is certainly a willingness for it to become the predominant channel of distribution in the Middle East and Asia.

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6.1 Introduction

The global economic crisis has been an important turning point for the Islamic capital markets the world over. It can be reasonably argued that years between the emergence of Shari’a-compliant finance as a distinct sector (starting in the 1970s) and the onset of the credit crunch in August 2007 marked the initial, albeit rather drawn-out phase of extensive development for Islamic finance. This was a period characterized by the gradual emergence of Shari’a-compliant products in key categories and of rapid growth in the number of Shari’a-compliant financial sector institutions. By the time the crisis hit, Islamic finance had established itself as a large industry with an international footprint and a diverse array of products and services. Even though the growth and convergence potential of the sector is far from exhausted, the initial phase of dynamic expansion and innovation now appears to be largely over. The global crisis has been an important test to the sector and an ultimately valuable reminder of the need to structure products and strategies in a way that makes them resilient in the face of economic uncertainty. The downturn, by creating thorny problems, has also enabled the industry to grow its human capital base in the form of more experts with an understanding of what to do when Islamic financial products run into difficulties.

The impact of the crisis on Islamic finance has been dichotomous. On the one hand, it has become clear that the principles underpinning Islamic finance, which in turn are based on centuries-old tried and tested values, have protected Islamic finance from the excesses that brought the Western financial system to the brink of collapse. The aversion to leverage has been particularly important in the face of a systemic shock triggered in essence by reckless credit expansion. Those market participants that used to criticize Islamic finance, as well as government regulators in countries with sizeable Shari’a-compliant industries, for being too restrictive and conservative, now applaud and seek to emulate them. As people the world over seek to return to traditional values in finance, Islamic finance stands in good stead as an established paradigm whose credibility has been enhanced by its performance.

On the other hand, however, Islamic finance has obviously not been immune to the crisis. The downturn has severely tested pre-crisis assumptions and euphoric attitudes while also underscoring the need to better define and structure Shari’a-compliant products. Having been subjected to this test, the industry now has a much better idea of what works and what does not. But the crisis has also underscored the extreme urgency of broadening the product offering in Islamic capital markets and Shari’a-compliant finance more generally. The Islamic institutions that ran into difficulty typically had excessive exposures to a single asset class, often real estate, in the relative absence of established, Shari’a-compliant alternatives. The clients of Shari’a-compliant institutions were hurt by the limited retail product offering which still makes it difficult for people to build diverse portfolios balanced in terms of risk and return. Companies relying on Islamic finance have struggled due to the general underdevelopment and tensions of Islamic capital markets at a time when banks became reluctant to lend.

Thankfully, the crisis has coincided with important progress in addressing these limitations. The initiatives in the Gulf region have been particularly important, although they partly reflect the fact that the GCC had been lagging behind the other main hub of Islamic finance, namely Malaysia, in a number of respects. The most important progress has taken place in the area of debt capital markets where a number of important initiatives are underway with respect to the market in-
The first explicitly Islamic financial institution, the Islamic Social Bank of Egypt and by 1976, nine Egyptian banks. In 1971, the Mit Ghamr model was embraced by the Nasr nations, first among them Tabung Haji, or Pilgrims Management and also resulted in considerable progress in procedures and know-how for dealing with stressful situations. Among other things, some of the regional governments have been forced to provide far greater clarity on the differentiation and structures. But there have been significant government issues – primarily, but not exclusively in the conventional space – also in the rest of the region with the exception of Saudi Arabia which is not planning to tap the market before the national debt to GDP ratio is brought below 10%. However, even in Saudi Arabia, important benchmark issues continue to be made by the partially state-owned SABIC and Saudi Electricity.

Government activism has in turn encouraged others, most notably state-owned companies, to tap the sukuk and markets. In Saudi Arabia, additional expectations are created by the pending implementation of the mortgage law which would create a market for mortgage-backed securities. Partly because of the downturn in the IPO market and restrictions on bank lending, bonds and sukuk are now belatedly gaining popularity as ideal instruments for funding long-term development and infrastructure projects as well as corporate restructuring needs. By doing so, they offer opportunities to buy into the some of the most compelling growth stories in the region. Nonetheless, a great deal of work remains to be done in terms of developing attractive and cost-effective products that can compete with the conventional alternatives.

The growing popularity of sukuk has coincided with an acute recognition of the need to address some of the weaknesses of the still-emerging market. Developments over the past year, triggered in part by efforts by AAOIFI, have led to greater structural and conceptual uniformity of the market. The defaults in Kuwait, Saudi Arabia, and the UAE have boosted transparency and risk management and also resulted in considerable progress in procedures and know-how for dealing with stressful situations. Among other things, some of the regional governments have been forced to provide far greater clarity on the nature of implicit guarantees and investors themselves are likely to be more discriminating, at least for a time.

6.2 The beginnings of Islamic capital markets

The emergence of Shari’a-compliant finance was perhaps somewhat paradoxically led by banks, ie credit institutions, first among them Tabung Haji, or Pilgrims Management and Fund Board, established by the Malaysian government in 1962. An Egyptian bank in Mit Ghamr began to invest its funds on a profit-sharing basis in 1963. In 1971, the Mit Ghamr model was embraced by the Nasr Social Bank of Egypt and by 1976, nine Egyptian banks had adopted an explicit no-interest policy.

The first explicitly Islamic financial institution, the Islamic Development Bank (IDB), was established by Organization of Islamic Countries in Jeddah in 1975. Other notable Shari’a-compliant institutions that came into existence soon after included Faisal Islamic Bank of Sudan (1977) and the Bahrain Islamic Bank (1979). Pakistan authorized Islamic banking at the state level in 1979. IDB acted as an important catalyst for the Islamic banking industry, with the incorporation of Dubai Islamic Bank in 1975. The Malaysian government issued the first Islamic bond in 1990. The 1980s saw a steady expansion in the geographic footprint of Islamic financial institutions, as Shari’a-compliant banking and financing concepts spread rapidly across Asia. In 1981, Pakistan allowed its conventional banks to offer interest-free counters across branches to mobilize deposits on profit/loss sharing basis. Malaysia, on the other hand, adopted a gradual approach in implementing Islamic principles for its financial system. Malaysia established its first Islamic bank, Bank Islam Malaysia Berhad in 1983. Countries such as Sudan and Iran also started reforming their banking systems to conform to Shari’a principles. However, the major development in Islamic finance was the emergence in 1985 of a distinct insurance concept, takaful or Islamic insurance. The process was initiated by the Council of Organization of Islamic Conference (OIC) that declared takaful as Shari’a-compliant. Nonetheless, the range of products and services remained narrow until the 1980s, with the focus being on deposits and savings activities.

6.3 Growing sophistication

By the late 1990’s, the need for distinctive capital market solutions became evident in the face of a palpable economic take-off of majority-Muslim emerging markets such as Malaysia and the Gulf countries. This ultimately led to the introduction of several new innovative products such as sukuk, Islamic equity funds, and various structured products. The first private-sector sukuk issues were launched in Malaysia in the 1990s, but over time, also governments played a key role in sponsoring these developments. The Malaysian government issued the first global sovereign sukuk in 2002 and this encouraged other Muslims countries to follow suit. Increasing deregulation and liberalization of capital markets in the GCC and other Islamic countries, along with the growing demand for innovative financial products, paved the way for the creation of an Islamic capital market infrastructure, complete with Islamic equity indices, asset-backed securities, investment banks and brokers/dealers. In recent years, a growing number of Islamic solutions have emerged for asset management and venture capital services. Product innovation was above all driven by the growing Shari’a-compliant financing needs of corporate and governments but also a pressing need to address the
liquidity management problems of Islamic banks.

6.4 Islamic equity markets

The Islamic equity market is composed of equities of companies that do not engage in activities that are considered haram (forbidden) in Islam. This excludes ventures involving gambling, pork (food businesses), alcohol (wine and liquor makers), tobacco (cigarette and related product companies), pornography (entertainment and hotel stocks), and arms and ammunition. Similar restrictions pertain to companies whose debt is to a large extent interest-based or those that derive a significant proportion of their net income from interest payments on deposits held in conventional financial institutions. Such entities are excluded even if their main business is otherwise halal (permissible). In addition, equity offerings of conventional financial services institutions (including banks, mortgagers and insurers) and companies with high debt or cash positions are also not considered Sharia-compliant.

The identification of Sharia-compliant stocks in turn made possible the creation of Islamic indices. The Islamic equity index was first launched in Malaysia by RHB Unit Trust Management Bhd in May 1996. This was followed by the launch of Dow Jones Islamic Market Index by Dow Jones & Company in February 1999 and the Kuala Lumpur Sharia Index by Bursa Malaysia in April 1999. In October 1999, the FTSE Group also launched the FTSE Global Islamic Index Series. Major index providers, which include MSCI, S&P, and Dow Jones, have in recent years launched a large number of similar Islamic indices.

The growth of the Islamic equities market can be gauged from the progress made in Malaysia. The number of Sharia-compliant equities listed on Bursa Malaysia has increased steadily from 787 in 2004 to 847 in May 2010. In fact, Sharia-compliant securities accounted for 64% of the total market cap of Bursa Malaysia in 2009, compared with 58% in 2003.
6.5 Sukuk markets

Sukuk are generally thought of as the Shari’a-compliant alternative to bonds. Indeed, much of the initial evolution of the market arguably involved the financial re-engineering of bonds with a view to giving them a Shari’a-compliant veneer. Even though the stricter interpretation of sukuk essentially views them as analogous to preference shares, the references to bonds have persisted due to the use of sukuk in raising capital for a finite period, until recently typically up to five years and virtually never more than ten. However, the past year has seen efforts to widen the range of tenors through the issuance of seven-year, as well as short-term (less than a year) sukuk.

Efforts have been underway for a number of years to give sukuk a more distinctive Islamic identity, in part by basing them on the principle of risk-sharing. Recent efforts by AAOIFI have been particularly important in this regard, both in terms of fueling greater standardisation and by seeking to ensure that sukuk have a concrete underlying asset. Indeed, AAOIFI found that the vast majority of the pre-2008 sukuk issuance was in violation of its new rules. Under the proposed paradigm, the issuer of a sukuk provides a financial certificate to investors who are given proportionate ownership of the underlying asset for a pre-defined period. Moreover, unlike conventional bonds, which provide a fixed interest to bond holders, the sukuk issuer agrees to provide a return to investors in the form of payments that are linked to cash flows generated from the underlying asset for which capital is mobilized. This model should, under the circumstances, not provide any guarantees of principal repayment at the end of the period as the value of the asset can vary.

The first sukuk ever was issued by Shell MDS in 1990 for MYR 125 million (USD 33 million). Since then, the progress of the market depended heavily on efforts of the Malaysian government that had made the world’s first sovereign USD 600 million sukuk issue in 2002. Malaysia’s Cagamas MBS has issued USD 540 million worth residential mortgage-backed securities. Malaysia has also seen issuance by corporates, including notably a pioneering USD 2.86 billion issue by the PLUS highway concessionaire in 2006. The government’s investment arm, Khazanah Nasional, issued the first exchangeable sukuk the same year.
Following the Malaysian precedent, also other Islamic countries entered the sovereign sukuk market. Bahrain led the way with a USD 100 million issue in 2001. Qatar issued a global sukuk of USD 700 million in 2003, and Pakistan came out with USD 600 million issue in 2005. In the Gulf, Bahrain remains the most active sukuk market. The country regularly issues short-term sukuk for liquidity management. In 2002, Islamic Liquidity Management Centre was established in Bahrain in order to boost sukuk issuances. Qatar has recently intensified its efforts to develop the national debt capital markets and this year issued domestic sukuk, as well as bonds, partly for the purposes of liquidity management in the banking sector.

The world’s first global corporate sukuk issuance for USD 150 million was made by Kumpulan Guthrie, a Malaysia-based company, in 2001. Since then, sukuk have not only grown in size but in product sophistication and structure. Bai bithaman ajil was initially the most popular form, accounting for 77% of total issues in 2001. However, efforts aimed at standardisation, notably by AAOIFI, have now effectively made ijarah the dominant structure, albeit in a market that has seen historically subdued issuance levels.

Global sukuk issuance grew steadily from USD 5.8 billion in 2003 to USD 33 billion in 2007. Even as the onset of the financial crisis and the debate on Shari’a compliance standards temporarily reversed the positive progress, restrictions on bank credit and depressed stock markets have stimulated interest in bonds and sukuk. Moreover, sukuk have continued to benefit from high yields as well as perceptions of them as a ‘less risky’ investment proposition compared with conventional bonds, in part because they are typically backed by physical collateral. Indeed, efforts to ensure that this is the case have been among the focal points of recent efforts to standardize the sector. Moreover, the huge public and private investments undertaken in emerging economies, particularly in infrastructure, have boosted funding requirements in areas essential for economic development. Leading Middle Eastern sukuk issuers include companies such as the petrochemicals giant SABIC and the Saudi Electricity Company, as well as a growing number of real estate developers.

In spite of the promising potential and market drivers, the progress made in recent years was abruptly reversed in 2008 when total global sukuk issuances declined to USD 15 billion, as the broader debt capital markets dried up globally. In terms of types of sukuk, Bai bithaman ajil was initially the most popular structure, albeit in a market that has seen historically subdued issuance levels.

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In spite of the promising potential and market drivers, the progress made in recent years was abruptly reversed in 2008 when total global sukuk issuances declined to USD 15 billion, as the broader debt capital markets dried up globally. In terms of types of sukuk issuances, corporate sukuk nonetheless continued to narrowly overshadow sovereigns and accounted for 56% of all sukuk issues in 2008. 2009 and 2010 have been marked by a cautious but a fairly consistent recovery. In 2009, sukuk issuances rose to USD 27.1 billion, which was followed by a further rebound to USD 38.0 billion in 2010. Nonetheless, the upturn has been an uneven and somewhat anxious one, due to the prominence, especially in the Gulf, of market stress linked to high-profile sukuk restructurings. These have in some instances necessitated government intervention and regulatory innovation. Concerns over the restructuring terms have tended to make for greater market tension in the sukuk space as compared to conventional bonds.

(Exhibit 7). At the same time, the reliance of the market on a limited number of large issues by sovereigns and blue-chip names has translated into considerable quarterly variation in issuance volumes (Exhibits 5 and 6). Periods of market stress – some of them linked to the European sovereign debt crisis – have prompted many issuers to delay their plans. The market was also hit by the sharp cycle in real estate as well as, to an extent, in finance. Many of the property and financial companies that had driven sukuk issuance before the crisis largely withdrew from market. In the GCC, financial sector sukuk issuance declined from 17% in 2008 to 6.7% in 2009 while the share of real estate plummeted to 3.6%. The impact of these changes was particularly linked to the troubles of the UAE economy and especially Dubai. By contrast, corporate issuance has been robust in the dynamic Malaysian and Indonesian markets where new activity has been driven by a robust economic rebound.

As corporates retreated, sovereign issuance has once again become the backbone of the GCC sukuk markets. Sovereigns made up 91% of GCC sukuk issuance in 2009, up from 65% in 2008. 2010, by contrast, saw something of a revival in the corporate space, although sovereign programs also continued apace, most notably in Bahrain and Qatar. Also the Indonesians, Gambian, and Brunei governments tapped the Shari’a-compliant markets. Although corporate issuance has by no means normalized, there have been a number of landmark issues, not least the Saudi real estate developer, Dar al Arkan’s USD 450 billion issue in early 2010, which was the first Saudi 144a corporate issue open to US investors. Saudi Electricity Company broke new ground with a SAR 7 billion seven-year issue, having previously limited the tenors to five years. In general, the sluggish nature of the GCC sukuk market seems to reflect at least in part the residual concerns about sukuk structures and the potential risks pertaining to default-type situations. Under the circumstances, the improvement seen in the pricing of GCC sukuk’s has been clearly slower than that observed in the conventional market.

The end of 2010 has seen tentative signs of optimism in the sukuk market. The Dubai World deal has boosted confidence, while the European situation gained a temporary respite from the Greek bail-out and the establishments of broader bail-out mechanisms. While the situation is showing signs of deteriorating again, GCC and South-East Asian sukuk issues are internationally active in terms of their fundamentals and prospects. There are signs that the region will reap at least some of the benefits offered by the latest wave of US quantitative easing as US investors seek yield outside their home markets. Even as the GCC sukuk markets have languished in recent terms, there has been increasingly strong momentum in South-East Asia, some of it involving Malaysian Ringgit-denominated issues by GCC entities. However, the positive momentum, especially in the wake of the Dubai World deal, is expected to lead to the reactivation of some of the GCC pipeline, even if political unrest in North Africa may temporarily curb the momentum. The regional refinancing needs are growing and the range of sukuk products widening in terms of tenors. Moreover, there is a structural imperative for catch-up in the GCC. During the crisis, Malaysia has consolidated its status as a sukuk hub in spite of the sig-
nificantly smaller size of its economy – only about a fifth of the GCC (Exhibit 9). Quasi-sovereign infrastructure spending has been a critically important dimension of sukuk issuance and highlights the potential in this regard also in the GCC. Merely matching, the relative size of the Malaysian sukuk markets would offer considerable upside potential for the GCC.

The near-to medium-term outlook for the global sukuk markets is generally benign, both thanks to a projected cyclical recovery in many of the key issuer markets and a number of powerful structural forces. While the cyclical recovery should reduce the need for government sukuk issuance, the pace of the upturn in bank lending may prove cautious. The current pipeline for bonds and sukuk in the GCC and South East Asia alike is sizeable and many issuers are likely to proceed with their plans in conditions of diminished market stress, not least because of the demonstrated benefits of developing new sources of capital. In particular, corporates are likely to be able to reliably and cost effectively fund their long-term needs through bonds and sukuk. Bank credit has been repeatedly shown to be an inadequate means of long-term capital raising, both due to the inevitable tenor mismatches and also the cyclical challenge of elevated risk aversion, as demonstrated during this crisis. The most compelling case for long-term sukuk finance comes, as noted, from the infrastructure development plans of emerging markets, although sustained success in this regard will necessitate structural innovation and longer tenors. In the GCC alone, infrastructure investment needs are estimated at possibly USD 120 billion over the next decade. The regional development plans envisaged total spending amounting to hundreds of billions of dollars in the next five years – USD 385 billion in Saudi Arabia, USD 129 billion in Kuwait, etc. The aggregate value of ongoing construction projects is in excess of USD 700 billion. A number of challenges persist in terms of developing acceptable sukuk solutions and the secondary markets needed for a larger, more liquid market. However, the developments of the past several years give grounds to cautious optimism in this regard.
Exhibit 7: Average yields of sukuk and GCC conventional bond spreads
HSBC/NASDAQ Dubai, Bloomberg

Exhibit 8: Sukuk issuance by type globally (2010)
Source: Moody's Investors Service, NCBC Research

Exhibit 9: Geographic distribution of primary sukuk issuance in 2010
Source: Standard & Poor's, NCBC Research
CHAPTER 7
Islamic asset management

7.1 Introduction

Nearly all activities labelled today as “Islamic asset management” or “Islamic wealth management” are not at all related to their conventional cousins. Islamic asset management is primarily a supply side phenomenon, driven by Shari’a compliancy and related Shari’a premium (higher management fees charged by the Islamic fund managers). Sometimes it is accused of being random, undisciplined, and lacking professionalism, but there is certainly a distinct improvement as evidenced by many Western fund managers in Islamic fund management.¹

The Shari’a premium based argument assumes that investors are looking for Shari’a compliancy only and may not in fact attempt to seek to improve their chances of achieving long-term savings objectives through disciplined investing. Instead they randomly purchase investments from their bankers who offer Shari’a compliancy with the help of their Shari’a boards. By extension the theory assumes Muslim investors may not be interested in planning and executing an investment savings program based on modern, global investment practices, instead assembling a hodge-podge of investments in a haphazard fashion.

While this approach has worked in favour of the Islamic fund and asset managers in the past, this however is not appealing to a vast majority of new users of Islamic asset management services, many of those may have advanced university degrees, communicate in many languages, or run complex businesses. The younger generation of Muslims care deeply about Islam in all aspects of their lives, including their investments. This newly emerging trend requires change in Islamic asset management styles and the underlying fund management practices, which must not only be Shari’a-compliant but also generate risk/return profiles commensurate with their conventional counterparts. The conventional asset managers who have been involved in Islamic finance seem to resist this new trend, believing that the new trend is limited to only a very small proportion of Muslim investors. Many such asset managers have surprisingly suggested that:

- Our Muslim clients don’t want Islamic investing
- Our bank tried one Islamic equity fund and because it didn’t sell we know Muslims don’t want Islamic investing
- Our bank won’t go into an area of investing we don’t understand
- In our experience it won’t work
- Our capital-guaranteed structured products sell so well we don’t want to change the product mix for Muslims
- We’re afraid to sell Islamic asset management to existing Muslim clients

These excuses are surprising as the basic genetic coding of Muslims is presumably identical to the rest of the world’s population. Universal human values, including the need to organize and execute savings plans, should be the same for Muslims as they are for anyone else. These same asset managers prefer to offer everyone else (Brazilian ranchers, Italian industrialists, Australian artists, California pension funds, etc.) wealth and asset management services derived from a disciplined, professional and well-established process.

It is mistakenly thought that the old asset management model only applies to Muslim markets, not to those in, for example, Brazil, Russia, the United States, Germany, or China. In those markets we know that most banks approach potential clients with a very specific

¹ Some wealth management bankers have an alternative theory. This alternative theory supposes that Muslims have a proclivity to managing their own wealth, making the asset allocation decisions themselves. It also supposes that Muslim wealth holders don’t disclose all their assets to their banker, thereby preventing the banker from helping the client make rational allocation decisions. Perhaps they are right or at least in some cases, in particular with the more sophisticated family offices with professional staff and substantial assets under management. But one must doubt this is the case with the vast majority of clients, including the tens of thousands who have already placed some portion of their wealth in professional—but conventional—wealth management or private banking programs, nearly all in Europe since no similar service yet exists anywhere in the Muslim world.
service offering: “We will manage your assets according to the principles of Modern Portfolio Theory, matching your investment profile with an investment strategy and a pool of carefully diversified investment products that will have a high chance of achieving your investment objectives.” Seemingly this is the global standard, which must be applicable to Muslim investors who seek Shari’a-compliant investing.

7.2 Foundations of asset management

As has been detailed elsewhere, Modern Portfolio Theory forms the bedrock of asset management everywhere, and should by any measure form the bedrock of Islamic asset management. This was first conceptualized in 2009, showing how first an asset manager examines a particular client’s profile—whether the client is an individual or an institution—deriving from that a roadmap for investing. The client profile quantitatively and qualitatively describes the client’s investment objectives by indicating risk and reward preferences, defining end-term investment objectives, and shows current and future assets and liabilities.

From the client profile one can choose an investment strategy that has a certain probability of achieving the client’s investment goals. There are only three kinds of strategies: Income, Balanced and Growth, indicating low-, medium- and higher-risk investing styles. All other strategies are derived from these and only these three.

An investment strategy is then matched with an asset allocation model, where there are only four categories of assets: Cash (money market), Fixed Income, Equities and Alternative Investments (being any asset that is not in the first three categories). These categories are themselves reflective of risk, where Cash and Fixed Income are relatively less risky, and Equities and Alternative Investments inherently more risky. More risky assets means more risky portfolios, and vice versa.

Asset allocation models are critically important as numerous attribution analysis studies have shown repeatedly, that investment success or failure normally evolves from the macro decisions made by the asset manager, not micro decisions. Macro in this sense means not whether to buy Nokia or Motorola, and not whether to buy on a Monday and sell on a Friday. Security selection and investment timing have been shown to be almost insignificant to investment performance.

Instead, the larger decisions on whether to move portions of a portfolio toward Cash and Fixed Income, and away from more risky investments like Equities, can have the single greatest impact on investment performance. Likewise choosing whether to invest in telecommunications equities versus natural resource equities can have a much greater impact on investment performance than time and effort spent on which equities to invest in the respective categories.

It is not unusual or coincidental; therefore, that Modern Portfolio Theory results in asset allocations highly cor-

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Cash (money market)</th>
<th>Fixed Income (bonds)</th>
<th>Equities</th>
<th>Alternative Investments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balanced</td>
<td>5%</td>
<td>45%</td>
<td>65%</td>
<td>15%</td>
</tr>
<tr>
<td>Balanced</td>
<td>5%</td>
<td>45%</td>
<td>65%</td>
<td>15%</td>
</tr>
</tbody>
</table>

Exhibit 1: Hypothetical model portfolios, conventional asset management related among professional asset managers. Typically the three investment strategies invested in the four asset categories come up with allocations as shown in the Exhibit 1.

While the above is a somewhat crude depiction of the three investment strategies and their composition of four asset categories, it is in fact illustrative of how professional managers actually do make investment allocations for real-world clients everywhere.

This is intuitively correct. One doesn’t need an advanced degree in statistics to understand that expecting higher rewards will involve higher risks, and vice versa. Nor does one need professional qualifications to conclude concentration of investments into one or a few assets is inherently more risky, and that diversification is inherently less risky. We illustrate the risk-reward ratio and its meaning for portfolio investment strategy selection in Exhibit 2.

As an indication of what this means in the real world, take a look at contemporary Balanced allocations made today by well-respected names in the asset management industry. This can be seen in Exhibit 3.

<table>
<thead>
<tr>
<th>Institution</th>
<th>Strategy</th>
<th>Cash</th>
<th>Fixed Income</th>
<th>Equities</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>UBS Fund Management</td>
<td>Balanced</td>
<td>1%</td>
<td>52%</td>
<td>47%</td>
<td>0%</td>
</tr>
<tr>
<td>Credit Suisse Asset Management</td>
<td>Balanced</td>
<td>-1%</td>
<td>42%</td>
<td>47%</td>
<td>12%</td>
</tr>
<tr>
<td>JPMorgan Asset Management</td>
<td>Balanced</td>
<td>5%</td>
<td>45%</td>
<td>50%</td>
<td>0%</td>
</tr>
<tr>
<td>Julius Baer Asset Management</td>
<td>Balanced</td>
<td>7%</td>
<td>41%</td>
<td>49%</td>
<td>3%</td>
</tr>
</tbody>
</table>

Exhibit 2: Risk/Return Profile

Exhibit 3: Contemporary balanced allocations
There are general correlations among all asset managers in all investment strategies, where asset allocation is the result of disciplined, studious analysis of expected future risks and rewards among the four major asset categories.

7.3 Foundations of Islamic Asset Management

Modern Portfolio Theory is known to underpin all professional asset management everywhere and it should not be an exception for Muslim clients seeking Shari’a-compliant investing. In the above-referenced work, it was shown that there is essentially no difference between conventional asset management and Islamic asset management—whether the client is an individual or an institution—except in security selection in compliance with Shari’a. The common, universal steps of the professional practice we call asset management are: 1) client profiling, 2) investment strategy selection, 3) asset allocation, 4) security selection, and 5) investment monitoring and rebalancing. Only at Step 4, security selection, does Islam enter the equation. All other steps are identical for all clients, regardless of faith. Even security selection is nearly identical, the only difference being the selection of high-quality, qualifying assets that have an acceptable degree of Shari’a-compliance.

Fortunately, the Islamic banking community has delivered what we believe is a minimum number of mutual fund securities that are in fact fully Shari’a-compliant and represented in all four asset categories. Each asset category has a Shari’a equivalent: murabaha or trade finance funds for Cash, sukuk or trade finance funds for Fixed Income, Shari’a-compliant shares for Equities, and numerous “other” securities such as real estate funds or commodity funds for Alternative Investments.

Therefore, one can conclude Shari’a-compliant investing would comprise the identical three investment strategies and four asset categories common in conventional investing. General allocations can be seen in Exhibit 4.

<table>
<thead>
<tr>
<th>Income</th>
<th>Balanced</th>
<th>Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash (murabaha)</td>
<td>5%</td>
<td>5%</td>
</tr>
<tr>
<td>Fixed Income (sukuk)</td>
<td>65%</td>
<td>45%</td>
</tr>
<tr>
<td>Equities</td>
<td>15%</td>
<td>35%</td>
</tr>
<tr>
<td>Alternative Investments</td>
<td>15%</td>
<td>15%</td>
</tr>
</tbody>
</table>

Exhibit 4: Hypothetical model portfolios, Islamic Asset Management

These allocations are essentially immutable, i.e., if an asset manager wishes to accept an investment mandate from a Muslim client seeking Shari’a-compliant investing, then the asset manager will construct a portfolio allocation essentially along the same ratios used for any other client with the same client profile. Tolerance for risk and expectations for reward are inherent elements of professionally constructed allocations.

7.4 Shari’a-compliant funds universe

It should come as no surprise that Muslim investors are identical to people of all faiths in their need for planned, disciplined savings. Such common human characteristics and behaviours are not exclusive to any race, ethnic class, or faith. They are universal. Among them is the need to save for the future, itself not a spiritual activity.

To do this, one must examine security selection, the only element of the common rules of professional asset management that requires adaptation to Shari’a. Focus should be on the universe of Shari’a-compliant assets to determine just how many investment funds meet global standards. The question is: can an asset manager assemble a professional portfolio of Shari’a-compliant assets that will meet international asset management standards yet at the same time satisfy the spiritual component of a client’s investment objectives?

No asset management of any kind can be done without data tools. These data tools are found in abundance in the conventional world of asset management. They include Bloomberg, Reuters, Morningstar, IdealRatings, Eurekahedge and many others. In fact, each of these mentioned services have Islamic components, databases that presumably fill the needs of professional investors for information on securities available in the Islamic asset universe.

Unfortunately, on more careful examination it is found that none of these services meet professional standards for asset managers seeking to fulfill the majority of Islamic investment mandates. All of them have incomplete listings of the available universe of Shari’a-compliant securities mostly suited for the average investor, and even most wealthy investors. All but the highest-net-worth investors would find the existing listings of Shari’a-compliant securities unusable for constructing diversified portfolios in all asset classes.

Importantly this is so because the large majority of investing is done on a funds-of-funds basis. That means most allocations are made from an assembly of funds, where each asset category in every investment strategy is populated with funds, not individual securities like stocks or bonds. When witnessing actual allocations in the Swiss private banking industry, for example, there are almost no cases of “smaller” accounts being invested directly into individual securities such as stocks or bonds. Smaller is often measured in the tens of millions of dollars, where a client account of say USD 50 million or less is considered “small.”

While the threshold of “small” will vary from bank to bank, or manager to manager, the concept is the same: 1) managers cannot dedicate cost-effective individualized investing to every client account, and even less so for smaller accounts, 2) most investment failure or success is not based on individual security selections but on broader investment decisions that can be achieved with funds-of-funds allocations, and 3) resources at all asset management units—whether in banks or investment companies—are limited, so that no manager can be said...
to be professionally competent in all asset markets all the time, therefore stimulating the need for managers of specialized funds.

Funds-of-funds allocations predominate in the asset management universe. Even very large multi-billion dollar pension funds and endowments utilize funds for much of their allocations. Very few very large investors, in fact, will buy straight securities for all of their allocations. With over 3 million investible securities worldwide it is no wonder that mutual funds dominate the asset management allocation process. Specialization in various geographies, industries and securities is much sought after in the investment world, and nearly always via mutual funds.

And, the universe of conventional funds is rich and large. As of the end of 2009 there were somewhere around 65,000 mutual funds worldwide according to the Investment Company Institute Factbook. These funds manage collectively around USD 23 trillion in assets, one of the largest pools of managed money anywhere. A very large number of these funds are identified by the major data sources (e.g., Bloomberg, Reuters), with substantial data on each fund’s history, volume, domiciliation, liquidity terms, and much more. Clearly this eases the professional responsibility of an asset manager seeking a universe of conventional funds for selection and investing into a client allocation.

But what of the Islamic mutual fund space? As was detailed previously in the Global Islamic Finance Report 2010, the Sharia-compliant universe consists of a trifling 830 mutual funds and ETFs and about USD 82 billion in assets under management. Other studies have indicated the Sharia-compliant universe is even smaller, with about 750 funds managing only around USD 52 billion in assets. A global search today would likely show about the same, or perhaps even less. By either number of funds or assets under management, the Islamic funds universe is indeed very small; with Sharia-compliant funds numbering only 1.3% of their conventional cousins, and only 0.36% in assets under management compared to the global funds universe.

And, a majority of Islamic funds is not available to professional investors simply because they don’t meet professional standards. Typical screening and filtering—based on track record, domiciliation, liquidity and assets under management—reduces that number to substantially less. Adding a Sharia filter, where funds without acceptable Sharia-compliance are eliminated, brings the total number of professionally acceptable Islamic funds to 99, comprising around USD 30 billion in total assets. With only 99 funds in an investment universe and only USD 30 billion in managed fund assets, one must ask: can we achieve professional investment management for clients seeking Sharia-compliant investing? The short answer is yes, of course we can. In fact, one could conclude we have a professional responsibility to meet our client demands for professionalism, global standards and Sharia-compliance. If there is a path to achieve these goals then there is neither excuse nor reason for not achieving these goals.

7.5 Construction of Islamic portfolios

Sharia-compliant funds were small and few prior to 1999 when Sharia screening methodologies like those of Dow Jones and FTSE got global recognition. Since then, they are growing fast in size and number. The net new number of mutual funds in 2007, for example, was over 160. Later, with the global financial crisis, that...
Islamic asset management...

The initial allocation was made using a standard Balanced investment strategy, and benchmarking was quite crude. These early results were stunning. Despite handicaps in both allocation and benchmarking, the initial results gave confidence that further refinement would show sustained outperformance of Islamic allocations. (Exhibit 5)

These initial results showed an Islamic allocation had nearly 24 percentage point positive variance above a conventional benchmark. By any measure and for any asset manager these results are significant to an extraordinary degree. The fact that further enhancing the allocation and benchmarks resulted in continued positive variance (Exhibit 6) confirms the validity of the initial assumptions.

Further, this performance was achieved during remarkable economic times. The time scale from January 2006 through December 2008 included one of the largest run ups in asset pricing in modern history. Then, as was well documented, markets crashed worldwide and asset valuations tumbled in some cases as much as 90% or more. Asset deflation was not over by the end of 2008, either, despite the upturn in global markets by December of that year.

The initial allocation, therefore, straddled the manic bubble and the equally manic collapse, yet still maintained sizeable outperformance, reflecting a superior style of investing in both strong and weak market conditions.

These initial results were derived from the following allocation as seen in Exhibit 6.12 The above allocation was reasonably diversified, including investing in all four asset categories. It was also generally aligned with the Balanced investment strategy portfolios produced at the time by major global asset managers. Unfortunately, upon further testing it was determined the initial allocations were weak in some of the key criteria used to filter and sort qualifying investment funds, as well as diversification weakness (concentration risk). One weakness was the use of a proxy for Fixed Income during the majority of the time period results were measured. Another was the overweighting of global and Arab emerging market equities.

Further, there was no real effort to properly benchmark the results. The above benchmark is composed of 1) a 50% weighting from the Dow Jones U.S. corporate 5-year investment grade bond index, 2) a 35% weighting from the S&P 500, and 3) a 15% weighting from the NASDAQ 100.

It was initially thought that these weightings were sufficient for a comparative benchmark simply because the price volatility of the components were guessed to be roughly equal to the volatility experienced by what would have been a more accurate benchmark, if one had been constructed.

Moreover, it was thought at that time the results were so clearly superior that the underlying premise—Islamic asset management could be proven equal or even superior to conventional investing—would survive even more sophisticated portfolio modelling and benchmarking.

And, they did.

7.6 Testing the Islamic Allocation Model

For this year's report new set of portfolio allocation models were formed thus creating an updated global database of Shari'a-compliant assets which were sorted and filtered using the same conventional techniques (plus, of course, adding the Shari'a-compliance filter described in previous works).

<table>
<thead>
<tr>
<th>ASSET &amp; ASSET CATEGORY</th>
<th>ALLOCATION</th>
</tr>
</thead>
<tbody>
<tr>
<td>Money Market</td>
<td>3%</td>
</tr>
<tr>
<td>(a UAE bank liquidity fund)</td>
<td></td>
</tr>
<tr>
<td>Fixed Income</td>
<td>42%</td>
</tr>
<tr>
<td>(for the first 21 months a hypothetical sukuk benchmark, followed by 15 months of actual returns for a Saudi-based sukuk fund)</td>
<td></td>
</tr>
<tr>
<td>Equities</td>
<td>35%</td>
</tr>
<tr>
<td>(four equity mutual funds weighted nearly 50% toward global and Arab emerging markets, from both global and regional bank asset management departments)</td>
<td></td>
</tr>
<tr>
<td>Alternative Investments</td>
<td>20%</td>
</tr>
<tr>
<td>(40% of the allocation was in a globally diversified high-growth fund of funds, while 60% was placed in a global real estate fund established by a bank in the UAE)</td>
<td></td>
</tr>
</tbody>
</table>

Exhibit 6: Initial Islamic portfolio allocations
Many anomalies appeared during the process of identifying the 830 mutual funds and exchange-traded funds that were discovered. Some were obvious, some not so. The process itself was simple. Our search involved naming any investible security that had both the nomenclature “fund” and “Islamic” on it. One would think this would be straightforward, but it is not always so. For one, hundreds of investment products were created since around 2002 by the dozens of newly created “Islamic” banks in the Arabian Gulf region. A good deal were just very high risk real estate development funds (e.g., nearly all products from Gulf Finance House), which were categorized as pure private equity. Others were not so obvious.

One well-known bank in the Gulf region, for example, refused to disclose any information at all on their funds—both Shari’a-compliant and conventional—saying such information was given to customers only. This is at direct odds with the industry practice of listing all funds on the Internet and providing regular, transparent disclosure of those funds for interested investors of any kind. For this bank all their Shari’a-compliant funds had to be deleted from the database, as full disclosure and transparency are a requirement of asset management anywhere and all the time.

Many funds were mislabelled, knowingly or not, which caused considerable confusion and presumably caused the same confusion among investors. On closer investigation of one particular sukuk fund, further investigation disclosed the real nature of the fund, again very high-risk real estate speculation that had nothing to do with the commonly referred to concept of sukuk.

As indicated above, the resulting funds that met all professional tests—including track record, assets under management, liquidity, ability to clear and settle across borders, and of course compliance from respected scholars—left us with only 99 funds representing about USD 30 billion in assets under management. This itself is a concern for professional asset managers who wish much larger pools of potential assets to choose from in all asset categories.

But the risks associated with these funds were considered, and it was determined that indeed the 99 funds and USD 30 billion in assets met the minimum requirements for assembling Shari’a-compliant portfolios. Much is made about investment risk, in particular risks in investing in funds that are too small or too new. Most of these arguments are acceptable, but at the same time it must be recognised that risk is sometimes immeasurable, or at least difficult to measure. What, for example, is the additional risk of a fund with only USD 90 million of assets under management if a bank’s investment criteria prohibit funds with less than USD 100 million? And, what is the additional risk if one buys a fund with only a 3-year track record versus the often-cited minimum 5-year track record? These questions have yet to be answered.

Exhibit 7: Portfolio performance
Suffice to say that of course there is risk, but that risk management is holistic in nature, funds are always going to be risky (as are all kinds of investments) and perceptions and measurements of risk change over time. The successful asset manager embraces a risk management attitude that takes in both qualitative and quantitative elements, and rejects formulaic approaches to reducing or eliminating investment risks.

### 7.7 Refinement of portfolio modelling

We begin here showing the results of our latest modelling, including much more sophisticated asset selection, allocation measurements and security selection. Our newest results (from January 2011) are displayed in Exhibit 7.

Again, the results are startling for any professional who understands these kinds of portfolio comparisons. In the above performance chart we show the results of our more highly refined Islamic allocation for a typical balanced investment strategy. Then we add the results from commonly available conventional mutual funds from major global investment firms, all with highly similar investment strategies, i.e., balanced.

We have changed the composition of the allocation using different funds in order to assess performance analysis. It uses real-world comparisons as benchmarks. The new Islamic portfolio allocation is seen in Exhibit 8.

We would like to point out that this new, more sophisticated Islamic allocation is purely unmanaged, unlike the referenced benchmarks from BlackRock, Credit Suisse and Julius Baer. In other words, we established a reference allocation as of 31 December 2010, and then looked to see how it would have performed over the previous three years. The other funds were actively managed during these same three years. But, despite this difference, it is still highly illustrative that a credible portfolio comprising world-class Shari'a-compliant funds still outperforms the nearest competition available from the conventional asset management universe.

Now, look at the results. While we are not maintaining a 24 percentage point outperformance, we can see that our Shari'a-compliant portfolio was in negative territory for only 12 of the 36 months under observation, while the conventional portfolios were underwater for almost all of the 36 months. Not until the market rally of December 2010 did two of the three conventional funds turn positive. During two thirds of the measured time period Islamic investing had a double-digit percentage outperformance over conventional investing. And, delayed pricing information may have somewhat distorted the very last month—December 2010—as pricing for one of the 12 Islamic securities within the portfolio was not available at the time of this writing. (Exhibit 9)

The outperformance margin between Islamic and conventional investing varied over time, but it varied mostly in the 8 to 12 percentage point range, at one time as high as 18 percentage points and in the last half of 2010 averaging close to 10 percentage points.

In the real world of investing, this kind of outperformance is considered an amazing achievement. It’s what delivers tens of billions of new investment dollars to star hedge fund managers. It’s what makes or breaks asset managers seeking to claim they’ve achieved alpha, or consistent outperformance above their benchmarks.

We have constructed like-for-like portfolio allocations in USD-referenced balanced investment strategies using investment products that meet global standards for liquidity, size, transparency and corporate governance.

### ASSET & ASSET CATEGORY

<table>
<thead>
<tr>
<th>Money Market</th>
<th>5%</th>
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<tbody>
<tr>
<td>(a liquidity fund from the Saudi operations of a global European bank)</td>
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</table>

<table>
<thead>
<tr>
<th>Fixed Income</th>
<th>45%</th>
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<tr>
<td>(one third invested in a sukuk and trade finance fund from the Saudi operations of a global European bank, and two thirds invested in a trade finance fund from the Saudi operations of a different global European bank)</td>
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</table>

<table>
<thead>
<tr>
<th>Equities</th>
<th>35%</th>
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<tr>
<td>(two thirds invested in two funds from major U.S. fund managers, one global equities and one U.S. equities, and one third invested in emerging market equity funds from major U.S. fund managers)</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Alternative Investments</th>
<th>15%</th>
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</thead>
<tbody>
<tr>
<td>(slightly more than two thirds invested in commodity ETFs from major global providers, and slightly less than one third invested in two funds, one global real estate and one “fund of funds” alternative investment vehicle)</td>
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### Exhibit 8: New Islamic allocation portfolio

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<tbody>
<tr>
<td>2008</td>
<td>-0.7%</td>
<td>3.4%</td>
<td>-1.3%</td>
<td>0.7%</td>
<td>1.6%</td>
<td>-1.6%</td>
<td>-1.3%</td>
<td>-1.8%</td>
<td>-1.3%</td>
<td>-11.0%</td>
<td>-1.0%</td>
<td>5.2%</td>
<td>-9.2%</td>
</tr>
<tr>
<td>2009</td>
<td>-1.6%</td>
<td>-2.2%</td>
<td>4.9%</td>
<td>1.7%</td>
<td>3.1%</td>
<td>-1.7%</td>
<td>2.7%</td>
<td>0.4%</td>
<td>2.6%</td>
<td>0.8%</td>
<td>2.5%</td>
<td>-0.5%</td>
<td>12.9%</td>
</tr>
<tr>
<td>2010</td>
<td>-2.4%</td>
<td>0.5%</td>
<td>1.5%</td>
<td>0.8%</td>
<td>-1.8%</td>
<td>0.5%</td>
<td>2.0%</td>
<td>-1.1%</td>
<td>3.3%</td>
<td>0.9%</td>
<td>-0.1%</td>
<td>1.9%</td>
<td>6.0%</td>
</tr>
</tbody>
</table>

### Exhibit 9: Monthly Shari’a-Compliant Portfolio Performance, 2008 through 2010
as well as Shari’a-compliance. In the above table we’ve used the global USD-referenced balanced mutual funds as comparisons. It’s obvious there is an extremely high degree of correlation among all three of the funds. This correlation illustrates perfectly that there is indeed a global standard for balanced investing, and that asset managers everywhere consider the common mixture of money market, fixed income, equity and alternative investments to be the gold standard for globally diversified portfolios. But, what about their benchmarks?

Each of the funds we’ve tested—the balanced products from BlackRock, Credit Suisse and Julius Baer—all display their own benchmarks as references. Their benchmarks are established to give some guidance as to the success or failure of the respective managers in achieving their stated investment objectives.

We’ve taken those benchmarks and compared them to our Islamic allocation during the same period. As one could guess the results are nearly the same. (Exhibit 10)

What we find fascinating about this chart is again the very high correlation among the BlackRock, Credit Suisse and Julius Baer benchmarks, those benchmarks they construct to compare their own allocation performance. And, of course, in our claimed like-for-like investing methodology our Islamic allocations again beat conventional allocations over time. While there is clearly spread compression in the latter months of 2010, and occasionally before, there are equally months of spread expansion.

We have added our first, crude benchmark to this chart to illustrate that our initial assumption—that our modeling Shari’a-compliant portfolios could withstand higher levels of sophistication in asset allocation and benchmarking—was indeed correct. While we didn’t maintain our large degree of outperformance, the outperformance achieved is stunning still to professionals in our industry. (Exhibit 11)
7.8 Critique and Conclusion

Asset allocation professionals reading this will immediately grasp we have not proven direct, like-for-like allocations between our Islamic model portfolio and its conventional cousins because we did not disclose all the funds used in our modelling. They are right. A proprietary data set was used on mutual fund selections, which cannot be disclosed for confidentiality reasons.

We can observe Islamic portfolios appearing to consistently outperform conventional portfolios during highly stressed downward market conditions. Equally, the same Islamic portfolios seem to enjoy performance equal to similar conventional portfolios during upward-moving markets.

Further testing and analysis is required, especially attribution analysis of Islamic portfolio allocations and the various conventional funds to be used as comparisons. Attribution analysis may help us understand more of the reasons for the outperformance of Islamic investing. It is of course largely due to the fact Islamic investing avoids inherently risky assets such as highly leveraged financing institutions and companies. This alone must account for some portion of the outperformance. But what other contributions are being made?

Islamic asset management has been proven to be equal to or perhaps even superior to conventional investing. The proof is in the pudding.
8.1 Introduction

The major catalyst for the development and growth of the Islamic finance industry in the twenty first century has been the rapid pace of economic growth and accumulation of wealth in the Gulf States and amongst the Muslim populations of the Far East. This catalyst has driven Islamic retail, corporate and investment banking and stimulated developments in asset and wealth management. Islamic asset and wealth management – the former being the manufacturing arm of Islamic products, and the latter being the sales and distribution channels for this product - are the relative newcomers of a young industry.

8.2 Islamic asset management

In regards to Islamic asset management, product development and the manufacture of Islamic funds has been commendable. The Islamic fund universe has grown at a strong pace. As an example, in 1996, there were approximately 40 Islamic equity funds whereas in 2010 the total universe has grown to more than 800 across various asset classes. This suggests substantial growth in the number of organizations involved in Islamic asset management in a space of less than 10 years.

Equity exposure dominates the Islamic fund universe with over 52 percent of the total number of Islamic product being equity funds. In terms of AUM, these equity funds represent almost USD 20 billion of the approximately USD 50 billion universe. A distant second goes to private equity and real estate offerings with a combined 18 percent of the total followed by money market, balanced and fixed income. Within the universe of equity products, the majority fall into the categories of Malaysian or GCC equity. This means that building a diversified portfolio with global Islamic equity exposure has been challenging for the Islamic investor. The industry is not only limited by the opportunities for diversification but also marked by considerable concentration. The top 20 Islamic funds (by AUM) make up more than 60 percent of the fund universe. Although the number of products has grown and the Islamic fund universe now offers far more diversification than was available 10 years ago, in terms of asset classes there are still large gaps. There are legitimate reasons that need to be considered here. In the conventional industry, there is a great deal of diversity of funds but most of this is concentrated in the US and Western Europe. Not many emerging economies at a level of development comparable to that of Malaysia or the GCC have a significantly high degree of product diversity. It is fair to say that the limitations are, to a significant extent a function of broader economic and financial sector development. Hence Islamic fund managers can only create a fund when the components exist. The lack of sukuk funds for instance, has been ultimately mainly due to the lack of sukuk issuance and secondary trading.

8.3 Islamic wealth management

Islamic wealth management is still very much in its infancy. But it must be kept in mind that financial services in Muslim countries, especially the GCC, are also young. The Saudi banking sector emerged as recently as the 1950s. In this regard, it does not differ dramatically from conventional wealth management which is young compared to the conventional banking. As a point to note, it was only 1955, when Harry Markowitz published his Modern Portfolio Theory, stressing the need for moderation and diversification among investments setting the stage for wealth management as it is known today.
As another point, the emergence and categorization of the 'mass affluent client' as a market segment came into full force in the 1990s, spurring the beginning of wealth management as a sector separate from traditional private banking targeting only the high net worth clients.

The global financial crisis has provided an opportunity to demonstrate how Islamic finance, including wealth management, can benefit both Muslims and non-Muslims alike. Good governance and prudent risk management are inherent to Islamic finance and are two factors that have allowed the industry some protection from the worst of the crisis. However, this is not to say that the industry has by-passed the volatility of the past 3 years. This troubled economic period has highlighted an over-dependence on real estate and private equity among Islamic institutions and investors. Possible explanations for this are the underdevelopment of the Islamic wealth management industry, limited diversified investment products and failures in Islamic distribution channels.

As Islamic wealth management is less developed, there are still large sections of the Muslim investing public who have no exposure to Islamic funds. Whilst the Islamic asset management industry is working to develop a wider scope of products to allow Islamic investors comparable and diverse investment options, wealth management has the responsibility of opening doors to potential investors for these product manufacturers, by expanding their distribution channels and offering new avenues to raise AUM. This includes moving outside the traditional markets of the GCC and Malaysia for new customers and looking to other Muslim markets, as well as tapping the growing Muslim communities in the Western world.

8.4 Opportunity and market size

One of the challenges in analyzing both the current and potential market size is the difficulty in obtaining accurate data. Market size data is often inconsistent. For new market-entrants, this affects how the market opportunity is viewed and how a market entry strategy is formulated, especially distribution strategy.

One facet of quantitative analysis is demographic trends of Muslim countries and growth of number of Muslims. The numbers are large and rapidly increasing with over 1.5 billion Muslims worldwide. Additionally, the demographics of Muslim countries are heavily towards the under-40 age group, especially in the GCC. This would suggest that what underpins the growth expectations of the Islamic asset management industry is a booming younger Muslim generation of potential investors.

It is fair to say that the increasing wealth and education levels of the Muslim mass affluent sector validate an assumption that this sector offers the strongest growth potential for uptake of Islamic products. Hence, means of attracting this sector are an important consideration for distributors when formulating a strategy of maximum reach. Distribution strategy must also focus on attracting high and ultra high net worth clients and family offices who although generally considered to be less focused on Shari’a-compliant investments, will appreciate and consider Islamic products if the asset management industry continues to build suitable product and maintain performance.

8.5 Current Islamic distribution environment

Whereas the foundation of the conventional asset management industry has been the institutional investor followed by the high net worth investor, Islamic asset management focuses on retail investors as institutional investors of the Muslim world. Hitherto, there has been a slow adoption of Islamic funds.

The current situation of Islamic funds distribution to this market has been through asset managers’ in-house channels. The most common example seen today is in retail banks, where the asset management arm manufactures funds and the retail arm distributes them.

Few Islamic banks have moved towards open architecture platforms and the trend has been to focus on sales of proprietary funds. To date there are very few Islamic banks in any part of the world that have successfully created a third party distribution culture in their retail or private banks.

Where successful third party distribution has been seen on a broad scale is through regional operations of large international banks. It is relevant to note that Islamic funds need not be confined to Islamic platforms or to Muslim investors only. Both the product and the client base are far broader than that. Along with Muslims in the mostly Muslim majority OIC countries, successful distribution must target the non-Muslim majority segment in OECD countries by re-positioning and re-branding Islamic products as compatible with SRI and ethical investment frameworks.

Conventional banks are also proven, capable and efficient possible avenues for Islamic product sales. The large global retail banks as well as specialized private banks have raised trillions of dollars for global asset managers, and Islamic products can be added to their vast product lineups. Increasing cooperation between Islamic retail banks and large conventional fund managers’ thorough Islamic white label offerings will also enhance distribution reach as there will be added incentive to raise the AUM of these funds.

In addition to bank channels, another open architecture distribution opportunity is takaful. Takaful companies represent two opportunities for Islamic asset management – Firstly, the takaful funds where all the contributions are pooled and secondly the unit linked life insurance and savings schemes. Related untapped distribution channels include group life plans and defined contribution plans in both corporate and government pension sponsored plans.

Distribution platforms are another key opportunity. These platforms offer execution, custody and reporting
options along with access to a vast number of mutual funds. Global distribution platforms have been a dominant force for conventional distribution and are especially useful for banks looking to implement open architecture. To emphasize the importance of this channel, the assets under intermediation (AUI) of one of the top 10 of these platforms is larger than the entire Islamic asset management industry. For a Islamic asset manager, these platforms offer a vast opportunity to increase access to their funds. Multi-manager Shari’a-compliant funds embedding both in-house and third party funds are another potentially significant channel to raise assets into Islamic funds. Islamic brokerage firms and independent financial advisories are still very much longer-term industry developments. Structured Shari’a-compliant product platforms are another avenue that has been explored lightly. Whereas direct fund sales have not been as successful as hoped, capital protected products have surpassed expectations and represent an important source of retail AUM gathering.

Finally, as in the conventional asset management world, a segment worth influencing is investment consultants who advise institutional investors. As the number of institutional investors looking towards Islamic products increases, the recommendations of these consultants will become vital in decision making.

8.6 Considerations for growth and development of Islamic distribution

Fund domicile and cross border distribution

Given that the growth of the Islamic funds industry is dependent on successful distribution channels, the future of distribution is key to the industry as a whole. The progress of the distribution industry requires further targeted development of sales channels as well as understanding the regulatory framework and investor concerns of the geographies and markets that are being targeted.

Understanding the idiosyncrasies of different geographies and markets is vital, as sales and distribution strategies that work in one geography, might not be suitable for another. In terms of the international market, the biggest hindrance for most Middle Eastern asset managers is the regulation, administration and custodial set-up of their products. Although many funds in the region are well-managed with encouraging track-records and a focus on sectors of international interest (e.g. Saudi Equities or GCC Sukuk), operationally they fail to pass cross-border distribution requirements that are standard to international markets and organizations. There are examples of institutions, which have acknowledged the domicile issue as a barrier to further growth and are endeavoring to set up acceptable cross-border product by launching UCITS structures, which have become the global standard for investment funds.

Shari’a-compliance

Another challenge that can pose restrictions for cross-border distribution of Islamic funds is differing understandings of acceptable Shari’a-compliance standards. A strong point of discussion within the industry has been around the unification in Shari’a standards, although even with organizations like AAOIFI in Bahrain and the IFSB in Malaysia, as yet there is no unifying body for Islamic jurisprudence. Whilst the basis of compliance criteria are generally shared – such as low debt-to-equity ratios, avoidance of unacceptable industries - there are situations where interpretations can differ slightly making a fund that might be compliant to one Shari’a board, non-compliant to another. One example of this is Islamic cash management products, for which there are several established and accepted means of implementation in Malaysia, but generally only one acceptable implementation in Saudi Arabia.

The discussion on Shari’a-compliance is a separate and multifaceted discussion. For the purposes of this chapter the relevant points to note are that, like fund domicile and regulatory status, Shari’a standards and Shari’a boards are also aspects for consideration in the development of strategic distribution plans.

8.7 Other supporting factors for a successful distribution industry

Increase investor education and awareness

Education and awareness of the investing public is inherent to the success of the Islamic asset management industry and vital in any discussion around growing Islamic product distribution channels. Post credit-crisis, the wealth management industry continues working to address the issue of regaining investor trust and confidence. Islamic investing offers many advantages highlighted by the credit-crisis and these messages should serve to erase skepticism and apathy of potential Islamic investors. The global financial crisis has highlighted that good governance and prudent risk management inherent to Islamic investing can benefit both Muslim and non-Muslim investors alike.

Whilst the issue of a comprehensive and integrated regulatory and Shari’a-compliant framework to provide investor protection and industry standardisation is not discussed in full in this paper, it is also a vital development for strengthening investors trust in the Islamic finance industry.

Two broad groupings of the Islamic investing public exist with differing educational requirements. The first being investors previously partaking in conventional investing. This demographic has previously invested in conventional products for either reasons of availability or performance. For those investors who are Muslim, but have a lower Shari’a sensitivity or are less pre-occupied with religious compliant investment portfolios, education around the benefits of Islamic investing and highlighting it as a diversification tool or separate asset class for both Muslims and non-Muslims alike is key.

The second demographic is first-time investors. First-time investors whether Muslim or non-Muslim, require
8.8 Government support and public policy

In the western world, growth in AUM in the conventional asset management industry is facilitated and encouraged by government and public policies. For example, the pension fund market is stringently regulated in these countries and it is the policy of governments to encourage and reward their citizens and institutions to invest into mutual funds by continued education on the benefits of savings and offering, such as tax incentives.

In Muslim countries, government and public policy does not drive the Islamic mutual funds industry in a similar manner. Little has been done to encourage the development of voluntary or occupational schemes. For example, all the pension funds in the GCC are state run. These government run entities make the investment decisions on behalf of the contributors, but generally do not invest in Islamic products. There are few private sector employee-controlled pension, superannuation or retirement plans and no tax benefits of investing in a Shari’a-compliant mutual fund portfolio. The west also has state funds but a plethora of others have been allowed to operate, and have proved to be major contributors to the AUM of conventional mutual funds.

Government support and public policy can play an important role in supporting and encouraging the growth of Islamic asset management. Government encouragement of pension plans and collective saving schemes, creating clear standards for Shari’a-compliant alternatives to conventional investing and banking, facilitating the operations of Islamic institutions and eliminating any distortions to competition are important policy tools that, among others, can help the industry grow in the direction it needs to.

8.9 Conclusion

This chapter has explored the subject of distribution of Islamic funds, outlining some existing trends and challenges for the industry. To date, distribution has primarily been via direct retail banking networks. These networks have been the only successful distribution implementation however they have focused on proprietary products and few have moved towards open-architecture models. The need for evolution in both open-architecture and third-party distribution channels to allow for expanded product penetration is paramount to the growth of the industry. With the size of the Islamic asset management industry estimated to be between USD 360 billion to 480 billion, the approximately USD 50 billion in AUM today is a small fraction of that potential. Leading Islamic asset managers have to break from the in-house retail network based model and adopt the distribution model of the successful conventional asset management firms to reach this estimated size.

Considerations for growth of the industry should focus on expanding the geographical and product positioning from a handful of Muslim nations to the greater OIC as well as the OECD countries. The similarities of Islamic products with SRI and ethical asset management products will open up a far greater target market than what exists today. Importantly, the global financial crisis has highlighted that good governance and prudent risk management inherent to Islamic investing can benefit both Muslims and non-Muslims investors alike. Unless Islamic asset managers take concrete steps to establish funds which can be sold easily across multiple jurisdictions extending beyond Arab regions, the growth of the industry will remain challenged. It is imperative that the 60 or so Islamic funds already established in Europe, a handful of which are UCITS, be expanded upon and then strategically passported to wealth management centres and made available through the right distribution channels.

There are several avenues to be explored as distribution channels, including Islamic and conventional banks, insurance and takaful platforms, fund supermarkets, fund of fund managers, multi-managers, structured product providers and platforms, independent financial advisors and consultants. Fund domicile and varying acceptance in Shari’a-compliance pose some challenges to global expansion; however it is encouraging to see examples among the GCC asset managers who are working to address this. Increasing awareness and education, as well as shifts in policy and support from institutional investors will also help drive the success of the Islamic fund industry. Without widespread channels for the sale of funds, the industry will struggle to achieve its full potential. If distribution strategies are not successful in attracting AUM, the concern is that asset managers will begin to pull back from Islamic fund development.

As a final thought, the Islamic asset and wealth management industry is in its infancy and distribution channels are similarly in the nascent stages, with much room for
development and growth. Islamic bank assets are expected to reach USD 2 trillion by 2015, and Islamic-investment products potentially have an important role in fostering the development of financial services and a savings and investment culture in many majority-Muslim countries. There are challenges, and the anticipated growth has not been seen to date, but Muslims around the world are demonstrating an increasing interest in investing according to their religion and increasing wealth and education levels of the Muslim mass affluent sector will drive the growth in funds. Shari’a-compliant products potentially have an important role in fostering the development of financial services and a savings/investment culture. Once distribution channels are focused and efficient, and the product universe is diverse and acceptable in all markets, there is no reason why we should not see substantial growth in the Islamic asset management industry. It is a massive opportunity to be tapped with a natural market looking for direction.
CHAPTER 9
Islamic equities

9.1 Introduction

The Islamic finance value chain begins with Islamic banking and continues through to the takaful business and into capital markets. At the tail end of this value chain, Islamic asset management exists to service the investment needs of these other components.

The Islamic asset management industry has shown formidable progress in recent years. No other financial industry, market or jurisdiction in the last decade has experienced such a remarkable growth. Globally, the Shari’a-compliant AUM has grown to USD 52.3 billion\(^1\) with approximately 800 funds, in comparison to the conventional mutual funds’ universe of 70,000 funds which accounts for almost USD 19 trillion in assets under management (AUM).

As Islamic equity is fast-becoming a popular asset class, understanding the factors influencing the performance of Islamic equity indices will help make Islamic investing a viable alternative to conventional equity investing based on comparable risk-return indices performance.

This analysis also serves to shift the mind-set of investors regarding Socially Responsible Investing (SRI). Most American, European, Japanese and Australian pension houses have provided specific allocation for SRI portfolios and ethical investments. Islamic investing goes beyond a traditional ethical investment approach because an additional layer of risk management exists on top of the SRI / ethical screening. This built-in layer of risk management delivers the “coup de grace” of Islamic investing - high quality assets with strong fundamentals and low debt-to-equity ratios are examples of criteria that stocks must fulfil in order to be considered Shari’a-compliant.

9.2 Mitigating the core misconception on Shari’a performance

A core misconception is the view that the pursuance of a Islamic investing approach will result in a significant performance drag because the investment universe is limited in comparison to the conventional investment universe. While it is understandable that investors in UK, Europe and the U.S.A possess this misconception, we believe that this analysis will clarify and deepen the understanding of the nature of Islamic investment performance and its total return.

The evidence will show that a Islamic equity investment approach grants comparable risk-return performance. The resulting investment universe is an outcome of sound investment screening which produces a more stable portfolio with resilient characteristics in a down trending market. The financial ratios screening that is part and parcel of the Islamic equity investment approach serves as an automatic and embedded quantitative portfolio risk management overlay. The Dow Jones Islamic Market World Index (DJIM World) has a universe of 2,374 stocks, which is 20% of the Dow Jones Global Index (DJ Global) of 11,970 stocks. However, its market capitalisation of USD 12.3 trillion\(^2\) is 40% of the Dow Jones Global Index’s total market capitalisation of USD 31.2 trillion.

The meltdown of global equity markets in 2008 that was precipitated by high global inflation due to the increase of oil prices is a case in point. The screening beyond ethical / permissible stocks showed that during the period from October 2007 to March 2009, the DJIM World’s total return was 7.27% higher than the DJ Global. (Total Return: DJ Global: -50.48% vs. DJIM World: -43.21%). The Islamic index, therefore, demonstrated a
more stable and less volatile portfolio, providing investors with a more prudent alternative for consideration.

Another myth to Islamic investing pertaining to managing risk is that there are limited hedging capabilities. The popularly held but mistaken view is that the unavailability of Shari’a-compliant hedging instruments might hinder portfolio’s performance. The fact is that the Islamic investment approach permits the use of derivatives for purposes of hedging with proven Shari’a-compliant underlying assets. Derivatives used for hedging are restricted only if there are significant elements of speculation or uncertainty and gambling and can be subjected to exploitation, which is prohibited in Islam. Islamic concepts such as wa’ad and salam are used to transact the hedging initiatives. Having mitigated the above core misconceptions, the belief is that there is sustainable value proposition to the performance of Islamic equity investment.

9.3 Value proposition to the performance of Islamic investing

The Shari’a–compliant investment process exercises prudence because approved portfolio constituents are companies whose finances are not highly leveraged. The screening process enforces the principle that acceptable Shari’a-compliant stocks should not be involved in excessive risk taking, high borrowing, and exploitation of contracts.

The SRI approach, practiced by pension houses, does not employ similar financial ratio screening. We believe that the addition of this screening will bring the risk-return performance of ethical investing to the next level. It also demonstrates that in addition to delivering comparable returns with mainstream investing, the Islamic investment approach is more fiscally ethical as it screens out financially risky stocks to provide a more stable and prudent alternative.

Overall, a Shari’a-compliant portfolio will be less exposed to:

1) De-leveraging;
2) Extreme solvency;
3) Liquidity concerns; and
4) Portfolio risk management

9.4 Benefits of Islamic investing

Besides the socially-responsible motivation, other reasons for conventional investors to invest according to Shari’a include:

- **Comparable returns to conventional investments over longer periods** (five years), although they may outperform or underperform conventional investments over shorter periods, as can be seen in Exhibit 1 below. In fact, over the last five years, the DJIM World outperformed the DJ Global by an average of 1.88% per year, returning 10.22% as compared with 0.45%. The same can be said for the period between October 2007 and March 2009, the worst bear market in decades, when the DJIM World reported -43.21% compared to -50.48% for the DJ Global (Exhibit 2).

- **Greater stability of returns** – Shari’a-compliant eq-

Exhibit 1: Five-year Cumulative Index

**DJ Global vs. DJIM World (October 2005 - September 2010)**

*Returns are for price levels of the Dow Jones indexes only and do not include dividend reinvestments*
Islamic equities are less volatile than their conventional counterparts, both in times of crisis as well as in times of stability. One reason for this is that excessive financial leverage is prohibited. This can be seen by comparing the volatility of the DJIM World with that of the DJ Global, as illustrated in Exhibit 2.

- **Embedded risk management** – To be considered Shari’a-compliant, equities must pass a rigorous screening process, which ascertain, among other things, whether the underlying companies are sufficiently capitalised to weather difficult times, and liquid enough to meet short term obligations. This process sets strict limits for various financial ratios, such as debt-to-total market-capitalisation or debt-to-total-assets ratio to limit leverage, and cash-to-market-capitalisation or cash-to-total-assets ratio to ensure sufficient liquidity and productive use of cash. Due to such rigorous screening, the underlying companies were better capitalised and more liquid than many of their conventional peers. Therefore, they were less exposed to the de-leveraging, extreme solvency, liquidity concerns and the consequent sharp price declines experienced by their peers during the global financial crisis.

- **Greater transparency** – Since transactions and contracts must be free of uncertainty, and terms and conditions clearly defined at the outset, Shari’a-compliant investments may produce more predictable results.

- **Diversification** – While they are highly correlated, Shari’a-compliant investments limit the downside slightly better than conventional investments do. As shown in Exhibit 2 and Exhibit 3, during the recent bear market, Islamic funds fared better over the period than conventional portfolios did, by declining less, experiencing lower volatility and recovering nearly as much as the ground lost when the markets recovered.

What is interesting is that even during the 18-month up-trending market from February 2009 to September 2010, the DJIM World outperformed its conventional counterpart consistently. Our analysis below will explain the cause of such behaviour.

### Exhibit 2: Comparative Returns* and Volatility
Source: Bloomberg

<table>
<thead>
<tr>
<th></th>
<th>DJ Global</th>
<th>DJIM World</th>
<th>Difference</th>
</tr>
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<tbody>
<tr>
<td>Total Return</td>
<td>-50.48%</td>
<td>-43.21%</td>
<td>7.27%</td>
</tr>
<tr>
<td>Annualised Total Return</td>
<td>-37.87%</td>
<td>-31.83%</td>
<td>6.04%</td>
</tr>
<tr>
<td>Annualised Volatility</td>
<td>34.08%</td>
<td>32.47%</td>
<td>-1.62%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>DJ Global</th>
<th>DJIM World</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Return</td>
<td>2.93%</td>
<td>12.45%</td>
<td>9.52%</td>
</tr>
<tr>
<td>Annualised Total Return</td>
<td>0.58%</td>
<td>2.37%</td>
<td>1.79%</td>
</tr>
<tr>
<td>Annualised Volatility</td>
<td>20.48%</td>
<td>19.22%</td>
<td>-1.26%</td>
</tr>
</tbody>
</table>

### Exhibit 3: Two-year Cumulative Index Returns*
**DJ Global vs. DJIM World (October 2008 - September 2010)**
Source: Bloomberg

* Returns are for price levels of the Dow Jones indexes only and do not include dividend reinvestments.
on sovereign debt troubles and continued doubts about economic recovery. While the road to recovery has not been smooth, Islamic investing has displayed its strength over the conventional investing approach, especially in these volatile times.

It has been encouraging to observe that all three global Islamic indices by Dow Jones, MSCI and FTSE have been outperforming their own conventional global index counterparts over the last three years. Exhibit 4 shows the cumulative three year performance of the global Islamic indices and their corresponding conventional indices.

Investing in Islamic equity does not mean one has to sacrifice investment performance. Islamic indices exhibited respectable outperformance of between 5.57%-8.53% over a three-year period ending 30 September 2010. However, it is not only this outperformance in volatile market conditions that speaks positively for Islamic investing but also its performance across a full market cycle.

While the indices have similar performance, there is still variation across the three Islamic indices. The difference in performance across the Islamic indices may be due in part to the variation in the index construction processes. The differing screening criteria introduced by the various Islamic index providers may cause a variation on the eligible constituent lists.

9.6 Qualitative comparison of Islamic index screening processes

Islamic principles are derived from the Quran and Sunnah, which state very clearly at a core level what is permissible, and confer certainty on what is and is not haram. There is a further layer of debate and refinement among Shari’a scholars – ijmá and qiyas – where they must come to a consensus and reasoning based on assumptions and analysis of what is permissible. This explains that screening at the permissible industry level generally does not differ but financial ratios screening does result in a variation of the overall constituents. The Shari’a scholars of each respective index provider (Dow Jones, MSCI, FTSE) have come to different consensus on the financial formulas used to interpret and refine the respective index provider’s financial ratios screening. Therefore, each index provider may have slight variations on the screening criteria being followed and consideration must be given to whether those variations materially impact the requirements of the respective index users.

9.7 Islamic index construction: industry and financial ratio screening

The industry screening processes between the three index providers are similar. The main variation is in the financial ratio screening where DJIM World measures its debt and cash financial ratios over market capitalisation while FTSE and MSCI measure them over total assets. Computing the ratios against market capitalisation can result in these ratios being less stable when equity markets are volatile. Market capitalisation is the market’s perception of how much the business is worth, and tends to fluctuate subject to market sentiment, economic sentiment, and global macroeconomic factors.

The Islamic financial ratios are more stable when total assets are used instead of market capitalisation. Also, with total assets as the base, it will mean that the ratios are derived from the company’s balance sheet and shareholders financial commitments, which will more clearly reflect how financial decisions are made and how management runs the business.

9.8 Islamic index maintenance

Each Islamic index provider’s index maintenance review frequency will affect the timing of the inclusion and removal of eligible stocks, and hence will have slight varying performances across the Islamic indices. Again, while each index provider may have minor variations on the review frequency, consideration must be given to whether those variations materially impact the requirements of respective index users.

The composition of the DJIM World and MSCI are reviewed quarterly while the FTSE Global Islamic Index Series is reviewed semi-annually.

From a Shari’a-compliance standpoint, the more reviews and rebalances are done to an index, the more accurate the constituent list will be. Meanwhile, from an index user standpoint, if reviews occur too frequently, the index may exhibit more volatility from repeated rebalancing. As such, index review processes should not take place more than on a quarterly basis. Certainly, our recommendation would be to strike a balance where index reviews occur at most on a semi-annual basis.
The following analysis will look at the factors that influence the outperformance or underperformance of Islamic equity indices and their conventional counterparts. The Dow Jones Islamic Market Indices were selected because of the availability of sufficient track record for analysis. The three pairs of investment indices under examination are:

1. Dow Jones Islamic World Market Index and Dow Jones Global Index;
2. Dow Jones Islamic Asia Pacific ex-Japan Index and Dow Jones Asia Pacific ex-Japan Index.
3. Dow Jones Islamic Emerging Market Index and Dow Jones Emerging Market Index

### 9.10.1 Dow Jones Islamic Market World Index and Dow Jones Global Index

The results show that this is generally in line with our conviction that global conventional and Islamic indices demonstrate comparable performance. On a three-year cumulative basis, the DJIM World outperformed the DJ Global. In addition, the comparison of historical volatility of these two indices reveals that the DJIM World is less volatile by 1.78% over the last three years. (Exhibit 6)

The Dow Jones Global index has 11,970 constituents with a market capitalisation of USD 31.2 trillion. In comparison, the DJIM World has 2,374 constituents with a market capitalisation of USD 12.3 trillion. The more limited Islamic investment universe with 80% fewer constituents delivered comparable performance in a more stable manner than its conventional index counterpart.

Further examination of sector allocation (Exhibit 7) for these two indices reveals that the weight of certain sectors differed widely due to the Islamic principles and screening methodology. The financial sector has a 21.35% allocation of the conventional index, but only a 0.33% allocation of the Islamic index. Therefore, when the financial crisis occurred in September 2008, the Islamic index performance benefited from a lack of exposure to the volatile financial sector.

### 9.10.2 Dow Jones Islamic Market Asia Pacific ex-Japan Index and Dow Jones Asia Pacific ex-Japan Index

There are a total of 13 countries in Asia Pacific ex-Japan including Australia, India, Taiwan, South Korea, China, Hong Kong, Singapore, Indonesia, Malaysia, Thailand, New Zealand, Philippines and Sri Lanka. These nations have proved more resilient, having learnt from the 1997-1999 Asian economic crises. Growth in these countries is being supported by resource-based industries in addition to their growing domestic consumption.

However, a look at the top constituents of both indices, Exhibit 8, reveals some commonality. In fact, the two indices have the same companies in five out of the top 10 constituents e.g. Exxon Mobil, Microsoft, Johnson & Johnson, Procter & Gamble and IBM. Familiar companies like Microsoft, IBM and Google Inc. are amongst the top 10 constituents of the Islamic index. Well known oil and gas companies like Exxon and Chevron, and pharmaceutical and healthcare companies Pfizer, Novartis and Johnson & Johnson also rank in the top 10 Islamic index constituents.

Moving away from the developed world, let us examine the performance of an investment universe purported to be the next global growth engine: Asia.

### Exhibit 5: Three-year cumulative performance for Global market indices

Source: Bloomberg (30 September 2010)

<table>
<thead>
<tr>
<th></th>
<th>DJ Global Index</th>
<th>Islamic World Market Index</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dow Jones</td>
<td>-24.46%</td>
<td>-17.12%</td>
<td>7.34%</td>
</tr>
</tbody>
</table>

### Exhibit 6: Historical volatility (annualised) for Global indices

Source: Bloomberg (30 September 2010)

<table>
<thead>
<tr>
<th></th>
<th>DJ Global Index</th>
<th>DJ Islamic World Index</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>3-year</td>
<td>25.41%</td>
<td>23.63%</td>
<td>1.78%</td>
</tr>
</tbody>
</table>

### Exhibit 7: Dow Jones sector allocation for Global market index

Source: Factsheet as at 30 September 2010

<table>
<thead>
<tr>
<th>Sector</th>
<th>DJ Global %</th>
<th>DJIM World %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financials</td>
<td>21.35%</td>
<td>Technology</td>
</tr>
<tr>
<td>Industrials</td>
<td>13.00%</td>
<td>Oil &amp; gas</td>
</tr>
<tr>
<td>Consumer Goods</td>
<td>11.75%</td>
<td>Health Care</td>
</tr>
<tr>
<td>Oil &amp; Gas</td>
<td>9.99%</td>
<td>Industrials</td>
</tr>
<tr>
<td>Technology</td>
<td>9.60%</td>
<td>Basic Materials</td>
</tr>
<tr>
<td>Consumer Services</td>
<td>9.38%</td>
<td>Consumer Goods</td>
</tr>
<tr>
<td>Basic Materials</td>
<td>8.49%</td>
<td>Consumer Services</td>
</tr>
<tr>
<td>Health Care</td>
<td>7.97%</td>
<td>Telecommunications</td>
</tr>
<tr>
<td>Telecommunications</td>
<td>4.32%</td>
<td>Utilities</td>
</tr>
<tr>
<td>Utilities</td>
<td>4.15%</td>
<td>Financials</td>
</tr>
</tbody>
</table>
bases. High productivity in the agriculture and manufacturing sectors has boosted consumer and business confidence. A country like India has grown to be one of the largest exporters of software and other information technology-related services. The region’s economic growth has been a result of the expansion of the financial sector with investment flows moving into China and India. Consistent higher growth than the developed world has been achieved by this group of emerging middle-income economies, while strong domestic consumption coupled with robust exports have kept investor sentiment upbeat on the region.

Similar to the global indices comparison earlier, the Dow Jones Asia Pacific ex-Japan Islamic index showed comparable performance against its conventional counterpart.

The Dow Jones Islamic Market Asia Pacific ex-Japan index cumulatively outperformed the Dow Jones Asia Pacific ex-Japan conventional counterpart by 3.02% over a three-year period. Similar to the global indices comparison findings, the Islamic index recorded a slightly lower volatility of 0.14% than its conventional counterpart.

The conventional index has 3,402 constituents with a total market capitalisation of USD 4.5 trillion in comparison to the smaller universe of the Islamic index with 846 constituents and a total market capitalisation of USD 1.7 trillion as at 30 September 2010. Once more, the Islamic index recorded similar performance in a more stable manner. Again, this happens even though there is a significant difference in the majority of sector allocation weightings.

With the not-so-smooth economic recovery, sectors like financials, information technology, materials and industrials lagged the broader market, causing downward pressure in the equity market. However, when we compare the top 10 constituents of both indices, there are four common constituents – BHP Billiton, Samsung Electronics, Taiwan Semiconductor and China Mobile.

Other familiar names that make up the top 10 list of the Islamic index are Infosys Technologies and Reliance Industries of India, POSCO of Korea and CNOOC Ltd of Korea.

We believe that despite the big difference in sector allocation between the conventional and Islamic indices, where the conventional invests 60% of its top 10 constituents in banks, the Islamic index is more spread out.
and exhibits diversification of risk from the standpoint of country and sector allocation.

### 9.10.3 Dow Jones Islamic Market Emerging Markets Index and Dow Jones Emerging Markets Index

A low quality rally does not favour Shari’a-compliant portfolios which tend to be of higher quality as they are restricted by Islamic guidelines on level of debt. The consistent underperformance of the Islamic emerging markets index versus the conventional emerging markets index is in some way being influenced by the rally on risky assets and also the sector weightings.

Conversely, Exhibit 14 shows that the Islamic emerging market is less volatile than the conventional by 1.43%. This does not mean that the investors’ Shari’a-compliant portfolio will be in tandem with these indices. Having done this analysis, the investment managers who manage Islamic emerging markets will have to relook into value adding by taking positions outside the index weightage and be more active in quantitative research towards their core belief in superior stock selection for consistent superior performance (alpha).

The Islamic emerging market index contains a larger exposure to the oil and gas, basic materials, technology and telecommunications sectors, compared to the conventional emerging markets index. Meanwhile, the conventional emerging markets index has greater exposure to the financials, consumer services and consumer goods sectors. Emerging market countries have been fundamentally more attractive than developed countries, showing stronger economic growth, more favourable demographics, higher current account surpluses and lower levels of debt at the country, corporate and consumer levels. All these have benefited the financial, consumer services and consumer goods sectors. On the other hand, the oil and gas, basic materials, technology

---

### Exhibit 11: Dow Jones sector allocation for Asia Pacific market index

Source: Factsheet as at 30 September 2010

<table>
<thead>
<tr>
<th>Sector</th>
<th>%</th>
<th>Sector</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financials</td>
<td>31.82</td>
<td>Basic Materials</td>
<td>24.67</td>
</tr>
<tr>
<td>Industrials</td>
<td>14.18</td>
<td>Technology</td>
<td>17.96</td>
</tr>
<tr>
<td>Basic Materials</td>
<td>13.07</td>
<td>Industries</td>
<td>15.83</td>
</tr>
<tr>
<td>Technology</td>
<td>9.85</td>
<td>Oil &amp; Gas</td>
<td>12.44</td>
</tr>
<tr>
<td>Consumer Goods</td>
<td>9.00</td>
<td>Consumer Goods</td>
<td>8.74</td>
</tr>
<tr>
<td>Consumer Services</td>
<td>6.97</td>
<td>Telecommunications</td>
<td>7.86</td>
</tr>
<tr>
<td>Oil &amp; Gas</td>
<td>6.06</td>
<td>Health Care</td>
<td>4.15</td>
</tr>
<tr>
<td>Telecommunications</td>
<td>4.34</td>
<td>Utilities</td>
<td>3.91</td>
</tr>
<tr>
<td>Utilities</td>
<td>2.86</td>
<td>Consumer Services</td>
<td>3.69</td>
</tr>
<tr>
<td>Health Care</td>
<td>1.85</td>
<td>Financials</td>
<td>0.75</td>
</tr>
</tbody>
</table>

### Exhibit 12: Top 10 constituents for Asia Pacific ex-Japan market index

Source: Dow Jones (data as at 30 September 2010)

<table>
<thead>
<tr>
<th>Constituent</th>
<th>USD'billion</th>
</tr>
</thead>
<tbody>
<tr>
<td>BHP Billiton Ltd.</td>
<td>126.39</td>
</tr>
<tr>
<td>Samsung Electronics Co. Ltd.</td>
<td>72.81</td>
</tr>
<tr>
<td>Commonwealth Bank of Australia</td>
<td>71.84</td>
</tr>
<tr>
<td>Westpac Banking Corp.</td>
<td>65.48</td>
</tr>
<tr>
<td>Australia &amp; New Zealand Banking Group Ltd.</td>
<td>58.68</td>
</tr>
<tr>
<td>National Australia Bank Ltd.</td>
<td>52.00</td>
</tr>
<tr>
<td>Industrial &amp; Commercial Bank of China Ltd.</td>
<td>51.34</td>
</tr>
<tr>
<td>China Construction Bank Corp.</td>
<td>44.66</td>
</tr>
<tr>
<td>Taiwan Semiconductor Manufacturing Co. Ltd.</td>
<td>43.95</td>
</tr>
<tr>
<td>China Mobile Ltd.</td>
<td>42.67</td>
</tr>
</tbody>
</table>

Total no of constituents = 3402

Total market cap = USD4.52 trillion

<table>
<thead>
<tr>
<th>Constituent</th>
<th>USD'billion</th>
</tr>
</thead>
<tbody>
<tr>
<td>BHP Billiton Ltd.</td>
<td>126.39</td>
</tr>
<tr>
<td>Samsung Electronics Co. Ltd.</td>
<td>72.81</td>
</tr>
<tr>
<td>Taiwan Semiconductor Manufacturing Co. Ltd.</td>
<td>43.95</td>
</tr>
<tr>
<td>China Mobile Ltd.</td>
<td>42.67</td>
</tr>
<tr>
<td>Infosys Technologies Ltd.</td>
<td>38.66</td>
</tr>
<tr>
<td>Reliance Industries Ltd.</td>
<td>36.32</td>
</tr>
<tr>
<td>Hon Hai Precision Industry Co. Ltd.</td>
<td>30.45</td>
</tr>
<tr>
<td>POSCO</td>
<td>30.35</td>
</tr>
<tr>
<td>Newrest Mining Ltd.</td>
<td>29.26</td>
</tr>
<tr>
<td>CNOOC Ltd.</td>
<td>29.07</td>
</tr>
</tbody>
</table>

Total no of constituents = 846

Total market cap = USD1.69 trillion
and telecommunications sectors have been affected at a
global level and performance of these sectors within the
Islamic emerging market index has dragged the overall
performance down relative to the conventional emerg-
ing markets index.

We also believe that the conventional emerging markets
have financial sectors that have been resilient. As banks
in emerging markets report better-than-expected results
and credit conditions continue to improve, investors are
returning to the market and positioning themselves for
an emerging market global economic recovery.

Exhibit 15 demonstrated that the top 10 constituents
of global Islamic emerging market are invested in coun-
tries like Brazil, Russia, China and Mexico. Interestingly,
the sectors in the top 10 constituents of both indices
focus on oil and gas. There are four common constituen-
ts out of the top ten of both Islamic and conventional
market indices. However, there are six similar compa-
ies although with different share types. Three of these
common constituents come from the oil and gas sector;
namely Petrola Brasileiro S/A, GAZPROM OAO and
OGX Petroleo e Gas Participacoes S/A. We believe the
uncommon counters which come from technology and
basic materials were not performing as good as the fi-
nancial constituents.

Although the total number of Shari’a-compliant con-
stituents is only 851, its market capitalisation at USD 1.8
trillion is a respected 51% of the conventional market
capitalisation.

Unlike the global and Asia Pacific Islamic indices, the DJ
Islamic Emerging Markets Index underperformed the DJ
Emerging Markets index over three years with higher
volatility. We encourage further examination into the
attribution of the performance of these indices to shed
further light on the difference in performance.

9.11 Value added
optimisation for Shari’a
performance

The results of the index analyses shed light on what
the investment manager must focus on. The Asia Pacific
Shari’a-compliant portfolio whose three years annual-
ised volatility at 32.99% is more challenging to manage
than a global Shari’a-compliant portfolio whose three
years annualised volatility is lower at 23.63%.

The challenge to the investment manager is to provide
value by changing the portfolio weights and taking small

<table>
<thead>
<tr>
<th>Cumulative Performance</th>
<th>DJ Emerging Markets</th>
<th>DJIM Emerging Markets</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Three-year</td>
<td>-5.23%</td>
<td>-12.43%</td>
<td>7.20%</td>
</tr>
</tbody>
</table>

Exhibit 13: Three-year cumulative performance for Emerging Market
Source: Bloomberg (30 September 2010)

<table>
<thead>
<tr>
<th>Annualised Volatility</th>
<th>DJ Emerging Markets</th>
<th>DJIM Emerging Markets</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Three-year</td>
<td>34.42%</td>
<td>32.99%</td>
<td>1.43%</td>
</tr>
</tbody>
</table>

Exhibit 14: Three-year emerging market volatility
Source: Bloomberg (30 September 2010)

<table>
<thead>
<tr>
<th>DJ Emerging Markets Constituent</th>
<th>%</th>
<th>DJIM Emerging Markets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sector</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Financials</td>
<td>26.81%</td>
<td></td>
</tr>
<tr>
<td>Oil &amp; Gas</td>
<td>13.24%</td>
<td></td>
</tr>
<tr>
<td>Basic Materials</td>
<td>13.16%</td>
<td></td>
</tr>
<tr>
<td>Industrials</td>
<td>11.88%</td>
<td></td>
</tr>
<tr>
<td>Technology</td>
<td>9.34%</td>
<td></td>
</tr>
<tr>
<td>Consumer Goods</td>
<td>8.64%</td>
<td></td>
</tr>
<tr>
<td>Telecommunications</td>
<td>6.68%</td>
<td></td>
</tr>
<tr>
<td>Consumer Services</td>
<td>5.54%</td>
<td></td>
</tr>
<tr>
<td>Utilities</td>
<td>3.19%</td>
<td></td>
</tr>
<tr>
<td>Health Care</td>
<td>1.52%</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>DJIM Emerging Markets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sector</td>
</tr>
<tr>
<td>Oil &amp; Gas</td>
</tr>
<tr>
<td>Basic Materials</td>
</tr>
<tr>
<td>Technology</td>
</tr>
<tr>
<td>Industrials</td>
</tr>
<tr>
<td>Telecommunications</td>
</tr>
<tr>
<td>Consumer Goods</td>
</tr>
<tr>
<td>Health Care</td>
</tr>
<tr>
<td>Utilities</td>
</tr>
<tr>
<td>Consumer Services</td>
</tr>
<tr>
<td>Financials</td>
</tr>
</tbody>
</table>

Exhibit 15: Dow Jones sector allocation for Emerging Market index
Source: Factsheet as at 30 September 2010
positions out of the index. Active stock selection can be based on three core beliefs, namely:

- Improving and sustaining business fundamentals;
- Rising investor expectation; and
- Attractive relative valuation

In addition to optimising the portfolio, the investment manager may add value by:

- Evaluating whether major market changes are due to Islamic concerns, market concerns, or perhaps both;
- Evaluating whether pricing differentiation between conventional and Shari’a-compliant securities are due to Islamic interpretations, Islamic market dynamics or imbalance, regulatory requirements, or government initiatives;
- Advising clients on potential benchmarks for their portfolios;
- Identifying risks peculiar to Shari’a-compliant securities and markets, and mitigating them effectively;
- Optimising a client’s portfolio by anticipating market trends that could affect the securities universe; and
- Understanding a client’s Islamic investment needs and then structuring an optimal asset allocation based on the above abilities.

These capabilities coupled with a disciplined investment process should yield sustainable investment returns over the longer term.

9.12 Conclusion

Over a longer time period, the Islamic investment approach has merit through a strong bull market, and not just during a down-trending market, as some would argue. For example, from 1 January 2004 to 30 September 2009, the MSCI World Islamic significantly outperformed the MSCI World by over 15%.

The analysis of Islamic equity indices, both quantitatively and qualitatively, shed light on how variations in performance of Islamic indices have come about. Similar performance comparison with conventional equity indices will illustrate that Islamic investment is a clear alternative worthy of consideration by all investors. As Islamic index providers further refine their index construction and maintenance processes, the acceptance of this investment process will gain further credence with mainstream investors.

Both Islamic and ethical funds are for clients with similar investment preferences. Investors should adopt and use both ethical and Islamic investment strategies, not only because such investments allow a focus beyond the bottom line, but also because their returns are comparable, if not better, to those from conventional investments.

We have examined the performance of both conventional and Islamic equities via their respective index performances, which are transparently constructed and globally visible. The comparison has shown that both are...
able to achieve similar investment performance despite the different index construction processes. We believe this is evidence that the Islamic investment approach is a credible complementary investment alternative that all investors should consider, with the guidance of an experienced Islamic investment manager.
MSCI Global Islamic Indices
When performance matters

For over 40 years MSCI has supplied the world’s leading institutional investors with performance benchmarks. Today, thousands of pension funds and asset managers rely on the quality and reliability of the MSCI indices. Covering 70 countries, including Middle East and North Africa (MENA) markets, the MSCI Global Islamic Indices reflect Sharia investment principles and are based on the market leading MSCI Global Equity Indices.

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New York: +1.212.804.3901

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CHAPTER 10

Islamic derivatives

10.1 Introduction

Derivatives are contractual arrangements between two parties, whose value is derived from a reference parameter, be it stock, commodities, indices, currencies etc. It can be used for either hedging, speculation or for arbitrage. Although Islamic finance, according to its basic tenets, is adverse to the use of derivatives for speculative purposes (by reason of excessive risk taking or Gharar), they are needed by the industry: companies as well as banks need effective hedging tools, whether they are geared towards a Shari’a-compliant conduct of their business activities or run on conventional grounds.

Over the last years there has been a strong push into a further development of Islamic derivatives. Initially disputed by some as an overall concept and deemed in contradiction to Shari’a, there are nowadays a number of structures which have been approved by Shari’a boards across the globe. Without reaching unanimity on the topic, certain classical Islamic instruments are in use for engineering pay-offs which are similar to conventional derivative contracts, such as swaps, forward contracts etc.

Prominent Islamic instruments in this context are:
- Wa’ad, i.e. the unilateral promise or, legally speaking, the undertaking by a party to enter into a future transaction at the election of the other party.
- Arbun, i.e. “earnest money” or a non-refundable down-payment, rendered in view of a future sales transaction which shall work as an incentive to the prospective buyer to eventually enter into the envisaged sales contract. However, there is no further obligation on the arbun-buyer to enter into the sales contract. At its maximum the buyer may lose the down-payment in case he opts not to enter into the subsequent sales transaction. If the sales contract is concluded, the down-payment is deducted from the purchase price.
- Salam, i.e. a sales contract, in which a specific type of good in a specified quantity is sold in view of a future defined delivery date. The purchase price has to be paid in full in advance.

The majority of structures rely on commodity murabaha which serves as a building block for facilitating the required cash flows. Commodity murabaha had come under scrutiny since its use in modern Islamic banking is considered akin to monetization or tawarruq which, according to the applicable AAOIFI Shari’a Standards (No. (8) and No. (30)) and a recent OIC Fiqh Academy ruling would only be permissible under relatively tight conditions. The industry did not and does not always comply with these requirements. However, since no other equally viable instrument seems to be in place in structuring (mark-up) cash flows, commodity murabaha remains a tolerated means of building-up Shari’a-compliant structures in contemporary Islamic finance.

Lately, major market players developed standard documentation for the purpose of facilitating the use of derivatives in Islamic finance. The most prominent standard contracts have been developed by IIFM / ISDA:
- The ISDA / IIFM Tahawwut Master Agreement (“TMA”) was developed by International Swaps and Derivative Association, International Islamic Financial Market and major international market players and delivers a framework agreement similar to conventional ISDA Master Agreements which, when developed further, could be used for a variety of Islamic derivatives. According to the Schedules developed to date, the financial institution which finances the commodity (the “mustawriq”) has the right to physically deliver the commodity to the purchaser of the commodity (the “mustawir”) or to sell it for a spot price.
- The ISDA / IIFM Tahawwut Master Agreement (“TMA”) was developed by International Swaps and Derivative Association, International Islamic Financial Market and major international market players and delivers a framework agreement similar to conventional ISDA Master Agreements which, when developed further, could be used for a variety of Islamic derivatives.

2 The OIC International Council of the Fiqh Academy, Resolution 179 (19/5), 30 April 2009, available online: www.isra.my, rules: “[…] it is not permissible to execute both tawarruq (organized and reversed) because simultaneous transaction occurs between the financier and the mustawir, whether it is done explicitly or implicitly or based on common practice, in exchange for a financial obligation. This is considered a deception, i.e. in order to get the additional quick cash from the contract. Hence, the transaction is considered as containing the element of riba.” AAOIFI Shari’ah Standard No. (30) requires the following aspects to be observed monetization (tawarruq) to be permissible:
- real asset transfer requirement: there should be a real commodity that the seller owns before selling it (3/1);
- operationally the identifying documents for the commodity shall be made available (4/2) and the commodity must be sold to a party other than the one from whom it was purchased on deferred payment terms (4/5);
- documentation-wise the contract for purchasing the commodity on deferred payment terms and the contract for selling it for a spot price to the market afterwards shall not be linked together in a form pre-empting the mustawir’s right to actually obtain the commodity and get it physically delivered (4/6);
- the tawarruq shall sell the commodity by himself or through his agent but not through the Bank (4/9).

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3 Instead of exchange of equal amounts for equal amounts (cf. Sura 2:275) which Shari’a requires for all ribawi commodities like, gold, silver, food-stuff (salt, wheat).

4 An arrangement which, from its pay-off structure, is similar to a conventional Interest Rate Swap.
TMA allows the documentation of an Islamic Profit Rate Swap and an FX Swap.

- The IIFM Master Murabaha Agreement (with related Master Agency Agreement for the Purchase of Commodities and a Commodity Purchase Letter of Understanding) can be seen as a proposition on how to document interbank or corporate lending based on commodity murabaha.

While the TMA is considered a true leap forward in terms of how sophisticated Islamic derivatives could be documented, the IIFM Master Murabaha Agreement is not likely to gain comparable importance.

Firstly, because the IIFM Master Murabaha Agreement has to compete with other tried and tested contractual arrangements and enters the stage at a very mature stage in terms of commodity murabaha documentation.

Secondly, market standards usually incorporate the agency aspect for the underlying commodity trades rather than documenting this through a separate agency agreement, which adds heavy documentation and requires further signatures. Therefore, the IIFM Master Murabaha Agreement might at best prove successful in the area of corporate lending, since a corporate may not dispose of their own tailored agreements. However, in the interbanking market, commodity murabaha is likely to remain documented through home-tailored agreements already in use in the market. This is further supported by market practice in Islamic inter-bank lending according to which the depositing party (i.e. the murabaha buyer) usually imposes its murabaha documentation on the lender. This further restricts the prospect of a wider use of this documentation throughout the industry.

10.2 Variety of structures for Shari’a-compliant derivatives

GIFR 2010 (Chapters 14 and 15) delivered in-depth insights on how derivative structures based on the above classical fiqhi contracts work.

In terms of a recap the below exhibits provide an overview on the most common structures.

These structures rely on a combination of sets of commodity murabahas and/or sets of wa’ad to enter into the purchase or sale of Shari’a-compliant commodities or other assets.

10.2.1 Lack of express guidance from leading standard setting bodies (AAOIFI, ISFB)

Despite the fact that the widespread misuse of derivatives is by and large identified as a major trigger to the current financial crisis which by contagion quickly spread into the “real economy”, major industry organizations in the field of Islamic finance, i.e. AAOIFI and IFSB, have not yet issued any express statement regarding the structuring or the use of such instruments.

Also, neither AAOIFI nor IFSB have issued any standard on wa’ad, which further causes a prolific use of this Islamic instrument for structuring complex and, as the case may be, cutting-edge transactions.

Across the board two generic stances can be extracted with regards to the assessment of the role of derivatives in the current environment:

Stance A: The misuse of derivatives is one of the most prominent roots of the current economical crisis.

Exhibit 1: Islamic cross-currency swap (MYR/US$)

- Counterparty = Paying MYR and Receiving USD
- Bank = Paying USD and Receiving MYR
- Exchange Rate: 1 USD = 3.5 MYR (appr.) (as at 11 August 2009)
“[...] A revolution in packaging and distributing credit-based instruments was underway. It was called ‘financial innovations’. We all believed in the fallacy that these sophisticated tools and instruments would create value. Apparently and in hindsight, the value they created was mostly illusory and in turn was a prelude to the boom in shadow banking which was mainly based on excessive leverage. It was a textbook-style manifestation of regulatory sabotage. [...] a detachment between what is real and what is financial. This decoupling notion which is different from the one prevailed at the advent of the crises was the catalyst for what had to come a full-blown economic, financial and social imbalance for us to deal with for the next generation. [...] Our efforts should center on how we better serve the real economy. We believe we can do without those synthetic instruments that contributed in bringing the whole financial system down to its knees.”

Stance B: Islamic finance is in dire need of effective risk management instruments and therefore has to embrace Islamic derivatives as the only viable mean of facilitating such effective risk management.

“To the extent there are not enough Shari’a-compliant liquidity and risk management products, then clearly Islamic finance would be disadvantaged compared to conventional banks and would be less able to manage their liquidity risks.”

The above observations complement each other rather than contradicting themselves: Islamic finance needs derivatives for efficient hedging, yet, the question is how to contain these financial “weapons of mass destruction”.

Surprisingly, the two major standard setting bodies in terms of Shari’a-compliance, AAOIFI and IFSB, to date have not issued a comprehensive framework or issued at least a single statement dedicated to sophisticated Islamic derivatives.

Exhibit 2: Full profit swap structure

Exhibit 3: Total return swap structure


As regards AAOIFI, newly issued rules deal indirectly with the issue: the new Shari’a Standards comprise now a specific standard (Standard No. 31) on “Controls on Gharar in Financial Transactions”. According to the prescription of gharar, risk taking in its excessive form is prohibited. In view of the use of derivatives not only for hedging and arbitrage, but also for speculation, this standard seems to be at least indirectly linked to the universe of Islamic derivatives.

A glance at the new AAOIFI Standard reveals the following:

“(4) Gharar violated the transaction when it satisfies the following four conditions:

1. If it is involved in an exchange-based contract or any contract of that nature.
2. If it is excessive in degree.
3. If it relates to the primary object of the contract.
4. If it is not justified by a Shari’a-recognizable necessity”. And:

“(4/2/1) Gharar is excessive when it becomes a dominating and distinctive aspect of the contract, and is capable of leading to dispute. However, assessment of gharar for such purpose could differ according to place and time, and has to be determined in the light of normal practice (urf). [...] Gharar in any of these forms sets the contract null and void.”

Lastly:

“(4/4) Need in this context (which could be public or private) refers to the situation when refraining from commitment of Shari’a-banned gharar leads to severe hardship, though may not amount to mortality. Need should also be inevitable, i.e., there should be no Shari’a-permitted way of accomplishing the task, except through the contract that involves excessive gharar. Commercial insurance, in the absence of takaful (solidarity insurance) can be cited here as a fitting example.”

In this context, though beyond the scope of this chapter, it could be of interest, on whether the win-lose-probability involved in modern day derivative contracts would qualify as “excessive gharar” due to the above definition. Further, the question on whether or not the absence of comparably effective Shari’a-compliant risk management and hedging solutions could trigger the use of cutting-edge structures by reason of maslaha (public interest) and darura (public need), as being addressed in (4/4) above, is a topic Shari’a boards will have to take into account in their further assessment of sophisticated derivatives structures as those outlined above.

From the point of view of the above structures in use for engineering Islamic derivatives, it may be question-able whether their win-lose character (featured by all derivatives contracts) makes them contain gharar as “dominating and distinctive aspect of the contract” (AAOIFI Shari’a Standards No. (31), (4/2/1)). Since this AAOIFI Shari’a Standard has been published only very recently, its implementation by Shari’a boards has yet to be proven and such practice will deliver further insights from a more scholarly point of view, which would go beyond the scope of this chapter.

In summary, we observe that despite the importance of Islamic derivatives for effective risk management guid-ance throughout the industry, major standard setting bodies have not yet delivered a comprehensive state-ment on their view towards such instruments, but have issued new rules which are yet to be tried and tested in practise.

Contrasting the somehow rudimentary standardisation, the market itself lately leaped a great deal forward in terms of convergence by market practice through the delivery of a standard documentation for Islamic profit swaps: the so-called Tahawwut Master Agreement developed after several years of working group efforts by ISDA and IIFM (“TMA”).

10.2.2 Increasing market standardisation by ISDA Tahawwut Master Agreement as important step forward

The TMA features a similar documentary approach as the 2002 ISDA Master Agreement but is designed to be consistent with Shari’a principles.

The outlines of the TMA follow largely a conventional ISDA Master Agreement but also contain specific terminol-ogy and features relating to the specific design of Shari’a-compliant derivatives transactions.

Major issues which had to be dealt with during the working group discussions (which lasted several years) were, among others the design of a structure accommodating the distinction between done deals and future transactions which, under Shari’a, must not be consid-ered separately.

A transaction under the TMA will technically follow the mechanisms described above, i.e. it is essentially based on the concept of unilateral promises (wa’ad) to enter into several commodity murabahas over the lifetime of a transaction. In the framework of the TMA, “Transactions” (i.e. concluded murabaha transaction) and “Designated Future Transactions” (i.e. not yet concluded murabaha transactions to which a party commits to enter into in the future) are clearly demarcated. In addition to the above, the parties agree via a further set of unilateral promises to enter into so-called musawama transactions if, e.g. due to an event of default, the contractual arrangement has to be terminated earlier than scheduled at the outset. Under a musawama transaction, a party commits to buy a specified quantity of a specified commodity at a price, which is determined according to a specific formula contemplated in the agreement.

The significance of the TMA for potential convergence throughout the Islamic finance industry cannot be under-estimated. As opposed to murabaha master documen-tations such as the one launched lately by IIFM, the TMA enters the stage when only a few players had yet developed similar documentation. Therefore, and also due to the strong presence of ISDA as “convergence agent” (by setting standards and providing documenta-
tion) in the conventional derivatives markets, the TMA can be considered a true leap forward for developing Shari’a-compliant derivatives and will encourage new participants to enter the market, both on the buy-side and at the supplier’s end.

The documentation remains work-in-progress: ISDA so far only provides Schedules allowing for documenting Islamic profit rate swaps or FX swaps. Expectedly, and with more wide-spread market practice, the industry will develop more Schedules in order to benefit from the modular nature of the ISDA framework. From a more technical / legal point of view, further work needs to be done in order to develop suitable collateral documentation (Credit Support Documentation) together with netting opinions, assessing the close-out mechanism in the relevant jurisdictions.

In terms of transactions costs, the fact that the TMA delivers a ready-to-use contractual framework which is available for relatively complex transactions, this will further reduce the “Shari’a-premium” to be paid by its users in the past for such transactions (i.e. documentations costs), therefore directly serving the competitiveness of the Islamic derivatives industry.

To date the TMA has not yet gained sufficient traction in the market which is understandable since the documentation is still at a relatively nascent stage (the final documentation was only made available by end of Q1 2010) and the market will have to prove to which extent it wants to make use the documentation in its transactions.

The TMA, even though being in several respects similar to the ISDA 2002 Master Agreement, will have to be tried and tested in courts in its own right, which may add or reduce its credibility in the market. This accounts particularly for the Shari’a-specific features of the documentation.9

10.3 The market for sophisticated Islamic derivatives as a primary OTC market lacking widely used standardized contracts and sufficient volume

10.3.1 OTC market lacking widely used standardized contracts

The market for sophisticated Islamic derivatives, other than commodity futures like, notably, the crude palm oil futures contracts (FCPO) traded on Bursa Malaysia, is an OTC market (as opposed to a market where such financial instruments would be exchange-traded). In contrast to conventional markets for sophisticated derivatives markets where master documentation is in use with respect to non-commercial terms and further product specific schedules are offered for documenting the commercial terms (cf. ISDA 2002 Master Agreement), comparable Islamic derivatives have been fully tailor-made in the past.

As an OTC market at a nascent stage, the market for more sophisticated Islamic derivatives remains in terms of size and commercial terms a very opaque market with a wide array of structures and differing levels of sophistication in terms of Shari’a-monitoring. It caters for a mixed crowd of Islamic and conventional players, for corporates and banks, for true hedgers, arbitrageurs and – presumably - speculators. Transparency and overall volume are the primary challenges to enable the market for Islamic derivatives to reach the critical mass required for kicking-off in terms of scale effects and liquidity.

10.3.2 Tradability and trade in sophisticated Islamic derivatives

The market for sophisticated Islamic derivatives is a market without trading activities in the sense that parties used to enter into a derivatives contract and stick to this agreement until expiry of the respective contract. Given that until the issuance of the TMA, there has been a complete lack of standardized contracts in the field of more sophisticated Islamic derivatives, this is not surprising. Without standardized contracts used in the market and a secondary market respectively, any trading activity would prove cumbersome as such tailor-made contracts may be suitable for one party but may not necessarily be suitable for another party. Conventional markets faced similar restrictions in their early stages when by the lack of standardized contracts, derivatives had not yet reached the quality of negotiable instruments.

In the long run, the TMA could change this picture, since it introduces a comparable modular approach as known from its conventional counterpart (e.g. ISDA 2002 Master Agreement) to the sphere of sophisticated Islamic derivatives.

To date, the markets in sophisticated Islamic derivatives have not significantly kicked-off despite the release of the TMA. Supposing a future market on such instruments would eventually reach a higher level of liquidity and volume, the question could arise on whether instruments like Islamic profit-rate swaps or Islamic FX swaps would be tradable under Shari’a. Since the above structures mostly rely on underlying commodity murabaha contracts, their tradability would be restricted in the sense that trading would be allowed once the underlying murabahas have matured, whereas during the life of a murabaha contract this would be considered as trading in debt (bay al-dayn) which is proscribed by Shari’a.

10.4 Outlook

10.4.1 De facto standardisation by market practice (TMA)

As stated above regulatory standards on derivatives from major standardisation organizations (AAOIFI, IFSB) are still non-existent.

In contrast, the market itself has been moving forward...
towards convergence by creating a potentially new market standard by the launch of the TMA recently. To date this template documentation is still incomplete in various respects (i.e. more product-specific Schedules, availability of credit support documentation etc.) and yet has to be tried and tested in courts to gain more confidence by the industry. Despite these apparent gaps it appears that the new standard documentation, both in its contents as well as in the way it has been manufactured (as a true East-West joint effort), the TMA indicates the way forward for standardisation in Islamic derivatives and could be used as a role model for further overall convergence.

The level of sophistication of the TMA and its architecture as potential multi-product documentation (as soon as more product-specific Schedules will be available) point towards a consolidation of future structures to be used for Islamic derivatives. Since the TMA relies on wa’ad, murabaha and musawama as key Islamic contracts, other structuring options, e.g. salam, are likely to run out of practice for the Islamic derivatives industry.

10.4.2 Challenges arising from reduced market volume and a fragmented market

In the first place, derivative markets exist because hedgers seek protection and arbitrageurs are in the quest for profit based on market inefficiencies. Additionally, there is significant headroom left for speculators as additional market participants. To date, Islamic derivatives, due to the Shari’a proscription of the trading of debt, cannot be traded according to the majority of scholarly views on this matter. The Malaysian market, where Shari’a-compliant palm oil futures contracts have been deemed permissible as early as 2003,\(^{10}\) is not likely to change this picture with respect to the less lenient centres of Islamic finance, in particular the Middle East.

Solutions are hard to be found from a classical fiqhi perspective, since the proscription of trading in debt (bay al-dayn) is, for a large number of scholars, perceived as one of the cornerstones of Islamic finance. Therefore, the buy-and-hold character which applies to most Islamic financial instruments based on commodity murabaha is likely to continue monopolising the markets for Islamic derivatives for the near future. In terms of the further development of the Islamic derivatives markets, in particular with respect to pricing and liquidity, these restrictions will continue to be one of the major obstacles for an increase in market efficiency in Islamic financial markets, including Islamic derivatives markets.

The journey towards a full-grown Islamic financial universe has gathered pace only one and a half decades ago. We stand now at a market size of around USD 1.13 trillion, whereas the critical mass in terms of market liquidity and scale effects on transaction costs would require much more. Discussions on issues of market transparency, e.g. by coordinating the establishment of trade repositories for credit, rates and equity products, which are currently under way for the conventional derivatives market are yet to be kicked-off in the Islamic derivatives markets.

The global financial crisis has put conventional financial precepts on trial. Islamic banking, for a number of inherent values, has been struck to a significantly lesser extent. Despite the fact that Islamic finance still has a long way to go to reach efficient liquidity and risk allocation for the underlying “real economy”, important steps have been accomplished over the last twelve months. The settling-in of a broader base of acknowledged structures for Islamic derivatives and the emergence of a multi-product documentation which, in terms of sophistication, can aptly compete with conventional derivatives instruments (ISDA / IIFM Tahawwut Master Agreement) are milestone achievements. Yet, the markets have to gain more experience with the use of these instruments and structures and their documentation.

From a scholarly perspective, relevant standardisation organizations (i.e. AAOIFI, IFSB) will have to further promote a continuous debate on the use and the tradability of these instruments. Standardisation organizations should live up to the unique opportunity to be instrumental in a further careful development of Islamic derivatives which truly serve the needs for hedging and efficient risk management in the aftermath of the global financial turmoil.

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CHAPTER 11
Efficiency and profitability in Islamic banking

11.1 Introduction

Since the opening of the first Islamic bank in Egypt in 1963, Islamic banking has grown rapidly all over the world, fulfilling the needs of both Muslims and non-Muslims alike. Its operations now include deposit taking and lending as well as all other aspects of banking and financial services.

There are currently 500 financial institutions operating in more than 75 countries worldwide offering Islamic banking and finance products\(^1\).

Dubai Islamic Bank, established in 1975, operates in a dual banking environment and was the first private Islamic bank designed to achieve maximization of profit on a commercial platform, offering commercial consumer products and banking intermediary services. It led to the development of what is now known as the “Islamic window” concept; a segregated division of a conventional financial institution specializing in Shari’a-compliant products and services. Today, many countries have allowed conventional banks to set up Islamic window operations\(^2\), opening the way for prominent international banks to offer Islamic banking and finance products and services.

<table>
<thead>
<tr>
<th>Country</th>
<th>Market share in 2008 (%)</th>
<th>Growth rate of assets of Islamic banks (%)</th>
<th>Growth rate of assets Of banking system (%)(^a)</th>
<th>Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Saudi Arabia(^b)</td>
<td>35.0</td>
<td>33.4</td>
<td>19.0</td>
<td>2003 – 2008</td>
</tr>
<tr>
<td>Bahrain(^c)</td>
<td>29.0</td>
<td>37.6</td>
<td>9.6</td>
<td>2000 – 2008</td>
</tr>
<tr>
<td>Kuwait</td>
<td>29.0</td>
<td>28.3</td>
<td>19.0</td>
<td>2002 – 2008</td>
</tr>
<tr>
<td>UAE</td>
<td>13.5</td>
<td>59.8</td>
<td>38.1</td>
<td>2001 – 2008</td>
</tr>
<tr>
<td>Qatar</td>
<td>11.5</td>
<td>65.8</td>
<td>38.1</td>
<td>2002 – 2008</td>
</tr>
<tr>
<td>GCC average</td>
<td>23.8</td>
<td>45.0</td>
<td>24.8</td>
<td></td>
</tr>
<tr>
<td>Jordan</td>
<td>10.3</td>
<td>20.6</td>
<td>11.2</td>
<td>2001 – 2008</td>
</tr>
<tr>
<td>Turkey</td>
<td>3.5</td>
<td>41.0</td>
<td>19.0</td>
<td>2001 – 2008</td>
</tr>
<tr>
<td>Malaysia</td>
<td>17.4</td>
<td>20.0</td>
<td>14.0</td>
<td>2000 – 2008</td>
</tr>
</tbody>
</table>

Table 1: Market share and growth in assets of Islamic and conventional banks in selected countries
Source: Hasan and Dridi (2010)
\(^1\) Estimates of the number of IFIs vary considerably between institutions. For instance, the IMF estimates that the number of IFIs has increased to more than 300, while the Association of Islamic Banking Institutions Malaysia (AIBIM) estimated that there are around 486 IFIs around the world. GIFR 2011 estimates the number to be 500.
\(^2\) There are two types of IFIs. The first are institutions whose entire businesses are conducted in compliance with Islamic law. The second are those institutions that offer Shari’a-compliant products and services, but whose businesses are not conducted in compliance with Islamic law. However, the need for appropriate segregation between conventional financial activities that are impermissible in the Shari’a and Shari’a-compliant products and services has lead to the development of the “Islamic window” concept.

\(^a\) Including Islamic banks
\(^b\) Including Islamic windows
\(^c\) Growth rate is calculated for the total of wholesale and retail, while market share is for retail only.
The popularity of the “Islamic window” operations has significantly spurred the growth and development of the Islamic banking sector. Studies have shown that the industry will continue to grow at a rapid pace in the coming years. GIFR 2011 research indicates that the Islamic banking industry is set to achieve an estimated 10% increase after nearly 20% annual growth rate for the last one decade. The current size of the industry stands at USD 1.1 trillion (a slight increase from the USD 1.03 trillion as reported by GIFR 2010). This remains well below the potential size of the industry, which is no less than USD 4 trillion.

The Islamic financial market is currently most developed in Iran, Saudi Arabia, Malaysia, and the majority of the GCC countries. In Malaysia, a country which has been recognized as an Islamic banking hub for the east, the Islamic banking industry has been growing at an average rate of 18.9% per annum in terms of assets since the year 2000. The Malaysian Islamic banking sector’s total assets accounts for approximately 12.8% of the banking system’s total assets, while the market share of Islamic deposits and financing stood at 14% of the total banking sector’s total deposits and financing.

Despite having undergone considerable developments during the past few decades, empirical evidence on the performance of the Islamic banking sector is still in its infancy. Furthermore, studies on Islamic banks have generally focused on theoretical issues, and empirical works have relied on the analysis of descriptive statistics rather than rigorous statistical estimation (El-Gamal and Inanoglu, 2005).

11.3 Efficiency performance of Islamic banks

There are at least three reasons to why the study of the efficiency of Islamic banks is important. First, an improvement in cost efficiency means achieving higher profits and increasing the chance of survival in deregulated and competitive markets. This is particularly relevant for Islamic banks as they compete head-on with conventional banks in many areas. Second, customers are interested to know about the price and quality of bank services as well as any new service that banks could offer. This would be influenced by a bank’s overall efficiency of operations. Third, an awareness of efficiency features is important to help policy makers formulate future policies which would affect the banking industry as a whole.

Although literature examining the performance of the conventional banking sector is vast, empirical studies on Islamic finance is sparse. However, this is gradually changing as a number of recent studies have sought to apply various statistical methods to examine the performance of Islamic banking sectors worldwide. Among the most notable studies to examine the efficiency of Islamic banks are by Hussein (2003), Hassan and Hussein (2003), El-Gamal and Inanoglu (2005), Sufian (2007), and Hassan (2007).

Hussein (2003) provides an analysis of the cost efficiency features of Islamic banks in Sudan between 1990 and 2000 estimating cost efficiency for a sample of 17 banks over the period. The analysis is novel as Sudan has a banking system based entirely on Islamic banking principles. The results show large variations in the cost efficiency of Sudanese banks with foreign owned banks being the most efficient, whilst state owned banks were found to be the most cost inefficient. The analysis is extended to examine the determinants of bank efficiency. Here, he finds that smaller banks are more efficient than their larger counterparts. In addition, banks that have higher proportion of musharaka and mudaraba finance relative to total assets also have efficiency advantages. Overall, the substantial variability in efficiency estimates is put down to various factors, not least the highly volatile economic environment under which Sudanese banks have had to operate over the last decade or so.

In another study on the Sudanese Islamic banking sector, Hassan and Hussein (2003) examined the efficiency of the Sudanese banking system during the period of 1992 and 2000. During the period under study, the Sudanese banking system had exhibited 37% allocative efficiency and 60% technical efficiency, suggesting that the overall cost inefficiency of the Sudanese Islamic banks were mainly technical (managerially related) rather than allocative (regulatory) causes.

El-Gamal and Inanoglu (2005) looked at the cost efficiency of Turkish banks over the period 1990-2000. The study compared the cost efficiencies of 49 conventional banks with four Islamic special finance houses (SFHs). The Islamic firms comprised around 3% of the Turkish banking market. Overall, they found IFIs to be the most efficient due to their emphasis on Islamic asset-based financing which led to lower non-performing loans ratios. Furthermore, the SFHs achieved high levels of efficiency despite being subjected to branching and other self-imposed constraints such as the inability to hold government bonds.

The Malaysian Islamic banking sector has also attracted researchers’ interest. Among others, Sufian (2007) examined the efficiency of the Malaysian Islamic banking sector during the period 2001-2004. The empirical findings from the study indicate that scale efficiency outweighs pure technical efficiency in the Malaysian Islamic banking sector, implying that Malaysian Islamic banks have been operating at a non-optimal scale of operation. He suggests that the domestic Islamic banks have exhibited a higher technical efficiency compared to their foreign Islamic bank peers. He suggests that during the period of study the foreign banks’ inefficiency was mainly due to scale rather than management.

The study by Hassan (2007) is among the few performed to examine the efficiency of Islamic banks in a cross-country setting. The findings indicate that during the period 1993-2001, Islamic banks have exhibited a relatively higher profit efficiency compared to cost efficiency. He suggests that the main source of inefficiency is allocative rather than technical. Similarly, his results suggest that the overall inefficiency was output related. The results indicate that on average the Islamic banking industry is relatively less efficient compared to their conventional counterparts.
11.4 Issues and challenges

Existence of economies of scale is an impetus for banks to grow larger, but such benefits may not necessarily outweigh the costs that larger financial institutions impose on the economy. If size benefits outweigh costs, limiting size of banks is not prudent, and such restrictions will push bank risk-taking outside the regulatory parameters. It is preferable that the policymakers impose costs on complex and large financial institutions commensurate with their contribution to systematic risks. Measures could include imposing capital charge and improving macro-prudential supervision of the financial system (Mester, 2010). Such prudential macro-regulation is more apt for Islamic banking industry as they have a universal banking character, which necessarily makes them more complex organizations.

At a time when the conventional banking sector is facing many challenges relating to the credit crunch, Islamic banking is progressively taking the center stage. In some countries, foreign Islamic banks have been allowed to enter their once closed banking system. In Malaysia, steps have been introduced to liberalize the banking sector to participation from the foreign Islamic banks. Other financial centers like London, Singapore, and Hong Kong are also entering business partnerships with banking institutions from the Middle East.

On the one hand, the move augurs well in terms of innovation and development of Islamic banking products and services. The large multinational banking players may have added advantages stemming from their wide international presence to mobilize Islamic banking funds from the Middle East, as well as their dynamism and innovativeness in introducing and promoting new Islamic banking and finance products to cater for the domestic market’s needs. They may also possess inherent economies of scale as a direct extension of their other international operations and so are capable of competing with the incumbent banks.

On the other hand, the entry of new foreign players into the domestic markets will heighten competition, necessitating the smaller Islamic banks to consolidate and cascade down into a need for smoother transitions that maintain Shari’a-compliance. The smaller Islamic banks will have to strive harder to enhance their efficiency and productivity so as to remain competitive, profitable, and most importantly durable. Furthermore, banks failing to follow best practice methods and exhibiting low cost efficiency have the tendency to fail (Berger and Humphrey, 1992; Wheelock and Wilson, 1995; Barr et al. 2002).

It is obvious that the role and responsibilities of IFIs are to serve the financial needs of their various stakeholders, while giving proper consideration to the legitimacy of their operations from a Shari’a point of view (Ahmad, 2006). In mainstream economics, where in principle the promotion of private (individual) self-interest is considered primal for enhancing social well-being, efficiency and productivity criteria for banks had to remain focused on profit, which is the main reason for them being in business. For Islamic banks too, profit adequacy is a requirement for survival but it is supplemented by auxiliary considerations. Furthermore, if an Islamic bank’s profit is higher, it will definitely pay more zakat and be able to offer more attractive profit/loss sharing ratios on deposits and loans.

Another issue pertaining to the Islamic banking and finance sector is the need to adapt to a more universal banking model. By doing so, Islamic banks may be able to offer more non-traditional banking products such as salam and istsina (sale by order), mudaraba (partnership of skill and capital), and musharaka (joint venture) compared to bay’ muajjal and ijara, which are the most commonly used modes of financing currently. These products will prove to be potent for entrepreneurial development, as the products are relatively collateral free. By carrying an equity flavour and risk-sharing values, Islamic banks can play a significant role in developing new entrepreneurial friendly products not readily found in conventional banking. In the absence of money lending environment, entrepreneurs should stand a better chance to flourish and perform even better. This in turn, could help nurture the establishment of entrepreneurial activities and in the long-run, is expected to flourish the growth and development of the micro-enterprises.

Other issues facing the Islamic banking community is the need for money market instruments that are Shari’a-compliant. There is also an immediate need for short-term money market investments and tools for liquidity management, a space that could benefit immensely from the introduction of new instruments. Most available conventional banking instruments for liquidity management are interest based and therefore not Shari’a-compliant. Until new products or solutions are developed, this issue is going to severely hinder development on the Islamic banking inter-bank money market.

11.5 Determinants of profitability amongst Islamic banks operating in dual banking

The lack of academic endeavour to conduct research into Islamic banking and finance are pronounced by a dearth of comprehensive pertinent data and information. The studies so far have not adequately compared the determinants of profitability of Islamic banks with that of conventional banks. Hassan and Bashir (2005) appears to be amongst the very rare academic attempts to delve into the factors that determine profitability of Islamic banks and in turn, comment on the commercial viability of Islamic banks. This study demonstrates a positive relationship between capital and profitability as well as between loan to asset ratio and profitability. In addition, their study indicated a positive relationship between overhead and profitability. Notwithstanding these findings, there were no follow up studies undertaken to further examine the causes for the positive relationship between capital and profitability amongst Islamic banks. Such positive relationship appears to be counter intuitive to conventional wisdom.
None of the surveyed literature undertook a comparative study at the same time, into the patterns and the extent of the differences between the determinants of profitability for Islamic banks, and for those of conventional banks, all of which operate within a dual banking system. The studies into such differences, if any, between the profitability determinants of Islamic banks and conventional banks that operate side by side within the same market place, can be of relevance and significance from the perspective of evaluating the commercial viability of Islamic banks as a true alternative to the conventional banks. In this regard, the surveyed literature pertaining to Islamic banking, in particular, those of Bashir (2000) and Bashir and Hassan (2005) delve straight into the analysis of the determinants of profitability amongst Islamic banks without any attempt to compare performance of conventional banks with those of the Islamic banks operating in the same country. Within most dual banking systems, Islamic banks that operate alongside conventional banks, do not have as large a capitalisation, asset base and well diversified talent pool as compared to their conventional counterparts. Comparing the performance of Islamic banks with those of conventional banks may well shed some light as to what the differences are and how significant those differences bring to bear in establishing the true worth of Islamic banks as a viable investment and commercial proposition. Islamic banks worldwide are embarking to catch up to conventional banks in terms of services, market coverage, efficiency and market share. Understanding the differences, if any, between the determinants of profitability of Islamic banks and those of conventional banks operating within the same market place, will hopefully provide some touchstones as to how a blueprint can be structured in operating and regulating Islamic banks, strictly as profit seeking entities, rather than instruments and conduits through which self serving political and religious agenda are attained.

A study was undertaken comparing the performance of Shari’a-compliant banks with conventional banks. The data used was drawn from six Arabian Gulf countries and three Muslim dominant countries in South East Asia. Historical financials from one hundred and twenty six banks spanning from 1998 to 2005 were extracted from Bankscope databank compiled by International Bank Credit Analysts Association (IBCA). Table 2 below gives a breakdown as to the number of Islamic banks and conventional banks that were surveyed. However, the number of banks as surveyed is not exhaustive and there are some banks in the countries under survey, the financials of which had not been included in the Bankscope databank. For instance, no historical financials were provided for Al Rajhi Banks in Saudi Arabia in the Bankscope databank. Likewise, the historical financials of Kuwait Finance House in Kuwait were similarly not included as part of the databank in Bankscope.

11.6 Findings

Table 3 (see appendix) sets out the findings as to how Islamic banks differ from their counterparts.

When examined in means terms, Islamic banks (though only 10% of the total banks surveyed), scored better than conventional banks in pre-tax profit as percentage of total assets, other income as percentage of total assets and net income as percentage of total assets. However, what appears to be startling is the measurement of return on equity, i.e. net income as percentage of total shareholders’ equity. In this regard, Islamic banks’ return on equity is roughly 1/3 of that achieved by conventional banks. In terms of operational costs, Islamic banks demonstrated a higher mean score for cost to income ratio and staff expenses as percentage of total assets. As

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<th>From 1998 to 2005</th>
<th>Conventional</th>
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<td>Kuwait</td>
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<td>Qatar</td>
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<tr>
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<td>126</td>
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</table>

Table 2: Surveyed Banks
for capital adequacy measures, Islamic banks registered higher ratios in equity as percentage of total assets, equity as percentage of deposits and short term funds and marginally higher in the case of capital funds as percentage of total assets. Bankscope database defined capital funds as an aggregate of equity, hybrid capital and subordinated debt. As expected, Islamic banks did not register noticeable subordinated debt as a percentage of capital funds. Islamic banks commanded about 60% of tier 1 capital adequacy ratio of conventional banks. This could be explained by the fact that conventional banks can raise perpetual non-cumulative preference shares as part of their tier 1 capital structure requirements whilst Islamic banks are not able to raise preference share capital due to Shari’a constraints. Given that Islamic banks cannot access subordinated debt and hybrid capital in raising tier 2 capital, naturally the total capital adequacy ratio of Islamic banks are lower than that of conventional banks. As for total assets, Islamic banks appeared to have an asset base roughly 1/4 of that of conventional banks.

With regards to liquidity management, Islamic banks appeared to be over 38% more liquid than conventional banks when measured in terms of liquid assets as percentage of deposits and short term funds. Lower loan to deposit ratio of Islamic banks indicates that Islamic banks are not generating sufficient financings/loans from their deposit base, as compared to conventional banks. A higher inter-bank ratio amongst conventional banks underscored the inability of Islamic banks to deploy their excess liquid assets into loans to other banks given Shari’a constraints and lack of development of an Islamic inter-bank market. Bankscope’s database had defined inter-bank ratio as money lent to other banks divided by money borrowed from other banks. A higher ratio implies the bank concerned is a net placer of funds.

As for asset quality, the message appears to be mixed. Islamic banks appeared to have nearly 2.5 times more non-performing loans as percentage of equity when compared to conventional banks. Conventional banks provided more loan loss reserves as percentage of non-performing loans and as percentage of gross loans respectively, when compared to Islamic banks. Likewise, conventional provided marginally higher loan loss provisions as percentage of gross loans as compared to Islamic banks. However, conventional banks registered 48% more non-performing loans as percentage of gross loans when compared to Islamic banks. Given the above, it appeared that on a comparative basis, conventional banks had to write off more non-performing loans from their gross loans portfolio. The situation may seem dire at the outset without further investigation. It appears that the non-performing loans of Islamic banks warranted a higher write down on their equity as compared to conventional banks.

Table 4 and 5 (see appendix) below set out cross country comparisons. Bahrain registered the highest pre-tax profits as percentage of total assets, other income as percentage of total assets and net income as percentage of total assets. However, on net income as percentage of total equity, Saudi Arabian banks led with an admirable mean of nearly 21%.

As for operational cost measurement, Bahrain registered highest cost to income and staff expenses as percentage of total assets amongst the nine countries under survey. In terms of capital adequacy, the message is mixed. Bahrain registered highest equity as percentage of total assets. Oman took the lead for equity as percentage of total deposits and short term funds and capital funds as percentage of total assets. Banks in Saudi Arabia seemed to have the highest mean when it comes to capital funding through subordinated debt. Highest tier 1 capital adequacy ratio was registered amongst Indonesian banks, perhaps underscored by the presence of high perpetual non-cumulative preference shares issued during the Asian financial crisis, to resuscitate banks in dire consequences of recapitalization. Total capital adequacy ratio registered highest mean score amongst Omani banks, given the size and strength of the Saudi Arabian economy, it is only natural to see banks in Saudi Arabia registered highest mean score for total assets size which was 2.4 times higher than the next highest mean score for total assets size registered by Malaysian banks.

Other than Malaysia and Indonesia, oil and gas produce appeared to be a mainstay of gross domestic product generation for the rest of the seven countries under survey. Qatar, due to its small population, naturally scored the highest gross domestic product per capita. Indonesia registered the highest gross domestic product growth and gross inflation amongst the countries under survey.

In terms of financial market development, Malaysia leads in the banking markets and stock market. The leadership of Malaysia confirmed that the Malaysian economy is the highest leveraged amongst the nine economies with Malaysia’s total bank credit as percentage of gross domestic product outstripping its next closest rival Kuwait by 2.3 times. However, as for stock market liquidity, Kuwait has the most liquid stock market when considered strictly from the perspective of stock market turnover as percentage of stock market capitalisation and stock market turnover as percentage of gross domestic product. UAE and Indonesia had a larger banking market as compared to stock market when considered from the perspective of total banking assets as percentage of stock market capitalisation. Given the paternalistic instinct of Saudi Arabian government, it is not surprising to find that Saudi Arabia registered the highest mean score in terms of total central bank assets as percentage of gross domestic product.

A definitive analysis examining the extent to which the restrictive capital structure of Islamic banks impacted on their profitability and fee-based income generation capability cannot be fully realized, due to the disparity in the level and quality of disclosure of financials amongst banks in the countries surveyed. We merely reaffirms findings from established literature, that capitalisation by shareholders bears positively for generation of profits and fee-based income. After controlling for the country effect, the empirical results demonstrate that there is no noticeable difference between pre-tax profits, other income and net income generated by Islamic banks and conventional banks. This means that within a dual banking system, the results show that
Islamic banks do not enjoy any competitive advantage over and above conventional banks, in the context of generation of pre-tax profits, fee based income and net income. However, the results clearly show that country effect has an impact upon the type of banking. Put simply, the bases upon which Islamic banks in Malaysia generate pre-tax profits, fee based income and net income may differ from Islamic banks and conventional banks in Bahrain. Likewise, conventional banks in Indonesia would generate pre-tax profits, fee based income and net income on premises that are different from Islamic banks in Brunei.

The positive relationship between shareholders’ equity and the three performance measurements comprising pre-tax profits as percentage of total assets, other income as percentage of total assets and net income as percentage of total assets, reaffirm the findings of many other studies, which state that the extent of capitalisation by shareholders impacts positively upon profitability. Empirical results herein show that such positive impact is greatest in the context of generation of pre-tax profits. Be that as it may, net income as percentage of shareholders’ equity demonstrates a negative relationship with shareholders’ equity as percentage of total assets. Perhaps, this suggests that should the pace in the increase in shareholders’ equity outstrip profitability, returns on equity would demonstrate reduction given the enlarged denominator in shareholders’ equity. Total assets of banks do not seem to exert noticeable impact on generation of profitability and fee based income.

Empirical results also demonstrate that increase in secondary stock market trading could translate into increased profitability and fee based income generation for banks, albeit, the positive impact exerted may seem marginal. Of particular interest is the unanticipated country effect on profitability and fee based income generation. In this regard, banks in Qatar appeared to enjoy a higher propensity to generate profits and fee based income. Given that a great many financial market structure indicators and macro-economic indicators had been dropped as independent variables, due to statistical complications, this chapter cannot conclusively establish what exactly are the telltale signs that distinguish banks in Qatar as prime mover in profitability and fee based income generation as compared to other banks in this survey.

The positive relationship between staff expenses as percentage of total assets and other income as percentage of total assets, affirms the relevance and applicability of the expense preference behaviour theory in the context of generation of fee based income. Such finding is consonant with conventional wisdom that higher staff expenses are deployed towards hiring well trained staff of quality and experience, the services of whom are required to generate higher value added fee based income.

11.7 Conclusion

In the final analysis, this chapter reaffirms the previous findings as outlined in the surveyed literature that capitalisation by shareholders affects profitability positively. However, it is yet to be examined what contributes to the differences in profitability and fee based income generation by Islamic banks, as compared to their conventional counterparts operating within the dual banking system. At this juncture, it would appear that if ever there are differences or distinguishing features, the restrictive capital structure of Islamic banks as a factor does not seem to have contributed to the premises upon which profitability and fee based income are generated for Islamic banks and conventional banks operating within a dual banking system setting. Notwithstanding the above, the intertwining impact between country effect and type of banking system as shown in the empirical results may pave the way for future research into performance of Islamic banks and conventional banks of the same country operating in foreign countries. Such research may be meaningful given that the winds of change brought to bear by globalisation compel banks to compete outside their respective comfort zone of home country advantage.
Efficiency and profitability in Islamic banking

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International Monetary Fund: International Financial Statistics (June 2007)


### Table 3
**Average for period: 1998 to 2005**

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<th>Performance measurements</th>
<th>Mean</th>
<th>Standard Deviations</th>
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Appendix
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### Table 4
**Mean for period: 1998 to 2005**

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<th>Performance measurements</th>
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<td>Pre-tax profit as % total assets</td>
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CHAPTER 12
Shari’a assurance process

12.1 Introduction
To understand the role of Shari’a boards that ensure Shari’a-compliance of products and services for IFIs, one needs to know the exact meaning of Shari’a-compliance, its importance in the Islamic banking industry and how non-compliance can jeopardize the integrity of this system. With this understanding, we will be able to suggest a suitable mechanism that could help Shari’a boards in playing this role effectively to overcome the challenges facing them in this regard. This chapter will focus on the following key issues:

• meaning of Shari’a-compliance
• importance of Shari’a-compliance
• Shari’a-compliance challenges and mechanism
• Shari’a board functions
• measures to help Shari’a boards play their roles effectively

12.2 Meaning of Shari’a-compliance
Shari’a-compliant, in the context of financial contracts, refers to what is permissible in the Shari’a. In other words, if a contract has not been prohibited in Shari’a, it is Shari’a-compliant in principle. Do we need a specific or explicit Shari’a permission? The answer is No, we do not need a specific Shari’a permission, as in the case of contracts, the Shari’a has given us broad principles and rules which draw the line between what is prohibited and what is permissible. As long as a contract falls within permissible parameters, it is considered to be permissible and there is no further need for a specific evidence for its permissibility. Should a dispute arise on the Shari’a-compliance of a certain contract, the onus of proof is on those who declare it Shari’a repugnant and not on those who consider it Shari’a-compliant.

There is a difference in this regard between ibadat (acts of worship) and mu’amilat (transactions). In the case of the former, unless there is specific evidence allowing, recommending or obligating an act, it would not be permissible to carry it out as an act of worship. In the latter case, an act is permissible in principle, unless there is Shari’a evidence prohibiting it. This difference is due to the fact that acts of worship are defined and limited. In Islam, Prophet Muhammad is considered the supreme authority in interpreting and disseminating God’s instructions as to how to worship him, correctly. On the other hand, financial contracts facilitate the needs of people in different ages and times. These needs are not only unlimited, but also evolving with the passage of time through the emergence of new mediums of dealing with one another. Since Shari’a has come for the fulfilment of human needs in a just and fair manner, it has given mankind broad principles and rules to distinguish between a Shari’a-compliant contract and one that is Shari’a repugnant. The details of the structures and modalities are left for them to work out within those parameters and boundaries.

Some Muslim economists use the term Shari’a based to denote a higher and more desirable level of Shari’a-compliance which they feel cannot be expressed merely by the term Shari’a-compliant. For instance, they refer to murabaha and jara as Shari’a-compliant contracts, while they consider mudaraba and musharaka as Shari’a based transactions. This difference is not based on any Shari’a evidence, as Shari’a only categorizes contracts as permissible or non-permissible with no further category of farad (incumbent) or wajib (necessary) in financial contracts. Therefore, any contract which is Shari’a-compliant is also Shari’a based, meaning that the Shari’a has not disallowed it.
These economists argue that contracts like mudaraba and musharaka, being participatory in nature, serve the objectives of the Shari’a better through fair distribution of profit, and therefore, these contracts could be called Shari’a based, whilst the same is not true in case of those contracts which create a liability on the part of the customer such as the case in deferred payment sales.

One may agree with them to the extent that preference could be given to participatory modes of financing where equity participation is required or desired, but generalizing this as a policy to cover all areas of financing, and further relegating sale contracts to a secondary position is nothing but a gross misconception about the true nature and spirit of the Islamic financial system. An in-depth analysis will reveal that even in the case of mudaraba or musharaka, one party may be given a small share in profit, while in deferred murabaha or ijara they may get a fairer deal. Further, in many cases, financing may not be possible through mudaraba or musharaka such as the case of auto finance etc. where a murabaha or ijara contract may serve the objective of the Shari’a in a much better way than mudaraba, and thus, be more in line with the spirit of the Shari’a.

There are quite a few fallacies regarding Shari’a-compliance of Islamic banking of which a few are noted below:

1. Some Muslim economists, for instance, argue that Islamic banking will not be Shari’a-compliant unless it serves certain financial visions and objectives that they feel constitute the touchstone that determines whether a contract is Shari’a-compliant or not. They have, unfortunately, developed these visions on the basis of their studies of western finance and personal, rather than academic, readings of Shari’a. In a recent conference on Islamic banking and finance, to the utter dismay of the participants, one such economist claimed that had Imam Abu Hanifa and Imam Shafi studied finance, they would not have allowed some of the financial contracts that have been declared Shari’a-compliant.

This gentleman overlooked the fact that Shari’a scholars have disallowed many contracts which were deemed as legal devices to achieve an unlawful end, on the basis of itibar al maal or sadd al dinae. However, it must be noted that the decision about whether the end in question is lawful or unlawful, or the contract under question leads to this end or not can be pronounced only by qualified jurists of the highest order, who look at these issues from a purely Shari’a perspective based on the analysis of the entire body of fiqh literature and Shari’a texts relevant to the issue, in isolation of any alien discipline or system. This is not the task of an economist or any other expert for that matter, who might have developed his concepts and notions regarding the Islamic financial system under the influence of a western or conventional financial system.

2. Similarly, there are people who are judgemental of the Islamic finance industry based on their experience of some staff of IFIs not observing a proper Shari’a-compliant dress code. While there is no dispute that all IFIs should observe Shari’a principles in all areas including dress code or hijab, however non-compliance in such areas would not render their financial transac-

Shari’a assurance process
12.3 Importance of Shari’a-compliance

Since Islamic banking means banking in line with Shari’a principles and based on Shari’a-compliant contracts and structures, it is imperative for the regulators and the management of these IFIs to ensure Shari’a-compliance, not only as a corporate governance requirement, but also as a religious duty.

The importance of Shari’a-compliance can be gauged from the impact that it has in disseminating the message of Islamic banking, especially in such countries and areas where the masses are still sceptical about the genuineness of Islamic banking as a whole, or have apprehensions regarding certain products and practices. Any Shari’a-compliance breach can result in crippling reputational risk that does not remain confined to the erring institution only, but rather engulfs the whole entire industry or at the very least, those institutions that operate in the same geographical location. Therefore, all the stakeholders (the regulators as well as the institutions individually and collectively), must make concerted efforts to ensure Shari’a-compliance, not only at their own levels, but should also keep a vigilant eye on the violators in the market.

Since Islamic banks are bound by their bylaws, the rules and regulations as well as the contracts they sign with their fund providers to comply with the principles of Shari’a in all of their transactions and activities, they have to ensure that the profit they earn for their shareholders and depositors is halal. To that end, and in order to segregate tainted income and purify the profit of the IFI, Shari’a audit of the transactions is conducted regularly. In case the Shari’a audit finds that the Shari’a-compliance requirements of any transaction have not been fulfilled, the profit of such a transaction is declared Shari’a repugnant and directed to a charity fund. This shows that Shari’a-compliance is not only a religious and regulatory duty of an IFI, but also plays an important part in ensuring profitability of the institution.

12.4 Shari’a-compliance: challenges and mechanism for enforcement

One of the toughest challenges in the area of Shari’a-compliance is that while the industry has witnessed phenomenal growth in recent years, the academic institutions and the industry itself have not been able to produce trained and qualified people capable of running these institutions in line with the rules and objectives of Shari’a. This has made the task of ensuring Shari’a-compliance and proper monitoring of transactions and activities increasingly difficult; a task that requires immediate attention and remedy. Similarly, a lack of Islamic banking laws and appropriate rules and regulations to facilitate Islamic banking, especially in the area of Shari’a-compliance, combined with laxity on the part of the management of some institutions in putting in place an effective Shari’a-compliance system, pose serious challenges to the industry, with the potential of irreparably damaging the message of Islamic banking and impeding its growth and expansion to new horizons.

It is not strange to come across scattered examples of violations of Shari’a rules and principles by some institutions which adversaries use to tarnish the entire industry. It must be acknowledged that such instances of non-compliance could occur under any system due to error in human judgment in understanding the situation or application of the rules, or even as a direct result of misconduct or negligence. However, the remedy lies in a well defined compliance system and the commitment to abide by it, and there should be no complacency on this front. It is in this context, that we have recently witnessed a conscious effort by many IFIs and regulatory authorities to improve the Shari’a-compliance system.

It is the responsibility of the management to run the affairs of an IFI in a Shari’a-compliant manner. This task cannot properly be discharged unless a comprehensive Shari’a-compliance mechanism is put in place. This mechanism should be supervised and guided by a qualified Shari’a supervisory board. In the following section, the main functions and duties that should be assigned to the Shari’a board will be discussed. This will be followed by a discussion on the measures and tools necessary to enable the Shari’a board to discharge its functions in a befitting manner.
12.5 Broad scope of the Shari’a boards’ duties and functions

The following should constitute the main functions of the Shari’a board of an IFI:

a. Reviewing transaction proposals, answering queries, recommending appropriate solutions and issuing pronouncements and instructions for Shari’a-compliance.

b. Developing product manuals, along with sample documentation, process flows etc. to simplify the execution process of the transactions for the staff of the IFI.

c. Organizing and supervising training of the staff to ensure Shari’a-compliance in implementation of the transactions.

d. Supervising Shari’a audit of the executed transactions to ensure that the transactions have been implemented in line with the instructions of the Shari’a board, and to segregate any Shari’a repugnant income that the IFI may have realized through transactions not fulfilling the basic requirements of Shari’a-compliance.

e. Reviewing and approving Shari’a-related aspects in the bylaws, rules and regulations, all manuals and policies adopted by the IFI.

f. Ensuring that the profit and loss is calculated according to the rules of Shari’a under the terms of the agreements with the depositors and the approved policies.

g. Examining and approving the financial statements and annual accounts of the IFIs and issuing Shari’a-compliance reports, at least annually, expressing the extent of adherence of the management to the pronouncements, instructions and advice issued by the Shari’a board.

h. Examining all activities conducted in the IFI, whether directly linked to banking or of an ancillary or allied nature, including those activities that are only of operational or procedural nature, on the touchstone of Shari’a principles and advising the management accordingly.

Can a single Shari’a advisor handle all these responsibilities? Is it appropriate to assign all these duties and functions to a single person, or is there a need for establishing a full-fledged Shari’a board for this purpose? In this regard, different IFIs, in line with their bylaws and in the light of their declared objectives of Shari’a-compliance, have adopted different strategies and mechanisms. While some are functioning under the guidance of a single Shari’a advisor, others have established Shari’a boards which collectively share the burden of guiding and advising these IFIs. However, due to the diversity and vast scope of the duties and functions that are related to Shari’a in an IFI, and the need for collective input on the new issues and products that arise from time to time, a single Shari’a advisor will not be able to carry out these duties in a befitting manner. Therefore, the regulatory authorities should make it obligatory on the IFIs to constitute full-fledged Shari’a boards for fatwa and supervision of their activities from Shari’a perspective.

Some may argue that since many urgent issues and transactions cannot be delayed for a long period till a meeting of the Shari’a board could be called, and the IFIs require constant Shari’a guidance for smooth and timely management of their affairs, there is always a need for establishing a mechanism which would ensure provision of timely Shari’a guidance and involvement, and as such the model with a single dedicated Shari’a advisor would serve the purpose better. While there is a need for such a mechanism, one must not lose sight of the fact that it would not be an alternative for, nor a valid counter argument to the need for existence of a full-fledged Shari’a board. To address this issue, many esteemed IFIs have constituted executive committees, or appointed executive members of their Shari’a boards to provide this kind of immediate guidance and pronouncements, but the ultimate authority of Shari’a supervision, guidance and compliance vests in the Shari’a boards, and thus all the decisions of the executive committees or members have to be submitted for review and ratification by the Shari’a boards.

12.6 Measures to make Shari’a boards more effective

To empower Shari’a boards to play their roles effectively and discharge the heavy burden of the duties and functions assigned to them in a desirable manner, the regulators and the managements of IFIs, should take a number of very important measures, as highlighted below:

12.6.1 Regulatory requirement of Shari’a-compliance:

To enable Shari’a boards to discharge their duties as per the requirements of Shari’a, the regulatory authorities should ensure that IFIs are bound by the Shari’a pronouncements, opinions and guidance given by their respective Shari’a boards and the national Shari’a board, if any. Through reviews and inspection from time to time, the authorities should make sure that these institutions implement the Shari’a pronouncements and instructions in a timely manner and in both letter and spirit. The regulators should also penalize the erring IFIs to ensure that Shari’a-compliance stays at the top of their list of priorities.

12.6.2 The status, expertise and composition of the Shari’a board

The Shari’a board of an IFI should be an independent board appointed by the general assembly of shareholders of the IFI. The Shari’a board should be an apex body, with its decisions in relation to all the financial matters of the IFI binding on the management, and as such, it should not, and cannot, be made subservient to the board of directors in the IFI. This is the position of the Shari’a boards of the leading Islamic banks in the Middle East and other regions, although in some countries they are appointed by and report to the boards of directors, which is not an ideal situation.
The appointment and dismissal of Shari'a boards should be through a transparent procedure with the consent of the regulators to guarantee that the independence and impartiality of these boards are not compromised. Also, it is important that the most qualified available scholars in the field are appointed to the Shari'a board. The Prophet Muhammad (peace be upon him) is reported to have said, "If an authority appoints someone in a public position and there is someone else more qualified for the job amongst the Muslims, then he has cheated Allah, the Messenger and the Muslim community."

While this is true for every public post or position of authority, it is more so for membership of Shari'a boards of IFIs, whose decisions and pronouncements are issued in the name of Shari'a and as such bear the ultimate authority.

A Shari'a board should include at least one or more experienced Shari'a scholars with the capability to issue correct pronouncements on new issues in the light of Qur'an and sunnah and the fiqhi literature. It is also important that the Shari'a board should have the required technical knowhow on banking operations and commercial practices that would allow them to properly understand the issues and queries and enable them to give Shari'a-compliant solutions. This is because a Mufti issues a Shari'a ruling in relation to a query or issue after examining the case thoroughly, and therefore he has to have the capacity to understand all the dimensions of the case subject of the query.

12.6.3 Specialized training to Shari'a staff

The Shari'a board of an IFI would not be able to discharge its responsibilities in a proper manner unless a full-fledged Shari'a department manned by qualified staff is established within the IFI to assist the Shari'a board in all areas of their responsibilities and functions. This Shari'a department should have at least the following units:

- Product development, structuring and documentation
- Shari'a audit and compliance
- Shari'a training

Due to the unique nature and diversity of the tasks assigned to their Shari'a departments in particular, the staff of the department must have adequate knowledge of Shari'a as well as banking, as without a fine blend of expertise in these two areas, they will not be able to carry out their assignments in an appropriate manner.

Given the shortage of such qualified staff, the IFIs, as a short term remedy, have to be content with the best that the work market can offer and conduct on the job training, enhancing the capabilities of their staff, with the hope that in the long run the market will produce such manpower once the need for them is realized. Any proposed training programmes for the Shari'a staff should encompass both areas in a way that a staff with Shari'a background should be given specialized training in banking while the staff with banking and financial knowhow should undergo specialized Shari'a training.

12.6.4 Shari'a-compliance manual:

A Shari'a board will not be able to discharge its duties and functions unless the IFI develops a Shari'a-compliance manual which should determine the duties and functions of the Shari'a board and the responsibilities of the management vis-à-vis the Shari'a board. Experience has proven that one of the main factors behind success or failure of a Shari'a board in discharging its functions is the extent of the cooperation that it receives from the management of the IFI.

The following details the steps and measures that have to be taken by the management to ensure that the Shari'a board plays its role in an effective manner:

i. The management should get all products, policies, manuals, documents and advertising material approved from the Shari'a board. The profit distributions and annual accounts should be submitted for endorsement by the Shari'a board before their announcement. For effective product development, the management should provide the Shari'a board with all the information that will help the Shari'a board in arriving at Shari'a-compliant decisions regarding the proposed products.

ii. The management should get prior approval of the Shari'a board for any structured transaction and give adequate time to the Shari'a board for review of the transaction structure and documentation. It must submit to the Shari'a board all new contracts and samples that the IFI may be planning to use in future for review and approval by the Shari'a board before their execution.

iii. The Shari'a board members and Shari'a auditors should be provided unhindered access to all the books, records and documents of the IFI. The IFI should also submit proper explanation required by the Shari'a board especially in relation to those transactions which have been executed, in the opinion of the Shari'a board, in a Shari'a repugnant manner. In the event the management fails to implement the pronouncements and decisions of the Shari'a board or denies it access to the records and documents of the IFI, or does not furnish the required information, the Shari'a board should raise the matter with the BoD of the IFI. In case the BoD fails to address the issue, the Shari'a board should report all such irregularities in its periodic Shari'a-compliance report.

iv. The IFIs should have effective mechanisms to reward their departments and officers for Shari'a-compliance and penalize them for breach of Shari'a instructions.

v. As mentioned above the management should establish a full-fledged Shari'a department which should act as a link between the IFI's management and the Shari'a board. This would not only ensure involvement of Shari'a in the day-to-day affairs of the IFI, but would also help reduce the chances of errors in matters of Shari'a-compliance.

vi. Further, the Shari'a board should be provided with technical support of financial and legal experts at its request, especially when new products are developed or sample documentation is prepared.

vi. Further, the Shari'a board should be provided with technical support of financial and legal experts at its re-
I 2.6.5 Involvement of Shari’a board in product development, audit and training

It has been observed that in some IFIs, there is no involvement of Shari’a board/department in some important activities that are left to the management of the IFI. The issues to be raised to the Shari’a board are selected by the management at its own will, and the meetings of the Shari’a board are convened whenever the management desires; product development, documentation and manuals preparation are carried out by the management with very little involvement of the Shari’a board or staff, and Shari’a audit is either outsourced or conducted irregularly, covering only a small percentage of the transactions.

Such a state of affairs is not acceptable at all, as Shari’a-compliance in any IFI is more important than compliance with regulations, and while there are always compliance units or divisions to ensure compliance with regulations and rules of the regulatory authorities, how can an IFI eliminate or minimize instances of non-compliance with Shari’a rules and principles without having a robust Shari’a-compliance function which should be involved in the day-to-day functions of the IFI?

Some people may think that the duty of a Shari’a board is limited to giving Shari’a opinion and issuing of pronouncements regarding the queries raised or proposals and products submitted by the management, and oversight of the Shari’a audit to be conducted after the transactions. In fact, nothing could be more misleading or confusing about the duties of a Shari’a board. The Shari’a board of an IFI is the highest authority that is responsible for overall Shari’a-compliance of the IFI and for everything that is related to Shari’a.

Therefore, the tasks of product development, structuring of new transactions and documentation cannot be left to the management alone. Similarly, the Shari’a board should be directly involved in Shari’a audit and training of the staff on the products and services provided by the IFI.

Product development, structuring and legal documentation unit

When a product proposal is submitted for approval of the Shari’a board, it will not only issue the fatwa regarding the product, but would also ensure that it is executed in a fully Shari’a-compliant way. Therefore, the tasks of product development, complete with all the steps of preparing a product manual, which should detail the process flow of the transaction and the accounting entries, and the legal documentation to ensure that the terms and conditions of the contracts are in line with the principles and rules of Shari’a, have to be carried out by trained staff under the direct supervision and guidance of the Shari’a board.

The Shari’a boards should take a proactive role in this regard by guiding the IFIs to diversify their product suits, avoid dubious products and improve upon features of their services. The IFIs should try to address taxation and legal issues that at times force them to adopt not-so-desirable products and march onwards to create new instruments and products that should be different from their conventional counterparts in both form and substance.

The Shari’a board would be assisted in this task by the Shari’a department of IFI, which should have a unit specializing in the area of product development, structuring of corporate deals and documentation.

Shari’a audit under the supervision of the Shari’a board

The Shari’a audit should aim to ensure complete Shari’a-compliance in all the activities of the IFI, point out cases of Shari’a repugnancy, if any, and ensure transfer of any Shari’a repugnant income of the IFI as per the charity policy of the IFI. A strict and comprehensive Shari’a audit should be conducted in line with an audit plan to be approved by the Shari’a board. All activities of the IFI fall within the purview of the Shari’a audit, and as such all financing and transaction agreements, product documents, forms, brochures, agreements, services provided by the IFI and all the policies and manuals should be subject to Shari’a audit.

The Shari’a audit team should also interact with the staff during audit exercise to gauge the knowledge of the staff relating to their products. The observations of the Shari’a audit should be conveyed to those who are responsible for designing the training material and conducting the sessions for improving upon the features of the training programme.

Shari’a related training of the IFI staff:

It is obligatory on each and every Muslim to acquire the relevant body of Shari’a knowledge to perform his obligatory duties. Based on this principle, there is no doubt that acquiring knowledge of basic financial contracts is obligatory on each and every Muslim, as they have to enter into such transactions in their daily life.

However, an Islamic banker, in addition to the general knowledge for basic financial contracts whose acquisition is obligatory on every Muslim, has to acquire the knowledge of the products and services that he is responsible for, in order to be able to offer the same in a Shari’a-compliant manner. It is reported that Umar, the second caliph of Islam used to visit the markets of Madina, and ask the traders about the rules of Islamic financial contracts, and whenever he would find anyone lacking the required level of knowledge, he would order him to leave the market place and go to the scholars to seek the required knowledge.

This is not only a religious duty of an IFI staff, but also a requirement of corporate governance and a tool to mitigate reputational and operational risk for IFIs, which can lead to losses due to segregation of tainted income. Compliance with Shari’a principles and rules would not be achieved unless the employees of the IFIs are properly trained on the Shari’a-compliance requirements of their products and services.
It is imperative for Shari’a boards and departments of IFIs to take the following steps to address the issue of lack of proper training of IFIs’ staff.

To enable IFIs to recruit staff suitable for Islamic banking, the Shari’a board should lay down parameters and general guidelines for selection of IFI staff. However, since it might not be possible to find trained staff with the right aptitude and Shari’a inclination in the market, it would be the responsibility of the IFI to train the recruited staff adequately on all the products offered by it.

A proper training programme should be devised in a manner that it should start with basic and compulsory training sessions relating to the economic philosophy of Islam and concepts of Islamic banking and then move on progressively to specialized courses. The basic courses should be compulsory for all employees, irrespective of their job and the departments that they are working in, while the specialized courses on various products should be compulsory only for those employees who are directly dealing with such products. However, all staff should be encouraged to attend specialized sessions once they have been through their basic training.

The training material should be prepared by qualified Shari’a scholars cum trainers in very simple language, and the reading material should be given to the participants before the training session so that they get an idea about the subject, before the training starts. This will raise their level of comprehension and ensure that the training session would be lively and interactive.

The trainers, who should be qualified Shari’a scholars, or certified Shari’a trainers, should prepare effective power point presentations, but should avoid reading the presentation material. It must be noted that an effective training is always based on a two-way interactive communication with participants. The trainers should also address the operational issues related to their topic and give live examples.

The participants should be given tests so that the level of their comprehension and attention is gauged. The results of the tests should be communicated to the line managers as well as to the human resource departments.

Emphasis should be on training of both the junior and senior staff, as with more knowledge about the Shari’a aspects of the products, a senior staff would be in a much better position to guide his subordinate staff properly and ensure greater Shari’a-compliance.

Special training sessions should be offered to educate serious customers, or those customers who act as IFI agents in various stages of execution of their transactions, about the basics of Islamic banking and their responsibilities when they act as the IFIs’ agents. Similarly, they can attend the courses offered under the Shari’a training programme for the staff.

**12.7 Conclusion**

This chapter has tried to define the term Shari’a-compliance, highlight its importance and discuss the role that the Shari’a board of an IFI should play in this regard. Cognizant of the challenges and issues that have so far hampered the efforts in this regard, the chapter has highlighted some of those challenges and took them into consideration while suggesting remedial measures. In a nutshell, an attempt has been made to prove that an IFI cannot be fully Shari’a-compliant unless it is supervised and guided by a qualified and fully empowered Shari’a board which should be assisted in all areas of its responsibilities by a full-fledged Shari’a department, manned by competent resources especially in areas of product development, structuring, documentation, Shari’a audit and training.
Chapter 13

Human resource development

13.1 Introduction

Amidst an environment of considerable change in the global economic sphere and the growing significance of Islamic finance worldwide, human resource development has become the defining factor in sustaining the performance and competitiveness of IFIs. The unprecedented success and continued growth of Islamic finance could not have been achieved without human intellectual development. As John F. Kennedy once said, “Our progress as a nation can be no swifter than our progress in education. The human mind is our fundamental resource.” Since human capital plays a key role in driving the performance and market competitiveness, investment in this core pillar will be the defining factor in the sustainability of the Islamic financial services industry.

The shortage of skilled Islamic finance professionals is a global phenomenon and could impede the double digit growth that the industry is experiencing, making it imperative for the industry to focus on nurturing talent and developing cross-border expertise if it is to continue to drive current impressive growth rates and flourish alongside conventional counterparts. Developing human resource capacity and ensuring a future supply of skilled workforce is integrally linked to the overall growth and sustainability of the industry.

The Islamic financial industry is arguably in need of new market leaders to drive growth and scale as well as, most importantly, visionary leaders to deal with the new complex challenges that lie ahead. The pace of growth in the industry to date has posed real challenges for both regulators and operators to embrace better and sound prudential practice-related policies. A recent industry report (September 2010) from Deloitte’s Islamic Finance Knowledge Center (IFKC) revealed that most industry leaders agree on the need for new regulation, good governance, effective risk management frameworks, standardisation of products and services, and the need to invest in talent, leadership development and professional excellence. This chapter attempts to take the latter point further and probe the merit of adopting winning strategies in talent management and competency-based leadership. It begins with suggesting how IFIs can develop a skill formation strategy to be competitive in the global economy. The key requisite for this is that IFIs should host and develop an organization-wide ‘create awareness’ strategy for competency and professionalism in the workplace.
Obviously, this winning strategy acts as a catalyst to fuel a rally for change in the industry. Human resource development transcends finance practitioners and covers the full spectrum of the corporate landscape such as lawyers, accountants, auditors, fund managers and other financial intermediaries.

13.2 Importance of human capital development in Islamic finance

The shortage of skilled Islamic finance professionals is a global phenomenon and could impede the double digit growth that the industry is experiencing, making it imperative for the industry to focus on nurturing talent and developing cross-border expertise if it is to continue to drive current impressive growth rates and flourish alongside conventional counterparts. Developing human resource capacity and ensuring a future supply of skilled workforce is integrally linked to the overall growth and sustainability of the industry. The increasing demand for talented human resources in Islamic finance stems from 3 main factors: the internationalisation of Islamic finance, evolution of Islamic finance from faith-based to a business driven industry and the rising demand for Shari’a-compliant products and services, ranging from retail banking to insurance and the capital markets.

At present, the industry is growing at a much faster rate than human resource development. Figure 1 shows that asset growth, as a proxy for business volume, exceeded the availability of human capital of Islamic banks in Indonesia.

The global Islamic finance industry has evolved from a faith-based to a commercially driven industry for all communities. As Islamic finance is a customer to business model, it has proved appealing to Muslims as well as non-Muslims who are interested in ethical financing and investments. The rising participation of conventional players globally including issuers and investors, is a manifestation of the huge potential that Islamic finance has to offer to the financial and business communities. Conventional banks, for example, through their cross-selling of Islamic products have assisted in making Islamic finance more mainstream. As the scope for Islamic financial products has now expanded to more sophisticated products and services in response to a shifting customer base, the demand for Islamic finance experts in product structuring has never been higher before.

13.3 Human resource requirements

According to statistics released by the International Islamic University of Malaysia, a total of 2 million finance professionals will be required to fill in various positions in the Islamic financial institutions worldwide by 2020. This is in stark contrast to the estimated 92,000 finance professionals working in the Islamic finance industry in 2007. In Malaysia, a total of 12,000 Islamic finance professionals will be needed, almost double the current 7,826 professionals employed by Islamic banks in the country. The takaful industry in Malaysia currently employs around 2,460 professionals. However, with the recent approval of 2 new takaful licences, industry observers have projected that the industry is looking for around 100 to 200 people to enter the industry within the first 2 years of operations.

![Figure 1: Growth in Human Capital vis-a-vis Growth in Assets](Source: Indonesian Islamic banking outlook 2010)
In Indonesia, there are only 15,000 qualified Islamic finance professionals available to serve the 1,059 Islamic bank offices operated by 5 Islamic commercial banks and 24 Islamic bank units. AT Kearney reported that about 30,000 new Islamic banking positions will need to be filled in the Middle East, in the next 10 years. In a recent survey conducted by Deloitte, only 4% of Islamic finance leaders in the Middle East agreed that the Islamic financial institutions are properly staffed with people who have the necessary depth and experience relevant to the industry, while 61% of them felt that Islamic finance professionals require more training and skills development. These figures are alarming as it implies that Islamic finance professionals are currently perceived to be under-qualified and do not have adequate knowledge and skill in this area.

13.4 Issues and barriers to human resource development in Islamic finance

While the need for human resource development is evident, what is less apparent is the appropriate strategies and resource mobilisations that need to be adopted to advance human and talent development in the Islamic financial industry across the board. The development of intellectuals who are proficient in Islamic finance requires a comprehensive, systematic and goal-directed framework in order to develop a pool of high calibre Islamic finance professionals. The Islamic financial industry is currently lacking a global industry body to oversee standardisation of continuous education and training to break the human resource bottleneck.

Stakeholders have a role to play in developing the required human capital at the macro, meso and micro level. At the macro level, the most pertinent policy option is to introduce Islamic finance courses at various levels of the educational system. Government and regulators have a crucial role to ensure that a proper human capital framework and infrastructure for the Islamic finance industry are in place. At the meso level, institutions engaging in capacity building such as specialized training institutions, consultancy organizations and professional bodies are the main promoters of knowledge in Islamic finance. Finally, at the micro level, it is the actual suppliers of the educational services such as schools, colleges and universities who are the stakeholders. In addition to these 3 main groups of stakeholders, another important player is the Islamic financial services industry as the ultimate users of human resources. The involvement of the industry in areas such as curriculum design and delivery as well as providing practical support to educational providers, will ensure that graduates are equipped with the relevant industry knowledge.

The collaborative efforts of all these stakeholders in capacity building and human capital development through strategic ownership at the national, regional and international level is critical for the continuing success of Islamic finance. In Malaysia, for example, the government and regulator have taken several strategic initiatives to ensure the continuous enhancement and ready availability of a talent pool of high calibre Islamic finance professionals. The establishment of the Financial Sector Talent Enrichment Programme (FSTEP) by Bank Negara Malaysia, is a prime example of the kind of collaboration that the regulator, industry and training institutes have undertaken at the national level to meet the growing demand for well-trained and competent personnel for the Islamic financial services industry. At the international level, the IDB, through IRTI, is committed to the development and enhancement of human intellectual capital in Islamic finance via specialised training and educational programs. Other projects initiated by the IDB include helping member countries like Brunei to develop their human capital capacity building in Islamic finance.

Another issue is the diversity of human capital strategies currently adopted by IFIs across the industry. In multinational banks which operate an Islamic window, branch or subsidiary, their human capital strategies are more comprehensive in nature and very much in line with the conventional industry standards and norms. IFIs originating from the GCC or Asia, have yet to fully develop their human capital strategies, particularly in the area of compensation and benefits. Due to this diversity, IFIs in these countries more often than not base their salary and benefit package on country norms rather than industry norms. At the heart of the growth experienced by the industry is the critical issue of ‘brain drain’. The industry is facing difficulty in obtaining and retaining talented staff, who can be lured away from one institution to another with huge salary inducements. This has dire consequences, as it leads to a brain drain of qualified and highly experienced Islamic finance professionals, from more mature markets to mature or emerging markets. The main reason for this is the lack of company-wide strategies of attracting, recruiting, training, developing and retaining talent.

13.5 Setting the standard for Islamic finance talent

Since Islamic banking and finance is a trans-disciplinary subject, a multi-dimensional and inter-disciplinary human resource approach is needed for the education and training of Islamic finance professionals. According to BIBF, there is an urgent need for Islamic finance experts who are not only conversant on principles and concepts of Islamic finance but also on specific matters facing the operational side of Islamic banks such as taxation, accounting issues, Basel II and regulatory issues.

One of the pertinent questions posed in the development of human capital in Islamic finance, is the adequacy in terms of development and certification programmes that are in place to support the creation of a new wave of elite scholars. The plethora of courses and training in Islamic finance offered by institutions wishing for a piece of the USD 1 trillion Islamic finance pie, has resulted in a new set of challenges for the industry – no uniform standard for qualifications in Islamic finance.

There are many Islamic financial training programmes credited by Western accreditation or validation pro-
It must be clarified that the argument here is about peer-reviewed competence within the financial industry. Involved in development and delivery of Islamic training programmes must be at least one qualified Shari’a scholar. It must, however, be a requirement that at least one qualified Shari’a scholar is involved in the development and/or delivery of the training. These involved in development and delivery of Islamic training must demonstrate discernment, scrupulousness, and peer-reviewed competence within the financial industry.

It must be clarified that the argument here is about training programmes and not about academic qualifications. For academic qualifications, it is the academics who are better qualified and hence design and deliver such programmes. In fact, there are some Shari’a scholars whose academic qualifications are not impressive at all and that they must look into improving their academic credentials.

While it is imperative that Islamic religious institutions and Shari’a scholars are consulted for designing and development of Islamic financial training programmes, it is not absolutely important that such programmes are delivered by them as well. There are some trainers in the Islamic financial services industry, who have no background at all in Islam or in Islamic banking and finance. These trainers, especially those who are not Muslim, delivering training on Islamic legal contracts are probably the worst, because they lack real understanding of juristic issues.

The standards for an approved Islamic finance trainer vary, but generally, someone who has acquired sufficient knowledge of the Islamic law of financial transactions, either formally (preferred) or through a self-motivated disciplined approach can be considered as a good Islamic finance trainer. Such a person must ideally be approved by an Islamic professional body but he/she may be acknowledged so by peers and other qualified trainers and Shari’a scholars.

The issue of ensuring proper governance with respect to Shari’a scholars has taken a positive turn when the International Shari’a Research Academy for Islamic Finance (ISRA) proposed a global certification for Shari’a experts. To this end ISRA is already in the process of establishing a professional association which will have similar functions to that of other professional bodies. The association, to be known as the Association of Sharia Advisors (ASA), will not only regulate the Shari’a advisory services but will also lay code for Shari’a advisory practices and is envisaged to be the sole body that accredits these professional experts.

According to Islamic Finance 2009, a report published by the International Financial Services London, there are about 205 institutions providing education and training in Islamic finance globally with the UK at the forefront in providing global qualifications for the industry (see Figure 2). Although Malaysia comes second after the UK, the Research Intelligence Unit argued that the numbers of institutions offering education and training in Islamic finance is set to double, and the country’s influence over the curriculums as well as training programs in this are expected to grow in the Asian region.

There is a case for a single, internationally recognised and globally accredited Islamic finance qualification and certification as opposed to regional qualifications available in isolated geographies. Given that different countries introduce different professional qualifications in Islamic finance, the next step is the standardisation of professional qualifications for the industry which is the essential requirement for improving the overall quality of education in Islamic finance worldwide and thus ironing out differences in access to qualified Islamic finance professionals.
13.6 Conclusion

As the Islamic finance industry continues its international expansion and double-digit growth, the requirement for finance professionals who have the combined knowledge of Shari’a principles with knowledge of the market place will also increase. The need to develop and support demand-driven skill development and training programmes should be at the top of the agenda of industry stakeholders. The dearth of qualified Islamic practitioners can only be redressed by investing in the creation of world class education and training providers in Islamic finance; realigning the education and training programmes to suit the business requirements of the industry through forging greater collaboration between industry and academia; re-skilling conventional bankers who have crossed over to Islamic finance and by the offering of globally accepted qualifications that equip individuals with adequate Shari’a knowledge and technical skills.

Winning strategies in talent management: the evolving competence and professional landscape in Islamic finance practice

Who should drive the quest for professionalism in Islamic finance?

The important notion of embracing competence and professionalism in Islamic finance practice is not just an individual IFI’s concern; but rather it must be the concern of industry stakeholders collectively. This section attempts to initiate discussion on this dynamic topic and propose winning strategies that IFIs should adopt to enhance professional excellence.

Before moving further with the discussion, we hope to dispel the common fallacy that during uncertain economic times, organizations cannot afford to invest in human capital. Investing in talent and leadership development has provided generous rewards to multinational corporations (MNCs) and it must be allowed to do so for IFIs.

The triangular approach as an instrument for change

One of the indispensable needs of the Islamic finance industry is to embrace professionalism and a coherent set of best practices across the industry. Furthermore, the true benefit of any human capital development strategy depends on developing an approach which will ensure that any training or learning improves the overall business performance of the organization. To visualize and realize this objective in the workplace, IFIs must develop a holistic human resources solution to improve the capacity building process and follow best practices in this landscape. This is an essential building block to strengthen the industry infrastructure. Key to this is the need to provide a complete programme to improve the capabilities of IFIs in the following areas: leadership, management, finance, information and communication technology (ITC) and client relationship amongst others. Moreover, the key elements of the holistic solution approach can be segmented in the following three inter-related winning phases:

1. create and adapt a professional excellence culture
2. develop a competency and training strategy
3. build a competency-based leadership programme

Create and adapt a professional excellence culture

IFIs should create and adopt internationally-accepted competency frameworks and guidelines relating to professionalism in the workplace. They should also promote learning and professional excellence at all levels of the industry infrastructure: regulators, standard-setters, operators and industry associations. Human Resources Management Systems (HRMS) must be integrated with the specific Shari’a and Islamic jurisprudence knowledge and skills required for employees to build technical and individual competency. HRMS software vendors and professional advisory firms have developed best practices in methods and approaches which address the functional roles and operations of IFIs. Industry standards developed by the IFSB in business ethics, corporate governance, risk management and conduct of business could also be built into the HRMS to gauge employees’ understanding, performance and competency. This process will ensure a bespoke framework to the specific business objectives of IFIs— including those related to Shari’a, their business models, strategies and operations.

Develop a competency and training strategy

There is also the more direct approach in which IFIs should design competency-based training programmes. Here, the management and leaders of IFIs should think strategically about delivering a long-term human development policy and instill the concept of self-learning and lifelong learning within the organization. The major objective of competency-based programmes must be to embed in Islamic bankers the level of confidence and
knowledge required to do their work. Some of the important steps to be considered in this phase include:

1. Skills and knowledge identification: Islamic jurisprudence, Shari’a, financial and accounting reporting, risk management, client relations, etc.

2. Skills and knowledge analysis: segmentation of skills and knowledge into categories and functional roles.

3. Develop a training curriculum based on the above, training materials can be developed.

4. Development of assessment methods: test the benefit of learning and how it improves competency and reflects on the overall business performance.

5. Development of instructional materials: face to face teaching, case studies, group work, role play, e-learning, etc.

Build a competency-based leadership programme

The third winning phase of developing competence and professionalism strategy in Islamic financial services requires a programme that nurtures future leaders to drive the industry to a new level of scale and growth. This phase entails the development of specialized talents in different disciplines of Islamic finance practice such as risk management, strategic finance, investment, corporate finance, internal control or even Shari’a advisory. ‘Four Competency Capabilities’ are the prerequisite for leaders to be considered in this phase:

1. Individual competency: self-interest and knowledge in the chosen field of Islamic finance specialization, banking, takaful, waqf, etc.

2. Technical competency: ability and capability of the individual to perform certain expertise as a subject matter expert, e.g. as Shari’a advisor, professional accountant, or a risk management officer.

3. Social competency: ability to work as part of a team, develop a capacity for dialogue and achieve common objectives.

4. Professional competency: The right mix of skills, knowledge and the above three competencies to help the individual perform work in the desired way.

Looking ahead

The competency-based training and leadership approach is part of a strategic initiative for enhancing capacity building in the Islamic finance industry and developing best practices of competency and professionalism. One of the key challenges to this is securing the necessary commitment of the relevant stakeholders: executive leaders and decision-makers. A harmonized stand from all stakeholders to back these kinds of strategies and, more importantly, to commit and allocate adequate resources to ensure effective implementation is necessary for their success. In return, the management of IFIs is expected to devise policies and procedures for developing, improving and monitoring the effectiveness and achievements of these strategies. Likewise, industry professionals, practitioners and other policy-makers should play an effective role through continuous public dialogue to improve the essence of professional competence and its best practices for the well-being of the industry as a whole.

![Figure 3: The evolving competence and professionalism process in Islamic finance practice](image)
Chapter 14
Islamic banking systems

14.1 Introduction

For decades, banks in the conventional banking world have used pre-packaged software systems to meet their everyday processing requirements. Developing software internally to accommodate standard banking functions is now normally only done by the largest of banks, with the majority of institutions finding it more cost-effective to purchase a package then adapt it to meet their specific needs. The emergence of Shari’a-compliant banking has changed the demands made on those computer systems. Some vendors have reacted to those changed requirements and have produced standard Shari’a-compliant banking packages that can be tailored to meet the specific needs of an individual Islamic bank.

14.2 Islamic banking systems industry

The current business downturn has had its impact on the level of sales made to the Islamic banking sector, but there have been some sales made throughout 2008 and they seem to be continuing into 2009 and 2010.

In general terms, there are two broad categories of packaged banking systems that are available to meet the processing requirements of Islamic banking – those standard conventional banking system packages that have been specially modified and enhanced to cope with the new Islamic product set, and those that have been built from the ground up as Shari’a-compliant.

14.3 Suppliers of Shari’a-compliant systems

The suppliers of Islamic banking systems are of all different shapes and sizes. Some are small companies that have concentrated selling to a specific country or region. Some provide retail core banking capability – covering the basic needs of accounting, customer information storage, through to statement production and reporting – while others provide more niche processing such as wealth management or capital markets processing. But there are others that are truly international in scope and provide the wide range of functionality that may be expected from suppliers of universal banking systems.

The consensus is that there are around fifteen to twenty international suppliers of banking systems that claim to have Shari’a-compliance and that are selling outside of the vendor’s home region. Within this group there are around half a dozen leading companies.

The internal focus within vendor organisations varies between different suppliers. Some have elected to make Shari’a-compliant banking systems their primary package offering, while other conventional systems vendors have realised that although there are some fundamental differences, most areas of banking, from a processing point of view, remain just the same for both Islamic and conventional banks so offer an Islamic package alongside their conventional offering.

Certainly there are some internal bank processing silos that don’t need material changes, regardless of whether the processing is taking place within an Islamic or a conventional bank. An Islamic bank is still a bank – so must meet the same basic level of demands as any other member of the industry. In fact, often, an Islamic bank must meet those basic levels and then more. For example, regulatory reporting formats are dictated by the regulator in a particular country and while those formats apply to all banks in that country they were originally de-
The overall banking systems market is made up of several hundred vendors; some selling locally, some selling regionally, while others selling internationally. There are around one hundred vendors that are recognised as selling internationally. There is an Annual Sales League Table that tracks the sales of each vendor over the previous year. The table shows that two vendors, Temenos and Oracle Financial Services Software, have claimed a broader functionality, the Shari’a from-the-ground-up packages may offer 'more pure' Islamic processing, but because they are younger may not offer as much functionality. It is also problematic as to how much of the functionality offered by a modified conventional system may be applicable to an Islamic bank especially in terms of transaction set, as many conventional transactions are not applicable.

14.5 Leaders are emerging

In their various ways, those vendors that have chosen to do so have overcome the obstacles to entering the Islamic systems market and early entrants have taken advantage of the growing number of opportunities available. Already, some players seem to be leading the way.

14.6 Size of the Islamic banking systems market

Many of the vendors that populate the Islamic banking systems market also populate the conventional banking systems market, so it may be worthwhile to look briefly at the overall market to establish a benchmark, before looking at the newer Islamic market.

The overall banking systems market is made up of several hundred vendors; some selling locally, some selling regionally, while others selling internationally. There are around one hundred vendors that are recognised as selling internationally. There is an Annual Sales League Table that tracks the sales of each vendor over the previous year. That table shows that two vendors, Temenos and Oracle Financial Services Software, dominate the market and have done so for at least the last five or so years. These two vendors each have around twice the number of sales (about 40 each last year) as their competitors and a total user base in the order of 480+ and 320+ bank customers respectively.

In all, the current league table counts 431 new sales of banking systems during the year. These figures include sales of both conventional and Islamic banking systems, although, as will be seen later, the Islamic sales are of a substantially smaller order than the conventional sales. One reason for this is the relatively small base of Islamic banks that existed before 2003, although the growth in Islamic banking in recent years has been considerable. It is also the case that many Islamic banks do not go through the process of selecting a vendor to provide a complete banking system, but do so instead for their back office systems.

It is this similarity of common functions that has prompted some vendors, whose packaged systems offer a broad range of functionality, to realise that only specific areas need be changed to adapt to the Shari’a-compliant way and they can compete with some of the Shari’a specialists by offering broad functionality founded on an established user-base.

It is arguable that while the conventional systems may claim a broader functionality, the Shari’a from-the-ground-up packages may offer 'more pure' Islamic processing, but because they are younger may not offer as much functionality. It is also problematic as to how much of the functionality offered by a modified conventional system may be applicable to an Islamic bank especially in terms of transaction set, as many conventional transactions are not applicable.

14.4 But not for everyone

Not all vendors of packaged banking systems have developed Shari’a-compliant systems. Some have stood back either to see if this fledging market would, in fact, survive or because the development needs of their client-base lay elsewhere.

Developing a Shari’a-compliant system can cause some problems for vendors of banking systems. Unless the vendor has a development partner in the form of an IFI that will assist in specifying requirements, they will not find it easy to come up with the knowledge that is needed. There is a shortage of skilled people that have the IT skills and the Shari’a knowledge to enable a conventional banking system to be successfully modified to comply with Islamic processing, or to build an Islamic package from the ground up. This situation is not helped by the apparent lack of uniformity across the Islamic world as to what is and what isn’t acceptable. The functionality developed by a vendor in one part of the world may not be applicable, or saleable, in another region.

The vendor also needs to consider the commercial aspect of the cost of developing the system versus the expected returns from sales. It is not only the development costs that the vendor will have to bear but also the on-going maintenance costs. If two versions of the system are created, one conventional and the other Islamic, each change of code or new release of system will need to be tested against both the conventional version as well as the Islamic version. This will be an ongoing expense that will grow as the Islamic version of the system grows in size and functionality.

In some cases, vendors and even banks themselves have overcome some of these maintenance problems by segregating the changes into special areas or layers of the system. At Dubai Bank, the Equation system from Misys provides the core processing. When the bank decided to switch from conventional and become Islamic, the bank’s IT department built a new ‘layer’ on top of the conventional processing to accommodate the new Shari’a-compliant processing needs. Other vendors use parameter settings to significantly change the way instruments are processed. Temenos for example uses a ‘model-bank’ approach in its T24 product in which standard parameters can be set to invoke processing designed to meet Shari’a needs. ERI, although having built specialist processing for Islamic instruments into its Olympic Banking System, is able to use existing functionality originally developed for mutual fund processing to accommodate profit distribution.
much smaller magnitude. Excluded from those figures are large regional vendors that operate exclusively in their home regions of China, Russia (around 76 deals) and the US (estimated 400+ sales), although international sales by those vendors are counted.

14.7 Islamic sector

The Islamic banking sector of the systems market is more difficult to quantify. As mentioned, there are various estimates, but the consensus would seem to be that there are around 15 to 20 vendors that claim to offer Shari’a-compliant banking systems. One estimate is that there may be a total of combined sales of all vendors to Shari’a-compliant organisations over the years at a little over 200 or so.

Although the 431 sales in the last twelve months for all vendors include those to Shari’a-compliant banks as well as to conventional banks, there may be some indication as to the relative size of the Islamic banking systems market by looking at the sales figures of Path Solutions. This vendor’s primary product is a Shari’a-compliant banking system (iMal). It is regarded as the largest selling vendor of Islamic systems, last year recording eleven new sales (which put it in tenth place overall in the league table) bringing its total estimated installed user base to around 60 bank customers.

There does appear to be some regional variations in sales preferences. Some vendors seem to enjoy sales in all of the Islamic regions, whereas others may have a slightly more regional sales appeal.

14.8 Some essential characteristics of Shari’a-compliant systems

The most obvious characteristic of Shari’a-compliant systems is that the system should not calculate interest. This is not a problem for the Shari’a from-the-ground-up type package but it can be an issue for converted conventional systems. Ideally, converted systems should not only refrain from calculating interest but the wording should not appear on any screen or report. If the interest programs do have to be shipped as part of the system, then the interest rates should be set to zero at the global level.

In place of calculating interest, the system must be able to calculate and distribute profit. This profit distribution is probably one of the key differentiating factors between the different Islamic banking systems with various nuances being claimed by individual vendors.

The key requirement from a processing point of view is that client investment accounts can be assigned to a profit pool (or a combination of pools) and income and expenses allocated to those pools to calculate profit. That profit is then distributed to the accounts according to some predefined processing rules. To smooth out the amount of profit payable from period to period, the bank may use an intermediary equalisation account to take out the high profits in good times, supplement the low profits in bad times, or to make other accounting adjustments.

Quite often, a bank will do an interim calculation on its investment accounts to determine the order of magnitude of its outgoings and then, after adjustment, will recalculate the real amounts to be paid to customers.

Different packaged systems use different methods to achieve this profit distribution. Path Solutions for example, claims that at the heart of its iMal system is its real-time profit distribution engine. Other converted conventional systems, Misys’ Equation for example, use alternative methods to achieve the distribution.

Another important factor to be considered when looking at an Islamic banking system is the degree of control that a bank will have in its treatment of accounting events. Ideally, the system should allow for the complete user definition of all accounting explosions for each of its user-defined accounting events. Some systems are sophisticated enough to be able to account for events using multiple accounting standards.

A key requirement is the ability for non-IT users to build new products and assign operating parameters, processing rules and other variables necessary to bring new products to market quickly. Additionally, existing products should be capable of having parameters modified and processing rules changed. This flexibility is necessary to meet the changing needs of the Islamic banking marketplace.

The system should also have the ability to not only hold an Islamic-style general ledger, but also to be able to convert that layout back into a conventional format for regulatory reporting or for combining with other conventional banking group companies.

A workflow system is also considered essential. By using workflow the bank can assure its Shari’a board that each transaction is processed in exactly the same authorised manner each time.

14.9 The Islamic banking package market participants

There are many specialist vendors that operate purely within their home country but some internationally recognised vendors have been active in the Islamic banking systems market for some time and have built up fairly sizeable user group bases. New vendors are coming along and older vendors will be dropping out (for example, most probably the Misys systems at some point will be replaced by that company’s newer Bankfusion product).

Path Solutions has built its iMal system as Islamic from the very beginning. It is believed to have the largest user base of Shari’a-compliant financial institutions. But Path is not the only supplier that has built its system as Is-
Islamic from the ground up. Other vendors include Info-pro Sdn Bhd and Microlink Solutions Bhd which, as their names suggest, are Malaysian companies. Both systems have been designed and developed as Shari’a-compliant banking systems. Both are used widely within the Malaysian region and have now branched into other regions.

But the bulk of the market in terms of numbers is made up of conventional systems vendors that have modified their systems to meet Shari’a requirements. These vendors include the giant US-based international suppliers such as Fidelity National Information Services and Sungard Financial Systems which have systems that claim Islamic functionality and users. Of the two other leading conventional banking packages that have been mentioned, Oracle FSS’s Flexcube package is used at Shamil Bank in Bahrain which it won against strong opposition from Temenos and others. The vendor’s Indian development centres have been able to produce Islamic banking modules which add to the already significant functionality that was originally developed for its original parent company, Citibank. The system is also used at other banks in the Middle East including Dubai Islamic Bank. Temenos, meanwhile, is not to be ignored, with its Islamic offering of T24 being taken by some significant Islamic banks including Al Salam Bank in Bahrain, Bank Islam Malaysia and Meezan Bank in Pakistan.

Misys is a well-known name in all of the Islamic regions and has widely promoted one of its older systems, Equation, as being Shari’a-compliant with some notable success. The Islamic Bank of Britain, the UK’s only Islamic retail bank, uses the Equation product as does Al Baraka (in several locations), Sharjah Islamic Bank and a cluster of banks in Qatar. The product has possibly the largest user base other than Path Solutions.

In addition to the pure Islamic system vendors and the modified conventional system vendors, there is a third group that sits somewhere between the two. This third group is made up of independent organisations, often based in Muslim countries, which supply a conventional banking system that has been permanently modified to accommodate the Shari’a requirements. One of the vendors in this third group is International Turnkey Systems (ITS). This Kuwait-based company has taken the Phoenix system (under agreement from US supplier Harland Financial Solutions) and modified it to sell into Islamic banks. ITS has assembled a range of products for Islamic banks, some sourced from other suppliers (such as the NetEconomy anti-money laundering and fraud prevention package) and some developed in-house (such as its front-end system, IBS Islamic).

Kuala Lumpur-based Silverlake is a supplier of an Islamic core banking system (Siibs) that enjoys some degree of success mostly in the Asian region but also some sites outside of that region. The origins of the conventional version of the system seem to have a common source with the Siibs system offered by the US-based John Henry Associates. Nevertheless, the system has been extensively enhanced by Silverlake and now offers separate modules to accommodate a fairly wide range of Islamic processing.

The use of one Islamic banking package in a bank does not preclude the use of another for different purposes. Bank of London and the Middle East, for example, uses Path Solutions for its core Islamic processing but has chosen an Oracle FSS-supplied front-end for its specialist wealth management arm.

14.10 Around the regions

The main regional markets in the Islamic banking world naturally follow the concentration of Islamic banking services and are made up of the Middle East, Malaysia and Indonesia, the African nations, Asia Pacific/South East Asia (Singapore, Hong Kong) and the Pakistan/India/Bangladesh region. There are some variations between each region as to what is considered acceptable and what is not. Malaysia and Indonesia are generally regarded as the most liberal regarding acceptance of new products. Conventional banking is prohibited in Iran’s banking system.

In terms of the domiciled vendors, Asia is well represented with the Malaysian and Indonesian regions particularly rich in Islamic systems vendors with, as mentioned, Infosys, Microlink and Silverlake having an impressive number of implementations in the region and abroad. The Singapore-based developer System Access that created the Symbols system which claims Islamic users has now been absorbed into the US-based Sungard Financial Systems group as Sungard System Access but still maintains its Singapore operation.

India is also well served with package vendors for both conventional and Islamic banking and is home to some of the largest names in the industry. Of the many vendors resident in that country 3i Infotech, Infosys Technologies, Infrasoft, Polaris Software, Tata Consultancy Services (TCS) are known to have Islamic users of their systems. Pakistan has its own internal vendors but is represented internationally by Autosoft Dynamics and Bangladesh is home to Leadsoft.

The Middle East has its share of specialist vendors. As well as Path Solutions and International Turnkey Systems that have already been mentioned, there are vendors such as BML Istisharat and representative offices of most of the major vendors. International Computer Systems (London) Ltd, although having its head office in London, has a major development centre in Jordan and all of its Islamic customers are located in Middle Eastern countries.

London is also home to Misys; Geneva-based Temenos also has a major operating unit in that city as does ERI Bancaire.

14.11 Scope of packaged Islamic systems

Selecting the right system

An Islamic bank will need to select a package that best meets its functional requirements and that is most closely aligned to its type of business. Some vendors that
have been mentioned, Temenos, Oracle FSS, Path and Silverlake, for example, provide systems that are universal in nature so can generally cover the requirements of retail banking, wealth management and private banking, treasury and interbank transactions, corporate banking and some capital markets processing. Other systems, such as Equation, are better known for their retail capabilities. Yet others, such as ERI, provide specialist wealth management systems that cater to high net worth individuals and their investments, while the likes of Reuters (now Thompson-Reuters) has been traditionally strong in treasury operations and dealing rooms.

The selection of the most appropriate system is a critical project within itself because having once made the decision the bank may have to live with that system for some years to come. A poorly selected system may hamper the future growth of a bank. Systems selection processes can take several months, may involve many areas of the bank as well as its Shari’a board and may use the experience of outside consultants to guide the bank and ensure an impartial selection.

Special aspects of wealth management/asset management

Wealth management involves a financial institution managing an individual’s (or family’s) assets to meet the client’s investment objectives. For a manager in an Islamic bank this will mean that, although the range of Shari’a-compliant investment funds and securities is growing at an impressive rate, investments will likely be made in non-Islamic products.

A Shari’a-compliant asset management system, in addition to accommodating the Islamic transaction set and adhering to Shari’a prohibitions, will need to be able to screen non-Islamic securities to determine if they are acceptable as investments. One way to achieve this is through the use of Shari’a-compliant indexes such as those provided by Dow Jones or Thomson-Reuters. Other options would be to use collective investment funds (mutual funds, unit trusts or investment trusts, for example) that are operated by Islamic institutions and are accepted by the asset manager’s Shari’a board as being Shari’a-compliant. For other securities, it may be necessary for the Islamic institution to perform the screening themselves. The computer package must be able to accept screening criteria as set down by the institution’s Shari’a board, which will likely include examination of the business line of the underlying company, debt levels, sources of income, liquidity ratios and the like.

The use of acceptable securities brings into play the question of purification. This is a method of modifying the cash-flow received from the security by reducing it according to an estimated ratio of haram activities of the underlying company e.g. receiving profit income from interest, or receiving a proportion of its income from alcohol sales in a restaurant. Depending on the view of the asset manager’s Shari’a board, the purification may take place only on dividend income or additionally on capital gains made through the increase in share price of the company. The computer system used by Islamic asset managers must be able to track the level of purification necessary and direct this amount into a charity account.

If the same computer system is installed in a bank that has operations in different regions then it must be able to accept different compliance criteria for each region. For example, Islamic bonds issued in Malaysia are accepted as being Shari’a-compliant in that region but are not accepted (on the basis of bai’ al-dayn) in some other regions.

‘Sell-side’ investment management and capital markets

The term ‘sell-side’ refers to institutions that create and manage collective investments that are then sold as ‘units’ to other asset managers who are acting on behalf of their own clients (which are termed buy-side). If Investment Company A creates a Shari’a-compliant equity fund which it packages into units of $100 each, of which Islamic Asset Manager B buys units for its own clients, then Investment Company A is ‘sell-side’ and Islamic Asset Manager B is ‘buy-side’. It is, of course, quite possible for different departments of the same institution to act as buy-side and sell-side. Nevertheless, the demarcation is useful from a systems perspective.

The sell-side and capital markets systems will need to be able to accommodate the requirements of managing, issuing, and profit distribution of sukuk, equity funds, commodity funds, murabaha funds as well as complex musharaka and mudaraba investments.

Islamic banks may join together to jointly finance a large project. This arrangement, called syndicated financing, should be accommodated by the computer system when the bank is acting either as lead manager or as a syndicate member.

Treasury systems

The permissible operations of an Islamic bank are more limited in scope than those of a conventional bank. The concept of conventional treasury management is to use available cash balances, or projected balances, to generate income through monetary investments (interest). This is not available to an Islamic institution. Other conventional treasury operations involve future foreign exchange operations, fixed income products, derivatives, money market operations and the like, which, as a general statement, are not commonly available to the treasury department of an Islamic bank.

In their place are the Islamic transaction set including tawarq and reverse-murabaha. Recent rulings may have placed the compliance of these transactions in some doubt, but at least for the time being there is still a need for them to be processed.

The accounting of these transactions works differently to the accruals normally found in a treasury operation and some specialist treasury systems vendors, for example Thomson-Reuters, have modified their systems to meet this need. Other universal systems also offer treasury modules.

14.12 Types of Islamic institutions needing

Islamic banking systems
Shari’a-compliant systems

14.12.1 Islamic-only institutions

Fully fledged Islamic institutions, as do conventional banks, need some form of automated processing to cost-effectively handle the routine tasks associated with banking activities.

As has been mentioned, not all of the processing within a bank is of the form that is sensitive to the Shari’a. It is commonplace to find conventional systems processing in defined areas such as incoming/outgoing payments, fraud detection and anti-money laundering, regulatory reporting and maintaining data warehouses, teller and branch automation, general ledger and many of the other support areas within the bank. The Shari’a-compliant banking is needed for the Islamic account processing and monetary transaction postings, regardless of whether those accounts and transactions are retail investment accounts held by individuals, or the full-blown management of a sukuk issue in a capital markets environment.

In an Islamic bank, however, each new transaction process requires the approval of the bank’s Shari’a board and once granted that transaction must be processed in the same way each time. The documentation that is produced and the checks that need to be done to execute the transaction properly can be controlled by workflow systems.

14.12.2 Islamic windows

The situation of conventional banks operating an Islamic window is more problematic from a systems’ perspective. In this situation the bank is offering conventional banking to some clients and Islamic banking to others. Some of the support and transaction processing functions take a double blow – tellers and branches must maintain the segregation of funds, transactions must be processed by the appropriate computer system and general ledger entries must be kept separate. The bank will in effect have a dividing wall between its conventional processing and its Islamic processing – hence the term ‘Islamic window’, a separate area dedicated to Shari’a-compliant banking.

In general terms, operating an Islamic window will require the bank to operate two computer systems – one a conventional system and the other an Islamic system.

The practicalities of maintaining this strict segregation and ensuring that there is no co-mingling of funds means that only smaller operations find this form of banking practical. A small, high service-level private banking operation, for example, which deals in high value, low volume business could operate in such an environment if it accepts the increased overhead costs of running parallel but separate systems. Similarly, a specialised corporate banking institution may be able to keep its Islamic financing transactions and supporting business documentation quite separate from its conventional financing.

Other high volume operations generally find it more convenient to create separate subsidiaries.

14.12.3 Islamic subsidiaries

Creating separate Islamic subsidiaries may help solve the segregation issue but it can also create problems, for example, when it comes to combining financial results and footings from the conventional business and the Islamic business into one group statement for regulatory reporting or for annual statement production. The accounts themselves can be notionally merged to create a combined picture of the group but care and examination is needed when moving funds around the group for inter-company funding. The Shari’a board of the Islamic institution will need to verify that any co-mingling at a group level is of an acceptable amount and is absolutely essential for the operating of the group.

14.13 Future trends

Technology burden

Shari’a-compliant banking systems have been developed and the market for those systems is maturing. Vendors have shown that they can build and sustain their business by providing Islamic banking systems as their primary business offering.

To protect their position in the market, the leading vendors of conventional banking systems have moved to create systems that claim to have to a larger or smaller degree of Shari’a-compliance.

From a systems’ perspective there is still the issue that not all of a bank’s functionality is impacted by it becoming, or not becoming, an Islamic institution. Institutions have shown, as is the case at Dubai Bank, that if the switch is made to being an Islamic bank, not every system in the bank needs to be thrown out. The wheel does not need to be re-invented – the hub may need to be changed as well as maybe some very important spokes – but the whole thing does not need to be discarded.

This places on Islamic systems developers the overhead of developing functionality that is not particularly Shari’a sensitive while at the same time often burdening developers of conventional systems with two versions of software.

One technical solution to this predicament is the much vaunted Service Oriented Architecture (SOA) that, if implemented, will allow vendors to create individual ‘services’ (such as statement production, current account processing, unit fund pricing, etc.) and bundle them together in a fashion to suit the end customer.

There is work being done at National Bank of Kuwait (NBK) in this respect, where the TCS Bancs system is being ‘dismantled’ into its component parts (or services) and ‘reassembled’ into the shape that NBK wishes to implement it as its production system. Other vendors, including vendors of Islamic banking systems, are advanced in this respect and have to a greater or lesser extent implemented this technology.

This will help Islamic system vendors concentrate on the
Shari’a sensitive areas that are important to them and downplay other areas. As Islamic banking moves into mainstream conventional banks, further markets will be opened up to the Islamic systems vendors if they are able to deliver discreet Islamic services and accounting into existing computer systems.

Inter-bank market and platform

The industry needs to have Islamic banks more closely connected to each other not only in terms of products and strategy but in terms of bank to bank communications. This will not only aid liquidity management but the sharing of information on prices, making available to those in other countries on the ground market participants, and assisting in forming international joint ventures and syndications.

It is up to the Islamic banking industry to create the products and relationships necessary for this phase but it is up to the technology providers to make the necessary platform and systems available for use.

Flexibility and market turmoil

The Islamic banking sector is currently undergoing significant internal reflection and even some reclassification. The recent ruling on tawarruq, the beginnings of renewed debate on forms of riba, the internal discussions on what constitutes Shari’a-compliant products, Shari’a-based products and Shari’a-acceptance all point to the need to have computer systems that have sufficient flexibility to avoid locking an institution into a closed avenue. Of course, it is difficult to predict with accuracy where the industry will be in five years time but if the installed systems are based on current industry standards, have been developed by vendors who are experienced in getting their products to adapt to different market cycles and who have a skilled and plentiful support staff, then the bank will have taken the professional steps necessary to protect its future in this uncertain time and enable it to take advantage of future growth in the market when this inevitably occurs.

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Islamic core systems: new sales in 2009

Source: IBS Intelligence
PART 3
Regulation
CHAPTER 15
Regulatory bodies

15.1 Introduction

A key goal of trade and enterprise under the Shari’a is to share wealth among the members of the community through moral business practices. In order to be considered Shari’a-compliant, a financial institution or transaction must meet the Quran’s tenants against usury and uncertainty. Due to the achievements made during the last thirty-years by Islamic financial institutions (IFI), there has been a growing, albeit reluctant, participation in the securitization line of business. As a result, in addition to satisfying Shari’a-compliance requirements as stipulated by their advisory boards, Islamic financial products and services are now increasingly becoming subject to the rules and regulations imposed by certain regulatory bodies and industry-wide regulatory institutions which exist in connection with securitization. Regulations of Islamic financial services are developing as new Islamic finance structures are becoming more sophisticated, international and popular to investors and as regulators scramble to absorb the impact of the latest financial conditions.

15.2 Shari’a regulation in the context of Islamic Securitization Strategies

As international institutional investors and issuers have become interested in tapping into the increasing liquidity of the Middle East and North Africa (MENA), an essential requirement has been to familiarize themselves with a number of basic principles of Shari’a in order to fully understand and appreciate the strategic approach that IFIs have taken to invent sophisticated Shari’a-compliant products that also meet the standards stipulated by growing numbers of regulatory bodies and industry-wide regulatory institutions. Needless to say, such international investors and issuers view Islamic banking as yet another means to tap into the MENA wealth, but they are cognizant of the fact that they need to familiarize themselves with basic Islamic finance principles. These basic principles are set out below along with a description of how they relate to securitization transactions.

15.2.1 Riba

The prohibition of interest (riba) under Islamic law has historically prevented IFIs’ involvement in asset backed securitization (ABS)1. ABS has evolved tremendously in the non-Islamic world in various forms, for instance, interest-bearing credit and receivables (home equity loans, auto loans and credit card receivables) are the core asset classes financed through ABS and are a benchmark subsector for most floating rate indices. Profit and loss generation from ABS has traditionally been prohibited under Shari’a through the principal of riba. However, strategic developments created by IFIs and experts have provided a number of Islamic alternatives to ABS financial structures. Those financial structures permit the following assets to be securitized in accordance with Islamic law: (i) leasing contracts, (ii) equity interests, (iii) Islamic ABS in all of the above cases (sukuk), (iv) assets structured in accordance with mudaraba and wakala models, and (v) certain forms of sales contracts, provided that the underlying assets are Shari’a-compliant.

15.2.2 Gharar and Maisir

Secondly, uncertainty (gharar), and speculation or gambling (maisir) are banned under Islamic law, this prohibition results in risk being allowed only when it is shared among all parties and when all the terms and conditions of the transaction are clear and known to all parties.

1 Please note Riba paragraph under the ‘Haram’ heading.
The ban on uncertainty in the context of contractual terms and conditions is not, at least theoretically, far off from the approach applied to conventional products as this principal is usually self-governed by the parties themselves in order to limit unforeseen liability down the road.

The second implication under this principal is that no one participant should bare an unequal portion of the risk, profits and losses. This is the feature that sets Islamic financial products apart from their counterparts. The result is that conventional insurance securitization products are prohibited under Shari’a particularly in as far as issuers are made to guarantee fixed returns for lenders regardless of the actual performance or value of the underlying assets.

Takaful, an Islamic insurance concept that has been practiced in various forms for over 1400 years has become increasingly important to Islamic institutional investors wanting to invest takaful investment proceeds in sukuk and other Shari’-compliant instruments without being accused of exposure to gharar or maysir. Takaful is a system of Islamic insurance based on the principle of mutual assistance and voluntary actions where the risk is shared voluntarily and collectively by a group of participants. IFIs have created analogs to conventional insurance-linked products and securitization structures that incorporate the concept of takaful and are implemented through either a mudaraba (profit-sharing) model, or wakala (agency) model, or a combination of both. Mudaraba gives the right to the contracting parties to share the profit, while liability for losses is allocated among the participants; and under the wakala model, the takaful operator earns a fee for services rendered while liability for losses is borne by the participants. The fee may be varied based on the performance of the takaful operator. It can be a fixed amount or based on an agreed ratio of investment profit or surplus of the takaful funds. Takaful can provide insurance-linked cover against risks to the securitized assets, and takaful companies can also play an important role as investors in sukuk offerings.

15.2.3 Haram

It is a well-known fact that certain sectors, known as haram, are banned under the Shari’a, such as industries that involve the sale of alcohol, pork or pornography. Like other investors, Islamic investors look for a diversified mix of investment products to add to their portfolios. But, before they buy, they must determine if a specific investment is permissible by evaluating its business activities and financial records to determine where its primary revenue comes from and how income and expenditures are managed.

This reasoning also applies to the Islamic prohibition on riba, or interest, as well. If a company’s interest-based profits or holdings exceed certain limits, then investing in the company is forbidden. Even when these are found to be within tolerable limits, purification of earnings from these companies must take place which entails the investors donating any interest received, in contravention to Shari’a, to charity. Conventional investments do not have such restrictions or require-ments, where such industries like the gambling industry attract wide appeal.

15.2.4 Tangible and identifiable assets as collateral

Finally, Islamic securities must be backed by a tangible and identifiable asset. Consequently, collateral coverage is usually higher for IFIs than for conventional banks and certain disclosure requirements are necessary in the transaction documents between IFIs and investors that are not required for conventional investments. The fact that Islamic principles restrict investments in companies that are highly leveraged served Islamic investors well in the recent global market crisis. For example, Amana Trust Income (‘AMANX), an Islamic fund, easily made it into the top percentile of Morningstar’s large-value category in 2009, while financial stocks tanked and battered the returns of Amana’s competitors. The fund has returned 9.63% over the past year, -0.83% over the past three years, 5.92% over the past five years, and 5.64% over the past decade, making it into the top 8 funds in 2010 to invest in according to U.S. News and World Report. The fact that Amana Trust Income is barred from investing in banks or highly leveraged securities, regardless of how well or poorly they are performing ultimately saved them from the losses experienced by their conventional peers.

Growing awareness of and demand for investing in accordance with Shari’a principles on a global scale have been the catalyst towards making the Islamic financial services industry flourish. The challenge will be ensuring that the industry remains truly compliant with the spirit of Shari’a, such that IFIs express genuine willingness to assume the risk of the underlying assets as opposed to moving them off balance sheet and seeking balance sheet exposure through asset-backed-structures that do not necessarily adhere to the requirements and spirit of the Shari’a. If we also factor in the challenges which regulators need to tackle in order for there to be effective and timely formulation of standards, guidance or best practices where necessary, one can quickly begin to fathom the extent of the work that needs to be done. The good news is that numerous international and domestic initiatives have resulted in the development of global standards and benchmarks, as well as domestic regulatory schemes, which are discussed in the following section.

15.3 Regulation of Islamic financial products and institutions

We view the primary objectives of financial market regulation to include: (i) the pursuit of economic stability, translating into controls over the financial exchanges, clearing houses and securities settlement systems, (ii) transparency in the market and investor protection through equal treatment and disclosure requirements aimed to protect against inequitable dissemination of information, such as insider trading and market manipulation and (iii) to safeguard and promote competition in the markets, preventing concentrations, cartels and abuse of power.

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2 It should be noted that the issuance of conventional insurance-linked securities (“ILS”) has shown a gradual, if sometimes uneven, growth that increasingly involves new risk classes. Recent innovations in ILS have provided insurers and reinsurers with ways to improve capital efficiency through more diverse use of capital markets. Further, there have been various technical advances in new structures and methodologies that express insurance risk in terms similar to capital markets, in addition to broadening of the investor base.


4 From the powerpoint presented by Dr. Ashraf Umarani on the Islamic Business Resources Centre website.

5 Primary revenue is usually classed as revenue of 5% or more.


dominant positions. Such objectives apply equally in the context of the economies of the Islamic world.

Over the last two decades, markets have truly become global—corporations, accounting firms, investment banking firms, law firms, and now stock exchanges—all have internationalized. The Islamic financial services industry, comprising Islamic banking, Islamic insurance and the Islamic capital market, is an area that has grown to become an increasingly substantial segment within the global financial market and has gained considerable interest as a viable and efficient alternative model of financial intermediation. Indeed, the pace of Islamic financial market development has gathered such momentum that various international Islamic organizations have been established to ensure that Islamic capital markets are appropriately regulated and that any gaps in regulation are identified early to safeguard investor interest and at the same time pave the way for the industry to evolve in an orderly manner. This step is important in ensuring harmonization and clarity required in order to ensure the Islamic financial market place receives the respect that it deserves. Improved regulation would also move towards avoiding criticism along the lines of Sheikh Muhammad Taqi Usman’s comments in 2007 that 85% of the current structures of Gulf sukuk do not comply with Islamic law. The regulatory landscape of Islamic finance can be categorized in two separate categories. The first sets out international standards and norms agreed upon through the collaboration of industry leaders with expertise in Islamic finance. The second category relates to regulatory bodies within each country in which Islamic finance is practiced, each of which translates the international standards and norms of the first category into enforceable laws and regulations within the applicable jurisdiction. The first category is well established while the second category is still evolving. The following discussion covers the terrain of each category as of the date of this publication.

Category 1: Organizations Responsible for Setting International Standards for the Regulation of the Islamic Financial Services Industry

15.3.1 The Accounting and Auditing Organization for Islamic Financial Institutions (“AAOIFI”)

The AAOIFI has gained assuring support for the implementation of its standards, which are now adopted in the Kingdom of Bahrain, Dubai International Financial Centre, Jordan, Lebanon, Qatar, Sudan and Syria. The relevant authorities in Australia, Indonesia, Malaysia, Pakistan, Kingdom of Saudi Arabia and South Africa have issued guidelines that are based on AAOIFI’s standards and pronouncements. Such standards have proven to be very useful not only for Islamic banking practitioners but also for professionals in the conventional banking world who seek a quasi-codified approach to the study of Islamic law as it pertains to their operations.

Needless to say, such reports, alone, do not have a binding nature, but the extent to which its findings and recommendation can be granted a binding force hinges upon the adoption of such findings and recommendation by the various capital markets authorities at the national level.

The industry should actively lobby the regulators to adopt common standards throughout Islamic markets where Islamic banking is popular. In particular, a number of jurisdictions which traditionally are not considered to be Islamic banking power-houses are studying the merits of developing a securitization market and issuing sovereign sukuk, and efforts like those of AAOIFI and other organizations can constitute a good starting point in this aspect.

15.3.2 The Islamic capital markets Task Force of the International Organization of Securities Commissions (“IOSCO”)

In recognition of the increasing size of, and growing investor interest in the Islamic financial services industry, and the potential implications it may have on financial stability and investor protection, the IOSCO Executive Committee mandated the formation of an Islamic Capital Market Task Force to assist relevant regulators in assessing the extent of the development and potential regulatory issues relating to the Islamic capital market, as well as to gather information on Islamic financial products and activities. While Islamic banking is the oldest and most developed part of the Islamic financial system, there is great potential for the Islamic capital market as the industry matures and holdings of financial assets gradually transfer from the Islamic banking sector to the Islamic capital market. As has been the experience with burgeoning fast-growing markets, the Task Force report focused on the various regulatory issues that needed to be assessed on a timely basis in the Islamic capital market to ensure the protection of investors, the reduction of systemic risk and reflection that markets are fair, efficient and transparent.

The Task Force comprised of 11 IOSCO members spread across 5 regions. The Task Force was chaired by the Securities Commission of Malaysia. Other national regulatory systems represented on the Task Force included the Australian Securities and Investments Commission, the Indonesian Capital Market Supervisory Agency, the Jordan Securities Commission, the Nigeria Securities and Exchange Commission, the Financial Services Board of South Africa, the Thailand Securities and Exchange Commission, the Capital Markets Board, Turkey, the Italy Commissione Nazionale per le Società e la Borsa, the United Kingdom Financial Services Authority, and the United States Securities and Exchange Commission.

The work of the Task Force and the report generated was built upon gathering information from IOSCO members and external parties with expertise in the Islamic capital market, and to undertake an in-depth analysis of the information obtained. The report identified specific industry issues covering both regulatory issues as well as public and private sector initiatives within IOSCO members’ jurisdictions to accelerate the growth of the Islamic financial services industry. The report represented the first jurisdictional comparison of practices and approaches on Islamic capital market regulation.

16.3.3 The Islamic Financial Services Board (“IFSB”)

4 ‘Sukuk Issues and the way forward’ by Tan Wan Yeun.
9 An independent international organization, AAOIFI is supported by institutional members (200 members from 45 countries, so far) including central banks, Islamic financial institutions, and other participants from the international Islamic banking and finance industry, worldwide.
10 AAOIFI standards are available on AAOIFI’s website, http://www.aaoifi.com/.
11 The IOSCO seeks to promote investor protection, address systemic risks, increase investor confidence and otherwise develop the securities market by implementing regulation among other methods.
12 The Executive Committee takes all decisions and undertakes all actions necessary to achieve IOSCO’s objectives.
13 The IOSCO mandated formation of the Islamic Capital Market Task Force at the 2002 IOSCO annual conference and meetings held in Istanbul, Turkey.
140 Global Islamic Finance Report (GIFR 2011)
The IFSB,\(^{14}\) established in November 2002 in Kuala Lumpur, serves as an association of central banks, monetary authorities and other institutions that are responsible for the regulation and supervision of the Islamic financial services industry. The IFSB is expected to play a significant role in developing international prudential and supervisory standards and best practices for Islamic financial institutions.

The IFSB has developed two prudential standards for the Islamic financial services industry, namely capital adequacy and risk management standards. These standards were issued in 2005, and addressed the identification, classification, measurement and reporting of the risks for Islamic financial institutions. The IFSB is planning to develop standards on corporate governance, transparency and market discipline.

### 15.3.4 The International Islamic Rating Agency (“IIRA”)\(^{15}\)

The Islamic Development Bank (IDB) established the International Islamic Rating Agency in Bahrain in October 2002. The IIRA was established to rate, evaluate and provide independent assessments and opinions on the Shari’a-compliance aspects of Islamic financial institutions and Islamic financial products and publishes the data and information relating to rated entities and institutions and Islamic financial products and publishes the data and information relating to rated entities and financial instruments to the public. In addition, IIRA has introduced a set of rating products and services to foster greater Shari’a transparency, for both financial products and their issuers.\(^{16}\)

In August 2010, the IIRA joined hands with Dinar Standard, USA, to release a research report on the Pulse of the OIC (Organization of Islamic Conference member countries) Islamic capital markets. The research was conducted by selecting 28 major OIC markets based upon a combination of quantitative and qualitative assessment of data sourced from Dinarstandard.com and referenced third party sources. The report summarizes the current state of Islamic capital flow within its core OIC markets and covers three representative sectors: the stock markets of the OIC countries, the industry segment of sukuk and the Islamic Funds market.\(^{17}\)

**Category 2: Domestic Regulatory Bodies and Institutions Implementing Standards and Norms through Rule Making and Enforcement**

### 15.3.5 Malaysia

In August 2006, the Malaysia International Islamic Financial Centre (MIFC) initiative was launched to promote Malaysia as a major hub for international Islamic finance. Malaysia has the distinction of being the world’s first country to have a full-fledged Islamic financial system operating in parallel to the conventional banking system.\(^{18}\)

Malaysia’s central bank has tightened Shari’a rules for Islamic banks by requiring them to set up Shari’a review, audit and risk management functions to reinforce compliance. Rules for standardizing Islamic financing structures such as ijara, mudaraba and musharaka are expected to be seen by the end of 2010.\(^{18}\)

Malaysia also has a national Shari’a council whose financial rulings are used throughout the country’s Islamic financial institutions. Some critics, however, have often maintained that the Malaysian Islamic banking industry is too liberal in their interpretation of Shari’a and allow products to mimic conventional banking. Such a view has lost part of its appeal seeing that the Malaysian model withstood the test of the credit crunch as evidenced by the manner by which its capital markets have proven resilient to such events. In fact, the Malaysian model is attracting a growing degree of appeal among Shari’a practitioners in other jurisdictions particularly those concerned about possible conflict of interest issues embedded in other regulatory and compliance models, or who believe that Shari’a scholars may be over-stretched and that a combination of a track record of successfully closed capital markets transactions and dedicated Shari’a boards may mitigate such a challenge.

### 15.3.6 Bahrain

In 2006, Bahrain enacted the Central Bank of Bahrain and Financial Institutions Law (CBBL) that created the Central Bank of Bahrain (CBB) and vested in it all authority and responsibilities of financial sector supervision. The CBB asserts that it practices supervision in accordance with the Objectives and Principles of Securities Regulation developed by the IOSCO.\(^{19}\) It further states that the CBBL provides enhanced enforcement powers to the CBB and reinforces its operational independence, and also spells out insider trading as an offence. The 2008 annual report of the CBB adds that the review and development of the regulatory framework related to the capital markets are based on the International Monetary Fund Financial Sector Assessment Program recommendations as well as the IOSCO Principles.\(^{20}\)

The CBB became a signatory to the IOSCO Multilateral Memorandum of Understanding in 2008 signifying that it has the legal capacity to share supervisory information with other regulators.

It is noteworthy that the CBB was the first to make AAOIFI standards mandatory for all Islamic institutions. This is a prime example of how the status of such can elevate into being part of the law of the land. The CBB also has rules covering capitalization, risk management, financial crime and disclosure and is pushing to train Shari’a scholars to aid industry growth.

### 15.3.7 UAE

Securities regulation in the United Arab Emirates (UAE) is a potential source of confusion for investors and financial institutions. Generally speaking, there are two different regulatory schemes and three regulators.

Historically, the regulation of securities trading has been the domain of the UAE Central Bank. The Emirates Securities and Commodities Authority (ESCA) was created in 2000, after which the Central Bank and ESCA served as the two regulators under the federal regulatory scheme.

A separate regulatory scheme exists in Dubai in the...
Dubai International Financial Centre (DIFC), a financial “free zone” which has a separate legal and regulatory authority separate from the rest of the federal scheme. The regulator in the DIFC is the Dubai Financial Services Authority (DFSA) which ensures, among other things, that licensed entities comply with the procedural requirements set forth in the fatwa relating to their operations such as ensuring that the Shari’a board members continue to be engaged and that the fatwa is up-dated on an annual basis. More substantively, Islamic finance companies within the DIFC are expected to adhere to AAOIFI guidelines and Islamic banking activities are still guided by the UAE Central Bank. The appointment of Shari’a committees at these companies depends on the approval of the Ministry of Islamic Affairs.

15.3.8 Saudi Arabia

The Capital Market Authority (CMA) was established in July 2003 under the Capital Market Law by Royal Decree No. M/30. The CMA is now the sole regulator and supervisor of the capital market, and is composed of a five-member governing board, and a Committee for the Resolution of Securities Disputes. The CMA has legal and administrative independence, and reports directly to the Prime Minister. It also supervises the Saudi Stock Exchange, better known as Tadawul, an electronic share trading system, which includes a Securities Deposit Center. The formation of Tadawul as a joint stock company was formally approved in March 2007 pursuant to the Capital Market Law.

Saudi laws, by definition, are required to adhere to Shari’a so the Saudi Arabian Monetary Agency makes no differentiation between conventional and Shari’a-compliant banking. The kingdom is in the process of enacting its first Shari’a-compliant mortgage law which is expected to fuel more Islamic home finance in both individual and corporate arrangements. While the sukuk market in Saudi Arabia has only recently gathered momentum, many practitioners are of the view that the Saudi mortgage law will play a major role in sukuk issuances this year given the expected high focus on infrastructure buildup following the law’s passage.

15.3.9 United Kingdom

The Financial Services Authority (FSA) governs the regulation of Islamic finance in the United Kingdom. The Financial Services and Markets Act of 2000 (FSMA) applies equally to Islamic financial products and transactions as it does its conventional counterparts. The UK has also introduced legislation to provide relief from capital gains tax and stamp duty land tax for sukuk issuances and Shari’a-compliant home mortgages. Value added tax, however, remains a concern.

In August 2010, the first sukuk was issued to gather finance for a European corporate. The company in question is the maker of industrial milling machines in north-east England and the investor is DIFC based and Shari’a-compliant. A musharaka structure, also known as profit and loss sharing model was used. Despite the financing having only raised £10,000,000, this is a promising insight into the potential that Islamic finance has for non-Islamic countries through offering a further diversified investor base than what previously seemed available.

15.3.10 United States of America (“USA”)

The Securities and Exchange Commission (SEC) is the federal securities regulator of the United States. All securities, whether Islamic or conventional, are subject to SEC enforcement under the Securities Act of 1933 and the Securities Exchange Act of 1934.

Islamic finance in the United States is largely confined to allowing for Shari’a-compliant mortgage products for jariya or murabaha structures. Under regulatory rules, a bank must be a lender, which inhibits the development of standalone Shari’a-compliant institutions.

U.S. federal banking regulators have provided some formal guidance about Islamic products. The Office of the Comptroller of the Currency (OCC) issued two directives concerning Shari’a-compliant mortgage products. In 1997 and 1999, respectively, the OCC issued guidance about jariya and murabaha structures.

To date, five sukuk offerings have already been issued by USA issuers one sector being oil and gas (as demonstrated by the sukuk issued by the East Cameroon Gas Company which was the first ever USA sukuk and the first asset backed securitization). Further, University Bank in Detroit among other USA banks is offering Shari’a-based banking and in early 2009 University Bank was showing successful growth.

15.3.11 Other

As indicated above, the evolution of a robust Islamic banking industry is not always a factor of whether a country is constitutionally Islamic or is, for example, a member of such organizations as the Organization of Islamic States or the IDB. Some Islamic countries like Indonesia adopted a law last year removing double taxation on Islamic instruments as recently as April 2010. Given the fact that it is the world’s largest Islamic country by population, such development is substantial by all accounts. Turkey also is reported as issuing its first sukuk. The transaction was well oversubscribed which indicates investor’s interest in Islamic products in novel geographical locations. Other non-Islamic jurisdictions have also embraced Islamic banking in some shape or form. For example, Luxembourg is promoting itself as a haven for sukuk and Islamic investment funds and has signed tax treaties with the UAE, Qatar, Kuwait and Bahrain. In addition, currently Islamic investors enjoy no double stamp duty, no wealth tax and no liability to Luxembourg tax on profits and income. While, Luxembourg or Ireland, which has also taken a number of steps to attract Islamic investors, view this trend as a continuation of their efforts to attract global investors to use them as banking hubs, countries like the United States, United Kingdom and, very recently, Australia view this as a means to provide a level playing field for their Muslim population but also to be competitive in attracting foreign direct investments.

15.4 Conclusion
The lack of concurrent viewpoints makes it difficult to standardize Islamic financing.26 The international dimension which many Islamic financings are subject to also results in complete harmonization being difficult to achieve. Many observers correctly view standardization of Islamic finance regulations as important in increasing the marketability and acceptance of Islamic products. As is evident, international institutions have been established to promote international consistency in Islamic finance. Many leading Islamic financial centres around the world have adopted international Islamic finance regulation standards, but the need for implementation of standards on local levels continues.27

Whilst it is recognized that the need for harmonization is an important and desirable aim and efforts must be continued to work towards further achieving a more complete harmonization of the Islamic finance system, it is worth being aware that the certainty and other benefits that harmonization would bring are not the sole concern of those already involved or considering becoming involved in Islamic financing. Islamic financing can and will continue to be a successful method of financing due to its proven track record as a practicable method capable of rivaling conventional alternatives but with added inextricable interlinking with morality. Such an inherent moral aspect can be claimed as being the key feature attracting the arguably more conscious current and future generations. However, this should not be taken for granted, the industry should put more efforts into ensuring that the securitization products it is sponsoring are true to the spirit of Shari’a investment guidelines and to invest in the type of research and analytical technologies that would allow it to conduct due diligence and value assets in sectors that require special expertise like energy, healthcare and technology. Additionally, regulators should adopt the type of regulations that would allow them both to encourage but also to monitor the Islamic securitization industry.

26 “Islamic Banks: A Novelty No Longer,” Business Week, August 8, 2005.
CHAPTER 16
Regulatory issues: challenges and solutions

16.1 Introduction

The regulation of Shari’a-compliant products and services creates a special challenge for regulators and gives rise to specific issues. These include: the role and powers that regulators assume or should assume when regulating Shari’a-compliant products and services and the classification of Shari’a-compliant products and services within a conventional or non-Shari’a legal and regulatory framework to ensure that they are properly regulated. In framing solutions to these challenges, regulators and governments have looked at special regulatory regimes and, sensitive to the constraints on regulating Islamic finance, the focus on governance and disclosure. These are examined below.

16.2 The primary issue and challenge: formal or substantive regulation?

In addressing the issues of effective regulation of Shari’a-compliant financial services and products, a proper understanding of the underlying purpose of financial services and products regulation must be remembered. Generally, the interest that regulators have in protecting the users of financial services and products, including investors, the markets in which the providers of those services and products participate, including the exchanges on which financial instruments are traded, underpin and inform the use of regulatory authority and power. In the context of the regulation of Shari’a-compliant financial services and products, a further issue arises: should regulators leave it to the service and product providers to determine Shari’a-compliance by regulating the manner for and disclosure of such determinations – a formal approach? Or should regulators themselves seek to determine Shari’a-compliance within the matrix of investor protection and market integrity – a substantive approach?

Within a formal model of Islamic finance regulation, a regulator uses its powers to determine the standards for achieving a Shari’a-compliant outcome by, for example, setting out the requirements for SSBs. In this model, a financial institution’s Shari’a scholars are responsible for ruling on the standards with which the institution’s services or investment must comply for the institution to promote itself as Shari’a-compliant. In a substantive model of Islamic finance regulation, a regulator uses its powers to determine the substance of the Shari’a-compliant outcome. In this model, the regulator’s scholars, or other scholars identified by the regulator, are responsible for ruling on the standards with which the institution’s services or investment must comply for the institution to hold them out as Shari’a-compliant.

The model of regulation in the DIFC may be viewed as an example of the formal model; aspects of the regulation of Shari’a-compliant securities in Malaysia incorporate the substantive model. As part of the Malaysian Islamic capital market, the Securities Commission has its own Shari’a Advisory Council. The Council was given the mandate to ensure that the running of the Islamic capital market complies with Shari’a principles. Its scope of jurisdiction is to advise the Commission on all matters related to the comprehensive development of the Islamic capital market, and function as a reference centre for issues related to the Islamic capital market. The members of the Council consist of Islamic scholars/jurists and Islamic finance experts. The Council advises on and publishes a list of products which, in its view, are Shari’a-compliant.

Where a regulator is charged primarily with the protec-
16.3 The categorisation challenge

In considering the regulation of financial services and products, one can categorise the services and products as follows: banking; securities and investments; and insurance. Even where one examines the regulation of Shari’a-compliant services and products, these categories remain broadly appropriate. The categorisation of financial services and products is particularly important for the regulators that regulate those products and services because it determines: (a) the manner in which those offering the services and products should be licensed, for example, as banks or investment managers; and (b) the manner in which their products should be regulated, for example, imposing registration requirements for an offering of securities to the public.

The issue of categorisation highlights one of the challenges for regulators and product services and providers alike: how to ensure that, despite their special characteristics which distinguish Shari’a-compliant products and services from their conventional counterparts, regulators properly protect the users of Shari’a-compliant services and appropriately regulate the markets in which their providers operate. This is a particular issue in countries without a dedicated Islamic finance regulatory regime. For example, in the United Kingdom, where there is no special regime for the regulation of Islamic finance, the FSA requires an entity seeking to be licensed as a bank to apply for an authorisation to carry on the regulated activity of “accepting deposits”. A deposit is categorised as a “sum of money paid on terms under which it will be repaid either on demand or in circumstances agreed by the parties.” An Islamic bank which offers mudaraba or profit sharing investment account as a way for investors to maintain their savings would struggle to satisfy this requirement. However, in licensing the Islamic Bank of Britain, the FSA reached an agreement with the Bank whereby legally its customers would be entitled to full repayment, therefore satisfying the FSA requirements. However, the customers would have the right to turn down deposit protection after the event on religious grounds and choose to be paid out under a Shari’a-compliant risk and loss sharing formula. (See the FSA Paper on Islamic Finance Regulation in the UK: Regulation and Challenges, November 2007.)

The position in the United Kingdom can be contrasted with that in Bahrain which identifies, as regulated “Islamic banking services”, the activities of “accepting Shari’a money placements and deposits” and “managing Shari’a profit sharing investment accounts (PSIAs)”. This is backed up by an express requirement, as part of the general principle of integrity, for an Islamic bank to safeguard not only the interests of shareholders of the bank but also those of PSIAs holders.

The issue of categorisation has also arisen in the context of sukuk. In addition to the regulation of those who offer and sell sukuk, the financial regulators in the countries referred to above also regulate those who manage collective investments, such as mutual funds. The definition of collective investment vehicles is not uniform. However, for the purposes of explaining the characteristics of a collective investment vehicle, the following features are common in the United Kingdom, the DIFC and the Qatar Financial Centre (QFC): any arrangement the purpose or the effect of the arrangements are to enable persons taking part to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income; the arrangements must be such that the participants do not have day-to-day control over the management of the property; and the contributions of the participants and the profits or income out of which payments are to be made to them are pooled or the property is managed as a whole by or on behalf of the operator of the scheme or fund.

On their face, most sukuk vehicles will have the characteristics set out above, e.g. the holders of the sukuk certificates will participate in or receive profits or income arising from the assets in respect of which the sukuk are issued, they will not have day-to-day control of the assets, their contributions will be pooled in order to make the investment in the assets, and the assets will be managed by the operator of the vehicle which has purchased the assets or delegated. Therefore, the presumption is that, in the United Kingdom, DIFC and QFC at least a sukuk manager will need to be licensed to operate a collective investment scheme or fund.

Fortunately, for sukuk managers there may be relief in the form of an exemption from the requirement to operate a scheme or fund where the rights or interests of the participants are represented by debentures issued by a single body corporate which is not an open ended investment company. For these purposes, debentures include instruments creating or acknowledging indebtedness, including but not limited to bonds.

The DFSA, the financial services regulator in the DIFC, was the first to exclude expressly sukuk from the scope of its collective investment fund regime. The DFSA provide the following rule: “An arrangement does not constitute a collective investment fund if the rights or interests of the participants are evidenced by sukuk certificates where the holders of the certificates are entitled to rely on the credit worthiness of: (a) the issuer of the sukuk certificates; or (b) any other person who has assumed obligations under the sukuk certificates, for obtaining their rights and benefits arising under the certificates.”

The following reasoning underlies this rule: sukuk are similar to conventional bonds in that they are security instruments that provide a predictable level of return; they are structured to have the same risk characteristics as conventional bonds; therefore, they should be treat-
ed in the same manner as conventional bonds for the purpose of exempting managers from the requirement to be licensed or authorised. The UK Financial Services Authority and Treasury have developed similar rules.

16.4 Delivering regulation: general or special regimes

The regulators of Shari’a-compliant products and services have chosen different approaches to their regulation. Some do not require providers to submit to a special regime but regulate them as part of their general regulatory regimes. Others have dedicated regimes where institutions offering Shari’a-compliant financial services are required to do so using a special licence, while others only impose requirements on the part of providers’ businesses that offer Shari’a-compliant products and services via the concept of the “Islamic window.”

16.4.1 Regulation under a general regime

As discussed further below, some jurisdictions have adopted special regimes for governing Islamic finance service providers. The majority, however, regulate those firms offering Islamic financial services in the same manner as those offering conventional, i.e. non-Islamic financial services; when it comes to the manner in which Islamic securities are offered, the process for such offerings, even in those jurisdictions with special licensing regimes, the rules are, in effect, the same. (For example, the rules governing the listing of Islamic bonds issued by the Securities and Commodities Authority of the United Arab Emirates are near identical to the rules governing the listing of conventional bonds save for the use of word “profit” instead of “interest”).

Therefore, a firm looking to carry out business in Shari’a-compliant securities and investments, will, as a matter of law, require a license or authorization from that country’s securities and investments regulator. Generally, the scope or type of the firm’s business, both with respect to the particular activities it wishes to carry out, e.g. broking and dealing, asset management, and with respect to the particular securities or investments it wishes to carry on the activities, e.g. equities, mutual funds, commodity derivatives, will determine the type of license or authorisation for which the firm needs to apply. For example, in Saudi Arabia the Capital Market Authority (CMA) specifies five categories of activity for which it may grant a license: dealing, arranging, managing, advising and custody. It identifies the following securities and investments: shares (which include sukuk), debt instruments, certificates, warrants, units in investment funds, options, futures, contracts for differences and rights in any of these. A firm wanting to manage Shari’a-compliant investment funds would, therefore, need to apply to carry on all of the activities but, subject to the investment strategy and composition of the fund, it would not need to apply to carry on the activities with respect to all the securities and investments identified by the CMA.

16.4.2 Regulation under a special regime

The DIFC, QFC and Central Bank of Bahrain, have adopted special regulatory regimes, with similar provisions, to govern or supplement the general regulatory regime.

To take Bahrain as an example: In Bahrain the regulation of banking and financial services is governed by the Central Bank of Bahrain and Financial Institutions Law 2006. The law expressly recognises financial institutions governed by Shari’a principles as a specific subset of financial institution with respect to which a banking licence is required. It is perhaps, unsurprising, therefore that the Central Bank of Bahrain (CBB) has established a separate regulatory regime for Islamic banks alongside conventional banks, insurance institutions and investment business institutions. The law prohibits any entity from undertaking regulated Islamic banking services or from holding themselves out to be licensed to undertake such services without the relevant CBB licence. The CBB rules require any entity wishing to apply for a licence to carry on the activities of an Islamic bank to satisfy the conditions relating to legal status, mind and management, controllers, board and employees, board and employees, financial resources, systems and controls and other requirements, including those related to books and records, provision of information and general conduct.

Once licensed, the CBB rules require Islamic banks to comply with detailed provisions covering, inter alia, the financial promotion of products, rules for foreign exchange dealing, client confidentiality, customer account services and charges, margin trading and, as set out above, rules for mudaraba contracts. These rules rest on specific “Principles of Business” for Islamic banks similar to the principles of business for other entities and the principles under the regimes in the DIFC, QFC and United Kingdom, both of which apply to Islamic institutions in those jurisdictions. The “Principles of Business” for Islamic banks cover issues such as integrity, conflicts of interest, due skill and care, confidentiality, market conduct and management, systems and controls.

16.4.3 Regulation of the ‘Islamic window’

The DIFC Law Regulating Islamic Financial Business permits an authorised firm or authorised exchange, other than an institution that carries on its entire business in accordance with the Shari’a, to operate an Islamic window where it conducts a part of its business in accordance with the Shari’a as part of its overall business operations.

The Governance Standards recommended by AAOIFI contain special provisions governing Islamic window. The primary obligation for those institutions offering services through an Islamic window is to ensure that the Shari’a-compliant and non-Shari’a-compliant parts of
their business are kept separate, with the Shari’a parts subject to financial reporting standards recommended by AAOIFI and oversight by a Shari’a Supervisory Board. The Islamic window provides a compromise for those institutions that wish to participate in both the Islamic and conventional financial industries while ensuring that its Muslim clients are appropriately protected.

16.5 Regulating form? The focus on governance and disclosure

Where regulators choose to regulate Islamic financial institutions, the one regulatory characteristic, more than any other, that sets the regulation of those institutions apart from the regulation of conventional institutions, is the focus on governance systems and controls for ensuring Shari’a-compliance. The issue of internal Shari’a governance may, arguably, be more acute where a formal approach to the regulation of Islamic finance is adopted with regulators placing the issue of determining Shari’a standards firmly with the institutions themselves as opposed to leaving them to centrally identified SSBs.

In the DIFC, the DIFC Law Regulating Islamic Financial Business sets out a single substantive requirement for the conduct of Islamic Financial Business: an authorised firm which has an endorsed license authorising it to conduct Islamic Financial Business must appoint a SSB.

In its rules, the DFSA amplifies these requirements by reference to the AAOIFI Governance Standards – an approach that the CBB follows in Bahrain, although even more so by merely referring to the relevant AAOIFI Governance Standards as opposed to seeking to incorporate the substance of those standards into its rulebook.

The DFSA sets out rules: (a) governing the appointment of the SSB, including the requirement to have at least three members who are competent and independent of the firm’s management; (b) for demonstrating the process for appointing and retaining members of the Shari’a Supervisory Board, including the process for considering the suitability of the board; (c) governing the effectiveness of the SSB, including the requirement to ensure that the board is independent of and not subject to any conflict of interest with respect to the firm; and (d) governing the manner in which the SSB operates, including the requirement for reviews in accordance with relevant AAOIFI Governance Standards. With respect to rules governing the effectiveness of the SSB, the following requirements on a DFSA authorised firm’s employees are noteworthy: (a) to provide such assistance as the board reasonably require to discharge its duties; (b) to give the board right of access at all reasonable times to relevant records and information; (c) not to interfere with the board’s ability to discharge its duties; and (d) not to provide false or misleading information to the board.

The central role of Shari’a governance and focus of regulators that choose to regulate Islamic finance as the distinguishing practical feature that marks out any system of regulating Islamic finance is evident from the fact that the SSB issue arises in many contexts. These include: the governance of: Banks and other financial institutions, which would encompass the approval of the structure of particular products; the management of Shari’a-compliant investment funds – the DFSA and QFTRA rules referring expressly to the requirement for fund managers holding funds out as Shari’a-compliant to appoint SSBs to oversee the investment decisions of those funds; the governance of Shari’a-compliant markets and exchanges – the DFSA rules requiring markets and exchanges to appoint SSBs to oversee the activities of the relevant market or exchange; and listing of Shari’a-compliant products – the rules of exchanges, such as the Nasdaq Dubai, requiring the issuer of Shari’a-compliant securities, such as sukuk, to disclose the details of the Shari’a Supervisory Board which approved the securities to be listed as Shari’a-compliant.

Such is the importance of the SSB in the regulation of Islamic finance that, in plain terms, the question of what constitutes a Shari’a-compliant bank or financial institution may be answered simply by the statement: a bank or institution that has its own SSB.

This, in turn, highlights the central role of disclosure in the context of the regulation of Islamic finance, particularly where regulators employ a formal model where investors will rely on the Fatwa of a product provider’s SSB instead of any fatwa issued by a central SSB.

This would appear to underpin the single requirement set out by the DFSA with respect to the marketing and promotion of Shari’a-compliant products or services: before a firm communicates any marketing material to a person, it must ensure that, in addition to the information generally required by the DFSA for inclusion in any marketing material, the DFSA requires that the marketing material state which SSB has reviewed the products or services to which the material relates. In addition, in Saudi Arabia, the Capital Markets Authority requires the manager of a Shari’a-compliant investment fund to disclose not only the identity of the SSB that approved investments made by the fund, but also the criteria for determination.

16.6 Conclusion

There is no doubt that the advent of Shari’a-compliant products and services introduced a fresh challenge to how financial services and products are to be regulated, taking into consideration the special features of Shari’a-compliant products and services and new challenges. The fact remains and remains that often it is the features which Shari’a-compliant products and services share with conventional products and services, such as the integrity of underlying investments and asymmetry of information regarding such investment, are likely to remain at the forefront of regulators’ minds. However, this does not displace those challenges, but with the development of standards by international bodies such as AAOIFI and the IFSB and the increasing interest taken by national regulators, the challenge should be met. Even if the solutions are never perfect, and regulatory solutions seldom are, regulators’ recognition of the issues that they and participants in the Islamic finance industry need to address can only be viewed positively.
CHAPTER 17
Risk management and Shari’a challenges

17.1 Introduction

The Islamic finance industry has expanded rapidly. It now branches out into non-Muslim countries in Europe, North America and Asia/Australia and the recent financial crisis has brought it much international attention. Although Islamic finance has proven to be a success story, a closer look reveals that the industry faces a number of operational challenges and structural weaknesses. This chapter analyses these challenges in light of some recent incidents in the industry. It also focuses on some interesting products launched by some of the industry players, without or before proper regulatory and Shari’a frameworks were developed for such products.

A number of studies point to the stability and resilience of an Islamic banking system, but it must be understood that applying Islamic formalism in practice is neither a guarantee for commercial success nor a shield against an economic crisis. For example, it seems that the Islamic Bank of Britain and HSBC Amanah started their operations in the UK with optimistic forecasts about the size of the Islamic banking market in the country and demand for Islamic financial services by the UK Muslims. However, these two initiatives (and indeed others) in the country have yet to attract any significant business from their targeted population. Islamic Bank of Britain has so far attracted only 50,000 customers out of a Muslim population of 2.5 million in the UK. The bank received a boost in demand for its home finance product during the crisis, but was limited by the lack of capital – this was remedied most recently with a capital infusion of GBP 20 million by the Qatar International Investment Bank. This is an example that Shari’a-compliance alone is not sufficient and that it cannot completely escape market conditions and economic reality.\footnote{See Mohammed Amir: The UK Islamic Banking Scene, in: Islamic Finance News 7 (2010) 35 [1 September], pp. 14-15.}

Regarding the resilience of Islamic banking and finance during the last financial crisis: It is correct that Islamic banks performed better than those conventional banks (in particular investment banks) which were highly leveraged and deeply involved in speculative trading activities. Most of the largest global players fell into this category. But what is often ignored is the fact that besides Islamic banks, also a large number of conventional banks were unaffected in the first round of the crisis (2007-2008), which led to the downfall of the more iconic investment banks. Many banks in emerging markets with limited international exposure fared pretty well, as did banks with a strong deposit base, prudent lending policies, no speculative trading activities and a strong regional commitment. Most Islamic banks share these economic characteristics, and these characteristics along with the formal Shari’a-compliance of instruments and contracts explain the resilience of Islamic banking and financial institutions in the first round of the crisis.

In the second round of the crisis (2009) however, IFIs were also hard hit by the crisis, with some banks carrying problems from the first round. A recent working paper of the IMF\footnote{See Maher Hasan and Jemma Dridi: The Effects of the Global Crisis on Islamic and Conventional Banks: A Comparative Study, IMF Working Paper, WP/10/201, Washington 2010.} found for a sample of Islamic and conventional banks, that the profitability of Islamic banks was better than that of conventional banks in 2008, but after a sharp decline of profits of Islamic banks, the picture reversed in 2009 in most countries.

It is encouraging that a default of an Islamic bank has been avoided so far, although several bailouts and debt restructurings have already taken place. Some prominent cases of bailouts or restructurings are The Investment Dar (Kuwait), Gulf Finance House (Bahrain), the Islamic mortgage providers Tamweel and Amlak (Dubai), Noor Islamic Bank (Dubai) as well as the intervention of the Central Bank of Qatar in favour of Islamic banks there. Some critics also argue that the bailout of Citigroup and AIG by the US government has also saved their Islamic
businesses – which gave rise to some adverse comments from anti-Islam movements in the US.

Further, there has been a considerable number of sukuk defaults hitting the headlines most recently: 3 15 defaults were recorded in 2009 and 6 until September 2010. 12 of these cases occurred in Malaysia, 4 in Pakistan, 4 in the GCC and 1 in the USA.

To summarise, although Islamic banking and finance tends to be hit by a crisis with a lag, the current crisis has hit Shari’a-compliant financial products hard. Therefore, it is fair to assume that Islamic banking and finance is connected with its conventional counterparts and that they share each other’s gain and pain.

17.2 Regulatory challenges

Many individuals and institutions have analysed the causes of the financial crisis and published proposals on how such a crisis could be prevented in the future. Two documents are of high relevance for the Islamic finance industry:

The first is a report published jointly by the IFSB, the IDB and IRTI. This report identifies shortcomings in the Islamic finance industry and indicates steps that should be taken to enhance its resilience and stability. The report mainly reflects the perspective of the inter-governmental role of IDB and of regulatory authorities of Muslim states, who are the member states of IFSB.

The second is the report of the Basel Committee to the G20. The proposals made in this report (supplemented by a number of reports on particular aspects) – known as Basel III – have been adopted by the G20 as the basis for the reform of banking regulations.

17.2.1 Islamic finance industry: building blocks for financial stability

IFSB, IDB and IRTI have identified in their report eight building blocks to strengthen the financial stability of the Islamic financial system, which are detailed below:

- The development of a comprehensive set of cross-sectoral prudential standards covering banking, takaful and capital markets.

- The development of a liquidity management infrastructure.

- The strengthening of financial safety net mechanisms (Shari’a-compliant lender of last resort facilities, emergency financing mechanisms and deposit insurance schemes).

- The development of a reliable crisis management and resolution framework (comprising bank insolvency laws, arrangements for dealing with non-performing assets, asset recovery, bank restructuring and bank recapitalisation).

- The implementation of accounting, auditing and reporting standards, supported by adequate governance arrangements.

- The development of a macro-prudential surveillance framework and financial stability analysis to address system-wide stress resulting from common exposures of financial institutions.

- The strengthening of the rating processes to improve the transparency of risk profiles.

- The stronger involvement in capacity building and talent development to address the human capital deficiencies in the Islamic finance industry.

The basic premise of the IFSB/IDB/IRTI proposals is that Islamic finance is an integral part of the global financial system. Therefore Islamic solutions must be compatible with the general regulatory system designed for conventional finance. Thus reforms of Islamic finance regulations have to take up the reform agenda of Basel III. Specificities of Islamic finance have to be considered, and some rules and regulations may be adjusted (or at least deliberated) by regulatory authorities and banking supervisors. This means that Basel III will be relevant for Islamic finance (as was Basel II and still is). The application of Basel III rules and regulations pose several challenges to IFIs.

17.2.2 Global reforms: Basel III

The core of Basel III is the tightening of global capital adequacy rules and liquidity regulations. In addition, transparency shall be increased and risk management must be improved.

17.2.2.1 Capital requirements

The new Basel III capital requirements are as follows (in full force only on 1 January 2019, i.e. after a long phase-in period):

- The minimum ratio for common equity capital (= core Tier 1 capital which has the highest loss absorbing quality) will be raised from 2% to 4.5% of total risk weighted assets.

- The total Tier 1 capital ratio will be increased from 2% to 6%, and the total minimum capital will remain at 8%.

- A capital conservation buffer of 2.5% for the absorption of losses during periods of financial and economic stress will be introduced. It must be funded by common equity which brings the required core Tier 1 capital ratio to 7%. Total capital plus conservation buffer adds up to a minimum ratio of 10.5%.

- An additional countercyclical buffer of common equity or other fully loss absorbing capital in a rage of 0 to 2.5% shall be implemented according to national circumstances. This buffer shall become effective only in periods of excess credit growth that results in a system wide build-up of risk.

- In addition to these risk-based ratios (capital as per-

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9 The next IFSB standards dealt with capital adequacy (December 2006), corporate governance (December 2006) and disclosures to promote transparency and market discipline (December 2007).

Meeting the capital requirements may be a challenge, in particular for smaller Islamic banks. The tightened standards may induce mergers of smaller banks or support the establishment of larger institutions in the future. It seems that raising capital is – in principle – not a major issue for IFIs, and the capital of many Islamic banks exceeds today’s minimum requirements by far. Thus it can be assumed that most Islamic banks will be able to meet the new capital requirements. Similarly, most Islamic banks are far less leveraged than conventional banks (in particular investment banks) and should not have a problem with the leverage ratio.

While the capital requirements are no particular threat to Islamic banks in general, a number of specific issues have to be considered and negotiated with regulators and supervisors. For example:

- What is the status of sukuk with respect to capital requirements? Depending on the structure of the sukuk and in particular the priority of sukuk holders’ claims over designated assets in default cases, a sukuk without priority for claims of sukuk holders may be considered as subordinated debt, i.e. as Tier 2 capital. But in this case, the structure of the sukuk is seemingly asset based and not asset backed which could be challenged from a Shari’a perspective.

- Similar questions come up regarding the status of investment accounts or mudaraba deposits. It seems that many regulators, in particular in non-Muslim countries – which now are targets for expanding IFIs – treat investment accounts and mudaraba deposits not differently from conventional deposits.

However, if the risk bearing qualities of investment accounts and mudaraba deposits were considered more seriously (both by regulators and Islamic banks), this could have far reaching systemic implications. (see below section 17.2.2.4)

17.2.2.2 Liquidity standards

The financial crisis demonstrated that a strong capital base is necessary but on its own not a sufficient condition for stability. It must be supplemented by strong bank liquidity. Basel III introduces as a measure for global minimum liquidity standards, the liquidity coverage ratio (LCR) that requires banks to hold sufficient high-quality liquid assets to withstand a stressed funding scenario that is specified by the national supervisors.

Mary Islamic banks hold extremely large cash reserves (reportedly up to 90%) so that they should be able to meet the LCR. Large cash reserves however, can be seen as underutilized liquidity, which should be reduced. But by converting cash into other Shari’a-compliant liquid assets, the question of specific risks (especially market risks) comes up, and along with it the question of asset quality. The present liquidity infrastructure of the Islamic finance industry is such that in terms of liquidity and security (= quality) no Shari’a-compliant substitutes for government bonds exist in most jurisdictions.

Commodity murabaha or tawarruq generate liquid assets, but if they conform to Shari’a rules as laid out by the OIC Fiqh Academy, these instruments are subject to specific market risks, which probably will disqualify them as high-quality liquid assets. However, if they meet the conventional quality requirements (i.e. avoid the specific market risks), they may not meet strict Shari’a interpretations because the trading component and the associated risks are in practice factually eliminated.

Although it has long been recognised that the underdeveloped liquidity infrastructure is the achilles’ heel of Islamic finance, only a few central banks of Muslim countries (notably Malaysia, Sudan and Bahrain) provide instruments for an effective liquidity management of IFIs (such as regularly issued liquidity sukuk). To overcome the deficits in the liquidity infrastructure of the Islamic finance industry, IFSB facilitated the recent establishment of the International Islamic Liquidity Management Corporation (IILM). Sixteen central banks and monetary authorities and two multilateral organisations signed the Articles of Agreement on 25 October 2010. IILM shall issue high quality Shari’a-compliant financial instruments at the national level and across borders.

17.2.2.3 Risk management

Basel III refines some risk management requirements as spelled out in Basel II, and it adds a few new aspects with limited relevance for Islamic finance (in particular regarding re-securitization). The main challenge for IFIs is thus not new: It is the observance of the Basel II standards. Basel II underlies IFSB’s first published standard on risk management in 2005, but this standard is only a recommendation and is not enforced in most jurisdictions.

It is reported that many Islamic banks still struggle with the implementation of Basel II (in its original version or adapted according to the IFSB standard). Some of the near defaults of IFIs indicate that the risks of high leverage combined with maturity mismatch have not been assessed and addressed properly (with dangerous consequences during the economic downturn). Other cases indicate an overconcentration of financing and assets in one sector such as real estate (in particular a problem in some but not all GCC countries).
IFIs with claims against other troubled IFIs discovered a new dimension of the credit or counterparty risk, namely the legal uncertainty and doubtful enforceability of (clauses in) Shari'a-compliant contracts and the lack of recognized restructuring and resolution procedures.

A lack of precision in the documents of Islamic products caused much concern regarding the ranking, recourse and remedies of creditors in cases of (near) default. Other unclear or misunderstood clauses in Shari'a-compliant contracts and products (e.g. sukuk) gave rise to lawsuits. There it became apparent that the legal qualities of many Shari'a-compliant contracts had not been tried and tested in courts (and also not the enforceability of court rulings). It was learned that the lack of established procedures makes the restructuring of Islamic debt instruments more cumbersome than conventional restructurings. Not only have commercial interests to be reconciled. The restructuring plan needs an approval by the Shari'a board of the obligor and the Shari'a board (or boards) of the creditor (or creditors). Given the multitude of Islamic law restrictions for further negotiations and revisions of concluded contracts, it may easily happen that different boards adhere to different Shari'a interpretations and come to an understanding only after time consuming debates.

In addition to these difficulties, a new type of Shari'a risk has become visible in the case of Blom Development Bank vs. The Investment Dar (TID). TID argued at court that a Wakala arrangement was not in compliance with Shari'a and therefore was void because it went beyond the corporate powers of TID. The company was bound by its constitutional documents to Shari'a-compliant transactions only. What is relevant here is the fact that the Shari'a-compliance of the Wakala arrangement was quite successfully disputed by the management of TID although it was initially approved by the company's own Shari'a board.10

So far Shari'a risk meant that the opinion or fatwa of a Shari'a scholar or a Shari'a board could be challenged successfully by another scholar or board so that the claim of Shari'a-compliance cannot be upheld. The new quality in the Blom vs. TID case is that a declaration of Shari'a-compliance by a Shari'a board was challenged by the management of the company, i.e. by people who themselves are no Shari'a experts (but seemingly had good arguments).

One could pass over such an incident if the Shari'a approval were given by a board composed of inexperienced beginners. But this is not the case for the Shari'a board of TID: Today it comprises four scholars who are all board members of KFH and member of 12 other boards (as chairman in 11 of these 12).12 The three other members13 hold between 18 and 21 Shari'a board positions, and two of them are also active members of the AAOIFI Shari'a board.14

The management of TID made things worse by bringing the case to the court only after they faced financial distress. This has happened for the first time in the short history of Islamic banking and finance. Other notable legal cases like the Islamic Company of the Gulf (Bahamas) Ltd vs Symphony Gems (2002) and Beximco of Bangladesh vs Shamil Bank of Bahrain (2003) had the same nature of attacks on Shari'a compliancy made by the management of the companies, which sought fatwas from their respective Shari'a boards and subsequently attempted to discredit them when things went wrong from a financial viewpoint. Although the text of the judgment15 may suggest to many that experienced scholars were negligent in recognising that the Wakala agreement was the formal cover for an interest transaction in substance, the more important issue is related with the bad intent of the management of such IFIs. Nevertheless, many observers have speculated about various reasons – but all have quite unpleasant implications and are seemingly biased against the scholars.

- Maybe the scholars did not have enough time to study the documents in depth and with the necessary diligence. A large number of board positions of scholars and voluminous or complicated documentations do not go together well, especially if the management pressures for a swift decision. But then, why did the board approve the arrangement without a thorough examination?

- Maybe the scholars did not fully comprehend the economics behind the contractual arrangements. This may be due to insufficient or biased information given by the management. But then, does it mean that the assessment of the Shari'a-compliance depends on the circumstances in which a contract is executed? More pointed, could it be that a contract is Shari'a-compliant in one situation and non-compliant in another one?

- Maybe the scholars have intentionally faded out all economic substance and based their approval on purely abstract considerations. But then, where to stop the formalism? It is always possible to decompose more complex contracts into smaller and smaller pieces until one reaches a level of granularity where the ‘contractual atoms’ are all Shari’a-compliant in themselves because they are assessed in isolation, i.e. without caring for the interconnectedness of and interrelations among the individual elements. Then ‘everything goes’. This cannot be a compelling position. Therefore the connections and relations must be brought back into the picture. They are the bridges from pure logic to the real world, and from legal form to economic substance.

The full significance of the new dimension of Shari’a risks is to be explored. But even now a number of very serious conceptual questions arise. The following are just some examples and by no means exhaustive:

- What is the value of a Shari’a-compliance fatwa of a high calibre Shari’a board if it can be challenged (even in court) by the management of the own company (which certainly understands the commercial or economic substance of a contractual arrangement)?

- If there is a dispute about the Shari’a-compliance, who will decide the case – especially in countries without explicit Shari’a courts?


11 TID’s Annual Report 2007


- In reaction to the Blom vs. TID case it has been proposed to include clauses in contracts, which make initial Shari’a board approvals final and prevent a company from raising objections later, against fatwas issued by its own Shari’a board. This may be a solution for individually negotiated contracts, i.e. mainly in investment banking. But what are the implications for retail clients who have to accept contract forms designed by the bank?

The new dimension of the Shari’a risk has also far reaching implications for disclosure and transparency requirements as well as for corporate and Shari’a governance. Further, it gives an additional stimulus to consider more radical ideas for a reform of the regulatory regime of the Islamic finance industry.

**17.2.2.4 Transparency and market discipline**

The basic idea underlying Pillar 3 of Basel II, is that banks have to disclose sufficient information so that market participants (e.g. depositors) could make informed choices and, for example, ‘punish’ banks with poor risk management practices. Market discipline would force banks to improve their risk management practices and thus contribute to more stability in the financial system. Basel III has tightened and extended the disclosure requirements in particular with respect to (re)securitisation exposures and off-balance sheet vehicles. IFSB has adapted Pillar 3 of Basel II to the specificities of Islamic banking in its standard on “Disclosures to Promote Transparency and Market Discipline”.14

The first challenge for IFIs is to adapt their disclosure practices to Basel II (and III) and IFSB requirements: In view of the risk sharing qualities of (mudaraba based) investment accounts, Islamic banks should disclose to the investment account holders (IAHs), for example, their general investment objectives and policies as well as business strategies and risk-sharing policies, and the sources of returns paid out to investment accounts (actual investment income, release of investment risk and profit equalisation reserves, reduction of profit share of the bank).

In a (probably not representative, but nevertheless not irrelevant) survey of 22 IFIs, Hawkamah found that “14 IFIs (63.4%) recognize the IAHs right to monitor the performance of their investment and the associated risks and 13 IFIs (59.1%) inform ex ante IAH of the risk profile of the institution, investment strategy and associated risks. Only 54.6% of IFIs make adequate and timely disclosure to IAH and the public of material and relevant information on the investment accounts that they manage.”17

But even if the information were made available on time and by all Islamic banks, it is very questionable whether they would be processed efficiently by the market (i.e. the IAHs). The major concern and challenge is that IAHs seemingly do not appreciate correctly the risk exposure of their funds. They may even ignore completely that their funds are at risk – irrespective of what clauses in deposit contracts they have signed. IFIs, and in many jurisdiction the regulators, contribute to this risk ignorance.

Investment accounts are often treated by regulators as deposits, and they require the cover by a deposit insurance scheme. If IAHs see their funds in analogy to conventional savings or term deposits, they will most probably overlook the limited range of the deposit insurance. Deposit insurance protects the principal only in the case of a bank default (and not in cases of losses from poor investments). If a conventional bank suffers heavy losses on its asset side, this may cause a bank default because of fixed deposit liabilities. In contrast, an Islamic bank can pass on the losses from the asset side to the liability side of the balance sheet (if all mitigating techniques are exhausted). This would save the Islamic bank from default but reduce the principal of the IAHs since the deposit insurance is triggered only by a bank default.

If IAHs were aware of this, rumours of the expected passing on of losses could lead to a bank run. Deposit insurance is effective as a remedy for bank runs only in conventional banking, but not in a Shari’a-compliant system. This implication is often overlooked and hardly reflected in the capital requirements for investment accounts. Capital requirements should be higher for IFIs than for conventional banks not in spite but just because of the loss-sharing capacity of investment accounts: The deposit insurance is largely redundant; only Tier I capital has an effective loss absorbing capacity in IFIs.

The risk ignorance of IAHs is strongly supported by the practice of Islamic banks. Islamic banks usually advertise anticipated rates on return for investment accounts, and the actual rates have hardly ever fallen short of the anticipated rates. In order to meet the expectations, Islamic banks have developed several instruments such as investment risk reserves and profit equalisation reserves, which are built up in good years with high profits, and drawn down in years with unexpectedly low profits. If these reserves are insufficient to beef up the disbursed ‘profits’ (i.e. income from operations [especially investments] plus liquidation of reserves) to the level expected by the IAHs (and determined by the market rate of interest for [risk free] conventional savings and term deposits), then shareholders can abandon parts of the profit shares due to them.

Reserves as well as ‘voluntary sacrifices’ in favour of the IAHs (which prevent a bank run and thus protect primarily the shareholders’ capital) are practices approved as Shari’a-compliant by individual Shari’a scholars as well as institutions such as AAOIFI and IFSB. However, the effects are a reduction or elimination of the risk awareness of the IAH, and a transformation of profit-sharing accounts with variable returns (which are known in absolute amounts only ex post) into quasi-deposits with de facto predetermined returns (which are known ex ante).

As long as this practice of Islamic banks continues and is supported by regulatory regimes, market discipline will hardly become effective in Islamic banking even if disclosure practices were improved massively.

17.3 Corporate and Shari’a governance
Corporate governance standards for IFIs in general, and Shari’a governance standards in particular, have been published or drafted by several reputable institutions such as AAOIFI, IFSB, Bank Negara Malaysia and Hawkamah. In addition, one must not ignore governance principles of international institutions such as the OECD, the EU and the Basel Committee. IFIs with the ambition to penetrate more Western markets will increasingly be confronted with the codes and standards of the host countries. Western countries do not have specific rules for Shari’a governance, but one can assume that regulators and supervisors will expect the application of their general principles to Shari’a boards, which are at the core of the organizational structure of IFIs.

17.3.1 Governance principles and Shari’a board practices

AAOIFI explicated in the Governance Standard No. 5 on “Independence of Shari’a Supervisory Board” that Shari’a Supervisory Board (SSB) members, “should be and appear to be free of any interest which might be regarded, whatever its actual effect, as being incompatible with independence, objectivity and integrity.” (Appendix A).

- Therefore, “SSB members should not be employees of the same IFI.” (para 7).

- “The continuation of the same SSB member on a Shari’a supervision engagement over a prolonged period of time may pose a threat to independence.” (Appendix A).

- “Personal and family relationships… can affect independence. There is a particular need to ensure that an independent approach to any assignment is not endangered as a consequence of any personal or family relationship.” (Appendix A).

The Governance Standard No. 5 has great implications for the procurement of Shari’a advisory services by IFIs, as the rotation of members of Shari’a boards at present is not being practiced by any institution in the world. Furthermore, a small number of Shari’a scholars have for long dominated the industry, which is being perceived as unhealthy for the practice of Islamic banking and finance. There is also evidence of the members of the same family representing the Shari’a board of the same institution. Also, it is important that members of the Shari’a board of AAOIFI or the regulators do not advise individual institutions and transactions, a practice that is prevalent to a great extent in Malaysia, but not elsewhere.

The Falak “Shari’a Report 2008” lists 253 scholars and Funds@Work has identified 320 scholars in 2010. The divergence of practices of Shari’a advisory from the newly-created Shari’a governance frameworks is understandable, as before these, no such guidelines were available and the individual institutions adopted a model that fitted well in their business plans and strategies. It must, however, be emphasised that the regulators in almost all countries, except Malaysia, have by and large failed to implement these standards. Without their accepting and implementing such guidelines, Shari’a advisory services will keep on attracting criticism from the industry observers.

The AAOIFI standards for Shari’a boards are supplemented by several recommendations of IFSB such as the following:

- The number of Shari’a board memberships should not become too large. Shari’a board members with multiple appointments “must ensure that sufficient time and attention” is allocated to the affairs of each IFI.

- IfIs should hire and nurture “young members of the Shari’a board with promising potential to expand the talent pool in the profession.” The Shari’a boards shall be composed of senior and junior members with different lengths of experience.

A confrontation of these recommendations with the practice of Shari’a boards in most jurisdictions (with Malaysia as the most important exception) reveals striking differences.

For 370+ IFIs with a total of 1141 Shari’a board positions and 280 scholars, the top 20 of the scholars (7.1%) hold individually between 14 and 85 and as a group 621 board memberships (54.4%), while the remaining 260 scholars (92.9%) hold individually between 1 and 11 and as a group 520 board memberships (45.6%). This raises serious doubts whether sufficient time and attention can be allocated to all IFIs.

The nurturing of young scholars is still an exception to the rule, and performance assessments of Shari’a boards and individual board members are virtually non-existent. The composition of Shari’a boards seems to be guided more by a desire for homogeneity, rather than diversity of schools of jurisprudence and nationality. Board compositions have a strong country bias, meaning that the IFIs of a specific country include mainly top scholars from the same country.

Another concern regarding transparency and accountability has been summarized by IFSB as follows:

“More often than not, a majority of Shari’a boards… mention in their Shari’a pronouncements/resolutions only whether a transaction…is permissible or non-permissible. Rarely…do they make available supporting evidence that could be examined by others”.

As a result, it is very difficult to improve public awareness in terms of understanding the basis of and justifications behind a Shari’a pronouncement/resolution. A leading Shari’a scholar forcefully endorsed this posi-
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17.3.2 Accumulation of Shari’a board memberships and clusters of Shari’a scholars

Empirical research on Shari’a governance has started only recently. Therefore, it comes as no surprise that the number of questions still exceeds the number of answers by far. Two questions and provisional answers shall be put forward here (with some indications for further empirical research).

(1) Why is it that IFIs still chase the big names of the Shari’a scholars’ guild? Scholars with 30+ Shari’a board memberships can devote only limited periods of their own working time to new board memberships, and if demand and supply determine the fees of scholars, the top names will be the most expensive choices.

One might argue that the wealth of experience and the permanent involvement in the development of advanced products and techniques can make up for the limited time. This could be a convincing explanation if most of the IFIs that form new Shari’a boards and appoint well established scholars were very innovative firms with fresh products and new techniques. A cursory screening of the product portfolios of some relevant IFIs gave rise to doubts about this explanation.

If the expertise of a top scholar is not the prime motivation to get him on the Shari’a board, then it could be his name that disseminates a positive signal to retail customers, other business partners and regulators. It would be interesting to learn how many retail customers know the Shari’a board members of their Islamic bank. It might be that this percentage is very low: The customers expect that the bank has a Shari’a board but are quite indifferent with regards to the members.

A third explanation might be that big names are a signal for business partners in the financial sector (other Islamic banks, institutional investors, rating agencies, etc.). However, the partners will hardly take big names on a Shari’a board as a sufficient guarantee for Shari’a-compliance according to their own standards. They will probably check the Shari’a qualities of transactions or contracts by their own Shari’a boards. Therefore the signal is not that straightforward.

So what could be the rationale to engage a very expensive top scholar with serious time restraints? Maybe one can find an answer by considering why very busy scholars accept new assignments. For this purpose one could outline a model for the maximisation of income, prestige or intellectual satisfaction over the whole lifetime of a Shari’a scholar. However the model may be specified, it probably will show that the maximum cannot be reached by accepting each and every offer of a board membership; there is a critical number of boards one person can credibly serve. Once this number is exceeded, the credibility of the scholar and the assumed seriousness of work, loyalty and commitment will decline. As a consequence his market value (in terms of money and reputation) will start to decrease. If then top scholars cannot (in their own interest) accept every offer for a Shari’a board membership, the successful attraction of a top scholar signals to the business community (and to the public sector) that this Shari’a board membership is of special importance to him, and this disseminates the signal that this IFI is somehow ‘superior’ to others.

It has to be conceded that the outlined model does not have much explanatory power as long as one cannot specify the maximum number of credible board memberships (20, 30, 50, 100?). But it can draw the attention to a challenge for the Islamic finance industry, namely the long-term credibility of Shari’a governance systems with Shari’a boards only on the level of individual IFIs (in contrast to systems with a Shari’a board on the national level).

(2) The latest study on Shari’a scholars networks reveals that there are ‘clusters’ of top scholars who sit together on relatively large numbers of Shari’a boards of different IFIs. How could this clustering be explained and what are its implications for the effectiveness of the Shari’a governance?

The emergence of clusters could be due to deliberate decisions of IFIs when they form a Shari’a board. Then it would be interesting to learn, what is the attraction of those combinations of scholars which can be found frequently: specific expertise or signals to the market?

An alternative explanation for the emergence of clusters could be that Shari’a scholars themselves prefer to cooperate in particular combinations: A top scholar will accept a Shari’a board membership only if the IFI includes other scholars of his choice. Given the limited time budgets of overloaded scholars and their profound knowledge of the special expertise of other scholars, it is sensible for them to bring in trusted and tried and tested partners in order to exercise an internal division of labour in the Shari’a board.

Such a specialisation and division of labour would narrow down the scope of different opinions articulated in the Shari’a supervisory system, and the challenge is to prevent the emergence of an oligopolistic opinion leadership. A remedy could be the better documentation of pronouncements/resolutions of Shari’a boards and the public access to supporting evidence. Then external experts and other scholars could analyse positions of leading scholars and challenge them. Young scholars would get the opportunity to test and prove their qualifications in an intellectual discourse (or dispute) with established scholars. Bright young scholars could gain recognition from top scholars as well as from market players through their contributions in seminars, conferences and publications. This should open the

30 IFSB: Guiding Principles on Shari’a Governance Systems … op. cit., para 59.
31 See the summary of a conference paper of Mohamed Ali Elgari by Mushtak Parker: Shari’a Governance in Islamic Finance Industry, in: Arab News, 22 March 2010 [http://www.zawya.com/pdfstory.cfm?storyid=ZAWYA201003220232070&is33700100322]; excerpts of this paper were recently published: The Shari’a Governance Way, in: Islamic Finance Asia, November 2010, pp. 31-32. Some of Elgari’s main theses were summarized by Parker as follows: i) Shari’a decisions must always be supported by a body of evidence; ii) Shari’a declarations must always be capable of being defended by those who issued them with the same rigor with which they were issued; iii) procedures for the reversal of fatwas [are needed] because Shari’a scholars are not infallible and can make mistakes which have to be retracted and corrected; iv) ethics of disagreement [are needed] because Shari’a scholars’ guild? Scholars with 30+ Shari’a board memberships can devote only limited periods of their own working time to new board memberships, and if demand and supply determine the fees of scholars, the top names will be the most expensive choices.

17.3.3 Global certification of Shari’a-compliance?

Shari’a engineering creates increasingly complex structured products with approval by prominent scholars. At the relatively early stage of development of Islamic banking and finance, innovations were very often the result of reverse engineering of conventional products – an attempt to bring Western technologies into Islamic banking for purposes of risk management and product diversification. In the absence of industry-level standards for such innovations (which is quite natural as innovation almost always precedes regulation and standardisation), many of the innovations in Islamic banking and finance were mired by suspicion and distrust. At the core of many new Shari’a-compliant synthetic products is the concept of unilateral promise (wa’ad). Promises are not contracts and therefore not subject to restrictions such as the prohibition of gharzar (contractual uncertainty). Another recent innovation is the use of commodity murabaha or tawarruq to create savings accounts and term deposits with guaranteed principals and fixed returns for the depositors. This continues the tradition of modifying or supplementing old trade contracts in such a way that these products look similar to conventional products in their economic effects.

Consequently, an increasing number of articles and commentaries in Islamic finance journals and web blogs (many of them happen to be based on some ill-informed opinions) of the last few years, document a growing discomfort of many observers as well as industry practitioners with the spread of legal formalism and the neglect of economic substance in the Islamic finance industry. In addition, sometimes prominent Shari’a scholars or institutions articulate well founded concerns about this direction of the industry. Outstanding and widely noticed examples are:

- the criticism of sukuk by Muhamad Taqi Usmani,
- the fatwa on Tawarruq by the OIC Fiqh Academy,
- the criticism of total return swaps by Yusuf Talal DeLorenzo.

Such controversies make it obvious that there is no consensus among leading scholars on basics of even widely used Islamic products (such as sukuk and tawarruq). Many more differences of opinion do exist among Shari’a scholars or Shari’a boards of IFIs, although less fundamental than in the three cases quoted above, but still relevant enough to become an impediment for a wider or even general acceptance of innovative products. The continuation of the fragmentation of the market is seen as an obstacle to the rapid global expansion of the Islamic finance industry. The call for more standardization of Islamic finance products is often heard – though not shared by all because some consider standardization as a hindrance of innovation.

Against this background the secretary-general of AAOIFI, Mohamad Nedal Alchaar, has announced in August 2009 an initiative “to do screening of all products available in the market and evaluate the adherence of those products and the compatibility the Shari’a principles and rules. We will identify those products that are in violation and we will voice it out to the public.” He further claims: “The most important enforcement form of our [Shari’a] standards is through our Shari’a scholars. … Those scholars are on the Shari’a boards of most financial institutions; therefore our standards are enforced through our Shari’a scholars in an indirect way.”

This statement must not be seen as a warning to Shari’a scholars, but rather to the management of the institutions offering Islamic financial services, as it is they who have in some cases failed to implement Shari’a guidelines as enunciated by their Shari’a boards.

- In the widely publicised case of Blom vs. TID, some industry observers put the blame on Shari’a scholars (two of them being active members of the Shari’a board of AAOIFI), but it is the management of TID that seems to have misused or abused the Shari’a in the event of financial distress. There were of course some more fundamental questions raised on the practice and products in Islamic banking and finance, which go beyond the scope of this chapter.

- Similarly, in case of the criticism of the use of wa’ad in structuring a total return swap by Deutsche Bank and approved by the Shari’a board of Dar Al Istithmar, the initial criticism came from some industry observers, primarily because of its new application in Islamic banking and finance, for which there was no prior Shari’a precedent. More importantly, products based on wa’ad are now widely accepted and are increasing in number and enterprise value. It is, therefore, crucial that proper Shari’a governance frameworks are developed to regulate such products. International Shariah Research Academy (ISRA) for Islamic Finance is working on creating such a framework.

- Indirect enforcement of AAOIFI standards has not worked in the past, but a number of Shari’a controversies has helped AAOIFI in becoming a more effective organisation for accounting, governance and Shari’a standards. The controversy on sukuk, for instance, highlights weaknesses of indirect enforcement of AAOIFI Shari’a standards, but it also points to a more effective role of the organisation in Shari’a and regulatory matters. The debate was spurred by Muhammad Taqi Usmani in 2007, who was and still is the chairman of the AAOIFI Shari’a board. Alchaar asserts that the AAOIFI standard for sukuk “is very clear”. In particular, it “was also clear that when an issuer would like to buy back a sukuk, that should be done on the basis of the net value of assets, its market value, fair value or a price to be agreed, at the time of their actual purchase.” The AAOIFI Shari’a standard no. 17 on sukuk was issued in May 2003. The hypothesis that Shari’a standards are enforced indirectly by AAOIFI’s scholars in the boards of IFIs implies that no Shari’a board with at least one
AAOIFI scholar should have approved a sukuk issue with a repurchase guarantee at face value or at the issue price since 2004 (and especially not after 2007). If a few sukuk could be identified which violate the AAOIFI standard but were approved by a board on which a AAOIFI scholars sits, the hypothesis of indirect enforcement is refuted. Therefore, it is required that the regulatory bodies in different countries must subscribe to a Shari’a framework as adopted by them.

If the indirect enforcement of Shari’a standards cannot be taken for granted, then the awarding of a “Shari’a-compliance seal” gets a completely new orientation: It is not just the acceleration of a process that is going on anyway. On the contrary, it is the enforcement of one opinion against the resistance of others – it is an attempt to monopolize the power of definition.

This is diametrically opposed to the opinion of leading Shari’a scholars such as Elgari who is a member of the AAOIFI Shari’a board: “There are those who think that... consistency and predictability can be assured through the ‘centralization of power’ and monopolizing the authority to issue Fatwa by one body of scholars. Unfortunately, this did not and will not work because it goes against the egalitarian nature of the Islamic system. Scholars are just like the rest of us. There is no special power bestowed upon them. Hence, their authority is derived from political, and not Shari’a sources.”

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CHAPTER 18
Post-crisis regulatory environment for Islamic financial services

18.1 Introduction

The sub-prime financial crisis was not simply the result of excessive leverage and inadequate capital but also concoction, of a gradual deterioration of business leadership, lapses of governance in the regulatory framework (particularly in derivatives markets) and an ineffective risk-management framework, that had been brewing for some time. There is consensus among researchers that the regulatory and supervisory framework was not adequate to forecast and prevent the crisis. However, the crisis itself has highlighted several regulatory and governance related issues: the market-discipline mechanism proved to be too weak; the decision-making of corporate leaders was overly driven by short-term goals; trust in corporate leadership declined; corporate boards were slack in their oversight and risk control; business ethics and values were compromised; risk management and supervision failed due to a lack of foresight; the quality of bank supervision was compromised; and finally, the corporate incentive and remuneration system was skewed in favour of financial results over responsibility.

The consequences of the crisis on the way financial intermediation and markets operate will be felt for many years, impacting not only conventional financial institutions but also their Islamic counterparts.

18.2 Core issues shaping the future of regulatory and supervisory framework for the financial industry

18.2.1 Failure of market discipline

“What has occurred is a shock to a set of intellectual assumptions about the way that markets work, about their self-equilibrating character.”

Lord Turner, IOSCO, June 11, 2009

The financial crisis has disproved the widely held notion that the invisible hand of the market would instil market discipline and resolve conflicts amongst market players without any further need to regulate the market. It was soon realized that not only was the financial-market information incomplete, but that the market could be manipulated by market players for their own personal interests. This observation is particularly applicable to the derivatives and structured markets, where the level of complexity is higher than markets for other financial products. This failure of market discipline led by financial innovation undermined the effectiveness of a regulatory model that rested, at least in large part, on transparency, disclosure, and market discipline to curb excessive risk-taking.

18.2.2 Failure of corporate governance and risk management

“Corporate governance is one of the most important failures behind the present financial crisis.”

De Larosière Group (2009)

“This Report concludes that the financial crisis can be, to an important extent, attributed to failures and weaknesses in corporate governance arrangements.”

OECD report (2009)

It was only after the Asian crisis of 1997-98, that is-
18.3 Key drivers of change

There is no doubt that the lessons learnt from the crisis will shape the changes in the regulatory and supervisory framework and practices. The debate on which direction a policy-maker needs to take has already been heating up on several international forums, including the Financial Stability Forum (FSF), the International Monetary Fund (IMF), national authorities, and standard setting bodies who are collaborating to address deficiencies and invoke enhancements. Working groups at FSF and the G-20 are reviewing a wide spectrum of related issues including complex and difficult legal and institutional hurdles to improve cross-border cooperation in regulation and the resolution of troubled institutions.

Figure 1 is a very good depiction of how financial institutions were surrounded by different pressure points which came to surface during the crisis. This gives an idea of the nature of the issues under consideration for shaping new financial landscape. The environment within which today’s financial institutions are operating is changing and the key drivers for change include defining capital and its adequacy, liquidity, securitization, rating agencies, compensation, OTC derivatives, and systemically important entities. In this section, select key drivers will be discussed, along with how each driver will impact the Islamic financial services industry.

18.3.1 Capital Requirements

The first realization is that in the increasing complexity of the present financial system and growing innovative practices of financial institutions, activities cannot be sustained with the current capital requirements without clear segregation of commercial and investment banking activities. Keeping this in mind, Basel III recommends that financial institutions substantially raise the quality and quantity of capital with a much greater focus on common equity to absorb losses. Enhanced capital buffers can help protect the banking sector against credit bubbles that can be drawn down during times of stress. Key features of Basel III’s new capital requirements include (i) increase of the minimum levels of capital under Basel (6%-8% Tier 1); (ii) change of rules in regard to composition/definition of capital (66%-75% from Tier 1 composed of retained earnings and common stock); (iii) requirement of countercyclical shock-absorbers/buffers (that vary with the economic cycle); (iv) requirement of a leverage ratio, limiting asset size (both on and off balance sheet); and (v) additional charges of capital related to firms considered systemically relevant.

Proposed changes in the capital requirements are a step in the right direction. The IFSB has already announced a review of existing capital adequacy requirements in light of the proposed Basel III requirements. Determination of capital requirements for IFIs is not straightforward.

18.2.3 Breach of trust

The current financial crisis has significantly damaged aspects of social capital. The Edelman Trust Barometer, which tracks the level of trust in different countries, observed that people began to lose trust in business leaders and became critical of their irresponsible actions, especially in the US. In the case of the United States, home to some of the largest corporate collapses, trust in business leaders dropped 20% points as a result of the crisis. At just 38%, this was even lower than the levels witnessed during the Enron and dot.com crises and came close to the levels in Western Europe, which has historically displayed the lowest trust levels in businesses amongst all nations surveyed by the tracker. Similarly, survey clearly showed a sharp decline in the trustworthiness and credibility of CEOs in all major industrial economies.

18.2.4 Deteriorating business ethics and values

The current financial crisis has also highlighted a decline in moral and ethical values in senior management, who cared less about moral edifice and focused more on circumventing regulatory constraints and finding loopholes in the law. Greed and personal empire-building became the norm on Wall Street with little emphasis being placed on producing moral and ethical business leaders.
There are two main issues. First, technically, IFIs is supposed to be on “pass-through” mode, where all profits and losses on the asset side are passed to the liability side (to investors/depositors) and therefore, the need for capital is minimal. In this mode of intermediation—just like mutual funds—the purpose of capital is to cover negligence and operational risk. However, the reality is that capital requirements have been set on similar lines for IFIs as they have for conventional banks to maintain the confidence of investors. Along the same vein, it is expected that the capital requirements for IFIs will also be modified to comply with Basel III. Increased capital requirement can also impact the efficiency and return on equity for IFIs.

The second issue with capital requirement concerns the exposure of IFIs to real assets that are subject to price volatility as well as to liquidity risk. It is observed that several Islamic banks, especially in the Middle East have considerable exposure to the real estate sector. Depending on how the assets are valued—book value or market-value, the financial health of Islamic banks can deteriorate as a result of price volatility. In addition, requirements to adjust capital to economic cycles and Islamic banks’ activities to the real sector will come into play in determining new capital requirements. Policy makers and authorities can develop sophisticated capital requirements to combat pro-cyclical pressures only after they understand the nature of risk/return reward of assets of IFIs which are definitely different from their conventional counterparts. Since Basel III will change capital charge for securitization risks, IFIs dealing with the sukuk market could also expect changes. Finally, as discussed below, additional requirements for liquidity in Basel III will put additional burden on Islamic banks to maintain adequate capital and the levels of minimum capital are expected to increase.

18.3.2 Liquidity

The current financial crisis is termed a ‘perfect liquidity surprise.’ Liquidity problems associated with the financial crisis have forced the regulators to get tough on this issue. Basel III incorporates the introduction of minimum liquidity standards and monitoring of liquidity coverage ratio (LCR) of financial institutions. The LCR is a ratio meant to ensure that the firm has enough liquid assets to cover a short term crisis based on a predetermined set of cash inflows and outflows established by the BCBS. Such liquidity issues have serious implications for IFIs for several reasons. First, IFIs do not have access to short-term liquidity through markets. One of the biggest impediments for IFIs is the development of liquid markets where securities can be traded efficiently at minimal transaction cost. Second, due to heavy concentration of trade or commodity finance, assets of Islamic banks are illiquid, i.e. murabaha-based assets cannot be traded in the secondary market. Third, whereas conventional banks have access to liquidity provided by a lender of last resort, Islamic banks can not benefit from such facility as the lending is interest-based. This means that although, an Islamic bank may be in good financial health but still could face additional capital requirements due to low liquidity which could hamper its growth or efficiency.
18.3.3 Quality of information

For markets, policy makers and financial authorities, multi-laterals (IMF and World Bank) appropriate coverage and quality of information is increasingly becoming critical for their capacity to assess risks and vulnerabilities. Regulators are looking for better information on the range of financial institutions’ activities such as ‘off balance sheet’ risks (involving better consolidated supervision), and the risks of financial inter-linkages. New regulatory and supervisory environment will be “information-focused” and financial institutions will be required to enhance the information collection and disclosure as required by the regulators.

What does this mean for financial institutions? This mean that the financial institutions will have to improve, enhance, and upgrade overall flow and the quality of information in their institutions. They will need to be very focused on satisfying the reporting and disclosure requirements for the regulators and supervisors. The financial institutions should expect to address this issue across all business lines and functional areas from front to back office. For some institutions, it would require an upgrade of risk reporting systems or development of new risk measures.

The General level of transparency and disclosure of information is low in the Islamic financial services industry. The impact of quality of information on IFIs could be from two directions. At the institutional level, they would be required to enhance the flow and quality within the institution which could demand automation of manual monitoring processes, upgrading information systems and improving the transparency of data and information for reporting purposes. This could be a challenge considering that majority of Islamic financial institutions are of small size and do not have surplus funds to invest in the information infrastructure.

The quality of information is relevant to investors and also the regulators, but in several countries where Islamic banks operate, the general quality of information is considered low. Table 1 shows a comparison of the information disclosure index of Middle East and North Africa (MENA) countries with G7 countries, and Table 2 shows the depth of credit information in the region. This index measures the rules and practices affecting the coverage, scope and accessibility of credit information available through either a public credit registry or a private credit bureau. The index shows relatively low levels as compared to the developed economies of G7. National authorities and regulators need to take concrete steps to enhance information at a systemic level so that all participants in the system can benefit from it. Enhancing the flow and quality of information can be considered as a key driver where the Islamic financial industry needs to pay attention.

18.3.4 Risk management practices

As previously mentioned, a failure of risk management was observed during the financial crisis and as a result, risk management practices have come under close scrutiny and a review of the risk framework is expected. It is expected that policy makers and regulators will be taking a very close look at how banks arrive at their measures of exposure, how they risk-weight their assets, and how they engage in risk mitigation activities. Requirements from the regulators on risk measures and enhanced quality of information will pressurise financial institutions to be vigilant to requirements for new products and to comply with the regulatory requirements.

The risk framework in IFIs is gradually evolving but is still at an early stage. The emphasis is on credit risk management and the awareness of market and operational risk is not adequate. Due to size, some financial houses cannot afford an extensive enterprise-wide risk-man-

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<tr>
<td>Average MENA</td>
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<td>6.13</td>
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<td>Average GCC</td>
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<td>6.5</td>
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<td>Average Non-GCC</td>
<td>5.6</td>
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Table 1 - “Extent of disclosure index protecting Investors” Index


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<th>2005</th>
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<tr>
<td>Average MENA</td>
<td>1.93</td>
<td>2.21</td>
<td>2.69</td>
<td>3.13</td>
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<tr>
<td>Average GCC</td>
<td>3</td>
<td>3</td>
<td>3.33</td>
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<tr>
<td>Average Non-GCC</td>
<td>1.5</td>
<td>1.9</td>
<td>2.3</td>
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Table 2 - Depth of credit information index (0-6) Getting Credit

agement system; which further exposes them to operational risk due to manual processes. In terms of risk technology, there are a hand-full of technology vendors who are taking their conventional product and offering them to Islamic banks with some modifications. It is critical that a proper risk framework for Islamic products and financial institutions is developed so that meaningful risk measures such as value-at-risk are maintained and proper back-testing and stress-testing of exposures are undertaken to satisfy upcoming requirements.

18.3.5 Supervisory framework

In the standard setting area, the focus of policy work is on the market risk rules, systemically important banks, the reliance on external ratings and large exposures. Basel III is the core regulatory response to the financial crisis but with the regulatory changes. The next critical task is to promote more collaborative supervision at the global level. It is expected that authorities will be paying more attention to improve supervisory practices and cross-border bank resolution practices in addition to further development of supervisory standards. The working group on Financial Stability Board (FSB) has identified areas of the Core Principles for Effective Banking Supervision that could be expanded or clarified to address topics related to the supervision of systemically important financial institutions. One key challenge for the bank supervision would be to assess risks associated with innovations and how such exposure is monitored. The main challenge for both supervisors and the Islamic financial industry would be to develop and enhance supervisory framework. If one takes the example of the MENA region where there is large concentration of IFIs, supervisory standards, legal institutions governing the resolution of large cross-border financial firms and insolvency issues are under-developed for both conventional and IFIs. Unless these impediments are removed, the financial system will be prone to instability. The current practice is to treat Islamic banks similar to conventional banks when it comes to supervision but this practice is not optimal. Islamic institutions have different contractual agreements and without understanding the underlying contracts, supervision can overlook areas of potential problems. Although, standards for exposure, governance, and supervision have been issued by IFSB, these standards are yet to be adopted formally by regulators and national authorities. National supervisory authorities may be very familiar with supervision framework and methodology of conventional financial institutions, but they need to pay attention to revising supervisory standards and manuals for Islamic institutions in addition to getting serious about implementing IFSB standards. Another dimension of complexity in supervision is introduced by the existence of “Islamic windows” by conventional banks and the need for maintaining proper firewall to segregate Islamic assets from conventional assets.

As Basel III incorporates macro-prudential measures to help address systemic risk and inter-connectedness of financial systems; regulators and supervisors need to enhance the supervision of Islamic institutions by forcing these institutions to: improve their internal risk systems; compliance with reporting requirements; transparency of disclosures and quality of information. Without focusing on these issues, the authorities would not get a meaningful understanding of the risk such institutions pose to the systemic risk.

18.4 Going forward

It is essential that a long-term and broader approach is taken by the industry. It would be a mistake to limit the efforts to short-term goals such as the implementation of Basel III. However, the opportunity should be taken to address structural issues facing the industry. To make high growth sustainable, attention needs to be paid to developing infrastructure and institutions which promote Islamic finance. For example, Islamic finance is considered a risk-sharing system but current practices of Islamic finance significantly diverge from this core feature. Therefore, steps should be taken in this direction to promote the essence of the Islamic financial system which is risk-sharing and promotion of equity-based financing. To foster the development of Islamic finance, there is a need to emphasize its risk sharing foundation; reduce transaction costs of stock market participation; create a market-based incentive structure to minimize speculative behaviour; and develop long-term financing instruments as well as low cost efficient secondary markets for trading equity shares. These secondary markets would better enable the distribution of risk and achieve a reduction in risk with expected payoffs in line with the overall stock market portfolio.

Further, there should be a collective and collaborative effort by all the stakeholders in the Islamic financial services industry to meet the upcoming challenges. Key stakeholders such as IDB, IFSB, AAOIFI, and key central banks such as that of Malaysia and Bahrain need to pool resource together and work with international standard setting bodies and multilateral institutions such as the IMF for coordinated response to upcoming regulator and supervisory changes. The Task Force on Financial Stability and Islamic Finance recommended that an Islamic Financial Stability Forum (IFSF) be established as a broad-based and constructive strategic platform to promote financial stability within the Islamic financial system. Such forum should collaborate closely with the Financial Stability Board (FSB) to exchange ideas on strengthening financial stability of IFIs. Without a common platform, it would be difficult for individual national authorities who might be pre-occupied with adjusting to changing environment for conventional institutions to pay due attention to issues of the Islamic financial services industry.

As mentioned earlier, it is essential to develop a set of comprehensive, cross-sectoral prudential standards and supervisory framework covering not only Islamic banks, but also takaful companies and capital markets. The IFSB who has issued standards, needs to be more forceful in convincing national authorities to implement such standards. The IFSB also needs to seek help from the IMF to fill the gaps in standards and adequate training of national authorities. One of the challenges in the implementation of the macro prudential framework is the development of key financial indicators which serve as benchmark for the assessment of financial soundness and exposures to vulnerabilities of the financial system. Such indicators also facilitate a relative assessment of
their interaction with broader macroeconomic developments. This task requires: a design of indicators to suit IFIs; comprehensive statistics of financial institutions’ activities; high quality of information available and design of templates to undertake financial sector assessments.

The development of efficient legal and economic institutions and a sound governance framework is important for the emergence and growth of a sound financial system. Institutions lay the foundation of the system and the governance framework ensures that the rules are enforced so that the desired results are achieved. The Islamic financial system is based and centred on risk sharing and affording equity finance a pre-eminent position in the financial system. Given the moral hazard and agency problems associated with equity-based financial contracts, institutions and governance become even more important in developing a risk-sharing financial system. Institutions governing economic transactions such as property rights; trustworthiness, truthfulness, fatefulness to the terms and conditions of contracts, transparency, and non-interference with the workings of the markets and the price mechanism-so long as the market participants are compliant to the rule-provide a reasonably strong economy where information flows unhindered, and participants engage in transactions confidently with minimal concern for uncertainty regarding the actions and reactions of other participants. The result is that in such an economy with reduced uncertainty, economic agents will be encouraged to engage in risk-sharing contracts.

Finally, while conventional finance also expects business leaders to exhibit ethical behaviour, it does not have a sound enforcement mechanism other than market discipline, which has come under a scathing attack during the current financial crisis. On the other hand, the Islamic financial system derives its values from the teachings of Islam and can expect ethical governance from the leaders, managers, and other stakeholders, who follow the rules prescribed by the Shari’a. Promoting ethical governance that fosters trust and formal governance mechanisms will become more effective in protecting the interests of stakeholders. Leaders of the Islamic financial industry should realize the importance of this enormous responsibility of not only behaving in an ethical manner but also to promote the best business ethics across their institutions.

References


Chapter 19

The Malaysian model

19.1 Introduction

As a leading international hub for Islamic banking and finance (IBF), Malaysia has always been seen as a jurisdiction which has successfully established its own unique model and set new benchmarks for the regulatory and supervisory framework for IBF. The success of the Malaysian model is even more outstanding considering that, compared to other OIC member countries, it is a diverse nation in terms of race, culture and religion, and its Muslim population control less than 30% of the nation’s wealth as compared to its non-Muslim population.

This chapter summarises the Malaysian model of regulating and supervising IBF, covering its historical development, strategic framework and foreseeable trends moving forward.

19.2 Defining ‘Regulatory and supervisory approaches’

‘Regulatory and supervisory approaches’ refers to the various frameworks purposefully and strategically put in place by the respective Malaysian authorities to deal with specific areas such as the licensing of IBF institutions; requirements for capital adequacy, risk management, Shari’a-compliance and corporate governance amongst IBF institutions, and the establishment of infrastructures such as capital and money markets, dispute resolution forums and talent enrichment institutions, as well as short, medium and long term strategies for the IBF industry generally. This conceptual understanding is important to ensure that one appreciates and recognises the complex and sophisticated interface between different levels of regulatory and supervisory framework for IBF in Malaysia. These frameworks are developed through cooperation between different bodies and agencies including:

(i) statutory authorities such as the Ministry of Finance (MoF), Bank Negara Malaysia (BNM - the Central Bank), Securities Commission of Malaysia (SC), Labuan Financial Services Authority (Labuan FSA) and the Inland Revenue Board (IRB);

(ii) exchange authorities such as Bursa Malaysia (Bursa-Mal) and Labuan Financial Exchange (LFX);

(iii) self-regulatory bodies and industry associations such as Association of Banks in Malaysia (ABM), Association of Islamic Banking Institutions Malaysia (AIBIM), Malaysian Investment Banking Association (MIBA), and Malaysian Takaful Association (MTA).

As may be observed in the later sections, the regulatory and supervisory approaches for IBF in Malaysia have been developed with clear strategic objectives of, among others:

(a) ensuring public confidence in the soundness and competitiveness of the Islamic financial system;

(b) meeting local needs without compromising on international standards and best practices;

(c) addressing the market’s various short term and long term needs, depending on the stage of its development;

(d) providing a conducive environment for business development and talent enrichment; and
The Malaysian model

19.3 Historical development

Rome was not built in a day. Similarly Malaysia has endured its own long journey in developing its IBF industry. Although Malaysia’s first fully Shari’a-compliant financial institution i.e. Tabung Haji (the Pilgrimage Fund) was established as early as 1963, a real drive towards establishing infrastructures for a proper IBF industry to flourish only began about twenty years later, marked by the enactment of an Islamic Banking Act (IBA) in 1983. From then onwards, the framework for the IBF industry in Malaysia underwent three main phases of development:

19.3.1 First phase: 1983-1992

Early initiatives were focused on building the necessary legal and infrastructural foundations that would enable IBF to be gradually introduced and developed, without causing any disruption to the existing conventional banking system. As opposed to Iran, Pakistan and Sudan which attempted to Islamise the whole financial system through radical reforms at around the same period, Malaysia deliberately opted for a dual-banking system approach whereby IBF could co-exist with its conventional cousins and offer an alternative range of products and services to the people. When the IBA was enacted, it was the world’s first piece of Islamic banking legislation as well as Malaysia’s. Takaful Act 1984 immediately followed a year later, which again marked the first legislation in the world that was tailor-made to govern the takaful (Islamic insurance) business.

During this period, Bank Islam Malaysia Berhad (BIMB) was the only full-fledged Islamic bank; a second full-fledged Islamic bank, namely Bank Muamalat Malaysia Berhad (BMMB) was only licensed in 1999. Although it seems as if the government deliberately granted a monopoly to BIMB to dominate the IBF market throughout these years, it is possible that the authorities wanted to ensure that they had adequately learnt and understood the business and market dynamics of an IBF institution properly before increasing the number of institutions in the market.

19.3.2 Second phase: 1993-2000

Within 10 years of the establishment of BIMB, more than 20 IBF products had become available in the Malaysian market. By then, the authorities considered the IBF market ready for the second phase: to increase the number of players, increasing competition as an incentive to improve efficiency and enhancing the overall market vibrancy. This phase witnessed the following:

- in 1993, permission was granted to conventional banks to offer IBF products and services through a ‘window’ concept known initially as the “usury-free bank-

19.3.3 Third phase: 2001-2010

The third phase of the IBF industry in Malaysia saw concerted efforts towards making it a truly global IBF centre. Two strategic documents, namely the BNM’s Financial Sector Master Plan (FSMP) and the SC’s Capital Market Master Plan (CMMP), are both 10-year roadmaps that complemented each other, respectively.

- the development of an Islamic capital market (ICM) marked by the issuance of the first Islamic security (now more popularly known as sukuk) by Shell MDS in 1990
- the establishment of a National Shari’a Advisory Council (NSAC) at both the SC and BNM (in 1996 and 1997 respectively).

The opening of Islamic bank window branches by conventional banks was legally made possible as the result of legislative amendments, specifically section 124 of the Banking and Financial Institution Act 1989 (BAFIA). This provision is consistent with the Government Investment Act 1983 (GIA) which was introduced earlier, and section 129 of the Development Financial Institution Act 2002 (DAFIA) which was later introduced in 2002.

By 1994, Malaysia had advanced its IBF market to the next step by setting up the Islamic Interbank Money Market to enable transactions in the wholesale money market on an Islamic basis.

- the liberalisation of the market through licensing of foreign Islamic banks;
- the launch of MIFC initiative, which is a community network of financial and market regulatory bodies, Government ministries and agencies, financial institutions, human capital development institutions and professional services companies that are participating in the field of Islamic finance with the aim of positioning Malaysia as the preferred international Islamic finance hub;
- the setting up of the Malaysian Deposit Insurance Corporation (MDIC) that also covers Islamic deposits; and
- the establishment of various talent development and research institutions dedicated to IBF, including the Institute of Islamic Banking and Finance Malaysia (IBFM), International Centre for Education in Islamic Finance
The Malaysian model

Despite intense competition from other financial centres aspiring to be the preferred hub for Islamic finance, Malaysia so far has managed to remain at the forefront and has won numerous awards and accolades as the best international Islamic financial centre.

19.4 Strategic Framework

As aforementioned, Malaysia adopts a ‘dual’ financial system which allows harmonious co-existence of IBF alongside the conventional financial system. In this respect, it is obvious that the authorities attempted to provide for IBF an enabling legal framework whereby anything that the conventional system can offer would always have an Islamic parallel or alternative. This is evident by the introduction of separate legislation and regulations to cover matters of similar nature, as reflected in Table 1.

The importance and clarity of the law and regulations as listed above cannot be overemphasized, because they form the backbone of every aspect of IBF operations in Malaysia. In other words, the development of activities of every IBF player are guided and dictated by the strong backing of law and regulations, leaving nothing to mere assumption or chance.

19.4.1 Strengths and advantages of the Malaysian model

Beside its ability to spur the growth of the IBF sector amidst a very diverse populace and within an economic environment strongly dominated by non-Muslims, it is worth mentioning that the Malaysian model has proven its resilience in the wake of two financial crises—namely the Asian financial crisis in 1997 and the recent global financial crisis. Without doubt, the Malaysian model has grown from strength to strength and can provide useful benchmarks to other jurisdictions which aspire to develop their own IBF industry.

The strength and advantages of the Malaysian model are numerous and deserve an analysis on their own. However, in summary, amongst the obvious advantages of the Malaysian model are the following:

(i) Sound and clear Shari’a-compliance and governance framework

The existence of a structured and powerful National Supervisory Advisory Council (NSAC) was originally intended to ensure clarity in terms of fiqh muamalat practices, but today it also has the power of final arbiter on Shari’a issues in any IBF dispute. By having legal authority, there will be coherence and assurance of validity of pronouncements by Shari’a scholars. In most other jurisdictions, the status of Shari’a pronouncements for IBF contracts remains vague and ambiguous when it comes to enforcement under the law.

(ii) Tax accommodations

In Malaysia, concerns about IBF contracts potentially attracting additional taxes that would make their products less competitive as compared to conventional financial contracts have since died down. The tax authorities, namely the MoF and the IRD have always cooperated with BNM and SC to ensure that, in a worse-case scenario, there will be tax neutrality between what has to be paid under an IBF transaction and what would be paid under a conventional financial transaction. In certain best-case scenarios, special tax incentives including remittance and rebate are given to encourage the use of IBF structures by market players.

(iii) Certainty and predictability of dispute resolution outcomes

By virtue of the common law system inherited from the

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Table 1: List of Law and Regulations for Conventional and IBF Products/System in Malaysia
British colonialists, the Malaysian courts apply the doctrine of judicial precedent and publicly report landmark decisions, thereby facilitating the development of certainty and predictability of dispute resolution outcomes for IBF cases.

The Reciprocal Enforcement of Foreign Judgments Act (1958) generally recognises the decisions made in courts of other common law jurisdictions such as the UK, Hong Kong, Singapore, thereby providing clarity on the enforceability of judgments obtained from the courts in these jurisdictions, even when it comes to IBF disputes. It also has a clear insolvency regime that permits speedy debt recovery and liquidation of assets, including for IBF institutions.

To add further depth to these capabilities, the Kuala Lumpur Regional Centre for Arbitration (KLRCA) provides a convenient alternative dispute resolution platform by having a specific rule to govern disputes involving IBF matters. The Rules for Arbitration (Islamic Banking and Financial Services) 2007 was specially drafted to provide a customised platform and mechanism for the resolution of disputes in the Islamic financial services sector.

(iv) Talent enrichment and thought leadership infrastructures

Central to its ambition to be a preferred international Islamic financial centre, Malaysia appreciates the importance of ensuring that its IBF sector is supported by a sizeable pool of competent human capital. It has established numerous unique institutions dedicated to talent enrichment and thought leadership, including:

19.4.2 2001 - Islamic Banking and Finance Institute Malaysia (IBFIM)

This institution is truly unique. It is owned by IBF institutions and its primary role is to provide training and consultancy. It focuses on programmes related to IBF and ICM. IBFIM’s mandate can be best described by referring to the FSMP where it mentions about IBFIM, “to increase the pool of bankers and takaful operators who are knowledgeable and competent, efforts will be directed to promote human capital development to support the envisaged growth of the industry via establishing an industry-owned institution on Islamic banking and finance dedicated to train and supply a sufficient pool of Islamic bankers and takaful operators as required by the industry.”

Similarly the CMMP mentions that IBFIM is “to develop local expertise to ensure the availability of a pool of skilled professionals who are well-versed in Syariah matters and are able to provide a range of relevant high quality value-added advisory and intermediation services.”

19.4.3 2003 - International Centre for Leadership in Finance (ICLIF)

Apart from providing training and consultancy, Malaysia realised that there is a need to start grooming and supplying leaders for its IBF market, especially if it wishes to see Malaysia become a world class IBF hub. Hence, a well structured development programme focusing on leadership capacity building for financial institutions and business corporations has been introduced by BNM, known as ICLIF. ICLIF is mandated to provide training and development programmes for young and intermediate leaders by offering short courses ranging from 2 to 4 weeks. The programmes offered by ICLIF are designed for specific needs, for instance, to groom middle class managers who are expected to be promoted in two years time. ICLIF is supported with resources from various prestigious institutions around the world including Harvard Business School, Stanford Graduate School of Business, Drucker School of Management, University of California Los Angeles (UCLA) and University of California at Berkeley (UC Berkeley).

19.4.4 2006 - International Centre for Education in Islamic Finance (INCEIF)

INCEIF is a global university offering expertise certification in various IBF related disciplines at post graduate level. Students enrolled to this programme come from various countries and INCEIF graduates are trained to become professionals of IBF in its programmes which are offered in three levels namely Chartered qualification, Masters and Ph.D. INCEIF received a generous grant of RM500 million from the Malaysian government to realise its vision to become the knowledge leader in Islamic finance industry.

19.4.5 2008 - International Shari’a Research Academy for Islamic Finance (ISRA)

Unlike many other institutions that focus on developing human capital, ISRA was established to enhance literature and research on Shari’a and fiqh ul muamalat. It provides an international platform to encourage discourse among Shari’a scholars, academicians, regulators and practitioners. To date, ISRA has organised many programmes and published various literature on the IBF industry.

(v) Depth and Width of its Capital Market

Following the Asian financial crisis at the end of the 1990s, the Malaysian authorities recognised that amongst the weak links within its financial system was the heavy dependence of the economy on borrowing from financial institutions to spur further growth. Since then, it has consciously developed its capital market, including the ICM, and has emerged as the largest bond market in Asia after Japan. Bonds and sukuk issued in the local currency, Ringgit (RM), has developed their market in Asia after Japan. Bonds and sukuk issued in the local currency, Ringgit (RM), has developed their own strengths and profile to enable issuers whether local or foreign, to generate capital in a cost efficient manner to the extent that the RM sukuk market is hardly affected, notwithstanding slowdowns in the sukuk market elsewhere as seen during the recent global financial crisis.

(vi) Deposit insurance protection

Malaysia is the only country in the world which has a
deposit insurance corporation that covers both conventional and Islamic deposits. The innovation made by the MDIC in this respect certainly has helped in strengthening public confidence in IBF institutions.

A word of caution

Notwithstanding its enviable merits and record of success, it should be noted that the Malaysian model is championed by a supportive and prescient government which has advocated reforms conducive to the development of Islamic finance. A heavy and dominant leadership of government authorities would be an absolute luxury for the IBF sector in most other jurisdictions. In this respect, it is not fair to compare the Malaysian model with the regulatory and supervisory approaches in other countries. It remains to be seen whether the Malaysian IBF industry can remain robust and vibrant if the government decides to take a backseat and leave the next stage of development entirely to the market.

As it has deliberately decided to adopt a ‘dual’ financial system, the IBF sector in Malaysia is also under constant pressure to remain competitive against its conventional counterpart, and hence, it remains to be seen whether the IBF players can withstand such pressure without the intervention of a helping hand from the authorities in the form of regulatory ‘green lane’ or tax incentives.

19.5 Foreseeable trends, moving forward

Law Harmonisation Committee

BNM has established a Harmonisation of Law Committee, chaired by the highly respected former Chief Justice of the Federal Court of Malaysia, Tun Abdul Hamid Mohamad. The Committee is established with the following objectives:

- To create a conducive legal system that facilitates and supports the development of the Islamic finance industry;
- To achieve certainty and enforceability in the Malaysian laws in regard to Islamic finance contracts;
- To position Malaysia as the reference law for international Islamic finance transactions and;
- For Malaysian laws to be the law of choice and the forum for settlement of disputes for cross border Islamic financial transactions.

It is observed that all this while English law has been the preferred law of reference for international Islamic finance transactions, therefore the objective of the Committee is arguably very ambitious. Considering that English law has a long tradition of being the reference law for international contracts and English courts command enormous respect in the international arena for its impartiality and independence, there are many reasons for people to be sceptical. However, if we consider that Malaysia is simply offering a value proposition whereby parties to an international Islamic finance contracts are comfortable that:

- The jurisdiction is neutral and impartial to all parties in the contract;
- The Malaysian law offers absolute certainty and predictability with regard to Shari’a issues, as the NSAC is the final arbiter on such matter – which no other jurisdictions can offer;
- The Malaysian courts and arbitration centre are competent in dealing with disputes arising from IBF contracts; then there is no reason to reject the possibility of making Malaysian law as the reference law for IBF contracts.

19.5.1 Initiatives to govern the Shari’a scholar profession

ISRA has announced its plan to come up with the first global certification for Shari’a scholars, seeking to bolster the industry’s reputation and make it easier for banks to find qualified advisers. As it is, the Shari’a-compliance and governance framework in Malaysia is already highly regulated compared to anywhere else in the world, with the BNM and SC each issuing specific guidelines on the appointment of members of Shari’a Committee and imposing various fit and proper requirements comparable to any other regulated professions that serve the financial services industry such as directors and auditors. Through its annual Muzakarah Cendekiawan Shari’a Nusantara (Regional Shari’a Scholars Symposium), ISRA is progressively building consensus amongst scholars in the South East Asia region. If they manage to build on this and expand the scope and strength of the dialogue platform to other parts of the world, especially in the Middle East and Africa, there is a higher possibility for this initiative to transform into a more globally accepted professional association of Shari’a scholars that can provide a recognised certification and governance regime for this important group of gatekeepers in the IBF industry.

While it is well acknowledged that the Shari’a profession is largely fragmented into various schools of thoughts and in this respect remains an obstacle to bringing standardization of Shari’a best practices for the global IBF industry, ISRA has the appropriate government backing and a strong team that have so far done well in establishing its stature in the international arena. Hence, there are reasons to be optimistic that it can contribute positively towards establishing a better set up for the Shari’a scholar profession in the future.

19.6 Conclusion

Malaysia has shown that with proper planning and effective strategies, it has managed to overcome many challenges in developing its IBF industry, including withstanding two devastating periods of financial crisis. It has undertaken thoughtful and carefully calculated proactive as well as reactive steps in bringing IBF as a value proposition at the global stage. Its ability to es-
establish cutting-edge regulatory and supervisory framework that caters to local needs but meets emerging international demands is certainly commendable. If there are reflections that can be summarised from its long arduous journey to establish itself as a leading Islamic financial centre, it is that Malaysia has been continuously learning and adapting its regulatory and supervisory approaches to the challenges faced, and innovating expeditiously throughout the different phases of its IBF development.
Chapter 20

The Bahrain model

20.1 Introduction

Bahrain is central to the development of further regulations for the Islamic finance industry. As the global Islamic financial services industry gains momentum both in terms of confidence and recovery in a global economy that is still coming to terms with the effects of the credit crunch and financial crisis, the 7th IFSB Annual Summit was held in May 2010 at the Ritz-Carlton Hotel in Bahrain under the patronage of the Central Bank of Bahrain (CBB). The event attracted widespread interest from regulators and market participants from various parts of the world, including countries that attended the Summit for the first time. The CBB was the first financial regulatory authority to allow the Islamic window concept, where conventional banks are allowed to carry on Islamic banking business using their existing infrastructure, and Bahrain was the first country to develop and implement regulations specific to the Islamic banking industry.

20.2 The Central Bank of Bahrain

The Islamic finance sector is supervised by the CBB, which since 2002 has functioned as the single regulator for the entire financial system. This enables businesses in Bahrain to operate throughout the Kingdom with no ‘free zone’ restrictions.

The CBB is internationally recognised as the most successful monetary authority in the Arab world in terms of regulation, innovation, non-discriminatory treatment, licence management, and operational efficiency, whose regulations have created a business friendly environment to international standards.

The CBB was the first to make the AAOIFI standards mandatory for all Islamic institutions. The CBB also has rules covering capitalisation, risk management, financial crime and disclosure and is pushing to train Shari’a scholars to aid industry growth.

Bahrain has rapidly become a global leader in Islamic finance, playing host to the largest concentration of Islamic financial institutions in the Middle East. In addition, Bahrain is at the forefront in the market for Islamic securities (sukuk), including short-term government sukuk as well as leasing securities. The CBB has played a leading role in the introduction of these innovative products.

The CBB has installed a comprehensive prudential and reporting framework, tailor-made for the specific concepts and needs of Islamic banking and insurance. The CBB Rulebook covers areas such as licensing requirements, capital adequacy, risk management, business conduct, financial crime and disclosure/reporting requirements in relation to Islamic banks. Similarly, the specific features of takaful and retakaful firms are assessed in the insurance rulebook. Both rulebooks were amongst the first comprehensive regulatory frameworks in the Middle East that sought to regulate the Islamic finance industry.

20.2.1 Other regulators

In addition to the numerous IFIs active in its financial sector, Bahrain also plays host to a number of organisations central to the development of Islamic finance, including the AAOIFI; the Liquidity Management Centre (LMC); the International Islamic Financial Market (IIFM); and the Islamic International Rating Agency (IIRA).

There are five principal pieces of legislation which govern the financial system of Bahrain namely the Central...

20.2.2 The sector continues to grow strongly

Bahrain’s banking sector comprises both conventional and Islamic banking and is the largest segment within the Kingdom’s finance sector. Banks provide professional services and products to retail, wholesale and private wealth clients. Several locally incorporated banks have either branches or subsidiaries in other countries throughout the Middle East, Far East, Africa, Europe and the USA.

There is a growing need for venture capital and other sources of innovative financing to encourage and respond to the rise in entrepreneurs. The increase in private wealth has fuelled demand for private and retail banking services as more personal wealth remains in the region, an affluent middle class continues to grow, and customer needs become ever more sophisticated.

20.3 Islamic financing structures - regulatory aspects

Due to the nature of Islamic banking transactions, Islamic banks, as opposed to their conventional counterparts, are additionally exposed to price risk in their banking book. The CBB recognizes that such risks need to be identified and measured for regulatory capital purposes.

Islamic banks are therefore subject to different capital adequacy and disclosure requirements from conventional banks.

20.3.1 Capital Adequacy

The CBB’s Capital Adequacy Module (CA)\(^5\) sets out regulations and provides guidance on the risk measurement for the calculation of capital requirements for all Islamic bank licensees. These requirements vary according to the category of Islamic bank licensee concerned, their inherent risk profile, and the volume and type of business undertaken.

The purpose of such requirements is to ensure that Islamic bank licensees hold sufficient capital to provide some protection against unexpected losses, and otherwise allow conventional banks to effect an orderly wind-down of their operations, without loss to their depositors.

Although, the CA’s regulations are consistent in all substantial respects with the approach recommended by the Basel Committee on Banking Supervision and IFSB for capital adequacy, the CBB recognises that the Basel Committee guidelines may not address specific characteristics of the various products and services offered by Islamic banks. Therefore, the CBB has adopted a risk-based approach and has tailored the regulations to address the specific risk characteristics of Islamic banks.

(a) Capital Adequacy Ratio (CAR)

Under CA’s regulations, all locally incorporated banks are required to maintain a CAR (both on a solo and a consolidated basis where applicable) above the minimum “trigger” CAR of 8 %. Any breach of the minimum trigger CAR of 8 % will subject the bank to a formal licensing reappraisal by the CBB.

For Islamic banks, CAR is calculated by applying the regulatory capital to the numerator and risk-weighted assets (RWAs)\(^6\), credit risk, market risk, operational risk (plus other factors such as unrestricted Profit Sharing Investment Accounts (PSIA)) to the denominator\(^6\).

Islamic banks are not contractually obliged to make good losses arising from Islamic financing assets funded by investment accounts.\(^7\) However, to be prudent, the CBB requires Islamic banks to provide regulatory capital to cover minimum requirement arising from 30 % of the RWAs and contingencies financed by the unrestricted investment accounts. Therefore, for the purpose of calculating its CAR, the RWAs of an Islamic bank consist of the sum of the RWAs financed by the Islamic bank’s own capital and liabilities, plus 30 % of the RWAs financed by the Islamic bank’s unrestricted PSIA. This is to account for the additional risk potentially arising from Islamic financings in unrestricted PSIAs.

(b) Governance and disclosure for Islamic banks

Under the CBB disclosure and governance rules,\(^8\) Islamic bank licensees are subject to additional governance requirements and disclosures to provide assurance to stakeholders that they are following Shari’a principles. In ensuring compliance with Shari’a principles, each Islamic bank licensee must establish an independent SSB consisting of at least three Shari’a scholars and complying with AAOIFI’s Governance Standards for Islamic Financial Institutions No.1 and No.2\(^9\).

All Islamic bank licensees are required to have a Corporate Governance Committee (CGC) which must comprise (in addition to independent directors) a Shari’a scholar (who is a member of the SSB) for the purpose of leading the CGC on Shari’a-related governance issues, and also to coordinate and link the complementary roles and functions of the CGC and the Shari’a Board\(^9\). In addition, all Islamic bank licensees are required to have an Audit Committee which communicates and coordinates with the CGC and the SSB to ensure that information on compliance with Shari’a rules and principles is reported in a timely manner.

20.3.2 Mudaraba

The CBB has set out contractual and capital adequacy requirements specific to mudaraba contracts to ensure that these contracts are Shari’a-compliant, that the associated risks are properly reflected in the CAR, and that such risks are properly disclosed to customers.

(a) Background and general requirements

A mudaraba is an arrangement between the bank and a customer whereby the bank contributes capital to an
enterprise or activity which is to be managed by the customer as the mudarib (labour provider). Profits generated by that enterprise or activity are shared in accordance with the terms of the mudaraba contract whilst losses are to be borne solely by the bank unless the losses are due to the mudarib’s misconduct, negligence or breach of contracted terms. Mudaraba financing can be carried out on either a “restricted basis” or an “unrestricted basis”.

(b) Minimum terms and conditions for mudaraba contracts

The CBB has set out the type of terms and conditions (mudaraba terms) which it believes Islamic banks should include, as a minimum, in such contracts (where the bank acts as mudarib).

According to the mudaraba terms, all mudaraba contracts should include (amongst other things) details relating to limits/restrictions on investments to be made by the bank, specific reference to the segregation of the contract assets from the bank’s assets, the liability of the bank for breach of contract and negligence, the liability of investment account holders (customers) being limited to their contributions under the contract, and the deduction from profits of the bank’s fees, the valuation of the contract assets and the bank’s share of profits as mudarib. It is clear that the purpose of these terms is to ensure that customers are fully aware of the risk born by them when entering into a mudaraba. Under the mudaraba terms, all Islamic bank licensees should ensure that the relevant terms and conditions are clear, concise and unambiguous, and are not intentionally misleading.

(c) Policy statement - mudaraba

Banks must have a policy statement as to the policies and procedures in place to safeguard the interest of the PSIA holders. The statement must include, amongst other things, the basis of allocation of expenses, profit or loss to the PSIA; the policy on the priority for investment of own funds and those of unrestricted investment account holders and for making provisions and reserves against assets and equity for PSIA.

(d) Capital adequacy requirements for mudaraba

As the fund provider, the bank is exposed to the risk of losing its capital investment (or capital impairment risk) upon making payment of the capital to the mudarib. Any loss on the investment is to be borne solely by the capital provider, but is limited to the amount of his capital. The CA requires that these risks of mudaraba are included in the calculation of the RWAs so that risks are properly reflected in the CAR.

20.4 Collective Investment Undertakings (CIUs) and Private Placement Memorandums (PPMs)

20.4.1 Regulation of CIUs

The activity of offering CIU holdings to investors resident in Bahrain is a regulated activity which requires the appropriate CBB licence. It is not possible to offer CIU holdings to investors resident in Bahrain on a “cross-border” basis from outside Bahrain. Where an overseas operator of a CIU wishes to offer an overseas domiciled CIU to investors resident in Bahrain, it must itself hold the appropriate CBB licence or appoint an appropriate CBB licensee as its distributor.

No person may offer holdings in a CIU unless that CIU is either authorised by, or registered with, the CBB. Where a CIU is structured as a series of separate offerings, such as an umbrella fund with a series of sub-funds, each sub-fund will require a separate authorisation or registration.

To avoid supervisory duplication, the Module CIU provides that overseas domiciled CIUs which are already approved by their ‘home’ regulator in certain recognised jurisdictions are simply required to register with the CBB, prior to being marketed in Bahrain.

20.4.2 Three classes of CIUs

(a) Retail CIUs are open to all investors and are subject to detailed regulation and supervision by the CBB. The CBB’s “New Collective Investment Undertaking Rules” provides that every Bahrain domiciled retail CIU requires the publication of a prospectus.

(b) Expert CIUs may only be offered to expert investors, which are individuals or institutions which have financial assets of at least USD 100,000. The minimum investment is set at USD 10,000 or equivalent. Expert CIUs have greater flexibility than retail CIUs. Notably, they are able to utilise higher aggregate and individual exposure limits and they may invest in a wider range of asset classes, including, amongst other things, real estate, commodities, unlisted securities and hedge funds. An expert CIU must be authorised by the CBB.

(c) Exempt CIUs may be offered only to accredited investors, which are individuals or institutions with financial assets with a value of at least USD 1,000,000. The minimum investment is USD 100,000 or equivalent. Exempt CIUs are only ‘regulated’ to the extent that they must register with the CBB prior to being offered to investors. Exempt CIUs are not subject to any restrictions on their investment policies and as a result of this, they may exhibit high risk characteristics, such as, high levels of leverage and the taking of large speculative positions. Bahrain domiciled exempt CIUs may only be offered to accredited investors when offered within the Kingdom of Bahrain. They may not be promoted through mass communication channels (such as the press, radio or television). Exempt CIUs must not quote the CBB as the regulator of the CIU and must clearly display a statement of the fact that the CIU is considered exempt for the purposes of the CBB’s CIU regulations. In addition, exempt CIUs must disclose all relevant features of the CIU in their offering documentation.

(d) Shari’a-compliant CIUs (which apply to Expert and

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14 Where the capital provider allows the mudarib to make investments subject to specified investment criteria or certain restrictions such as types of instrument, sector or country exposures.

15 Applicable to auditor and independent auditor.

16 Where the capital provider allows the mudarib to make investments subject to specified investment criteria or certain restrictions such as types of instrument, sector or country exposures.

17 Where the capital provider allows the mudarib to make investments subject to specified investment criteria or certain restrictions such as types of instrument, sector or country exposures.

18 Where the capital provider allows the mudarib to make investments subject to specified investment criteria or certain restrictions such as types of instrument, sector or country exposures.

19 The CBB’s “New Collective Investment Undertaking Regulations” provides that overseas domiciled CIUs which are already approved by their ‘home’ regulator in certain recognised jurisdictions are simply required to register with the CBB, prior to being marketed in Bahrain.

20 Where the capital provider allows the mudarib to make investments subject to specified investment criteria or certain restrictions such as types of instrument, sector or country exposures.

21 Where the capital provider allows the mudarib to make investments subject to specified investment criteria or certain restrictions such as types of instrument, sector or country exposures.

22 That of dealing in financial instruments.
Retail CIUs only) have special provisions in the Module CIU. The operator of the CIU must appoint two or more Shari’a advisers. All offering documentation must contain provisions describing the Shari’a-compliant nature of the CIU, the process for achieving such compliance and the names of the Shari’a advisers. The operator of the CIU must ensure that the operations and investments are subject to compliance reporting and monitoring by its Shari’a advisers in accordance with applicable AAOIFI standards.

(e) Overseas CIUs must provide the most recent copy of their prospectus available to the CBB within 30 calendar days of any revision. The CBB licensee responsible for distributing an overseas domiciled retail CIU or overseas domiciled expert CIU must ensure that the CIU’s prospectus (and simplified prospectus where applicable) are kept up-to-date. In addition, the CBB licensee responsible for distributing an overseas domiciled retail CIU or overseas domiciled expert CIU must provide explanations and such other information supplementary to the prospectus as may be reasonably required by a potential investor.

20.4.3 PPMs

A private placement is a private solicitation of funds which is not made available to retail investors by public offer or advertising. It is made only to “accredited investors” and/or entities whose shareholders are all “accredited investors” and/or the issuer’s or promoter’s directors, management and staff members. A PPM must be made in denominations of at least USD 100,000 or equivalent in other currencies. The solicitation is made by way of a memorandum offering of shares or subordinated debt instruments for capital raising purposes. All PPMs relating to the issue of financial instruments by licensees of the CBB on their own account (e.g. for new licensees that want to raise regulatory capital and existing licensees that want to increase their regulatory capital), must be approved by the CBB’s before they are distributed.

The PPM must contain statements relating to the suitability of investors as well as statements on risk. This means that statements to the effect that all prospective investors should make their own investigation into the offer, and consult their own advisers concerning the risks of the investment and the suitability of the financial instruments for their individual requirements should be included. In addition, there must be a statement as to the liquidity and possible lack of a public market for the financial instruments on offer.

The memorandum must outline the particular types of risks associated with the financial instruments to be issued. The list of requirements in this document is not intended to be exhaustive. Financial institutions have an obligation to ensure that all relevant financial and risk information is placed in the PPM to allow investors to make an informed decision.

Comparative summary with mudaraba

As can be concluded from the above, the requirements applicable to CIUs and PPMs in Bahrain are clearly defined by the CBB. CIUs’ prospectuses and PPMs must effectively disclose all intrinsic features and risks related to the investments in question. The requirements to issue a prospectus or PPM ensure that a certain level of disclosure is satisfied, and thereby ensures that investors are able to make an informed decision to invest or not.

The rules applicable to CIUs and PPMs differ somewhat from the requirements of mudarabas as these are less stringently regulated. Guidelines and rules exist as we have seen, but mudarabas continue to flourish in what remains a relatively flexible regulatory system that applies differing disclosure standards to conventional CIUs.

20.5 Takaful

20.5.1 Background

Takaful is the Islamic counterpart of conventional insurance and is based on concepts of mutual solidarity and financial aid whereby a group of participants agree among themselves to support one another jointly for the losses arising from specified risk. Most Islamic scholars agree that takaful, which is based on the concept of ta’awun (i.e. mutual assistance), is fully consistent with Shari’a law.

20.5.2 Takaful Models

(a) “Wakala” Model: the operator is the agent of the participants, and is entitled to a fee which is deducted from the contributions made by the participants into a general takaful fund or the investment profits derived from investing the general takaful fund and which may be performance-related.

(b) “Mudaraba” Model: the operator is entitled to a fixed %age of any investment profits or surplus, which will be paid into the participants’ takaful fund.

(c) “Mixed” Model: the wakala contract is adopted for underwriting activities, while the mudaraba contract is employed for the investment activities of the takaful fund.

20.5.3 Regulation in Bahrain

(a) The CBB’s Takaful Module (TA) sets out regulations and requirements on takaful relating to principles of business, capital adequacy, disclosure, management, systems and control. Most of the CBB’s laws and regulations on takaful apply in full to conventional insurance firms (some special rules relating to disclosure and capital adequacy apply only to takaful firms):

(i) Conduct of Business: The CBB has adopted international standards of regulation and its principles of business apply to both insurance and takaful firms. These rules are similar to the ones applied in the UK. In the UK, for instance, the Insurance Conduct of Business rules require (amongst other things) that all insurance/takaful firms observe proper standards of market conduct and high standards of integrity, act with due skill, care and
diligence, ensure transparency, and maintain adequate resources to run the business.39

The takaful firms are additionally required to disclose clearly to participants and shareholders information about the performance of their business, plus other details relating to wakala/mudaraba fees paid to the takaful operator. As a minimum, this information is required to comply with relevant AAQIIF standards.41

(ii) Capital adequacy

The capital framework laid out by the CBB for Takaful operators maintains that all takaful funds are subject to available capital and solvency requirements equivalent to their conventional counterparts. Each takaful fund must maintain and calculate its solvency requirements as if each were a separate licensed insurance firm.32

Takaful firms must maintain separate books of account in respect of each type of business and for each fund. The Wakala fee charged for a takaful contract must be directly proportional to the costs associated with establishing and maintaining that contract.33

In instances where the takaful fund’s available capital fails to meet the required solvency requirements,44 the shareholder fund must provide a loan to the takaful fund in order for the deficient fund to meet its solvency requirements. Any loan from the shareholder fund will present an additional risk to the shareholders of the takaful operator. Due to this additional risk, the minimum the takaful operator must include is a specific note in its financial statements explaining the arrangements and their implications to shareholders.35

(iii) Shari’a Supervisory Board

Each takaful firm is required to have a SSB, whose duty is to direct, review and supervise the activities of the firm in order to ensure that they are in compliance with Shari’a rules and principles. The same provisions exist in the newly enacted UAE takaful law (the UAE Takaful Law), which substantially reflect the Shari’a Standards recommended by AAQIIF standards, and reflect an additional layer of corporate governance that Takaful operators will need to satisfy.36

(iv) Governance Committee

One of the major regulatory issues relating to takaful is the potential conflicts of interest arising between the shareholders and participants of the takaful fund.37 The IFSB has recently issued a governance paper on this aspect suggesting the creation of a “Governance Committee” to look after the interests of the participants and ensure that they are fairly treated. Similar rules apply under the CBB to both insurance and takaful firms (though not dealing specifically with the issue of the takaful-related conflicts of interest) requiring insurance and takaful firms to treat all policyholders and shareholders fairly and act with honesty, integrity and in the best interests of all policyholders and shareholders.38

(v) Analysis

Although the CBB does not propose to establish rules as to what constitutes a takaful product, as this is a matter for each firm’s SSB, the CBB has an obligation to ensure that consumers of takaful products are afforded the same level of protection as that afforded to the purchasers of conventional insurance products. In addition, the CBB has an obligation to ensure that the operations of takaful firms do not represent a threat to the stability of Bahrain’s financial services industry or wider economy. This explains the reason why most of the rules under the CBB are applicable to both insurance and takaful firms. As the CBB governs both insurance and takaful firms under the same regulatory regime (which does not favour one over the other), companies from both fields have been able to conduct their businesses in a fair and competitive environment.

The CBB implemented special requirements for takaful (in relation to solvency requirements, business conduct and disclosure) to provide protection for participants against the additional risk associated with takaful products and ensure that such products are Shari’a-compliant. International standards of insurance regulation, such as conduct of business, capital adequacy, management, systems and control apply to all insurance and takaful firms in Bahrain. Despite this, the following issues should be considered:

(A) Challenges for the takaful industry

A big challenge for takaful operators, particularly in Bahrain where both insurance and takaful firms operate in competitive environment, is that they compete on a global basis with conventional international insurance firms. Low entry barriers, which encourage new players, may raise the standards of insurance and takaful offerings in the market, but at the same time increases competition. The advantage conventional insurance has is the huge resources that they have and their brand strength that provides assurance to potential clients.

(B) Adopting the “National Shari’a Supervisory Board”

As the CBB does not advise on what constitutes a takaful product (it is the duty of the Shari’a Supervisory Board), adopting a supreme supervisory body like the National Shari’a Supervisory Board under the UAE Takaful Law may be pivotal. This law established the Supreme Committee for Fatwa and Shari’a supervision (Supreme Committee), a national Shari’a board for the takaful industry whose job is to issue fatwas on takaful and investment issues for the takaful industry and to classify and explain fatwas and opinions relating to takaful issued by the SSBs of the takaful operators. The Supreme Committee has a supervisory role on the takaful industry as a whole and has the power to investigate the Shari’a-compliance of takaful operators and to require them to adjust their operations in the event that issues are identified. This will ensure consistency and clarity as to the Shari’a requirements of takaful, which is to the benefit of the takaful industry as a whole.

33 Similar rules apply to Takaful firms under the CBB rules; CA-8
34 All Bahraini insurance licenses require the CBB’s approval for the distribution of dividends to shareholders; CA-8
35 This requirement is specific to Takaful firms, CA-8
36 Such a loan from the shareholder fund to the Takaful fund must be pre-approved by the CBB as well as ensuring that the loan represents capital meeting the permanence and quality requirements outlined in the capital adequacy rules of the CBB; CA-8
37 Resolution No. 4 of 2010 of The UAE Insurance Authority Board
38 TA-1.1.7
39 The takaful funds belong to the participants and not the takaful operator; the takaful operator will be remunerated, whether in the form of a Wakala fee or an investment profit share, for managing the underwriting investment activities of the takaful funds
40 The primary objective of the Governance Committee would be to find an appropriate balance in addressing the interests of all stakeholders (i.e. shareholders and participants), while giving special attention to the interests of the Takaful participants who are largely underrepresented and lack adequate access to information (Islamic Financial Services Board, Guiding Principles on Governance for Takaful (Islamic Insurance) Undertakings, December 2009)
41 Modules HCI.1.1.10 and HCI.1.1.11
42 It is not permitted for a scholar who is a member of the Supreme Committee to also be a member of any Shari’a Supervisory Board of any UAE takaful operator
CHAPTER 21
The DFSA model

Oh, East is East and West is West, and never the twain shall meet,
Till Earth and Sky stand presently at God’s great Judgment Seat;
But there is neither East nor West, Border, nor Breed, nor Birth,
When two strong men stand face to face, tho’ they come from the ends of the earth!

21.1 Introduction

Rudyard Kipling’s poem, A Ballad of East and West (1895), is sometimes mistakenly cited as an example of irreconcilable differences between two worlds. Indeed, if one reads only the opening line of the oft repeated verse quoted above, it is easy to see how the misunderstanding can occur. The reality is rather different as in this verse Kipling is in fact discussing egalitarianism and reconciliation. This is perhaps a good metaphor for describing the DFSA approach to the regulation of Islamic finance as it has sought to create a level playing field able to combine conventional finance with Islamic finance as well as introducing a flexible Islamic finance regime accommodating both liberal and conservative scholarly opinions.

A core element of any financial services market is the authority of its legal and regulatory environment. With the recent global financial crisis leading towards greater convergence and dialogue amongst regulators, the approach of the DFSA towards both conventional and Islamic finance markets has always been to adopt a pragmatic approach to the development of the DIFC as a new capital market.

The DIFC is an onshore financial free zone in the Emirate of Dubai, part of the United Arab Emirates (UAE), with no local partner requirements. Comprising 110 acres, the DIFC has its own legal and regulatory system,
based on English common law, including having its own civil and commercial courts, and its own financial services regulator, the DFSA. The character of the Centre is international and, largely, a wholesale one, although retail business is allowed. This means that most customers of DIFC firms will be either other businesses or professionals and high net worth individuals. Some issues concerning the retail market will therefore be less important for us; for example, it is difficult to see the DIFC becoming a centre for Islamic microfinance. On the other hand, as an international onshore centre, it has businesses from many countries operating within. DIFC offers these businesses an international framework through which they are regulated and is not tailored to the needs of a specific national market. The federal law under which the DIFC is established provides that within the Centre the normal civil and commercial laws of the UAE do not apply. That means that the DIFC has had to create its own legal regime (including, for example, Companies Law, Data Protection Law and Employment Law), and of course its own laws and rules for financial services. The significance of this is that they have created an idiosyncratic approach to regulating Islamic finance using a blank sheet of paper. This has given the DIFC an advantage in creating a regime that welcomes all types of Shari’a interpretation – be it liberal or conservative.

21.2 Crossroads between East and West

Dubai sits in the enviable position of spanning Eastern and Western time zones and the DIFC has been engineered to fill the gap between Europe and Asia – not just for the benefit of time zones but also the

DFSA Rulemaking and Policy Development

NASDAQ Dubai

DME

Listing Rules
Business Rules

DIFC COURT

DFSA

Rulebook Modules:
General (GEN)
Authorisation (AUT)
Supervision (SUP)
Enforcement (ENF)
Conduct of Business (COB)
Prudential Insurance (PIN)
Prudential - Investment, Insurance Intermediation & Banking (PIB)
Anti Money Laundering (AML)
Islamic Financial Business (ISF)
Collective Investment Rules (CIR)
Ancillary Service Providers (ASP)
Offered Securities Rules (OSR)
Authorised Market Institution (AMI)
Recognised Bodies & Recognised Members (REC)
Price Stabilisation (PRS)
Takeover Rules (TKO)
Glossary (GLO)
Prudential Returns (PRLU)
cultural and practical benefits of acting as a bridge between conventional finance and Islamic finance, as well as bridging the divisions that exist amongst different scholarly opinions within Islamic finance. Its range and scope extends far beyond its 110 physical acres and this is one of its core attractions as an emerging centre for Islamic finance.

21.3 The three pillars of the DIFC

The DIFC has three core parts – the DIFC Authority which provides overall direction for the development and marketing of the DIFC. The DIFC Courts which offer the DIFC’s its own civil and commercial court system – effectively making the DIFC a quasi “state” within a state, albeit still subject to the criminal law of the UAE and lacking any form of sovereignty. And finally there is the DFSA.

As an integrated regulator, the DFSA regime is based on international best practice and is applied uniformly across all firms, including Islamic firms, using a risk based approach. There is no scope for regulatory arbitrage between conventional and Islamic firms in the DIFC. As a risk based regulator, the DFSA focuses on the specific risk posed by the firm. Consequently laws, rules and supervisory practices are formulated to take consideration of the actual risks posed by the business in question. A corollary of this is that similar risks should be treated the same. So where the risks in Islamic and conventional finance really are similar, then the same rules should apply. But of course a regulator needs substantial knowledge of Islamic finance to know when the risks are similar, and where they are subtly different. The DFSA have had to modify the integrated, international standards in order to reflect the specifics of Islamic finance which are not ordinarily accommodated within international standards. Underpinning all this is the DFSA Shari’a systems philosophy, whereby it prescribes the obligation for a firm to have systems and controls in place to ensure that the business is operating in accordance with Shari’a.

21.4 Significant features

Turning to the significant features of the regulatory regime, the DFSA is an independent integrated regulatory authority based on the UK’s FSA model. It has statutory authority with guaranteed operational independence and funding. Its regulatory approach is based on international standards, best practices and the laws of the world’s leading financial jurisdictions. The DFSA has modeled their regime using the principles and standards of the following sources – IOSCO, Basel, IAIS (DFS...
hosted the IAGS annual conference and triennial meeting in 2010, FATF and from an Islamic perspective the standards of the AAOIFI and the IFSB. Active members of both bodies sit on various DFSA committees, informing opinion and helping to shape the standards as well as to implement them. But business models in Islamic finance continue to evolve rapidly, with new standards being created year by year. There are still important gaps which need to be filled.

21.5 Level-playing field

Our DFSA’s cross-sectoral approach to regulation has many benefits and is key to its practical approach to Islamic financial services regulation. The cornerstone of the regime is risk-focused. They have intentionally sought to create a level playing field by applying the same set of regulations, subject to due modification, to all authorised firms regulated in the DIFC, irrespective of whether or not they are conventional firms, Islamic firms or conventional firms housing Islamic windows. 11% of the total population of firms are Islamic of which 5% are full fledged Islamic firms and 6% are Islamic windows. The DFSA have the advantage of not having to modify legislation, or ‘bolt on’ Islamic finance to an established conventional financial system. This structure provides a sound basis to address the specific features of capital markets regulation, including Shari’a-compliant capital markets products.

21.6 Fundamental approach

One challenge which is often associated with Islamic finance, is the lack of standardisation. This is a consequence of inconsistencies in respect of laws and regulations of the market within which Islamic finance operates and the issues which may arise as a result of the incorporation of Islamic and conventional finance into the same capital market framework. There is also the ongoing issue of the lack of commonality of Shari’a contracts and rulings. Indeed, it is this very inconsistency that has led DFSA to adopt a Shari’a systems’ based approach to the regulation of Islamic finance, using a facilitating regulatory framework. This has been achieved by creating clearly defined, international regulatory parameters within the DIFC which is conducive not only to the cross-sectoral features of Islamic finance, but the pace of innovation in this industry.

The DFSA’s pragmatic approach in respect of regulating Islamic finance is to provide an integrated regulatory framework with due modification to reflect the specifics of Islamic finance. Fundamental decisions were made early on to allow a great deal of flexibility. There are specific categories covering both pure Islamic firms – acknowledging this defined market, as well as Islamic windows. Contract forms that must be used for particular types of transaction are not prescribed by the DFSA. However, the regime is flexible enough to allow the use of Islamic windows – effectively providing conventional financial houses with the flexibility of combining the best of both worlds – perhaps the best example of east meeting west.

21.7 Shari’a governance

The most important decision was on Shari’a governance. Although there are regulators in some countries who believe they should play no part in anything with a religious dimension, when a firm or product claims to be Islamic, that is a very significant claim it makes to its customers. Other regulators make themselves the arbiters of Shari’a matters, typically by establishing their own Shari’a Council as the effective authority within their area of responsibility. That has the advantage of securing uniform interpretation locally, but in a world where there is no overall consensus – and if there were, a Shari’a Council would probably not be necessary – it does risk solidifying divisions along national lines.

21.8 Shari’a systems regulator

In a centre where both firms and customers are international, DFSA decided to be a Shari’a systems regulator. This means that any firm that claims to be Islamic must have a SSB made up of competent scholars. It must have systems and controls to implement the SSB’s rulings, and must have annual Shari’a reviews and audits, following AAOIFI standards. It must also disclose details of its SSB to its customers, allowing them to make their own decisions about the reliance they are prepared to place on its rulings. As an active regulator whose staff are well-experienced in evaluating systems and controls, DFSA supervises to ensure that these arrangements are working in practice as well as on paper.

We believe, incidentally, that this is a model well-suited to many Muslim-minority jurisdictions, where regulators would balk at arbitrating on religious matters, because it places the onus of compliance on the firm, and transforms the problem into one of systems and controls.

21.9 Prudential requirements

The next question that needed to be considered was the prudential regime for Islamic firms, particularly how much capital they need to hold. For Islamic banks, standards were drafted utilising those of the IFSB. In particular, the DFSA pay close attention to the concepts of Displaced Commercial Risk (DCR) for Profit Sharing Investment Accounts (PSIAs).

In principle, PSIAs are investment accounts, in which the investors bear risk to both principal and return. In practice, they are often offered as an alternative to a conventional interest-bearing deposit account, and it is not always clear that bank customers understand the risks to which in principle they are exposed. Even if they do, many PSIAs share the basic problem of banking maturity transformation. Fundamentally, the customers can withdraw their money faster than the bank can recover its loans or realise its investments. This creates pressure...
on the bank to maintain returns at market-competitive rates, even where it is not obliged to do so – so-called Displaced Commercial Risk (DCR).

The IFSB standards this through a variable parameter (\( \alpha \)), which allows regulators to set a capital requirement for PSIAs at any level up to that which would be applicable to deposits, and on a similar basis of calculation. DFSA sets \( \alpha \) at 35%, reflecting the relatively sophisticated market previously mentioned. IFSB standards have been used to give guidance on the treatment of Islamic instruments, even where they are held by conventional firms.

The DFSA supervises five prudential categories of Authorised Firm, which are shown in the diagram below. Category 5 represents Islamic financial institutions which are banks managing PSIAs; however, the regime is flexible enough to allow firms to carry on categories of financial activity elsewhere so long as they have the permission to do so either exclusively as an Islamic financial institution, or as an Islamic window, which will appear as an endorsement on the firm’s license (nb: category 1 will allow an Islamic window, but an exclusively Islamic bank managing a PSIA must seek a Category 5 License).

### 21.10 Takaful

For takaful, although the DFSA included provisions on the treatment of Islamic instruments and zakat, when it drafted its regime no international standards were available. At that time, the business models of takaful companies had not yet settled into a clear pattern. However, the DFSA have extensive powers to waive or modify its own rules in particular cases, and have used them to recognise properly the typical structure of a modern takaful company, which involves one or more pools of money which are considered to belong to policyholders within a shareholder company. In this area, the IFSB has issued a draft standard. This is aligned with the standards for conventional insurance which are emerging from the IAIS.

### 21.11 Disclosure

The DFSA requires the same degree of disclosure for Islamic transactions as required for conventional products. Transparency and disclosure is an obligation on all authorised firms. This means that a firm must provide details of the Shari’a Supervisory Board (SSB) as well as details of any subsequent changes to the board that has undertaken the Shari’a review. In addition, a copy of their annual report must be provided to the board of the Authorised Firm which is duty bound to pass this onto the DFSA. It is also vital that any appropriate disclosures are made vis-à-vis AAOIFI standards.

The DFSA have also implemented a set of disclosures specific to Islamic finance, in addition to those about the SSB. For example, a takaful company has to disclose the basis on which any surplus in the takaful fund will be shared; a bank managing a PSIA must disclose how profit is allocated between the bank and the client. Again, these disclosures largely follow standards from the IFSB and AAOIFI. There are also specific rules for Islamic funds and for sukuk. In both cases these are reasonably straightforward, and relate mainly to Shari’a governance. In the context of sukuk, the DFSA regime prescribes regulations for the offer of sukuk; and holding sukuk as investments. In this case the prudential requirements, which are based on international standards, but duly modified for Islamic finance, will apply, including the specific risk weights prescribed for sukuk. In respect to the offer of securities, including sukuk, it is an activity to which the Markets Law 2004 and Offered Securities Module apply. For the offer of Islamic securities, the DFSA requires the following initial and ongoing disclosures to be made:

- details of the SSB that has undertaken the Shari’a review for the offer;
- the opinion of the SSB as to whether the offer is Shari’a-compliant;
- description of the underlying structure of the transaction;
- any applicable disclosures prescribed by AAOIFI Shari’a Standards;
- financial accounts be audited in accordance with...
AAOIFI or other acceptable standards

- any subsequent changes to the SSB

These requirements are found in Islamic Finance Rules, which apply to any person making an offer of securities held out as Islamic or Shari’a-compliant. There are specific requirements in the Listing Rules of NASDAQ Dubai which also apply to all types of securities that are held out as being Shari’a-compliant.

21.12 Recent rule book enhancements

The DFSA have recently restructured the rulebook to group more of the material relating to Islamic finance in one place, and have also, through its website, made available tailored Islamic finance handbooks so that firms undertaking Islamic finance business in a number of areas can see quickly all the rules that apply to them. They have made significant changes to the funds regime introducing a new type of fund, exempt funds, which can be either conventional or Islamic. Such fund structures lend themselves well to hedge funds and private equity funds. One important innovation for such funds is lifting the AAOIFI requirement to have three scholars on an SSB. Given that the fund manager would in any case have to have its own SSB of three scholars, the DFSA decided that a firm would be allowed to have single scholar for an exempt fund, given that such funds are designed only for ultra high net worth and sophisticated investors rather than retail. It was reasoned that given the scarcity of scholars, this was a pragmatic approach to take.

21.13 Mutual recognition

In 2008 the DFSA signed a mutual recognition agreement for Islamic funds with the Malaysian Securities Commission, which allows domiciled Islamic funds both in Malaysia and the DIFC to be marketed and sold in each jurisdiction. They now have 53 bilateral Memoranda of Understanding with other international regulators – the more agreement there can be between regulators then the greater prospects for growth can take place.

21.14 Future regulatory challenges

For the future, there are a number of challenges for regulators. One will be to keep up with the development of standards, both conventional and Islamic. The financial crisis has spurred the development of new standards in conventional finance, and Islamic finance will need to respond. To give just one example among many, the Basel Committee is consulting on new standards on liquidity and stress-testing. Regulators of Islamic finance will need to consider their response, and in fact the IFSB is working on standards of its own. But standards are no use unless they are implemented, and we are also seeing new international pressure for standards implementation. So any regulator will have a sustained challenge to implement new standards. In Islamic finance, the challenge will be greater because of the relative novelty and complexity of this area.

Second, regulators will need to keep up with the continuing rapid development of the business itself. New models and structures are constantly being proposed and tested in the market, and it is unclear which of them will survive. For example, the range of possible sukuk structures is enormous and their economic characteristics, and hence the regulatory risks are not necessarily specified by the principal contract involved. For example, it is possible to have a mudarabah sukuk which, economically, looks similar to a conventional debt instrument, or one which looks like a collective investment fund, or one which looks like an equity. Although in practice, most sukuk have been structured to resemble debt instruments, it is possible that future sukuk will have more elements of genuine asset, rather than counterparty risk and so need for different market disclosures. In another area, there is a constant search for short-term liquidity management instruments not based on commodity murabaha, and should a new structure become an industry standard, regulators will need to consider what risks it poses.

Third, as the whole industry grows, it faces the challenge on how to deliver Shari’a governance. There are at least two sets of issues here. One is that in an industry with more firms, and larger firms, a governance regime in which an SSB has to sign off on each new structure, transaction or product implies a requirement for more scholars, while the training and development of new scholars itself is a long process. The second, related set of issues is that the existing governance and review standards were drafted with mainly Islamic banks in mind. But the industry now has a wide variety of firms and for the intermediary sector – brokers, advisers, etc – which is generally characterised by smaller firm sizes, the full burden of the standard Shari’a governance structures may impose transaction costs which inhibit the ability to compete with the conventional industry, and which may not be justified by the volume and complexity of the Shari’a decisions that need to be made. Most likely, these problems will not be solved by one method alone. We are already seeing changes in the Shari’a advisory industry, whose effect is both to shift some of the burden away from the most senior scholars and to provide a better development path for new scholars. Another means is the development of industry standards to reduce the need for individual transaction approvals. Standard documentation structures are one example, but standard Shari’a screens for equity investments are another. A third may be the development of new governance standards and the DFSA is actively working with AAOIFI on this issue. Regulators will have their part to play in these developments, which will be essential if the industry is to grow at anything like its recent speed.

Islamic finance continues to evolve and its ability to adapt and innovate will continue to drive the need for a practical response from regulators. The DFSA believes that its facilitative infrastructure and its use of Islamic windows to bridge the gap between the...
conventional and the Islamic provides a helpful and flexible approach to the regulation of this growing industry. The DIFC has some unique advantages as a centre for Islamic finance, spanning as it does both east and west.
CHAPTER 22

The UK model

22.1 Introduction

The types of changes required to financial and legal infrastructures to facilitate Islamic modes of finance may seem relatively simple but in reality they are often complex and have to be undertaken with sensitivity and awareness of political and commercial issues. The experience of the United Kingdom is one that may offer insights and guidance to other countries contemplating how to go about making the sort of legal, fiscal and regulatory changes necessary to facilitate Islamic finance. In certain respects, the case can now be made that Islamic modes of finance are often more feasible in the United Kingdom than they are in many Muslim-majority states because of the advances that have been implemented.

In this chapter we shall look at certain aspects of this development in the United Kingdom, since they may well shed light on the types of changes that could usefully be made in other countries (whether they are secular or Muslim-majority).

22.2 Segregation

The issue of segregation is an interesting one. So far as pure IFI’s are concerned, the question of whether they need to segregate their business lines and the sources of funds they deploy to conduct Islamic financial activity should not be a factor from a constitutional or regulatory perspective. In reality, the fact that some IFI’s have partially funded their activities by entering into Shari’a-compliant inter-bank arrangements with conventional banking syndicates is something that they may have to address in the longer term. In the recent past such activity has been and in the medium term, will continue to be a feature of IFI funding. Clearly, an IFI that funds itself in this manner, together with its independent SSB, has to be satisfied that such activity is permissible. Their approach to this may simply be that the form of contract generally used to raise the funding involved (i.e. commodity murabaha on a tawarruq basis) is an acceptable activity and/or the funding requirement, combined with the purpose to which the cash raised will be deployed, are sufficiently important for the Muslim community and the parties involved that they should be considered permissible.

So far as Islamic windows are concerned, the issue is one that potentially has to be treated more sensitively. At the moment, conventional firms participate in Islamic financial activities under a variety of different legal models. Some have established separate legal entities through which they conduct or ‘book’ most of their Islamic financial activity. Others simply conduct their business through existing legal entities but may have a brand name under which their Islamic products are marketed.

As indicated by the previous paragraph, even IFI’s may not have sufficient resources, whether through deposits or equity to fund their activities from Islamic sources, or they may wish to secure a source of funding that is less expensive than equity. The majority of Islamic windows will similarly have insufficient (if any) Islamic resources to support their activities and invariably funding will be provided from the bank’s general treasury.

At the present time, there is no universal requirement that suggests Islamic financial products can only be provided by IFI’s (as opposed to by Islamic windows) or that Islamic windows must take the form of fully segregated businesses. Similarly, it is not generally a legal or regulatory stipulation that the resources used to fund such activities should be Shari’a-compliant. Such limited guidance as is available can be found in AAOIFI Financial Accounting Standard No 18 (Islamic Financial Services Offered by Conventional Financial Institutions). This Standard does state that the Islamic window should
appoint a Shari’a Supervisory Board and also encourages greater disclosure about how the Islamic window treats funds, rather than setting any prescriptive rules, but these recommendations are not mandatory.

It is the case that where Islamic windows receive deposits from Muslim retail clients, the Shari’a Supervisory Board will usually impose an obligation upon the Islamic window that the funds received should not be deployed in haram activities. In the United Kingdom this has resulted in efforts to ring-fence the cash that cannot be deployed in conventional treasury activities, with a view to it only being deployed in Shari’a-compliant short term money market or investment products. This treatment must be distinguished from the well developed short term deposit business conducted through commodity murabaha where IFIs will sell commodities to conventional banks on deferred payment terms. When the conventional bank sells the commodities it has bought in the market, it is not under any obligation to deploy the purchase price it receives in a Shari’a-compliant manner. Similarly, the funds used by the conventional bank to settle the deferred sale price obligation are not required to come from halal sources. In this context, scholars accept the fungible quality of cash and what is being paid is the purchase price for commodities.

It is also worth mentioning that the segregation of funds on the liability side of a transaction is different to the treatment of funds receivable by the IFI on the asset side. Where an IFI receives income (or profit) from sources that are not wholly halal, it will be required to put such funds through a purification process. From a United Kingdom regulatory perspective, there is no requirement to do this but the Shari’a Supervisory Board will impose the conditions that it expects the IFI and/or Islamic window to adhere to in this regard.

22.3 Role of the FSA

The FSA is currently the key regulatory authority of the United Kingdom. It acts under the authority of the Financial Services and Markets Act 2000 (FSMA) which sets four statutory objectives for the FSA. They are: protecting consumers, maintaining market confidence, preventing financial crime and increasing public understanding of financial services. Under FSMA, only “authorised” or “exempt persons” (as those terms are defined in FSMA) are permitted to carry on a “regulated activity” in the United Kingdom unless there is an available exclusion or exemption. Since approximately 2002, the general approach of the FSA towards Islamic finance has been one of broad support for a developing area of innovation. This has been reiterated in several FSA publications.1

22.4 Regulated activities

The business of banking itself is not a defined regulated activity. In order for an activity to be regulated under FSMA, it must be carried on by way of business and be specified in an order made under section 22 of FSMA, the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (RAO). It is important to emphasise that the UK policy approach, as set out in FSMA, is to regulate activities rather than products. This means that a firm will not only need to consider the regulatory profile of the Islamic finance products it offers, but also whether the way in which it deploys those products would constitute carrying on a regulated activity within the meaning of FSMA, and whether it will require any permissions from the FSA to carry on these activities. This would for example, be the case if a credit institution also carries on investment product related activities such as dealing in or advising on investments.

22.4.1 Deposits

The core regulated banking activity is ‘accepting deposits’, so any institution wishing to conduct such activity must be authorised. Other examples include effecting or carrying out contracts of insurance and advising on investments. It is the definition of products being offered by Islamic firms (or by conventional firms wishing to open an ‘Islamic window’) that is critical to the authorisation process. Although the economic effect of certain products is substantially the same as conventional products, the method used to achieve that may be significantly different from a contractual and legal perspective. This means that it is important to analyse each product carefully to determine whether or not it falls within the RAO.

Definition - In many respects, the central regulatory issue that differentiates Islamic firms from conventional firms is most clearly illustrated by examining the different treatment that is accorded by the conventional banking system and the Islamic banking system to deposits. In the United Kingdom, for RAO purposes a deposit is defined as:

“a sum of money paid on terms under which it will be repaid either on demand or in circumstances agreed by the parties”

22.4.2 Debtor-creditor relationship

The definition connotes the requirement for capital certainty and in the UK conventional bank context, a deposit by a customer of cash with a regulated deposit-taking institution results in a debtor-creditor relationship. The bank is contractually obliged to return the sum deposited on demand or on such other specific date as may have been agreed (i.e. for a time deposit) and this applies to current accounts and savings accounts. The sum deposited should be returned with or without interest (again, as determined under the terms of the deposit arrangement). In any event, the principal amount deposited has to be returned in whole and the customer is only supposed to be exposed to the insolvency of the bank. This philosophy is further supported by the statutorily established Financial Services Compensation Scheme, which provides certain levels of protection for the depositor in the event of the bank’s insolvency.

22.4.3 Islamic deposit accounts

The approach described in the preceding paragraph is fundamentally different to the Islamic treatment of a deposit. Islamic financial institutions may typically offer three types of deposit account: the current account, the...
savings account and the investment account. Only in the case of the current account, where the IFI acts as a fi-
duciary, is the bank obliged to repay the sum deposited in full. However, the simple current account does not entitle the depositor to any increment on the amount deposited, so this is really a method for the safe storage of money, as opposed to saving or investing for a profit. In the case of the savings account and the investment account, because Islam proscribes the existence of riba in financial transactions and does not permit profits to be derived solely based on the time value of money, an interest bearing deposit is not feasible. A different approach is required. If a depositor expects to receive an increment on the cash he deposits with an IFI, he has to allow the IFI to use those funds in the course of its business and accept the commensurate risk that the IFI may lose all or part of the funds deposited. It is only by the assuming the risk of loss that the Islamic depositor is entitled to an increment (usually called a profit) when the funds deposited are returned.

22.5 Non regulated activities

Having said this, many of the other financial activities, transactions and operations entered into or undertaken by IFIs are functionally equivalent to their conventional counterparts and may not even be regulated activities for the purposes of the RAO. For example, the activities of leasing and money transmission are not regulated activities in the UK although they are in certain European jurisdictions (and the impending payment services directive may change this for money transmission).

22.6 No discrimination

The approach of the FSA to the growth of Islamic finance in the United Kingdom has been to create a regulatory framework which recognises the special features of Islamic finance and finds appropriate regulatory responses to them rather than simply applying solutions that have been devised for traditional Western non-Islamic banks or insurance companies. Wrapped up within this however is the idea that the users of Islamic financial products must have the ‘same degree of protection’ as the users of non-Islamic products. The FSA considers that it offers a ‘level playing field’ when dealing with applications from both conventional and Islamic firms. Whilst the FSA has stated it is happy to see the growth of Islamic firms in the United Kingdom, it has also stated that it would not be appropriate, or legally possible, to adjust its standard for one class of institutions. The approach of the FSA was summed up by Sir Howard Davies (when he was Chairman of the FSA) during a speech he made in Bahrain in September 2003 as ‘no obstacles, but no special favours’.

22.7 Depositor protection

At its simplest, the notion of a ‘depositor protection scheme’ is therefore anathema to the Islamic banking system. This is an interesting area and one where more work on the part of Islamic firms may be required as the industry develops. Some writers have suggested that it would be feasible to create Shari’a-compliant depositor protection schemes based on principles of mutual risk-sharing similar to takaful. The conventional philosophy behind a depositor protection scheme is the desire to assure depositors that their funds are ‘safe’ (up to certain agreed limits) should the bank become insolvent. From an historical perspective, this is a rational component of the fractional reserve banking system and consistent with the concept of a lender of last resort. The relatively low levels of depositor protection afforded demonstrate that it is primarily designed to protect the ‘small depositor’ or ‘consumer’, a person who is the focal point of much of the United Kingdom’s financial regulatory system and consumer protection legislation.

There is an interesting parallel in this ideology with various aspects of Islamic jurisprudential thinking. In particular, the requirement for certainty and transparency (full disclosure) under such legislation is, in many respects, similar to the Islamic prohibition against gharar (uncertainty) that also requires full disclosure of all terms and contractual certainty in commercial dealings. From an Islamic perspective however, the absolute prohibition against riba does mean that notions of caveat emptor (i.e. buyer beware) still prevail in the banking system, so the consumer is less ‘protected’ than his conventional equivalent. There is probably an argument that more work should be undertaken in this regard. Recent global events have demonstrated (in the Western world at least) that the general level of confidence in the banking system can evaporate overnight and it was only through a huge concerted effort of many governmental ‘lend-
ers of last resort’ that the crisis appears to have been prevented from deepening even further. Although the Islamic banking system does not encourage the behaviour that triggered the crisis in Western economies, it would be foolhardy to consider itself insulated or immune from the sort of potential collapse in confidence that can arise in a financial crisis. At some point in its development, particularly as the industry increases in scale, pressure may arise for the Islamic financial system to devise a scheme for the protection of depositors. In theory, this could be established on a mutual (or takaful) basis with contributions to a central fund being made by all of the participants in the system: namely, the Islamic financial institutions themselves, their customers or depositors and the State or regulator.

Threshold conditions - The FSA’s regulatory analysis starts when it is asked to authorise the establishment of a new IFI in the United Kingdom. In this process it still applies the five threshold conditions that would also be considered when looking at the establishment of a new conventional bank, as follows:

First - adequate resources - the firm must have adequate resources, both financial (capital and liquidity) and non-financial for the activities it wishes to carry on;

Second - management - for a firm incorporated in the United Kingdom, its head office and ‘mind and management’ must also be in the United Kingdom;

Third - legal status - the firm must have the correct legal status for the activities it wishes to undertake. This reflects the requirement of the European directive that
places certain limits on the legal form that firms accepting deposits or conducting insurance business must take:

Fourth - close links - the FSA must be satisfied that any ‘close links’ a firm has to another firm or person will not prevent the effective supervision of the firm; and

Fifth - fit and proper - this assessment takes into account its connections with other persons, including shareholders and employees, and the nature of the activities it wishes to undertake to consider if it will operate in a sound and prudent manner.

A flexible approach - The application of the threshold conditions is intended to be flexible so that they can be applied to a firm whatever sector it is working in. For example, the capital resources required by a bank are likely to be different to those of an insurance company, whilst those of an Islamic bank and a conventional bank are likely to be similar and would therefore be examined and applied on a similar basis.

22.8 Islamic Bank of Britain

So how has the UK gone about solving some of the issues identified above? The FSA first had to look at the definitional problems of a deposit during 2003 and 2004 when it was asked to authorise the establishment of the Islamic House of Britain. The solution at the time was a pragmatic one: the Islamic Bank of Britain resolved this problem by offering full repayment of the deposit but informing the customer how much should be repayable to comply with the risk-sharing formulation required by Shari’a principles. This approach allows customers to choose not to accept full repayment if their religious convictions dictate otherwise. Sitting behind the terms and conditions relating to deposits in which this principle was set out, was the further fact that the Articles of Association of the bank were amended to make it clear that the bank’s depositors were to be paid our before shareholders. Also established was a profit stabilisation reserve account and that would also be deployed for the benefit of the depositors. This multi-limbed solution was devised, with the approval of the FSA, for the deposits established by the Islamic Bank of Britain. The Islamic Bank of Britain was the first and remains the only retail finance bank established in the UK and operating upon wholly Islamic principles.

22.9 Regulatory capital

Under the regulatory capital regime in the UK (and the rest of Europe), there is a requirement for firms to hold capital against their “risk-weighted” assets to reflect the risks which they may be exposed to against counterparties. For these purposes, there is a complex regime to determine the calculation of the value of the assets against which capital must be held and one of the aspects of the regime is the extent to which sums owing between a bank and its counterparties may be netted against each other before calculating the value of the assets. This netting creates significant benefits for the bank if it can be achieved as it lowers the regulatory capital requirement. There are a number of requirements in order for the netting to be effective, including the key one of reciprocity between the parties under which they must both be acting in a principal capacity. In the light of this, the requirements are couched in terms of netting of mutual debits and credits and some of them refer specifically in this context to loans and deposits. The application of this analysis is an example of the difficulties of the single framework approach adopted in the UK under which Islamic products are treated under existing concepts although their application is in certain ways strained. A great deal of work has been done in this area and the FSA has, for example, accepted that obligations under a murabaha can be treated as meeting the relevant capital requirements for on balance sheet netting even it is necessary to take a purposive construction of the rules in certain respects in order to reach this conclusion. In principle, the same analysis should be applicable in relation to mudaraba-based deposit-like products but the position is much less clear in relation to a wakala-based product. This is because in certain respects, a wakala-based product has aspects of an agency type relationship built into it and it is unclear that for English law purposes it would meet the mutuality test. This is a good example of the tensions between conventional and Islamic categorisation as a number of Middle Eastern jurisdictions permit wakala-based products to be treated as on balance sheet for banks in spite of these categorisation issues.

22.10 Consumer Credit Act

Lending to individuals is subject to separate regulation as set out in the Consumer Credit Act 1974, as amended by the Consumer Credit Act 2006 (“CCA”). This regime will apply in relation to such Islamic finance products as murabaha or tawarruq facilities, when they are provided to individuals and not secured by way of a first charge over land. The regime also captures finance facilities that are secured over land by way of a second legal charge. The key element for the application of this regime is the deferral of repayment and the absence of interest is not material. The CCA regime is highly formalistic. The regulatory authority responsible for overseeing the regime is the Office of Fair Trading. Most businesses that lend money to consumers are required to be licensed by the Office of Fair Trading. The CCA applies to personal credit agreements between a creditor and an individual (which now excludes all bodies corporate and partnerships of four (4) or more persons, but continues to apply to sole traders and small partnerships). There are certain exceptions to the CCA regime (most notably, FSA-regulated first charge mortgages) and before 6 April 2008 it did not apply to loans of more than GBP 25,000. However, as of 6 April 2008, the GBP 25,000 limit was removed with the effect that all credit agreements with individuals (which includes partnerships with two (2) - three (3) partners or unincorporated bodies) will be regulated by the CCA unless subject to an exception.

There is a tension between the formulaic approach of the CCA regime (that is designed to protect consumers)
and an Islamic philosophy of risk acceptance (although on a basis that should be certain and transparent). In this regard, the higher levels of disclosure required for consumer products would seem to fit well with Islamic notions of fairness in contracts. Where difficulties can arise is in an area such as the early payment of a consumer financing product. The CCA requires early repayments to be made in accordance with a specified formula inherent in which is the calculation of an interest component over a period of time. This does not match well with Islamic requirements where riba is proscribed. In international commercial contracts the approach of the scholars has been to allow the debtor the right to request early settlement but his obligation is to repay the amount outstanding in full and rely upon the discretion of the financier to provide a rebate for early settlement. The scholars have consistently refused to allow any attempt to describe the amount to be rebated by the use of formulas. It is difficult to imagine them changing their minds about this approach even in the context of consumer products.

22.11 Shari’a-compliant or not?

Another aspect of Islamic finance that financial regulators around the world have to get to grips with is the fundamental question of whether they should have a role in deciding if a financial product is or is not Shari’a-compliant? The same issue has to be responded to in both Muslim-majority and non Muslim jurisdictions, so it is not unique. An individual who is an expert in financial regulation (whether he be a Muslim or not) may not necessarily also be an expert in Shari’a and fiqh al muamalat, so it is questionable whether a financial regulator should ever assume the ability to determine matters of Shari’a-compliance. In the UK, the FSA has repeatedly stated that it recognises the special position of the Shari’a Supervisory Board within an Islamic bank but it does not seek to regulate the composition, competencies or operation of that board or the people who comprise it. The FSA’s principal concern is whether Shari’a scholars have an executive role or an advisory role. This matters for the following reasons:

Any person acting as a director of an authorised firm must be registered under the FSA Approved Persons regime. This regime requires any director of an authorised firm to have the relevant experience. If the Shari’a scholars are seen to have a directorship role, some of them may not meet the competency and capability requirements; and on the assumption that the Shari’a scholars are directors, their role is likely to be that of an executive director, as it will involve active participation in the activities of the organisation concerned.

From the FSA’s perspective, each Islamic financial institution needs to demonstrate that the role of its Shari’a Supervisory Board is purely advisory and does not interfere with the management of the institution. Those firms that have been authorised by the FSA thus far have been able to demonstrate this. In examining SSBs, the FSA focuses on the governance structure, reporting lines, fee structure and the terms and conditions of the contract establishing the Shari’a Supervisory Board. The FSA has reiterated on several occasions that it does not wish to be a ‘religious’ regulator of, or have to supervise, Shari’a scholars and this approach in many respects correlates with the philosophy adopted by the English judiciary. Of course, the question of whether or not an individual is appropriately qualified to provide Shari’a advice to Islamic financial institutions is another topic that the industry has to deal with, but provided Shari’a scholars perform their advisory functions in an independent manner and do not cross the rubicon and start assuming executive functions they are not required to be Approved Persons.

22.11.1 Roles of Shari’a scholars

As the Islamic financial system continues to develop (in both volume of business and complexity of product), it will inevitably be the case that the demands and expectation placed on the currently limited pool of scholars will evolve. Eventually, the roles and functions that Shari’a scholars undertake will need to be better demarcated as the demand for greater levels of transparency increases (for example, so as to distinguish between the advisory function and the audit function and each of these have both an ‘internal’ and ‘independent external’ aspect to be considered). From a regulatory perspective, the question that arises is: who should determine these issues? Even in Muslim-majority countries it is not clear that leaving this to Allah will be a satisfactory answer as pressure for more transparency, certainty and standardisation continues to grow.

In a secular country such as the United Kingdom, it is extremely unlikely that it would be feasible (or appropriate) to establish any sort of similar function which, although ‘independent’, would operate under the auspices of the FSA. For the time being, it must be the case that the financial regulator cannot assume responsibility for Shari’a-compliance, all it can do is help facilitate the framework in which IFIs can operate and leave Shari’a-compliance to those more suitably qualified.

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CHAPTER 23
The Pakistan model

23.1 Introduction

Islamic finance has witnessed rapid expansion over the years and can now truly be considered a global industry both in terms of geographical spread and assets class coverage. The IFSB, estimates assets of the Islamic financial industry to reach USD 1.600 billion along with revenues of approximately USD 120 billion by 2012. Currently the Middle East and Asia are the largest Islamic financial markets while the United Kingdom, Australia, China, France, Germany, Hong Kong, Italy, Korea, Luxembourg, and Singapore are among the list of non-Muslim countries providing Islamic finance services. Islamic financial institutions have gone through major transformation, while proactively responding to market demands. Given that 22% of the world population is Muslim, even a 1% contribution by IFIs towards global financial assets and deposits depicts a significantly untapped market.

Pakistan remains at the forefront in promoting Islamic finance. Efforts in this regard can be traced back to the mid-60s, when the Banking Companies Ordinance (BCO, 1962) was amended to allow non-interest based transactions. Following this, in 1973, Article 38(F) of the constitution of Pakistan directed the elimination of riba from the country’s economic system. However, initial attempts of establishing Islamic finance as an alternative to the conventional system did not meet success. A landmark event in the evolution of Islamic finance in the country was achieved in 1980’s when banks were directed not to accept interest bearing deposits and the Modaraba Companies & Modaraba (Floatation & Control) Ordinance 1980, and Modaraba Companies and Modaraba Rules (1981) were promulgated. Financial institutions were instructed to conduct their business in line with Sharia principles. Despite being way ahead of other countries introducing Islamic finance reforms at that time, this model could not meet its objectives. This was primarily due to lack of planning for smooth transition, limitations of the proposed system to adjust to market dynamics, and apprehensions in its implementation on part of majority of the stakeholders.

In the beginning of the 1990s, the Federal Shari’a Court classified banking transactions non-Islamic and an appeal was filed before the Shari’a Appellate Bench (SAB) of Supreme Court of Pakistan (SCP). The SAB, in response to this appeal, not only directed to transform the whole system to a purely Islamic system by 30th June 2002, but also prescribed detailed guidelines for the transformation. This time round, there was a greater sense of maturity on part of all the stakeholders. The government and the central bank, the State Bank of Pakistan (SBP), have remained committed ever since the court’s decision to introduce Islamic finance reforms based on strong Sharia’ and market fundamentals. This process has also been supported by the progress made in Islamic finance internationally, providing local stakeholders an opportunity to learn from global experiences and ensuring a dynamic regulatory framework that facilitates market development.

At present, the Islamic finance industry consists of banking and non-banking institutions. The banking sector contains full-fledged Islamic banks, stand alone Islamic branches of conventional banks; while non-banking institutions include mudaraba companies, mutual funds and takaful companies etc. The (SBP) regulates the banking sector, while the non-banking sector is regulated by the Security & Exchange Commission of Pakistan (SECP).

23.2 Banking institutions

In line with the SAB of the Supreme Court of Pakistan’s instructions to transform the banking system into an...
Islamic banking mode, SBP introduced an exclusive Islamic banking policy first time in 2001. The prime focus of the policy was to develop the Islamic banking market in parallel with the conventional banking industry. Today, there is a dedicated Islamic banking department at the SBP facilitating and monitoring 5 full fledged Islamic banks (IBs) and 13 conventional banks with Islamic branches with a total network of around 700 branches across the country. Having a dedicated department for the Islamic banking industry reflects the commitment of the central bank to not only ensure Shari'a-compliance by IFIs, but to also facilitate development of the industry.

**Regulatory Framework**

The central bank has formulated the regulatory infrastructure for the Islamic banking industry on the basis of existing regulatory framework for conventional banks, while accommodating the unique characteristics of Islamic banking institutions (IBIs).

### 23.2.1 Establishment of Islamic banking institutions:

The SBP adopted a three-pronged strategy to develop the Islamic banking market at a higher pace to enhance the breadth of the overall financial industry. According to this strategy, banks were allowed to offer Islamic financial services under the following three structures:

- **Full fledged Islamic banks**

  On 1st December, 2001, State Bank of Pakistan issued detailed Criteria (Part-I strategy) for setting up of Scheduled Islamic Commercial banks based on Shari'a principles in the private sector. The criterion indicated obligatory features such as

  - the proposed bank needs to be a public limited company listed on stock exchange having 50% shares for general public offering
  - minimum paid up capital of Rs. 1000 million
  - minimum Capital Adequacy ratio (CAR) of 8% on the basis of risk weighted assets
  - sponsor directors should not be less than seven while at least 15% paid up capital should be subscribed personally by them
  - the bank needs to commence operations within six months of grant of permission and all financial transactions are required to be in accordance with the injunctions of the Shari'a

- **Islamic banking subsidiaries**

  As Part-II of the strategy, a new clause was inserted in sub-section (1) of section 23 of the Banking Companies Ordinance 1962 in November 2002 to allow the scheduled commercial banks to open subsidiaries for Shari'a-compliance operations. The detailed criterion for opening up of subsidiaries mentioned the similar criterion of paid up capital and CAR as required for full fledged Islamic banks. However, there is an additional condition of having CAMEL ratings of 1, 2 and 3 during the last three on site inspections. Islamic banking subsidiaries are allowed 49% shares for public offering compared to 50% share in case full fledged Islamic banks

- **Stand-alone Islamic banking branches (IBBs)**

**Guidelines for opening IBBs by existing commercial banks were formulated as Part-III of the strategy. The eligibility criterion for this mode mainly focused on the financial strength of the bank as is evident by capital base (net capital free of actual and potential losses), adequacy of its capital structure, record of earning capabilities, future earning prospects of the bank, managerial capabilities, bank’s liquidity position, track record of the bank’s adherence to prudential regulations, credit discipline, quality of customer services etc. Stand-alone IBBs have got the similar criterion of CAMEL ratings as for Islamic banking subsidiaries, along with the condition that there should not be any major adverse inspection findings against the bank. Banks need to identify experienced and trained key staff to handle the IBBs’ operations. Moreover, all conventional banks having Islamic banking license for IBBs should maintain a minimum Islamic banking fund of Rs 50 million as seed capital, and should also maintain a Capital Adequacy Ratio (CAR), prescribed by the SBP for banking system.

- **Statutory liquidity and cash reserve requirement**

  For Cash Reserve Requirement (CRR), the Islamic Banking Department (IBD) maintains a separate current account with the State Bank where commercial banks are required to maintain 5% of demand liabilities. However, for Statutory Liquidity Requirement (SLR) due to the lack of Shari'a-compliant approved securities, the banks can maintain 40% of their SLR in the form of cash. Therefore on a weekly basis, Islamic banks have to maintain almost 9% of demand liabilities while 8% on daily basis in the current account with the central bank.

### 23.2.2 Instructions & guidelines for Shari'a-compliance

**a) Shari'a board**

As an advisory body for the banking sector on procedures, laws and regulations pertaining to Islamic banking, a national-level Shari'a body ‘Shari'a board’ was established at SBP. The Shari'a board members consist of Islamic scholars, bankers, accountants, lawyers and experts of other relevant fields. The composition of SBP’s Shari’a board has been formulated in a way that it can guide on almost all aspects of Islamic finance regulation.

The board has a minimum of five members; at least two members are Shari’a scholars, a Chartered accountant, a lawyer, a member representing banking system and director of the Islamic Banking Department (IBD), SBP. The board is chaired by the Shari’a scholar while the IBD director, is secretary to the board.

In order to promote Shari’a-compliance in the Islamic banking industry, the central bank has issued detailed Shari’a-compliance instructions and guidelines in addition to other prudential regulations, guidelines that are
to be followed by the Islamic banking institutions, unless specifically mentioned otherwise. These instructions contain guidelines on areas like appointment, removal and working of Shari’a advisors; conflict resolution in Shari’a rulings; Shari’a-compliant modes; use of charity fund, introduction of new products and services, internal Shari’a audit, investment in shares, etc.

- **Shari’a advisor**

Apart from having a Shari’a board at SBP, each Islamic bank is required to appoint a Shari’a advisor before commencing its operations. The primary responsibility of a Shari’a advisor is to ensure the Shari’a-compliance of the products and procedures of banking. In this regard, one significant duty of the advisor is to submit a report on the basis of periodic review of the banks’ operations. These periodic reviews should have a particular focus on ensuring Shari’a-compliance and adherence to SBP regulations.

Since, the Shari’a advisor plays a central role in ensuring compliance of Islamic principles, SBP has issued a detailed ‘Fit and Proper’ criterion for his/her eligibility. This criterion lays out contemporary educational qualifications as well as experience and exposure requirements for becoming a Shari’a advisor. According to the SBP criterion, a person can work as Shari’a advisor only for one bank. Moreover, the Shari’a advisor is responsible for arranging and conducting Shari’a training programmes for staff and offering advice on any matter referred to him by the Board of Directors (BOD)/management.

- **Conflict resolution in Shari’a rulings**

In case of a conflict between the Shari’a advisor of an Islamic bank and the SBP’s Inspection staff or between other SBP departments or management of any IBI and their Shari’a advisor which remains unresolved at bank level, the case can be sent to the SBP Shari’a board. However IBIs can also use this option for issues related to Shari’a-compliance.

- **Shari’a advisors forum (SAF)**

Considering the sensitive nature of Shari’a-compliance, SBP has provided an option of a Shari’a advisor forum. In case of an Islamic banking issue of mutual/collective interests, meetings of Shari’a advisors for discussion and possible resolution can be called that can then form a sub-committee to submit its research based findings to the SBP for final resolution. The matter can also be discussed at the Shari’a board of SBP when the need arises.

- **Establishment & use of charity fund**

Islamic banking institutions have been directed to establish a charity fund; and the source of revenue for the fund is income of non-Shari’a-compliant sources or penalties and late payment charges received from clients in default or overdue cases. The charity fund amount is supposed to be utilized for social welfare purposes.

- **Introduction of new products and services**

While the central bank has provided some essential elements to be followed to develop products, banks in this regard have also been given flexibility subject to conditions like:

  - It has to be based on AAOIFI Shari’a standards if SBP has not provided any guidelines
  - Vetting by Shari’a advisor
  - IBIs are required to prepare a full set of documents including agreements, process flows, checklists and manuals pertaining to the deposit, the investment and financing products

### 23.2.3 Essentials & model agreements of Islamic modes of financing

The central bank has adopted AAOIFI Shari’a standards subject to certain clarifications and amendments to provide essential elements to be followed as minimum requirement for Shari’a-compliance while developing certain products. The central bank has provided essentials for 1) mudaraba 2) musharaka 3) diminishing musharaka 4) ijara 5) murabaha 6) musawamah 7) salam and 8) istisna. Moreover, the central bank has also developed model agreements including Murabaha Facility Agreement, Musawamah Facility Agreement, Lease Agreement, Salam Agreement, Musharaka Investment Agreement, Istsina Agreement, Agreement for Interest free Loan, Muradaba Financing Agreement and Syndication muradaba Agreement. However, banks have been given flexibility as discussed above to introduce their own products subject to certain conditions.

### 23.2.4 Shari’a standards

In order to bring standardization, harmony and to put the local industry at par with the international industry, the central bank is reviewing and customising AAOIFI Shari’a standards in a gradual manner. Up until now, the AAOIFI’s Shari’a Standards No.3 (Default in Payment by a Debtor), No.8 (Murabaha to the Purchase Order), No.9 (Ijara & Ijara Muntahia Bittamleek) and No.13 (Mudaraba) have been tailored to be adopted by IBIs in Pakistan. Moreover, to ensure the compliance of these regulations, it has been decided that failure to comply with them may invoke penal action under the provisions of Banking Companies Ordinance, 1962.

### 23.2.5 Risk management

Being the supervisor and regulator of the financial sector, risk management is one of the key concerns of the central bank. Following the same strategy of standardising of Shari’a standards, the central bank has provided detailed guidelines of risk management on the basis of guidelines offered by IFSB. These guidelines can be used as a basis to establish an effective risk management system. There are fifteen principles of risk management that are applicable to six categories of risks viz: credit risk, market risk, liquidity risk, operational risk, equity investment risk and rate of return risk.

**To make risk management more effective and uniform for conventional and Islamic banking institutions, the central bank has introduced measures like:**
• Institutional risk assessment framework (IRAF)

SBP has developed detailed Shari’a-compliance questionnaires drawn from the overall Shari’a-compliance framework of institutional risk assessment framework (IRAF). IRAF is an offsite self-assessment of risk on inputs relating to four areas, namely compliance with standards, codes & guidelines supervisory & regulatory information; financial performance & condition and market information & intelligence.

• Shari’a-compliance inspection

As a regulator, the major concern of the central bank is to monitor and ensure financial sector stability. Therefore off site monitoring and inspection of banking institutions is of great significance. Shari’a-compliance of the Islamic banking institutions cannot be judged by following procedures of conventional banks. Therefore SBP has developed a Shari’a inspection manual with the help of leading consultants. SBP staff has also been trained by these consultants. SBP inspectors review Islamic financial arrangements, general banking services and operations, financial statements and accounting records of Islamic banking institutions to ensure that all transactions and operations are being carried out in accordance with Shari’a principles, in their substance and form.

• Development of enforcement framework

Along with the development of a Shari’a inspection regime SBP has also developed an enforcement framework for Shari’a-compliance in Islamic banking institutions.

23.2.6 Other initiatives

a. Islamic microfinance business

As in the case of Islamic banking industry, SBP has accepted the responsibility of developing a micro finance industry in the country. Realizing the burgeoning demand, SBP has allowed provisioning of Islamic microfinance and has also formulated guidelines for Islamic microfinance products and services. These guidelines provide an explicit framework for extension of various modes of services conditional to institutional arrangements, responsibility of institutions of raising awareness about Islamic finance products and processes and also of provision of detailed contacts for potential clients.

b. Islamic finance for agriculture

The regulatory infrastructure of banking sector has also set out guidelines for Shari’a based agriculture financing. This includes Shari’a based modes of financing for working capital and term financing.

c. Islamic export refinance scheme (IERS)

The central bank has extended to Islamic banking institutions, a musharaka based export refinance facility for traders. For this purpose, the central bank has identified a limit of 1.5 times of IBs equity in the first year of their operation of IERS. This limit for subsequent years will be fixed subject to IBs’ financial performance. In case of Islamic branches of conventional banks, the overall limit of the bank for the scheme does not change. However, conventional banks can get the approval of up to a maximum of 10% of their limit for their Islamic branches. Guidelines also provide detailed criterion for profit and loss sharing between the central bank and the bank offering IERS services through the establishment of takaful fund.

23.3 Non-banking financial institutions (NBFIs)

In 2002, the supervisory and regulatory role of non-banking financial institutions was transferred from the SBP to SECP. Islamic NBFIs in Pakistan constitute of 27 mudaraba companies, 15 mutual funds and five takaful companies.

Regulatory Infrastructure

23.3.1 Mudaraba companies

Mudaraba is a two tier structure that is established for specific or multi purposes, and can also be perpetual or floated for a specified period. Leasing is the most common business mudarabas undertake.

Mudaraba companies, one of the prime initiatives of Islamisation in the country during the 80’s, have got the highest business share among Islamic NBFIs. Their regulatory framework “Modarba Companies and Modarba Ordinance 1980” was introduced at the time of their promulgation in 1980’s followed by Modarba Companies and Modarba Rules 1981 and Prudential Regulations for Mudarabas by Securities & Exchange Commission of Pakistan.

SECP has provided detailed regulations for mudarabas including:

• mudarabas have been directed to create and build up a reserve having an amount of at least 10% after tax profit till the reserve fund becomes equal to paid up capital. Thereafter an amount of at least 5% after tax amount should be credited to the reserve

• the commission has introduced a limit on liabilities; seven times of equity of mudaraba for the first two years of operation that can then be enhanced to ten times in subsequent years. Moreover, limit on per party exposure - 20% of the equity of the mudaraba - has also been put in place.

• to ensure sustainability, mudaraba companies have been directed to follow certain conditions including

- ensuring that the current asset to liability ratio of the borrower does not fall below 1:1

- total borrowing of the borrower does not exceed ten times of the capital and reserves (free of losses) of the borrower

- Fresh/additional accommodation in the form of long term facilities should be provided on the basis of debt equity ratio not exceeding 60:40:
Regulating Islamic finance in the USA

Government of Pakistan

International sukuk has floated five issues of its

To deal with taxation of the Islamic financial industry, a

nature of this area, particularly for liquidity management.

pace of growth in this sector is slow despite the critical

nance certificates have been introduced. However, the

based domestic and one international sukuks term fi-

SECP is also responsible for regulating the Islamic capital

23.3.3 Islamic capital market

SECP is also responsible for regulating the Islamic capital

market. Up until now, two musharaka based, five ijara

based domestic and one international sukuk term fi-

23.3.4 Taxation issue

To deal with taxation of the Islamic financial industry, a

committee at the Institute of Chartered Accountant of

Pakistan (ICAP) has been established to devise accounting

standards for Islamic modes of financing. Due to the

unique nature of the Islamic financial industry, a compre-

hensive feedback involving all stakeholders was required,

for which the central bank has played the key role. On

the basis of accounting treatment defined by ICAP, ef-

fective tax treatments are framed and sent to the con-

cerned government departments for finalization. For the

banking industry, Finance Bill 2007 has announced equal
tax treatment for both conventional and Islamic banks.

23.4 Conclusion

Though, the Islamic finance sector in Pakistan has a his-
tory of around five decades, it was only in 2001 that

things turned around and the Islamic finance industry’s
evolution process witnessed a rather successful trans-
formation. It stands today as a serious alternative to

the conventional finance sector. All stakeholders need
to ensure now is that the reputational damage caused
by the weak implementation during the 1980’s does
not happen again as it would seriously hamper Islamic
finance’s future in the country. The central bank has
played a key role in facilitating the ascension of the

domestic Islamic finance industry, so that it reaches a point
of recognition both at the local and international level.

Despite achieving 6% of banking portfolio, Islamic fi-
nance institutions are confronted with some key chal-

lenges that have slowed their pace of growth to some
extent. Issues faced by the overall industry including
banking and non-banking institutions are broadly related
to finance and governance. The industry has not been
able to grow at the expected pace, primarily due to
lack of skilled human resources, limited development
on the product innovation front, and absence of invest-
ment avenues especially in the short term. While SBP
has been conducting a number of Islamic finance training
programs, market players need to step up their own ef-
forts to compliment the central bank’s efforts in order to
increase availability of specialized human resources. On
the product development front, the SBP has been col-
laborating with both international and local institutions
to introduce regulations that are aligned with Islamic
principles and facilitate market development. However,
regulations should be formulated in close collaboration
with international agencies.

Due to the prudence of the financial system, the country
did not face any serious external shocks caused by the
recent global financial crises. Regulators in the country,
particularly the central bank, have already introduced
effective risk mitigation regulations, however the liquid
management infrastructure for Islamic financial institu-
tions needs to be developed further. Islamic finance has
established itself as an alternative to the conventional
finance system. Islamic finance in Pakistan now needs
to demonstrate a higher level of resilience and partner
closely with international players to meet market expec-
tations in the future.

2 Government of Pakistan has floated five issues of its international sukuk.
CHAPTER 24
Regulating Islamic finance in the USA

24.1 Introduction

As the Shari’a broadly addresses human activity, so does Islamic finance – in principle particularly – urging a concern for all of creation as service to the Divine. Among other things, Islamic tenets promote honesty, transparency and fairness, express concern for the well being of employees, partners and counterparties, and place certain limits to monopoly and wealth concentration. These more general principles, along with detailed technicalities and legalities, fall under the purpose of Islamic law: securing benefit and preventing harm. Readers may already be well aware of this or may wonder what exactly its relevance is to a discussion of law and regulation. This is mentioned, because it is important to first understand the subject under consideration for regulation before tackling the questions of whether regulation is appropriate and then finally how best to regulate.

The United States is not normally considered among the most significant markets for Islamic finance. Any discussion of the Islamic finance industry in the U.S. must thoughtfully consider its prevailing social and political climate. What some term “Islamophobia”, which persists in certain, sometimes influential, quarters of American society would certainly vigorously challenge any perceived attempt at establishing or integrating the Shari’a, Islamic law or Islamic finance (whether in theory or in practice) within the U.S. framework. Indeed, a few already challenge whether Islamic transactions and financial products should even be permitted in the country. Consider for example the proposed ban on Oklahoma state courts from considering Shari’a law (or international law for that matter) when making decisions. This proposal was approved by more than 70% of Oklahoma voters. But note that the proposed law was struck down by a U.S. federal judge.¹

In fact, there has been tremendous innovation and success for contemporary Islamic finance in the U.S. There have also been, and will probably continue to be, important governmental and regulatory efforts to welcome and integrate Islamic finance into the prevailing in the U.S. legal framework. Admittedly, these efforts have not been as conspicuous as those made by certain other Western nations, such as the United Kingdom or even France. But this is not in itself a problem, especially when regulatory efforts in the U.S. have enabled Islamic finance to innovate and succeed globally. In fact, such an approach may be wiser given some of the vocal opposition.

This chapter explores the question of whether and how to regulate the Islamic finance market in the United States. We begin by discussing the American Islamic finance market, compare and contrast U.S. and Islamic commercial laws generally, and discuss both the ease and the challenge of implementing Islamic principles within the U.S. regulatory framework. Lastly, this chapter presents the innovation that has taken place overcoming some of these challenges and asks: Given such innovation and success, is specific regulation appropriate? Does the answer to this question depend on whether such regulation speaks to transactions (e.g., an investment) or actors (e.g., a bank)?

24.2 The U.S. Islamic finance and investment market

As an industry in the U.S., Islamic finance has a straightforward and practical objective: conducting business transactions profitably and responsibly, as the notion of both profit and responsibility are defined and controlled by Islamic norms. The concern is not creating legal or

¹ Muneer Awas v. Paul Ziriax, Agency Head, Oklahoma State Board of Elections, et al., Case No. CIV-10-1186-M, November 29, 2010.

The UK model

Pain, No Gain] (Winter 2007) [hereafter No
Univ. of Chicago J. Int’l L. 469
Private Equity Transaction,
Light of an American Islamic
ments in the U.S. see Umar
Islamic growth equity invest-
returns. For a case study in
infrequently because control
positions. They take place
ments are typically minority

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2 Growth equity invest-
ments are typically minority
positions. They take place
infrequently because control
makes compliance with Islamic
law difficult and because of
Islamic restrictions on share-
backs. For a case study in
Islamic growth equity invest-
ments in the U.S. see Umar
F. Olofipo, The State of an Industry
in Light of an American Islamic
Private Equity Transaction,
Univ. of Chicago J. Int’l L. 469
(Winter 2007) [hereafter No
Pan, No Gain].

2 Namely, knowledge and
experience with such transac-
tions, helping them to take
place elsewhere.

4 See e.g., Rushd Siddiqui,
Shari’a-compliance, Perform-
ance and Conversation: The
Case of the Dow Jones
Islamic Market Index, Univ. of
Chicago J. Int’l L. 427 (Winter
2007).

5 For instance, we are aware
of a well-established GCC-
based Islamic investment bank
the Shari’a supervisory board
of which does not permit
private equity investments in
privately-held U.S. companies
with any conventional bor-
rowings.

6 See e.g., Faisal Makhzoum,
Islamic Banking: The Untold
Billion-dollar Story, available at
http://www.nowpublic.com/
world/islamic-banking-untold-
billion-dollar-story (last visited
December 2, 2010).

7 See e.g., Ayman H. Abdel-
Khalil, Islamic Universal
Gos
sukuk: The Dawn of a New
Frontier, Islamic Finance News,
Deals of the Year 2006
Handbook, p. 32 (stating,
“The successful closing of the
ECP sukuk transaction, which
constitutes the first ever sukuk
backed by oil and gas assets
in America (as described in
more detail below), supports
the foregoing conclusion.
In fact, one can argue that
American oil as gas law,
unsure whether oil and gas rights
are characterized as seizable
and alienable real property
with well recognized legal at-
tributes, satisfies a number of
Sharia’s requirements.”

8 See John Maksis, The Islamic
Origins of the Common Law,
77 N. CAR. L. REV. 1635
(1999).

24.3 The two legal systems

It may surprise some to learn that Islamic financial laws and U.S. regulations are not (in our experience and knowledge) wholly inconsistent. In fact, in the financial realm, we find a number of similarities and parallels between the two systems of law.7 There is even re-
search evidencing the origin of many aspects of Anglo-
American contract law and trust law in Islamic law.8 This
is not to say that the two legal systems are premised
similarly and that premises are unimportant. On the
contrary, they are quite important, but the question we
focus upon in this chapter is what practical challenges

The U.S. Islamic finance market may be subdivided
into two segments: One segment we might term the
“wholesale” or “foreign-institutional market.” Here, we
mostly see foreign Islamic investors – in the form of
investment banks, private and some public investment
companies, and family offices – targeting the U.S. on a
one-off basis sometimes and in other instances through
a private investment fund or other collective investment
mechanism. In the early years (the mid to late 1990s),
the wholesale Islamic market focused on the residential
and single tenant real property markets – probably in
large part because Islamically prohibited issues could be
more easily avoided (than with other property types,
such as shopping centres, in which a myriad of prohib-
ited matters generally arise). Early in this decade, Islamic
investors added to this wholesale market commercial
office property investments as the applied Islamic legal
method became more tolerant of some of the other-
wise prohibited, as detailed below.

Wholesale Islamic finance practice in the U.S. would
subsequently add to its transactional portfolio private
equity transactions in the form of leveraged buy-outs
and, less frequently, growth equity type investments.9
Most importantly, for our purposes, the developments
that led to such private transactions took place in the
United States and then produced global consequences.10
It may very well be that this was spurred on by devel-
opments in the public securities market – namely, the
landmark establishment of the Dow Jones Islamic Mar-
ket Indexes in 1999. The fatwa which was issued in con-
nection with these indexes enabled public securities in-
vestment on an Islamic basis. Previously, Islamic investors
(thought they) could invest only in businesses that were
entirely and in all aspects in line with Islamic tenets and
lacking any conventional debt (whether by borrowing or
as income). This fatwa, as has been previously discussed
in detail by others,11 (i) begins the analysis of whether an
investment is permissible with an assessment of the se-
curity to be acquired, (ii) evaluates the nature of the pri-
mary business (and not all business lines) of the target,
and (iii) permits and tolerates conventional debt (owed or
earned) if certain specified ratios (limiting its pres-
ence) are adhered to. This result is demonstrative of a
recognition by at least some Muslim jurists that absolute
compliance is not currently obtainable, and, accordingly,
in some very limited instances (i.e., not all prohibited
matters), de minimus variations are permitted. Income
resulting from such variances are subject to some kind
of removal process, such as through charitable dona-
tion and or a subsequent effort to further minimize the
variance.

The extension of these principles from the public mar-
et to real estate investing and even to private equity
did not happen immediately. This seems rather to have
taken some years. Ultimately, such an extension has ad-
vanced Islamic transactional activity and broadened the
target asset profile. From time to time though we still
see a hesitation by some, or an outright unwillingness
by others, to extend these principles to private equity
though to some they make more sense there than in
the public markets.5

The wholesale American Islamic finance market has also
seen significant developments in financing structures of
global consequence. These accomplishments include a
handful of sukuk issuances in recent years using Rule
144A adopted in the U.S. in 1990 as well as the recent
Islamic derivatives contract launched by the Interna-
tional Swaps and Derivatives Association (ISDA) with
Bahrain-based International Islamic Financial Market (fo-
cusing on profit ratio and currency swaps).

The second segment of the American Islamic finance
market consists of the “retail” where American needs are
identified and addressed (often self-addressed) to
enable the acquisition of homes, retirement savings
and investment, and general consumer banking in ac-
cordance with Islamic tenets. American Muslims have
been keen to develop financing structures to enable
home purchases. These efforts began more simply, and
with time, demand, expertise, and savvy grew. Financ-
ing mechanisms and related documentation became
more sophisticated with the simultaneous presence of
murabaha, ijara and musharaka structures in the mar-
ketplace, became arguably more compliant with Islamic
principles, and created competition and success. Strong
demand also saw the creation of an Islamic secondary
market structure to provide for much needed liquidity
in at least one instance of a residential mortgage prod-
uct. Shortly thereafter, a nationalized and standardized
U.S. commercial mortgage product was developed in
the U.S., which it seems but for the credit crisis, might
have produced one of the world’s first CMBS sukuk.
The American Islamic retail market is also witness to a
variety of U.S. asset managers, offering investment vehi-
cles and opportunities, but mostly to offshore persons.
The market seems to have self-addressed the need for
Islamic mutual funds for U.S. persons.

Overlap between these “wholesale” and “retail” market
segments is rare unfortunately, and has taken place, for
example, in the form of multinational financial institu-
tions offering Islamic products to U.S. persons and the
recent sukuk issuance by General Electric Co. We do
expect to see an increase in the overlap with time, par-
icularly as the retail market matures and the opportuni-
ties therein are better appreciated.5

Global Islamic Finance Report (GIFR 2011)
do these more theoretical or jurisprudential differences create for the practitioner of Islamic finance to address. We do not find many challenges in number.

The introduction of this chapter spoke of the broad purposes of Islamic law as well as the limited practical aim of Islamic finance in the U.S. Comparing Islamic financial law with U.S. law, we find a number of parallels between the two at their respective theoretical or “policy” levels. Both legal systems, for instance, share concerns against exploitation and unjust enrichment, seek to preserve and protect property rights, and enact laws to fulfill such purposes. The importance of honesty, transparency, and fair dealing within Islamic law, for example, may be analogized to the stated rationale and purposes of U.S. securities laws and consumer protection regulations. At a more particular level, we find the detailed requirements of each legal system having parallels in the higher purposes of the other system though they differ in some cases in the “minute” of how they go about achieving the same purposes.

The Shari’a has a broad freedom to contract, and some interpretations have it broader than others. This is particularly so in the realm of finance and transactional law where the majority of Muslim jurists presume legal permissibility without a textual indication to the contrary. In addition, Islamic law emphasizes the importance of consent and the rights of contracting parties. Similarly, U.S. contract law affords a broad freedom to contract, and, as under Islamic law, the subject matter of the contract must not be prohibited. While one can certainly argue that what is prohibited under U.S. law is of a different nature than that under Islamic law and that these differences represent a significant “philosophical” difference, practically speaking, there is generally little difference when effectuating transactions. Moreover, what is prohibited under Islamic law is not generally, if ever, required by U.S. contract law. Thus, the parallels between the legal systems and their respective contractual freedoms allow Islamic parties to freely engage in Islamic transactions in the U.S. upon the terms and conditions to which they and their counterparties agree. Further, though proper and sufficient specificity, it should generally be possible to utilize Islamic law by incorporating it, or aspects of it, as contractual terms rather than as a governing law per se.

Finance in the Anglo-American model is premised on a debtor-creditor model central to which is interest-based lending and the idea that money can itself earn money. The Islamic finance theory, on the other hand, is said to envisage a model where risks and rewards are allocated differently. The most conspicuous features of Islamic finance are its prohibitions of gharar and, moreo, riba. It is usually because of these foundational divergences that many view Islamic financial laws and U.S. financial laws as incompatible and even diametrically opposed. But, as has been shown by various others, these prohibitions are indeed not unique to Islam, and, at the very least, many of the purposes for which such prohibitions are believed to have been legislated are not unimportant to U.S. law. Much of the challenge in conducting Islamic finance transactions in the U.S. does not come from conflicts of law per se, but from varying business practices and expectations, namely the debtor-creditor model on which the U.S. economy is so heavily dependent.

Very often, gharar can be alleviated by proper specification of material terms and conditions (such as subject matter, price and time of delivery) at the time of contracting. Such specificity is a common practice in the U.S. It also has other, sometimes unexpected, implications, resulting, for example, in certain contract provisions, such as post-closing purchase price adjustments, being deemed impermissible. But gharar has its deepest implications upon conventional insurance and derivatives, generally prohibiting both.

Certainly, Islam’s prohibition of riba creates some interesting tensions and challenges in the U.S. (and elsewhere). It would be rather difficult to assert that any party is obligated by U.S. law to borrow at interest or to otherwise engage in a ribawi transaction (except in very limited, narrow instances perhaps). However, one could assert that certain laws, namely tax laws and those regulations governing banks, as well as prevalent business practice or custom (sometimes adhered to by some Islamic finance professionals themselves), have created challenges if not outright contradictions with the rules of riba and Islam’s requirements for market or asset risk sharing.

U.S. tax laws give preferential treatment to debt-based instruments and to interest earned on debt, which it does not afford to equity-based structures. Islam’s preference, particularly in the consumption context, to not incur debt and to take on a market or asset risk instead, seems to stand in tension with these tax laws. Perhaps more significantly, U.S. laws governing banks and banking stand in direct conflict with the notion under Islamic law, that to legitimately profit, a financier must bear a market or asset risk and not merely a credit risk. For example, U.S. banks are not permitted to own real estate unless held for their own use or as collateral in connection with an enforcement action. Moreover, as a matter of custom and not law, banks strongly prefer to utilize (their own standard) conventional loan documentation. This customary preference, coupled with the aforementioned regulations, prohibit banks from bearing the risks required by Islamic law and thus from directly (or to some correctly) participating in an Islamic financing.

As such, when transacting in the U.S., Islamic parties must decide whether to utilize equity or debt structures. It seems though that to date, the attraction of leverage prevails in most Islamic transactions in the U.S., whether we speak of the wholesale or the retail markets. Given the regulatory as well as the “cultural” barriers to engaging in an Islamic financing structure where the financier is given an asset risk, the probability of convincing the usual sources of lending to participate in an Islamic financing in both form and substance are slim at best. This is probably why structures in contemporary Islamic finance have focused on form. And perhaps thus, conventional finance came to be a part of nearly all of the American Islamic financing structures, particularly in the wholesale market segment. 9

Further, Islamic parties typically describe their leverage structure as a single interest-bearing transaction for tax purposes so as to avail themselves of the preferential tax treatment not otherwise available. 10 This tax-driven

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9 Acceptance of a conventional component in retail Islamic financing structures appears quite low. In our experience, many American Muslims, rightly or wrongly, tend to be sceptical of the Islamic finance industry and any products offered to them generally seem to fare best when they are end-to-end compliant with Islamic tenets. Even then, as was the case with a prior murabaha mortgage product, many American Muslims were generally unwilling to deem it Islamic. While the lay Muslim individual is not the legal arbiter of whether something is permissible, such individuals can and do play a significant role in the success and failure of retail products.

10 It is worth noting that we understand some users of Islamic home finance in the U.S. have elected not to avail themselves of the interest deduction under U.S. tax laws.
characterization, together with the form of the underlying leverage, continues to spur many discussions in the industry regarding form and substance—a summary and analysis of which is beyond the scope of this Chapter. Were they not to agree to such a recharacterization, Islamic investors would forego the aforementioned preferential treatment and perhaps be unable to convince some of their conventional counterparts to do business together.

It is important to note that Shari’a advisors (generally but with reluctance from some) permit the aforementioned tax-driven recharacterization. It may also be worth noting that these advisors often permit the use of conventional insurance (in the absence of Islamic insurance options in the U.S.), even when insurance is not a U.S. legal requirement per se but sometimes of the financier as a contractual requirement. While Shari’a scholars have no choice but to work within the existing U.S. regulatory framework, they very well could simply not issue the relevant fatwas, more strongly advocate for the use of equity, and object to the tax-driven recharacterization. That they tend to be permissive (though sometimes while noting an objection) is not only a reflection of scholarly deference to applicable U.S. law in the U.S. market, but the flexibility of their jurisprudence when interacting with long-established, nearly standardized business practices and norms. For our purposes, this flexibility is demonstrative of how Islamic financial law and U.S. laws are interacting productively.

In our experience, Shari’a advisors typically create legal dispensations in those very rare cases in which Islamic law and U.S. laws conflict. For instance, when the murabaha-based home finance product was structured, the absence of a reduction in the total purchase price (which would typically result from a total prepayment in conventional finance) potentially ran afoul of U.S. state usury laws because the net effect of the absence of such a reduction could have been a rather high interest rate. Accordingly, the Shari’a advisor permitted the purchase price reduction. This is again demonstrative of the Shari’a advisors method for effectuating Islamic transactions in the U.S.

To the foregoing, we add that Islamic law is not wholly or generally applicable to non-Muslims. While this is perhaps an obvious descriptive point, it is also one that holds true prescriptively as a matter of Islamic jurisprudence. This is another factor easing transacting in the absence of a reduction in the total purchase price, which would typically result from a total prepayment in conventional finance. This is again demonstrative of the Shari’a advisors method for effectuating Islamic transactions in the U.S.

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11 For a detailed explanation and corresponding diagram of such leverage structures, see Mogul, Separating the Good from the Bad: Developments in Islamic Acquisition Financing, American Univ. Int’l L. Rev., Vol. 23, No. 4 (2008).

12 As is more often the case in the retail American Islamic finance market.


14 See id.

15 See id.
While this case does not evaluate Islamic financial law, it does highlight an aspect of the environment towards its presence in the U.S. To some extent, this decision eases the pressures and challenges upon Islamic finance and Islamic finance practitioners may take some comfort in the objective applicability of the rule of law.

As many Islamic transactions contractually stipulate U.S. laws (such as those of Delaware or New York) as governing, legal practitioners have expected that U.S. courts would generally have been enforcing the agreements and documents as written. In the wholesale market, we have most recently seen the East Cameron Gas sukuk project before a U.S. bankruptcy court. Here, the court has likely established an important legal precedent, vindicating the theory of asset-backed Islamic finance by holding that the asset transfer under the sukuk constituted a true sale and thus the assets should be distributed to the sukuk holders. While further implications of this case remain to be realized, it does appear that the decision will likely provide comfort to potential U.S. sukuk issuers.14 And in the retail segment of the American Islamic finance market, we have seen a number of residential mortgage financings come before various courts, providing the industry with further instruction and insight. These courts have generally enforced documents and contracts written and interpreted on the structures as secured financings.17 Courts in the U.S. and other non-Islamic jurisdictions are likely to continue to interpret or resolve disputes with Islamic transactions.

It is worth noting that the East Cameron sukuk, like, for instance, the Dar al-Arkan 2010 sukuk issuance, relied on the aforementioned Rule 144A. This rule allows issuers to market the sukuk to onshore U.S. investors by providing a safe harbour from registration for certain private placements, checking accounts and certificates of deposit, and documents as written. In other words, Islamic investors may hold that the U.S. legal framework can practically include within it Islamic financial laws and practice.15 This is then again evidence in support of the practical congruence of Islamic and American laws and of the sufficiency of the latter when transacting in compliance with the former.20

### 24.5 Regulating the market

The objective of (simply) transacting and the success Islamic investors have had in doing so in the U.S. is an argument against the need for regulation specific to transactions compliant with Islamic laws. With regard to the wholesale market, existing regulation in the United States is equally applicable to all investor and investment types, whether Islamic or conventional. It is, moreover, evidently sufficient since in our experience we do not find anything in the contemporary practice of Islamic transacting per se to warrant specific, additional regulation or controls. Practically speaking, what differentiates the wholesale Islamic financial market from the conventional one are considerations of the ethical sort (e.g., what type of business may be acquired) – considerations not actually addressed by the existing securities regulations, for instance, are fairly robust and broad in their conception. It would probably be of comfort to this market though much greater concern is that such amendments may even slow the direction of Islamic finance towards further qualitative Shari’a-compliance by cementing existing structures as final and not works in progress.21

With respect to the American Islamic retail market, again we do not find any overwhelming need for additional specific regulation. Consumer regulation and securities regulations, for instance, are fairly robust and broad in their conception. It would probably be of comfort to this market though much greater concern is that such amendments may even slow the direction of Islamic finance towards further qualitative Shari’a-compliance by cementing existing structures as final and not works in progress.21

Where we find most merit for regulating Islamic finance is with respect to an Islamic bank the establishment of which has been a long standing goal of American Muslims. While there is no such bank per se currently, there are banks offering products, such as Islamic savings accounts, checking accounts and certificates of deposit, under the purview of parent licenses. One may, however, counter that regulations regulating the business of banking should be amended to accommodate Islamic finance or that a parallel system of regulation should be designed. Before we adddress this contentin, it is important to have defined Islamic finance. Will the regulated Islamic finance be one in which banks can take on asset or market risk (which we might term asset-backed) or will banks be permitted to only bear risks that are incidental to the asset (what we might term as loosely asset-based), as per the OCC advisory letters?18

Given that Islamic risk-reward allocation principles cut through the heart of U.S. banking regulation and such regulations would be so significant and novel and dis-

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16 See 17 C.F.R. § 230.144A.

17 As mentioned earlier, it is possible to incorporate aspects of Islamic law as contractual terms and utilize a local law as governing. This seems in our experience to be the prevailing practice.

18 An interesting alternative to relying exclusively on the U.S. court system would be to utilize arbitration and appoint persons with knowledge and experience with Islamic matters.

20 See e.g., Muhammad Taqi Usmani, sukuk and Their Contemporary Applications (trans. Yusuf Talal DeLorenzo).
turbing to the very model of banking, one would not expect any regulations adopted for the former possibility (i.e., asset-backed) anytime soon. This leaves us with regulations of some kind for the latter conception of Islamic finance (i.e., loosely asset-based). This would be a tremendous undertaking which if successful could further span growth through increasing knowledge and comfort in the marketplace. The key questions are what form this kind of regulation would take place in and what issues or subjects it would address given the paucity of issues (once we leave aside issues of financier risk). One area, mentioned previously, would be placing Islamic financings on an equal footing with conventional finance in tax regulations. Perhaps Islamic investors could simultaneously seek to locate alternative, more flexible sources of funding that are not subject to banking regulations and that have learned of the soundness of Islamic financial principles so as to break free from certain customary practices. In jurisdictions other than the U.S., a separate somewhat parallel regime that speaks to what truly distinguishes Islamic from conventional banking (namely its risk-reward allocation requirements) would seem to be more viable and appropriate.
CHAPTER 25

Taxation of Islamic financial products in Ireland

25.1 Introduction

During 2010, the Republic of Ireland amended its taxation laws to accommodate Islamic finance more favourably. These amendments were aimed to give Islamic financial structures and transactions the same tax treatments as their conventional counterparts.

For the benefit of those who are not very familiar with the Republic of Ireland, it is a small scenic country located on the island of Ireland at the western border of the European continent. The total population of Ireland is estimated to be slightly less than 4.5 million as of 30th April 2010. According to the official census carried out in 2006, the total Muslim population in Ireland was estimated at around 32,500.

Given the above, one might be wondering why Ireland would change its taxation laws to accommodate Islamic finance and, even if they did, what would be the interest of IFIs in Ireland? It might therefore be useful to give a high level summary of the attractiveness of Ireland as a financial centre and the benefits that should now be available to IFIs by considering Ireland in their various investment structures.

25.2 Ireland as a financial services centre

- Ireland is a long standing member of the European Union (since 1973) and is an established gateway to the European Union (“EU”).

- The EU operates on a single market concept. Various EU directives allow free movement of goods, capital, services and people within the Union. Using these directives, it should be possible for an Ireland based IFI to sell its services in other EU countries, either on a cross border basis or by setting up a physical presence there, without seeking any second authorization. The authorization from the regulatory authorities in Ireland should suffice.

  - Ireland is only the second country in the EU (and the only country in the Euro-zone) with English as the official language.

  - With the growing focus on regulatory matters, the European regulatory oversight which can become available on using an Irish entity in the structure should enhance the comfort of investors.

  - While Ireland remains one of the founding member States of the OECD, the corporation tax rate (12.5%) in Ireland is the lowest amongst the OECD countries. Furthermore, it should be possible for an Irish company to offset any foreign taxes paid against its Irish tax liability. Ireland has consistently followed its investment friendly policies. Despite the recent financial turmoil, all the leading political parties in Ireland have supported the decision of not changing the corporation tax rate.

  - An Irish regulated fund does not pay any tax in Ireland. Moreover, income or gains received by non-Irish residents from an Irish regulated fund, whether as distribution or as capital gain on a disposal of the investment, should not be subject to any Irish tax.

  - Ireland has an attractive securitization regime. It should be possible to structure the transaction in such a way that an Irish securitization vehicle only pays a nominal amount of tax.

  - Ireland has a well tested agency banking model which allows the investors to substantially reduce the upfront

establishment cost and avoid long term commitments (such as leases). This is typically achieved by renting most of the systems from a reliable third party supplier (another banking company). The use of this mechanism in start ups provides the opening of an easy and cost effective exit, if for any reason the investors decide to pull out. Of course, the set up of the bank’s own infrastructure remains at the discretion of the investors. Typically, foreign banks would start with an agency banking model and gradually shift to their own systems.

The above reasons have helped Ireland develop itself as an established international financial services centre. This has also helped Ireland develop a deep pool of local expertise in the financial services sector. The following key statistics evidently support this fact.

• Ireland is considered the home of aviation leasing and finance. Along with the US, Ireland is the world’s largest aviation leasing centre. It has more than 3,000 aircraft and engines under management with an estimated value of over USD 100 billion.

• Ireland is also considered a location of choice for setting up investment funds. The total value of fund assets under administration in Ireland is estimated at over USD 2.4 trillion2 (1,784 billion Euros).

The above only provides a bird’s eye view of the opportunities available in Ireland. While the Irish domestic banking sector might take a little while to recover, the availability of the international trading platform remains isolated from the domestic banking issues. In summary, the market for an IFI setting up its base in Ireland would not be restricted to Ireland. It should allow the IFI to expand its wings and cover the entire EU market. Ireland should be seen as an excellent provider of an enabling platform. It should not be considered a market in itself.

25.3 Ireland and Islamic finance

With the above summary, it is now appropriate to discuss the key Islamic financial products as to how they can be structured using Ireland and its matchless economic offerings. Note that where references have been made to Shari’a-compliant returns being treated as interest for tax purposes, the reference is only used to identify the same tax treatment for Shari’a-compliant returns and interest under Irish tax law. The return itself should in no way be misconstrued as interest.

25.4 Key tax principles of Irish tax law

The key principles of Irish tax law relevant to financial services companies are summarised below.

• Trading income of companies is taxed at the corporation tax rate of 12.5%. The term trading is not conclusively defined in Irish tax law. There is however a considerable amount of case law available on the subject. Fundamentally, income earned from activities that are undertaken through efforts and deployment or resources is considered trading in nature.

• Trading income is broadly measured under the accounting principles (IFRS or Irish / UK GAAP) under which the financial statements are prepared. Certain capital assets qualify for capital allowances (tax depreciation) at 12.5% on a straight line basis, as opposed to accounting depreciation which is added back to the accounting profit.

• Non-trading income is taxed at the rate of 25%. The term “non-trading income” generally refers to income that is not derived during the course of a trade. For example, interest income received on surplus cash balances held by a non-financial services company. For a company engaged in financial services trade, one would not expect any income classified as non-trading income. However, there can be situations where a financial services company is held as deriving non-trading income, such as, if a company receives income after it has ceased to trade.

• Capital gains are taxed at 25%. However, there are various exemptions available to non-resident investors and situations where a charge to CGT does not arise. For example, a charge to CGT should not arise to a company where it has held more than 5% of the shares of the investee trading company for more than 12 months.

• The general VAT rate in Ireland is 21%. However, financial services are generally exempt from VAT.

• Stamp duty rates depend on the nature of instrument conveying the transfer of interest in the underlying asset. For example, a transfer of shares in a company would attract stamp duty at 1%.

• Irish tax law contains group relief provisions whereby tax loss of a group company can shelter taxable income arising in another group company. Similarly, group relief provisions are also available for capital gains tax, VAT and stamp duty and these help avoid tax costs on intra group transactions and transfers of assets.

25.5 Taxation of Islamic financial transactions

It should be noted that the economic substance of Shari’a-compliant transactions discussed in this chapter is not very different from their conventional counterparts. However, as the return under Islamic arrangements is not in the form of interest, Shari’a-compliant transactions are structured differently to their conventional counterparts. As the Irish tax system follows a form based approach rather than a substance based approach, these different arrangements could result in a different tax analysis than the one for a comparable conventional structure.

25.5.1 Tax Briefing Issue 78

In October 2009, the Irish tax authorities published
The briefing confirmed that Shari’a-compliant investment funds will be taxed in the same manner as conventional investment funds; an ijara transaction (which is similar to a leasing or hire purchase arrangement) will be taxed in the same manner as conventional leasing or hire-purchase transactions and that a takaful or retakaful would be treated in the same manner as an insurance or re-insurance transactions.

25.5.2 Finance Act 2010

The Finance Act 2010 introduced additional and important amendments to the Irish tax law, the Taxes Consolidation Act, 1997 (“TCA 1997”) to deal with other Shari’a-compliant products and transactions which were not clearly covered under existing law and therefore not covered by Tax Briefing Issue 78.

The new provisions refer to various Shari’a-compliant transactions as “specified financial transactions”. A specified financial transaction must be carried out at arm’s length and involve a “finance undertaking” or a “qualifying company”. A finance undertaking is defined as:

- a financial institution, as defined in Irish tax law. This broadly covers most banking companies and credit institutions licensed by the central bank.
- a company whose income consists of either or both income from (a) the leasing of plant and machinery and (b) income from specified financial transactions.

As defined, the term finance undertaking does not cover conventional financial services trading companies (excluding financial institutions and leasing companies). Apparently, such companies currently cannot avail the special provisions enacted for Islamic financial transactions. It is however expected that the legislation will be suitably amended to extend the scope of this definition. However, until such time as the legislation is amended, it is recommended that any financial services trading companies (other than financial institutions and leasing companies) intending to enter into Islamic financial transactions should seek prior clearance from Irish Revenue authorities on the applicability of the tax provisions specific to Islamic finance. The Irish tax authorities are generally very business friendly and one would expect them to favourably consider a genuine application (that is not just tax motivated) on this point.

A qualifying company is defined as a company which:

(i) is resident in Ireland;
(ii) issues investment certificates (sukuk) to investors, and
(iii) redeems the investment certificates after a specified period of time.

The legislation categorises the specified financial transactions into the following three types:

- “deposit transactions” (mainly banking deposits) – the amount of Shari’a-compliant return is referred to in the legislation as “deposit return”.
- “credit transactions” (mainly loans and mortgages) – the amount of Shari’a-compliant return is referred to in the legislation as “credit return”, and
- “investment transactions” (mainly sukuk) – the amount of Shari’a-compliant return is referred to in the legislation as “investment return”.

Broadly, the return paid and received under a specified financial transaction should be treated in the same way for tax purposes as interest. Therefore, in the context of a trading activity, the return would be taxable at 12.5% or deductible as a trading expense. In the context of Islamic bank deposits, the deposit return should be subject to the same tax rules that apply to conventional bank interest. Similarly, in certain specific situations where the deductibility of interest is available on a paid basis, the same treatment should apply on the amount of credit return paid in the relevant accounting period, provided the other relevant conditions are complied with.

The Irish VAT legislation has also been amended to confirm that those specified financial transactions that correspond to financial services are to be treated as ‘financial services’ for VAT purposes. Essentially, this means that those Islamic financial arrangements that correspond to conventional financial arrangements should be considered as VAT exempt financial services.

Irish stamp duty legislation has also been amended. However, at this stage, the amendments made are restricted to the issue, transfer and redemption of Islamic bonds (sukuk). A transfer of other Irish property as part of a Shari’a-compliant financing arrangement (such as a Shari’a-compliant mortgage of an Irish property) under current law could potentially entail additional stamp duty costs.

25.5.3 Tax election

In order for the provisions relating to specified financial transactions to apply, the Irish law requires that an election must be made by the finance undertaking. This election can be made on a transaction by transaction basis or in respect of all transactions that are of a similar nature. The election is actually designed to ensure that any conventional transactions that are similar in form to specified financial transactions do not automatically fall into the special regime for Islamic financial transactions. The objective is to help both, Islamic and conventional financial institutions, to make an informed choice.

The making of an election is only required in respect of specified financial transactions that have been specifically catered for in the tax law. For example, an election is not needed in respect of transactions and arrangements where the tax treatment has been clarified in Tax Briefing Issue 78 (discussed earlier).

The provisions relating to specified financial transactions...
would not apply to any transaction unless the transaction has been undertaken for bona fide commercial reasons and does not form part of any scheme or arrangement the main purpose of which or one of the main purposes of which is the avoidance of income tax, corporation tax, capital gains tax, value-added tax, stamp duty or capital acquisitions tax.

The tax implications discussed in this chapter are specific to the finance products explained and to the manner in which they are structured. Where these products are offered to customers in a manner different from the manner explained in this chapter, the tax implications may differ.

25.6 Shari’a-compliant funds

A Shari’a-compliant fund is one that does not defy Islamic principles. The basic structure of a Shari’a-compliant fund is not very different from a conventional fund. However, the arrangement between the fund and its service providers (in particular the investment manager) is based on the concept of mudaraba, musharaka or wakala. In addition, the investment decisions of a Shari’a-compliant fund are influenced by Shari’a principles.

In common with other Islamic entities, a Shari’a-compliant fund would normally have a supervisory board comprising Shari’a scholars who can approve the structure and operations of the fund from a Shari’a perspective.

25.6.1 Taxation of a Shari’a-compliant fund

Tax Briefing Issue 78 clarifies that, the taxation of funds, as provided in Irish tax laws should also apply to Shari’a-compliant funds. In summary, all funds set up after 31 March 2000 are exempt from tax. This allows the profit to accrue gross of tax. Instead, tax is imposed on a chargeable event which includes distributions made from a fund or disposal, transfer or redemption of fund units or shares.

In general, full tax exemption is available on distributions made to a non-Irish resident who has provided a specified declaration in relation to his residency status. Similarly, a non-Irish resident is not taxed on any gains arising on a disposal of fund units (or shares).

25.6.2 Taxation of service providers to a Shari’a-compliant fund

In a Shari’a-compliant fund, the remuneration of the service provider is determined on the basis of the arrangement between the fund and the service provider, i.e. whether it is a mudaraba, musharaka or a wakala arrangement. Under any of these arrangements, the remuneration of the service provider would comprise a fixed fee or a share in the profits of the fund or a combination of both. In either case, Revenue have clarified in their Tax Briefing Issue 78 that income received by a service provider, including an amount which is linked to the profits or performance of a fund should be treated as fee income where it relates to duties performed by the service provider.

25.7 Indirect taxes

25.7.1 VAT

As confirmed by Revenue in Tax Briefing Issue 78, the VAT analysis of a fund would depend on the activities of the fund. There is no general VAT exemption available to funds. However, an Irish investment fund with investments outside of Ireland should not be subject to any considerable Irish VAT. In addition, most services received by an Irish fund remain exempt from Irish VAT.

A Shari’a-compliant fund differs from a conventional fund, as it has a supervisory board comprising of Shari’a scholars. These scholars provide guidance on the structure of the fund and on investment and activities of the fund including the treatment of income received by the fund. The Shari’a scholars normally charge fees for their services.

The VAT treatment of the fee charged by Shari’a scholars would depend on whether the fund falls within the exemption contained in VAT law for investment management services and whether the services of the Shari’a scholars are an integral part of the overall management service. If it can be demonstrated that the services of the Shari’a scholars are an integral part of the overall management service, then it should be possible to argue that no Irish VAT arises on the fees paid to Shari’a scholars.

25.7.2 Stamp duty

As confirmed in Tax Briefing Issue 78, a liability to stamp duty does not arise on the issuance or redemption of units/shares in a fund. In addition, the transfer of units/shares in a fund is not chargeable to stamp duty to the extent that the fund is an approved investment undertaking, or a common contractual fund, as defined in Irish tax law.

The stamp duty analysis in relation to any transaction undertaken by a fund would depend on the nature of the transaction and the instrument involved.

25.8 Leasing and hire-purchase transactions

The term ‘jāra’ literally means giving something on rent and an ijara structure is principally used for leasing activities. The term jāra would normally refer to an operating lease but the arrangement can also be used to achieve a finance lease result. Furthermore, an ijara arrangement can be combined with a diminishing musharaka to structure a hire purchase transaction.

25.8.1 Overview

In an ijara arrangement, the lessor either holds an inventory of assets for lease in anticipation of customer demand or acquires an asset following a specific request by any of its clients. The asset thus acquired by the les-
sor is leased to the customer for an agreed rent payable over an agreed period of time. The leased asset must be capable of some halal (permissible) use and the rental should be charged only from that point of time when the usufruct (the right to use) of the asset is handed over to the lessee.

During the term of the lease agreement, the asset remains the property of the owner who would normally assume the burden of wear and tear. The lessee may however be required to carry out the periodical (ordinary) maintenance. Moreover, if the asset is to be insured, the insurance expense must be borne by the owner. However, the cost of insurance may be factored into the calculation of the lease rental. The lease rentals should be specified in the lease agreement, although these can be fixed or variable amounts.

If the lessee defaults in making a lease rental payment, the lessor cannot charge any interest. However, the lease contract may require the lessee to make an additional payment towards a charitable cause. To enforce this, an ijara agreement would normally require the charitable payment to be routed through the lessor.

25.8.2 Operating lease
A normal ijara arrangement would generally refer to an operating lease whereby the asset is returned to the lessor on the expiry of the lease period.

25.8.3 Finance lease
Similar to a conventional finance lease, in a Shari’a-compliant arrangement the value of the asset is broadly recovered during the primary lease period and a nominal or token lease rental is charged during the secondary lease period.

25.8.4 Taxation
A conventional operating lease arrangement can also be considered a Shari’a-compliant ijara arrangement provided the other aspects of Shari’a are complied with, e.g., the leased asset is capable of some halal (permissible) use. These Shari’a aspects should not have any bearing on the taxation of the ijara contract. Accordingly, Tax Briefing Issue 78 confirms that an ijara contract should be taxed on the same basis as a conventional operating lease.

A finance lease, from an Irish tax perspective, is treated as an operating lease unless the lessor company has made a specified claim to be taxed in accordance with the normal accounting practice in respect of all relevant short term leases. Accordingly, a Shari’a-compliant finance lease transaction should be treated for tax purposes in the same way as if it were a conventional finance lease.

Where the lessee has made an additional payment to the lessor towards a charitable cause, Tax Briefing Issue 78 confirms that such payment will be treated as lease rental income received by the lessor from the lessee. Accordingly, the lessee may be entitled to a tax deduction provided the lease rental payments qualify to be a tax deductible expense. The Tax Briefing also confirms that if the lessor utilises the amount paid by the lessee in making a donation to a Revenue approved charity, the lessor will be entitled to a tax deduction in accordance with the tax law provisions that grant an expense deduction when a donation is made to a Revenue approved charity. However, where a non qualifying charitable donation is a legitimate expense of entering into the leasing transaction, it is arguable that the expense should be treated no differently than any other expense incurred wholly and exclusively for the purposes of the trade of the lessor or as an expense incurred in deriving non-trading income chargeable to tax.

Tax Briefing Issue 78 specifically states that the tax treatment referred to above only relates to leasing of plant and machinery and other chattels and does not apply to a lease of immovable property.

25.8.5 Hire-purchase
An ijara arrangement which is similar to a hire purchase can be structured in either of the following two ways.

- The lessee and the lessor would enter into a normal ijara arrangement. The term of the ijara would be the same as the intended term for an equivalent finance lease.

- In addition to the normal ijara contract, the lessor would promise to transfer the title of the asset to the lessee in either of the following ways.

  - By way of gift (for no consideration)
  - For a token or other consideration
  - By accelerating the payment of the remaining amount of lease rentals, or by paying the market value of the asset

The transfer may be contingent upon a particular event, e.g., a transfer by way of gift may be contingent upon the payment of the remaining instalments.

- The promise is binding on the lessor only, whereas the lessee has an option not to proceed with the transfer.

- The promise should be contained in a separate document and cannot be taken as an integral part of the ijarah contract.

- If the transfer is subject to any stipulation, such as payment of the remaining instalments, the transfer cannot be made until the condition is satisfied, e.g. even if one instalment is unpaid.

In the other arrangement, an ijara is combined with a diminishing musharaka arrangement to achieve a Shari’a equivalent of a conventional hire-purchase arrangement. This can be illustrated and summarised in Exhibit 1.
The hire-vendor and the hire purchaser enter into an arrangement whereby they jointly acquire the asset. The asset is normally acquired in the name of the hire-vendor (as security).

The hire-vendor’s interest in the asset is divided into a number of units.

The hire-purchaser promises to acquire the hire-vendor’s interest in the asset over an agreed period (the hire purchase term) for an agreed price payable in instalments (economic equivalent of principal repayments in a conventional hire purchase). This is a binding promise on part of the hire-purchaser.

The hire-vendor’s interest in the asset is leased to the hire-purchaser. (The rentals substitute interest payments in a conventional hire-purchase arrangement)

As the hire-purchaser gradually increases its interest in the asset by making payments towards the acquisition of the hire-vendor’s interest, there is a corresponding decrease in the hire-vendor’s interest in the asset. As a natural consequence of this decrease in the hire-vendor’s interest, the rental payments decrease over time. This is very similar to an amortisation schedule for a conventional hire-purchase arrangement.

The legal title is transferred to the name of the hire-purchaser after all the instalments have been paid.

### 25.8.6 Taxation

For tax purposes the arrangement outlined above should be treated as if it were a conventional hire-purchase arrangement. The tax treatment of any additional payment made by the hire-purchaser to the hire-vendor (to compensate for a default in rental payment) towards a charitable cause should be the same as that set out under 25.8.

Irish Revenue have specifically stated in Tax Briefing Issue 78 that the above tax treatment would not apply to a hire-purchase transaction involving immovable property.

### 25.8.7 Indirect taxes

#### VAT

As confirmed in Tax Briefing Issue 78, the normal VAT rules concerning leasing (a supply of services), transfer of title (supply of goods) or hire purchase (a supply of goods), as appropriate, would apply to the respective ijara arrangements. Fundamentally, the VAT treatment of ijara arrangements is no different from the VAT treatment of conventional leasing and hire purchase arrangements.

#### Stamp duty

Tax Briefing Issue 78 confirms that a charge to stamp duty should not arise in relation to operating/finance lease and hire purchase arrangements set out above where the asset involved does not comprise immovable property or an interest in immovable property.

In light of the above, the guidance previously issued by Revenue in relation to the taxation of conventional operating and finance lease transactions and hire purchase arrangements should, in substantially similar circumstances, also apply to the equivalent ijara arrangements.

### 25.9 Takaful (insurance) arrangements

Based on the concept of social solidarity, cooperation and mutual indemnification of losses of members, takaful is an arrangement amongst a group of persons participating in a scheme under which the takaful members (policyholders) jointly indemnify each other against any loss or damage that may arise to any of them. In broad terms, a takaful arrangement is similar to mutual insurance with the difference that takaful members would normally not be shareholders or unit holders in the takaful company, which operates the takaful fund. The company is paid a fee for its services and/or is entitled to a share in the return received on the fund’s investments. The takaful funds are invested in a Shari’a approved manner, i.e. the normal prohibitions relating to investments apply.

The term “general takaful” is normally used as a reference to the general insurance arrangement while the term “family takaful” would normally refer to a life assurance arrangement.

A retakaful (reinsurance) arrangement also works in a similar way where the takaful companies assume the role of the takaful members and the retakaful company assumes the role of the operator of the scheme.
The illustration from Tax Briefing Issue 78 is reproduced in Exhibit 2 to explain the structure of a takaful arrangement.

### 25.9.1 General takaful (general insurance)

The key defining characteristics of a takaful arrangement are as follows:

- A company sets up a takaful fund and invites contributions from persons (takaful members). Takaful members pool funds by way of contributions. This fund is used to make compensation (claim) payments for any loss or damage arising to any takaful member. The claim payments are generally restricted to actual damage or loss and the opportunity costs (such as loss of potential income) are generally ignored.

- The takaful company operates the whole arrangement relating to (a) the management and receipt of contributions, (b) claim management and payments, and (c) the management and operation of takaful fund.

- The company tracks takaful funds separately from its own share capital and reserves. Accordingly, a loss relating to takaful funds is charged to the takaful fund and ring-fenced from the company’s reserves. Likewise, a loss relating to the company’s investments/activities is borne by the company and ring-fenced from takaful funds. Normally, the company’s share capital and reserves (including fee income) are used to pay marketing and management expenses and commission payments.

- The relationship between the takaful company and takaful members (policyholders) can be based on the concept of mudaraba, musharaka or wakala. The recent trend is to use a wakala/mudaraba mix relationship between the company and the takaful members (policyholders).

- The company would normally charge a fee for its services relating to the management and operation of the takaful scheme and funds. The fee may be fixed or a share in the returns on takaful investments. It is also possible that the company is paid a fixed fee and is also entitled to a share in the returns received on takaful investments. The arrangement is normally set out in the insurance policy or other related documentation.

- If a shortfall arises in the takaful fund, the company would normally make an interest free loan to the fund. Generally, the loan is repayable only out of a future surplus arising in the takaful fund. If subsequently, there is a surplus in the takaful fund, the surplus is first used for the repayment of any interest free loan owed to the company and the balance can either be reserved for future losses or the company may decide to make a distribution to takaful members (policyholders). The distribution amount may be adjusted against the contribution payment relating to the following year.

- On dissolution or winding up of a takaful fund, any surplus in the fund may be distributed amongst those who contributed to the takaful fund or amongst those who are members (policyholders) of the fund on the day of dissolution or winding up. The surplus or any part thereof may also be given to charity. The takaful funds cannot be diverted to the company.

### 25.9.2 Taxation

Tax Briefing Issue 78 confirms that a takaful arrangement, outlined above, is broadly similar to a conventional insurance arrangement and should be taxed under the same provisions of Irish tax law (TCA 1997) as those applicable to conventional insurance companies. Accordingly:

- Contributions received by a takaful company from policyholders (takaful members) are to be treated as taxable income. The question whether income is on trading account will depend on the facts and circumstances of the case.

- The deductibility of expenses incurred by a takaful company for management, marketing, claims and commissions and any provisions in respect thereof should be treated in the same way as such expenses incurred by a conventional insurance company with the same level of activity.

- The deductibility of a contribution payment paid to a takaful company is to be treated in the same way as an insurance premium for a conventional insurance policy.

### 25.9.3 Family (life) takaful

A family (life) takaful arrangement works in a broadly similar way to a general takaful arrangement. It is similar to a conventional life assurance or a savings scheme wrapped in a life policy. The following are the key differences:
The amount received from a member (policyholder) is split between a contribution account and an investment account. The split is generally based on the actuarial valuation of the associated risks and is agreed with the policyholder at the time of issuance of the policy. The contribution account is generally reserved for life assurance claims. If the takaful member survives the policy term, the member is only entitled to receive the amount paid into the investment account and any accumulated profits attributable to such amount.

The profit made on takaful investments is apportioned amongst the policyholders (takaful members) or retained as a reserve for future. The arrangement is normally set out in the insurance policy or other related documentation, as is the case with conventional life assurance.

25.9.4 Taxation

Tax Briefing Issue 78 confirms that the taxation of a family (life) takaful company, which is an assurance company, as defined, is to be determined under the same principles as those applicable to a conventional life assurance company. It also confirms that the taxation of members (policyholders) of a family (life) takaful company is to be determined on the same basis as that applying to policyholders of a life assurance company.

As a result, an amount paid by an insured person is to be treated in the same way as a payment under a conventional life assurance policy is treated. Similarly, a maturity or claim amount paid by a family (life) takaful company is to be treated in the same way as a claim or maturity payment under a conventional life assurance policy is treated.

25.9.5 Retakaful (reinsurance)

A retakaful works in a similar way to a takaful. Various takaful companies participate in a retakaful fund set up by a retakaful company. In this arrangement, the takaful companies assume the role of the policyholder in a general takaful arrangement and the retakaful company acts as the operator of the retakaful arrangement.

25.9.6 Taxation

As confirmed by Revenue in Tax Briefing Issue 78, the taxation of a retakaful company should be determined under the same principles as those applicable to a conventional reinsurance company. Accordingly, the tax principles outlined in 25.9.1 above equally apply to retakaful arrangements. Contribution payments made by takaful companies participating in a retakaful arrangement (and received by the retakaful company) should be treated in the same way as reinsurance premium under a reinsurance arrangement between insurance/reinsurance companies.

25.9.7 Indirect taxes

VAT

As confirmed by Revenue in Tax Briefing issue 78, takaful (general and family (life)) and retakaful arrangements are to be treated in the same way as conventional non-life and life insurance and reinsurance arrangements for VAT purposes, i.e. the services rendered will be exempt from VAT. Consequently a VAT charge will not arise on service charges made by a takaful/retakaful or a family (life) takaful company to the individual or pooled contributions from the takaful members.

Stamp duty

For the purposes of stamp duty, takaful arrangements are to be treated as policies of insurance/reinsurance or life assurance, as the case may be. As clarified in Tax Briefing Issue 78, a liability to stamp duty (commonly referred to as “Insurance Premium Tax” or “IPT”) arises under stamp duty law in relation to takaful (general and family (life)) and retakaful arrangements where the risk is located in Ireland. If the risk insured is located outside of Ireland, a charge to Irish stamp duty should not arise.

25.10 Retail banking deposits

An Islamic bank normally raises deposits using mudaraba, wakala or musharaka arrangements. Sometimes, different types of deposits are structured using different arrangements. For example, a bank may use a mudaraba model for the equivalent of a savings account and a wakala model for the equivalent of a fixed term deposit account.

In the mudaraba or wakala structures, the bank acts as the investment manager/partner or agent while the depositor is treated as the investor or principal. In a musharaka structure, the bank would mix the amount of deposit with its own share capital and reserves and utilise the pool in making Shari’a-compliant investments.

The structure of a retail banking deposit is illustrated in Exhibit 3.

The profits are shared between the bank and the depositor on a pre-agreed ratio. Although the depositor solely bears the risk of loss in a mudaraba or a wakala structure, the bank would normally, from a commercial perspective, build up and maintain enough reserves to avoid any shortfall arising in future. Moreover, as the investments are not linked to individual deposits, the risk from a depositor’s perspective essentially becomes a credit risk on the bank. This is similar to the risk with a conventional deposit with a bank.

Generally, the agreement between the bank and the depositor allows the bank to periodically calculate and pay the share of profit according to its own calculations and estimates. It also allows the bank to carry forward as reserves any undistributed surplus which the bank deems appropriate to provide for future losses. Normally, the agreement provides that the depositor would accept all such calculations and that the decision of the bank would be binding on him. The depositor also authorises the bank to charge appropriate fees and administrative costs and to retain the amount of the bank’s share in the profit.
25.10.1 Tax treatment for the bank

The Shari’a-compliant banking deposit arrangements are referred to in Finance Act 2010 as "deposit transactions". The tax treatment for the bank and for the depositor is set out below.

The return paid on a Shari’a-compliant bank account should be treated for tax purposes as interest and should be subject to the same tax (and withholding tax) rules as those applicable to bank interest on conventional deposits, unless the deposit return is considered a distribution under section 130 of Irish tax law (TCA 1997). Under s130, interest can be reclassified as a distribution where it is, to any extent, dependent on the results of the company. Given the profit participating nature of many of these arrangements, Irish Revenue have issued additional guidance clarifying that deposit return will not be re-characterised as distribution solely by virtue of the profit participating nature of the arrangement provided the transaction is expected to yield a return equivalent to an interest return on a comparable conventional arrangement and where the expected return agreed at the time of entering into the arrangement is not subsequently altered except to the extent of the movement in interest rates applicable to conventional banking deposits.

Moreover, notwithstanding the legal form of the deposit arrangement which may provide for a profit sharing arrangement between the bank and the depositor, the deposit arrangement between the bank and the depositor is not treated as a partnership for tax purposes.

Where the return is in excess of interest payable on a comparable conventional deposit and the amount should not be classed as distribution under section 130 of TCA 1997, the depositor should be treated for tax purposes as if the depositor has earned interest income from a relevant deposit taker, i.e. a conventional bank or credit institution licensed as such by the central bank. Accordingly, the depositor should be subject to the tax rules that are applicable to earning interest income on a conventional bank account.

Where the Shari’a-compliant deposit does not fall within the scope of a specified financial transaction, then, depending on the arrangement, the return received by the depositor could either be treated as a ‘share’ of profit from a partnership or income received by a principal from an agent acting on behalf of the principal. In either case, a resident individual could be taxed on such income at the marginal rate of tax, income levy and health levy and may also be subject to social security levies and charges as self-employed (where earning trading income). The tax treatment of a corporate depositor would also depend on the facts and circumstances of the depositor, e.g. whether a trade is being carried on.

In addition to the above, there could be other administrative issues. Where a non qualifying Shari’a-compliant bank account is considered as a partnership between the bank and the account holder, partnership tax returns may need to be filed. Furthermore, while a conventional bank depositor may not be required to file an income tax return (depending on the facts and circumstances), a Shari’a-compliant depositor who is treated as receiving a share of income from a partnership (with the bank) would be required to file tax returns.

25.10.3 Indirect taxes

A qualifying Shari’a-compliant deposit arrangement is regarded as corresponding to a conventional banking deposit arrangement. Accordingly, the fees levied to the depositor should be for “agency services” in relation to “the operation of any current, deposit or savings account” and consequently should be exempt from VAT.

25.11 Lending arrangement and asset backed financing (murabaha)
Typically, banks and financial institutions use a murabaha arrangement as a substitute for debt financing and asset backed lending arrangements. The legislation refers to these arrangements as “credit transactions”.

A murabaha is an outright sale, at a marked-up price, where the seller discloses its profit margin to the purchaser. The marked-up price is generally payable over time. Where the purchaser (borrower) delays in making the payment or any instalment thereof, he is required to make an additional payment towards a charitable cause. To enforce this, the agreement normally provides that the payment should be made through the finance undertaking. Under Shari’a principles, the finance undertaking should not use such payment for its own benefit and should give it away in charity.

### 25.11.1 Debt financing

Where the objective is to raise cash, the murabaha structure commonly used is illustrated in Exhibit 4.

The finance undertaking purchases a commodity for cash (for say 100) which is then sold on to the borrower on a deferred payment basis with an agreed margin of profit (say 20) inherent therein. The ‘margin’ is a substitute for interest and is generally not very different from what would be charged under a conventional lending arrangement. The borrower, immediately on purchasing the commodity, sells the commodity into the market for cash at its market value (which should again be 100). In the process, the borrower has generated cash of 100 and has an obligation to pay 120 to the finance undertaking.

The commodity which is commonly used is copper, as it is freely traded on the commodity exchange market. Gold and silver cannot be used, as Shari’a prohibits trading in gold or silver on a deferred payment basis. Any transaction in these commodities would have to be carried out on spot.

Another approach that is also sometimes made is the sale and immediate buy back of the asset by the borrower. In the first step, the borrower sells part or all of its interest in the asset to the finance undertaking for cash. The borrower immediately reacquires the interest in the asset from the finance undertaking at a marked-up price payable in the future. As a result, the borrower generates cash and also reacquires its interest in the asset with a liability that is to be discharged in future.

### 25.12 Asset backed financing arrangement

Where the objective is to provide the Shari’a equivalent of an asset backed financing transaction, the following structure can be used as can be illustrated in Exhibit 5.

Similar to the debt financing structure described above, the finance undertaking purchases the asset in the open market (or from the borrower) and then sells it back to the borrower at a marked-up price. Generally, the margin is disclosed to the borrower. The asset may then be used by the borrower while the borrower has a deferred liability towards the finance undertaking to be discharged over an agreed term.

### 25.13 Corporation tax

**Finance undertaking’s taxation**

For a finance undertaking, the tax treatment of the lending arrangement set out above should not be different from a conventional lending arrangement. In both scenarios, described above, the ‘mark-up’, being the difference between the cost and the sale price, should be treated as taxable income of the finance undertaking. Whether such income is on trading account or otherwise will depend on the activities of the finance undertaking. From a timing perspective, where such income arises on trading account, the taxable trading profits are to be computed on the basis of the accounting measure of such profits computed under Irish / UK GAAP or IFRS.

Qualifying payments made to charities by the finance undertaking should be tax deductible. Furthermore, where a non qualifying charitable donation is a legitimate expense of entering into the murabaha transaction, it is arguable that the expense should be treated no differently than any other expense incurred wholly and exclusively for the purposes of the trade of the lessor or as an expense incurred in deriving non-trading income, where relevant.

**Borrower’s taxation**

For a borrower, the tax treatment of the transactions discussed above should not be different from a conventional borrowing arrangement. The mark up should be treated for tax purposes as if it were interest payable on a loan made by the finance undertaking to the borrower.
or on a security issued by the borrower to the finance undertaking, where appropriate.

On the basis that the "borrowing" is for the purposes of the trade of the borrower, the timing of the tax deduction would generally follow the accounting measure of the expense in the profit and loss account computed in accordance with Irish / UK GAAP or IFRS. Similarly, where the borrower would have been entitled to claim interest as a deduction on a payment basis if it were conventional financing, the tax deduction should be available when such return is paid by the borrower.

With specific reference to a debt financing transaction set out in 25.11, the legislation clarifies that the borrower is not entitled to claim a tax loss arising on the immediate disposal of the commodity in the market.

With specific reference to an asset backed financing arrangement set out in 25.11, the legislation clarifies that:

(a) the finance undertaking is not entitled to claim capital allowances (tax depreciation) on the cost of the asset which is acquired by the finance undertaking for the purposes of entering into a credit transaction,

(b) the borrower is to be treated as having acquired full interest in the asset on the date of entering into the credit transaction. Accordingly, where entitled, the borrower may claim capital allowances (tax depreciation) on full cost of the asset from that date,

(c) the amount treated as interest is not to increase the tax basis of the asset for the borrower. Accordingly, the amount treated as interest is to be ignored by the borrower in claiming capital allowances or in calculating a capital gain or loss on a subsequent disposal of the asset, and

(d) where the borrower disposes of its interest in the asset to the finance undertaking and then immediately reacquires the interest from the finance undertaking, the disposal of the interest by the borrower to the finance undertaking is to be ignored for tax purposes, i.e. the disposal would not give rise to a gain or loss. The disposal of the interest by the borrower may potentially be subject to capital gains tax under the legislation. It is hoped and expected that legislative amendments will be introduced to address this.

For employers entering into credit transactions, as set out in 25.11 above, with their employees, the legislation specifically provides that the transaction would be treated for tax purposes as if the employer has made a loan to the employee. Accordingly, the rules relating to preferential loan arrangements should apply, i.e., there could be tax implications if the return receivable by the employer from the employee is lower than interest arising at the benchmark rate (market rate, as specified in Irish tax law).

25.13.1 Indirect taxes

VAT

As the credit return is to be treated for tax purposes as interest arising on a loan, the arrangements set out in 25.11 above should be considered as a VAT exempt financial service relating to negotiating, giving and management of credit.

Stamp duty

On the basis that the transaction would involve goods that are capable of transfer by physical delivery, a stamp duty cost may not arise on the transaction. Where the transfer is made under an instrument, a charge to stamp duty could arise depending on the nature of goods and the instrument.

25.14 Property mortgages

A Shari'a-compliant equivalent of a conventional mortgage is achieved by combining an ijarah arrangement with a musharaka arrangement. This approach is commonly referred to as a diminishing musharaka arrangement. It can also be achieved by way of a murabaha arrangement. Both of these arrangements are discussed below. Shari'a-compliant mortgages are also referred to as "credit transactions" in the legislation.

25.14.1 Diminishing musharaka

A diminishing musharaka can be illustrated in Exhibit 6. This arrangement is achieved through the following steps. Normally, these steps are achieved under different legal agreements.

- The customer (eventual owner) and the finance undertaking enter into an arrangement whereby both parties contribute capital and acquire the property (either in the market or from the customer). This can either be a partnership or a co-ownership arrangement. The respective interest of the parties is divided into a number of units. The legal title to the property normally rests with the finance undertaking, as a security.

- The property is rented out to the eventual owner who retains the sole and exclusive use of the property including the power to sub-lease. The eventual owner pays the finance undertaking rent for the lease of its beneficial interest in the property. The rent, which can be reviewed periodically, would normally be an amount equal to the economic return on the finance undertaking's investment in a conventional mortgage.

A diminishing musharaka may be illustrated in Exhibit 7. The construction of a diminishing musharaka can be illustrated in Exhibit 8. The structure of a diminishing musharaka can be illustrated in Exhibit 9. The application of a diminishing musharaka can be illustrated in Exhibit 10.
The agreement would normally allow the eventual owner to sell the asset during the currency of the arrangement. However, this permission can be subject to a condition that the sale consideration is sufficient to fully discharge the finance undertaking’s remaining interest in the property. The finance undertaking does not gain anything from a profit made on the sale of the asset. Likewise, the finance undertaking does not take up any loss sustained on the disposal of the property. Generally, the finance undertaking would charge a settlement fee for administering the account and releasing the deeds.

The amount of rent payable to the finance undertaking decreases proportionately as the eventual owner acquires its interest in the property. If a payment for rent or acquisition of ownership interest is not made by the due date, the eventual owner may be required to make an additional payment towards a charitable cause. To enforce this, the agreement normally provides that such payment should be routed through the finance undertaking. Under Shari’a principles, the finance undertaking should not use such payment for its own benefit and should give it away in charity.

25.14.2 Murabaha

The murabaha arrangement used is as discussed in 25.11. It can be illustrated in Exhibit 7.

Exhibit 7

The property is purchased by the finance undertaking for cash (in the market or from the customer) and is then sold on to/(back to) the customer (eventual owner) on a deferred payment basis at a marked-up value. The amount is payable over a term which would typically be the term under a comparable conventional mortgage. The ‘mark-up’, which is determined on the basis of the term of the arrangement is the financial equivalent of an interest return under a comparable conventional mortgage. Similar to a conventional mortgage, the finance undertaking may keep a lien over the property.

Similar to a diminishing musharaka, if an instalment is not paid by the due date, the eventual owner may be required to make an additional payment to the finance undertaking to be utilised towards a charitable cause.

25.14.3 Corporation tax

The corporation tax implications are outlined below. You should note that the legislation does not expressly cover remortgage transactions involving the transfer of a mortgage from one finance undertaking to another or portfolio transfer transactions involving two or more finance undertakings. Under the legislation, where an interest in a property is acquired by a finance undertaking from a third person (other than the customer) the new legislation only applies where the finance undertaking has acquired such interest jointly with the customer. One would therefore recommend prior revenue clearance for any transaction that involves the transfer of a mortgage (or a portfolio of mortgages) from one finance undertaking to another. It is expected that Irish Revenue would be helpful in sorting out any genuine problem.

Finance undertaking’s taxation

Under either of the arrangements set out in diminishing musharaka and murabaha the finance undertaking should be treated as having made a loan to the customer. Accordingly, under a diminishing musharaka arrangement as set out above, the rent payable by the customer for using the property is to be treated as if it were interest arising on a loan made by the finance undertaking. Similarly, under a murabaha arrangement the incremental amount payable by the customer, i.e. the amount which is over and above the consideration paid by the customer, should be treated for tax purposes as if it were interest arising on a loan made by the finance undertaking. Whether such income is on trading account or otherwise will depend on the overall activities of the finance undertaking. Where a finance undertaking carries out the transaction as part of its trading activities, income from the transaction should be treated as arising on trading account. If so, then from a timing perspective the taxable income should be based on the accounting measure of income as computed under Irish / UK GAAP or IFRS.
Where the finance undertaking is obliged to make a charitable donation (for any additional payment received from the eventual owner) and such payment can be considered as a legitimate expense of entering into the diminishing musharaka or murabaha transaction, it is arguable that the expense should be treated no differently than any other expense incurred wholly and exclusively for the purposes of the trade of the finance undertaking or as an expense incurred in deriving non-trading income, where relevant.

**Eventual owner’s taxation**

On the basis that the rental or the incremental payments under 25.14 above are treated as interest for tax purposes, the customer (eventual owner) should be entitled to mortgage interest relief (where it is a principal private residence that would qualify for such relief under conventional financing arrangements).

The legislation specifically clarifies that:

(a) the finance undertaking is not entitled to claim industrial building allowances (tax depreciation on industrial building) on the cost of the property which is acquired by the finance undertaking for the purposes of entering into a Shari’a-compliant mortgage (credit transaction),

(b) the borrower is to be treated as having acquired full interest in the property on the date of entering into a Shari’a-compliant mortgage (credit transaction). Accordingly, where entitled, the borrower may claim industrial building allowance (tax depreciation on industrial building) on full cost of the property from that date,

(c) the amount treated as interest is not to increase the tax basis of the property for the borrower. Accordingly, the amount treated as interest is to be ignored by the borrower in claiming industrial building allowance (tax depreciation on industrial building) or in calculating a capital gain or loss on a subsequent disposal of the property, and

(d) where the borrower disposes of its interest in the property to the finance undertaking and then immediately reacquires the interest from the finance undertaking, the disposal of interest by the borrower to the finance undertaking would not give rise to a balancing charge or a balancing allowance. The disposal of the interest by the borrower may potentially be subject to capital gains tax.

For Shari’a-compliant mortgage arrangements entered into between a finance undertaking and its employee(s), the legislation specifically provides that the transaction should be treated as if the employer has made a loan to the employee. Accordingly, the rules relating to preferential loan arrangements should apply, i.e., there could be tax implications if the return receivable by the employer from the employee is lower than interest arising at the benchmark rate (market rate as provided in Irish tax law).

**25.14.4 Indirect taxes**

**VAT**

As the credit return is to be treated for VAT purposes as interest arising on a loan, the Shari’a-compliant mortgage arrangements set out in 25.14 should be considered as a VAT exempt financial service relating to negotiating, giving and management of credit. The rental arrangement between the finance undertaking and the customer (eventual owner) should be seen as part of the overall financing arrangement and not as a separate arrangement. Accordingly, VAT should not arise on the rental arrangement.

**Stamp duty**

There should be no Irish stamp duty costs if the property which is the subject of the transaction is located outside of Ireland.

In relation to a property located in Ireland, there are a number of stamp duty issues that could arise on structuring a mortgage in a Shari’a-compliant manner. The most significant is the duplication of stamp duty costs, as the arrangements outlined in 25.14 involve two transfers of title to the property (first to the finance undertaking and then from the finance undertaking to the eventual owner) and each of them could potentially be subject to stamp duty. A remortgage of a property could also be subject to additional stamp duty costs. Furthermore, the transfer of a portfolio of Shari’a-compliant mortgages by one finance undertaking to another could involve a transfer which would be subject to additional stamp duty costs.

In addition, the eventual owner’s entitlement to reliefs, such as first-time buyer’s relief, could potentially be restricted.

The lease agreement could also be subject to stamp duty.

**25.15 Changes needed in the legislation**

In order to address the above issues, amendments would need to be made to Irish stamp duty legislation. This would mainly involve the following:

- The second transfer (from the finance undertaking to the eventual owner) would need to be exempted from stamp duty provided the due amount of stamp duty in relation to the first leg of the transaction, i.e., the transfer to the finance undertaking, has been duly paid.

- It could be provided that no stamp duty charge shall apply if the person selling the property also enters into an arrangement with the finance undertaking which involves a reacquisition of the same property.

- The transfer of a Shari’a-compliant mortgage portfolio between finance undertakings could be specifically exempted from a stamp duty charge.

- In order to preserve stamp duty reliefs available to the eventual buyer, it needs to be provided that the eventual owner (and not the finance undertaking) shall be deemed as purchaser of the property for the pur-
poses of determining the applicability of any exemption or relief from stamp duty.

- An exemption from stamp duty can be provided on lease agreements entered into with a finance undertaking where the lessee has also entered into a contract with the finance undertaking which involves the acquisition of the entire interest of the finance undertaking over a term which does not exceed the term of the lease agreement.

### 25.16 Inter-bank placement of funds

A Shari’a-compliant placement of funds between banks is typically structured under a murabaha arrangement. It would fall under the definition of a “credit transaction” under the legislation. It can be illustrated in Exhibit 8.

![Exhibit 8](image)

As can be noted from the above, Bank A is placing a deposit with Bank B. Typically, a commodity (say copper) is used and all the transactions are entered into almost at the same time. It is common for banks to enter into a master agreement which contains the common elements of the arrangement and governs all murabaha transactions that take place between the two banks going forward.

#### 25.16.1 Corporation tax

On the assumption that both the banks will enter into the above transaction as part of their normal trading activities, the tax treatment of the above arrangement should not be different from a conventional arrangement relating to inter-bank placement of funds. The ‘mark-up’, being the difference between the cost and the sale price, should be treated as taxable income of the bank placing funds and a tax deductible expense for the other bank. Also, from a timing perspective, the taxable trading profits of both the banks should be computed on the basis of the accounting measure of such profits computed under Irish / UK GAAP or IFRS.

#### 25.16.2 Indirect taxes

**VAT**

The VAT analysis should be the same as that outlined earlier. Being a financial service, the arrangement should be exempt from VAT.

**Stamp duty**

As set out in 25.13.1, on the basis that the transaction would involve goods that are capable of transfer by physical delivery, a charge to Irish stamp duty may not arise on the transaction. Where the transfer is made under an instrument, a charge to stamp duty could arise, depending on the nature of instrument and the goods involved.

### 25.17 Inter-corporate lending

A Shari’a-compliant inter-corporate lending transaction also typically is structured under a murabaha arrangement. The structure is exactly as illustrated in 25.16 above except that two corporate entities enter into the arrangement instead of banks. This arrangement would also fall under the definition of a “credit transaction”.

#### 25.17.1 Corporation tax

**Lending company’s taxation**

The ‘mark-up’, being the difference between the cost and the sale price, should be treated as taxable income of the lending company. Whether such income is on trading account or otherwise would depend on the trading position of the lending company.

**Borrowing company’s taxation**

For the borrowing company, the tax treatment would not be different from a conventional borrowing arrangement. The mark up should be treated for tax purposes as if it were interest payable on a loan made by the finance undertaking to the borrower or on a security issued by the borrower to the finance undertaking, where appropriate.

On the basis that the “borrowing” is for the purposes of the trade of the borrowing company, the timing of the tax deduction would generally follow the accounting measure of the expense in the profit and loss account computed in accordance with Irish GAAP or IFRS. However, where the borrower would have been entitled to claim interest as a charge relief if it were conventional finance, the tax deduction should be available when such “interest” is paid by the borrower, in line with the rules relating to interest as a charge relief.

#### 25.17.2 Indirect taxes

**VAT**

The VAT analysis should be the same as that outlined in 25.13.1. Being a financial service, the arrangement should be exempt from VAT.

**Stamp duty**

As set out in 25.13.1, on the basis that the transaction would involve goods that are capable of transfer by physical delivery, a stamp duty charge may not arise on the transaction. Where the transfer is made under an instrument, a charge to stamp duty could arise, depend-
25.18 Securitisation

A sukuk arrangement is broadly similar to a conventional securitisation arrangement. However, in compliance with Shari’a principles, the underlying asset has to be capable of transferring at a value other than book value and must be capable of some halal (permissible) use to produce income for the note holders. The scholars broadly agree that under Shari’a principles, cash and cash equivalents cannot be traded for a value other than par. Accordingly, tangible assets (such as property or machinery or plant) and financial assets (such as shares and securities) that principally draw their value from tangible assets are used in structuring sukuk transactions. The financial assets must entitle the owner to a proportionate beneficial interest in the underlying tangible assets.

Broadly, a sukuk SPV issues certificates known as sukuk (referred to as investment certificates in Finance Act 2010) to investors for cash which it uses to fund the purchase of an asset. The beneficial interest in the asset is transferred to the note holders for cash consideration. The sukuk represents a proportionate share in the beneficial ownership of the underlying asset that has been the subject of the arrangement. The asset gives rise to income that is acceptable from a Shari’a perspective and that can be paid to the sukuk holders. The amount of income is generally not very different from what would be a return under a commercial bond issue in a securitisation transaction. It is possible to structure a sukuk arrangement whereby a class of assets is involved instead of a specified asset or assets.

A typical sukuk arrangement is illustrated in Exhibit 9.

The new legislation applies to sukuk (investment certificates) that:

(a) have been issued by an Irish resident company which redeems them after a specified period of time, i.e. the term of the transaction,

(b) are issued to the public (including companies) in general. The reference to public is in general terms and does not require listing on a stock exchange,

(c) entitle the owner to share the profits and losses of the issuing company in proportion to the number and value of the certificates, and

(d) are treated partly or wholly as a financial liability of the issuer company in accordance with IFRS or Irish / UK GAAP.

sukuk arrangements would fall under the definition of “investment transactions” in the legislation.

25.18.1 Ijara based securitisation arrangement

Fundamentally, the beneficial ownership of the assets (whether real assets or financial assets carrying an interest in the underlying real assets) is transferred by the originator company to a ‘special purpose vehicle’ (“SPV”). The SPV finances the purchase by issuing sukuk to investors. The interest in the underlying assets is then effectively leased by the SPV to the originator for periodic lease rentals that are received by the SPV for onward distribution to sukuk holders. The originator also undertakes to reacquire the interest of the SPV/sukuk holders in the underlying assets at an agreed price. The lease rental amounts economically equate to interest or return in a conventional securitisation arrangement. On the expiry of the arrangement, the beneficial interest is transferred back to the originator company and the sukuk are redeemed by the SPV from the proceeds realised on transferring back the assets.

25.18.2 Wakala based securitisation arrangement

This is largely based on the same arrangement as set out for ijara based securitisation. However, instead of leasing its interest in the assets to the originator, the originator is appointed as agent for a fee and or a share in profits derived from the use of the asset. As agent, the originator uses the asset on behalf of the SPV. The SPV may also allow the agent to retain any amount of profit generated from use of the asset which is in excess of a specified threshold that would belong to the SPV. The share of income paid to the SPV is the economic substitution of interest or return under a conventional securitisation arrangement.

25.18.3 Mudaraba or musharaka based securitisation arrangement

This arrangement is also largely based on the same ar-
rangement as set out above for ijara and wakala based securitisation. Under this approach, the SPV enters into a partnership arrangement with the originator whereby any profit arising from the use of the asset is shared between the borrower and the SPV. Generally, the SPV’s share of profit would be an amount which would economically be very similar to interest on a bond or return under a conventional securitisation arrangement.

25.18.4 Corporation tax

On the basis that the amount of investment return does not exceed an amount which would be interest arising on a conventional investment of a similar nature, the amount of investment return should be treated for tax purposes as if it were interest arising on a security. If the amount of investment return exceeds the amount of what would be interest on a comparable conventional investment, the key implications are discussed in more detail below along with discussion on the taxation of the sukuk issuing SPV.

The securitisation regime outlined in Irish tax law applies only where the securitisation SPV owns financial assets. Accordingly, where the originator transfers financial assets (such as shares of companies whose business is in compliance with Shari’a principles), the Irish securitisation regime should be applicable to a Shari’a-compliant securitisation SPV. Where the originator transfers real assets to the sukuk SPV, the Irish securitisation regime will not apply.

The new Irish legislation relating to Islamic finance transactions specifically confirms that for tax purposes the sukuk holders (certificate owners) are not to be treated as having a direct legal or beneficial interest in the assets held by the sukuk issuing SPV. Consequently, the sukuk holders are not entitled to claim any capital allowances or industrial building allowance (tax depreciation) in respect of the assets held by the sukuk issuing SPV. Moreover, any income, profits, gains or losses arising from or attributable to the assets are treated for tax purposes as if such income, profits, gains or losses have accrued to the sukuk issuing SPV and not to the sukuk holders.

24.18.5 Taxation of sukuk holders

The taxation of investment returns for sukuk holders is summarised below.

(a) Where a sukuk holder, who has acquired the sukuk directly from the issuing company (“the original sukuk holder”), receives any return from the sukuk issuing SPV, such return is treated as an investment return for the original sukuk holder.

(b) Where the original sukuk holder redeems the sukuk, the gain or loss on such redemption is treated as the investment return. It should be noted that where the original sukuk holder disposes of the sukuk in the secondary market, the gain or loss on such disposal is not considered as the investment return. Instead, such gain or loss is treated under normal tax rules and a distinction is made between the capital and revenue nature of the gain depending on facts and circumstances of the case.

(c) Where a person who has acquired sukuk from the secondary market (“the subsequent owner”) receives any return from the issuing company, such return is treated as an investment return.

(d) Where a subsequent owner redeems the sukuk, the investment return on such redemption is calculated by comparing: (a) the disposal proceeds received by the subsequent owner, with (b) the amount received by the sukuk issuing SPV from the original sukuk holder. The balance of the gain or loss arising to the subsequent owner (being the difference between the redemption proceeds and the acquisition value of the sukuk) would have to be treated under normal tax rules and a distinction made between the capital and revenue nature of the gain depending on the facts and circumstances of the case.

Where part of the return is considered as a distribution, the tax analysis may be different to that outlined above.

25.18.6 Taxation of sukuk issuing SPV

The sukuk issuing SPV is entitled to a tax deduction in respect of the investment return paid to sukuk holders unless it is considered a distribution (being in excess of what would be interest under a comparable conventional arrangement). As mentioned in 25.10.1, interest can be reclassified as a distribution where it is, to any extent, dependent on the results of the company. However, Irish Revenue have issued additional guidance clarifying that investment return will not be re-classed as distribution solely by virtue of the profit participating nature of the arrangement where the expected return on the transaction is determined at the time of entering into the transaction and is equivalent to an interest return on a comparable conventional arrangement. Where the sukuk is issued by a qualifying Irish securitisation vehicle, the reclassification should not apply in any event solely by virtue of the profit participating nature of the instrument, as is the position in the case of qualifying Irish securitisation vehicles.

25.18.7 Indirect taxes

VAT

The normal Irish VAT provisions applicable to conventional securitisation arrangements should apply on the securitisation (sukuk) arrangement.

Stamp duty

No Irish stamp duty should apply to the issue, transfer or redemption of sukuk (investment certificates). The normal provisions of SDCA would apply in respect of assets acquired or disposed of by the sukuk issuing SPV. For example, a charge to Irish stamp duty may not arise on the transfer of the asset are located outside of Ireland.
CHAPTER 26
Taxation of Islamic financial products in Luxembourg

26.1 Introduction

For several years already, Luxembourg has been evolving as a global hub for Islamic finance. The Government has been instrumental in putting the measures and means in place to allow the development of Islamic finance. It has been the first European stock market to launch and list sukuk, has been the first European Member State to be admitted to the Council of the IFSB, and has organised frequent government sponsored missions to GCC countries, underlining its commitment to making Luxembourg a primary hub for the development of Islamic finance.

Luxembourg is indeed very well positioned to attract Islamic finance projects thanks to its highly qualified multicultural professionals, its favourable and flexible legal and regulatory environment (investment vehicles compatible with Islamic finance, securitisation law) and its state of the art investment fund industry (Luxembourg is the second fund domicile globally after the US).

Furthermore, another fact which supports the case of Luxembourg as a jurisdiction of choice is its favorable and very flexible tax environment, which is in constant evolution to meet investors’ needs. Indeed, Luxembourg tax authorities issued two tax circulars in 2010 to describe the major principles of Islamic finance, define several Sharia compliant agreements (musharaka, ijara, istisna’, murabaha, sukuk, mudaraba…) and clarify the tax treatment of murabaha and sukuk under Luxembourg tax law as well as the tax treatment in regard of registration duties and VAT applicable to murabaha and ijara agreements.

Those competitive advantages combined to governmental efforts have started to produce results since, as of today, Luxembourg is already the largest non-Muslim fund domicile with 7% of the global market share of Shari’a-compliant funds. In addition, it is worth noting that sixteen sukurs are currently listed on the Luxembourg stock exchange.

26.2 Favorable legal and regulatory environment

In April 2008, the Government set up a cross-working group to review the compatibility of Luxembourg legal and regulatory environment with Islamic finance and identify possible obstacles to its development in Luxembourg. The report was very favorable and stressed the fact that Luxembourg is in a position to offer a range of legal vehicles that address the specific needs of Islamic investors and project promoters.

Luxembourg holding and investment vehicles can therefore all be considered as compatible with Shari’a principles and could be classified as follows:

- Regulated vehicles such as Part I UCITS and Part II UCI (undertakings for collective investments);
- Lightly regulated vehicles such as the SICAR (Investment Company in Risk Capital) or the SIF (Specialised Investment Fund);
- Unregulated vehicles such as the SOPARFI (Société de Participation financière – Fully taxable company) or the SPF (Private Wealth Management Company – Tax exempt company);
- Either regulated or unregulated vehicles depending on several criteria such as the Securitisation Vehicle (SV - based on the Law of 22 March 2004 on securitisation). Luxembourg vehicles are also well placed to support
the other new investment trends such as Microfinance and SRIs (Socially Responsible Investments) which are in line with certain moral values encouraged by the Shari’a.

26.3 Domestic and international taxation

Unlike some other jurisdictions, Luxembourg tax law is based on an economic approach (known as wirtschaftliche betrachtungsweise) and substance over form principles. As a result, Luxembourg domestic tax law is considered as one of the most flexible of the European Union and is in constant evolution to meet financial professionals and foreign investors’ needs. It goes without saying that the Luxembourg tax regime has been tried and tested over the years, which provides for tax certainty and security.

Although Luxembourg is an onshore jurisdiction with an aggregate corporate tax income rate of 28.59%, the flexibility of Luxembourg tax law (many exemptions are possible) combined to an appropriate tax planning often leads to significantly lower effective tax rate in the hands of Luxembourg fully taxable companies.

The main advantages of Luxembourg domestic tax law could be summarised as follows:

- an extensive participation exemption regime for corporate income tax on capital gains and dividend income as well as for net wealth tax purposes and outbound dividend payments
- an IP tax regime which provides an 80% tax exemption on income deriving from IP rights thanks to its broad scope (software, domain names, patents etc), resulting in an effective tax rate of 5.7%.
- tax certainty and security thanks to the possibility to obtain, on a case by case basis, advance tax agreement letters from the Luxembourg tax authorities
- interests paid by Luxembourg companies are not subject to withholding tax in Luxembourg and are generally considered as deductible expenses for corporate income tax purposes
- no withholding tax on liquidation proceeds
- the financing of Luxembourg companies may be done through various debt, equity or hybrid instruments which ensure a tax-efficient overall structure as well as a tax-efficient profit repatriation to the investors
- no exit tax nor controlled foreign corporation (CFC) rules in Luxembourg domestic law
- a VAT rate of 1.5% which is the lowest VAT rate within the European Union

In regard to international taxation and as a founding member of the European Union, Luxembourg companies are entitled to the benefits of the parent-subsidiary, interest and royalties, and merger directives (they have all been incorporated into domestic legislation).

Furthermore, Luxembourg companies have access to Luxembourg’s wide network of double tax treaties with 59 treaties currently in force and 17 other treaties under negotiation or awaiting ratification. Luxembourg tax treaty network includes the United States, major European countries, India, China and Hong-Kong but also many Muslim countries all around the world.

The combination of a very attractive domestic tax law, access to European Union directives, and a wide treaty network, makes of Luxembourg a prime location for international tax planning.

26.4 Tax measures in favour of Islamic finance

In 2010, Luxembourg tax authorities issued two tax circulars to describe the major principles of Islamic finance, define several Shari’a-compliant agreements (murabaha, ijara, istisna, murabaha, sukuk, mudaraba…) and explain the tax treatment of certain Shari’a-compliant instruments.

The first one is the circular n° LG-A No. 55 issued by Luxembourg tax authorities (hereafter the “First Circular”), which aimed at clarifying the tax treatment of murabaha and sukuk under Luxembourg domestic tax law. According to the First Circular, sukuk are considered as debt for Luxembourg tax purposes, which imply that:

- any yield payment under the sukuk is treated as tax deductible at the level of the party that has issued the sukuk and
- no withholding tax applies on such a yield payment under Luxembourg tax law.

In regard to murabaha, which is defined in the First Circular as a purchase and resale agreement with deferred payment, it stipulates that the income taxation can be deferred over the term of the transaction subject to the respect of the following conditions:

- the agreement between the parties shall clearly state that the capital provider acquires the targeted good with the objective of reselling it (immediately or within a period of time that cannot exceed six months after the acquisition)
- the predetermined mark-up, which stands for the remuneration of the capital provider for providing the funds, must be clearly specified in the agreement, and explicitly known and accepted by the parties involved;
- the remuneration must be spread over the deferral period for accounting and tax purposes in the finance provider’s books (based on a straight-line method), regardless of when reimbursement is actually made.

The second tax circular that we have mentioned above, circular n°749 (hereafter the “Second Circular”), was issued on June 17th 2010 by Luxembourg VAT authori-
ties, and aimed at clarifying the tax treatment of murabaha and ijara agreements in regard to registration duties and VAT.

The Second Circular starts by defining a murabaha as a cost-plus sale agreement and an ijara as a leasing agreement. It also underlines that an intermediary structure, such as a SPV (special purpose vehicle), is often used to acquire the real estate in the context of murabaha or ijara arrangements.

The Second Circular reminds that the generally applicable rule according to which the sale of the shares of a Luxembourg company which owns real estate does not trigger transfer tax, by contrast to the sale of shares of a partnership or an economic interest grouping (GIE - groupement d'intérêt économique) which owns Luxembourg properties, which triggers a 6% transfer tax, as per article 9(1) of Law of December 21st, 2001. This rate may be increased to 7.2% if the seller discloses in the deed that the purpose of the transaction is to purchase the property to resell it. However, if the acquisition deed and the resale deed are registered at the same time, only a 1.2% transfer tax rate will apply.

If we summarise the above, the Second Circular stipulates that, under conditions, the acquisition of a property situated in Luxembourg under a murabaha arrangement is subject to a 1.2% transfer tax levied on the acquisition price of the property while a standard acquisition of Luxembourg located property is generally subject to a 6% transfer tax.

The Second Circular also aims to clarify the transfer tax treatment applicable predetermined profit margin agreed by both parties in a murabaha. According to the Second Circular, the latter is treated as capitalised interest and is therefore not subject to transfer tax, under the following cumulative conditions:

- the client must take possession of the property immediately after the resale;

- the time between the acquisition of the property and its resale to the client must not exceed 10 days; and

- the acquisition deed must contain a clause which specifies that the property was purchased under a murabaha agreement, which must be attached to the acquisition deed.

In regard to VAT implications, the Second Circular also confirms that SPVs created under murabaha and ijara agreements are subject to VAT and, in particular, to tax exemptions on certain real estate transactions as set forth in articles 44§1 f) and g) and 45 of Luxembourg VAT law. The Second Circular does not imply however that the transactions will be automatically liable to VAT.

25.5 Looking at the future of Islamic finance in Luxembourg

Luxembourg has taken very important steps in order to be viewed by the international community as a financial center which provides innovative and added-value solutions for Shari’a sensitive investors.

The efficient tax regime, the legal and regulatory flexibility and the two tax circulars on Islamic finance are three factors which contribute to provide for more security for Shari’a-compliant transactions carried out in or through Luxembourg.

But one should not forget that competition is very intense in Europe as financial centers such as Ireland and Malta are actively trying to develop their capabilities and attractiveness in Islamic finance. The offshore financial centers are also very well known by MENA based fund managers and investors who still use offshore corporate vehicles for their flexibility and ease of use.

Luxembourg financial center is at a turning point in regard to Islamic finance. The promotion of Luxembourg in the Middle East has started to produce results, but the market still needs to be educated in regard to the Luxembourg benefits for estate planning and cross border investments.

To achieve this objective, Luxembourg regulators and professionals should continue their regular visits to GCC countries and increase their presence in the Middle East by opening representation offices or desks which aims to promote Luxembourg locally and take part to/sponsor events important for the Islamic finance business community.

2 The Central Bank of Luxembourg will host the IFSB annual summit in May 2011.
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CHAPTER 27
Shari’a governance

27.1 Introduction

The recent financial crisis that affected many countries has prompted a call for revision and review of current financial practices. Among the reforms called for were improved corporate governance, disclosure, transparency, regulatory supervision and risk management. These developments have, to a certain extent, triggered market participants to examine the loopholes and the areas that need improvement in the Islamic finance industry. One of the areas that standard-setting bodies and regulators have identified as needing improvement is the Shari’a governance aspect of Islamic finance. Obviously, Islamic finance is subject to a variety of regulatory standards as well as standards of prudence and corporate governance issued by a number of different bodies. However, Shari’a matters are unique to Islamic finance; they have no role in conventional finance. Since the inception of Islamic finance, Shari’a matters have been the concern of the Shari’a authorities within the industry. These include the Shari’a department of any particular financial institution, Shari’a scholars and the National Shari’a Advisory Council in the jurisdictions that have one, such as Malaysia, Pakistan and Sudan. The time has come for a solid framework to be put in place for Shari’a governance, because the Shari’a is considered the core element of Islamic finance, without which the whole industry will be in danger. The integrity of any Islamic financial product greatly depends on its compliance with the requirements of the Shari’a, and any deficiency in this aspect will surely affect the market and stakeholder confidence. This chapter will highlight the importance of Shari’a governance and look at the challenges to providing a robust Shari’a governance framework as well as possible solutions.

27.2 Shari’a governance

Shari’a governance can be defined as the process and mechanism that will ensure that an IFI not only complies with the Shari’a in its operation and offerings, but that it also achieves the objectives of the Shari’a.¹ The governance process Shari’a, includes the processes and mechanisms in the following areas:

27.2.1 Shari’a advisors

This includes the qualifications for appointment as a Shari’a advisor, the duties and roles of Shari’a advisors, their mandate, conflicts of interest, independence, transparency, etc.

27.2.2 Financial institutions offering Islamic financial products

This includes their duties and roles, relationship with the scholars, obligations regarding Shari’a decisions, implementation, management of Shari’a matters, etc.

27.2.3 Shari’a governance framework

Shari’a governance involves the setting up of a clear and comprehensive framework of governance to regulate the current Islamic finance industry and its future development. Shari’a advisory Shari’a or supervision over IFIs is not regulated in some jurisdictions (Wilson, 2009).² Thus, a clear and comprehensive framework of Shari’a governance is lacking, which raises concerns about the effectiveness of the supervision performed by the Shari’a advisors in those countries. Effective governance of the industry would require defining the main actors, namely the Shari’a advisors, their responsibilities and the roles they need to undertake for the well-being of the whole Islamic finance sector. From a regulatory perspective, there has been a focus upon four elements that need to

¹ Many parties confine the purpose Shari’a governance into ensuring Shari’a-compliance only; for example, see Shari’a governance definition in IFSB (2009), IFSB-10: Guiding Principles On Shari’a Governance Systems For Institutions Offering Islamic Financial Services, Kuala Lumpur: Islamic Financial Services Board, p. 1-4. However, it should also include achievement of Shari’a objectives as well as this is the real mission of Islamic finance system and all other Islamic systems.

be ingrained in the scholars for a comprehensive Shari’a governance system to be established. They are: competence, independence, confidentiality and consistency.

Shari’a advisors must be experts in Shari’a, especially in fiqh mu’amalat (laws of transactions), and should also possess an adequate understanding of finance, both conventional and Islamic. In order to ensure high-quality Shari’a decisions, Shari’a advisors should also possess deep understanding of Maqasid al-Shari’a, have the ability to conduct research and derive legal rulings, have sufficient understanding of various Shari’a issues in Islamic finance and possess good personal qualities such as boldness, trustworthiness and dynamism. As for the duties of Shari’a advisors, they should include involvement in designing the framework for the establishment of IFIs, giving advice to existing IFIs on matters pertaining to Shari’a issues, monitoring the activities and procedures of such institutions, developing products and underlying contracts, acting as the reference for Shari’a matters for an IFI specifically and for the Islamic finance industry in general, providing training and awareness programmes for the staff of the IFI, supervising the Islamic finance industry, and representing the Islamic finance institution in forums on Islamic finance designed to exchange ideas and share experiences (Daud, 1996).

However, Shari’a advisors are mostly known for their involvement in approval of products. Nevertheless, it should be realized they are not kowtowers who will endorse whatever that comes to them. Endorsement has to be done after full investigation and satisfaction that a product is in line with Shari’a requirements. Therefore, it is very important that they are involved in the whole process of product development as illustrated in figure 1.

In executing those roles, Shari’a advisors must observe the following:

a. ensure that product development uses the acceptable principles of the Shari’a;

b. ensure that the decisions of the Shari’a boards are understood by the practitioners;

c. scrutinize the documents related to products and transactions, as negligence will result in non-compliance and negative legal consequences;

d. possess full knowledge of the purpose of the products and how they are applied;

e. assess the economic implications of the product for the Ummah;

f. strengthen the governance of Islamic financial institutions and embed Islamic values in the financial institutions’ business operations and governance.

These considerations are really important as they enhance the role of the Shari’a advisor in order for effective Shari’a governance and supervision to take place.

In relation to this matter, the efforts of a number of institutions to provide comprehensive Shari’a governance should be commended and followed. They include various fatwas and standards on Shari’a governance and auditing issued by AAOIFI, and guiding principles on Shari’a governance issued by IFSB and by certain regulators such as Bank Negara Malaysia, who have outlined a ‘Shari’a Governance Framework for Islamic Financial Institutions’ (Bank Negara, 2010).

Another factor that can help enhance the Shari’a advisors’ effectiveness is for the management and shareholders of the IFI to commit themselves to the independence of their Shari’a advisory board and to following its guidance and recommendations on best practices from a Shari’a perspective.

Moreover, the institution should assist in the establishment of a Shari’a department or secretariat within the institution to, amongst other things, assist the Shari’a board. The secretariat will render great help to the Shari’a board by providing resources, collecting fatwas and the IFI’s reports, conducting research, assisting in

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### Figure 1: Product development process

![Diagram of product development process](https://example.com/diagram.png)
the product development process and in conducting internal reviews or audits or any other assistance required by the Shari’a board.

Although Shari’a governance is mainly the task of the Shari’a advisors, the IFI’s management and shareholders need to cooperate with the scholars in order to ensure the effectiveness of that framework. Several jurisdictions such as Malaysia have listed various roles and responsibilities of IFIs towards the Shari’a board. Additionally, laws friendly to the Shari’a and to Islamic finance are also significant for facilitating Shari’a governance (Djojosugito, 2008).3

27.3 The importance of Shari’a governance

Governance in all its forms is important as it ensures that an institution is always on track, capable of reaching its objectives, and following its own standard procedures as well as best practices. Governance guards the venture from malpractice, controversies and adverse impact on its stakeholders. It will preserve confidence in the system; without it, confidence in the system will diminish, leading to a systemic run on the institutions and, in the end, the collapse of the system.

More importantly, Shari’a governance based on divine guidance is expected to have a greater impact on the operations of the institutions. Therefore, the roles of Shari’a advisors are not confined to ensuring that the products and services are Shari’a-compliant; rather, they should also ensure that the operations of the institution and the overall Islamic finance system are truly Islamic in spirit and that they move towards fulfilling the objectives of the Shari’a. In addition, the existence of Shari’a governance will make the institution more responsible, accountable and transparent. This is because the ultimate principle in Shari’a governance is responsibility to Almighty Allah, who observes the conduct of all human beings, whether open or hidden. Therefore, any malpractice or breach of trust by a Shari’a advisor or the management of an Islamic finance institution is considered a sin, its magnitude increasing with the magnitude of its adverse impact on the Ummah.

Effective Shari’a governance will lead to the following results:

1. The products and operations of the institution will be Islamically based and will fulfill the objectives of the Shari’a.

2. The management will observe best practices and taqwa (God-consciousness) in all actions.

3. The shareholders of the IFI will not expect a high return only but will also participate in promoting social good.

4. Islamic financial institutions will acquire added value in terms of Shari’a-compliance, trustworthiness and transparency.

Therefore, effective and comprehensive Shari’a governance is very important and will be the determining factor in the uniqueness of Islamic finance and its offerings. Without it, Islamic finance will not be any different from conventional finance.

27.4 Challenges to effective Shari’a governance

At present, it is difficult to say that Shari’a governance has been effectively applied. Several events and signs observed in the industry indicate that improvement is necessary. For instance, sukuk defaults have raised anew several unsettled Shari’a issues and highlighted uncertainty over investors’ interests (Saleem, 2010).4 In addition, several legal actions against IFIs have raised some questions over the fairness of the contracts used by Islamic finance institutions. Differences of interpretation of the Shari’a have also raised concerns in the industry about the impending Shari’a-risk impact for institutions offering Islamic financial products. In fact, there is no uniform mechanism used for Shari’a governance. At present, different models of Shari’a advisory services are applied as illustrated in figure 2.

It has been highlighted in many venues that Shari’a advisory needs to be improved and Shari’a advisors need to be better equipped. Some points of discontent with Shari’a advisory are lack of focus, adequate numbers, knowledge, experience, exposure and training. There is still a gap of knowledge between Shari’a advisors and industry practitioners; only a few scholars are finance savvy, and only a few practitioners are Shari’a savvy, although commendable efforts are being made to remedy this state of affairs with the growth of many educational and training organizations specializing in Islamic finance.

Another problem is the lack of a specific institution or method for ensuring that the qualifications of Shari’a advisors are maintained or enhanced. This matter is crucial in order to ensure the validity and integrity of decisions made by Shari’a advisors.

Moreover, there is an abundance of fatwas available in the market. Although every qualified scholar can make

![Figure 2: Different models of Shari’a advisory applied worldwide](http://www.islamic-banking.com/resources/7/NewHorizon%20Previouse%20Issues/NewHorizon_Jan-Mar-10.pdf)
Shari'a governance in select jurisdictions

A lot of progress has been made in strengthening Shari'a governance frameworks. Regulations and guidelines in secular jurisdictions ensure that there is a form of monitoring and supervision. Certain countries have a more robust framework addressing the governance issues that could arise. There are three in particular which need consideration:

1) The presence of a National Shari'a Advisory Council
2) Fit & Proper criteria of scholars
3) Conflict of interest rules

Different jurisdictions have varying approaches to the aforementioned points. A review is therefore in order to see how certain countries have addressed Shari'a governance.

National Shari'a Advisory Council (NSAC)

The size of the NSAC differs between nations with Pakistan having five members (as of 2007) whilst Malaysia has 11 (as of 2008). With the exception of Brunei, the Islamic legal school of thought that the scholars are expected to follow is not stated. Provisions in Brunei statute require that indigenous scholars on the board be versed in the Shafi school whereas foreign scholars can be of a different school. Moreover, not all the members are required to be Muslim. Brunei legislation also contains procedural information regarding the meetings including quorum and voting rights.

In Malaysia and Pakistan, the NSAC is attached to the central bank whilst in the UAE and Brunei, it is attached to governmental departments. The DFSA acts as the NSAC for the DIFC but it is not an independent Shari'a body.

Shari'a boards of IFIs are expected to report to the NSAC on a range of issues. These include

- The names and qualifications of the members
- Appointment and dismissal of members
- Disputes on Shari'a related members
- Transactional documentations for approval on Shari'a-compliance

Reciprocally, the NSAC will offer guidance and provide fatwas on products, which is binding. BNM is widely recognised as having one of the more advanced Shari'a governance frameworks and was one of the first jurisdictions to have a formal Central Bank Shari'a board. Recent updates to the Shari'a guidelines with regards to the fit & proper criteria of the Shari'a board has changed as was mentioned earlier. Shari'a board members are now required to posses at least a bachelors degree in Shari'a with exposure to Usul Fiqh and Fiqh Muamalat.

Furthermore the new guidelines aim to improve the whole Shari'a governance process by making it necessary for each bank to establish three functions to enhance the Shari'a governance framework, which are a Shari'a risk management control function (for identifying all areas in which there is a possibility of non-Shari'a-compliance), Shari'a review function and a Shari'a audit function.

In contrast to AAOIFI guidelines and its own previous guidelines, the new BNM framework has made it mandatory for there to be at least 5 Shari'a members per board. The guideline also recommends at least one Shari'a board member to sit on the BOD to act as a bridge between the two entities.

The UK and Singapore do not have NSACs; therefore reliance is placed on the IFI board to offer the necessary guidance. However, both these nations suffer more acutely the problem of not having active recourse to scholars.

Having a central Shari'a board is beneficial as it means the existence of an ultimate Shari'a authority within a particular jurisdiction which has the right for final approval of new products and services offered by Islamic financial institutions. According to a McKinsey report, other benefits of having a centralised Shari'a board is that it provides certainty offering a minimum level of Shari'a-compliance required by legislation, which individual boards are required to follow. SSBs of different IFIs can offer contradictory fatwas, which reduces certainty in the practice of Islamic finance and can add a layer of confusion as to the merits and authenticity of Islamic finance. Furthermore as Shari'a expertise is no doubt limited, the setting up of a centralised Shari'a board enables all players to benefit from top calibre scholars who sit on the board and may reduce the burden on individual Shari'a boards as they can look to the centralised

ijtihad, how can it be ensured that the proper discipline is observed, that sufficient contemplation occurs, and that there is strong justification for every word said? As Islamic finance moves towards further growth and expansion, it requires some degree of certainty, especially with its Shari'a governance system, so that public confidence is well preserved.

Other factors that remain as challenges to effective Shari'a governance are closely related to the IFIs themselves and to the existing systems in any given country. In developing products, the Shari'a advisory has to balance and harmonize the requirements of the Shari'a and the regulatory environment, including legal, accounting, and tax requirements. Certain jurisdictions are not friendly to Islamic finance in particular or the Shari'a in general. On top of that, Shari'a advisors must take into consideration the financial viability of prospective products. Moreover, major challenges can come from the upper management of Shari'a institutions themselves, who sometimes fail to understand and appreciate unique features of Islamic finance and Shari'a requirements. It is also challenging for Shari'a advisors to make decisions for institutions that do not provide assistance to their Shari'a boards and do not disclose material information. It is also difficult for them to work in institutions that focus on monetary objectives to the neglect of Shari'a objectives.

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board for guidance. It is noteworthy that in pre-modern Islamic courts, judges would have recourse to high-level scholars to assist them with rulings on particular cases.

On the other hand, having a centralised Shari'a board limits the number of opinions which may affect innovation. With a centralised board, there is a real possibility that scholars will offer a particular point of view at the expense of others. The parameters of Islamic finance will therefore be defined by a parochial perspective and not have the democratic quality that is currently evident. Some bankers and lawyers have criticised AAOIFI proposals to set up government level Shari'a supervisory boards to oversee Sukuk sales, as they feel it will increase bureaucracy within the industry.

**Fit and Proper Criteria**

Pakistan has a detailed set of criteria for Shari'a Advisors. Educational qualifications and experience are specific and require referential points (such as degrees from recognised universities or madrasas). Former BNM Guidelines in Malaysia required a qualification or the required level of understanding or knowledge, which may not have been necessarily confirmed by a formal academic institution. However recent Shari'a Guidelines have shown that now BNM requires that a Shari'a Advisor has at least a Bachelors Degree in Shari'a Law. In Pakistan, an advisor is required to have 4 to 5 years experience of issuing religious rulings, though this may be relaxed.

Members are expected to be honest, with integrity and have a good reputation, without criminal offences. Pakistan has added Financial and Solvency integrity to the criteria, whereas Malaysia has been more implicit. Malaysian rules opine that members should not have been involved in financial malfeasance or be in default for payments owed. The Bank Negara can disqualify members if it is found that members have been declared bankrupt. The DIFC require IFIs to keep documentation on:

- Factors taken to decide competency
- Qualifications and experience of the Shari'a board members
- Basis on which the IFI has deemed member suitable for the Shari'a board

Within the DIFC, the onus is upon the IFI to define what they expect from potential members of the Shari'a board.

The FSA have stated that if Shari'a board members are considered as being Directors, then it is more likely they will be considered as Executive Directors due to their active participation in IFI business. If this is the case, then sitting on different boards will create significant conflict of interests which would be contrary to the rules and regulation of the FSA.

The majority of Shari'a scholars do not have a proficient knowledge of conventional finance, which makes it difficult for them to effectively analyse and subsequently issue comprehensive fatwas. Initiatives such as the Islamic Finance Councils Scholar development program are very important in ensuring that the industry has a future supply of adequately versed Shari'a scholars who are competent in both Shari'a and conventional finance. UK, Bahrain and Malaysia have recognised the importance of the program as it facilitates the connection between financial practitioners and academics with Shari'a scholars and grants the latter a deeper insight into the finer, technical details of the conventional financial products and systems. Scholars have been particularly interested in how Islamic products can be structured to produce a competitive return without contravening Shari'a tenets.

**Conflict of interest rules**

Pakistan's legislation is strict. A Shari'a advisor is not allowed to work within a Shari'a board of another IFI and cannot hold an executive or non executive role. A Shari'a Advisor should neither have any substantial interest (5% or above) in the business of or be an employee of at: (a) Exchange Company (b) Member of Stock Exchange, and (c) Corporate Brokerage House.

However, these rules are only for Shari'a advisors. If a bank is to constitute a board, members can be part of boards of different IFIs. The Shari'a board of Meezan Bank and Bank Islamic Pakistan have the same scholar on both boards. Moreover, a member of the Central Shari'a board can be member of an IFI board. This is not permitted in Malaysia.

In Malaysia, a Shari'a scholar cannot sit on the various boards of IFIs within the same industry. Therefore, he or she can be on the board of a retail bank and also on the board of a Takaful institution. In the DIFC, the only requirement is that Shari'a scholars are not a Directors or Controllers of the IFI. However, details of other boards the scholar is part of or has been part of needs to be provided. Any conflict of interest has to be conveyed to the governing body of the IFI. If they are unable to handle the conflict, the member has to be dismissed and/or replaced.

In order to decide the position of Shari'a scholars.

The FSA have stated that if Shari'a board members are considered as being Directors, then it is more likely they will be considered as Executive Directors due to their active participation in IFI business. If this is the case, then sitting on different boards will create significant conflict of interests which would be contrary to the rules and regulation of the FSA.

At this juncture, it is convenient to look at the recent Funds@Work/Zawya study on Shari'a scholars. One of the key findings was that in an industry with over 300 scholars, there are 20 highly sought of scholars who sit on 54% of the Shari'a boards. In the top 20, many are sitting on up to and over 30 SSBs. This is largely due to the strong positioning of the program as the key tenet in order to decide the position of Shari'a scholars.
due to their expertise, credibility and shortage of qualified and experienced Islamic finance scholars within the industry. Critics, conversely, argue that this is creating a cartel like market and reducing opportunities, decreasing both efficiency and the potential for innovation and growth. Not only is there scope for conflicts of interest but more worryingly a derogation of duties. There will be increased pressure on scholars to report on time, which leads to inefficiency due to superficial reading of the documents or outsourcing to individuals or institutions without the requisite experience. The report also revealed that there is a probability of 80% for two of the leading ten scholars sitting on the same board. Problems of collusion leading to a conflict of interest may arise though this is more a presumption as there is no evidence that this has occurred. Another concern is once again the reliance on only a small group of scholars thereby reducing the opportunities for new scholars to develop experience and knowledge.

Looking at the codes of conduct of lawyers or accountants, there are strict and stringent rules in place in order to reduce the potential of conflict of interest. The Islamic finance industry cannot ignore best practices adopted by the conventional finance industry as these have been developed from years of experience. As a nascent industry, it has to learn from mistakes of the conventional financial industry, and act accordingly. To stimulate change however, impetus should be placed on the leading group of up and coming scholars, and provides opportunities for them to get into the industry.

27.6 Solutions

Various initiatives have been executed to address these challenges; for example, various educational institutions are offering Islamic finance courses. In addition, universities specialized in Islamic finance are being started to prepare a new generation of Shari’a advisors and to equip them with the necessary knowledge and exposure. Also, existing Shari’a experts from academia are being invited to join Shari’a boards of IFIs, which are providing them with training and exposure. As a matter of fact, some regulators have required institutions to provide continuous professional development programmes to Shari’a board members. Such initiatives will address the problem of the shortage and competence of Shari’a advisors. The fruits of these efforts will be seen with the passing of time.

Apart from the existing efforts, it is proposed that a professional body or organisation for Shari’a advisors be initiated to oversee their practices and conduct, for they are part of a profession that requires public trust as well the highest levels of integrity and competence. Such a body would regulate the Shari’a advisory industry, organize and ensure the continuous professional development (CPD) programme for Shari’a advisors, establish an acceptable qualification standard for members and oversee their conduct. It may also be given a mandate to issue professional certification to Shari’a advisors that would allow them to practice and to determine the renewal of that certification by periodic review and screening, to ensure that the Shari’a advisor is competent and at all times exercises the best professional, educational and ethical conduct. The features of the proposed organisation can be seen in figure 3.

Challenges involving the existing system in a given country will require serious attention and commitment by the government and regulators to prepare a supportive environment for the advancement of Islamic finance. As for challenges posed by IFIs, greater participation of Shari’a advisors and regulators is required in order to influence them to change their stand and current practices. For instance, Shari’a advisors will need to propagate the importance of Shari’a governance and the institution’s participation in ensuring its performance. This will include explaining to the institutions the added value that they will possess and the benefit that they will be

Figure 3: Features of Association for Shari’a advisors
able to give to the society.

As for regulators, the commendable efforts of IFSB and BNM need to be followed. They have issued lists of actions that IFIs must take in order to ensure effective Shari’a governance. For instance, in the ‘Guiding Principles on Shari’a Governance Systems for Institutions Offering Islamic Financial Services,’ issued by IFSB (2009)10, The IFSB have defined a Shari’a Governance system as ‘A set of institutional and organisational arrangements through which an IIFS (Institutions offering Islamic Finance Services) ensure that there is effective independent oversight over each of the following structures and processes:

(a) Issuance of Shari’a resolutions that govern the whole of its operation;
(b) Dissemination of Shari’a resolutions to operative personnel who monitor day to day compliance;
(c) An internal Shari’a review unit which verifies Shari’a-compliance;
(d) An annual Shari’a review ensuring that the internal review has been appropriately carried out.

The IFSB envisages the Shari’a governance system to work in the following way:

1. A business unit in the IFI will provide the Shari’a board with documentation upon the technical structure of the product or service they wish to offer.
2. The Shari’a resolution will be determined by deliberation between members of the Shari’a board who may advice on amendments in order to make the product Shari’a-compliant. The Shari’a board provides the ISCU or a Shari’a advisor with its pronouncement. The ISCU monitor day to day compliance and should be independent and separate from the IFI’s departments and business units.
3. The ISCU disseminates the resolution to the business unit who required guidance.
4. The business unit offers the products onto the market.
5. Shari’a audits will be undertaken by an internal Shari’a review unit, as part of the IFI’s compliance team. The unit will review the products and services and see if they adhered to the opinions of the Shari’a board. The unit reports to the Shari’a board.
6. In the event of non compliance, the internal Shari’a unit will recommend management to address and rectify issues of non compliance.

The IFSB recognise that any rigid rule based approach to Shari’a governance may act as a hindrance. The rules are to complement other standards by IFSB11 and regulatory policies of different jurisdictions. There is no one size that fits all but the system should be commensurate with the size and nature of the business.

Underscoring this structure, it has outlined the following principles:

Principle 1.2 declares that the Islamic finance institution has to ensure that its Shari’a board shall have clear terms of reference regarding its mandate and responsibility, well-defined operating procedures and lines of reporting, and good professional ethics and conduct.

Principle 2.1 requires that those overseeing the Shari’a governance system shall be at all times qualified, competent and possess good character to perform their respective roles. They shall include the dedicated officers or departments assigned to assist the Shari’a board and its members in their functions.

Principle 2.2 directs IFIs to facilitate continuous professional development for the Shari’a board and its officers, whilst Principle 2.3 mandates institutions to assess the performance of the Shari’a board, its contributions and commitment. These principles touch on the element of competence of the Shari’a board and its officers and how it can be attained and enhanced. Implementation of these recommendations is very important, and it is the responsibility of the Shari’a board to ensure that they are competent and worthy of the trust and responsibility bestowed upon them.

Principle 3.1 reminds the Shari’a board to be free from conflict-of-interest issues and that they must at all times be capable of exercising independent and objective judgment.

Principle 3.2 requires the IFI to provide complete, sufficient and timely information and resources to the Shari’a board. That shall include access to legal, accounting, financial or other relevant advice to assist in the execution of their duties. Para 5.1 asserts that the Shari’a board shall have access to all relevant data on the institution, even if it is confidential.

Apart from the above, there remains the challenge of harmonization and standardization of different legal interpretations of the Shari’a (Hassan, 2010).12 The issuance of various standards and parameters by stand-

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11 IFSB have issued principles on governance on IFIs who do not offer Takaful or Mutual funds, IFIs who do offer Takaful and IFS who offer Islamic Collective Investment Schemes.
ard-setting bodies such as AAOIFI and by relevant authorities as well as the development of various standard documents by different parties has contributed towards its resolution. Since standardization takes a long time to materialize, the focus should be on harmonization. In this respect, it would be helpful for various Sharia boards to disseminate their Sharia resolutions together with their justifications, as that would promote mutual respect.

27.7 The way forward

There are several pressing issues that need to be understood by the parties involved in Islamic finance in order to maintain the high quality of Sharia governance in the near future. These issues include:

27.7.1 Sharia legal rulings (fatwas)

Recent events and dialogue in the industry indicate misunderstanding or lack of understanding of the nature of fatwas. Sharia legal rulings (fatwas) are a result of scholars’ best efforts to derive the ruling of Allah for certain issues after necessary investigations. There are certain features of fatwas that must be understood. Traditionally, a fatwa is not binding unless it is declared part of the existing law by the relevant authority. However, to assure Sharia-compliance, Sharia governance and the Islamic finance framework or law may prescribe that resolutions issued by Sharia boards are legally binding upon the IFIs. A fatwa issued may be reviewed if it is found that the circumstances in which it was issued or the market conditions have changed (Al Zuhaily, n.d.).

This is in line with the principle of the Sharia that rulings can change with changes of time and circumstances (Al Zarqa, Mustafa Ahmad (1993) “Syarh Al Qawa'id Al Adillatuh”, 12th Ed., vol. 1, Damsyik: Dar al Fikr, p. 64-65).

Similarly, differences of interpretation in issuing fatwas are not strange in the tradition of Islamic legal thought; rather, this has been a common phenomenon throughout Islamic legal history and is known as ikhtilaf al fuqaha’ (differences of opinion among jurists) (Al Zuhaily, n.d.). This is because fatwas are affected by differing perceptions of scholars toward certain legal principles and their applications on the ground. It is also influenced by the detailed evidence they had knowledge of. Notwithstanding that, diversity of opinion among scholars has always been considered as a blessing because it enriches Islamic law and provides various perspectives and solutions for various issues. Therefore, diversity of opinion should not be considered a vice but a strength that Islamic finance can leverage on for wider applications and acceptance.

27.7.2 Fatwa issuance approach

It is vital for Sharia advisors to apply moderation (al-wasatiyyah) in resolving and arriving at Sharia’s decisions on issues related to Islamic finance. This means that the scholars shall investigate the issues and arrive at a decision without compromising the fundamentals of the Sharia. As for the interpretations, they might vary from one situation to another, depending on the circumstances and prevalent practices, as well as the needs of the industry and the society as a whole. Imam al-Shatibi (1997) emphasized the importance of moderation, when he said, “A virtuous mufti is the one who provides moderate and practical solutions for the public and does not burden them with unnecessary burdens (al-shiddah) and will not also be inclined towards excessive flexibility (to the point of compromising Sharia’s principles)”. Apart from this, it is pertinent that fatwas be issued based on adequate and reasonable justifications. Therefore, it is important that sufficient research be conducted prior to a resolution on an issue by a Sharia board. Only then can it be composed. That is so all the Sharia’s decisions or resolutions are made with due diligence and with utmost good faith.

27.7.3 Legal documentation

Recent developments in Islamic finance and laws have highlighted the need for clarity in Islamic finance legal documents, standard contracts and in the terminology of Islamic finance.

It is feared that transactions and products developed on sound Sharia’s principles are not clearly manifested in the contracts and may give rise to different interpretations or be vulnerable to challenge in court. Thus, the clarity of Islamic finance legal documents is very pertinent so as to ensure that they do not cause disputes between the parties and that the terms and conditions of the contract will be honored. In addition, that will assist judges in understanding the transactions and providing just resolution to the parties.

Another method to resolve such risk is development of standard contracts. Standard contracts and terminologies are also regarded as crucial in the industry as they will boost understanding and uniformity in Islamic finance practices and increase the speed of Islamic offerings as well as avoid disputes between parties. Some parties such as the IIFM and the Association of Islamic Banking Institutions of Malaysia (AIBIM) are currently working towards producing standardized documents.

27.7.4 Alternative Dispute Resolution (ADR) in Islamic finance

The application of Alternative Dispute Resolution (ADR) methods to Islamic finance is another pertinent tool for addressing the ever increasing disputes related to Islamic finance. Moreover, Sharia advisors and scholars will be engaged as the arbitrators or mediators in Islamic finance disputes. This completes the value chain of Sharia’s governance. As a matter of fact, on many occasions disputes are brought to the civil courts, whose judges do not understand the Sharia’s, which leads to different interpretations by the courts or a decision that an Islamic finance transaction is null and void.
27.8 Conclusion

Additional aspects that need to be observed so that the value chain of Shari’a governance is complete include legal documentation and litigation. Nevertheless, effective Shari’a governance is not solely the responsibility of Shari’a advisors; rather, all of Islamic finance’s stakeholders must take part in it; everyone must do whatever they can to ensure its performance. Flaws in Shari’a governance cannot be easily tolerated; they pose a grave reputational risk and Shari’a risk to the Islamic finance industry as a whole. Therefore, the existing Shari’a governance practices can still be improved with the participation and contribution of various parties. It is timely that “Shari’a based” becomes the main consideration or driver of the industry and not merely “Shari’a-compliance”. It must be realized and seen that Islamic finance is not just another form of finance; rather, it is a financial system that operates based on divine guidance that will provide best services to its clients.
CHAPTER 28
Islamic finance: when things go wrong

28.1 Introduction
In order to put into context the disputes that arise out of Islamic finance transactions, it is necessary to first understand the rules and principles that Islamic finance instruments and transactions are based on.

The basic principle of Islamic finance is the prohibition of investment in interest-based ventures and businesses that provide goods or services contrary to Islamic principles, such as tobacco, alcohol, gambling, and prostitution.

Islamic finance instruments should function in conformity with the principles of Islamic law (Shari’a). Shari’a is based upon the rules and principles found in its primary sources the (i) Quran and (ii) Hadith (teachings of the Prophet Muhammad (may peace be upon him)), and further clarified by secondary sources such as Ijma (scholarly consensus over the interpretation of the primary sources) and Qiyas (similarities drawn through analogy between modern day issues and those mentioned in the primary sources). Islamic finance instruments must, therefore, avoid:

• the payment or receipt of interest (riba)
• unconditional reward (some risk must be assumed)
• gharar (excessively tenuous/uncertain transactions); e.g. sale of an unborn calf, or items not in possession or not specified, or agreeing to a contract without specifying material terms of the contract
• maisir (speculative transactions); e.g., enrichment without labor (gambling), or possibly, hedge funds
• transactions involving haram (forbidden) goods or activities; e.g, illegal drugs, alcohol, pork, gambling, etc.

28.2 Popular Islamic finance products in the market

Some of the more popular Islamic finance products in the market are outlined below.

28.2.1 Musharaka
Musharaka is a partnership between two entities or persons whereby each contributes assets to a venture. Profits are shared by pre-agreement and generally cannot accord a higher share to the silent partner than his contribution of assets warrants. Losses must be shared pro-rata to the share of assets contributed. One partner may not guarantee the return or the capital of another.

28.2.2 Murabaha
In murabaha, under current market constructs, the customer identifies goods, which the bank purchases from the seller at the market price. The bank then sells the goods to the customer at a mark-up (disclosed to the customer); the deferred purchase price and mark-up is paid back by the customer to the bank in instalments over a period of time.

28.2.3 Mudaraba
Mudaraba is a limited partnership where one partner (rab al maal) injects capital in a business whilst the other (mudarib) runs the business. The partners share in the profits derived from the business, in a pre-determined manner based on profit, not capital, but the mudarib does not bear any losses, unless he is negligent.
**28.2.4 Ijara**

Ijara, meaning “to rent” in Arabic, involves selling the right to use an asset for an agreed upon lease period, during which the lessor retains ownership of the underlying asset. This is a common underlying construct employed in large project and property financing transactions.

**28.2.5 Iistina**

An istisna is a procurement agreement in which the price of the purchased goods or property (while agreed at the outset) may be paid up front, according to a schedule in instalments, in stages or at completion.

**28.2.6 Wakala**

Wakala is an Islamic agency agreement, and is jurisprudentially quite malleable to achieve varied commercial ends. In some cases, the bank, as its customer’s agent, invests funds in Shari’a-compliant assets for the purpose of generating returns for its customers.

**28.2.7 Sukuk**

Sukuk, wrongly called Islamic bonds (an oxymoronic term), refer to derivative ownership certificates. sukuk are issued with respect to an underlying asset and various constructs, such as musharaka, ijara or istisna. Holding a sak (the singular of sukuk) represents ownership in the underlying assets and revenues generated from such assets.

Most market sukuk are structured so that at the end of the term, the issuer must either repay the original amount invested or, if this cannot happen (i.e., the Nakheel potential default), then either the issuer renegotiates with the owners of the trade certificates, or sells the underlying asset and divides the proceeds amongst the owners of such certificates in amounts proportionate to their holding. Inevitably, this will result in a loss in the face value of the holder’s certificates. Naturally, any guaranteed price redemption feature raises enforceability issues as, at its core, a sak is not meant to be a capital guaranteed product.

**28.3 Shari’a in the United Arab Emirates (UAE) and the Kingdom of Saudi Arabia (KSA)**

The law in Saudi Arabia is largely derived from the Shari’a, and generally based on the Hanbali school of jurisprudence. In the event that a dispute arises by virtue of a conflict between the law of the state and the Shari’a, generally the latter will prevail. The Saudi government also promulgates, from time to time, rules and regulations in order to conform the laws of the state to the Shari’a.

In addition to the courts, dispute resolution fora in Saudi include the Banking Disputes Settlement Committee of the Saudi Arabian Monetary Agency (“SAMA”), the Commercial Paper Committee, the Grievances Board, and special committees formed by the Ministry of Commerce and Industry. SAMA’s Banking Disputes Settlement Committee assumes jurisdiction over disputes of a banking nature, and the Commercial Paper Committee assumes jurisdiction over disputes involving promissory notes. The Grievances Board has jurisdiction over bankruptcy issues, and commercial disputes not related to banking, and also has exclusive jurisdiction over claims against the Saudi government. Prior judicial decisions are not legally binding on courts and other judicial and quasi-judicial authorities in Saudi, which, coupled by the fact that Saudi courts do not have a system of publicly reporting judgments, renders it difficult to conclusively determine the interpretation and application of the law by the courts and judicial committees.

It is notable that the SAMA Committee, in informal conversations, has indicated that it would assert jurisdiction over Islamic finance disputes. This is remarkable because the SAMA Committee’s traditional jurisdiction extends to disputes of a banking nature involving banks and their customers. In its discretion, the SAMA Committee has read its jurisdictional ambit broadly to include disputes of an Islamic financing nature e.g., disputes that stem from ijara-based transactions. How the SAMA Committee actually adjudicates such disputes and the interpretation of constructs will be very important and instructive for the industry going forward. As yet, there is insufficient information to come to any considered position on this point.

UAE legislation expressly recognizes the Shari’a, and the UAE Civil Code requires that courts be guided by the Shari’a in the absence of legislation on point: “If the judge finds no provision in this Law, he has to pass judgement according to the Islamic Shari’a.” See UAE Civil Code, Article 1. The Code also delineates the order in which the four schools of thought will be referred to by the UAE courts, and requires that the judge search for “…the most appropriate solution from the schools of Imam Malik and Imam Ahmad bin Hanbal, and if none is found there, then from the schools of Imam Al Shafi’i and Imam Abu Hanifa as most befits.” Moreover, the UAE Civil Code expressly addresses certain Shari’a-based transactions and legislates on the rules, procedure and remedies relating to such transactions. See e.g., UAE Civil Code at Articles 568 to 579 (forward sales (istisna)), Article 582 (sale of unascertained goods (juzaf)), Article 583 (deferred sales), Articles 597 to 601 (sales by a terminally ill person), and Articles 614 to 653 (gifts (hiba)). However, whilst the basic structure of UAE legislation incorporates the Shari’a, both expressly and by reference in the absence of an express law, it is well understood that each jurisdiction has its respective interpretation as to what is or is not Shari’a-compliant. The dearth of case law does not lend itself to broad conclusions with respect to the UAE courts’ approach to commercial disputes. In a dispute subject to the UAE’s jurisdiction, we envision that the UAE courts will strive to ascertain the intent of the parties and give effect to substance over form with respect to the transaction under review. Indeed, such is the approach taken by at least one UAE court as noted below.
28.3.1 Judgements issued by the Dubai Courts

Traditionally, market structures incorporating the ijara construct are agreements of lease to purchase. The customer identifies a property that the bank or financial institution purchases and then leases out to the customer. The rental payment constitutes a progressive payment of the capital amount and a variable component that covers the profit element for the finance institution. Along with the ijara agreement, the customer signs a purchase undertaking whereby he agrees to purchase the property at the end of the lease term and at certain other pre-agreed events. In some circumstances, the bank enters into a sale undertaking.

We understand that recently there has been a case litigated in the Dubai Court of First Instance with respect to a matter involving default of an ijara transaction. While details are still forthcoming, to the extent that the case was based on the traditional ijara structure described above, we understand that the court took an approach of applying substance over form. The court ascertained that the true intent of the parties, and the real objective of the transaction, as a whole, was for the customer to eventually buy the property. Thus, the court held that the transaction was in essence “a contract for sale of property on deferred payment terms, rather than a lease. Accordingly, all payments of rental under the ijara are treated as payments by the customer towards the purchase of the property.” This was because the customer had identified the property and the transaction was structured towards an eventual sale of the property from the finance institution to the customer. The court granted the finance institution the remedy of specific performance of the purchase undertaking and the customer was ordered to purchase the property for the outstanding loan amount.

In upholding the intent of the contractual arrangements, and deviating from the form, the court adhered to the Shari’a principle that substance transcends form. As such, the ijara agreement was deemed to be a sale and purchase agreement, rather than a lease to purchase arrangement. This judgement, while reaffirming the Shari’a principle of substance over form, may implicate other Shari’a issues as such agreements generally also envision the parties creating an interim lessor/lessee relationship during which time the risk of loss sits with the financier. Naturally, registering a lessee’s name with the Dubai Lands Department further muddies the structural waters, as from a clear Shari’a analytical perspective, such registration ought not to occur until the substantive ownership has passed between financier and customer. We surmise that there is much more development to occur in this area of the law with a multitude of cases that are making their way to the courts on the back of the economic downturn and resultant defaults.

28.3.2 Sukuk and the potential Nakheel default

Sukuk have become the flagship Islamic product of the Islamic finance industry, and the markets have an estimated USD 100 billion in sukuk issuances. Sukuk are considered the most significant mechanisms for raising Islamic finance in the international capital markets. However, given that these are nascent structures in a developing and evolving marketplace, there is uncertainty surrounding how sukuk transactions will be finally adjudicated in the Gulf jurisdictions. Sukuk defaults have not yet been brought before the courts – so there is little indication as to how courts may approach such instruments. Many of the sukuk documents are drafted in accordance with and governed by English law. English courts have, in the final analysis, balked at effecting parties’ choice of law provisions when they elect to apply Shari’a principles. English courts have questioned whether Shari’a is definitive enough to apply; even if it were considered to be sufficiently definitive (and discrete provisions were incorporated into the contract by reference), it would not likely be enforced if it were to conflict with English law. Therefore, enforcement of English judgements in relation to Islamic products/transactions would invariably require a de novo review to determine whether the English judgement was congruent with Shari’a.

A case in point is the Nakheel sukuk – a sukuk that garnered the world’s attention when it became apparent that Nakheel may be unable to repay its holders. In the Nakheel case, holders of the subject trade certificates believed that they were guaranteed the return of their premium on maturity and a profit rate of 18.89% for the period of the sukuk issuance. They also believed that, in the event Nakheel was unable to pay its debts, Dubai World, and therefore by implication the Dubai Government, would guarantee the payments (including the premium). However, the Dubai Government had publically announced that it had never guaranteed the debts owed by the Dubai World to its creditors. As the development of Islamic finance is novel globally, the UAE had no established legal precedent on which the investors could rely on to make a claim over the sukuk assets, which are largely located in the UAE. For now, Nakheel has gained a temporary reprieve due to the Dubai Financial Support Fund making available sufficient funds to repay the first sukuk that matured on 13th May 2010. In December 2009, the Chairman of Dubai’s Supreme Fiscal Committee, during the announcement of the Dubai bailout, also announced a new bankruptcy law, stating that “the law will be available should Dubai World and its subsidiaries be unable to achieve an acceptable restructuring of its remaining obligations.”

While the Nakheel default has not yet been adjudicated before the courts, the problems posed by this default serve as a case study of the issues that the Islamic finance industry must address. At present, via Dubai Decree No. 57 of 2009, all disputes relating to Dubai World and its subsidiaries must be heard by a Special Tribunal that has been formed, rather than being referred to the Dubai Courts. Therefore it is with great anticipation that we wait to see if any action will be referred to the Tribunal and how the Tribunal, which does not comprise of Shari’a experts, will deal with such a dispute. Naturally, for the Tribunal to have the requisite standing, it will need to consult with Shari’a experts that bring in relevant background to assist the Tribunal in weaving its way through the labyrinthine maze of issues at play that include choice of law issues, interplay between Shari’a and English law, as well as jurisdictional law considerations.
The court’s conclusion reflected an interpretation that departed from accepted Shari’a wisdom or contain conventional bond defaults in sukuk garb, including whether such would be enforced in certain fora, are addressed in greater detail in “sukuk default or no default,” Legal Spotlight, Jan. 2010, Oliver Ali Agha and Claire Granger.

28.4 Disputes before the English Courts

28.4.1 Shamil Bank of Bahrain EC v Beximco Pharma Ltd and Others

The Shamil case is representative of the courts’ approach toward the conflict of laws that arises when parties select, as the governing law, both English law (or a national system of law) and Shari’a. In the Shamil case, Shamil Bank of Bahrain extended finance to various pharmaceutical companies in Bangladesh under a murabaha arrangement. Shamil Bank of Bahrain took the Bangladeshi companies and their directors (in their capacity as guarantors) to court because the companies failed to meet their payment obligations. The court found in favor of the Bank, and the Beximco defendants challenged the decision in the Court of Appeals on the basis of the governing law provision of the murabaha contract:

“Subject to the principles of the Glorious Shari’a, this Agreement shall be governed by and construed in accordance with the laws of England.”

The defendants argued that the intended effect of this clause was to (i) choose the laws of England and Wales as the governing law, and (ii) subject the enforceability of the terms of the contract to conformity with Shari’a principles. The defendants further argued that the murabaha contracts that formed the subject of the dispute were in fact “unlawful, invalid and unenforceable” under Shari’a principles since the contracts were in fact “disguised loans” for interest. Since riba is universally accepted as unlawful under the Shari’a, the contract would fail the test of validity under the Shari’a. The Shamil court reasoned that it has been well-established that a contract cannot be governed by two separate systems of law concurrently. Whereas parties to a contract may import specific provisions of a law from other than the system of law that they select as the governing law of the contract, a general reference to the principles of the Shari’a is not an incorporation of a distinct set of rules. The court went on to reason that under the Rome Convention 1980, scheduled to the Contracts (Applicable Law) Act 1990, the reference to the choice of governing law for the parties must be to the law of a country, not to a “non-national system of law.” The Shari’a is not the law of a country, but a collection of principles. Therefore, the court held that, irrespective of the election of the parties to subject English law to Shari’a, English law nonetheless applied because Shari’a was not a governing body of law, but merely embodied the Islamic religious principles to which Shamil Bank held itself out as doing business.

The court’s conclusion reflected an interpretation that leaned towards effecting the commercial purpose of the parties (as it ascertained from its reading of the documentation). The court asserted that it is “improbable in the extreme” that the parties intended for an English court to determine a dispute as to the compliance of a contract (based on Islamic finance constructs) to the principles of the Shari’a when the Shari’a contains opposing points of view. The court noted that, while it was possible to incorporate specific provisions of foreign law into a contract governed by English law, in this case no specific rules/principles were so identified. Implicit in the court’s holding was the suggestion that even where foreign law is so referenced, naturally, at most one could expect such provisions to become part of (rather than trump) an English law contract. The court noted, “it was plainly insufficient to contend that the basic rules of the Shari’a were not controversial. Such ‘basic rules’ were neither referred to nor identified. Thus the reference to the ‘principles of . . . Shari’a’ stood unqualified as a reference to the body of Shari’a law generally. As such, they were inevitably repugnant to the choice of English law as the law of the contract and rendered the clause self-contradictory and therefore meaningless.”

The court further noted that, for the purposes of the bank’s own regulation, the views of the bank’s own regulatory board are sufficient to monitor its compliance to its internal policy and mandate. Since the defendants did not concern themselves with the Shari’a-compliance of the form of the contract at the time of signing, or at any time prior to the proceedings in court, it was held that Shari’a-compliance was not of the essence from the perspective of the defendants and therefore not a valid defense to failing to meet their contractual obligations.

28.4.2 Islamic Investment Company of the Gulf (Bahamas) Ltd v Symphony Gems N.V. and others

This case is of significance because it is the first instance of an English court ruling on a transaction based on Islamic finance constructs. In this case, the Islamic Investment Company of the Gulf (Bahamas) Ltd. entered into a murabaha financing agreement with Symphony Gems N.V. Under this agreement, Symphony would identify a supplier for the precious stones and gems that it intended to purchase for its inventory, and Islamic Investment would then buy these stones and gems from the supplier and sell them to Symphony at an agreed mark-up. Symphony would pay Islamic Investment the marked-up price in instalments. However, under the agreement, Symphony agreed to make the payments regardless of whether or not delivery of the stones and gems was ever made or whether there was a defect, loss or breach; such payments were guaranteed by two guarantors from Symphony. Further, delivery of the purchased stones and gems was to be made directly to Symphony. Thus, even though Islamic Investment was buying the stones and gems and then selling them on to Symphony, it did not at any point undertake any of the risks associated with the transaction. It was agreed that the agreement was to be governed by English law.

The dispute under the agreement arose when one of the suppliers failed to deliver diamonds that Islamic Investment had bought pursuant to a request from Symphony. Symphony then failed to make payments to...
Islamic Investment in respect of the transaction. Islamic Investment sought to enforce the guarantee by filing for a summary judgement.

In its defense, Symphony claimed that since the subject agreement was a sale and purchase contract, the absence of delivery amounted to a breach on the part of Islamic Investment, due to which it could not make a claim for non-payment from Symphony. However, the court rejected this on the basis of the clear wording of the agreement, which did not make payment subject to delivery. Symphony argued that the agreement suffered from illegality under the laws of Saudi Arabia, where part of the transaction took place, and it further argued that since Islamic Investment’s charter prohibited it from entering into contracts that were not compliant with the Shari’a, the agreement was ultra vires and thus unenforceable. The court rejected both these arguments on the basis that the transaction did not have a sufficient connection with Saudi Arabia for it to be rendered unenforceable under the principle of illegality. The court further held that the agreement was not ultra vires under the law of the Bahamas, where Islamic Investment had been formed. The court did not examine whether or not the agreement was a valid murabaha, but ruled that even if the agreement was beyond the scope of the stated objects of Islamic Investment, it was not void ab initio. Symphony further invoked the Shari’a to defend against a claim for liquidated damages on the basis that such would amount to the payment of interest. However, the court held that the claim had been brought before an English court and by a company operating under the laws of the Bahamas, and as such, the grant of the remedy would not be subject to the laws of the Shari’a.

While this judgement, naturally, is relevant in the jurisdiction of decision, it may well suffer enforceability issues in Islamic fora because Islamic courts, e.g., in the Kingdom of Saudi Arabia (when they assert jurisdiction over a case) are likely to ascertain compliance with the law of the land before giving effect to foreign judgments that rule on matters that posit Shari’a arrangements at their core.

28.4.3 The Investment Dar Company v. Blom Developments Bank Sal

In the Dar case, pending trial as of the date of this publication, Investment Dar Company ("Dar"), a bank incorporated in Kuwait, entered into a wakala agreement with Development Bank SAL ("Blom Bank"). Under the agreement, Dar guaranteed to Blom a specified rate of return on the capital investment at the end of the investment period, characterized as "anticipated profit," payable regardless of whether or not the capital sum generated a profit in the hands of Dar. The investments made by Dar were not successful, and Dar failed in meeting its payment obligations under the wakala arrangements. Blom Bank sued Dar for repayment of the capital invested as well as the specified rate of return. In its defense, Dar argued that the wakala agreement was not Shari’a-compliant, and that under its constitutional documents, Dar was prohibited from engaging in non-Shari’a-compliant activities, thus rendering Dar’s assent to the wakala agreement an ultra vires act not binding on Dar. The governing law provision of the wakala arrangements provided that English law will be applied, and placed a condition that Dar will use the funds only for Shari’a-compliant investments.

Dar claimed that a guaranteed rate of return is essentially riba and based the ultra vires argument on Article 5 of its memorandum of association:

“The objectives for which the company is established shall be Shari’a-compliant. None of the objectives shall be construed and interpreted as permitting the company to practice directly or indirectly any usury or non-Shari’a-compliant activities.”

Dar survived Blom Bank’s summary judgement motion on the ultra vires defense. The court held that the case would proceed to trial (despite expressing some skepticism on the soundness of the ultra vires argument). However, the court awarded summary judgement to Blom Bank for the capital sum, reasoning that, even if Dar’s ultra vires defense prevailed, such would only apply to the fixed rate of return (i.e., the anticipated profit), and Blom Bank would still be entitled to restitution and thus the original capital sum. The main questions for the trial court to consider are (i) whether the wakala agreement was ultra vires; i.e., whether Dar lacked the legal capacity to enter into the wakala agreement, and (ii) whether to enforce a contract on the basis that it is not Shari’a-compliant, although the non-enforcement of the contract would ironically inure to the benefit of a party whose Shari’a board initially (and subsequently) affirmed the Shari’a-compliance of the contract.

28.5 Conclusion

The foregoing analysis shows that some of the most significant issues involving Islamic finance transactions are rooted in (i) the governing law and dispute resolution clause of the underlying transaction and (ii) the shortfalls of the structure from a Shari’a-compliance standpoint.

In the cases that have been examined here, the English courts have approached the cases with English law only and have set aside Shari’a law. This opens the door to several issues; most notably, parties that sought to enter into a contract based on Shari’a principles will be subject to remedies that may be in contravention to Islamic jurisprudence, including paying or receiving damages that include interest payments. Further, a judgement obtained by an English court that contravenes Shari’a principles will not be enforceable in an Islamic jurisdiction such as the Kingdom of Saudi Arabia, where one of the parties may be registered or where enforcement may be sought. Thus, the parties that sought to conduct business in compliance with the Shari’a but chose English law/courts as the preferred forum of dispute resolution may, if matters went to court, end up with remedies that are neither in line with the Shari’a nor enforceable in the home jurisdiction.

Where disputes are adjudicated in Islamic fora, judges are likely to examine the underlying construct through a critical lens, and where structures are found to have been developed outside of accepted parameters and
established Shari’a principles (e.g., AAOIFI guidelines), judges may, per their judicial prerogative, apply substance over form.\(^8\)

Therefore, when structuring Islamic finance instruments, any provisions that run afoul of the law of the jurisdiction may render the instrument of tenuous enforceability, and the form of a product may well be unravelled to effect substance over form. Notably, even where the law of the jurisdiction has been followed, to the extent the instrument posits a structure that runs afoul of core Shari’a principles, an Islamic adjudicative forum may still treat the instrument as a conventional instrument (and therefore undo the transaction, reverting parties to status quo ante, pre-transaction).

Whilst entering into Islamic finance transactions, it is thus imperative to (i) ensure that the contract is based on a sound structure that does not suffer from inherent flaws from a Shari’a perspective and (ii) avoid selecting a governing law and dispute resolution forum that reaches a result that may contravene core Shari’a principles. Otherwise, the parties to the contract may have, for at least one of the parties, unexpected and unpleasant surprises at adjudication.

\(^8\) Judges in Islamic fora have broader discretion to exercise than their common law counterparts and have a duty to effect justice rather than give due effect to the strict construction of the contract when doing so would have problematic or impermissible results. From a Shari’a perspective, a judge is to lean towards effecting justice between parties and lean away from the strict construction of a contract when giving effect to it would result in an egregiously unfair or impermissible result.
CHAPTER 29

Sukuk restructuring

29.1 Introduction

A sukuk transaction is restructured either as a result of an originator’s default or voluntary restructuring due to merger, acquisition or general corporate restructuring of an originator. The latter should not raise any concerns for sukukholders, as it is indicative of the performance strength of the originator. If a sukuk transaction is required to be restructured due to default of the originator, then the restructuring proposition of the transaction has a whole set of challenges from Shari’a, commercial and legal perspective. This chapter endeavors to identify some of the challenges that an issuer and related parties may come across in restructuring a sukuk transaction.

29.2 A Case for restructuring

The first question that strikes one’s mind is: what purpose does a sukuk restructuring serve? No single answer can satisfy the reader. A number of factors may favour restructuring of a sukuk transaction. The foremost purpose is to save the transaction. It also provides the originator sufficient time to financially reorganize itself and fulfill its obligations towards creditors and financiers in addition to offering better terms to the sukukholders, saving them from the undesirable consequences of excruciating enforcement proceedings.

Sukukholders may have to answer hundreds of questions, both legal and Shari’a, before even considering to make a move for enforcement proceedings. Out of the hundred questions, the first one could be: where do they stand considering the underlying sukuk structure? Which category do they fall in – creditors, owner of the underlying assets (sukuk ijara or ownership or co-ownership in a portfolio of assets) or investments (musharaka, mudaraba or wakala)? The determination of their categorization for a better position in enforcement proceedings very much depends on which side they have chosen to be at the time of choosing the sukuk structure; assets; investments; risk allocation; Shari’a considerations in relation to the relevant structure and balancing the foregoing consideration in the applicable legal regime in their favour. It appears that there has been less attention towards all of these important considerations.

Almost every sukuk structure, regardless of the underlying structure and jurisdiction, has some shortcomings and are more or less structured on exceptions and compromises on both sides – legal and Shari’a. Whether sukukholders would be treated as exclusive owners of the underlying assets and/or investments (whatever the underlying structure may be) and, therefore, have an exclusive recourse to the assets underlying investments and proceeds, or they have, in the absence of a security or collateral, a pari passu claim against the originator like other unsecured creditors. One important thing, that one can infer from the previous transactions, is that sukukholders seem to have ignored the fact that in order to have a claim against the originator, they may be required to fulfill certain requirements otherwise they may not have even an unsecured claim let alone a preferred or semi-preferred position being the owner of the assets or investments.

It may be safe to assume that if a sukuk transaction is structured keeping in view the Shari’a requirements, the result would certainly be different, as the same would give the sukukholder similar rights to that under covered bonds and securitization. In this context, it is necessary that when structuring a sukuk, one has to take into account the outcome of the enforcement proceedings
and the adaptability of the transaction for any possible restructuring as some of the structures may offer serious challenges when it comes round to restructuring.

29.3 Classifications of sukuk for restructuring

For restructuring purposes, sukuk can be categorized as follows:

(i) sale based structures which generally cover short-term liquidity instruments such as murabaha, salam and sale istisna sukuk;

(ii) investment based structures such as musharaka, mudaraba and wakala (this may include a combination of investment based structures, sale based structures and jara structures; and

(iii) ijara structures.

29.4 Restructuring of sale based sukuk – murabaha and istisna

The sukuk which are based on pure sale transactions and result in a payment obligation (murabaha and istisna), or delivery of assets (in case of salam), the restructuring of such sukuk is a real challenge from a Shari’a perspective. There are two possible options in relation to sukuk based on murabaha and istisna: (i) an extension in the payment obligations without any increase in the existing obligations; or (ii) in kind settlement i.e. exchanging the existing murabaha or istisna certificates with new certificates based on either an investment based structure or an ijara structure or combination of both.

The exchange cannot, due to Shari’a principles in relation to sale and assignment of the debt obligations, be for another debt instrument like another murabaha or istisna certificate. However, the real challenge is the restructuring of another sukuk transaction by the originator, in order to exchange the existing certificates as it requires:

(i) assets (if it is an ijara structure);

(ii) portfolio of assets (if an agency or co-ownership structure is intended); or

(iii) on-going profitable Shari’a-compliant business and investment activities of the originator (if either of musharaka, mudaraba or wakala structure is intended).

Such exercise requires meeting various legal, regulatory and Shari’a requirements and in relation to (ii) and (iii) above, seems to involve whole-sale restructuring of the organization and requires approval of all stakeholders in addition to the painstaking exercise of getting the exchange offer through the existing sukukholders. The success of this depends on the post-restructuring creditworthiness of the originators and the sukukholders’ consent and the Shari’a considerations which must be taken into account in an exchange offer, more particularly when an exchange of existing certificate with a new certificate is taking place. For the exchange process, Shari’a requires that the new certificate offered in exchange for the existing must represent ownership interest in the underlying assets and/or investments at the time of exchange.

The transfer of ownership should not be withheld post-exchange, offer and acceptance through any recognized clearing system or over the counter transactions.

Other than ijara sukuk offered in exchange for an existing murabaha and istisna sukuk, it is necessary that sukuk structured on investment based structures, should be independent of the existing murabaha and istisna payment obligations.

As for musharaka, mudaraba and wakala, which only come into existence once the relevant capital, either cash or in kind, is paid or placed at the disposal of the other partner, mudanib or wakeel. A debt or receivable cannot qualify as the required capital in the case of musharaka, mudaraba or wakala. No contractual set-off would be acceptable under Shari’a.

In view of the aforementioned Shari’a principle, musharaka, mudaraba and wakala sukuk to be offered in exchange for the existing sale based sukuk (murabaha and istisna) should represent at the time of exchange, ownership in the underlying investments. This is nearly impossible for an originator which has defaulted or requested restructuring of its payment obligations. However, if the originator has a pool of assets, the same (or part of them – even undivided share) can be sold in exchange for the existing certificates and therefore, provide a clean slate to both – originator and sukukholders for another agreed term on better terms and conditions as a fresh transaction.

One can easily infer how much input from Shari’a scholars would be required in restructuring murabaha and istisna sukuk transactions, as each step involved in the restructuring must ensure Shari’a-compliance in form and substance. An oversight, no matter how trivial may lead to Shari’a repugnancy due to the transactions’ close proximity with dealing in debts / receivables and extension of time in relation to discharge of such obligations for a consideration.

29.5 Restructuring of salam sukuk

Restructuring of salam sukuk is very complicated. Other than extending the date of delivery of the underlying assets or replacement of the existing assets with other assets of the same market value, there does not seem to be any viable solution. However, the question is how to compensate the sukukholders?

An equally important question is: can the permission to extend the delivery date apply to the substitute assets? Another option for the sukukholders is to mutually can-
Restructuring of sukuk based on investment structures – musharaka, mudaraba and wakala

Restructuring of sukuk based on investment structures such as musharaka, mudaraba and wakala or a combination of investment structures and sale structures (whereunder money is pooled or invested using investment structures and the return earned, together with the recovery of the invested capital, through a sale based structure), is relatively simple and offers less legal and Shari’a implications.

Nevertheless, nothing is as simple as it may appear to be. Restructuring can be achieved in two ways: (i) amending and restating the existing documents in accordance with the agreed terms and conditions between the sukukholders and other stakeholders; and (ii) exchanging the existing certificates with new certificates using the same underlying investments or different assets, investments or combination of both.

From the sukukholders’ perspective, consent of the required number of sukukholders as per the transaction documents would be required, which can be procured as per the transaction documents through circulation of notices on the recognized clearing systems or through dealers and agents.

Circulation of notice for the amendment and restatement of the transaction documents would require involvement of the relevant parties and entail costs and expenses which, considering the fact that the relevant parties would benefit from the restructuring do not seem to affect the balance of convenience and commercial benefits.

Considering that the restructuring only involves amendment and restatement of the existing transaction documents including capital markets documents, there may not be too many substantial legal and Shari’a implications and even if there are any, the same should not materially affect the underlying structure. However, restructuring through amendment and restatement may not have the effect and look of a new transaction, which usually is the most important consideration for the institutions as they would clean-up their books by removing the default transaction with a new transaction.

Another downside of such restructuring is the extension in the inherent risk which is an essential characteristic of investment based structures. Quite understandably, the investor of the existing certificates would like a change in the risk exposure from investment based, to a sale structure or at least an investment based structure in relation to the portfolio of the revenue generating assets. They could have recourse to this in the event of default or a change of the structure; from a pure investment structure to a sale structure (like sukuk ijarah or sukuk of leased assets).

The second choice is replacing the existing transaction with a new transaction. This can be done either using the same underlying investments / assets or different investments or a combination of both. In order to achieve any of the foregoing, the following steps would be required:

(i) an exchange offer should be circulated by a new issuer offering the existing sukukholders to sell their sukuk to the new issuer, against a new issuer’s promise to issue new sukuk either based on investment structures (in case the existing investments / assets are intended to be used to restructure the transaction), or sale structure (in case the new ijarah assets are to be used for restructuring). If the existing assets / investments are to be used, the process flow will be different;

(ii) the new issuer will have to appoint different dealers and agents to explain and arrange the exchange offer, however, the exchange process will be through the recognized clearing systems;

(iii) trading of the sukuk will be suspended; and

(iv) all other relevant regulatory requirements to be completed before the exchange offer. In order to offer an incentive for the exchange, the new issuer may combine the exchange offer with a tender offer, either to the extent of its ability to partially redeem the sukuk or as agreed with the sukukholders.

Tender offer, acceptance and settlement require strict compliance with Shari’a principles as to the transfer of ownership of the certificates, in order to avoid a forward sale or a conditional sale or retention of title, which may vitiate the sale from a Shari’a perspective. Following the...
exchange offer and tender offer, if the new issuer ac-
quires the relevant number of sukuk certificates, it would
be in a position to impose a compulsory exchange pro-
vided that such resolution is acquired pursuant to the
terms of the transaction documents.

Upon becoming owner of the existing certificate (pro-
vided in all cases it has the required number of the ex-
isting sukuk certificates, which is necessary for passing a
resolution for amendment or early redemption of the
existing sukuk certificates), the new issuer will exercise
its right under the transaction documents and require
the existing issuer to formally transfer to the new issuer's
ownership in the underlying assets and/or investments
to the new issuer.

This can be achieved through requiring the existing ob-
ligor/originator who is acting as a partner in the mush-
arakah or agent or a mudarib, to transfer the relevant
assets to the new issuer in accordance with the terms
of the existing documents. Following such a transfer, all
existing documents will be terminated.

The new issuer will become owner of the assets which
it has already acquired as a result of the exchange offer.
The new issuer will enter into a musharaka or mudaraba
or wakala arrangement with the originator on new com-
mercially agreed terms and conditions, whereunder the
new issuer's capital, to the extent applicable based on
the underlying Shari'a structure, will be in the form of the
assets / investments i.e. in kind contribution.

Once the underlying Shari'a contracts are in place, the
new issuer will issue the new sukuk certificates to the
existing sukukholders, who have sold their certificates to
the new issuer pursuant to the exchange offer. Such a
restructuring exercise will result in a new transaction for
the existing sukukholders, replacing the old transactions
based on new transaction documents including capital
market documents.

It is important to note that a significant Shari'a concern
as to the capital requirement for the new transactions
has been met using the existing investments and assets
as in kind capital - in the absence of cash. Otherwise a
simple sale and purchase of the underlying investments
or ownership interest for a cash settlement would not
have allowed the new issuer to set-off its obligations
to pay in relation to the existing certificates, against the
new sukukholders' obligation to pay for the new cer-
tificates, as is necessary under the relevant Islamic in-
vestment structures such as musharaka, mudaraba and
wakala. The Shari'a requires that the capital must be
contributed to commence, and give effect to, the rel-
levant Shari'a contract.

A contractual set-off in relation to musharaka, mudaraba
or wakala capital is not acceptable from a Shari'a per-
spective. If a set-off right is used in relation to mush-
arakah, mudaraba or wakala capital, the entire transaction
would be, from the outset, Shari'a repugnant.

However, if the existing investment structure is re-
placed with an ijara or musharaka structure, mudaraba
and wakala with a pool of segregated assets sold to the
existing sukuk transactions, in exchange for their exist-
ing certificates, the restructuring seems smooth from a
Shari'a perspective, except for compliance with Shari'a
and legal requirements as to permissibility of the un-
derlying transaction, risk and other commercial arrange-
ments.

There is no precedent on sukuk restructuring which
could have illustrated some of the challenges highlighted
above, nevertheless, various sukuk restructuring efforts
and tender offers have provided adequate insight into
the potential legal and Shari'a challenges into restructur-
ing a sukuk transaction. It is worth mentioning that in
restructuring a sukuk transaction, the most important
consideration is aligning the commercial arrangements
with the principles of Shari'a. Learning the lessons from
previous oversights in commercial, legal and Shari'a mat-
ters, the sukukholders, might at the restructuring stage,
consider choosing a strict compliance approach to get
better protection.

29.7 Restructuring of ijara
sukuk

Restructuring an ijara sukuk is relatively simple and in-
volves less Shari'a complications. Similar to other sukuk
structures, it can be achieved in two ways: (i) amending
and restating the existing transaction documents which
require only consent of sukukholders in accordance with
the requirements of the relevant transaction docu-
ments; and (ii) exchanging the existing certificates with
new certificates either using the same assets or new
assets.

The first category may not involve much intellectual in-
put from a legal and Shari'a perspective (other than the
necessary approvals and waivers from the respective
parties, if required), except the commercial agreement
as to the tenor, pricing and security. The amendment
and restatement is achieved pursuant to obtaining the
consent of all sukukholders, which very much depends
on a standard procedure set out in the documents, and
would be carried out if the required approvals and con-
sents are in place.

What makes sukukholders provide their consent more
or less depends on commercial decisions driven by a
number of balancing factors (some of them may touch
the core connection between the assets, and the sukuk-
holders' ability to have adequate recourse to the assets
to the extent of full recovery). In fact questions similar
to this, provide adequate evidence as to the true nature
of Islamic certificates which, apparently, never seem to
have been given sufficient attention. Sukuk transactions
continue to add to the long list of Islamic capital mar-
kets instruments which have not been improved in the
very shape in which they should have been in the first
place, being the certificates of ownership rather than an-
other de-shaped class of financing and debt instruments.
Some industry players are of the view that no improve-
ment has been seen in both form and substance, even
after much publicized criticisms and AAOIFI’s clarifica-
tions in the wake of sukuk controversies.

The second option is exchanging existing certificates
with the new certificates using the existing assets or new assets, or a combination of both. A new issuer will be established, which will issue an exchange offer or an exchange offer and tender offer together. The exchange offer will be circulated through the recognized clearing system, agents and dealers appointed for this purpose. The exchange offer will make an offer to the existing sukukholders to exchange their certificates against the new issuer’s promise to issue them with new certificates, after it has acquired the title to, and possession of, the underlying assets backing the new certificates.

Once the new issuer has acquired a sufficient number of certificates, it may be in a position to force non-accepting existing sukukholders to sell their certificates to the new issuer – imposing a compulsory exchange. If a tender offer was circulated, the sukukholders will get a partial redemption also. Following acquisition of the existing certificates, the new issuer will exercise its right under the purchase undertaking (issued in favor of the existing certificate holders) to purchase the underlying assets, which are the subject matter of the lease under the existing certificates.

A sale and purchase will be concluded between the new issuer and the old issuer. However, the purchase price will be deferred by the new issuer. Soon after the sale, the new issuer will buy the assets from the seller and exercise its right of set-off in relation to the purchase price it owes to the seller against the purchase price the seller owes to the new issuer under the previous sale.

Following acquisition of the assets the issuer will enter into a lease arrangement with the seller on commercially acceptable terms and conditions, and all other documents will be executed by the respective parties together with the capital markets documents. Following completion of the transaction, the new issuer will be in a position to issue the new certificates to the existing sukukholders, thereby resulting in a new sukuk transaction completely replacing the old transaction.

In doing so, if the additional assets are required to be included in the portfolio, the same can easily be achieved, thereby providing more comfort to the new sukukholders in addition to the better terms and conditions.

Shari’a scholars seem to have accepted the sale and purchase of assets for deferred consideration, and repurchase of the same assets and set-off in relation to the purchase price obligation by the respective parties, without any difficulty. Whatever the academic or practical Shari’a concerns that seem to arise from the above arrangement, or its resemblance with prohibited transaction in accordance with the principles of Shari’a and their respective implications on the Shari’a-compliance of the underlying transactions, it appears that such minor Shari’a repugnancies would be condonable (under the principle of permissible exceptions), given the fact that Islamic finance has never had the advantage of a same level playing field (in all respects) as its conventional counterpart and other comparable industries have.

When assessing the Shari’a-compliance of a transaction, it is necessary to take into account genuine impediments in ensuring strict or substantial Shari’a-compliance, that might have been due to a number of factors such as legal, regulatory, judicial, commercial acceptability and enforceability, even in jurisdictions which claim to have derived their legislative powers from the divine revelation.

29.8 Conclusion

Since most of the popular sukuk structures are based on an ijara or an investment structure, which entails ownership in an underlying asset and investments (as the case may be), restructuring should not be complicated from Shari’a perspective. The real challenge, however, is meeting the requirements of an alternative structure and if other creditors and financiers are involved in the overall restructuring of the obligations of the originator, the sukukholders may not have a wide ranges of choices and the same level of strength to negotiate as they would have in the case of a standalone restructuring of a sukuk transaction.

Recent sukuk default cases and the difficulties faced by the sukukholder would certainly serve as a wakeup call for all stakeholders, particularly sukukholders, to consider staying closer to the fundamental principles and requirements of Islamic capital market instruments which in all cases have the potential to address any situation that may arise at any stage of the transaction. It would not be an overstatement to say that the best possible protections for the sukukholders and the relevant parties to the sukuk transaction rest in compliance with the very basic principles of the relevant Shari’a contract.

Generally, the parties do not take the risk of deviation, no matter how trivial, from standard industry practices, legal and regulatory requirements in relation to a conventional transaction which in its entirety (structure, documentation, legal and commercial viability) offers a robust comfort to all stakeholders as compared to Islamic capital market instruments, which appear to have, so far, been lagging behind in various aspects. Considering the unique profile of Islamic capital market instruments in all aspects one may rightly expect a reflection of a greater degree of adherence to Shari’a and legal requirements at all stages in order to narrow the gap between theory and practice.
### 30.1 Introduction

From a niche subset of conventional finance to a lucrative alternative, Islamic finance has grown remarkably over the last 30 years. Muslim and non-Muslim governments, corporations and individuals are entering this market, leading to the development of new products to meet demand; economies of scale are being realised, prices are decreasing and products are becoming competitive. This has led to regulatory changes to accommodate Islamic finance with tax discretions and legal recognition of products. The trajectory of Islamic finance is thus onwards and upwards.

While this is positive, Islamic finance finds itself in a paradoxical situation. Ostensibly following the Shari’a, products are issued under a secular legal framework. In the event of a dispute, they are judged according to rules and regulations which can be contrary to the Shari’a. If this is allowed to continue, this will weaken the edifice of Islamic finance. Several commentators have added that without the establishment of a specialised body which judges Islamic finance institutions according to the Shari’a, true Islamic finance cannot be fully realised. The current practice where Islamic banking and finance disputes are heard and determined by the civil or common law courts will be counter-productive to the practice of Islamic banking and finance.

It is therefore imperative for the maturity of the Islamic finance industry to develop a dispute resolution system whereby Islamic finance transactions are judged according to the precepts of the Shari’a. The intellectual framework of Islamic finance is based upon looking at classical Islamic law, and deriving principles to be utilised for modern day financial transactions. If Islamic finance products are to work according to the Shari’a, they should be judged according to the Shari’a in the event of a dispute. Today, there is an opportunity to establish Shari’a based courts which will not be anachronistic but integrate seamlessly into the modern day legal framework: an example of legal pluralism.

### 30.2 The importance of a Shari’a court

The legal framework of a society is heavily based on the culture and traditions of its people, and this is important to have in mind when considering dispute resolution. It is argued that legal polities start from their dispute resolution processes from different points and have differing objectives. Broadly speaking, the differences between the western approach (the European based common and civil law systems) as compared to the Islamic approach usually revolve around the dichotomy of individualism and community. The former concentrates on the individual, whereas in an Islamic context, priority is given to ensuring congeniality in future relationships. Conflict is considered to be negative and threatening to the normative order and needs to be settled quickly or avoided altogether.

Arbitration has been seen by many as a panacea to the problem of accommodating the Shari’a into a non-Shari’a framework. In international transactions, parties can either opt to be judged according to a national court or laws and procedures that they define through the process of arbitration. Consequently, arbitration provides parties with flexibility, and freedom from the constraints of national courts.

In Malaysia and the UAE, there are Islamic finance arbitration centres, respectively The Kuala Lumpur Regional Centre for Arbitration and International Islamic Centre for Reconciliation and Commercial Arbitration for Is-
The Kuala Lumpur Regional Centre for Arbitration in Malaysia came out with its Rules for Arbitration (Islamic Banking and Financial Services) in 2007. The rules closely mirror those of the United Nations Commission on International Trade Law (UNCITRAL) Arbitration Rules, with modifications made only to meet the unique needs of Islamic finance in the case where the dispute arises from the Shari‘a aspects of the transaction. Rule 39 of the Islamic banking rules requires the application of both Shari‘a and the law chosen by the parties, while Rule 33 rules require that opinions made on points relating to Shari‘a, be referred to either the Shari‘a council or a Shari‘a expert.

Unfortunately, neither centre is extensively used by commercial parties. While there has been no extensive survey as to the reasons, industry experts have presumed that parties do not have confidence that arbitral awards will be enforced or that they can be circumvented. Litigation provides more certainty as the state represents the authority which will enforce a judgement. It is one of the reasons that parties are more comfortable with having English or New York law to govern the contract as opposed to Saudi Arabian or Malaysian law. Litigation also offers a beleaguered party the opportunity to enforce their rights whereas arbitration locks to reconcile parties and can derogate a party’s rights in order to ensure common good. Thus, the clamour for Islamic finance arbitration rests not only on the expediency of judging according to the Shari‘a, but also on the notion that antagonistic parties will be able to resolve their issues in a mutually beneficial and conciliatory manner; a process which will establish self-evident truths agreed upon by all parties. But, one should not be so naive to think that commercial transactions are pervaded by communal, altruistic motives. Profit maximisation will seek to gain and succeed in securing their rights in the event of a dispute, and this therefore necessitates litigation processes involving the court.

Currently, most Islamic finance contracts are governed by non-Shari‘a laws. International commercial parties have, broadly speaking, resorted to English or New York law to govern Islamic finance contracts. Both systems of law are respected, time tested, efficient and provide effective enforcement procedures. The product maybe Shari‘a-compliant, but in the event of a dispute, courts will judge according to these ‘secular’ based laws. This poses an immediate contradiction and one which brings a series of problems to the fore. Firstly, the philosophy of judging according to the Prophet, who states ‘You bring me lawsuits to decide, and perhaps one of you is more skilled in presenting his plea than the other, and so I judge in his favour according to what I hear’. Unfortunately, by arguing that a contract is not Shari‘a-compliant, it has been given the rubber stamp by the Shari‘a Supervisory Board to weaken the veracity of Islamic finance.

In Muslim countries, analysing the courts approach to Islamic finance contracts is laden with difficulty. The transparency of the court systems in most Muslim countries is poor and thus information is thin. It would be reasonable to assume that Saudi Arabia, whose legal system is based on the Shari‘a (more specifically the Hanbali school of thought), would offer an appropriate choice of law for Islamic finance contracts. Unfortunately, Saudi Arabia’s court system is hampered by bureaucracy, delays and a lack of enforcement of judgements, which deters commercial parties. The international community do not feel comfortable with the Saudi legal system, Iran and Malaysia are also viewed adversely, though Malaysia’s legal system does not claim to be based on the Shari‘a.

Thus, considering the legal differences between civil/common law and the Shari‘a, it is imperative for a Shari‘a court to be established. Unfortunately, with the failings of the legal systems in Muslim countries, there does not seem to be space for this to be achieved. However, the flexible and fluid international legal system presents other opportunities for realisation of a court.

### 30.3 Legal pluralism

The problem that confronts us is broadly speaking a geographical and contextual one. Each country has its own legal system, one which is conducive to the culture and needs of that particular country. The imposition of a Shari‘a court would be anachronistic within a certain system which has its own specific laws and processes. Consequently, it may be worth considering an international Shari‘a court, one which has a codified set of rules and with acceptance across the globe, rather than a na-
According to legal scholar John Griffiths, legal centralism first glance. Legal pluralism, where different systems can coexist together is a staple feature of all legal systems. According to legal scholar John Griffiths, legal centralism – the idea that there is only one type of law, namely that enacted by the state - is a myth and that legal plurality is evident in all social arenas. A legal system is pluralistic when the sovereign tolerates the application of different legal systems for different groups.

Ido Shahar (2008) divides legal pluralism into two categories:

1.) Legal pluralism in the strong sense – An agent can appeal to more than one tribunal of law

2.) Legal pluralism in the weak sense – The legal system assigns specific tribunals to specific categories of the population.

Leaving aside the latter, we see examples of strong legal pluralism in the western legal frameworks, especially in the sphere of alternative dispute resolution processes. Arbitration is become increasingly popular amongst commercial parties and is regulated by a number of domestic and international laws. The New York Convention provides a legal framework for international commercial arbitration which offers two crucial features in ensuring strong legal pluralism. The first is the autonomy given to parties to design dispute resolution procedures which includes choosing, if desired, the law by which the arbitration should be judged by. The second is that arbitral awards is recognised and enforced in by signatories to the convention which include many of the world’s commercial hubs.

Not all parties will be keen on arbitration, and undoubtedly commercial litigation using the courts of a country will be used. Notwithstanding this, international law has provided the avenue whereby the judgements of the courts of a sovereign nation can be recognised, once again strengthening the idea that western legal frameworks have a place for pluralism. As noted above, western court systems do not recognise Shari’a. However, European law has granted courts within the EU the power to recognise foreign judgments. Article 3 of Regulation No 593/2008 of the European Parliament states ‘A contract shall be governed by the law chosen by the parties’. However, the law is understood to be the law of a sovereign country. This point was raised in Beximco case in which the Court of Appeal stated ‘The doctrine of incorporation (of another law besides English law) can only sensibly operate where the parties have by the terms of their contract sufficiently identified specific ‘black letter’ provisions of a foreign law or an international code or set of rules apt to be incorporated as terms of the relevant contract such as a particular article or articles of the French Civil Code or the Hague Rules’. The problem for the litigants was that there has been no codification of the Shari’a.

It would therefore be beneficial for the Islamic finance industry to codify the Shari’a. Unfortunately, as most Islamic finance practitioners would attest, the Shari’a is not a fixed set of laws. The Shari’a is the cumulative attempts of Islamic scholars to define laws based on several sources, the key being the Quran. In this regard, there is a diversity of opinions in the Shari’a. In a modern day context, the differences of opinion have been seen as an obstacle to the development of Islamic finance. There have been calls for standardisation of contracts in order to provide certainty. Others have disagreed with standardisation, arguing that this goes against the ethos of Islamic law which promotes diversity of thought. However, a platform on which this diversity can coexist while facilitating certainty in transactions would reconcile the conflict. This is not out of the realms of possibility and in fact we have evidence from history where it has worked successfully.

30.4 Legal pluralism in the Shari’a

While in the seats of power a certain school of thought would be encouraged, it was difficult to ensure that all citizens followed the same school. Standardisation was difficult to achieve. Therefore within a single jurisdiction, the four schools would co-exist though not at all times harmoniously. It was a concern for Sultan Baybars (1260 – 1277) who saw how, by allowing the courts to be under the jurisdiction of one school of thought, namely the Shafi school, other schools were being shunned and strict opinions of the Shafi school were being utilised at the expense of its citizens. In 1265, Sultan Baybar appointed four judges in Cairo, one to represent each of the four schools of thought in Sunni Islam, to judge according to the jurisprudence of their respective school. The judiciary of Damascus was similarly reformed the following year. Over the next century four judges were appointed in other towns and cities. By the latter half of the fourteenth century, Aleppo, Tripoli, Hama, Safed, Jerusalem and Gaza each had its own quadruple judicial system.

The appointment of judges from one of the four schools continued up to the Ottoman conquest at the beginning of the sixteenth century. Scholars believe that the establishment of the quadruple judge system was to restore flexibility in the legal system which had become rigid. It was recognised that certain acts were permissible under certain schools, whilst prohibited by other schools. By having a coexistence of the four schools, individuals had the opportunity to go to a judge who offered an opinion which would be aligned to their requirements. This did not contravene the broad desire by the state and the judiciary, that the schools of thought should retain uniformity in jurisprudence. It was important in maintaining rule of law. Therefore, while there were different schools of thought coexisting as laws of the state, the schools themselves continued to follow the principles of law that defined them. This adherence is known as taqlid.

Within the quadruple judiciary in Sultan Baybar’s Cairo, the Shafi chief judge retained overall responsibility for the proper functioning of the system as a whole. One of his tasks was to ensure that non-shafi judges did not deviate from the doctrines of their respective schools.


Bound by the regime of taqlid, shafi judges sometimes would transfer certain cases to judges from other schools, when their school could not offer a favourable decision. In 17th Century Cairo, there is evidence of merchants attending to the judge of the school of thought he felt would accept a particular transaction. Transactions deemed contrary to the principles of a certain school, may have had acceptability at another school and therefore merchants would constitute deeds according to that particular school. ‘Forum shopping’ was thus identifiable in pre-modern Islamic courts and represents an example of strong legal pluralism. In the early days of Islamic law, people would trust the opinions of those who had contact with the companions of the Prophet. As the Islamic empire grew, it was necessary to have a trusted system in place to derive legal rulings. The rise of the now well established four schools of thought in Sunnism – when once there were multitudes of legal schools – is the end product of centuries of legal reasoning amongst scholars. Scholars slowly derived a fixed methodology in deriving legal rulings. Beginning in the twelfth century, treatises devoted to Islamic jurisprudence started to assert the right and duty of muftis and judges to follow the opinions of past authorities in their school of law rather than apply their own independent legal reasoning. Mohammad Fadel (1996) argues that this shift from independent legal reason (ijtihad) to following past authority (taqlid) was primarily motivated by the desire to limit the discretionary power of legal officials through the creation of uniform rules. Taqlid allows jurists to work under the purview of a fixed body of laws and therefore follow a ‘rule of law’; the ideal that officials are bound by preexisting laws. By the 13th Century, scholars from the various schools of thought had created books of law which articulated the position of the school in a particular situation – the mukhtasar. It was imperative to concretise these rules in order to achieve uniformity and certainty. Scholars within their respective schools were required to follow these rules and only scholars who had reached the intellectual summit of their school could change legal doctrine in situations that demanded it. Fadel believes this system had the hallmarks of the modern day common law system.

The approach of Sultan Bayber offers a pragmatic way forward. His reforms established a platform on which the four schools could coexist, while at the same time ensuring that the jurisprudential edifice on which the school premises itself remained intact. With the mukhtasar, each school had recourse to a quasi statute book providing certainty for all concerned. A case with no precedent would be judged by judges through legal reasoning with the assistance of higher members in the school. But what is important is that they followed an agreed upon methodology. In the modern day Islamic finance industry, this is what is needed. There are a slew of divergent opinions; the formulation of which is not systematic and arguably does not often follow the established methodologies of the classical Islamic legal schools. A recognised system in deriving law needs to be adopted and it would make sense to adopt the principles and methodology of the accepted schools of thought. If states recognises their methodologies and codifies their rulings in Islamic finance, only then could a Shari’a court flourish.

It has to be emphasised at this point that the key problem that needs to be addressed in the Islamic finance industry, is not the rulings that are issued by the Shari’a scholars and banks but rather the method by which they reached their conclusion. The Islamic legal schools that have been established have a defined methodology, which has historicity. In the Shari’a courts of yesteryear, judges would seek the advice of those bellwether scholars (Muftis) within their school to ensure that they are following the schools methodology and precedents in issuing judgement. Consequently, it is expedient for rulings to be underpinned by a particular school, as it will make facile the judgement process in a Shari’a court. Not only can the court decide on whether there has been a contravention of the contractual clause, but also assess if the fatwa was formed using the correct methodology. This will increase credibility, transparency and effectiveness of the fatwa making process.

Moving to the present day, the OIC Fiqh Academy has been active in issuing rulings on Islamic finance products using a defined methodology. In terms of codification, AAOIFI and the IFSB have been especially prominent in issuing standards and codifying them. Recently, Malaysian based research institute, ISRA, teamed up with Kuwait Finance House to translate their Shari’a rulings and Shaykh Yusuf De Lorenzo has translated a series of rulings by Gulf banks.

While these are steps in the right direction, without state recognition, an element of arbitrariness will resurface though Islamic finance rulings. It is important therefore for the state to support and ensure judicial recognition. In this regard, only Malaysia is making any real progress. The approach of Malaysian courts to Islamic finance contracts has evolved since the early 90s. As a common law jurisdiction, Malaysian courts were initially unwilling to judge according to the Shari’a. However, recently there has been a greater willingness by judges to address Shari’a issues though they still remain untrained on Shari’a law. Furthermore, Malaysia is making great strides in reforming their legal system to accommodate and judge Islamic finance contracts according to Shari’a precepts. The law of choice harmonisation committee, constituted in 2010, and referred in an earlier chapter, represents a fledgling attempt to bring the Shari’a precepts into the common law.

Yet there is a conflict between Middle Eastern institutions and Malaysia in regards to Islamic finance rulings. Malaysia is regarded as being too liberal; the Middle East is regarded as being too conservative. It is difficult for them to reconcile, but as mentioned above this is not necessarily a problem provided there is acceptance of the methodology utilised in deriving the rulings.

30.5 Conclusion

Critics argue that the common law system of England and Wales has the tools to deal with Islamic finance issues; if not from a Shari’a perspective, certainly from a commercial one. This is exactly the problem. The Shari’a, while compromising a spectrum of views and opinions, is based on two key sources which define its legal framework and more specifically its philoso-
phy: the Quran and the Sunnah (acts and sayings of the Prophet Muhammed.) The premises of these two are not similar to the premises of English law (or any other non-Shari’a jurisdictions), and therefore its approach to adjudicating on Islamic finance disputes will certainly be different.

This is important to remember, especially when considering the authenticity of Islamic finance. Many believe that Islamic finance is not Islamic - though mainly from an ethical standpoint. The premise will be reinforced if Shari’a principles are judged from a non-Shari’a perspective, and by judges without the requisite training in Shari’a. It should not be expected that those who have not had the training should judge according to the Shari’a just as it should not be expected that someone with Shari’a training should judge according to a system law he/she has had no experience in.

Therefore, the creation of a Shari’a court provides the avenue for adjudication based on Shari’a law. It was hoped that arbitration would fulfil this need but it has not appeared particularly successful, possibly due to the informality of arbitration. It would therefore be favourable for a state to create the legal framework for the Shari’a approach to be manifested. Malaysia is certainly on this path forward.

But Malaysia will adopt an idiosyncratic approach to integrating the Shari’a, as do other countries that purportedly base their legal system on the Shari’a, such as Saudi Arabia and Iran. Additionally, Islamic law is a composite of many different opinions, which at often times are similar, but occasionally contrary. The differences of opinions have been problematic in stimulating certainty in the industry. However, this can be resolved by taking lessons from the actions of Mamluk Sultan Baybar, in the 13th century, who instituted the quadruple judiciary, where the four schools of legal thought in Sunni Islam were allowed to coexist. An example of strong legal pluralism, parties had the option of choosing a particular school by which their commercial transaction would be underpinned.

However, in the modern day context, the methodology used to derive rulings has to be uniform according to a particular school and that a school’s rulings should be codified and recognised. The Hague rules, is an international treaty on the carriage of goods by sea. This is globally recognised and accepted in courts of law throughout the world. Similarly, the various established schools of law under Islamic should also be codified and recognised.

Once achieved, it will allow the creation of an international Shari’a court – similar to the International Courts of Justice which works outside of state authority. The creation of an International Shari’a court in Islamic finance may be idealistic. Currently, there is no real support for it and countries such Malaysia and Bahrain are moving forward independently, changing regulations, and creating a system which supports and encourages the progress of Islamic finance. But it is an idealism that will strengthen Islamic finance, and more specifically the judgement of commercial disputes between parties transacting on the basis of the Shari’a.

\[\text{IMF (2009)}\]
\[\text{Van Den Berghe (2009)}\]
\[\text{Becht 2009:2.}\]
\[\text{Kirkpatrick (2009)}\]
\[\text{Edelman (2009)}\]
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PART 4
IFCI and Country Sketches
The Islamic finance industry has come a long way from its humble roots to assume a significant position in the wider financial framework. IFIs total around 500 and are geographically spread across 75 countries. The size of the industry is approximately USD 1.1 trillion and estimated to have an annual growth rate of 10% per annum despite the difficult overall economic environment. It is now time for the masses to establish with greater certainty where the industry really stands, and see if an objective view can be taken on the current state of affairs in the industry, in order to formulate policies / strategies towards a sustainable future course. Indeed central banks, regulatory bodies, state governments, investors, financial institutions, consumers and other stakeholders in the industry would like to take a more informed decision based on objective reasoning, as opposed to merely following subjective fantasy.

An area of particular interest is gauging the depth and incidence of Islamic finance across the globe. It is also important to understand the elements that make one country more conducive to progressing with Islamic finance as compared to another. Even when relying on quantitative information, it is important that conclusions

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<th>VARIABLES AND THE DESCRIPTION</th>
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<td>VARIABLES</td>
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<td>Muslim Population</td>
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<td>Number of Institutions involved in Islamic Finance Industry</td>
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<td>Number of Islamic Banks</td>
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<td>Regulatory and Legal Infrastructure</td>
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<td>Central Shari’a Supervisory Regime</td>
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are not based on univariate observations. Unfortunately, however, a common perception about country ranking is based on univariate analysis.

Univariate analysis is the usual way of assessing countries against one another based on one or more variables. In doing so, however, each variable is studied in isolation from others, and as such, it is unable to help form a definitive collective view. More dependence on individual observation to a particular question of interest could be misleading if due weight is not attached to each observation. An isolated analysis, though useful, therefore remains limited in terms of its reliable acceptance.

It is only fair to rank countries by looking at all the available information and form a collective view – a multivariate analytical approach. This study therefore aims at developing a unique and completely objective Islamic Finance Country Index (IFCI) – the first of its kind and a major breakthrough in appraising the industry. IFCI is based on multivariate analysis of available information on countries included in the analysis, whereby each category of information is assigned weights by the analytical system in a purely statistical fashion. Below, we describe the process of constructing the IFCI, together with the description of data used and its respective limitations.

The IFCI aims to rank countries involved in the industry on the basis of available information/data on various variables of interest across each of these countries, by conducting a multivariate analysis in a purely objective manner to avoid any personal bias / a priori judgement affecting the outcome. Construction of the IFCI began with letting the data speak for itself. To that end, the IFCI focused on gathering data on 15 different variables of interest across 75 countries in the world. The heterogeneous nature of each of these countries and inadequacy of data resulted limited the IFCI to only 36 countries, with the focus reduced to just 8 variables. In all cases, data has been collected from various secondary sources; including central regulatory bodies, individual IFI’s published accounts, global agencies’ websites, various periodicals, authentic newspapers, and other country specific resources involving extensive data search procedures. Below is the list of these variables and the way they are defined for the purposes of IFCI:

Data was gathered on the above 8 variables for all 36 countries included in the IFCI. The data was then coded and organized to enable multivariate analysis and eventual construction of the IFCI using SPSS. In a multivariate analysis, one is always interested in knowing first the structure of data/information collected – i.e. whether the various levels of moments are observed to see if data has any useful information content to draw inferences from. Factor analysis is one correlational technique to determine meaningful clusters of shared variance in the data set. It attempts to identify underlying variables that explain the pattern of correlations within a set of observed variables. This procedure is often used to reduce the number of variables in a data set but can also be used to explore the latent structure of the variables in the data file – a purpose for which we employed Factor Analysis.

In order for Factor Analysis to be applicable, it is important that the data fits a specification test for such an analysis. The Kaiser-Meyer-Olkin Measure of Sampling Adequacy is a statistic that indicates the proportion of variance in observed variables that might be caused by underlying factors. High values (close to 1.0) generally indicate that a Factor Analysis may be useful with data. If the value is less than 0.50, the results of the Factor Analysis probably won’t be very useful. We found this measure to be 0.8, which is reasonably close to 1.0 and hence provided us comfort that the data was fit for Factor Analysis. Bartlett’s test of sphericity is another specification test which tests the hypothesis that the correlation matrix is an identity matrix, which would indicate that given variables are unrelated and therefore unsuitable for structure detection. Small values (less than 0.05) of the significance level indicate that a factor analysis may be useful with the data. In our case, this test value was found to be significant at 0.00 level which was another strong confirmation that the data set was of a high quality and very fit for Factor Analysis.

Once satisfied with specification tests, we ran Factor Analysis to compute Initial Communalties using Principal Axis Factoring method of factor extraction. For correlation analyses, Initial Communalties measure the proportion of variance accounted for in each variable by the rest of the variables. This procedure provided us a statistically significant method of assigning objective

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<th>VARIABLES</th>
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<tr>
<td>Number of Islamic Banks</td>
<td>21.8</td>
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<td>Central Sharia Supervisory Regime</td>
<td>19.7</td>
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<tr>
<td>Number of Institutions involved in Islamic Finance Industry</td>
<td>20.3</td>
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<tr>
<td>Size of Islamic Financial Assets</td>
<td>13.9</td>
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<tr>
<td>Size of Sukuk</td>
<td>6.6</td>
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<tr>
<td>Muslim Population</td>
<td>7.2</td>
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<tr>
<td>Education and Culture</td>
<td>5.7</td>
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<tr>
<td>Regulatory and Legal Infrastructure</td>
<td>4.9</td>
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weights to all 8 variables entering the data set in a collective fashion. As a result of data speaking for itself in a multivariate manner, any subjectivity or univariate objectivity was completely ruled out in assigning the weights. These weights, in order of their respective significance, are reported in the table below:

The above table indicates interesting findings as to which variables contribute greatly towards the ranking of countries. Interestingly, it appears that countries with a higher number of full-fledged Islamic banking institutions stand greater chances of ranking high in the list. On this basis, one would expect Bahrain to top the list with 26 banks, followed by Iran, Malaysia, Indonesia, Sudan, UAE, Saudi Arabia and Kuwait. However, as confirmed by the results of the multivariate analysis, this is not the case in reality – indeed what is clear from the findings here, is that future growth lies in establishing more Islamic banking and financial institutions (with a greater emphasis on these being fully fledged Islamic as opposed to Islamic windows). The most striking observation to note is that countries with a formal state level Shari’a supervisory regime are better placed to rank higher (Iran, Malaysia, Pakistan, Indonesia, Bahrain, Kuwait and Sudan may sound as the only candidates on this basis as such regimes do not exist at the moment in other countries in the world). A clear message to emerge from this finding is that prospects of growth are higher in those countries where Central Shari’a Supervisory regimes are already in place or in the making. In the past, the most popular measure of a country ranking used has been to look at the size of Islamic financial assets. On this basis, one can intuitively expect countries like Iran, Saudi Arabia, Malaysia, UAE, Kuwait, Bahrain and Qatar to top the list. However, as noted by the multivariate country index discussed below and the lower weight assigned to it in the table above, this is indeed a misleading measure of a country ranking – the contribution of this variable is yet reasonably strong at a level of 14%. Surprisingly, being active in the sukuk market does not necessarily contribute extensively in country ranking. This is also true in case of the size of the Muslim population in a country and as such mere presence of Muslims in a country does not necessarily guarantee a higher place in the ranking. While one would expect presence of a supportive regulatory and legal framework to have a high positive correlation with ranking of the country, it appears, on the contrary, to contribute least by having a lower positive correlation. Educational and cultural awareness in a country is also an important contributor but far less than a Central Shari’a Supervisory regime to Islamic windows. This is despite Pakistan deriving little advantage from having a higher Muslim population, a variable which has lower weight in the index.

A very interesting and surprising observation is the ranking of Indonesia which has assumed 4th place in the country rankings despite, for example, the size of its Islamic assets being about 12 times less than its next ranked country of UAE. This finding is relatively insensitive to the population bias as well because of the objective weights assigned to all variables including population which contributes to only 7% to the index itself (on the basis of size of assets, Indonesia would have ranked 11th instead which indeed is misleading based on multivariate results).

Another interesting case is that of Pakistan which has gone 7 steps the ranking from 14th position (based on size of Islamic assets only, for example) to 7th. This can be explained better knowing that Pakistan does exercise a Central Shari’a Supervisory regime – a factor which carries about 20% of the weight in the index construction. This is despite Pakistan deriving little advantage from having a higher Muslim population, a variable which has lower weight in the index.

A very attention-grabbing finding is the case of India for example, which has occupied 11th position in the overall ranking, leaving behind countries like Qatar (12th), Turkey (14th) and UK (15th). This is despite the current diminutive size of Islamic financial assets and the absence of a full-fledged Islamic banking institution, even though it is a country with the third largest Muslim population in the world. We would therefore like to take a cautious view on the standing of India and remind ourselves of the size of Islamic assets in Qatar, Turkey and UK which are far greater than India. In case of Qatar and UK, one explanation may be a smaller Muslim population. All said, in terms of % value of these countries in the index (Figure 2), India and Qatar stack very closely while Turkey and UK are not very far behind either.

While ranking data is presented for all 36 countries, we do not present dedicated discussion on countries ranked 16th to 36th because of their % value in the index which is either 1 or less. In fact, the first 15 countries represent about 88% of the total index position which is a good enough subset to limit plausible discussion on results.

The above table indicates interesting findings as to which variables contribute greatly towards the ranking of countries. Interestingly, it appears that countries with a higher number of full-fledged Islamic banking institutions stand greater chances of ranking high in the list. On this basis, one would expect Bahrain to top the list with 26 banks, followed by Iran, Malaysia, Indonesia, Sudan, UAE, Saudi Arabia and Kuwait. However, as confirmed by the results of the multivariate analysis, this is not the case in reality – indeed what is clear from the findings here, is that future growth lies in establishing more Islamic banking and financial institutions (with a greater emphasis on these being fully fledged Islamic as opposed to Islamic windows). The most striking observation to note is that countries with a formal state level Shari’a supervisory regime are better placed to rank higher (Iran, Malaysia, Pakistan, Indonesia, Bahrain, Kuwait and Sudan may sound as the only candidates on this basis as such regimes do not exist at the moment in other countries in the world). A clear message to emerge from this finding is that prospects of growth are higher in those countries where Central Shari’a Supervisory regimes are already in place or in the making. In the past, the most popular measure of a country ranking used has been to look at the size of Islamic financial assets. On this basis, one can intuitively expect countries like Iran, Saudi Arabia, Malaysia, UAE, Kuwait, Bahrain and Qatar to top the list. However, as noted by the multivariate country index discussed below and the lower weight assigned to it in the table above, this is indeed a misleading measure of a country ranking – the contribution of this variable is yet reasonably strong at a level of 14%. Surprisingly, being active in the sukuk market does not necessarily contribute extensively in country ranking. This is also true in case of the size of the Muslim population in a country and as such mere presence of Muslims in a country does not necessarily guarantee a higher place in the ranking. While one would expect presence of a supportive regulatory and legal framework to have a high positive correlation with ranking of the country, it appears, on the contrary, to contribute least by having a lower positive correlation. Educational and cultural awareness in a country is also an important contributor but far less than a Central Shari’a Supervisory regime to Islamic windows. This is despite Pakistan deriving little advantage from having a higher Muslim population, a variable which has lower weight in the index.

A very interesting and surprising observation is the ranking of Indonesia which has assumed 4th place in the country rankings despite, for example, the size of its Islamic assets being about 12 times less than its next ranked country of UAE. This finding is relatively insensitive to the population bias as well because of the objective weights assigned to all variables including population which contributes to only 7% to the index itself (on the basis of size of assets, Indonesia would have ranked 11th instead which indeed is misleading based on multivariate results).

Another interesting case is that of Pakistan which has gone 7 steps the ranking from 14th position (based on size of Islamic assets only, for example) to 7th. This can be explained better knowing that Pakistan does exercise a Central Shari’a Supervisory regime – a factor which carries about 20% of the weight in the index construction. This is despite Pakistan deriving little advantage from having a higher Muslim population, a variable which has lower weight in the index.

A very attention-grabbing finding is the case of India for example, which has occupied 11th position in the overall ranking, leaving behind countries like Qatar (12th), Turkey (14th) and UK (15th). This is despite the current diminutive size of Islamic financial assets and the absence of a full-fledged Islamic banking institution, even though it is a country with the third largest Muslim population in the world. We would therefore like to take a cautious view on the standing of India and remind ourselves of the size of Islamic assets in Qatar, Turkey and UK which are far greater than India. In case of Qatar and UK, one explanation may be a smaller Muslim population. All said, in terms of % value of these countries in the index (Figure 2), India and Qatar stack very closely while Turkey and UK are not very far behind either.

While ranking data is presented for all 36 countries, we do not present dedicated discussion on countries ranked 16th to 36th because of their % value in the index which is either 1 or less. In fact, the first 15 countries represent about 88% of the total index position which is a good enough subset to limit plausible discussion on results.
Figure 1: Islamic Finance Country Index (IFCI)

Index value

United Kingdom 8.8
Turkey 10.4
Egypt 10.7
Qatar 11.2
India 12
Sudan 14
Bangladesh 16
Bahrain 22
Pakistan 26
Kuwait 26
United Arab Emirates 26
Indonesia 29
Saudi Arabia 35
Malaysia 40
Iran 63
AFGHANISTAN

October 7th 2011 will mark 10 years since the NATO led forces entered Afghanistan. The attack brought promises of liberty, hope, democracy, prosperity and women rights to a country long crippled by years of war from both within its borders and beyond. 10 years on, the Afghani people are still mulling over whether these promises have been met, while America and its’ allies worryingly ponder as to how to withdraw their 13000 strong force in the face of a strengthening Taliban insurgency. A decade on, it is unlikely there will be cessation of hostilities in this war torn nation.

Opportunities in the rubble of war

Be that as it may, the rebuilding efforts continue in the midst of bombs and gunfire. It was hardly going to be a smooth transition from failed state to a flourishing democracy, though the building blocks are clearly visible. Afghanistan’s government is limited to using short-term bills and international aid to finance development and have received more than USD 32 billion in international aid since 2001 to rebuild. The financial sector is slowly developing. Essentially, the banking system had to be created from a blank piece of paper with a complete overhaul of the banking sector in 2003. Local and international consultants, advisors, visionaries and practitioners gathered to setup a framework for the system with attempts to bring its banking standards up to those of its neighbours, Pakistan and Iran. At present, total deposits stand at USD 3.58 billion as of August 2010, according to a central bank report. But bankers estimate that there is close to USD 30 billion in circulation that remains untapped by the banking sector.

In 2009, the Central Bank of Afghanistan introduced a five year plan to enhance the banking framework. A pressing concern is how to attract a larger customer base. Currently, only a tiny proportion has a bank account with over 95% not having access to banking services. Poverty along with the threadbare number of banking branches across the country, contributes to this high figure. Additionally, potential customers have rejected conventional finance as it is antithetical to Islamic financial tenets. There is therefore a potentially significant captive market for Islamic finance.

Subsequently, the five year plan recognises the expediency of the Islamic finance market for Afghanistan’s rejuvenation. The central bank has set up an Islamic finance division to work on Islamic finance and a Shari’a board. Currently, there is no specific Islamic finance legislation nor is there a fully fledged Islamic bank. But out of the 17 conventional banks that operate in the country, six of them have Islamic banking windows.

Afghanistan’s central bank expects an Islamic banking law to be enacted by September and the inauguration of a fully fledged Islamic bank soon after. The central bank is planning to issue three banking licenses once the law has passed, and a number of banks have already shown interest. The government hopes that Islamic banks will tap into the giant reservoir of unbanked customers. In addition to establishing Islamic banks, the sector is looking at innovative means to draw customers. In this regard, mobile banking has significant attraction especially as the physical infrastructure of the banking system is at an embryonic stage.

Corruption in the elite

Unfortunately, the banking sector has taken a battering recently and suspicions are high about the industry. In the birth pangs of Afghanistan’s banking sector, it should not come as a surprise that corruption has already inflicted damage to the integrity of the system. Early 2010 saw American investigators and their Afghani counterpart unearth opaque tributaries of money going from depositors’ accounts at Kabul Bank – the country’s largest private bank - into personal accounts of senior banking and government officials. It is estimated that...
USD 900 million is missing from the bank, which for a country whose GDP is currently at a meagre USD 11.76 billion (World Bank 2008) staves a sizable hole in their rebuilding budget. Investigators believe that the USD 900 million includes failed loans and loans to fictitious organisations. It is hoped that Islamic banks and its already intuitive attraction to a country predominately Muslim and conservative, will galvanise the sector.

**Third sector development**

Moving away from banking, the third sector has seen Islamic finance play a crucial role in reaching out to the impoverished segments of society. Organisations such as FINCA Afghanistan have developed Shari’a-compliant microfinance products. It currently has 10000 clients with an average loan size of USD 385. The World Council of Credit Unions (WOCCU) program established the country’s first national association for Islamic investment and finance cooperatives (IFCs), or credit unions, which are intended to benefit small and medium-scale business owners, farmers and low-income households in underserved rural areas. In December 2009, The U.S. Agency for International Development (USAID) awarded WOCCU USD 60.5 million to expand financial services in southern and eastern Afghanistan.

As the anniversary fast approaches, the Afghani people have plenty of milestone events to deliberate over. Has the War on Terror in their country been a resounding success? The answer on the lips of most Afghans would be no. But in the rubble of war, there are shoots of opportunity: opportunities that need to be taken quickly before they flounder. Islamic banking is present in Afghanistan, but nascent; demanded but not extensively supplied. 2011 could be another milestone year but it is for the Afghans to take the right steps. Seemingly they are on the path but have to be careful not to trip up.
Algeria is a country situated in North Africa along the Mediterranean Sea. It boasts of a rich cultural heritage due to its unique history, as the country has been subject to various forms of occupation throughout its past. A mixture of Berber, Arab, Turkish as well as French influence has given the local populace much diversity. Algeria possesses natural resources in abundance such as oil and gas. However, there is high unemployment and poverty within Algeria leaving much of the youth disenfranchised. This is clearly evident from the recent demonstrations held against the government, with more expected, inspired no doubt by the success of similar protests in Egypt and Tunisia.

With the majority of the population being Muslim, one would expect Islamic finance to already be well established within the country. Unfortunately, the government of Algeria has been slow to facilitate the entrance of Islamic finance, stunting its growth. The scepticism and attitude of the Algerian government has no doubt been influenced by historical events in the country, i.e. the civil war in the 90’s.

However there are signs that the government is warming towards Islamic finance. This change in attitude is due to the fact that the leadership of the country is keen to attract investment from the rich Gulf States and furthermore Algerians themselves, now want more access to financial services which are at par with their religious beliefs. Furthermore, as was mentioned earlier, there is much unemployment and unhappiness at the current regime, thus Islamic finance expansion will create much needed jobs and may ease some of the pressure on the government.

The year 2010 saw some crucial developments in the Algerian legislative framework, to facilitate the growth of Islamic finance within the country. After the government received much criticism for stifling the growth of Islamic finance, it responded by amending the Law on Money and Credit in May 2010. The amendment which was due to come into play this January (2011) aims to make it easier for banks to offer both conventional and Shari’a-compliant finance and enable them to establish their own respective Shari’a boards.

The law amendment will hopefully fuel the growth of Islamic finance within Algeria, as even though there are a few IFIs currently operating within the country, the market share held by Islamic banks is still insignificant. Besides retail and investment banking, there is also potential for Shari’a-compliant micro-finance, which has not escaped the attention of potential entrants to the market.

The clamour for Islamic finance is growing louder. Conferences were held in 2010 and MPs have started to promote its cause. Thus it is expected that Islamic finance will play a much greater role in future in the Algerian economy.
AZERBAIJAN

Azerbaijan is a country which is strategically located near the Caspian Sea. It is rich in culture and resources possessing large reserves of both oil and natural gas. With the majority of its nearly 9 million strong Muslim population, it seems a ripe market for Islamic finance to enter.

The country gained independence from the Soviet Union in 1991, after years of occupation which had curbed religious activity. Islamic finance development was slow within Azerbaijan, as well as in other Muslim countries in the region. Gradually, a reawakening of religious values amongst individuals in the region has occurred and this, in turn, enabled Islamic finance to make some inroads into the financial system.

Due to an absence of appropriate legislation and regulation stemming from a lack of support from the government, much of the Islamic finance activities in the country had been informal and silently countenanced by regulatory bodies and government. However, it appears as though Islamic finance seems to be becoming more and more “official” in a sense.

Kovsar Bank has been offering Islamic financial services for some time now; but the bank was recognised by the government not as an official “Islamic” bank, but rather a bank which offers alternative or interest-free finance. The IDB was critical in changing the views of the Azerbaijani government towards Islamic finance. It was involved in the setting up of an Islamic investment fund known as the Caspian Investment Company (CIC), a joint-venture between the IDB and Azerbaijani government. By creating an amicable partnership, the government was exposed to the potential benefits of Islamic finance. Compounding this good will, the Islamic Corporation for the Development of the Private Sector (ICD) has been providing certain Azerbaijani Banks credit to use for “unofficial” Islamic finance offerings such as ijarah.

Today, the largest bank in the country, the International Bank of Azerbaijan (IBA) has expressed its wish to introduce Islamic financial services. The bank is in the final stages of opening up an Islamic window, after a team worked tirelessly since 2009 to formulate a strategy and engage relevant stakeholders. The Islamic banking window is expected to begin operations in 2011. Other banks within the country which have been looking at setting up an Islamic banking window include Turan Bank. The ball has started to roll which could have lasting effects for Azerbaijan and impress the rest of the region.

The government however still needs to amend certain laws and do more to facilitate Islamic finance in the country. However the future of Islamic finance seems bright and the importance of Azerbaijan cannot be underestimated. This view is supported by IDB choosing to have its 35th annual meeting in the country in 2010.
AUSTRALIA

The Ashes have returned to England, much to the dismay of the passionate Australian fans, who had been so used to their imperious cricket ticket team discarding rivals with their technical mastery, elegant deliveries and an unflinching ruthlessness that teams had already lost before walking on to the pavilion. Unfortunately, time waits for no man and the old guard, one by one, have left; it is up to the new guard to learn from their example and move forward.

Similarly, 2010 also saw the previous Prime Minister, Australian Labour Party’s Kevin Rudd leave and hand over the reins of power to his Deputy, Julia Gillard. In the ensuing parliamentary elections, the Labour Party narrowly claimed victory, forming a minority government, and entered into its second term in power. Policies have therefore not altered significantly and the focus of developing Australia as leading financial centre still remains. This is good especially for the progress of Islamic finance in the country. The previous government had shown a great deal of enthusiasm for the establishment of an Islamic finance hub in Australia. This was ostensibly driven by former Assistant Treasurer, Senator Nick Sherry, who has set the groundwork in place for Islamic finance to flourish in Australia.

Demistifying Islamic finance

On May 27th, the Treasury launched a joint publication with Malaysian based law firm Zaid Ibrahim and Co, entitled ‘Demistifying Islamic finance’. The booklet was a general introduction to Islamic finance intended to raise awareness and encourage growth. Furthermore, the publication hoped to dispel misconceptions regarding the link between terrorism and Islamic finance. At the official launch, Sherry was keen to point out the government’s support on Islamic finance’s ethical precepts stating, “The Australian Government works to foster competitive and efficient markets that promote consumer wellbeing, a secure financial system and sound corporate practices. This work supports a market system based on integrity, transparency and clarity — the same principles which are set out in the Quran and the Sunnah and which form the basis of Islamic finance”.

It was an edifying comment, one which unfortunately brought the ire of the more prejudicial and contemptuous segments of Australian society. Nevertheless, it was a statement of intent, a culmination of months of discussions, networking and consultations.

To augment and develop their capacity in Islamic finance, Australia has sought the assistance of Malaysia and Middle Eastern nations with Sherry making a number of official visits of Islamic finance hubs such as UAE, Bahrain, Qatar and Malaysia. At the end of 2009, the Malaysian Islamic Finance Centre (MIFC) sponsored a roadshow which consisted of seminars and roundtable discussions with government officials on opportunities to be gained from Islamic finance. To strengthen the relationship, the Australian Treasury signed a Memorandum of Understanding with Bank Negara Malaysia in order to foster long-term strategic business development in conventional and Islamic finance between Malaysia and Australia. Zaid Ibrahim & Co became the first Asian law firm to open offices in Australia in 2009 with a focus on advising upon Islamic finance services. Concurrently, UAE expressed interest in developing commercial relationships with Australia. The Dubai Export Development Corporation has undertaken two Islamic financial services mission to Australia aiming to strengthen the export of Islamic financial services. The Corporation which consists of leading IFIs such as Noor Islamic bank have also been assisting the Australian government in potential changes in legislation to accommodate Islamic finance.

The year of the reports

The aforementioned booklet was not the first piece of literature issued by the government. In fact 2010 can be
regarded as the year of reports and consultations, with three other publications being issued over the course of the year. The year began with the Australian Financial Centre Forum (AFCM) releasing ‘Australia as a Financial Centre: Building on our Strengths’, more commonly known as the Johnson Report. The AFCM was established in September 2008 to promote Australia as a leading financial centre. The Report was the result of in-depth analysis looking at ways Australia can boost financial services and improve the competitiveness of their Australia’s (sic) financial sector and issued a number of recommendations. Recommendation 3.6 requested the Board of Taxation to see if amendments had to be made to Commonwealth taxation provisions in order for treatment of Islamic products to be on parity with that of their conventional counterparts, in terms of economic substance. Recommendation 4.8 called for the removal of regulatory barriers. The document highlights Islamic finance as a key growth area and one which would tap into the highly liquid Middle Eastern market as well as provide access to offshore saving pools. This was a pivotal document, signifying Australia’s sincere interest in developing the regulatory framework for Islamic finance products.

The Johnson Report was followed by the Australian Government’s trade and investment development agency, Austrade, launch of a booklet entitled Islamic finance. The booklet highlighted Australian market as strong market for investment and the development of an Islamic finance hub in the Asia Pacific. It would come as no surprise that the February 12th launch was in front of Islamic finance hub in the Asia Pacific. It would come as no surprise that the February 12th launch was in front of Islamic institutions which facilitates commodities trade for Middle Eastern and Malaysian investors.

Regulatory bodies are responding to the increased interest in Islamic finance. The Australian Financial Markets Association (AFMA), the body representing wholesale banking and financial markets on regulatory issues, has formed the Islamic Finance Committee and is in regular dialogue with the Treasury regarding taxation matters. Senator Sherry has spearheaded a review of Australian tax laws in order that IFIs are not unfairly penalised. A working group at the Board of Taxation has been established to review and suggest amendments and it is expected that the report will be published June 2011. Senator Sherry hopes there will be legislative changes to accommodate Islamic finance more effectively by the end of 2011.

Following the change of government, the Board of Taxation released a discussion paper examining tax frameworks and identifying its limitations in accommodating Shari’a-compliant products. The paper focused on seven Shari’a-compliant products, looking at risk management strategies adopted by IFIs. An appraisal was made as to the tax ramifications of these products. The products analysed were murabaha, commodity murabaha, ijara wa iqtina, istisna, salam, diminishing musharaka and an ijara sukuk.

The report is to be followed by a series of consultations with stakeholders with an interest to developing Islamic finance. Submissions have been requested to assist in the process and consultation forums convened by the Board of Taxation have been planned in major Australian cities: Canberra, Melbourne and Sydney.

Islamic finance in Australia

Zaid Ibrahim & Co in Australia was not the first commercial organisation with a stake in Islamic finance to enter the country. In 2008, Kuwait Finance House was the first foreign Islamic bank to set up operations in Australia. The current focus of KFH is on developing and promoting wholesale markets which enable cross border transactions between Australia and Islamic finance hubs. In 2009, Australia’s Macquarie Group Ltd and Gulf Finance House partnered together to establish a joint Islamic financial services platform in the Middle East. Terms of the agreement included planned placement of a USD 100 million convertible murabaha. But it is the grassroots organisations that build up a profile. Any changes in the regulatory framework will result in an improved financial environment in which to offer a range of Islamic financial products, thereby potentially increasing customer base. Indigenous Islamic finance is still in its infancy in Australia with only a few small initiatives, providing a limited number of services for the small but growing Muslim community within Australia. Recent figures show that Australia has a Muslim population of approximately 340,390. This population has expanded rapidly by more than 80,000 (or 28%) from 1996 to 2006. The Muslim Community Cooperative (Australia) Ltd (MCCA) was the first provider of Shari’a-compliant services, founded as cooperative in 1989. It offers Shari’a-compliant home loans and was the largest originator of Shari’a-compliant residential home loans in Australia. Over the last year or so, it has branched out into asset management. In 2009, MCCA Income Fund became the first Australian Securities and Investment Commission (ASIC) regulated Shari’a-compliant retail fund.

MCCA lobbying was a crucial factor that prompted the amendment of the Stamp Duties Act in the State of Victoria, which has the largest population in Australia. The State Parliament amended the Governing Act in 2004 so that sales/re-sales taking the form of “Cost Plus” arrangements would be treated as unitary transactions. This removed the double taxation problem on ijara mortgage arrangements, the main structure used in property acquisition. While Victorian state law has been amended to provide relief against double taxation, other states continue to levy stamp duties at each stage of the ijara transaction. This problem was addressed in the Board of Taxation paper.

The success of MCCA has lured other Shari’a-compliant organisations such as Iskan finance and Islamic Cooperative Finance. Iskan concentrates on home financing while the latter has a range of services including offering investment funds such as Zakat funds. The interest is not limited to Islamic finance organisations. In 2009, National Australia bank committed USD 15 million to introduce Shari’a-compliant loans. These are no interest loans provided to low income earners who have difficulty accessing credit. In the same year, LM Investment Management Ltd, a specialist income

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funds manager issued Australia’s first onshore Shari’a-compliant fund focusing on global property and business markets. The LM Australian Alif Fund is marketed via LM’s international network of licensed financial advisers, intermediaries, wholesale platforms, private banks, pension funds, corporate and institutional investment consultants spanning beyond 32 countries. In September 2010, the Central Bank of Bahrain authorised formation and marketing of the Hyperion Australian Equity Islamic Fund, the first Shari’a-compliant offshore fund comprising of stocks on the Australian Stock Exchange which are deemed to be Shari’a-compliant. The fund is hoping to provide investors in the Middle East exposure to the Australian equities market.

**Oh no! No ball**

The last two years there has been significant progress within the Islamic finance space in Australia. It has taken 20 years, but Australia is well on course to achieving an extensive and indigenous Islamic finance industry. La Trobe University is well aware of the zeitgeist and became the first university in Australia to offer master degree in Islamic banking and finance. The course also provides exemptions to part one of the Chartered Islamic Financial Professional qualification, thus showing a holistic approach adopted by La Trobe. They have further developed an E-learning masters course in partnership with Dubai’s Ethica institute.

Yet not everyone is happy with the approach undertaken by Australia’s government in supporting Islamic finance. Liberal Party member Cory Bernandi has voiced his opposition, arguing that Shari’a law is in opposition to Australia’s western values. Fortunately, party colleagues have been quick to dismiss his criticisms, supporting the governments’ efforts in removing barriers to integrate Islamic finance into the Australian system. It would seem then that there is a unity amongst the politicians on this most sensitive of matters. 2011 will prove how committed they are to the cause.
BAHRAIN

As a small Island in the Persian Gulf, Bahrain has made significant waves in the Islamic finance sector. Its success has much to do with the free market policies of the government, who have encouraged international firms to enter the market. According to the Index for Economic Freedom 2011 published by the Heritage Foundation and the Wall Street Journal, it is the world’s 10th most free economy and the only Middle Eastern nation in the top 20. By having an open economy, it has allowed the proliferation of ideas and innovation, thus encouraging private sector developments in Islamic finance. More so than this, the support of the government and the central bank has been crucial to Islamic finance’s growth in Bahrain.

State of the industry

According to the Bahrain Economic Development Board (BEDB), the financial sector had contracted slightly in 2009. However, the shrinking output was marginal, at only 1%, suggesting that Bahrain had survived the financial crisis relatively well. Bahrain owes its success to its open market, liberalised policies and ongoing country marketing which has attracted foreign financial institutions to set up branches there and retain majority ownership. The IMF has stated that high initial levels of bank capital and sound prudential norms established by the Central Bank of Bahrain (CBB), ensured the resilience of the financial system. Recourse to extensive direct interventions seen in many countries has not been required. In addition, the CBB has endorsed Islamic finance and is keen to ensure transparency, efficiency and competitiveness, in order to boost the Islamic finance industry.

Bahrain’s strength in the insurance and financial services sector has provided this island state a prominence in the Islamic finance market. According to Kuwait based Al Sabek, Bahrain has 20 Islamic funds investing nearly USD 1 billion. It has more IFIs than any other purported Islamic finance centre. According to the Oxford Business Report (OBS) it has 27 Islamic banks out of 140 banks operating in the Kingdom, representing USD 25.5 billion in assets –approximately 10% share of total global Islamic banking assets. Moreover the banker accords it a favourable statistic: four of the top five Islamic banks in the world are from Bahrain. The annual growth of the banking sector in the last five years has been remarkable since 2005, averaging approximately 48%. However, this has been impacted due to the global recession. While retail remains healthy, the wholesale sector requires a rethink in strategy. A major concern has been the concentration on real estate – Bahraini Islamic banks are rumoured to have 70% of their capital invested in the Islamic finance investment of choice. The CBB has attempted to put a cap on real estate exposure since 2006, but this has been met with a chorus of disapproval. However, due to the sluggish real estate market, a change of focus is needed for Islamic banks. Inertia will prevent an accelerated approach, but there are opportunities, for instance, in the local private sector. In November, BMi Bank and Tamkeen launched an Islamic financing scheme for local private sector companies. The scheme hopes to invest USD 13 million dollars for the development of local entrepreneurship. Insurance has been vibrant in Bahrain. In 2009, it was the only segment of the financial sector to experience growth, having reportedly expanded by 6%. Bahrain also has 18 takaful operators – seven of which are fully fledged takaful providers - and one retakaful firm. Established conventional insurers such as Allianz and Chartis have bases in Bahrain where they offer both conventional and Islamic insurance. Bahrain remains a top choice for international insurers keen to set up takaful divisions to service GCC countries, and there are currently 177 insurance policy writers in Bahrain. This is a testament to the highly regarded regulatory centre Bahrain has created for insurance services. Gross premiums for takaful companies in Bahrain reached USD 72.54 million in 2008, representing a 73% jump.
from the previous year. By the end of 2008, takaful firms accounted for 42% of the paid up capital of Bahraini insurers. In 2009, the seven takaful companies had gross contributions of USD 87 million, representing a 22% increase from the previous year. Family takaful represents the largest sector. Gross premiums from retakaful registered 217.6% growth between 2008 and 2009, highlighting the growing importance of retakaful structures. In September, T’azur, a regional takaful company headquartered in the Kingdom of Bahrain, signed an agreement with Hanover Retakaful, the Bahrain-based Islamic subsidiary of Hanover-Re, one of the world’s leading reinsurers. Consolidating resources between the Islamic and conventional sectors will be important in strengthening Bahrain’s position as an insurance and takaful centre in the financial markets. These achievements have been recognised by the industry. At the annual International Takaful Summit it has been awarded Best Financial Centre three years in a row.

Standardisation in a world of diversity

Being the base of standard making bodies such as AAOIFI has provided Bahrain with a position to influence the direction of Islamic finance. AAOIFI, whilst a small body with few resources, has been active in setting out accounting, auditing and Shari’a standards for the Islamic finance industry. Its preeminent Shari’a board and committees are infused with prominent practitioners of Islamic finance as well as leading scholars. For an industry still finding its path, intellectual disagreement was likely to occur under the auspices of bodies such as AAOIFI, which is gradually becoming the most influential international fiqh body. Indeed, AAOIFI’s chairman, Sheikh Taqi Usmani’s 2008 criticism of the sukuk industry sent reverberations throughout the industry. Questions were being asked as to the nature of sukuk and whether they could be classed as Shari’a-compliant. Parallel to Usmani’s criticism, the credit crisis ensued which was followed by the default of the Nakheel Sukuk. Combined, the sukuk industry took a beating, one that is only now recovering from. Sukuk have generally been an important part of Islamic finance’s product portfolio, not least because of its potential for innovation. But intermittent moments of reflection, where premises and postulates are questioned, are required for the health of any nascent industry, not least Islamic finance.

Thus AAOIFI’s announcement in August pertaining to the limitation of a scholar’s role on multiple Shari’a boards is seen as a positive means to ensure transparency and diversity on Shari’a boards, while at the same time increasing human resource capacity. They also called for the creation of a national Shari’a board to audit and clarify Shari’a products and reduce the incidence of disagreement amongst scholars. However, this has not been met with complete support, with many arguing that it would increase bureaucracy.

The announcement has also contributed to the ongoing polemic discourse regarding standardisation. In this regard, the International Islamic Financial Market (IIFM), a Bahrain based standards setting body for the Islamic capital and money markets, has been paramount for the pedagogy of Islamic finance. Its primary focus lies in the standardisation of Islamic products, documentation and related processes. The recent collaboration between New York’s International Swaps and Derivatives Association (ISDA) and Bahrain based International Islamic Financial Market (IIFM) in the creation of the standardised Tahawwut hedging agreement, is an achievement in terms of the flexibility of Islamic finance to create Shari’a-compliant derivatives. The agreement hopes to counter the ongoing problem of risk management within the industry. The IIFM have also looked at drafting standardised documents for asset backed bonds and creating repos to manage funds. These initiatives affirm Bahrain’s strong advocacy of international standards for the Islamic financial sector along with better risk management practices.

Liquidity Challenges

Another pervasive problem has been the lack of liquidity in the market, due to the absence of secondary money markets. Bahrain is the only GCC country to issue three and six month domestic Islamic bills. To address this challenge, Bahrain Financial Exchange (BFX) launched its Islamic finance division, the BFX Management Centre (bFX) to facilitate greater liquidity by the opening of a secondary market, granting the platform for the trading and repackaging of sukuk. Converting them into shorter term debt. Government sukuk will be utilised in short term debt structures. The bFX was set up in 2002 in Bahrain, to act as a conduit between banks looking to place surplus funds in traded investments.

Improving the framework

The CBB pioneered the development of a comprehensive regulatory framework for Islamic banks in 2001, followed in 2005 by a regulatory framework specific to Islamic takaful and retakaful companies. The CBB has published detailed guidelines for Islamic banking in the country, similar to those of conventional banks. However, there are two additional requirements: each Islamic bank must have an independent Shari’a board, and Islamic banks need to adopt AAOIFI standards for financial reporting.

The Waqf Fund for research, education and training has recognised the need to develop financial professionals who have knowledge of both Islamic and conventional finance. The Waqf Fund is an endowment capital fund that has the support of Islamic banks and conventional banks with Islamic windows. The fund supports and finances training, education, research and other developments in Islamic finance. It was set up in 2006 by the CBB, in partnership with 15 leading Islamic institutions and three conventional banks that also have units offering Islamic banking services. It unveiled
plans to conduct training programmes in conjunction with the Scottish based Islamic Finance Council UK (IFC) for Shari’a scholars, auditors and compliance professionals, aimed at enhancing their understanding of global financial markets. The fund is also working with BIBF to increase the skills base for the sector through a graduate sponsorship programme. It provides support for graduate students from the banking, finance, accounting and economics streams of the University of Bahrain and other institutions to obtain diplomas from the institute, while also receiving work experience at selected banks. In March, the Waqf Fund announced it had just completed the selection process for the second batch of graduates for the programme.

International multiservice firms such as Deloitte are capitalising on Bahrain’s position as an Islamic finance centre by the creation of its new Islamic Finance Knowledge Centre (IKFC). The IKFC is designed to help Deloitte’s clients tap into the Islamic finance field by providing experts who will support the firm’s Middle Eastern audit, tax, consulting, risk and financial advisory.

**Expanding the industry**

Bahrain Association of Banks (BAB), an umbrella body, which works closely with the CBB. At the World Bank/IMF meeting it launched The Handbook of Islamic Banking & Finance, an introductory text designed to explain Islamic finance products to non-specialists. An initiative such as this, in the centre of capitalism, highlights Bahrain’s intention to spread information and knowledge about Islamic finance to a wider audience. As the Islamic finance industry grows, a recurring need will be having expansive and high quality sources of information. In February, an Islamic finance directory was launched in Bahrain by Thomson Reuters. The directory consists of details of Islamic finance professionals and scholars, rating agencies, industry standard bodies, consulting firms and subsidiaries from 25 countries.

Industry analysts comment that Islamic commercial banks are sitting on a bed of liquidity and are unsure as to how to deploy the cash. The foreign markets are proving to be lucrative and many banks have sought to tap into international markets. Al Salam Bank, Bahrain’s fastest growing lender by revenue, has been especially active in providing Shari’a-compliant financing for the investment in prime real estate in commercial hubs of the UK. They are also looking for USD 500 million in Asia Pacific markets such as Singapore, Malaysia and Indonesia, to profit from the flourishing markets within the region. Al Baraka Banking Group also plans to expand into the Asian market having finalised its merger with Emirates Global Islamic Bank in Pakistan, in October. These are just some of the latest developments and are a testament to the growing power of Bahrain’s Islamic banks. More investment, especially in non-Muslim countries, will increase awareness of Islamic finance and diversify the product portfolio of Islamic banks.

**Political upheaval**

The recent protests in Bahrain revealed much discontent with the ruling elite. It starkly showed on the global stage the long-term fissures between the Sunni government and the Shi’a majority who make 70% of the population. For the Islamic finance industry in Bahrain, there is unlikely to be ramifications given that the industry is thriving and the foundations are truly set. Moreover, Islamic finance is fortunate as it encompasses Sunni and Shia schools of law. Ideologues such as Baqr al Sadr were Shi’a. But with mighty discontent, markets become mightily anxious. These will be testing times but Islamic finance in Bahrain is likely to remain resilient.
Bangladesh’s foray into Islamic finance has not been without ambivalence; a flux between avidity and vacillation. The Saudi Prince Faisal’s vision for a pan-Islamic bloc naturally embraced the newly independent Bangladesh in the 1970s. Bangladesh ratified the IDB charter in 1974 and was, at one point, advocating separate banking systems though this never transpired. The Bangladesh Islamic Bankers Association, a voluntary organisation whose objective were to abolish riba from the Bengali economy, was an effective lobby group in the early 80s, encouraging Islamic banking to develop. Their efforts spearheaded the incorporation of the Islami Bank Bangladesh Ltd (IBBL) in 1983, which was not only the first Islamic bank in Bangladesh, but is also considered the first interest free bank in South East Asia. Islami Bank Bangladesh Limited (IBBL), started as a joint venture multinational bank with 63.92% of equity contributed by IDB and financial institutions like Al-Rajhi Company for Currency Exchange and Commerce of Saudi Arabia, Kuxait Finance House, Jordan Islamic Bank, Islamic Investment and Exchange Corporation of Qatar, Bahrain Islamic Bank, Islamic Banking System International Holding S.A. Dubai Islamic Bank, Kuwait Ministry of Awqaf and Islamic Affairs.

**Legislative inertia**

To the chagrin of Islamic finance supporters, legislation however was not changed. There were slight amendments made to accounts to fulfil the special requirements of Islamic banks. Necessary amendments were made in the Income Tax Ordinance (1984) which viewed both the profits paid on mudaraba as expenditure. This was hardly the absolution of interest from the economy, ardently desired by exponents of Islamic finance, but it provided a level playing field and enabled more Islamic banks to enter the market.

Democracy became the de jure political system in Bangladesh in 1991 after 20 years of dictatorship; and so began a debilitating rivalry between the two leading parties in Bangladesh - the Awami League and Bangladesh National Party - which is ongoing today. Power shifted hands between the two parties approximately every 5 years, affecting stability and the achievement of long term goals. Each party oversaw certain developments for IFIs in Bangladesh which has gradually improved the legal framework for Islamic banks, though in a piecemeal manner. However, one constant has been the power and authority of the Bangladesh central bank, Bangladesh Bank, who regulates institutions engaged in financial activities and has the power to issue licenses to new banks.

Bangladesh does not have a bespoke Islamic Banking Act. A draft Islamic Banking Act, which would have been included in the authoritative Banking Act (1991), was discussed in Parliament but was not passed as law. Nevertheless, several clauses were incorporated in the Bank Company Act (1991) regarding the mechanism of Islamic banking. In 1997, the Bangladesh Bank sought suggestions from banks working in Islamic finance in order to facilitate a consonant environment to Islamic banking. It was hoped this would lead to an Islamic banking act. 14 years on, an act has not been forthcoming. In 2004, the government formed an eight-member expert committee to draft the proposed insurance laws, including a Takaful Act for Islamic insurance companies. The interim cabinet, however, turned down the proposal.

**Show me the money**

Arguably, Islamic finance could have been quite prominent with the right level of government support and focus. Practitioners in the field add that Bangladesh Bank is not doing enough to fully establish Islamic finance in the country. A lack of liquidity has been blamed on insufficient legal support from the central bank. Criticisms have also been made about a lack of expertise and a minimal portfolio of products. Islamic banks rely
extensively on murabaha to generate profit. However, the wider socio-economic picture has to be considered. Bangladesh is one of the poorest countries in the world, with systematic corruption in all segments of society, low incomes, a widening gap between the rich and the poor, a sizable unbanked population, political instability, cronyism and weak legal enforcement.

Banks face excess liquidity issues due to a lack of response from good credit borrowers and the lack of adequate interest free financial instruments. Industry practitioners state that the central bank has not provided legal support which has accentuated the liquidity problem. Furthermore, there is a dearth of expertise to appraise, monitor, evaluate, and audit Shari’a-compliant financing projects. There has not been much success in devising an interest free mechanism that places funds on a short term basis. Profit sharing risk is seen as too high and therefore banks have resorted to debt financing structures such as murabaha. The central bank is attempting to resolve these issues and have encouraged foreign banks to roll out more Shari’a based products.

To date, there have only been two issuances of sukuk to generate cash flow: the IBBL 3000 million Taka Mudaraba Perpetual Bond (which has no maturity) and the government’s Bangladesh Government Islamic Investment Bond, which also used mudaraba as an underlying structure. The objective of the latter was to maintain the SLR of Islamic banks, as well as providing an outlet for investment or procurement of funds. Aside from these instruments, Islamic banks are still heavily dependent on deposited funds. There is a need to develop primary and secondary markets as well as innovation and diversification of the product portfolio of banks.

Another challenge for Bangladesh Bank has been determining a suitable profit sharing mechanism for depositors and the banks with respect to mudaraba accounts. The profit sharing ratio under a mudaraba can be determined by the commonly used weightage system or the Investment Income Sharing Ratio (ISR). The differences are subtle but have caused much debate amongst adherents of Islamic finance in Bangladesh. The Central Shari’a Board for Islamic Banks of Bangladesh (CSBIB), a non-corporate body, registered in 2009, committed to the promulgation of Islamic finance in Bangladesh, have argued for the latter. The Bangladesh Bank has prescribed the weightage system as a standard for Islamic banks to follow to generate a rate of return. The central bank has granted some preferential provisions to develop Islamic Banking in Bangladesh including a lower Statutory Liquidity Reserve (SLR) as compared to conventional banks. Since 1993, the SLR for Bangladesh Banks has been fixed at 10% whereas for conventional banks it has hovered around 20% and is currently at 18.5%. Infrequent changes have been made over the years to conventional banks’ SLR, in order to increase supply of funds thereby reducing interest rate differentials. The lower percentage takes into account the prohibition for Islamic banks to invest in interest bearing instruments, thereby reducing their liquidity. However due to the global economic downtown with the parallel increase in commodity prices, Bangladesh has suffered from increased inflation rates. In May 2010, the SLR was increased to 10.5% for Islamic banks.

Central Bank Guidelines

The Bangladesh Bank Governor, Dr. Atiur Rahman, in December 2010, reemphasised the commitment of Bangladesh Bank to develop Islamic finance in the country and publically called for Islamic banks to follow the Shari’a completely. Bangladesh Bank set up a research and Islamic economics division in 1990 under the Department of Research within the bank, to conduct timely analysis of the Islamic finance industry in Bangladesh.

In 2009, Bangladesh Bank issued guidelines through a circular on the operation and management of Islamic banks which supplement existing banking laws. The guidelines were a result of discussions between Bangladesh Bank, several Islamic banks in the country and the Central Shari’a Board.

The guidelines represent the first attempt to provide an operational framework for Islamic banks. The guidelines cover a number of points including corporate and Shari’a governance, product definitions and operational frameworks, alternative investment modes, and conversion of conventional banks into Islamic banks. However, guidelines are limited by a number of shortcomings and ambiguities. This has been admitted by Bangladesh Bank, though no amendments have been made. The guideline makes formation of a Shari’a board for Islamic banks optional, though this is contrary to global industry practice. There is also stringent criteria for a Shari’a board candidate to meet. Practitioners argue that a paucity of candidates who meet these criteria would deprive the Islamic banking industry of the necessary talent to go forward. They are therefore asking Bangladesh Bank for a relaxation in the stipulations.

State of the industry

It is a common lament that the level of Islamic finance expertise in Bangladesh is not sufficient for a robust Shari’a board, but this has not hindered Bangladesh’s progress. Currently, Bangladesh has seven fully fledged Islamic banks and eleven Islamic finance windows with their own Shari’a boards. The banks are Islami Bank Bangladesh Ltd, Al-Arafah Islami Bank Ltd, ICB Islamic Bank Ltd, Export Import Bank of Bangladesh Ltd (EXIM), Social Islami Bank Ltd, Shahjalal Islami Bank Ltd and First Security Islami Bank Ltd. Exim Bank Limited and First Security Islami Bank Limited were conventional banks who fully converted into Islamic banks in 2004 and 2009 respectively. There are just shy of 300 branches offering Islamic finance products. According to Bangladesh Bank, Islamic banking systems in the country account for 25% of all private bank deposits with 30% of investments made by banks concordant to Shari’a principles. In December 2010, HSBC launched HSBC Amanah in Bangladesh which offers a full range of products in the country for both retail and commercial customers. The Amanah service is only available in 8 countries and therefore reflects the opportunities available in Bangladesh.
Since the inception of the first takaful company in Bangladesh in 2000, the takaful industry has grown. As with banking, the absence of legislation pertaining to takaful has not presented obstacles for the formation of several more takaful companies. Today, there are as many as 62 insurance companies operating in Bangladesh, of which six are fully fledged takaful operators, and 13 have windows. As of 2008, total assets for takaful institutions were 9.7 million taka, constituting 7% of total assets of the insurance sector. Total premium was 5.7 million taka in 2008, constituting 12% of total premiums of the insurance sector. In March 2010, the government enacted the Insurance Act 2010, with a provision for the creation of an Insurance Development and Regulatory Authority. It was proposed that Shari’a consultants would sit on this board, but to date, the authority has not been constituted.

Islami Bank Bangladesh: an international success

The burgeoning Islamic finance sector in Bangladesh owes a considerable amount to the activities of the first Islamic bank in Bangladesh, IBBL. Since opening in 1983, IBBL has become a conglomerate which has branched out from its traditional focus of Islamic finance. IBBL created a Foundation which has established hospitals, schools and arts institutions. In August 2010, IBBL announced an initiative to award two years term education scholarship for 200 poor students, who were achieving high grades in their class. They have also been entreated by Nigerian based Jaiz International to set up the first Nigerian Islamic bank. An agreement was signed between the two organisations in December 2009. Under the agreement, the IBBL will help develop capacity building programmes for the training and development of the workforce and design and implement appropriate procedures for all processes, transactions and products to ensure smooth operations of the proposed Nigerian bank. IBBL have already deposited USD 35 million to the Central bank of Nigeria. For their endeavours, Global Finance, the USA based financial magazine awarded IBBL best IFI in Bangladesh for the year 2010. It has previously won the award 6 times over the last decade.

What of microfinance?

Bangladesh is internationally known for being the birthplace of microfinance. It is also reputed as the NGO capital of the world, most of whom have a significant component dedicated to microfinance. Consequently, Islamic banks have entered into the microfinance space within Bangladesh, providing Shari’a-compliant products mainly based on Bai‘ Muajjal. The IBBL has offered products through its Rural Development Scheme (RDS) project and utilised its extensive network and presence in rural villages to develop a framework which encourages entrepreneurship and spiritual growth under an Islamic aegis. As a comparison with other larger and more widely known microfinance outfits such BRAC and Grameen, RDS has done remarkably well especially with a lower uptake. According to 2008 statistics, RDS has been offered by 129 IBBL branches and covers 10,000 villages across Bangladesh. The number of participants is just below a million.

Socio Islami Bank limited (SIBL), is one of the seven fully fledged Islamic banks in Bangladesh which is active in rural financing though does not concentrate on microfinance. It focuses on SMEs, agrofinance, remittance and alternative delivery channels. There is a shift of focus from high income transactions in a bid to bringing economic mobility to a high percentage of the low income earners and create adequate employment opportunities, income generation and poverty alleviation which will lead onto financing industrialisation.

To the future and beyond

There is an alterity in the approach of the Bangladesh government and the central bank to Islamic finance in the country. Their influence in driving the industry forward cannot be underestimated, but at the same time industry practitioners feel more can be done. They are certainly exasperated by the lack of legislative amendments needed to strengthen the industry. But even accounting for this backdrop, the private sector has done remarkably well in allowing a flourishing of the Islamic finance sector. They need to do more in developing human capital; a common bugbear for most IFIs and more efforts are required to educate the public about Islamic finance.

The talent is there but needs to be channelled appropriately. Unearthing charismatic and influential individuals has not been a problem for Bangladesh. Mohammed Yunus is the founder of Grameen Bank and winner of the Noble Peace Prize; Jaseem Ahmed a former director at Asian Development Bank, now succeeds industry heavyweight Professor Rifaat Abdel Karim as Secretary General of the IFSB. It was a surprise appointment due to his relative inexperience in the industry, but it is an achievement Bangladesh should be proud of. In the Islamic finance sector, they could be proud of more.
BOSNIA

Bosnia is a country situated in the Balkans, born out of the ashes of the former Yugoslavia. The country was the subject of a horrendous conflict among different ethnicities with some favouring independence and others favouring to remain with the Yugoslav federation. Tragically there was genocide committed against ethnic Bosnian (Muslims). After 10 years of relative peace, there is still tension between the different ethnicities and thus a rapid Islamisation of the financial landscape is likely to be met with strong opposition.

Islamic finance entered Bosnia in 2000 with the setting up of the Bosna Bank International (BBI), which was supported by the IDB, Abu Dhabi Islamic Bank as well as Dubai Islamic Bank. The bank faced opposition from non-Muslims before its opening, but has been well received by the Muslim population. It has managed to offer some innovative Islamic financial offerings such as a Hajj and Umrah Investment account. Besides this, the bank also offers other Shari’a-compliant financing products for home and vehicle financing amongst its service offerings.

Interest in Islamic finance in Bosnia is increasing according to insiders familiar with local sentiments. Around 40% of the population is Muslim, hence it is a location which can be lucrative for Islamic finance. Many Bosnian Muslims are studying Islamic finance abroad in places such as the International Islamic University Malaysia (IIUM) as well as Bank Negara Malaysia’s University for Islamic Finance, INCEIF. Furthermore there are also undergraduate as well as postgraduate courses offered locally in Islamic finance by the International University of Sarajevo.

The Malaysian government has a strong affiliation with Bosnian Muslims, as it is one of the few countries which assisted them during the civil war. Furthermore many Bosnians who have studied or are currently studying in Malaysia have been given scholarships. BBI’s CEO, Amer Bukvic, is an alumni of the IIUM. This strong relationship may prove vital in future as Malaysian interest could help propel the Islamic finance industry in Bosnia forward.

In 2010, a conference held in Bosnia under the auspices of the IDB, was attended by around 600 participants. The aim of the conference was to showcase Bosnia as an attractive place for investment as projects of up to USD 11 billion were showcased. The country is also trying to leverage on its strategic location to highlight the role it can play as a link between Europe and the rest of the Muslim world. Furthermore trade between Bosnia and the UAE is set to increase. However much more needs to be done in Bosnia for Islamic finance to flourish. There are certain issues which need to be hammered out so that the country appeals to GCC investors; and motivates international institutions to set up Islamic windows in the country. Some have suggested that the government should issue sovereign sukuk. Additionally more effort needs to be undertaken to educate the government and the various regulatory bodies so that necessary amendments to legislation can be made in order to facilitate further Islamic finance development.
To date, Brunei has not done much. We still have a lot more to do in terms of market capability, human capital development, international Islamic banking, international takaful. In terms of capital market, we are not yet ready’, said Ethica Consultants’ executive manager Sri Anne Masri, at an Islamic Finance News road-show in December. Her comments suggest that Brunei have an enervated Islamic finance market. This would seem to be a harsh assessment but reading between the lines, Masri was not mourning the ineffectualness of Brunei. Rather she was exposing the desire and ambition of Brunei to be an international market leader.

In the beginning

Brunei’s first official engagement with Islamic finance was in 1991 with the opening of Perbadanan Tabung Amanah Islam Brunei (TAIB), a trust fund created to assist local Muslims undertake Hajj in 1991. Two years later, the International Bank of Brunei Berhad, a commercial bank was converted into Brunei’s first full-fledged Islamic bank, renamed as Islamic Bank of Brunei Berhad (IBB). A second conventional bank was transformed into an Islamic bank in 2000, the year in which the Sultanate established the Brunei International Financial Centre.

It was in 2006, that Brunei kick-started the industry with series of legislative changes beneficial to Islamic financial banking and insurance firms. Indeed, the year saw the constitution of a national Shari’a board and the merger of the two standing Islamic banks in Brunei to create Bank Islam Brunei Darussalem (BIBD). The government launched a rolling short term sukuk al-i’jara programme to boost liquidity for banks. The Sukuk Holding Properties Inc and Sukuk (Brunei) Inc were set up by the Ministry of Finance to issue sukuk. To date, the government has issued USD 2.1 billion worth of short-term sukuk al-i’jara.

Through issuing the sukuk, the sultanate became the first sovereign nation to issue securities without previously setting up a conventional capital market. A beneficial outcome has been the curtailment of national debt. However, for further development, it is expedient for Brunei to develop an independent monetary policy. Currently, there is a reliance on Singapore to set interest rates, and though over the years this has worked well for both countries, any further developments in the capital market will require Brunei to step out on its own. The establishment of the Monetary Authority of Brunei in 2011 is a positive step in achieving independence as it will act as the central bank of Brunei, concentrating on the formulation and implementation of monetary policies, supervision of financial institutions and currency management.

Towards an Islamic finance hub

With a small population, the need for numerous and manifold financial institutions in a country is limited. But as an offshore centre, a variety of financial services and institutions is necessary for an efficient, dynamic market; and Brunei has opened the markets to a number of international financial services companies to set up in the Sultanate. For Islamic banking, this has not been the case. Previous legislation for Islamic banking was narrower in focus, restricting foreign ownership which has meant that there is currently no foreign bank offering Islamic bank services. However, legislation was changed with the passing of the Islamic Banking Order 2008, which permits financial institutions licensed as offshore companies to undertake Islamic banking. By extension, international banks can partake in Islamic financial activities in Brunei. However, while paid up capital for a local Islamic bank has to be USD 100 million, for foreign banks, the figure rises to USD 500 million, which may prevent foreign banks in applying for the license. Nevertheless, in March, the Brunei government invited Malaysian Bank Rakyat, Malaysia’s biggest Islamic cooperative bank to open a branch in Brunei. While there have been no further developments with Bank
Rakyat still considering its options, it shows the change of stance of the government.

The entry of another Islamic finance bank may have a positive impact in developing new products and services within the local markets. Islamic banks in the country do not have the incentive to foster innovative product development, because of the small population and also the need for loans from state run companies is limited. Financial institutions are known for their excess liquidity due in part to the abundant oil resources in the country but there isn’t a pressing need to convert it into debt finance. Privatisation may alter this state of affairs and the Brunei government has shown interest in enabling the private sector to play a larger role in the development of the economy.

However, currently there are only two Islamic financial intermediaries: BIBD and TAIb. BIBD is the only bank to have a universal banking license. BIBD has more than 14 branches located in all Brunei’s four districts and according to its website; BIBD has the single largest distribution of ATM networks in the country. BIBD also has two subsidiaries, namely Takaful BIBD Shd Bhd which primarily provides insurance coverage and BIBD At-Tamwil Berhad, a finance company, which provides hire purchase financing for vehicles and consumer products.

In 2009, BIBD arranged a USD 850 million international sukuk issues with IDB. BIBD was also the lead manager for GE’s USD 500 million sukuk and lead underwriter of the only private sukuk issuance in Brunei, Brunei’s LNG USD 68.7 million sukuk. BIBD’s investment banking division is growing in stature after opening their investment banking division in 2008. Since then the number of services has expanded to cover fund management, treasury, risk management and security services.

The main concern for BIBD is retail, which has outpaced conventional banking over the last few years and has a higher participation of local consumers than traditional Islamic finance hubs such as Bahrain. It is estimated that Brunei’s Islamic finance sector accounts for around one third of banking assets and more than 25 per cent of deposits while providing nearly 60 per cent of total financing. This is a reflection of the growing level of consciousness amongst Muslims in the country adhering to religious principles. According to Brunei’s ministry of finance, Islamic banking assets in 2009 were about BND 6.3 billion (USD 4.81 billion) or 40% of the total banking sector in Brunei. Unofficial figures suggest that this has grown to 45% in the last year.

The second institution, TAIB, is also the oldest IFI in Brunei. It offers a range of products and services from retail based products - such as saving accounts and home financing – to corporate financing. TAIB offers all banking products except cheque facilities. A reflection of the growth of Islamic finance in the country can be inferred from the increasing uptake of their products. TAIB reports a steady growth of more than 50 per cent per annum for its Home Financing Portfolio. There has also been a 20% increase of their short term fixed deposit product. With a low minimum deposit of USD 100, as compared to conventional banks which charge USD 1000, this is spurring on people to save thereby realising a secondary aim. Part of TAIB’s strategy is to inculcate a savings culture in a country with a high GDP per capita and they have been active in offering financial management education programs. This follows the general trend adopted by the Brunei government in encouraging prudential money management. The Brunei government issued tighter rules on credit cards in order to curb the increasing debt incurred by Bruneians.

On the institutional side, TAIB is a cornerstone investor in the Securus Fund, the world’s first Sharia-compliant data centre fund, which offers a long-stabilised cashflow and is managed out of Singapore. Data centres are purpose-built real estate facilities housing rack-mounted computer servers. Data centre demand has been driven by the rapid rise of e-commerce, social networking and file sharing. Supply of data centre space has been unable to match the growth in demand.

**Takaful**

In 2008, the Takaful Order was enacted ensuring a level playing field with conventional insurance companies. The Order required Takaful providers to be better capitalised. Official figures show that while assets at conventional insurance companies shrank between 2008 and 2009, the takaful industry grew by 5.2% from USD 144.2 million to USD 151.8 million. General takaful has been the most successful segment of takaful; while family takaful has experienced slow growth. In November 2010, Takaful Islamic Bank of Brunei and Takaful Bank Islam Brunei Darussalam announced they would be merging. The new entity will be known as Takaful Brunei Darussalam. Merging facilitates a consolidation of resources and experience. Part of the problem for the takaful industry is that the expertise in this field is limited; though takaful companies have managed to increase their profile both within and beyond. In December 2009, Insurans Islam Taib became Brunei’s first IFI to receive a rating from an international ratings agency, Fitch.

**If it says its halal, it is halal.**

The government’s long term development plan, LKN 2007-2010, explicated Brunei’s keenness in establishing itself as an Islamic finance hub. However, this is not the only avenue through which they hope to achieve long term growth. Part of Brunei’s strategy is to diversify from oil and gas, which has been been key to the success of Brunei’s economy. But an acquiescing to the gradual depletion of resources, Brunei has sort other means to vitalise its economy, namely the halal industry. By, creating products and financial services which are permitted under Sharia, the government hopes that it will encourage trade in goods and services which is emblematically halal. Brunei has already hosted five International Halal Market Conferences (IHMC); the most recent convened in June. The IHMC organisers stressed that this event is not just food related, and companies and organisations that are involved in Islamic finance, economic policy, travel and tourism, hospitality, media and networking were encouraged to participate. To add to this, in 2009, the government owned Wafirah Holdings, unveiled the global halal brand, a trademark
indicating comprehensively that a certain product is halal and has passed the vetting standings of the Shari’a. The brand is hoped to be a key diversifier for the local economy. Ghanim International Food Corporation holds the licence to manage the brand which it hopes will be taken up by companies from other Muslim countries. The company, a 50-50 joint venture between Hong Kong-based logistics firm Kerry FSDA and the Brunei government will be focusing on assisting export-ready SMEs. Ghanim is working with global manufacturers to make and then market them worldwide through Kerry Logistics supply chain, under the Brunei Halal brand. In October, the Brunei Halal range of products was successfully launched in Singapore and is now available at the Lion City’s biggest supermarket chain, NTUC FairPrice Cooperative Ltd.

Challenges remain

Brunei hopes to build by combine the Halal brand with Islamic finance to bolster its international profile. However, there are number of challenges that need to be overcome if Brunei wishes to progress in Islamic finance. A pervasive problem is that even with a high percentage of consumers of Islamic banking services, there is a still a lack of understanding about Islamic banking products, which affects the development of human resources in this field. More education is required.

Universiti Islam Sultan Sharif Ali (Unissa), earlier this year, held an International Conference on Islamic Finance, where experts collectively agreed that, “human resource development is a key factor in helping boost Brunei’s Islamic finance sector”. Unissa offers a Bachelor Degree programme on Islamic finance, to introduce Islamic finance to the workforce. The Authority for Info-communications Technology Industry of Brunei Darussalam granted USD 151,600 to Crescent Sdn bhd for its ‘Premier Global End-to-End Online Programme for Masters of Islamic Banking and Finance’, which would allow the attainment of a Masters in Islamic Banking and Finance (MIBF) through an online program. The programme is scheduled to begin next year.

Human resources and product innovation and proliferation are two crucial issues Brunei need to tackle in order to compete with traditional Islamic finance hubs. But signs are good for Brunei. However, whether they can be forging a path like their neighbour Malaysia, remains to be seen though maybe they do not need to be like Malaysia; maybe they need to be like Brunei: a small nation with a big voice.
The Islamic finance market in Canada has yet to take off. The problem for the Islamic finance market is the low Muslim population and its localisation to Toronto, but even with this in mind, there is significant potential for a thriving Islamic finance industry. Providing the interest from policy makers remains and is sustained by organised and effective lobbying from market players both domestically and internationally, there is a bright future for Islamic finance in Canada.

2010 witnessed a number of encouraging developments. In March, the Usury Free Association of North America (UFANA) hosted the inaugural conference on Islamic finance which was well attended by industry players from across the globe. Senior representatives from four of the five big Canadian and representatives from the Ontario Ministry of Finance and the Federal Ministry of Finance were in attendance, highlighting the level of interest amongst the government and the financial fraternity. With over 30 speakers, discussions on retail banking and the capital markets dominated the agenda over the course of two days.

The conference provided the platform for the unofficial launch of UM Financial’s - Canada’s premier IFI offering Islamic financing and investment solutions – iFreedom Plus MasterCard. The official launch took place on Aug 15. Charging no interest and no monthly or transaction fees, iFreedom will be the country’s first Shan’a-compliant credit card. UM Financial reported that one thousand customers had already registered for the card, and they expect to deploy 10,000 cards in their first year. Card accounts will be managed by Mint Technology, which operates other prepaid card programs.

Continuing the series of firsts, Assiniboine Credit Union (ACU) launched the country’s first of its kind Islamic mortgage based on diminishing musharaka as a pilot project for the local Muslim community in Winnipeg. The long term success of this project will depend on the response by the community over the coming year. The product has been in the works for four years since the company was approached by members of the local Muslim community led by Shaikh Hosni Azzabi, Winnipeg’s Imam. This is the first mainstream financial institution in Canada to offer an Islamic mortgage directly to its members, allowing them to have a personal relationship with the financier. The structure was approved by the Canada based Islamic Finance Advisory Board, an independent, nonprofit organization, which provides and promotes Shan’a-compliant advisory and audit to the financial services industry.

Gowling Lafleur Henderson LLP prepared a report released in March for Canada Mortgage Housing Corporation, a government provider of insurance for housing, on the potential of Islamic home mortgages in Canada. The comprehensive report, which analysed the actions undertaken by other countries in implementing Islamic finance, such as the UK, concluded that there would not be any significant legislative hurdles in accommodating Shan’a-compliant financing in Canada. This is good, especially with the fall in prices of Shan’a-compliant mortgages since the first home financing instrument was offered in 1979. However, the report was quick to point out that no conclusive empirical research had been undertaken to assess the level of demand for Shan’a-compliant mortgages and Islamic retail products in jurisdictions where it is offered, including Canada itself. Most of the optimism about strong demand seems to be coming from anecdotal evidence.

Consequently, the termination of the frontier Alt Oasis Canada Fund in April, one of only two managed Shan’a-compliant equity mutual funds in Canada, could be considered ominous. A low number of unit holders and the costs associated motivated the decision. Arguably, one cannot infer too much from this as the product was designed for high net worth individuals. In fact, on
the institutional side, there is a growing level of interest from international Islamic banks, especially from the cash-rich Gulf States, in Canada real estate. Kuwait Finance House (KFH) has established a joint venture with Killam Properties to acquire up to CDN 450 million (USD 447.5 million) of multi-family residential properties in Canada. The agreement is considered to be the first real estate investment for KFH in Canada. Following the signing of this agreement in November, the Canadian Minister of International Trade, Peter Van Loan, acknowledged that Islamic banks from Kuwait can play a key role in investing in Canada. Canada has also been strengthening trade relationships with Islamic finance centres such as Saudi Arabia and Qatar.

Some of the credit of drawing the attention of the government to Islamic finance has to be given to Toronto Financial Services Alliance, a public-private alliance dedicated to the promotion of Toronto as a financial centre. In 2008, they created the Islamic Finance Working Group (IFWG) to discuss and propose ways in which Islamic finance can enter the Canadian markets. In May a report entitled ‘Making Toronto the North American Center for Islamic Finance: Challenges and Opportunities’ was released by the IFWG. The report recommended productive ties between banks and Muslim owned businesses, clarification and amendments of the regulatory framework, strategic alliances with Islamic finance centres to advise, educate and promote Islamic finance; and increasing foreign direct investment from the Gulf. The IFWG hopes to undertake further research on the development of the Islamic retail sector, the issuance of sovereign sukuks, taxation of Shari’a-compliant products and education programs in Islamic finance.

As with most non-Muslim countries looking to accommodate Islamic finance, there has been talk in the Canadian financial sector about the issuance of sukuk with HSBC Bank Canada and UM Financial indicating that they are in the process. Values of the sukuk could reach up to CDN 2 billion but since further details have not come out, for the moment, the market remains quiet. Unfortunately, for the Islamic finance industry in major non-Muslim centres (think UK); any talk of issuing sukuk is usually followed with disappointment. It will be a shame as Canada’s economy has emerged from the recession faster than the other G-7 Nations. Low interest rates, low inflation and a stock market - which according to statistics, Canada has increased 42 per cent over the past five years - paint a healthy picture for the Canada economy.

While the Big Five1 banks have previously shown little interest in Islamic finance, there is a slow change in perspective. Representation in the UFANA conference was indicative but what has been more promising is their involvement in formulating academic courses in Islamic finance. University of Toronto’s Rotman School of Management will offer MBA students an elective in Islamic finance in 2011. Toronto’s Centennial College, a community college recognized as one of the most culturally diverse post-secondary institutions in Canada, launched an Islamic finance course in May. The online course is being offered in association with London’s Security and Investment Institute (SII), providers of the accredited Islamic Finance Qualification.

Other academic institutions such as Ryerson University’s Ted Rogers School of Management are showing interest in the growth of Islamic finance. In June, they hosted the G20 Islamic Finance Summit, in association with UFANA. A one day event, it was a series of panel discussions looking into the role of Islamic finance in the global markets. A small event with a grandiose name, it is an appropriate metaphor for the growth of Islamic finance in the world: a niche alternative with grand ambitions. In Canada, these ambitions have yet to be realised but the formative steps have been made.

1 The big five banks are: Royal Bank of Canada, Toronto-Dominion Bank, Scotiabank, Bank of Montreal and CIBC
China’s economy continues to grow at an impressive rate. The confluence of a strong internal industry along with a diversification in the international economy has given China a global influence. But China is looking for a symbiotic relationship; for institutions to invest in China. There aren’t many countries, who would deny this invitation, not least countries from the Middle East. The relationship is gathering strength following 9/11, as the Gulf States looked to the East to invest their windfall earnings and with China being an economic powerhouse, opportunities are not hard to come by.

The new silk road

According to global consultancy McKinsey in 2008, the Gulf has the potential of earning USD 4.7 trillion by investing into Asia. This not only includes China but also subcontinental Asian nations such as India. Nevertheless, through interpolation, the profits that could be earned from China alone are staggering. Already, the Middle East has shown keen interest, ploughing millions into the China through investments and capitalising on the capital markets. Reciprocally, China has invested billions into energy, technology and physical infrastructure in especially North African countries such as Libya, Mali and Sudan. In 2009, the two-way trade between China and the Arab states hit USD 107.4 billion, compared with USD 36.4 billion in 2004. China also has diplomatic ties with all 22 Arab League states.

Into this dynamic relationship, Islamic finance is making headway. In 2006, Shamil Bank partnered with a local Chinese partner, CITIC International Assets Management (“CIAM”) - the asset management arm of CITIC Group, a major state-owned Chinese conglomerate - to launch the first ever mudaraba property fund for investment in selected Chinese properties. Across the Gulf there was a strong demand from investors which included high net worth investors and financial institutions. It was expected that the returns could be as high as 18% IRR.

Unfortunately, things have not been as successful as hoped. The 9th investors report released on September 2010, revealed that the IRR has been declining. Part of the problem has been the Chinese government increasing restrictions on currency conversions resulting in extensive delays when converting into dollars thus translating into a lower IRR. Other problems have been the inefficiencies of the district government and the property bubble which is likely to burst in China. There is an expectation that property prices will fall by as much as 10 – 20%. China has responded by adopting aggressive tightening measures. The fund is therefore looking to exit by the end of 2010. After years of double digit growth, a flattening out was bound to occur, but the Chinese machine is likely to weather the storm with the steely determination and focus that facilitated its expansion. Economists predict the downturn will be minimal.

This level of stability and economic expansion provides the attraction for Shari’a-compliant funds to invest in China and capitalise on growth sectors. Prudential Fund Management (PFM), a Malaysian based company launched a Shari’a-compliant fund Prudential Dinasti Equity Fund in 2009, which leverages on the anticipated consumption growth in China. PFM has also worked with Dow Jones to create the Dow Jones Islamic Market Greater China Index which it used as a benchmark for the fund. The index will measure the performance of companies in China, Hong Kong and Taiwan that have passed screens for Shari’a-compliance.

In 2010, Hong Leong Tokio Marine Takaful launched its new China Growth Income Plan (CGIP). The five-year capital preserved investment plan uses murabaha and wa’ad to invest in key growth sectors in China, which include information technology, telecommunications and commodities. Another example is the ALIMAN A20 fund, a USD 100 million Islamic wholesale fund that will invest into the 20 largest Shari’a-compliant
China companies, listed in Shanghai or Shenzhen stock exchanges. It was the first non-ringgit Islamic wholesale fund and the first to focus on China A-shares.

Looking to Malaysia

As Malaysia look for opportunities to progress economically, they are leveraging on their experience and success in Islamic finance. Building strong commercial relationships with China will act as a channel through which Malaysia can develop. Deputy Finance Minister of Malaysia, Donald Lim Siang Chai recognised this in his speech at the 15th Malaysian Capital Summit, held in December. He encouraged IFIs in Malaysia to set up joint ventures with Chinese intermediaries, transferring expertise for investment. How China reaction will respond largely depends on how they perceive the profitability of Islamic finance. But the signs are good. These signs are not only evident by the number of funds that are investing into China, but also through the partnerships which are being formed between Malaysian and Chinese entities. The Liaoning Province Authority in China have signed a memorandum of collaboration with the Islamic Banking and Finance Institute of Malaysia (IBFM), and the Kuala Lumpur Chinese Assembly Hall (KLCAH), to provide interested organisations in Shenyang, capital of Liaoning with Shari’a advisory and consultancy services as well as training in Islamic banking and finance. It has to be noted that in Malaysia, one of the key consumer groups of Islamic finance are the Chinese. Some commentators even believe that the Chinese are bigger consumers of Islamic financial products than the Muslims.

Ningxia: the site for the first Islamic bank in China?

Being a staunchly secular society, it is difficult to calculate the number of Muslims in China. Figures vary wildly with some estimates at 60-70 million while others approximate between 20 – 100 million! Either way, this is a sizable amount with high concentration of Muslims found in the northwest provinces of Xinjiang, Gansu, and Ningxia. Ningxia is China’s only Muslim autonomous region with a 36% Muslim population. The region is hoping to develop a free trade zone with Muslim countries and has launched a plan to train more Arabic speaking professionals over the course of the decade. In September, Ningxia hosted a China-Arab economic and trade forum which was classed as a modest success by some commentators. Attendees included former Jordanian Prime Minister Nader al Dahabi.

As the proud Hui people of Ningxia seek to express their Muslim identity, Islamic finance is likely to play a greater role especially with regards to building up trade relations with Muslim countries. It is already attracting attention as the potential venue for the first Islamic bank in China. The Chinese government have launched a feasibility study into opening an Islamic bank, though details are scant and there are still deliberations as to the form the Islamic bank will take. Industry sources state that the Chinese government have drawn advice and technical assistance from a number of organisations with expertise in Islamic finance including the professional services firm, Deloitte. The whispers coming from behind closed doors are positive but still

no real development has taken place on the ground. It remains to be seen whether an Islamic bank will be formed but the interest is there.
EGYPT

At the time of writing, Egypt is under military rule. The Mubarak regime has been toppled leaving a void and a great deal of uncertainty as to who will take the reins of power. An array of candidates with divergent ideologies is seeking power. What their political and economic approach will be and how the international community will respond to the regime, is still difficult to ascertain. Hence, the future of Islamic finance in Egypt remains uncertain. But as a country commonly regarded as the birthplace of Islamic finance, aversion is unlikely.

History of Islamic finance

It has become gospel that the Mt Ghamr was one of the first IFIs in not only Egypt but the world. It is true that the practices of the bank were Shari’a-compliant but it never advertised itself as being an Islamic bank. Only after Islamic banking and finance became part of the financial nomenclature in the late 70s that Mt Ghamr became consensually regarded as the first IFI. In fact, the first self regarded Islamic financial provider was an Islamic window set up by Bank Misr. The first fully fledged Islamic bank to appear in Egypt was Faisal Islamic Bank in 1979. The appearance of these banks is owing to a special law enacted in 1977, which accorded many advantages over conventional banks. It was surprisingly supported by most Members of Parliament including leftists, who initially had reservations.

Thus, the creation of the Islamic finance industry in Egypt is partly due to the concerted efforts of the government, to create an alternative to the ‘usurious’ conventional system. This was buttressed by the widespread religious revival during this period accompanied with greater returns on deposits offered as compared to conventional banks, and a high proportion of Islamic deposits in foreign currency. Conventional banks opened more windows to capitalise on this growth which diluted the share of fully fledged Islamic finance banks but reflected market potential. This took a severe swing with the collapse of Islamic investment companies in the late 80s and early 90s. These fund management companies were created on the back of religious legitimacy as well as the offer of high returns, significantly better than those offered by competitors. Unfortunately, companies such as El Rayan and El Saad, were effectively setting up ponzi schemes that claimed to invest in Shari’a-compliant assets. Millions of Egyptians were affected by the schemes and the government had to confiscate the assets and shut down these Islamic investments companies. The move had a widespread effect on the Islamic finance industry as a whole. By dint of association, the fall of the investment companies discredited Islamic banks. Customers began to express doubts on Islamic banks and subsequently long queues of account holders looking to withdraw their money were seen outside Islamic banks. It was not only socioeconomic factors which adversely affected the Islamic financial sector. In terms of financial health, the devaluation of the Egyptian pound and the precipitous reduction of the rate of return on Islamic deposits to a level below conventional deposits further added to the woes. Islamic banks were also guilty of mismanagement, which was reflected by the high levels of bad loans. The failings of Islamic banks led Sheikh Mohammed Sayyed Tantawi, Mufti of Egypt (1986-1996) and Al Azhar (1996-2010) to issue a controversial fatwa in 1989, ruling that the type of interest charged by conventional banks was lawful. A few years later he supported his fatwa by stating that conventional banks were more Islamic than the nominal Islamic banks and they should be shut down or at least not be labelled Islamic.

Islamic finance in the 21st century

Tantawis’ statements did not find much support from Members of Parliament who recognised that Islamic finance does play a part in meeting a specific demand within the country. But the strong political will of the 70s and early 80s has been replaced by caution and
doubt. Experts argue there is tremendous potential for the Islamic finance industry to blossom but the political will is absent and consumers are still dubious about the efficacy and veracity of Islamic financial institutions after the debacle of late 80s. The government has not removed the tax obstacles which affect Islamic finance transactions. Islamic Banks are regulated by the Central Bank who has made it clear that they will regulate Islamic banks on the same terms and conditions as conventional banks. There is no secondary market for short term investors to sell Islamic products which will deter institutional investors. Furthermore, the weak infrastructure is compounded by the lack of available talent within this field.

Today, there are three Islamic banks in Egypt Al Baraka, Faisal Islamic Bank of Egypt and National Bank for Development. The government expressed desire to issue sovereign sukuk and enact enabling legislation. This is a positive step forward, arguably resulting from the success of its neighbours in the Islamic finance market. Moreover, lenders such as Abu Dhabi Islamic Bank and Bahrain’s Al Baraka Banking Group have already bought large stakes in Egyptian banks which suggests the development of the Islamic finance market in Egypt can be driven by gulf based banks that have the capital and the expertise to invest into the infrastructure of the Islamic finance market.

In terms of takaful, Saudi Egyptian Insurance House was established in 2003 and was the first takaful insurance company in Egypt. The company has been followed into the sector by eight others companies that all started operating in mid 2008, with fifty percent of the capital coming from the Gulf countries. According to figures published by the Egyptian Financial Surveillance Authority in 2009, takaful companies in Egypt currently hold a 5 percent stake of the USD 1.45 billion Egyptian insurance market. There is an expectation that the takaful industry will grow dramatically over the next few years.

However, despite Egypt’s long history in Islamic finance and its commendable developments in recent years, only 3 - 4 % of its total banking industry - valued at USD 193 billion - is involved in Islamic finance according to the consultancy McKinsey & Company in 2009. There is therefore room for growth.

That was last year

How Islamic finance will fare with the change of regime is conjectural. Islamic finance in Egypt has over the years endured fluctuations of popularity both in terms of demand as well as government support. Assuming the next regime continues the policies of the Mubarak government, it is likely progress will be slow with marginal developments spread out over a period of time. A more supportive government can build momentum in the industry utilising the support and experience of Islamic finance hubs in the region such as Saudi Arabia, UAE and Bahrain. But the bedrock for a thriving Islamic finance industry is already present in Egypt. Egypt has the 6th largest Muslim population, a legal system that affirms certain aspects of the Shari’a and home to the oldest seat of Islamic learning in the world, Al Azhar. Al Azhar operates the Saleh Kamel Center for Islamic Economic studies and has been the site for many conferences. The infrastructure is there; how the next government utilises this infrastructure to develop Islamic finance remains to be seen.
ETHIOPIA

Ethiopia has had a strong relationship with the religion of Islam from the time of the Prophet Muhammad. It is one of the oldest independent countries in Africa only suffering a brief period under the occupation of Mussolini’s Italy. Sadly the economic situation today is regrettable, as Ethiopia is one of the poorest countries in Africa and has been plagued by recurring famine and drought. It has one of the lowest GDP per capita in the world. Furthermore, the tolerance that existed between Muslims and Christians at the time of the Prophet has vanished and has been replaced by tension.

Muslims in Ethiopia make up about 33% of the population which is a sizable amount. Islamic finance has begun operating in other countries in East Africa; however there is scepticism among non-Muslims, as they are of the misconception that Islamic finance is solely for Muslims. Another misconception is that Islamic finance promotes terrorism. Thus much needs to be done to educate the local population within Ethiopia and other countries in the region as to the true nature of Islamic finance.

Due to a strong demand from local Muslims, the National Bank of Ethiopia (NBE) late last year approved a directive which will make it easier for banks in Ethiopia to have windows which will offer interest-free banking services based on profit sharing schemes as well as Sharia-compliant financing. The establishment of Islamic finance in Ethiopia may greatly benefit the economy as more Muslims may be encouraged to use the banking system rather than informal channels. Furthermore, it will attract much needed investment from the other parts of the Muslim world. However, according to the prime minister, for the time being, foreign banks will not be allowed to be involved, and the shareholders will have to be from Ethiopia.

The first bank planning on setting up an Islamic bank is Zemzem Bank, which this year has sold shares worth 100 million birr. This surpassed the capital level required by the NBE by 25 Million birr. Zemzem was established in 2008 but had to wait to float shares until the RBE approved the directive on Islamic banking, which it took two years to do. Zemzem Bank is now gearing up to have its first general assembly, and it is expected that other banks will begin to offer Islamic financial services in the near future. Additionally as was mentioned earlier, Ethiopia is looking for increased investment from Muslim countries and has been actively engaged with the IDB, having a meeting with them in early 2010.

The response of the Ethiopian public to the share offering together with the warming of the government, are positive signs that the future of Islamic finance in Ethiopia is bright. Islamic finance may help recreate the atmosphere of tolerance among the different faiths, as it was at the time of the Prophet Muhammad (peace be upon him).
France

There has been an uneasy relationship between France and Islam, a country which has the largest population of Muslims in Europe. The furore over banning the niqab in public institutions has led to the question as to whether secularism can coexist with religious orthopraxy. The far right have exclaimed that permission to wear such a conspicuous religious symbol could lead to an islami-sation of the country. It may be an extreme point of view but it is nevertheless a point of view that resonates amongst the general populace.

However, this level of trepidation does not seem to have affected the growing interest France has in Islamic finance. Undoubtedly, there are elements of the French parliament and society who reel in horror at the prospect of Islamic finance creeping into the country, but this is to be expected. But generally, a more salutary stance is taken towards this aspect of Islam, possibly because for the French, the niqab and Islamic finance two represent divergent perspectives. The niqab infers exclusion, Islamic finance suggests inclusion; the niqab is archaic, Islamic finance is modern; the niqab brings conflict, Islamic finance brings prosperity.

Du Finance Islamique

France’s introduction to Islamic finance did not occur in the corridors of the French Parliament. French banks such as Societe Generale, Credite Agricole and BNP Paribas have long been active in the Islamic finance space and have bases in Muslim countries, such as Saudi Arabia and Bahrain. But now France are turning inwards, recognising that the potential size of the market for Islamic finance in France is large. The potential customer base however is far greater and it includes old French colonies such as Algeria, Morocco, Tunisia, Lebanon, Senegal and Mali countries France still has strong trade links with.

In order to promote France as a market for Islamic finance, Minister of Economic Affairs, Christine Lagarde has been a leading figure. Her endeavours in creating working groups and pushing for legislative changes have been influential in advancing Islamic finance in France. Her efforts are coterminous with those of non governmental entities. Organisations such as the Invest in France Agency (IFA) have been proactive in building partnerships with countries and institutions that work in Islamic finance. In addition, non profit promotion bodies have been created such as the France Institute of Islamic Finance which is chaired by Mr. Hervé de Charette, former Minister of Foreign Affairs and Chairman of the Franco-Arab Chamber of Commerce. Their stated objective is to ‘promote and help the development of Islamic finance in France and in the world’ through lobbying, research and training.

Paris Europlace is another organisation whose remit is to promote Paris as a financial centre. It has since 2007 been a keen advocate of developing an Islamic finance market in Paris by establishing an Islamic Finance Commission. Paris Europlace reached an agreement in January 2009 with AAOIFI to promote the AAOIFI’s Shari’a standards in France so as to encourage initiatives in asset management and the development of new bank and insurance activities. In December 2010, Paris Europlace convened a conference with Dubai’s DIFC to discuss how France can partner with the GCC banking industry and become a key player in Islamic finance.

But France is not only looking to the Middle East for assistance. In October 2010, Banque de France and Bank Negara Malaysia signed a Memorandum of Understanding (MoU), to promote the advancement of the Islamic finance industry. The MoU states that the two banks will enhance their cross-border financial activities, including promoting and supporting Islamic finance transactions. The MoU called for mutual cooperation on human capital development, and development of the financial market infrastructure.
The government have shown enthusiasm in developing the market recognising the growth of Islamic finance in the last few years, especially in the Middle East. Also, the global recession stimulated a reassessment of values and methods of doing business. The quest for ethical practices in the financial market led Lagarde to declare that Islamic finance is inhaled with those ethical principles. Thus it is not altogether a coincidence that the French interest in Islamic finance arose only in the last few years.

What do the Muslims think?

Salim Saifi, an investment advisor with IFA Middle East stated in June 2010 that France’s Islamic finance sector registered a growth rate of 29 percent in 2009, compared to 6.8 percent for conventional banking. This has mostly been, unsurprisingly, in the real estate sector. In the three years to 2009, Islamic real estate transactions worth approximately 3 billion euros have taken place. But these have been high end transactions. For the average Muslim, France does not offer any Islamic financial services to cater to their religious requirement. A survey carried out by the French Institute of Public Opinion (IFOP) suggested that 55% of the Muslims would be willing to borrow even if they have to pay more for it. Unfortunately, there isn’t the political nor the commercial will to offer retail services. At least for the time being, any developments will be occurring in the commercial markets.

Amending the law

The government, on the other hand, have been quite enthusiastic about the prospects of Islamic finance in France. The interest began in earnest from 2007. A Senate information report looked at how Islamic finance can be fostered through overcoming fiscal and legal obstacles and included five references to the need to encourage the emergence of Islamic finance in France. In July 2007, the French financial regulator, l’Autorité des Marchés Financiers (“AMF”) laid down terms and conditions for setting up a fresh investment funds in line with the Shari’a, and noted in particular the importance of UCITS in developing Islamic funds.

It further clarified that the AMF treats Shari’a funds in the same manner as it treats other investment funds such as socially responsible funds, which use different criteria to build their portfolios. However, they emphasised that in the screening process for the funds, management has to be independent, with exclusive power over the final decision, though they can take advice and utilise Shari’a guidelines. A second point related to the purification of income that Shari’a funds have to undertake from time to time, which could negatively affect an investor’s income. AMF stipulated that while this is permitted, references should be made in the prospectus about purification and the charities to which the monies will be donated.

The AMF statements were the first regulatory guidance issued, which expressly referred to Islamic finance. It represented a start in aligning Islamic finance tenets with the precepts of French law. The statement, however, was not the first example in which regulators mulled over Islamic finance. Loi no 2007-211 of 19 February 2007 brought the common law concept of Trusts into French legislation whose secondary effect was to lay the groundwork for the issuance of a French sukuk.

It is on sukuk and amending tax laws to accommodate Islamic finance that France has focused. The Sénat, the upper house of the French legislature, held a series of roundtable discussions on Islamic finance with key international players in May 2008. They looked at Islamic funds and amendments to tax laws that would have to be made in order to not unfairly penalise Islamic financial instruments. A government report published in 2008, estimated that France could tap into 120 billion euros in capital from Islamic finance, by making adjustments to its tax and banking law.

On 2 July 2008, the AMF clarified, through a statement published in French, English and Arabic, the criteria required to be followed for sukuk to be admitted into the French market. Primarily, the focus was on prospectuses which were required to adhere to EU regulations, in particular the Commission Regulation (EU) no. 809/2004 of 29 April 2004 implementing Directive 2003/71/EC (the Prospectus Regulation). After delineating the two categories of sukuk, namely asset backed sukuk and asset based sukuk, the statement goes on to elucidate that since the Regulation does not provide for any specific annexes that deal with sukuk, the prospectus will be required to be prepared according to the annexes which list comparable products. By way of example, Prospectuses for Asset backed securities will be prepared ‘on the basis of the annex XIII with regards to the terms and conditions of the issue (in so much as the nominal amount of the bond is equal or greater than 50,000 euros), and the annexes related to “Asset Backed Securities”, with regards to the issuer and the assets (annexes VII and VIII of the European Regulation21). The AMF clarified further the drafting of prospectuses for sukuk in October 2010, with emphasis on the need for prospectuses to include the Shari’a parameters and the Shari’a board overseeing the product.

A point of interest is that the AMF in the July statement classified sukuk as bonds which is contrary to AAOIFIs opinion that sukuk are “certificates representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects”. A subtle though controversial point, it is unlikely to raise too many brows as the AMF emphasised that it is not within their remit to regulate sukuk according to the Shari’a. However, the 2010 statement makes no mention to Islamic bonds, possibly as a deliberate attempt to appease potential issuers and investors. AAOIFI were certainly impressed by France’s work in providing the infrastructure for the issuance and listing of sukuk approving the tax and regulatory changes made to issue sukuk.

Give me a tax break

Contrarily, for tax benefits, sukuk need to be structured as a debt instrument according to binding instructions issued by the Ministry of Economy and Finance in February 2009. Then, subject to compliance with
France’s capitalisation rules, remuneration paid to the investors will be deductible from the taxable income of the borrower, and there will be no withholding tax if the investor is a foreign national. The instructions considered the fiduciary transfer of property between SPVs, and determined that VAT is exempt provided the fiduciary continues to use the property for an activity subject to VAT.

The investor should have no voting rights and in the event of default, investors will be given priority for repayment. There is no capital guarantee though investors could be reimbursed the full nominal value, but no higher, depending on the value of the underlying asset.

The instructions also clarified the approach to be undertaken for murabaha. As noted above, most of the Islamic finance transactions in France were in real estate. Parties relied on the Marchand de Biens statutory regime in which a company could buy property or acquire shares in real estate in order to resell them. The financier would be liable for reduced stamp duty on purchase from the seller. They would also be liable for VAT on the portion of profit directly related to intermediary services.

By using this regime, transactions could be structured using the murabaha model. However, there were several incongruent aspects to the regime including the possibility of speculation through the two operations of purchase and sale. It was also unclear how tax authorities would treat the murabaha profit, the portion which related to the opportunity cost of the deferred payment to the financier. The instructions determined that the profit would be considered interest and would be taxed on an accrual basis for the duration of the murabaha. The fees for the intermediary services would therefore have to be calculated on a lump sum basis. If the financier is a foreign entity, there would be no withholding tax.

The instructions also considered commodity murabaha, stating that VAT is exempt if there is no physical delivery of commodities within France. This was in line with French tax law.

Exciting times in Paris

The February 2009 instructions were updated in July 2010. At the same time, new tax instructions were issued on ijara and istisna transactions. The gradual progress made by France in Islamic finance has drawn approval and attracted leading Islamic banks. AAOIFI have praised France for their efforts to create the infrastructure necessary for the issuance of a sukuk.

In 2005, permission was sought for the creation of a Sharia compliant bank, Tayyir, by Syrian born Investor Fahmy Saddy. Banque De France signed a MoU; however a clause in contract called for a French majority shareholding. This proved to be difficult as many of the clients approached were apprehensive of being involved in Islamic banking activity for political reasons. In 2009, Banque de France agreed to waive its restrictions and accept a reputable foreign bank. Bahrain’s Al Baraka has said they are interested in opening five branches in France, while Qatar Islamic Bank signed a MoU with Banque Populaire Caisse D’epargne, emphasising cooperation and provides access to the French retail and SME market. The intricacies and details of the cooperation are still being hammered out but show the interest global Islamic banks have with developments in France.

In November 2008, AIDIMM (Association for Innovation and Economic Development and Real Estate) and IFAAS (Islamic Finance Advisory and Auditing Services) joined together to create of the ACERFI (Audit, Compliance & Research in Islamic Finance). This was regarded as the first Shari’a board in France and consists of a number of Islamic scholars. ACERFI will concentrate on research and ensuring Shari’a-compliance of products.

Additionally, a number of universities have started to offer Islamic finance masters. Paris Dauphine and the University of Strasbourg offer Masters’ degrees, while business schools such as ESC Reims offer modules in Islamic finance.

The return of the unhappy right

The tax instructions are positive developments for Islamic finance in France but it has to be noted that they did not change the law, just clarified the fiscal application. Changing the law would be a tiresome undertaking not least because of the rigidities of the French civil law system. The looming shadow of laicite – the separation of state and religion- is a constant headache for exponents of Islamic finance in France. It is a gargantuan hurdle; to some extent explaining why the issuance of a sukuk has been delayed in France and why the government are dragging their heels in pushing Islamic finance forward. They can hardly be blamed for stuttering. On June 9th 2009, the French Senat passed a bill for the easy access of credit to SMEs. An amendment was made which effectively facilitated the issuance of sukuk. This was met with dismay amongst the right but the uproar was not large enough to derail the changes. Consequently, the French Socialist opposition challenged the legality of the new legislation on Islamic finance before the Constitutional Council. The Council ruled that the provision should not have been lumped into a broader bill on financing for medium and small businesses as it was a separate issue. Their justification was that the provision was challenged not on technical points but rather over the procedure followed in parliament. The socialists were simply content that it had been quashed.

And therein lays the problem for France and Islamic finance. The public space is a sacred, secular arena; the imposition of religious symbols whether it is in the form of veil or a bank which brazenly calls itself ‘Islamique’ is an anachronism. Balancing the sensitivities surrounding laicite and attracting investment, the ‘Islamic’ way, is imbued with difficulty. Nevertheless, the push to issue a sukuk continues with Thierry Dissaux, chief executive officer of the French Deposit Guarantee Fund, saying that a sukuk will be issued in 2011. The framework is there, the political will is in place, but then again, we cannot be too sure.
In the Muslim world, Gambia may not be typically associated with Islamic finance. Yet this West African nation which overlooks the Atlantic Ocean has made remarkable progress in the field, though largely under the radar.

There are currently fourteen banks within the local industry of which one is an Islamic Bank. The sole Islamic bank in the nation, Arab Gambian Islamic Bank Ltd (AGiB), was granted licence to begin operations by the central bank of Gambia in 1997, through the amended Financial Institutions Act of 1992. Although Finbank of Nigeria acquired 70% of AGiB in 2008, it has continued to be run on Shari'a principles.

Islamic finance has also made inroads in the Gambian Insurance sector. Takaful Insurance Company Gambia was established in 2007 and is now one of the 11 insurance companies which make up the sector. In 2010, the company disbursed 2 million dalasis to their customers, in addition to the setting up of a scholarship fund for needy students.

The Gambian government has been proactive in promoting Islamic finance, and has provided changes in regulation to facilitate the expansion of takaful. Local municipalities have even begun offering their workers takaful coverage through the Takaful Insurance Company Gambia. Furthermore the Gambian government has used salam sukuk as part of their liquidity management programs.

Due to the high population of Muslims within the country as well as the need to attract foreign investment, the government has been actively engaging the Middle East. In 2010, Gambia and the IDB signed four agreements to finance development projects in the country worth a value of USD 46 million. Part of the financing will go towards further developing the University of Gambia, and this may pave the way for possible courses in Islamic finance in future. The agreements signed in 2010 brought the total financing of the IDB in Gambia to USD 310 million, in various sectors of the economy.

The signs from the top level are positive and coupled with the rising demand from the local population, one can expect Islamic finance to continue to expand in Gambia.
Following the issuance of the first European sukuk by the Germany Federal State of Saxony-Anhalt in 2004, there was a lack of political will for an Islamic finance market within Germany. This is surprising as Germany has the second largest Muslim population in the EU of 4.3 million, the majority being Turkish. Moreover, German multinational financial institutions such as Deutsche Bank, Commerzbank, insurance giant Allianz, and others, have been active in the structuring and distribution of Islamic financial productions in the Middle East and Asia. The home market has not been as dynamic but with historical ties to Turkey, this may change.

**German multinationals**

German banks have a good reputation for product development in Islamic finance. Deutsche Bank introduced two sukuk, for Bahrain and for the Islamic Development Bank, into the market in 2009 and has become one of the major players in the Islamic banking business. In 2006, Deutsche Bank developed the DWS Noor Islamic Funds, through its mutual fund arm DWS investments. There are several funds under the DWS Noor Islamic Fund brand, structure to capitalise on opportunities in growth markets such as China and Japan. Dubai Islamic Bank is one of the distribution partners for the fund.

Structuring mutual funds has been one of the main products structured by German banks. They have been useful to tap into the home markets. Commerzbank structured the Al-Sukoor European Equity Fund on behalf of Al-Tawfeek Company for Investments, largely aimed at Turkish expatriates in Germany and the Benelux countries, and later marketed to Turkish retail investors in Turkey as well. But the Fund closed after four years.

Recently, Cologne-based Meridio AG launched the Meridio Global Islamic Multi Asset Fund, a Luxembourg-domiciled mutual fund, which the promoters claim is the “first approved, actively managed, international, ethically compliant, balanced mutual fund under European investment laws” and is aimed initially at retail and institutional investors in Germany and the Euro zone but hopes to be branched out to the East. The investment pool comprises Shari’a-compliant equities and sukuk. It is a dual currency (us dollar and euro) open-ended multi-asset mutual fund.

**The Turkish connection**

While the most of the activity in Islamic finance is occurring outside of Germany, this is not to say that there aren’t attempts to raise awareness at home. Particularly prominent has been Institute for Islamic Banking and Finance (IFIBAF). As a promotion body, it has been active in raising awareness about Islamic finance throughout Germany. IFIBAF also provides consultancy and Shari’a advisory services to institutions seeking to provide Islamic finance products and services. The Central Council of Muslims, ZMD, a Muslim representative body commenced an initiative for establishing a program to certify the Shari’a-compliance of a product. However, ZMD is not recognized by all Muslims in Germany as their authorized representative. The Muslim community in Germany is not a homogenous group and therefore it is difficult to create a lobby to encourage Islamic finance in Germany.

The Turkish community however makes a sizable proportion of the German Muslim population; and there have been concerted efforts to offer tailor made financial products for the community. Deutsche Bank has set up a product line, Bankamiz, specifically targeting ethnic Turks that have been quite successful. However, Bankamiz products are not Shari’a compliant; but do reflect the potential of targeting ethnic groups. Indeed, the strong Turkish contingent has attracted Kuveyt Turk to set up a branch in Germany. The Federal Financial
Services Authority (BaFin), has issued a limited banking license to Kuveyt Turk Participation Bank. However, it is only permitted to collect funds that are transferred to accounts in Turkey that conform to Islamic rules. It is expected to start operations in the first quarter of 2011.

The role of BaFin

In 2009, BaFin organised a conference on Islamic finance in Frankfurt. The event was attended by 160 delegates from home and abroad and discussions centred on structuring Shari’a-compliant products and the prospects of Islamic finance in Germany. BaFin wishes to lay the legal and regulatory framework for Islamic finance, concluding that the German legislative framework can accommodate Shari’a-compliant products. However, since then there has been no real effort to facilitate Islamic finance in Germany.
It would seem the enthusiasm for Islamic finance is petering out for the island state. Optimism was high two years ago for Hong Kong to be an Islamic finance hub outside of the Middle East and Malaysia, but things have not materialised that way. The 2010 budget speech was the first time that Islamic finance was not mentioned since 2007, and there have been few meaningful changes in tax law to facilitate Shari’a-compliant products. Even the prospect of issuing a sovereign sukuk has taken a blow when the Airport Authority announced that it would not be issuing a sukuk to raise money for a third runway even though they are still interested in building a runway. Thus, the question is how committed are Hong Kong to the development of Islamic finance in the country?

The Hong Kong Monetary Authority speaks

Very committed is the answer given by Hong Kong Monetary Authority Executive Director, Edmond Lau. The proof is in the pudding and Lau can point to a number of examples which show that Hong Kong is committed to Islamic finance. Hong Leong bank opened the first dedicated Islamic window which offers Shari’a-compliant wholesale and investment banking solutions. In 2009, CIMB Bank, another Malaysian bank launched its first Shari’a-compliant product in Hong Kong: a commodity murabaha with Hong Leong bank approved by the Hong Kong Monetary Authority. CIMB bank became the second bank in Hong Kong to have an Islamic finance window.

To build this embryonic industry, focus has been on education. The Treasury Markets Association (TMA) has provided education programmes and organised a series of workshops and seminars on Islamic finance. In September 2009, HKMA signed a MoU with Bank Negara to assist in the developing Islamic finance industry in Hong Kong through capacity building, facilitating cross-border transaction and human resource development.

Later that year Malaysia Securities Commission (SC) and the Hong Kong Securities and Futures Commission (HKSFC) signed an MoU, allowing for the fast-tracking of local Islamic finance products into the Hong Kong market and vice versa. The MoU also states that the two institutions will share information and experience about the development of a legal and regulatory framework in relation to Islamic collective investments schemes. Hong Kong is also seeking the cooperation and expertise of Brunei to work together in putting Islamic finance on par with conventional finance. With these developments and recognising the long term importance of Islamic finance in the country, Hong Kong University of Science and Technology’s Business School introduced an Islamic finance elective as part of its MBA programme in April 2010.

Acting as the conduit

As with most countries that have an interest in Islamic finance, the lure of tapping into Middle Eastern wealth has encouraged interest. Edmond Lau’s opening speech at the Islamic Finance News road show in May highlighted the large pool of oil money which Gulf States are looking to invest and hope is for Hong Kong to have the right funds and products on offer to meet the Gulf investment needs. National banks such as Hang Seng Bank have created Islamic funds. Furthermore, there is a growing interest by Gulf States to invest in mainland China using Hong Kong as a platform.

Hong Kong has been a key fund raising centre for China. By the end of 2009, the stock market in Hong Kong was the 7th largest in the world with half of the stocks populated by Chinese companies in a range of industries. The two most prominent Islamic indexes, Dow Jones Islamic Titan Index and Hong Kong Islamic index have half of its constituent companies based in mainland China. According to recent market figures the Hong Kong Islamic index has outperformed the Seng
Index by 2% in the last two year and has outperformed the Seng Index by 17%, since its inception in late 2006.

In summary, we can see a number of developments in the market. Most of the activity is occurring in the private sector, especially with multinational behemoth HSBC playing an active role in Islamic finance. The conveyed quiescence may have more to do with the ravages of the credit crisis than to diminishing of intent. It is true sukuk had been a major focus for Hong Kong, and with the Airport Authority’s announcement, intentions were questioned. But, the current discussions about amending the tax law as well as having three exchangeable sukuk on the stock exchange, indicates that the issue is far from being put to rest. Government affirmation of this is reflected through collaborations and discussions on amending aspects of the tax laws which may adversely affect the issuance of a sukuk and make it less competitive with conventional bonds. The focus is on four types of sukuk: ijara, musharaka mudaraba and murabaha; and it is hoped that legislation is passed in the next two years. The industry waits in anticipation.
2010 was a remarkable year for Islamic finance in India. There were at least half a dozen important developments but the two most conspicuous were the launch of the BSE TASIS Shari’a 50 Index and the court wrangling over the formation of an Islamic finance company promoted by the Kerala State Industrial Development Corporation (KSIDC) of the state of Kerala.

**BSE TASIS Shari’a Index**

Coverage for the launch of the BSE TASIS Shari’a Index has been prodigious. A lot has already been said and written about the Index. However what is worth highlighting is the methodology and performance of this index which in many ways is unique. In terms of methodology, the TASIS index has taken a strict line with Shari’a screening: less compromise with Shari’a means higher level of Shari’a-compliance.

Moving onto its performance, in the past few years the Indian economy has done very well, even during the recent global financial crisis. Consequently, a large number of Foreign Institutional Investors (FII) during, as well as after, the crisis invested in the Indian market. This has taken the performance of Indian Indexes to higher levels. When looking at the performance of the Indian stock market from this perspective, it is highly satisfying that the Shari’a Index has outperformed India’s bellwether Index (i.e. Sensex) by over 25%. Similarly the BSE TASIS Shari’a 50 Index has beaten the S&P India Shari’a Index by more than a 30% margin over the last two years.

The third notable feature of this index is the 8% cap assigned to its constituents. This is India’s first cap weighted Index which should reduce volatility in the index, i.e. fall less when the market drops and rise gradually when the market appreciates. As Exhibit 1 demonstrates, it has been consistently outperforming the market. Perhaps this is an indication of the inherent relative strength of the shares which constitute its universe.

**Kerala State Industrial Development Corporation (KSIDC) allowed to start Islamic finance operations through Al Barakah Financial Services Ltd**

The second noteworthy occurrence involves developments in the state of Kerala. This news also generated domestic and international interest. However, some of the reports which appeared on this subject were out of context and sensationalized. Before exploring the significance, it is necessary to clarify the sequence of events:

1) KSIDC took an interest in starting an organisation that will comply with Shari’a rules and regulations.

2) One of the Big Four accounting firms was commissioned to advise on the appropriate structure and business model for the proposed organization, keeping in view Indian regulations as well as Shari’a requirements.

3) A feasibility study report recommended utilizing a Non-Banking Finance Company (NBFC) model, regulated by the Reserve Bank of India (RBI). This was finalized keeping in view the presence of Islamic NBFCs in the country.

4) Al-Barakah Financial Services Ltd was incorporated on November 30, 2009 under the Indian Companies Act with the following objectives:

- To carry out the business of leasing and hire purchase of vehicles, home appliances, plant and machinery, aircrafts, ships, industrial and other equipments, properties and other assets; investment in assets, properties, shares and other securities; and to act as financiers, portfolio
managers, finance brokers and guarantors subject to rules and regulations issued by the Reserve Bank of India or such other government authorities from time to time. However, the Company shall not embark on or undertake any interest based financing.

5) It was also agreed that the state government would retain an 11% stake in the company and the remaining stake would be offered to businessmen drawn from various communities.

Once it became public, a Public Interest litigation petition was filed in the court comprising the following contentions;

I. The forming of an Islamic Financing Company by KSIDC “is a clear instance of the State favouring a particular religion”.

II. Formation of a Shari’a board composed of Muslim scholars “shows the identification of KSIDC with Islam, to the exclusion of all other faiths”

III. The prohibitions of interest, alcohol, eating of pig, etc. are against the constitution.

On January 5, 2010 a Division Bench of the High Court of Kerala, taking suo motu cognizance of the matter, ordered stay on the company’s operations. The stay order was modified by an order dated April 8, 2010 which removed the stay on the company’s operation, but the State was still prohibited from participating in the business of the company in any manner. The Court also requested submissions from a number of parties including the Union of India through the Ministry of Finance and the Reserve Bank of India (RBI)

After hearing the arguments of all the parties involved the High Court of Kerala dismissed all the petitions filed against the company in February 2011.

Some interesting aspects of the case

1) The Reserve Bank of India in its affidavit to the court submitted that with the current statutory and regulatory framework it is not legally feasible for banks in India to undertake Islamic Banking activities and the same holds true for Islamic NBFCs as well.

The High Court dismissed this assertion of the Reserve Bank. The Court in its order said that interpretation of the law is subject of the judiciary not the executive.

2) On the question whether an Islamic NBFC can function in India, the Court left the matter to the Reserve Bank of India on the pretext that the Court did not want to preempt the RBI from examining the matter. Many reports appeared in the media mistakenly reporting that the High Court had allowed Islamic banking in the country.

Other developments

1) The National Spot Exchange of India Ltd has received a Shari’a-compliance Certificate from TASIS for its platform for the electronic trading of gold, silver and copper on a spot basis. Considering the preference of a vast majority of Indian investors for investments in gold and silver, it is expected that the Shari’a-compliant trading of these commodities will further deepen the market in India.

2) Alpha Star Shipping LLC which has operations in...
Dubai and other countries has started a short-term musharaka investment scheme. This is the first of its kind for an Indian company and will provide working capital to the company as well as provide Shari'a-compliant returns to a large number of investors.

3) The General Insurance Corporation of India has successfully completed its first year of its retakaful operation. The company has started retakaful operations in Malaysia and the UAE.

4) The Taurus Ethical Fund (TEF), India’s first Shari’a-compliant mutual fund has outperformed India’s best indices once again. On the 31st January 2011, the TEF gave an absolute return of 15.07% in one year, as compared to the return of 7.71% by the Benchmark Index (S&P CNX 500 Shari’a) and is ranked 20th out of 64 funds in the Open-end Equity Mid and Small cap category (Value Research) in a 1-year time frame. The fund also outperformed the Benchmark Index since its inception and has given a CAGR of 56.95%. During the FY 09-10, TEF declared 3 dividends amounting in aggregate to Rs. 4.50 per unit. During the FY 10-11 it declared a dividend of Rs. 1.80 per unit on 10th Dec’10. Details of the dividends are as follows:-

<table>
<thead>
<tr>
<th>Dates</th>
<th>Dividend Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>10th Dec’10</td>
<td>(18%) Rs. 1.8 per unit</td>
</tr>
<tr>
<td>19th Feb’10</td>
<td>(20%) Rs. 2.0 per unit</td>
</tr>
<tr>
<td>18th Sept’09</td>
<td>(10%) Rs. 1.0 per unit</td>
</tr>
<tr>
<td>31st Jul’09</td>
<td>(15%) Rs. 1.5 per unit</td>
</tr>
</tbody>
</table>

This can be graphically represented in Exhibit 2.

5) The Pure Stock Pension Fund (PSPN), is India’s first Shari’a-compliant scheme regulated by the IRDA (Insurance Regulatory and Development Authority). This is the only scheme in India which is regularly audited by a Shari’a board. This scheme has performed very well. Its performance can be seen in Exhibit 3.

In conclusion, it is clearly apparent that Islamic finance has had an eventful year in India. With one of the largest population of Muslims in the world, India’s government can no longer choose to ignore the industry. It is expected that this year, more hurdles will be crossed, facilitating the way for India to reach its potential to be a regional powerhouse in Islamic finance.

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Exhibit 2: Dividend performance

Exhibit 3: Comparative study of returns
INDONESIA

Indonesia is the biggest economy in South East Asia, with the fourth highest population in the world. It is part of the G-20 countries. Indonesia has abundant natural resources and sustained GDP growth since 1998. Foreign investment is increasing. Indonesia is an archipelago of over 18,110 islands, of which 6,000 are inhabited. A tourist destination favoured by holidaymakers, Indonesia has the largest Muslim population in the world. But it cannot lay claim to being a leader in Islamic finance. This may change over the coming years depending on government and central bank commitment, which in the last few years has been present, though some say underwhelming.

Let’s start at the beginning

It is thought that Indonesia’s transformation into a Muslim polity was due to the integration of Muslim traders coming from Yemen. Anecdotal evidence suggests that the populace were impressed with the high standards exhibited by the merchants, scrupulous in transactions and ethical in nature. Whether apocryphal or not, the message should have moral ramifications for an industry which in 2011, will celebrate its 19th anniversary in Indonesia. In 1992, pursuant to the Banking Act no. 7, Bank Muamalat Indonesia commenced operations; the country’s first Shari’a-compliant bank. In 1993, an arbitration forum was set up to tackle Islamic finance disputes, the Badan Arbitrase Muamalat Indonesia (BAUMI), initiated by the Indonesian Council of Ulama. The Council were pivotal to the creation of an Islamic finance industry after organising a conference on riba in 1990.

A number of legislative changes followed strengthening the legal framework, the most crucial being Act no. 10 of 1998 which strengthened the legal foundation for Islamic banks to set up. The legislative framework was strengthened the following year with Act No.23. Indonesia’s central bank, Bank Indonesia, was permitted to utilise Shari’a-compliant instruments as part of its monetary policy. Prior to these changes, there had been only one commercial bank and a number of Shari’a rural banks. A distinctive feature of the Indonesian financial system has been the proliferation of rural credit banks to serve, as the name would suggest, the rural sector. These are small outfits, broadly conducting microfinance transactions. Since the liberalisation reforms of 1988, these institutions have been increasing. Many of these banks offer Shari’a-compliant products to their customers. In addition, Islamic savings and loans cooperatives (Baitul Mal wa Tamwil) are also quite common.

After 1999, the Islamic finance infrastructure in Indonesia started to take shape. The Indonesian Council of Ulama set up the National Shari’a board, an independent body authorised to issue rulings on Shari’a products. The year 2000 witnessed the formation of the Jakarta Islamic index. Bank Indonesia created the Islamic banking bureau in 2001 to regulate, supervise and license Islamic banks. In 2002, Bank Indonesia released ‘The Blueprint for Islamic Banking Development in Indonesia’, a strategic plan segmented into three periods and detailing clear priorities to create in Indonesia, “A sound Shari’a banking system that is competitive, efficient and compliant with prudential practices, and capable of supporting real economic sector through the implementation of share based financing and trades with real underlying transactions in the spirit of brotherhood and good deeds to promote well-being for all society” 2011 will mark the end of the third period according to the Blueprint. At the end of the year, Indonesia can truly assess how successful it has been. However, from 2002 to 2008, the industry remained sluggish. Positive developments included the issuance of corporate sukuk, but the regulation created lags and innovation was stymied; critics argue due to the civil law system. 2008 proved to be a groundbreaking year. First there
Current state of the industry

In 2007, Indonesia had three commercial Islamic banks; three years on, there are 11 commercial Islamic banks. According to Bank Indonesia, as of 2010 there are 28 Islamic windows operating in the country as well as 143 Islamic rural credit banks. There are three full fledged takaful firms, three retakaful firms and 36 Shari’a units of conventional insurance companies. Bank Indonesia has a Directorate of Islamic Banking, which is comprised of a number of departments involved in research, supervisory and licensing. Asset growth of Islamic banking has been more than double that of the country’s conventional banking industry. According to the Directorate, Indonesia’s Islamic banks’ assets grew 47 percent in 2010, reaching 100.26 trillion rupiah. The Islamic finance industry however still makes a small percentage of the total banking industry in Indonesia – 3 to 4 percent of total banking assets. But it has made credible progress over the last three years and is hoping to grow further. In the takaful sector, annual premium growth has exceeded 40% over the last five years. Once again, the sector itself constitutes only a small share of the overall insurance market. Notwithstanding the tiny market share, multinational insurance companies such as Prudential, Allianz and AXA have entered the Indonesian markets.

Bank Indonesia’s ‘Grand Strategy of Islamic Banking Development’ released in 2008 is a bold vision, hoping that Indonesia will become a holistic and preeminent Islamic banking sector, a leader in the ASEAN (Association of South East Asian Nations). Since 2000, Bank Indonesia has issued over 25 regulations on Islamic banking from tax amendments to licensing requirements. Bank Indonesia is currently finalising its five year plan (2011- 2015) for local Islamic banks to boost the development of the Islamic banking industry. The plan will focus on seven main aspects – human resources development, arrangement and supervision, supporting infrastructure improvements, strategic alliances, customer empowerment and product innovations.

But a constant criticism of the government has been their failure to quicken changes in legislation, especially with respect to tax. Only in the last two years has legislation been amended to remove double taxation on murabaha financing. National banks are pressuring the Indonesian government to match tax breaks offered by Malaysia as well as creating and promoting incentives for people to put their money into Shari’a banks.

There is also concern with the product approval process. Currently, Islamic banks have to get their products approved by the Shari’a board and then Bank Indonesia, which is regarded as being cumbersome and time consuming. Bank Indonesia, Indonesia Council of Ulema and the Indonesian Accountants Association has established a working group whose job it is to review new Islamic banking products. Once approved, banks will no longer need to go through the aforementioned process. IFIs are still expected to retain a Shari’a board to supervise and monitor.

Enhancing the rural sector

There is a large potential for growth in retail Islamic finance in Indonesia. One key avenue is through microfinance. According to estimates, more than 90 percent of Indonesia’s 50 million small businessmen have no access to regular bank financing. Thus there is a capacious market for IFIs to capitalise on. Microfinance is attracting commercial banks because of its wider profit margins and lower defaults, according to the central bank, which estimates the industry accounts for 70 percent of Islamic lending. Significant growth has occurred in the Islamic rural credit markets, with Bank Indonesia licensing over 35 new Islamic rural banks over the last five years.

Rural banking is not limited to the rural credit banks. Commercial Islamic banks have been active in this sector, impressed by the greater customer base as well as the lower default numbers on loans. These are typically structured using the murabaha contract. Bank Muamalat Indonesia, the oldest Islamic bank in Indonesia, has a number of branches serving the banking needs of women, farmers and SME’s. It helped establish 500 new cooperatives that provide micro financing in 2009, increasing to 2,500 the number of Shari’a compliant cooperatives. Bank Syariah Mandiri is adding branches in Java and Sumatra to offer microfinance loans while Bank Syariah BRI aims to triple its business in the rural sector in 2011.

Developing the capital markets

According to the Debt Management Office of the Finance Ministry, the government has sold 57.34 trillion rupiah of sukuk since 2008, when the first sovereign sukuk was sold. However, challenges still remain especially within the domestic markets. Investors are demanding higher return from sukuk as there is no secondary market in which active trading can occur. The sukuk market is not sufficiently liquid enough which prevents the sale of new sukuk. Poor demand has resulted in a number of failed auctions. Indonesia is attempting to bolster demand by marketing to international investors and changing its sale practices. Rating agencies such as Moody’s and Standard & Poor have raised the credit rating of Indonesia and expecting increases over the coming years. Moody’s accounted Indonesia’s economic resilience as a key factor determining their upgrade. In 2010, foreign holdings of Indonesian bonds – both conventional and Islamic – rose 79%. Thus a focus on international investors looks positive though more effort is needed to enhance the domestic markets. The corporate markets should also be a cause for concern. Analysts believe that there have only been 20 issues from corporates in the last five years, significantly lower than Malaysia.
On the other hand, Islamic funds based in Indonesia are doing well. Six of the 10 best performing Islamic funds in 2010 are from Indonesia. However, improvements need to be made to the Jakarta Islamic index. With only 30 Shari’a-compliant stocks, it is not sufficiently robust to create a thriving Islamic equity market. Indonesia has sought the assistance of UK regulators and industry players to improve the index as well strengthen their financial infrastructure.

Moving forward

Malaysian Islamic banks have a keen interest in Indonesia. Banks such as Maybank converted its Indonesian unit, PT Bank Maybank Indycorp (BMI), from a conventional bank into a fully fledged Islamic bank in October. Malaysia’s Affin Bank purchased the Indonesian conventional bank PT Ina Perdana and converted it into an Islamic bank in April 2010. Close alliances with Malaysia will benefit Indonesia, not only in terms of transferring education, experience and increasing product offerings, but also acting as a distribution channel for Indonesian funds and sukuks.

It is incumbent on Indonesia to ensure the groundwork is in place; and Bank Indonesia has shown resolve and determination to ensure the requisite infrastructure needed. On the advice of the central bank, the University of Indonesia began offering a Master’s in Islamic banking in 2009, to help prepare students for the industry. The school also offers an Islamic banking specialization for MBA students and plans to offer a bachelor’s in Islamic banking and a doctoral program.

However, government inertia and legislative hurdles will hinder Indonesia’s progress. If it is to truly meet the goals set according to Bank Indonesia’s strategic plans, Indonesia needs to be flexible and address challenges as they arise – sooner rather than later. The global Islamic financial market is on a precipitous climb upwards. Indonesia cannot afford to take small steps when its neighbours are taking giant strides.
Iran is one of the two countries (Sudan being the other one) in the world, which have transformed their economies and financial systems totally in accordance with Shari’a law. With a population of nearly 77 million and an annual GDP of about USD 826 billion (2009 estimates in terms of the purchasing power parity), Iran is an important economic player in the world. Its involvement and leadership role in Islamic banking and finance can be used for further strengthening the Islamic financial services industry world-wide, but surprisingly Iran features very marginally when it comes to the international power play in Islamic banking and finance. One obvious reason for this apparent marginalization of Iran in the global Islamic financial services industry is the economic sanctions imposed by United Nations, USA and the European Union. While this is an important factor that must have adversely affected the international engagement of Iran in Islamic banking and finance, it is interesting to look into some other factors that may explain the lack of leadership role played by Iran in the global Islamic financial services industry.

Islamic banking in Iran

Islamic banking was officially introduced in the country in 1983, with the passing of The Law for Usury (Interest) Free Banking, which requires all banks in the country to operate without engaging in paying or charging interest. It is, however, observed that the definition of the prohibited riba in Iran is rather based on an innovative concept. Although The Law for Usury (Interest) Free Banking does not explicitly define the prohibited interest, it seems as if the Iranian authorities follow a technical definition of riba, which states that a transaction involves prohibited interest only if it is between two independent parties. According to this doctrine of riba, the following conditions are found in any transaction that involves riba:

1. The existence of indebtedness;
2. The existence of a debtor independent from the creditor;
3. Prior agreement (at the time of entering into transaction) between the two parties so that debtor must pay more than what he borrows; and
4. The actual receipt of the excess amount.

If any one of the above is missing in a transaction, it does not involve the prohibited riba. Consequently, it is acceptable for all the government-owned institutions and departments to carry on with their interest-based transactions and arrangements, when dealing with each other. As all the banks were nationalized after the revolution in 1979, borrowing from such banks by public sector corporations and institutions remained interest based, as it was deemed permissible for government-owned banks to lend to other government sector organizations. This actually meant that the Central Bank of Iran did not have to devise any new mechanism or develop any tools for the conduct of its monetary policy in compliance with Shari’a.

Similarly, banks are allowed to offer non-contractual non-fixed bonuses in cash or in kind to the holders of interest-free deposits (Article 16(A) of the Law for Usury (Interest) Free Banking). This is very helpful for the banks to keep on operating without changing their accounting standards and practices. Because of these types of provisions in the legal framework, Islamic banking in Iran is not very distinctly different from conventional banking practices.

A further anachronistic feature of Islamic banks in Iran is that they do not market their Shari’a-compliancy at all. For example, none of the Iranian banks adequately highlight their Islamic banking operations on their website or other marketing materials. On the contrary, some banks actually refer to certain Shari’a repugnant...
practices and concepts. For example, Saman Bank, a privately held Iranian bank, lists on its website “interest rates” on a number of deposit accounts it offers. This is obviously not in line with the internationally acceptable Shari’a and Islamic financial reporting standards.

Whatever be the view on Shari’a authenticity of Islamic banking in Iran, the country tops the list of countries in terms of Shari’a-compliant assets held by banks and other financial institutions. With nearly USD 315 billion Shari’a-compliant assets (as reported by The Banker), Iranian Islamic banks and financial institutions represent over 30.5% of the global USD 1.03 trillion Islamic financial market, according to figures by Edbiz Consulting. This is significantly higher than any other individual country, including the two most influential Islamic markets, namely Saudi Arabia and Malaysia (representing 13.4% and 10%, respectively). In December, Iran’s Securities and Exchange Organization, joined the IFSB as a full member along with the Bank Eghtesad Novin, as an observer member.

Bank Melli Iran ranks number one Islamic bank in the world, in terms of paid up capital (USD 5 billion) and assets under management (USD 57 billion). 7 out of the top 10 Islamic banks in the world happen to come from Iran. However, after the government’s decision to ban daily withdrawals of above IRR 150 million (USD 15,139) in early 2010, there was concern that the Bank was going bankrupt. Bank Melli rubbished these concerns but with further rumours about the inevitable bankruptcy of two other banks, it suggests that the banking sector in Iran is far from healthy.

**Worries in the banking system**

According to industry figures released in January 2010, Iranian banks have USD 48 billion in bad loans according to industry figures released in January, which has led to a number of bank runs. In 2008, bad debts were at USD 15 billion, thus representing a 300 percent increase over the last two years. Iranian governments have often instructed state banks to provide low-interest loans to various sectors in order to boost the economy, saddling the banking system with non-performing loans. Unfortunately, who is to blame remains a vexatious point. A political tete a tete has ensued with the private sector accusing the government of corruption, nepotism and imposing too much bureaucracy. They further argue that money is given to government affiliated organisations who do not repay, which stifles entrepreneurship and growth. The government on the other hand, believes that private sector incompetence and malfeasance, along with the financial crisis have been key factors. Whatever the case may be, many factories have been built but are not functional making it difficult to pay loans back.

Another cause for concern has been the independence of the central bank. Since the inception of the central bank in 1960, the government has had significant control over central bank policies. With the passing of the Fifth Development Plan in 2010, this is changing as it curbs the power of the President in influencing monetary policy. Furthermore, the panel which decides on monetary policy used to comprise of government officials, but now the plan envisions a panel comprising seven economists. While they will be chosen by the government, parliament has to give a vote of confidence. This new system, still in its draft stages, hopes to reduce government control leading the way to less bias and the consolidation of vested interests.

**Economic and trade sanctions**

But while criticisms may be levelled at the Iranian government for monetary policy mistakes, it is difficult for the country to make comprehensive economic policies due to economic and trade sanctions from the USA, UN and the EU.

The crisis in the value of Iran’s currency in late September and early October was a manifestation of uncertainty, speculation and fear that has been caused by the cumulative effect of sanctions. Iranian government officials have attempted to assuage public fears, but with growing inflation and unemployment, the public are rightfully indignant. While the rate of growth in Iran’s real GDP in 2007 was 7.8%, the projected rate for 2010 was only 1.6% according to the IMF World Economic Outlook.

Sanctions have isolated the country from the international community and one obvious adverse effect of this is on Islamic banking in Iran. After the September 11 attacks in New York and the subsequent war on terror (and Iran being on the US list of the countries sponsoring terrorism), Islamic banks (like any other financial institution) would not like to engage themselves with the Iranian corporations and financial institutions.

It is unlikely that the sanctions will abate with the US accusing Iran of surreptitiously circumventing them through clandestine means. A case in point is the accusation that Iran is trying to set up a global network of banks in Muslim countries such as Iraq and Malaysia using dummy names and complex ownership structures. Consequently, pressure has been put on countries and institutions that are working with Iranian institutions to terminate their relationship. Lloyd’s, Credit Suisse and Barclays have been fined for processing payments by Iranian banks. The US has blacklisted 16 Iranian banks for allegedly supporting Iran’s nuclear program. Other countries such as Australia have followed suit and have placed their own measures against Iran. South Korea temporarily closed the Seoul branch of Iran’s Bank Mellat for two months and require it and other Iranian companies to get approval for future foreign exchange transactions.

Iran has therefore looked to build relationships with Muslim countries. At the Twenty-Sixth Session of the Standing Committee for Economic and Commercial Cooperation of the OIC (COMCEC) in Istanbul in October, Iran called for the creation of an Islamic fund and an increase in mutual trade among member states of the Organization of the Islamic Conference (OIC). In July, Heads of State and ministers from eight countries - Iran, Nigeria, Bangladesh, Egypt, Indonesia, Malaysia, Pakistan and Turkey - met in Nigeria to discuss developing business ties and reducing trade barriers.

Trade between the eight Islamic nations is estimated
to be worth about USD 68-billion a year, or about 3% of global trade. They intend to sign a preferential trade agreement by next year in an effort to double their trade with each other and strengthen economic cooperation and create an Islamic common market. Iran has also requested the IDB to increase its support of building the infrastructure in Iran and have appropriated a number of loans to invest in industry as well as physical infrastructure. In December 2009, it called on IDB to help sell Islamic bonds onto the international market. However, there has been little development since.

Lack of an Islamic financial policy in Iran

It appears as if the Central Bank of Iran and the government have failed to realize the potential of Islamic banking and finance in establishing Iran’s leadership role in the Gulf region and the wider OIC-bloc. Although legislation in favour of Islamic banking and finance exist in the country, there is no clear policy framework for the conduct and promotion of Islamic banking in the country. It is fair to point out that Iran is not the only country that has failed to develop such a policy framework; apart from Malaysia most other countries fall under this category.

There is a definite need at the government level to have an Islamic financial policy in addition to its fiscal and monetary policy frameworks. The objective of the proposed Islamic financial policy should be to promote the use of Islamic banking and financial tools for the conduct of fiscal and monetary policies by the government. Furthermore, it must endeavour to establish Iran as a major player in the global Islamic financial services industry. In the absence of such a policy, some neighbouring countries, particularly the UAE, stand better chances of benefiting from the tremendous growth potential in Islamic banking and finance.

Future of Islamic banking in Iran

The future of Islamic banking in Iran very much depends on how effective a role Iran can play in the global Islamic financial services industry. Malaysia provides an excellent example to emulate. By aspiring to be a global leader in Islamic banking and finance, Malaysia has not only developed a vibrant Islamic banking system at home but has also started exporting its model to neighbouring countries. Malaysia has undoubtedly started reaping the benefits of its investment in an Islamic financial infrastructure that it has created over the last 15-20 years.

Iran can play a similar role in the Gulf and Central Asian regions. In fact, Iran can have a competitive advantage over Malaysia, as the latter provides an example of dual banking system, while Iran has officially transformed its financial system completely in line with the requirements of Shari’a. Furthermore, it has the largest Islamic bank in the world, and of course it is located more central to the Islamic world as compared with Malaysia.

Iran can learn a lot from neighbouring UAE and Bahrain to bring-in the required flexibility to attract investments from the Gulf region. On another front, it must start positioning itself to export its Islamic banking expertise to the Central Asian countries like Azerbaijan, Kazakhstan, Uzbekistan and Tajikistan etc. In fact, by creating an Islamic financial alliance with the Gulf, Central and South Asian countries, Iran can play a lead role in banking and finance in the region. Given the strategic location of Iran (bordering Iraq, Afghanistan, Pakistan, Turkey, Azerbaijan, Turkmenistan and Armenia), it can play an instrumental role in the regional growth of Islamic banking and finance. Given that Iran has a number of uninhabited islands in the Persian Gulf, there is ample scope for developing an offshore centre of excellence for Islamic banking and finance.

As Iran has developed a very liberal Islamic financial regime, the Western countries must be led to buy into the argument that Islamic banking and finance can be used to bring socio-political reforms in Iran. For the west, this should be a more cost effective way of bringing Iran to the mainstream – an option that avoids heavy military and related expenditures associated with a more confrontational approach.
Although Ireland is home to a large Roman Catholic population and has experienced financial difficulty over the last year, to the surprise of many it has shown interest in facilitating Islamic finance. The country introduced legislation clearing the way for structuring certain Shari’a-compliant financial products. Islamic finance is not directly referred to in the legislation but comes under the umbrella term “specified financial transaction”. Like the UK, the specified financial transactions will have to meet certain requirements and can be broadly categorised as credit transactions (like the murabaha), deposit transactions (akin to the mudaraba) and investment transactions (akin to sukuk). Under the Finance Bill 2010, which came into effect in January 2010, the Irish Ministry of Finance has introduced significant amendments to facilitate Islamic finance transactions in Ireland, especially the origination and issuance of sukuk.

The Explanatory Notes to Ireland’s Finance Bill 2010 explains how legislation “is designed to extend the tax treatment applicable to conventional finance transactions to Shari’a products which are the same in substance as the conventional products.” Shari’a-compliant instruments would therefore be taxed in the same manner as their conventional counterparts.

The Finance Bill 2010 also deals with UCITS management companies and introduced changes that are aimed at enhancing Ireland as a leading location both for UCITS and non-UCITS funds and which also came into effect in January 2010. The finance bill also extends Irish stamp duty provisions to provide for relief from stamp duty arising on the transfer of fund assets under fund mergers and reorganizations. These provisions facilitate the structuring of Islamic funds. Dublin has is trying to challenge other similar domiciles such as Luxembourg. Many significant Islamic funds are registered in Dublin such as the Oasis Crescent Global Equity Fund and the CIMB Global Islamic Equity Fund.

In October 2010, the Irish Revenue Service outlined the tax treatment of Shari’a-compliant products and structures for the funds, leasing and Takaful industries. A more in depth analysis can be seen in an earlier chapter. The Irish government has been actively involved in engaging Bahrain and signed a memorandum of understanding with the island state in December. Members of the Irish delegation were given expositions and more information on Islamic finance by the Central Bank of Bahrain.

Whilst the government has been proactive in changing its legislation, it remains to be seen as to whether or not Ireland can emerge as a player in the Islamic finance industry, as recent economic woes may curb their enthusiasm. Furthermore, as the initial focus of Ireland’s Islamic finance foray will be in wholesale banking, it will be competing with the UK, a country with a longer history in Islamic finance.
If articles on Islamic finance are anything to go by, it seems as though the interest in Islamic finance in Japan is diminishing. During the period 2000-2007 the number of articles appearing in Japan on the subject of Islamic finance steadily rose. However, after peaking out in 2007, there has been a sharp decrease.

Up until 2007, Islamic finance itself had been enjoying significant growth, partly backed by rising oil prices. The increased profile of Islamic finance led to greater awareness amongst the Japanese. In addition, Japanese firms such as Tokio Marine, Aeon Credit Services, Toyota Capital were conducting Islamic transactions. These three major factors lead to the significant increase of the figure in the period.

Looking at Exhibit 1 after 2007, the decline in reports is due to the following two factors; (1) the Islamic finance industry showed slower growth globally due to the sharp fall in oil prices and the global financial crisis, which affected the infant industry in Japan, and (2) Islamic finance was not something new anymore in Japan and thus only articles of significant importance would be deemed worthy enough to print.

Notwithstanding the decline in media interest, one can argue that Islamic finance in Japan is in a transition stage, moving away from just mere interest. We are seeing subtle developments in the market, which suggest that what you may or may not read in the paper does not exemplify what is happening in the markets.

1.) Developments in the private sector

i) Nomura

In July, Japan’s biggest investment bank, Nomura issued USD 100 million sukuk with two years maturity, in the Malaysian market. It has been listed on the Bursa Malaysia. This is the first sukuk issuance by a Japanese entity. The Nomura sukuk is ijara backed, the proceeds of which are used for its subsidiary’s aircraft leasing activities. Nomura also raised funds in Bahrain via a commodity murabaha amounting to USD 70 million.

ii) Sumitomo Corporation

A general trading company, Sumitomo Corporation, showed its interest in Islamic funds. Although the details are to be disclosed in the future, this will be the first deal where a non-financial Japanese corporate utilizes Islamic finance. Sumitomo is quite active in Indonesia and other Islamic countries, so using Islamic finance models have the potential of enhancing relationships.

iii) Tokio Marine’s Nile Takaful

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In January 2010, Tokio Marine, Japan’s largest non-life insurance provider, launched a local business entity in Egypt, known as “Nile Takaful”. Tokio Marine is famous for its worldwide takaful network having retail presence in Saudi Arabia, Indonesia, and Malaysia. In Singapore, it has established a retakaful company. The opening of the Egyptian business is part of the company’s continuous global expansion of takaful provision.

2.) Sukuk tax exemption

Prior to 2010, the only policy action taken by the Japanese government to accommodate Islamic finance was the Ordinance to the Banking Act 2008. The Act allowed a bank’s subsidiary to offer Islamic financial products and services. In August 2010, the Financial Services Agency proposed a taxation change in sukuk transactions as part of comprehensive tax amendment proposals for the fiscal year 2011. The proposal was admitted within the budget authority.

The proposed change will exempt taxation on coupon profits for non-resident (i.e., foreign) sukuk holders. The FSA also provided guidelines for structured finance products, from which sukus can be formed under the Japanese legal framework.

The sukuk structure provided in the FSA’s scheme, uses a concept called “Special Purpose Trust” concept which facilitates the creation of the ijara form as depicted in Exhibit 2. The issuer (the actual fund raising entity such as a corporate or sovereign) transfers its asset to a Special Purpose Trust, and enters into a leasing (ijara) and trust agreement on the asset with the bank that manages the asset under this scheme. The profit rate is Shari’a-compliant as it is profit arising from the leasing activity, and is recognized under the Asset Liquidation Law of Japan.

Note that this scheme is not solely structured for sukuk; this is one of possible sukuk schemes using existing legal framework.

The scheme proposed by the FSA is sophisticated as it recognizes important features of sukuk. While sukus are similar to bonds, its structure renders it unique primarily because the structure involves another entity as a cash flow generator. FSA stipulation of a Special Purpose Trust provides for the keystone required to structure a sukuk. However, this measure is based on “tax neutrality” between conventional bonds; it does not give preferable treatment to Sukuk. This is in line with the concept of policy actions taken by other non-Islamic countries.

The FSA measure is important for three reasons. First, it focused on the capital market which is one of the major growth drivers of Islamic finance. Second, it paid attention to foreign investors, who are key players in the market. Third, it shows Japan’s positive attitude towards Islamic finance to Japan and to the rest of the world, after a lull period following the banking regulation change in 2008.

Looking ahead

In December 2010, the “IFN Roadshow Japan” organized by RedMoney came to Japan. Attended by renowned by international speakers, the event reflected the growing interest for Islamic finance in the private sector. The event was unique as many Japanese lawyers and accountants attended, with several Japanese lawyers taking the podium as panelists. This in the past was not common and reflects interest on Islamic finance is spreading to the cogs that run the financial markets. Hence Islamic finance looks set to play an important role in the financial landscape of Japan in future.

Exhibit 2: Sukuk structure under FSA scheme
Although one of the smallest economies in the Middle East (with an estimated gross domestic product (GDP) of about USD 34 billion in 2010 and population of 6.5 million), Jordan is one of the most important markets for Islamic banking and finance, with the history of Islamic banking going back to 1978, when Jordan Islamic Bank for Finance and Investment (later renamed as Jordan Islamic Bank) was set up – only three years after the creation of Dubai Islamic bank, which is considered as the first successful experiment with Islamic retail banking. Since then, the country has gradually progressed in terms of development of Islamic banking and finance.

The socioeconomic situation in Jordan is not good, with GDP per capita of USD 5,300. Like in many other countries in the region, promotion and further development of Islamic banking and finance in the country is now being perceived as a tool for socioeconomic reforms and for political management of the masses who have shown to be culturally aware of the role of Islamic banking in a modern society. In a country where economic turmoil is afflicting the country, with increasing prices and unemployment being symptoms of the problem, Islamic banking may be used as a tool for political management at least in the short run. Due to the global recession, economic growth halved at the beginning of 2010, and some political observers and economic analysts urge that the government of Jordan may consider the dual Islamic banking models as practiced by Bahrain and Malaysia.

Pioneering role of Jordan in Islamic banking and finance

Sami Hamoud, who is considered as one of the fathers of modern Islamic banking and finance, was a Jordanian who helped set up Jordan Islamic Bank. As one of the oldest players in Islamic banking and finance, Jordan has so far failed to capitalize on its pioneering role in initiating the global Islamic financial services industry. Friendly relations with the late King Hussain and Saudi Prince Mohammed Al Faisal and Shekh Saleh Kamel (founder and chairman of Dalla Albaraka Group) must be highlighted as an evidence of commitment of the government, to convince the major international Islamic financial players to invest in the country. It must also be highlighted that the government of Jordan was one of the very few governments in the region who were friendly enough towards Islamic banking to pass a special law enabling the creation of Jordan Islamic Bank in 1978.

Although the Jordan Islamic Bank received a lot of support from the members of the Muslim Brotherhood since the establishment of the second Islamic bank in Jordan, Arab Islamic bank, the customers of Islamic banks come from a more diverse background. Islamic banking has a potential to replace an informal economy created by a coterie of families and neighbourhoods, friends and co-workers who believe in following Islamic principles in business and finance.

Criticism of Islamic banks has been levelled by Islamists who feel that banks could do more in terms of providing social and development services and promoting Islamic values. People have been critical of the high mark ups charged by the bank and the low bank returns provided to customers. Consequently, a burgeoning informal economy has formed: a coterie of families, neighbours, friends and co-workers who have created financial support networks which follow Islamic principles.

The formal sector

As mentioned above, Islamic banking in Jordan dates back to 1978. By the end of 2009, there were 23 banks operating in Jordan, two of which were Islamic banks. There were also 28 registered insurance companies, three of which are takaful operators. Assets of the two existing Islamic banks in Jordan alone amounted to around 12.5 percent of the total banking system and
their financing accounts for over 15 percent of total credit. In 2010, two new Islamic banks were granted licences to operate in Jordan: Jordan Dubai Islamic Bank and Saudi’s Al Rajhi Bank, pushing up the share of Islamic banking in the financial sector of the country.

Opening new Islamic banks alone will not stimulate the Islamic financial market. Jordan faces a number of challenges if it is to have a more robust system, including creating a secondary market for Islamic securities. A further problem is the shortage of qualified and trained personnel skilled in Islamic finance. Additionally, supervisory authorities are constrained by their own limited knowledge of Islamic finance which affects efficacious supervision of Islamic banks.

At present, the Central Bank of Jordan applies a single regulatory framework to govern both conventional and Islamic banks though allowances have been made to account for liquidity and credit risks that are unique to Islamic banks. Enacting legislation which accounts for the specificities of Islamic banks would strengthen their service provision. Legislation is already present relating to Islamic finance. Besides the 1978 act setting up Jordan Islamic Bank, the government passed a banking law in 2000 which restructured banking in Jordan and included a major section formalising the law regulating Islamic banks. With this act, provisions were made relating to the creation of investment accounts, corporate governance and the composition of the Shari’a board.

The Jordanian government have recognised that Islamic finance may provide access to funds which they are in need of to cut their current account deficit which currently stands at USD 1.5 billion. In November 2010, the government completed the issuance of USD 750 million in five-year conventional bonds on the international markets. This was the first time in the Kingdom’s history that it has issued bonds on international markets, a sign of the growing need to acquire funds from abroad. Al Rajhi was hoping to issue a sukuk subject to the passing of a law which removed legal uncertainties regarding the issuance of sukuk, offered guarantees that protect investors, approved listing of sukuk on the local bourse and allowed a secondary market for Shari’a-compliant debt. The law was slated to be enacted by the end of 2010 but up to now, there have been no further developments.

Prospects

Throughout the Middle East there is a consistent kind of uncertainty about a number of things with a clear exception in favour of Islamic banking. Whatever be the changes in socio-political and economic aspects of the region in general and in Jordan in particular, Islamic banking is bound to prosper in the country. In Jordan, the conservative Muslims have always been in favour of modernizing Islam in the form of practices like Islamic banking. This has also translated itself into development of social projects. While there is a growing informal sector, Islamic banks have not been shunned and show potential for growth. Jordan’s government has been far more proactive in supporting Islamic finance in 2010 as they respond to the growing need to tap into alternative sources of income. Further, activity in this field through the issuance of sukuk is likely to assist, but strong political will is required. However, political will is underpinned by a stable government.
Prerequisites for Islamic finance development A necessary condition for effective socio-economic development is high investment activity, which allows the development of basic industrial sectors. This in turn maintains the social sphere, introduces new technologies and increases competitiveness of the country in international markets. In this regard, state economic policy needs to ensure strong support for investment activities and the creation of a favourable investment climate in the country. In Kazakhstan, total expenses for realizing the current State program of industrial development during 2010-2014 would account to USD 43 billion. Most of these costs are planned to cover the expense of attracting foreign investments.

The recent global financial crisis has produced a negative impact on the development of investment processes in Kazakhstan. Inflow of FDI into the country has decreased which has compelled the country to look for alternative sources of funding. Consequently, Kazakhstan has welcomed Islamic financing as it has shown within the crisis, healthy sustainability and natural viability.

The post-Soviet Kazakh economy has been in transition. It initially encountered Islamic finance in the mid 1990s, when the country joined the IDB in 1995 and the Al Baraka Group opened its first branch in the country in 1994. Unfortunately, lack of familiarisation meant that the branch had to close.

IDB on the other hand has been integral in advancing Islamic finance in the country. In 2002, the President of the IDB met with high-ranking Kazakh officials to discuss the prospects of Islamic finance in the country. The meetings led to IDB's Annual Meeting being held in Almaty, the capital in 2003. Equally, Kazakhstan was quick to become a member of the IDB Group.

At the same time, the private sector was witnessing activity. In 2001 and 2004 banks like Laniba Bank and Taib Bank opened their Kazakh subsidiaries. It is worth mentioning that these enterprises provided few benefits to local people. In 2005-2008, there were several loan syndications by large Kazakhstan second-tier banks with overseas Islamic banks where short-term trade finance facilities based on the murabaha mode were used: Bank TuranAlem (2005-2006 – USD 50 million), Bank CenterCredit (2006-2007 – USD 38 million), then again BTA with Calyon Bank/Abu-Dhabi Islamic Bank (2006-2008 – USD 200 million), the Alliance Bank with Calyon Bank/Abu-Dhabi Islamic Bank (2007-2009 – USD 150 million) and BTA– Abu-Dhabi Islamic Bank/ CIMB Bank (2007-2009 – USD 250 million).

MOUs between BTA and Emirates Islamic Bank (2007) and the sovereign wealth fund Kazyna with Qatar Islamic Bank (2008) were signed but never executed. The State Agency of Regulation of the Regional Financial Centre Almaty envisages Islamic finance will soon have 5% market share of the financial assets and even plans to issue sukuk in local currency. However, all these actions have been spontaneous, without preliminary analysis. Notwithstanding the haste, the need to introduce Islamic banking through official channels has gathered momentum and the initiative of preparing and adopting a new draft law has started albeit in tough financial times.

Legislation


The IF Law promotes the creation of a legal framework conducive to the introduction and development of
Islamic financial instruments in Kazakhstan. It eliminates certain restrictions obstructive to the entrance of Islamic banks into the local financial markets. The Law defines forms and methods of state regulation and supervision over Islamic bank activities, and addresses the operational environment of Islamic banks.

Pursuant to the IF Law, the government introduced a package of amendments and changes to the Civil Code, the Tax code, the Law on Banks and Banking Activity, the Law on Securities Market, the Law on Investment Funds, the Law on State Registration of Rights for Real Estate and deals thereupon, and the Law on Guaranteed Insurance of Deposits allocated at local second-tier banks.

Articles 52 to 58 of the Law on Banks and Banking Activity pertain to trade financing activity and allow banks to own the assets. This amendment allows the creation of products which are Shari’a-compliant. These new acts have revised the concept of originator with respect to securities issuance and as to who could be considered such. Changes in the law have also made it incumbent on every local Islamic bank to form Shari’a boards (conventionally written as Councils on principles of Islamic financing).

President N.Nazarbayev is a committed supporter and the main exponent behind granting IFIs full legislative basis. He has been instrumental in the establishment of the first Islamic bank in Kazakhstan by ensuring an accelerated ratification process of Articles of Agreement between Abu-Dhabi Investment Council and Government of Kazakhstan. The bank will be constituted through licensing a Kazakh branch of Al Hilal Bank with offices in Almaty and Astana cities.

However, there are shortcomings with the IF Law. For example, in issuing sovereign sukuk, state bodies such as the Ministry of Finance is omitted from the list of potential Islamic security originators promulgated by the law; there are multiple taxation deficiencies that have hindered the first Islamic Bank to facilitate its local operations through commodity murabaha or ijara; and on Sharia-compliance, the Financial Supervisory Agency and National Bank are actively enhancing the secular and conventional nature of the domestic financial system thereby making it harder for Islamic banks to compete. Basic terminology for Islamic financial instruments is only partly described in Kazakh legislation. A fuller expression of Islamic finance products utilising basic terminology for Islamic financial system thereby making it harder for Islamic banks to compete. Risk management as per best international practices.

Obviously, Islamic finance legislation needs review and improvement. This will take time. Nevertheless, there are positive developments in the industry and salutary comments coming from the government. In the Annual Message to the People of Kazakhstan by the President Nazarbayev on January 29, 2010, he issued a directive to create a Regional Center of Islamic Banking in Almaty for CIS countries. The Presidential Administration is thus committed to developing an indigenous Islamic finance industry. This is complemented by their desire to reconsider legislation and offer a systemic approach to building up the industry.

On August 3, the Road Map on the Development of Islamic Finance was approved. It consists of 14 systemic measures on improving Islamic finance legislation, attracting Sharia-compliant investments from OIC countries, getting memberships in international associations like IFSB, AAOIFI, IIFM, IIRA, LMC, introducing Islamic financial reporting standards, creating a central Islamic center and independent research center on issues relating to Islamic economy studies and current operational issues of global Islamic finances, establishing Shari’a-compliant institutions in microfinance, leasing and mortgage, opening a central Shari’a board, developing respective PPP instruments etc.

**Domestic Islamic finance private sector**

The Regional Financial Center Almaty was intended to be a leading coordinator in promoting Islamic finance activities in the country. However, this governmental institution pays more attention to general issues and gives less priority to the emerging private Islamic financial sector. Hopefully, the situation will change in 2011 when the theme of Islamic finance will gain more prominence in Kazakhstan due to the forthcoming chairmanship of Kazakhstan in the OIC (2011-2012). Add to this, there are several public events which will be held such as the Kazakhstan Islamic Finance Conference 2011.

The only domestic Islamic bank is Al Hilal Kazakhstan. It has planned to invest USD 250 million into the Kazakh economy in 2010 and expects the volume of investment to reach USD 1 billion in two years time. Al Hilal intends to finance large corporate projects utilising the murabaha contract (each contract not less than USD 5 million). There is reduced focus on the SME sector. Expectations are that a second Islamic bank will commence operations in the second half of 2011.

Shareholders of this second bank, as announced in July 2010, plan to concentrate its activities in retailing and the SME sector thereby competing with Al Hilal’s high end focus.

In Kazakhstan, Islamic insurance services are provided by the Halal Insurance Takaful Company (HITC). Due to legislative restrictions, it was established as a ‘Mutual Insurance Society’. The company has set the following targets and hitherto has been successful in meeting them:

1) Provide high-value Shari’a-compliant insurance products to local people. HITC provides three types of voluntary takaful insurance (medical insurance for travellers, including persons performing Hajj or Umrah; accident insurance; and property insurance.

2) Promote takaful to the public and spread knowledge on Islamic finance;

3) Lobby for changes into the Act on insurance activity in favour of creating fully fledged operations of takaful;

4) Prepare local specialists in takaful.
In the field of Islamic advisory and consultancy there are several private companies, one of them is the Istisna Corporation which within one year organized the following notable events: the first Kazakhstan Islamic Finance Conference, the first BIBF seminar in the region on AAOIFI standards, an intensive course on product development and Islamic financial engineering and an international conference on Islamic finance regulation issues in post-crisis period. Furthermore it has published an original of the Handbook of Islamic Banking in Russian to distribute within all CIS countries. The company provides Islamic finance consultancy services and investment intermediation with OIC countries. Another local Islamic finance training body is IbFTC. JSC Fattah Finance is a diversified Shari’a-compliant business in the field of asset management, education and is trying to develop a halal hub with the assistance of Malaysian partners. Furthermore it is also involved in a Hajj fund and will be involved in the setting up of the next Islamic bank, (together with Development Bank of Kazakhstan and Malaysian based Amanah Raya Co).

Overall, eight companies (which besides the above, also includes JSC Regional Financial Center Almaty, Almaty Financial Center Ltd., Al Hilal Islamic Bank, IFI Ltd. and Kausar Ltd.) are members of the Kazakhstan Islamic Finance Development Association (KIFDA), a self-regulating public body that acts to promote the huge potential of the Islamic finance industry in Kazakhstan and the CIS region. In this regard, the local Islamic finance private sector will play a leading role in further strengthening the institutional and operational capacity of the industry. Developments in Islamic finance can to be seen in parallel with the growth of the halal industry, which has grown over the last four years. It is likely that the preferred clients of Islamic banks will be halal certified businesses. Due to the lack of available Shari’a-compliant financing, they are forced to transact with conventional banks.

Issues

There are a number of challenges that confront the Kazakh Islamic finance sector. These include: 1) protecting investment depositors (probably through a takaful scheme) due to the absence of obligatory insurance of Islamic deposits; 2) development of Shari’a-compliance procedures, coordination of corporate Shari’a boards as well as creation of a central Shari’a board by the Financial Supervision Agency; 3) consideration and monitoring of socially-oriented Islamic financial products such as zakat, sadaka, qard al hasan, waqf property funds that will manifest through the systemic development of Islamic financial market; 4) legal adaptation of AAOIFI and IFRS standards; 5) assistance to Islamic banks for solving issues of short-term liquidity in the absence of an Islamic interbank market; 6) new changes into the current legislation regarding Islamic securities market development, including amendments of state bodies’ (Ministry of Finance) status as originator and further simplification of taxation regime for Islamic transactions; 7) launching a domestic Islamic fund market; 8) developing a research and analysis capacity (this is unlikely due to budgetary constraints and the absence of economists and thinkers with knowledge of both Arabic and English; 9) State bodies need to educate themselves about Islamic finance and take a more proactive role. Within this year, actions have not been undertaken by regulators (National Bank, Financial Supervision Agency, Ministry of Finance) to facilitate membership to IFSB, AAOIFI, IIFM, IIIRA, LIC; 10) detailed study and practical application of all available Shari’a-compliant financial instruments, especially linked to PPP modes such as diminishing musharakh. The government should provide all administrative and operational support to local private Islamic finance institutions in their start-up stage.

Perspectives

Addressing the above issues will promote real improvements in public life and lead to diversification in the economy. It will strengthen ethical norms practiced by businesses. The active role of the government in developing a dual system where Islamic finance can co-exist, is imperative. Stability will lead to inflows of FDI, especially from the OIC. For this reason, it is necessary to study the process by which other countries manage to adapt Islamic finance into the local legal system. Understanding methods would enable the building up of a competitive national economy and establish effective mechanisms of regulation and supervision. According to RFCA estimates, in 2020, Islamic finance share in the financial markets will be approximately 10%. Of course, this is a very optimistic view. But the institutional capacity in Kazakhstan is gradually taking shape.
Islamic finance in Kenya has a short history but it is one that has seen much progress. With an affluent Muslim community, it has managed to create a burgeoning Islamic finance market in a short period of time. Barclays first availed the opportunities in 2005, with the setting up of the La Riba account. Their pioneering work spearheaded the establishment of two licensed Islamic banks within three years: First Community Bank (FCB) and Gulf African Bank. By 2010, according to the Central Bank of Kenya (CBK) in May, they had 1,570 loan accounts and 58,548 deposit accounts and control 0.8 per cent of banking sector’s net assets within two years of operation.

Both banks have shown ambition to not only spread coverage of Islamic banking throughout the country but also to expand into other East African countries. With a growing number of branches – 29 from recent figures – their profile has grown which has allowed them to contribute effectively to the development of the industry in Kenya. Their success has stirred multinational banks such as Chase bank to offer Shari’a-compliant products through its subsidiary in Kenya. In July, the bank launched Chase Iman which offers accounts for individuals and asset financing for SMEs. Chase bank has been voted the fastest growing bank in 2009 and 2010. With the launch of Chase Iman, the bank has a wider vision. Barclays have continued to provide Shari’a-compliant products. The La-Riba Vehicle Finance and La-Riba Personal Finance products are seen as an answer to asset financing products provided by new entrants; and a means to serve the underserved Islamic community in Kenya.

FCB as the first fully fledged Islamic bank in Kenya has sought to be a trailblazer. It has sought to address the gaps that plague any nascent Islamic finance industry and in this respects it has achieved a number of milestones expedient for the industry. In October, it set up FCB Takaful Insurance to work in partnership with established insurance companies to offer takaful products. In February, they received approval to set up FCB Capital, an investment banking subsidiary and the first Islamic investment bank in Kenya. The bank’s products and services will cover a wide range of Shari’a-compliant investment activities. FCB Capital hopes to be a conduit through which foreign direct investment will be channelled for financing infrastructural projects. The bank has also been active in the local community. They set up the Islamic Finance Training Centre to train staff in Islamic finance. The Centre will facilitate the development of financial professions with skills and knowledge in Islamic finance. They have registered the Centre with the Ministry of Education in one of their Nairobi branches. FCB were also one of the four banks chosen by the government to work with the Youth Enterprise Development Fund, a development initiative formed by the government to support youth orientated SMEs with capital. FCB’s focus is on the Muslim community.

Gulf African Bank was set up a year after FCB and has experienced a difficult two years of consecutive losses. However, 2010 may prove to be a turning point as they have recorded profits for the first time. This bodes well for the overall strategy of the bank, which hopes to expand into other East African nations such as Uganda and Tanzania.

Its principal shareholder, GulfCap Investments raised KSH 1 billion as capital to launch Gulf Takaful Company. There is increasing interest for takaful in Kenya due to the growing middle class and the failure of conventional insurers to penetrate the market. Conventional insurers are therefore turning to the takaful markets. CIC insurance has invested sh120 million to create a subsidiary, Takaful Insurance of Africa. APA hopes to issues takaful products next year while Cannon Assurance has collaborated with FCB in joint venture to roll out takaful covers. FCB will develop and market the

IFCI ranking: 24
products; Cannon will focus on the financing. Morgan Stanley research suggests that takaful premiums in Kenya could potentially reach Sh20 billion in 2014, or 31 per cent of total insurance premiums last year.

The role of the government

The government and the CBK have been supportive of the development of the Islamic finance market in Kenya. The CBK have granted exemptions and provided leeway to Islamic banks in order to accommodate Shari’a-compliant products. The CBK hope to launch Shari’a-compliant treasury bills to boost liquidity and there are discussions regarding the issuance of a sovereign sukuk. However, this will be dependent on the support of the government who have, to date, shown commitment to building the industry. In his 2010/2011 Budget speech, Kenyan Finance Minister, Uhuru Kenyatta spoke of ‘the need to amend the law to accommodate Islamic banking products by introducing the concept of a return as opposed to interest’, and announced plans to further amend the Central Bank of Kenya Act ‘to facilitate Islamic transactions’. The current Banking Act has enabled Islamic banks to find alternative methods of deriving profits without recourse to interest. Article 16A (2) of the Banking Act as of January 2010 states: “An institution shall, in respect of a savings account, pay interest accruing, or a return in the case of an institution carrying out business in accordance with Islamic law, to that account as long as the minimum balance is maintained.” Whilst the difference is subtle, it has enabled banks to conduct Islamic financial transactions within the full purview of the law.

A brighter future

At the second East and Central African Islamic Finance Conference in May, delegates gathered to discuss the prospects of Islamic finance in Kenya. There is a real desire to create an Islamic finance hub in the East African country and with such accelerated developments this is a real possibility.
In 2009, a report published by the US based Centre of Diplomatic Strategic Strategies declared that Kuwait has been one of the biggest centres for Islamic finance in the last 30 years. The industry has grown to become an important segment of the country’s financial sector, sustained by increasing demand and a growing awareness in the domestic market of Islamic finance. Islamic banks have rapidly won market share from conventional ones and have become a successful substitute for traditional banking operations. This has led many domestic and multinational banks to seek a share of the Islamic financial market. Kuwait’s success has not been due to extensive regulatory changes or active participation of the government; but rather the dynamic activities partaken by IFIs in the market. One institution stands prominent in the success and transformation of Kuwait into an Islamic finance hub, namely Kuwait Finance House.

Kuwait Finance House: a bank with many faces

Kuwait’s association with Islamic finance dates back to 1977, when the Kuwait Finance House (KFH) was established. The Banks inception was a result of political manoeuvrings undertaken by the ruling Al-Sabah family in a bid to counter Arab nationalism. It was established with a 49% government share in capital and enjoyed certain perks for over 20 years such as freedom from central bank regulation and protected monopoly status as Kuwait’s only Islamic bank.

KFH has been particularly instrumental in creating a unique brand of retail based finance. Being outside banking regulations gave it the freedom to participate in both banking and trading activities. In an attempt to keep finance linked to the real economy, KFH have kept large inventories of real estate, automobiles and other products which are demanded by Kuwaitis. This has made KFH a hybrid between a bank and a trading company. KFH has new and used car showrooms, as well representatives available at most car distributors in Kuwait who can advise on its financing packages. KFH has established a separate affiliate, KFH Trade, for its car financing business. The bank is also one of the largest owners of real estate in the country. It has a real-estate affiliate which provides Shari’a-compliant mortgages as well as an ijara service that provides an ownership option for clients. In the early 80s KFH took advantage of government subsidies in the land market and invested heavily in real estate. Its investments were so substantial that it was accused of driving up prices. KFH subsequently diversified into other asset classes.

Criticism has been levelled at KFH and the model it has created. Accusations include the encouragement of unhealthy spending habits which manifested itself in high levels of debt amongst Kuwaiti citizens. They have also been culprits of offering products which many regard as comparable to prohibited activities. In 2009, to attract customers to their credit cards, KFH issued an awards programme for its cardholders offering KD 100,000 in prizes, which was construed to be akin to gambling. Paradoxically, many believe that the increased level of Islamic consciousness in Kuwaiti society owes to the business practices of KFH, who have actively promoted an Islamic lifestyle.

Kuwait Finance House has USD 1.5 billion in assets under management (AUM), with investment in the US, Malaysia, China, and the Middle East. The real estate arm which started operations in the 1990s, has previously invested in property in the United States and Europe, including Britain though it sold property in the United States and Europe, in 2005 and 2006 after prices shot up. In recent years there has been a change of policy, with a reversion to US and European markets. In December 2009, it invested USD 242 million into residential properties in Chicago.

Due to its success and consistently high profits, KFH has
expanded into other countries, most notably Turkey (where it is known as Kuveyt Türk Katılım Bankası AS). It is Turkey’s largest Islamic bank and has more branches there than in Kuwait. KFH started retail, commercial and investment banking operations in Malaysia in 2005 and it has opened representative offices in Singapore and Melbourne. KFH Malaysia helped develop a USD 1.3 billion real estate project in the country in 2005 as an Islamic equity property ventures. Five years on, the bank is embarking on its fourth building project in Malaysia using a similar equity concept. Unfortunately, few others in the industry have followed the same path, reflecting Islamic finance’s slow and difficult shift away from debt instruments. 

Moving away from the monopoly

For 25 years, KFH was the only Islamic bank in Kuwait and developed a degree of power and authority. The ruling establishment, while originally supportive, were looking to dilute their authority especially with fears that the bank was supporting Islamist activities. Kuwait Central Bank (KCB) was also keen to weaken KFH’s stranglehold in order to increase competition with conventional banks. Subsequently, in 2003, amendments were made to the Central Bank Law 32 1968, which allowed more players to enter the market. As a result, conventional banks such as the Kuwait Real Estate Bank converted into being an Islamic bank, changing its name to Kuwait International Bank and new Islamic banks such as Bouban Bank were formed.

Three more Islamic banks have set up in Kuwait since the passing of the legislation in 2003, namely: Al-Rahim Bank branch, Al-Ahli United Bank and Warta bank. While the latter bank is indigenous, the former two are part of a banking groups originating from Saudi Arabia and Bahrain respectively and were formed in the last two years. Ties are therefore becoming stronger between Islamic finance hubs.

The five banks sit in a market dominated by conventional banks – 16 in total. However, they have managed to compete effectively and according to a McKinsey & Co, witnessed between 2003 and 2009, compound annual growth rates in Islamic banking assets of 23%. In addition, according to the recent KCB annual report, there are 54 bespoke Islamic investment companies out of 100, thus surpassing non-Sharia-compliant investment companies. There are also 54 Islamic investment funds in the country out of 112. According to figures from 2009, the Islamic and Sharia-compliant companies make up 57% of the total Kuwait market capitalization.

Regulatory headaches and legal bellyaches

There has not been much in the way of enabling legislation for Islamic finance in Kuwait. This is a problem especially with regards to sukuk. Issuances of sukuk have been few, and much blame has been placed on the lack of appropriate legal mechanisms as well the government monopoly on all service sector projects. Previous mention has been given to the legislative act which enabled Islamic finance to operate. Most of the provisions of the act concern the mechanisms of an IFI. The Act, along with the amendments and additions made in 2003, creates a comprehensive framework addressing important aspects of Islamic banking. One important provision is on corporate governance which includes the stipulation that each institution should have a Shari’a board with three members. The Shari’a board is to report, not to the central bank, but the Ministry of Awqaf and Islamic Affairs. This is an interesting delimitation with KCB having no regulatory authority over the decisions of the Shari’a board, thereby separating the financial and Islamic aspects.

Islamists would like the government to do much more. In March, Five Islamist lawmakers including the head of Kuwait’s financial and economic committee, Barak Al-Muter, presented a draft bill to parliament for the full Islamisation of financial institutions in Kuwait. They argued that since the Kuwaiti constitution explicitly states that Islam is the religion of the state and is a major source of legislation, the Shari’a must be the de facto law. Separately, in March, the civil commercial department ruled that banks cannot collect additional interest on loans in accordance with Islamic regulations on which the state’s laws are based. Thus it would seem that Kuwait is heading towards islamisation of the financial sector, but this would be presumptuous. The central bank has attempted to level the playing field between the banks and not pandering to each and every request. In December 2010, KCB rejected a request by Islamic lenders to grant them exceptions from liquidity ratio requirements and for the withdrawal of excess liquidity. This was the second time the Gulf Arab state’s central bank rejected such a proposal.

There have also been chinks in the Islamic finance armour, caused by the global financial crisis. There were declines affected Kuwait’s real estate sector and stock market, which had a negative causation on Islamic banking profits. Merchant families and private sector organisations have also been affected by the recession. One notable example is Investment Dar. The Nakheel default in Dubai is commonly regarded as the moment Islamic finance structures began to be tested. However, prior to Nakheel, there was Investment Dar’s default of USD 100 million of sukuk maturing in October 2010. In April 2010, a Kuwaiti Court granted Investment Dar legal protection from its creditors. Since then it has attempted to restructure its debt.

Sunlight on the horizon

Undoubtedly, the recession would have an impact on the Islamic finance industry in Kuwait but as the world economy picks up, Kuwait will follow. Indicators are good that Islamic finance will continue to have a sizable impact on not only the financial markets, but also on wider society, KFH has stated that there will be double digit growth in 2010 due to Kuwait’s substantial oil revenue, increase competition in the market place and the development of new products on the market. Kuwait is also leading in terms of information technology. Path Solutions, the Kuwait based banking systems provider, has been achieving a great deal of success through the deployment of its iMal product. It was the first banking software firm to be recognized and certified by AAOIFI and has been adopted by leading Islamic finance organisations across.
the globe. The iMal software fills the gap of appropriate automated systems that accounts for the nuances of Islamic finance.

Kuwait also hopes to develop their research capacity in Islamic finance. Negotiations are underway for a Sabah Al-Ahmed Centre of Islamic Finance Research, an academic arena where researchers can devise Islamic finance solutions to problems arising in the financial markets. Thus, Kuwait is continuing their progress in Islamic finance with aplomb; slight obstacles are unlikely to wade it down.
Lebanon is a country of contrasts. Sadly, ethnic and sectarian tension alongside occasional war with Israel has caused much destruction and loss of life in Lebanon over the years. The instability in the country has caused it to economically suffer and has affected the growth of Islamic finance in the country.

Although the government enacted legislation on Islamic finance earlier this decade and made subsequent amendments, the industry has really struggled to gain a foothold in the Lebanese economy. According to estimates, Islamic financial assets are less than one percent of the total banking assets in the country, even though there are currently four Islamic banks, with a fifth having received its licence.

The government has been looking at making further amendments to legislation, to try and spur on growth in Islamic finance and has been actively engaging local stakeholders for their input. A problem that is common to many Islamic banks not just the ones in Lebanon, is the issue of how to manage excess liquidity. Realising this problem, the Lebanese central bank is looking at introducing a new facility this year which will enable Islamic banks in the country to manage their excess liquidity.

Whilst issuing sovereign sukuk would enhance the profile of Islamic finance, currently there are no plans for such an issuance. This is due to the fact that such issuances may require amendments in the current law, and the government does not want to be seen as favouring Islamic finance over conventional finance, but rather wants to create equal chances for them.

Lebanon was one of the first countries to only allow Islamic banks to offer Shari’a-compliant products, closing the door on the possibility of conventional banks having Islamic windows. This policy was later adopted by Malaysia and more recently Qatar. However, Malaysia initially allowed conventional banks to offer Islamic finance through windows, and only after the industry grew, did they adopt the policy. Early adoption of this policy by Lebanon stifled the growth of Islamic finance in the country.

However, according to executives at the Central Bank of Lebanon, Islamic banks are also to blame for their poor performance so far, due to the fact that they have not done enough to raise awareness about the industry and therefore, although Muslims make up 60% of the population, many of them are still patrons of conventional banks. Hence more needs to be done to raise awareness levels.

In a nutshell, it can be said that both the Lebanese authorities as well as the local Islamic finance players need to do much more to raise the profile of Islamic finance. There is no doubt potential for the industry to grow in Lebanon, as the country is home to a well educated Muslim population with expertise in banking. However, slow changes in legislation coupled with a lack of initiative by Islamic banks will hinder any further growth. Political instability in the country is another big issue that needs to be addressed.
The last few years have seen a boost in the Islamic finance movement, with the rise of Islamic finance ‘hubs’ and western governments’ willingness to give their Muslim communities access to financial services consistent with their religious beliefs. Luxembourg has played a key role in Islamic finance for a long time and pre-empted its growth by making available a whole range of Shari’a-compliant instruments – crucially, way before other western governments.

The importance of Luxembourg’s prime position for offering Shari’a-compliant investment instruments and vehicles is all the more exemplified by the fact that in many non-Muslim countries, the majority of conventional financial instruments are not tailored to Islamic finance in their existing form.

Strong government support and a favourable regulatory environment are the main drivers for Islamic companies and financial institutions to set up operations – and Luxembourg has long gone the extra mile to elevate its status to that of a global hub for Islamic finance. While Luxembourg is recognised as a leading European centre for Islamic finance, this is not the result of a recent initiative; rather, the result of a long track record in the sector. The Luxembourg stock exchange was the first European stock market to launch a sukuk; the Luxembourg Central Bank has recently been admitted as the first European bank of the Council of the IFSB; almost 40 Islamic funds are domiciled in Luxembourg, making it one of the world’s largest non-Muslim fund domicile with a 7 percent market share of the global market. A business-oriented environment, a proactive financial supervisory authority, and a flexible and secure framework are factors that enable Luxembourg to maximise the tax efficiency of its Shari’a-compliant products and spearhead global Islamic finance transactions.

Luxembourg remains a global investment centre and its renowned political and economic stability are key assets. In 2008, the Luxembourg government set up a multi-disciplinary taskforce charged with identifying obstacles to the development of Islamic finance and ways to further support its growth. Working groups focused on Islamic finance were also formed by the Luxembourg Investment Fund Association (ALFI) and Luxembourg for Finance. These are also taking place outside Luxembourg, in locations such as Dubai.
Luxembourg’s multilingual and multicultural workforce—of whom a fair proportion is knowledgeable in the field of Islamic finance—constitutes a prime vantage point. The commitment of advisory firms, auditors, lawyers and bankers to the continued growth of Islamic finance in Luxembourg is of paramount importance. Islamic finance-oriented education initiatives have also flourished, with the Diploma in Islamic Finance (partnership between the Luxembourg Banking Training Institute (IFBL) and the ICMA Centre of the University of Reading) and a further partnership between Luxembourg School of Finance (LSF) and INCEIF, the leading University in Islamic Finance in Malaysia.

A year ago, the Al Miyar platform was established in Luxembourg by Deutsche Bank, with an aim to facilitate the listing of Shari’a-compliant securities. Other platforms are currently under development and shall contribute to the expansion of the country as a global hub for Islamic finance.

In November 2009 the Central Bank of Luxembourg (BCL) became—and still remains—the first European bank to become a member of the IFSB, the prudential and supervisory standard setting body for global Islamic finance. The BCL will be hosting the 8th IFSB annual summit in 2011 (the first time the summit will be hosted by an EU member state). Also, the BCL was among eleven central banks and two multilateral organisations that signed an agreement for the establishment of the

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### Luxembourg’s tax treaty network (1 Dec 2010)

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To further boost its Islamic finance credentials, Luxembourg boasts a wide investment treaty network of over 80 countries (including Kuwait, Saudi Arabia, the United Arab Emirates, Malaysia, Kazakhstan, Uzbekistan, Turkey and India), and has concluded tax treaties with several Islamic countries (including the United Arab Emirates, Bahrain, Qatar, Malaysia, Morocco, Tunisia, Indonesia and Turkey).

A further impetus has been made to existing business relations and bilateral cooperation between Luxembourg and Bahrain and between Luxembourg for Finance and the DIFC with the signing earlier this year of an MoU. Luxembourg is also currently working on an MoU with several Central Banks established in Muslim countries.

The compatibility of the Luxembourg legal framework with Islamic finance requirements for the implementation of Shari’a-compliant products is of immeasurable importance. Luxembourg tax law is considered one of the most flexible and efficient within the European Union, and is constantly evolving to meet the needs of foreign investors. Islamic modes of finance such as mudaraba, musharaka, and diminishing musharaka; and Shari’a-compliant debt such as ijara, qard hasan, murabaha, or commodity murabaha, may be realised in a very tax-efficient manner. What’s more, unlike in many other jurisdictions, yield paid on pure income participating financing instruments may be deductible for Luxembourg corporate tax purposes and not subject to domestic withholding tax – irrespective of the status or residence of the recipient.

Luxembourg has recognised this and has developed a wide range of regulated investment vehicles (e.g. the société d’investissement à capital variable or SICAV, the société d’investissement à capital fixe or SICAF), semi-regulated investment vehicles (e.g. the société d’investissement à capital risqué or SICAR, the specialised investment fund or SIF), and unregulated holding companies (e.g. the société de participation financière or SOPARFI, the société de gestion de patrimoine familial or SPF), all accommodating the requirements of Islamic investors.

Besides this, a Shari’a board may be appointed in any type of Luxembourg regulated vehicle, and the purification of income is commonly accepted by Luxembourg authorities and service providers. Indeed, the Luxembourg financial supervisory authority has become increasingly familiar with Shari’a-compliant investment structures and is currently working on a set of guidelines or best practices for service providers to Islamic funds.

Shari’acompliant investment funds

As Europe’s largest centre for investment funds, Luxembourg has extended its reputation throughout the Middle East and in many ways spearheads the domiciliation of Islamic funds. Luxembourg is currently ranked fourth in terms of market share of Shari’a-compliant investment vehicles in the world, after Malaysia, Saudi Arabia and Kuwait, and is followed by Bahrain. There are currently almost 40 Islamic funds domiciled in Luxembourg, making it one of the world’s largest place of domicile outside of the Islamic world.

In recent years, Luxembourg has cemented its position as the most popular domicile for UCITS funds ("Undertakings for Collective Investment in Transferable Securities"). Originally created as a retail product, UCITS funds are widely sold both to the public and to corporate and institutional investors. Benefiting from a European distribution passport, UCITS funds may be marketed across the European Union, Asia, Latin America, and increasingly in the Middle East. Over 700 Luxembourg funds are registered in Bahrain (including Islamic Equity Funds, Shari’a-compliant Money Market Funds, Shari’a-compliant Exchange Traded Funds etc.), testifying to the suitability of all such funds to Islamic investors.

At the same time, Luxembourg has developed alternative structures, such as hedge funds, private equity and real estate funds. Structures such as the SIF (explained above) that allow a wide investment portfolio, are commonly used for Shari’a-compliant private equity and real estate schemes – be they aimed at institutional or high net worth individuals.

Sukuk

Beyond its particularly efficient investment vehicles, Luxembourg is a pivotal location for the listing of sukuk, especially due to its favourable legal framework allowing the issuance from all types of entities under various forms. The listing on the Luxembourg Stock Exchange is enhanced by limited administrative burden imposed by the Luxembourg financial supervisory authority – in stark contrast to many other jurisdictions.

In Luxembourg, the issuance of sukuk may ideally be structured through a SOPARFI or a securitisation vehicle. Both vehicles provide significant flexibility and may issue sukuk in the frame of private placements or listings on the Luxembourg Stock Exchange. Sixteen sukuk are currently listed and traded – including issuers from Malaysia, Saudi Arabia and the United Arab Emirates – with a combined value of over USD 7.8 billion, the first ever European stock exchange to list sukuk.

Microfinance

Microfinance aims at alleviating poverty through the supply of banking and financial services to poor or low-income clients. Such services are generally provided by microfinance institutions (credit cooperatives, non-governmental organisations). For investors, however, those services can be channelled through a microfinance investment vehicle (MIV) and this is where the Luxembourg investment funds sector comes into play.

The microfinance business is well-entrenched in the Luxembourg financial centre and enjoys strong government support. Almost 46 percent of global MIV assets are held by Luxembourg-domiciled MIVs, testifying to the country’s commitment for the continued growth and support of microfinance. Luxembourg provides a very attractive legal framework.
for MIVs which may be structured as UCIs, SICARs, SIFs or securitisation vehicles. As discussed previously, these vehicles can be used to build Shari’a-compliant MIVs. The choice of which vehicle will depend on the profile and requirements of investors. Luxembourg, as a leading European investment fund centre, offers all the flexibility and choice of MIV structures as well as recognised technical expertise.

The microfinance industry is gaining momentum by offering Shari’a-compliant investment products to Muslim communities that are reluctant to deal with conventional financial instruments, and Luxembourg ticks all the boxes to become a hub for Shari’a-compliant microfinance investment.

Charitable trusts

Luxembourg provides many advantages to companies and individuals willing to set up a foundation (or charitable trust) in Luxembourg.

This type of non-profit organization can donate funds, support organizations, or act as the sole source of funding for its own charitable activities.

There are broadly two types of foundations in Luxembourg:

- Individual (i.e. separate) foundation;
- Foundation as a “compartment” of the Foundation de Luxembourg, or sheltered foundation.

Major challenges facing the Islamic finance industry in Luxembourg

The magnitude of Luxembourg’s efforts - ever since the country’s emergence as an interesting holding and financing jurisdiction in the late 1980s - to elevate its status to that of a major international hub for Islamic finance is undeniable. But for all the efforts made, Luxembourg remains in the shadow of several other jurisdictions continuously favoured by Islamic investors. For all the cosmopolitanism that characterises Luxembourg’s workforce, the Muslim community in Luxembourg remains very small compared with its neighbouring countries. The hitherto arguably unforeseeable establishment of a retail Islamic bank in Luxembourg has, however, been mitigated by the two circulars of 2010. These were issued by the Luxembourg tax authorities in 2010 with an aim to cover and secure the domestic tax treatment of certain Shari’a-compliant transactions, that could pave the way for the marketing (on a European scale) of Islamic products issued by a Luxembourg-domiciled Islamic retail bank.

All players in the Luxembourg market are raising their game and are eager to show the Muslim world how essential Luxembourg can be for the future expansion of Islamic finance.

Looking ahead

Luxembourg has undeniably established a level playing field for all major Islamic products, and the factors underpinned in this article testify to its role as a global hub for Islamic finance. The flexibility, security and stability that Luxembourg offers, permit the availability of cutting-edge investment instruments and vehicles, Islamic products bearing exceedingly low effective taxation and the further expansion of Islamic transactions.
Malaysia is to Islamic finance, what America is to Capitalism: its indefatigable champion. Every limb and branch of the Islamic finance paradigm, Malaysia has a perceptible influence: from innovation in the capital markets to developing cogent education policies. Even with a dual market, where conventional and Islamic finance coexist, the government has shown more enterprise and boldness than any other self proclaimed Islamic finance hub to create an infrastructure which will fortify the domestic and global Islamic finance market.

No less a figure than the current US Secretary of State Hilary Clinton praised Malaysia’s efforts for what she described as a ‘creative approach’ to Islamic finance. Speaking at the International Institute for Islamic Thought and Civilization (IIITC) in November, Clinton further commented that Malaysia could be a global ‘thought leader’ in Muslim affairs. This is quite a panegyric for a nation far from the traditional home of Islam.

But the statement is underpinned with evidential substance, especially with regards to Islamic finance. Over the last ten years, Malaysia has progressively built their Islamic finance industry, creating a unique and distinctly Malaysian approach. Not fettered by the idea that Islamic thought development belongs to the Middle East or to South Asian countries such as Pakistan, it has taken necessary steps to ensure that Islamic finance will thrive globally. According to market practitioners, Malaysia has an array of Shari'a-compliant products and an alternative for every conventional product available. In such an environment, Islamic finance is bound to prosper. 

Industry overview

According to Central Bank figures from December 2010, Islamic banking assets totalled $109 billion according to the 2010-2011 Economic Report from the Ministry of Finance. There are 17 licensed Islamic banks, six of which are foreign owned; and 10 takaful operators, two of which are foreign owned.

The sukuk market has been particularly vibrant in 2010. The Bursa Malaysia has retained its position as the top sukuk listing destination. Malaysia’s Islamic bond auctions drew record bids this year. Demand for sukuk exceeded the amount offered. The excess demand was from Islamic banks in Malaysia as well from foreign investors. The government on the other hand borrowed less as the economy recovers from its first contraction in a decade; they are aiming to cut the budget deficit to 5.6 percent of GDP from a 22 year high of seven percent. That being said, the government have issued a number of sukuk this year including its first international debt issue since 2002. It is hoped that the five year dollar dominated jara sukuk will set a new benchmark for pricing bonds in Malaysia. The government sold USD 1.25 billion after attracting orders of almost USD 5.5 billion. In June, the Government announced a five year plan indicating that annual development spending will rise by 2015, and it is expected that sukuk will account for much of the expenditure. This is surprising as the government to date have taken a diminutive approach to issuing sovereign sukuk, hence explaining the scarcity of said issuances.

Notwithstanding the general size of the sukuk market, total sales of the sukuk have dropped 24 percent to USD 15.3 billion this year. In order to reverse the fall, discussions are underway between Bursa Malaysia and regulators on enabling companies to issue sukuk affordable to the public thereby broadening the customer base. Even with the fall in the sukuk sales, this has been offset by the ringgit rally, spurring demand from foreign investors. Commentators highlight strong national growth along with low indebtedness making the ringgit attractive to investors.

Malaysian firms have been active in all aspects of sukuk issuance. In 2009, CIMB was the top global underwriter managing USD 4.4 billion worth of sukuk, beating the
global giant HSBC. Bloomberg data shows that as of September 2010, three of the top five underwriters of sukuk are Malaysian based. Malaysia’s dominance in the sukuk market, as compared to its Gulf competitors owes itself to the broader breadth of its capital markets. There is a far more active secondary market in Malaysia and investor choice differs. In the Gulf, investors buy and hold bonds until maturity. Bank Negara and Securities Commission have provided better regulation with detailed rules for sukuk issuance, while in the Gulf, the set of standards are not as comprehensive.

With respect to fund management, according to the Malaysia’s Securities Commission, there are currently 152 Islamic funds registered with total Net Asset Value (NAV) of USD 7.1 billion. The Commission believe that the fund management sector is the fastest growing segment of Malaysia’s Islamic capital market, with an annual compounded growth of more than 25% over the last five years. Part of Malaysia’s success in the fund management industry is due its more innovative approach to product development as compared to the GCC countries that have based their fund structures largely to conventional models. Attractive tax incentives have been offered by the government contributing to the growth. Moreover, the Securities Commission has been active in collaborating with other important market regulators such as the DFSA and the Securities and Futures Commission of Hong Kong. These relationships have helped broaden the distribution network and promoted an exchange of ideas regarding the development of the fund markets. As part of Malaysia’s liberalisation policies, the government has issued 14 licenses allowing international companies to form Islamic fund management businesses and companies.

Liberalising takaful

At approximately 8 percent of the total insurance assets in the industry, takaful in Malaysia is not as strong as it perhaps could be. As compared to Islamic banking, which holds 19 percent of the Malaysian banking sector, takaful firms have not been growing as fast over the past ten years. Part of the problem is that takaful firms have few investment opportunities as compared to conventional insurers. There has been a difficulty in developing products and increasing distribution channel and with over reliance on the regional equity and real estate markets, takaful firm are limited from enhancing their liquidity base. A more pervasive problem has been the lack of global uniformity of Shari’a standards hindering the increase of demand.

Malaysia plans to address these problems by issuing long term paper; including longer dated sovereign sukuk. In order to increase competition, and bring in increased capital, Bank Negara lifted the cap on foreign equity holdings of takaful operators and conventional insurers from 49% to 70%. This has been part of their liberalisation plan for the whole financial sector; and the cap has also been lifted for conventional and Islamic banks. At the same time, Bank Negara issued four new family takaful licenses. Notable companies to have procured the licenses included Netherlands based ING and Friends Provident from the UK.

Changing regulation

Malaysia is considered as having the most systematic approach to Islamic financial services regulation of which they are continuously improving. A major benefactor has been the government who have allowed innovations and developments and encouraged the creation of an institutional framework which could support Islamic finance. Foreign bankers have stressed that Malaysia’s attraction as an Islamic banking hub is partly due to the government’s active support.

Consequently, the Malaysian legal framework for Islamic finance is undoubtedly the most comprehensive compared to other interested jurisdictions and credit has to be given to the Government and regulatory authorities such as Malaysia’s central bank, Bank Negara. Malaysia started with the passing of Banking & Financial Institutions Act (1983) which includes the Islamic Banking Act. This was followed swiftly with the Takaful Act 1984. In 2009 the government introduced two new updated acts — the Central Bank of Malaysia Act 2009 and the Capital Markets and Services Act (CMSA) 2009. A pivotal act has been the Central Bank of Malaysia Act 2009, which took effect in November of the same year. Two key pronouncements have been made in terms of regulation: 1) In Malaysia’s dualistic financial system, conventional and Islamic financial systems will share parity; and 2) Dispute in Shari’a matters shall be brought to the Central Shari’a Board of Bank Negara, the Shari’a Advisory Council (SAC).

Cumulatively, what this effectively means is that legal disputes in Islamic finance will be adjudicated by judges who have the requisite skills and knowledge in the Shari’a and more specifically, Fiqh ul Muamalat. Malaysia has taken a systematic approach to Shari’a governance, ensuring a reduction of conflict of interest and a minimisation of Shari’a differences of opinion through the institutionalisation of a centralised Shari’a board at the Bank Negara, who by law acts as the authority of last resort. There is also a Shari’a board that advises the Securities Commission. The centralised Shari’a board’s rulings are binding on courts and arbitrators. In the event of litigation, a dedicated judge has been placed in the commercial division of the High Court in Malaysia, who will preside over cases and will consult with the Shari’a board.

Bank Negara is in the process of changing Shari’a governance guidelines, which will set standards of Shari’a-compliance over the next decade. They plan to set parameters for murabaha, jara, mudaraba, musharakah, istisna and wadia contracts. In October, Bank Negara set up the Law Harmonisation Committee, a body tasked to seek ways of harmonising Shari’a laws with counterpart laws in the conventional system. The committee will gather the views and opinions of key stakeholders, deriving appropriate recommendations to strengthen the legal framework. The main objectives are to review existing Malaysian Islamic finance laws, propose necessary amendments to give legal recognition and develop the Malaysian legal framework as the law of choice for international financial transactions.

At Labuan International Banking and Financial Centre,
Malaysia’s offshore centre, there have also been amendments and enactments of legislation which will facilitate and strengthen Islamic finance. The Labuan Islamic Financial Services and Securities Act (2010) has made Labuan the first common law international financial centre to have specific legislation governing Islamic financial services.

Opening the markets

Much of Malaysia’s success owes itself to impressive foresight in 2001, with the launch of The Financial Sector Master Plan (FSMP), a strategic plan consisting of a series of measures and a timetable for the liberalisation of the conventional and Islamic financial sectors. Kuwait Finance House was the first foreign Islamic bank to set up in 2004. In 2006, the Malaysia International Islamic Financial Centre (MIIFC) was set up, whose core mandate is to promote Malaysia as a major Islamic finance hub. Since then, foreign ownership rules have been eased making it easier to trade in foreign currencies. The setting up of MIIFC facilitated the issuing of International Islamic Banking Licenses (IIBL) to a number of foreign owned banks. HSBC, Citigroup, and Standard Chartered and Al Rajhi now have standalone Islamic banking subsidiaries in Malaysia. In April, Bank Negara authorised Deutsche Bank to conduct a full range of Islamic banking activities in foreign currencies out of Malaysia. Not content to ease into their stride, Deutsche bank launched the global focus. Part of the objective of these megabanks will be to become an effective competitor with the conventional giants that dominate the market. Currently, there will be co-operation between leading institutions to assist in the development of real estate, energy capabilities, communication facilities, amongst other things. It is envisioned that sukuk’s will be a common source of raising finance.

The IIB regime has a number of features salutary to foreign firms who wish to enter Malaysia. Some incentives include tax exemptions till 2016 on income earned from Islamic banking and takaful operations conducted in foreign currencies. The regime allows 100% equity ownership and removes immigration barriers thereby making it easier to employ international experts who can add value to the IFI’s service provision. Malaysia has offered five licenses to international law firms to open dedicated Islamic finance branches in the country. This has proved less than successful with reservations coming from the Malaysian Bar Council and international law firms. The Council believe that this kind of deregulation will be detrimental to the local legal market, while the law firms argue that focusing on particular field would not be a profitable venture.

In November, Bank Negara announced that it would grant two licenses to foreign owned banks to establish Islamic megabanks in Malaysia. To be a megabank, the banks need to have USD 1 billion paid up capital and a global focus. Part of the objective of these megabanks will be to become an effective competitor with the conventional giants that dominate the market. Currently, there are discussions involving banks in Malaysia, Bahrain and Qatar but an element of secrecy surrounds the affair and details are scant.

But while there are concerted efforts to draw international financial institutions to Malaysia, domestic institutions are looking to regional markets. CIMB has a presence in 11 countries and is looking to expand further. Maybank, Malaysia’s largest lender, has plans to expand its Islamic finance business in Singapore and Indonesia. Khazanah Nasional Berhad, the investment holding arm of the Government of Malaysia issued its largest sukuk in Singaporean dollars with a value of SGD 1.5 billion making in the largest SGD issuance by a foreign issuer in Singapore. BIMB is one of the stake holders of Sri Lanka’s Amanah investments and is currently considering whether to raise its stake. In March, Asian Islamic Investment Management (AIMAN) partnered with Hwang DBS Investment Management Bhd to launch the USD 100 million Islamic Hwang DBS A20 China Access Fund, which grants investors access to the lucrative Chinese A-Share market, one of the two types of stocks issued by the Shanghai or Shenzhen stock exchange. The AIMAN A20 will invest into the 20 largest Sharia’a-compliant China A-share companies, in terms of their market capitalization. It is the first non-ringgit Islamic wholesale fund and the first to focus on China A-shares.

Focus is not limited to neighbouring countries. Working relationships have been established with indigenous IFIs and regulatory bodies in Gulf States and beyond. AmanahRaya Investment Bank partnered with Bahrain’s Capital Partners Holdings to launch the Global Halal Ventures Fund in May. The fund has been created to invest in halal related businesses in Muslim countries to tap into the huge demand available. Another example is the collaboration of Malaysian Islamic banks with their UK counterparts to stimulate cross border transactions between countries. We are seeing manifestations of partnerships between the two countries already. UK’s Standard Chartered and BIMB plan to offer Sharia’a-compliant derivatives in Malaysia, commencing from the first quarter of 2011. The derivatives will provide protection from fluctuations in price of basic commodities.

Ensuring protection for investors and creating an effective risk management framework is a key concern for Malaysian regulations. The Securities Commission have been proactive in securing ties with capital market regulators and has signed 29 MoUs since 1994. In December, Malaysia’s Securities Commission signed an MoU with Qatar Financial Markets Authority (QFMA) to strengthen cooperation, with a focus on enhancing investor protection.

To enhance the global framework for Islamic finance, Malaysia has ambitious plans to develop a space in which there will be co-operation between leading institutions and regulators. In October, sovereign wealth funds from Malaysia and Abu Dhabi signed an agreement to build a USD 8.4 billion international financial district in the capital, Kuala Lumpur. It will be a 34 hectare site for banks, professional service firms, regulators and financial institutions to co-locate. Construction is expected to commence in 2011 and highlights Malaysia’s ambition as well as need to bring in foreign investment to build the physical infrastructure necessary for Malaysia to achieve developed nation status by 2020. Leveraging on their Islamic credentials, Malaysia has attracted Gulf institutions to assist in the development of real estate, energy capabilities, communication facilities, amongst other things. It is envisioned that sukuk’s will be a common source of raising finance.
Malaysia’s progressive development of the Islamic finance industry is not parochial in outlook and delimited to within the borders of Malaysia. Multinational organisations such as the IFSB are based in Malaysia. IFSB has been prominent in the market for issuing international standards to ensure soundness, stability and transparency in the Islamic finance industry. In October, IFSB set up the International Islamic Liquidity Management Corporation (IILM). The primary objective of the ILM is to issue Shari’a-compliant instruments to facilitate liquidity management solutions for IFIs. This has been a particular problem for IFIs who are prevented from accessing conventional liquidity markets due to Islamic prohibitions. Through developing instruments and procedures to, and encouraging cooperation between member countries, it is hoped that this pervasive problem will be solved. Malaysia had already created the Bursa Suq al Sila in 2009, an electronic platform, that enables banks and companies to buy and sell basic commodities that are used as assets to back Islamic loans thereby managing short term liquidity. But the ILM represents a source organisation through which Shari’a-compliant instruments will be issued.

There were 11 central bank signatories to the agreement from Indonesia, Iran, Luxembourg, Malaysia, Mauritius, Nigeria, Qatar, Saudi Arabia, Sudan, Turkey and the United Arab Emirates. Multilateral organisations such as IDB and the Islamic Corporation for the Development of the Private Sector (ICD) are also signatories. The Malaysia parliament is currently drafting legislation for a special enabling act which will accord the ILM a diplomatic status granting it privileges.

The knowledge economy

Boasting a vibrant and dynamic market, Malaysian institutions and thinkers are highly sought after by countries wishing to develop their own Islamic finance capacity. China, Hong Kong, South Korea, Singapore, Indonesia, Australia, Brunei have all garnered assistance. It would suffice to give a few examples. In 2009, Bursa Malaysia and Korea Exchange (KRX) co-organised an Islamic capital market conference in South Korea to stimulate interest in the trading of Shari’a-compliant products. South Korea was looking to issue a sovereign sukuk, and sought advice from leading Islamic finance scholar, Dr Mohd Daud Bakar, of Amanie Business Solutions. Amanie set up in Dubai in 2008 to provide Shari’a advisory services, as well as offer a range of training and education programmes in Islamic finance.

Amanie’s expansion into Dubai attests to Malaysia’s pre-eminence in the field of education and training in Islamic finance, though many would argue that Malaysia’s more liberal approach to Islamic finance dilutes its authority on the subject matter. Nevertheless, as a leading market, it still holds credibility and value especially to those who are not well versed in this field; and with a mature academic system in Islamic finance, people are flocking to Malaysia.

Hitherto, Malaysia’s International Centre for Education in Islamic Finance (INCEIF), set up by the central bank in 2006, has been a leading provider of Islamic financial qualifications. These include the Chartered Islamic Financial Professional (CIFP), qualification, a Masters and a PhD. INCEIF have partnered with universities, such as Reading University UK, to offer Islamic finance programmes. In 2010, they have sought collaboration from three institutions in Jordan, the University of Luxembourg, Chinese University of Hong Kong and the Reims Management School in France. A wider network is part of INCEIF’s desire to be a truly global university. Returning back to the private sector, an important organisation in terms of producing ground breaking research and producing recommendations to strengthen the framework of Islamic finance has been the International Shari’a Research Academy (ISRA). ISRA has developed a global reputation for their research into Islamic finance, which has led to collaborations with local and international bodies to enhance Islamic finance thought leadership. In November 2009, they signed three memorandums with Affin Islamic Bank, IRTI and KFH Malaysia. The latter collaboration has resulted in translating to English, Shari’a resolutions from the fatwa and Shari’a supervisory board meetings of KFH held from its inception in 1977 up to 2009. The material will be source material to non-Arabic speaking Shari’a boards across the world.

Malaysia has also taken serious steps in ensuring there is more female involvement on Shari’a issues. There are currently 10 women Shari’a advisers in Malaysia. Anecdotal numbers suggest that there are no female advisers in the Middle East. Women are also chief executives of major financial institutions such as EONCap Islamic.

A quiet 2011?

It would be fair to say that ongoing growth of Islamic finance in Malaysia will continue with aplomb. Malaysia does have a dual system and the conventional system is still dominant; but the strong government support has given Malaysia a leading position in Islamic finance. So much so that regions in Malaysia can experiment - to some extent- with their financial systems. In August, Kelantan, one of the 13 states of Malaysia situated to the North East introduced gold dinars and silver dirhams as currency. Within a few months, gold dinars were sold out. However, the Bank Negara has warned that the currency cannot be used as legal tender; only the ringgit is permitted. The currency can however be used as investment.

This may have been a local occurrence but the audacity suggests the openness of the Malaysian market and willingness to countenance new, slightly controversial, projects. In many respects, Malaysia’s Islamic finance market has grown due to the flexibility and space granted to it. Provide the space and it is unlikely growth and innovation will be unabated.
Honeymoons are often instinctively associated with this idyllic island lying close to the Indian peninsula. The prospect of white sands and sky blue seas tempts and tantalises couples beginning their journey into married life. Tourism is therefore a major source of income, as thousands flock to experience what the Maldives call the ‘sunny side of life’. Ibn Battuta, the intrepid 14th century traveller commented that these ‘islands are to be reckoned as one of the wonders of the world’. He was also impressed by piety and religious uprightness of its inhabitants.

Seven centuries on, Ibn Battuta would have been quite intrigued with the culture and activities of its inhabitants and migrants. He would also have been impressed that the state religion of the Maldives is Islam. This is hardly surprising considering 99% of the Maldives’ 400,000 population is Muslim. What may have beguiled him is how 3000 people from the Maldives suddenly lost their citizenship due to amendments in the constitution. In 2008, a revision was made in which it states under Article 9d, ‘a non-Muslim may not become a citizen of the Maldives’ Islam is uncompromisingly a mainstay for the Maldives.

2008: a milestone year

2008 seems to be a milestone year for all things Islamic in the Maldives. An Islamic Finance Unit was established in the Maldives Monetary Authority to facilitate the setting up of an Islamic bank. This project was initiated with a USD 4 million grant as investment equity from the Islamic Corporation for the Development of the Private Sector (ICD). Work was carried out to develop a suitable regulatory framework and partners such as the Idb were called to assist in the setting up of the bank. In 2009, CIMA in Sri Lanka launched the CIMA Islamic finance qualification in the Maldives, anticipating the need to develop the human resource capacity in Islamic finance. There was yet an Islamic bank in the Maldives.

2010: so commences Islamic finance

It was only in August 2010 that the Maldives Monetary Authority issued a licence to Maldives Islamic Bank Private, establishing the country’s first IFI. The ICD holds a 70% stake in the bank and the remaining is held by the government of the Maldives. To develop the institution, the Maldives Islamic Bank (MIB) and the Islamic Banking and Finance Institute Malaysia (IBFIM) signed an agreement in November 2010 in which IBFIM will assist MIB develop their Shari’a-compliant banking products. There had already been Islamic finance activity in the Maldives since 2005. Amana Takaful (Sri Lanka) had been offering takaful services in the Maldives through agents. To consolidate, they received a general insurance license in March 2010 and have a branch in the capital Malé. To support the activities of the bank, the Maldives parliament sanctioned the Maldives Banking Bill which includes a chapter on the practices of Islamic banking. Maldives Islamic Bank enters a banking sector consisting of five banks, only one of which is a local bank. Opportunities therefore abound but just like those absorbed couples that come every year, Islamic finance in the Maldives is still in its honeymoon period.

MALDIVES
The groundwork is being laid for Islamic finance to flourish on this island state. It is already recognised as an attractive location for structuring Islamic funds, due to the taxation regime of the country. Taxation agreements with over 30 countries mean funds domiciled in Mauritius, do not incur any capital gains tax on shares in a company based abroad. Now, Mauritius is considering issuing a sukuk in order to draw investment from the gulf and the Far East.

For this to transpire, there have been several regulatory changes. Specifically for sukuk, an amendment was brought in the Public Debt Management Act 2008 that modifies the definition of government securities. Sovereign sukuk have now fallen under the definition. Consequently, there is an expectation that a sovereign sukuk will be released in 2011, which will facilitate the creation of an Islamic interbank money market. In turn, it is hoped that the money market will cater to the liquidity requirements of Islamic financial services that are present in the country.

A pivotal moment for Islamic banking in the country was the passing of the Finance Act 2007, which brought in amendments to the Banking Act 2004. The Act stated that banks incorporated under the 2004 Act were permitted to provide Islamic finance services, subject to the granting of a licence by the Bank of Mauritius. The first Islamic banking licence was granted in October 2009, with HSBC opening an Islamic window to provide basic Islamic finance services such as current accounts and term investment accounts. There haven’t been any significant enhancements in the product portfolio of HSBC. The Bank of Mauritius also published guidelines for Islamic banking which cover governance, risk management, capital adequacy and auditing standards.

The regulatory framework has therefore been set. Consequently, the recent announcement that an Islamic bank will be set up by the end of 2011, commenced phase two of the Mauritius progress in Islamic finance. Phase one comprised of building relationships with IFIs and centres. Mauritius has drawn guidance from the experience of other countries that have Islamic finance operations, particularly UK, Singapore and Malaysia. They have also become a full member of the IFSB in 2009 which has assisted Mauritius to develop their liquidity management capacity. Moreover, the Bank of Mauritius was one of the ten other central banks that signed the Articles of Agreement of the International Islamic Liquidity Management Corporation (IILMC) in October 2010.

Phase two will involve further developments of the financial markets in Mauritius. The setting up of an Islamic bank will lead to the proliferation of Sharia-compliant securities. Bank of Mauritius has already organised a seminar on Islamic capital markets in June 2009; and along with their membership to the IILM, there are signs that Mauritius are keen to enhance their own capital markets. The launch of the Islamic bank will act as a catalyst and accelerate the already impressive progress made by the island state.
The Kingdom of Morocco is a popular tourist destination for many holidaymakers from Europe and beyond. It has a rich culture stemming from Arab, Berber, French and African traditions. The country is situated in the north of Africa and strategically located along the coastlines of the Atlantic and Mediterranean coastlines. With the majority of the population Muslim, Morocco would seem a likely destination for Islamic finance. However, the government has been slow to encourage its development, due to the fear that it may back the Islamist opposition. Furthermore, terrorist attacks in Morocco have contributed to this stance.

The Moroccan government has started to allow banks to offer Sharia-compliant products following much demand for them. Initially, only conventional banks were allowed to offer some Islamic financial products such as ijara-based products. Stand-alone Islamic banks were not allowed in the country. Furthermore, even though conventional banks were allowed to offer Sharia-compliant products, the cost was much higher due to higher tax, and they were known as alternative financing products.

The years 2009 & 2010 saw significant regulatory changes in the tax structure in Morocco to facilitate the entrance of the IFI. In the Financial Act of 2009, steps were taken to remove the double imposition of registration fees on property financed by murabaha, and in January 2010, the VAT on alternative banking products such as murabaha and ijara was reduced to 10% from the previous 20% levy. This change created a more level playing field for Islamic banks to compete with their conventional counterparts.

Additionally, the Moroccan Central Bank gave its approval for an Islamic finance subsidiary to be launched by Attijariwafa, in May 2010. The subsidiary known as Dar Assafaa Littamwil announced its fund launch in July 2010, and is 100% owned by Attijariwafa Bank with a capitalisation of around USD 5.7 million. Although the start up capital was not so high, the Bank is willing to consider partners in capitalising the company.

Dar Assafaa will offer a whole range of Sharia-compliant financing through 9 branches such as vehicle financing, personal and consumer financing. The products will be marketed under the term “alternative” financing, the official term for Sharia-compliant financing.

Whilst the government seems to have changed its attitude towards the development of Islamic finance within Morocco, a lot more needs to be done so that the industry can make more inroads. Failure to do so will see Morocco lose the opportunity to capitalise on the benefits of Islamic finance for its economy and citizens.
Elections will be held in 2011 in Nigeria and it is likely that the current ruling party, the Peoples Democratic Party (PDP) will regain power once again especially since they have managed to hold onto power for the three previous elections (1999, 2003, and 2007). Some political analysts believe another term for the present incumbent, Goodluck Jonathan, will be good for the financial health of Africa’s most populace nation as he is known by the international community.

Possibly. But there are worrying signs that the economy is in the doldrums. In 2009, the Central Bank of Nigeria (CBN) bailed out 10 banks last year with 620 billion naira (USD 4.1 billion) to prevent a collapse of the financial system. Increasing inflation rates, depletion of currency reserves coupled with the foreign flight of oil income has led to questions regarding the management of the economy by the government. However, Goodluck Jonathan’s tenure as president began only in May after the death of the previous president. A year in power leading up to the elections may not be enough to give a proper appraisal of his rule.

Should he win the elections in April, part of Mr. Jonathan’s mandate will be to continue Nigeria’s aspirations of becoming a financial hub in Africa by 2020. The Financial System Strategy (FSS) 20: 2020 is a strategic economic plan launched in 2007 which aims to engineer Nigeria’s transformation into one of the 20 largest economies in the world by 2020. Part of its strategy to strengthen the domestic financial markets is improving finance access for the large unbanked sector and integrating the informal sector into the formal financial sector. In this regard, Islamic finance plays an important role.

Building relationships

It has been in the last few years that a concerted effort to bring Islamic finance into Nigeria has manifested. But recognition of Shari’a-compliant products has been inhered in Nigerian legislation. Non-interest banking is provided for in the Financial Institution Act 1991, in which profit and loss sharing is recognised; though the Act proscribes the use of religious terminology in the registration of a bank’s name. Following the passing of this Act, Habib Bank was given a licence to operate an Islamic banking window which is still operational today, but under the name of Bank PHB. In 2007, Bank PHB designed products to encourage Islamic banking in Muslim communities. However, this attempt did not achieve significant success or growth.

Material developments have occurred from 2009 onwards. Nigeria has sought to establish relationships with multilateral organisations such as the IDB, becoming a member in 2009. The IDB approved a Technical Assistance program to build capacity and create awareness on Islamic banking in Nigeria. Nigeria is hoping that IDB will assist in enhancing the physical infrastructure of the country, including construction, transportation and power. According to the Government, Nigeria does not need aid, but financial support, and will be looking for investment in order to reach their goals under the FSS. They also joined the IFSB in 2009. In April 2010, the IFSB agreed in principle the establishment of an inter-governmental special purpose entity to help in building liquidity management infrastructure. Along with membership with Islamic multilateral organisations, CBN has signed MoUs with other central banks such as Bank of Sudan and Malaysia’s Bank Negara to educate on the regulatory aspects of Islamic finance.

A portentous event occurred in July with the gathering of state officials in Abuja from eight Muslim countries: Iran, Nigeria, Bangladesh, Egypt, Indonesia, Malaysia, Pakistan and Turkey. Delegates sat to discuss the prospect of developing business ties and reducing trade obstacles thereby creating an Islamic common market. Trade between the eight Islamic nations is estimated
to be worth about USD 68 billion a year, or about 3% of global trade. Further, cooperation will increase trade and with Islamic finance being an important constituent of the financial markets for five of these countries, Nigeria’s Islamic finance market could benefit significantly.

EFInA (Enhancing Financial Innovation and Access), an independent non-profit organisation funded by DFID and the Bill & Melinda Gates Foundation was set up in late 2007, with a mission statement to promote Financial Sector Development and Financial Inclusion in Nigeria. It has taken a proactive stance towards Islamic financing, co-opting stakeholders and international market operators in Islamic finance to create a strategy to disseminate Shari’a-compliant products.

Amending legislation

Up to 2009, the regulatory framework was not sufficient for Islamic finance to prosper. Things changed with the passing of the law governing the operation of Islamic banks in March 2009. This was followed in January 2010, with the establishment of a non interest banking unit in the Financial Policy and Regulation Department of the Central Bank. In September, the Nigeria Deposit Insurance Scheme (NDIC) released its draft framework for a non-interest Deposit Insurance Scheme for discussion. NDIC had sent six of its personnel to Malaysia to acquire the necessary knowledge on Islamic deposit insurance thereby assisting them in creating an appropriate framework. In addition, the Debt Management Office (DMO) set a tentative timetable for the development of the first sukuk to be issued from Nigeria.

The CBN has strengthened the Islamic finance regulatory framework with the publication of “Guidelines on Shariah Governance for Non-interest Financial Institutions in Nigeria” (The Guidelines) and the “Framework for the Regulation and Supervision of Institutions Offering Non-interest Financial Services in Nigeria” (The Framework) released in Dec 2010 and Jan 2011, respectively.

The Guidelines clarifies that the CBN will set up a National Shari’a Advisory Board, to be called CBN Shari’a Council. The Guidelines contain details on the fit and proper criteria for scholars on boards which are to be set up for every IFI. The Shari’a Advisory Committee, as it will be known, will operate as an independent body for the bank.

The Framework does not make reference to Islamic banks instead defining them as non-interest financial institutions (NIFI) which, “transacts banking business, engages in trading, investment and commercial activities as well as the provision of financial products and services in accordance with Shari’a principles and rules of Islamic commercial jurisprudence”. In August, CBN had released information on the banking model in Nigeria. It defined non interest banks as specialised banks which are committed to setting up non-interest institutions such as Islamic banks. Since their formation, they have lobbied the government for an Islamic bank license in Nigeria but have been hindered by the then stringent capital requirements, a lack of committed investors and the global economic crisis. However, with the CBN publication and the lowering of the capital requirements, there is a greater sense of opportunity.

To encourage Islamic capital markets, the demutualisation of the Nigerian Stock Exchange (NSE) will allow foreign investments and create a trading platform on which Islamic securities can be traded. Currently, the NSE is in its early stages of demutualisation, but with the fall of investor confidence, the time is ripe for increasing the amount of tradable securities.

Challenges ahead

The CBN publications have not been met with resounding support. Accusations have been levelled against the CBN governor, Sanusi Lamido Sanusi, of having a ‘Northern Agenda’. Nigeria has been suffering from internecine strife between Muslims based in the North and the Christians in the South. The PDP has attempted to reconcile the two parties by having Muslim and Christian leaders alternating terms in power, but frictions still remain. For the spread of Islamic finance, there needs to be support from both sides. Thankfully, certain Christian groups have shown interest in operating a NIFI.

A more grievous problem is the economic situation...
and the underdeveloped infrastructure in the country. Nigeria is a dependent economy which is a major factor behind the depletion of reserves. Lack of investment in the infrastructure has made it difficult for the country to create a vibrant manufacturing sector though their oil reserves have been a sufficient substitute. The West African country holds the eighth-highest crude oil reserves among OPEC members but is seeking to diversify the economy by developing its finance industry. This will be a tough task. According to EFInA’s Access to Finance 2008 Survey, it showed that 68 million Nigerians representing 79 per cent of the adult population were unbanked. In addition, rampant corruption, imprudent management and the uneven distribution of wealth in the country have weakened the country’s economy. If Goodluck Jonathan is to succeed as President, he needs to find effective strategies in dealing with these issues. And whilst Islamic finance is unlikely to be priority in his policy agenda, it will certainly be a critical aspect in developing a much more robust and wide ranging monetary policy. The CBN have laid the framework; it is time for IFIs to seize the opportunities.
The desire for an Islamic economic system in Pakistan is as old as its independence. The Pakistan movement in British India during the first half of the last century was aimed at obtaining a separate country for the Muslims where they could lead their lives according to Islamic principles. This ideology necessitated every government, since independence in 1947, to take steps towards islamisation of the economy, especially the financial system. The founder of Pakistan, Muhammad Ali Jinnah, also emphasized the need for an economic system based on the Islamic principles of equity, justice and broad-based distribution of economic gains while inaugurating the country’s central bank, the State Bank of Pakistan (SBP) in 1948. Mr. Jinnah in his speech said:

"…I need hardly dilate on the important role that the State Bank will have to play in regulating the economic life of our country…I shall watch with keenness the work of your Research Organization in evolving banking practices compatible with Islamic ideas of social and economic life... The adoption of Western economic theory and practice will not help us in achieving our goal of creating a happy and contented people. We must work our destiny in our own way and present to the world an economic system based on true Islamic concept of equality of manhood and social justice. We will thereby be fulfilling our mission as Muslims and giving to humanity the message of peace which alone can save and secure the welfare, happiness and prosperity of mankind."

Further, all three constitutions the country has had since independence i.e. constitutions of 1956, 1962 and 1973, had preamble clauses that no law repugnant to the injunctions of Islam shall be enacted in the country. The 1962 and 1973 constitutions provided for the creation of the Council of Islamic Ideology (CII); the 1973 constitution (the existing constitution of Pakistan) also required the Government to ensure earliest possible elimination of riba from the country’s economic system as one of the principles of the state policy. The riba free economic system is thus a constitutional obligation of the government of Pakistan.

**Evolution of Islamic banking in Pakistan**

The Council of Islamic Ideology (CII) report on the transformation of the economic system to one based on Shari’a principles in 1970s, was the first serious attempt by a state institution to provide a strategy culminating in elimination of riba from the country’s economic and financial system. The report gave the necessary conceptual framework and time-frame for islamisation of the financial system, encompassing government debt and monetary policy. The report, prepared by a panel of Shari’a scholars, economists and bankers covered the islamisation of (a) government transactions for financing fiscal deficit, (b) State Bank of Pakistan’s domestic transactions and monetary policy, (c) bank deposits, (d) loans for fixed investment in industry, agriculture, construction, etc, (e) financing of working capital requirements, and (f) co-operative credit systems. The report recommended the government to complete the process of elimination of riba by July 1982.

The government started implementing the CII recommendations in the late 1970s with the conversion of specialized financial institutions like House building Finance Corporation (a government owned mortgage finance company with focus on low income clientele) to a riba free mode. It further demonstrated its strong resolve to eliminate riba in line with the recommendations of CII in early 1980s, by introducing significant changes in the legal framework including the introduction of Zakat and Ushr Law, amendments in the Banking Companies Ordinance and the Code for Civil Procedures, establishment of banking tribunals with civil and criminal powers and obligation to decide the recovery suits within 90 days. Further, the Mudaraba Companies Ordinance was promulgated to allow for establishment of mudaraba companies.

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and issuance of mudaraba certificates for raising funds to finance different ventures/projects. Also necessary amendments were made in the company law/securities regulations to allow corporates to raise funds by issuing Islamic instruments like Participation Term Certificates (PTCs) and Term Financing Certificates (TFCs).

In line with government policy, SBP also issued comprehensive instructions to banks to shift to a riba free banking system. The banks were advised to mobilize all remunerative deposits, i.e. all deposits other than the deposits in current accounts, on a Profit and Loss Sharing (PLS) basis. All local currency financing to industry and the business community was also required to be made through Shari’a-compliant modes. SBP gave twelve modes of Shari’a-compliant financing which the banks could use to extend financing to the industry. The twelve modes given by SBP included trade related modes of murabaha, ijara, salam, istisna; and investment type modes of musharaka and mudaraba. Qard hasan and loans based on service charges were also part of the modes given by SBP.

While sincere efforts were made by the government in the early 1980s to eliminate riba, the commitment of other stakeholders faded with time; which could partly be blamed for the limited success of the extensive efforts made to convert into an Islamic banking system. Further, it was presumed that the transformation would take place by making necessary changes in the legal and regulatory framework. But failure to consider mechanisms to ensure Shari’a-compliance in banks’ operations stunted such transformation.

The absence of a Shari’a-compliance framework grossly weakened public trust and confidence in the Islamic banking model. Consequently, a number of faith sensitive persons filed suits in the Federal Shari’a Court (FSC), a court established in 1980 to hear and decide cases/suits related to Shari’a. Interestingly, the FSC was not authorized to hear suits related to the economic and financial system during its first 10 years of establishment. In 1991, the court passed a famous judgment that declared a number of financial laws and practices in vogue at the time as repugnant to the Holy Quran. The court also directed the government to bring the system in conformity with Shari’a by June 2002 and constitute a commission for transformation of financial system (CTFS) to guide the government on the transformation.

The CTFS, constituted at the SBP in January 2000 in compliance with the court directive, in its report on the elimination of riba suggested the government to: a) introduce a law to prohibit interest, b) reinforce the system of corporate audit to improve banks’ comfort level about operating results of corporates/SMEs, c) make thorough reappraisal of the tax system to allow for provision of financial services based on musharaka and mudaraba, d) make recovery laws more effective and stringent, e) take steps to create mass awareness about the new system, and f) develop mechanisms for the training of banks’ staff in Islamic finance. The commission also recommended the government to constitute a permanent committee of Shari’a scholars, bankers and economists to advise the government on strategies required to islamise the banking and financial system.

Current Islamic banking scene

While the earlier attempts to transform the banking system as a whole met with only limited success, the current approach is to allow and promote Islamic banking in parallel to the conventional system to enable the masses to do banking according to their preferences. The existing framework allows three types of Islamic banking institutions (IBI): i) full fledged Islamic banks, ii) Islamic banking subsidiaries of conventional banks and iii) Islamic banking branches (IBBs) of conventional banks. The conventional banks having IBBs can also have Islamic banking windows in their conventional branches and can convert their conventional branches into Islamic banking branches as well. An elaborate Shari’a-compliance framework was also introduced that comprises the Shari’a board at the central bank which is the apex Shari’a body in the country for IBBs; the Shari’a advisors at banks’ level appointed based on SBP’s Fit and Proper criteria; internal Shari’a audit at IBIs level, and periodic Shari’a inspections by the SBP to assess Shari’a-compliance levels in IBIs. The composition of SBP Shari’a Board is unique as it includes a blend of Shari’a scholars, legal experts, accounting professionals, and professional bankers.

The introduction of a dual system in 2001 has so far been a success as the Islamic banking industry has grown since then and presently constitutes about 6.5% of the banking system in Pakistan. Starting from almost scratch the industry now has five full fledged licensed Islamic
The number reduced to two Islamic banks due to recent merger of 5 from 6 full-fledged Islamic banks. Notwithstanding the impressive growth during the last 6-7 years, the Islamic banking industry in Pakistan is still facing some major challenges, which if not prioritised, may have serious implications on sustaining growth.

First, the blurred distinction between Islamic and conventional banking products may weaken the very appeal of Islamic banking. The existing paradigm is based on developing Shari’a-compliant structures of conventional banking products, with only limited focus on the economic results they produce. While things are relatively better in Pakistan with respect to Shari’a ratings and acceptability of Islamic finance products, there have been demands particularly from conventionally trained Islamic bankers for liberalizing the Shari’a framework to bring it on par with Gulf and East Asian Markets. The excessive use of instruments like commodity murabaha (CM) particularly in the Gulf and East Asia, not only for liquidity management but also for extending personal loans to consumers, has received wide spread criticism. Although the use of CM in Pakistan is limited to only liquidity management, Shari’a scholars of some of IBIs have not allowed its use even for liquidity management. An objective assessment of the current paradigm is thus needed to see whether it is sustainable in its present form or needs some key changes. Options include a gradual movement towards risk and reward sharing modes.

Second, the business community and public at large need to be convinced about the utility and effectiveness of the Islamic banking initiative. Part of the problem is a lack of awareness, but the existing Islamic banking paradigm itself is also responsible for its limited acceptability as a distinct and viable system to cater to the financing needs of the real economy. There is thus not only a need for initiating a mass awareness campaign but also an expediency to design competitive Islamic finance products, clearly distinctive to conventional counterparts to serve the financing/banking needs of the masses.

Third, the present scope of IBIs is generally confined to cater to the short term financing needs of the real economy. While this scope is in line with the business model and deposit streams of conventional banks, it is not sufficient for Islamic banks. With this narrow scope, the Islamic banks will find it increasingly difficult to compete with conventional banks, which not only enjoy economies of scale but are also highly efficient and flexible when compared to Islamic banks. There is thus a need for Islamic banks to expand the scope of their business to areas and products where conventional banks have limited appeal, experience and skill set. One of the options could be to provide both commercial and investment banking services to be financed by different stream of deposits: current and PLS deposits for financing the short term trade based activities and restricted investment accounts (on the balance sheet) for financing the longer term investment banking business. The economies of scope so achieved will be instrumental in increasing the viability of Islamic banks, improving financial inclusion, augmenting entrepreneurial culture and significantly enhancing the returns to the depositors.

Fourth, despite some improvement in the recent past, the availability of suitably qualified and trained Islamic bankers still remains a key challenge for the industry not only in Pakistan but in almost all jurisdictions having Islamic finance. A large majority of Islamic bankers, particularly those interacting with the clients, do not have adequate understanding of Islamic finance and thus find it difficult to fully convince potential customers about the utility of Islamic finance and its distinction over conventional finance. They try to sell their products primarily on religious considerations rather than highlighting the business and economic utility of their products. The excessive use of ‘halal’ and ‘haram’ phrases for Islamic and conventional products respectively is limiting the target market of IBIs to faith sensitive clients. If Islamic finance lacks competitive solutions to conventional finance, there is no rationale to the market and promoting a system that gives sub-optimum solutions for meeting the financing needs of the real economy. Obviously, this is not the case; it is the limited capacity and understanding of existing Islamic bankers that create such doubts about the utility of Islamic finance. It is therefore, important that all stakeholders join hands to address the human resource capacity issue in Islamic finance.
Fifth, the lack of suitable liquidity management instruments has been a key issue particularly in Pakistan, where instruments like CM have limited acceptability. Issuances of the sovereign ijarah sukuk since 2008 partly addressed the problem. However due to limited availability of the sukuk (due to buy and hold strategy) and their infrequent issuance, these sukuk are not frequently traded in the secondary market, reducing their utility as a liquidity management instrument. Further, sukuk are being issued to raise public debt, which coupled with use of conventional benchmarks (T-Bills rate) for pricing, increases its resemblance with fixed rate conventional bonds. While the variable rate sukuk (based on musharaka/mudaraba) may be a longer term industry objective, in the short to medium term, sukuk for financing specific infrastructure projects of the government could significantly improve their Shari'a repute besides bringing greater discipline and transparency in selection and financing of infrastructure projects. Further, the frequency of their issuance will also have to be increased significantly to improve their tradability in the secondary market. The recent establishment of the International Islamic Liquidity Management Corporation (IILM) in Kuala Lumpur, Malaysia is also a very important development that will have far reaching effects on the growth of Islamic finance globally. The IILM would enable institutions offering Islamic financial services to invest surplus liquidity and provided an important avenue to member countries to raise public debt from international markets at competitive rates.

Sixth, significant steps have been undertaken regarding legal and regulatory infrastructure to provide necessary support for Islamic banking; however, there is still a need to have a thorough review of the existing legal and regulatory framework to incorporate necessary amendments to draw full support for Islamic banking, especially in case of insolvency of an Islamic banking institution.

Seventh, the varied Shari'a practices in the Islamic banking industry remain a challenge affecting public perception. AAOIFI has provided immense support in harmonising the Shari'a practices; nevertheless, there still remain some areas where conflicting Shari'a practices prevail in the market. Respective jurisdictions are working to bridge such gaps; however, efforts at an international level to synchronize Shari'a practices would have a significant, beneficial impact on the industry.

Eighth, the research and development in the Islamic banking industry is slow-paced. The industry needs an ongoing system of research and development which may serve towards broadening the scope and appeal of Islamic banking industry across the masses. This would also facilitate the enrichment of the product mix and help resolve the issues faced by the industry.

Future Outlook

Despite the issues and challenges highlighted in the above section, the future outlook of the industry in Pakistan is positive. The industry is likely to keep its growth momentum and continue to increase the depth and breadth of its services in the medium term. The geographical outreach presently concentrated in a few big cities is likely to expand to second and third tier towns and cities. This would provide the much needed penetration and a platform to further increase the pace of growth and diversify deposits and financing portfolios. Presently, the IBIs have no exposure in the agricultural sector, which besides high risk perception of the sector is also attributable to absence of IBIs in rural/semi rural areas. With the central bank encouraging banks including IBIs to increase their exposure in the agriculture sector, both through regulatory and promotional measures, it is highly likely that IBIs will develop a significant agricultural portfolio in the medium term (next five years). Similarly, some improvement in the IBIs exposure to SMEs is expected; presently IBIs have approximately two percent share in the number of SMEs accessing financial services from the banking system. The large un-banked population, estimated at more than 95% Muslim, also provides optimism about sustaining growth momentum particularly on the liability side. Further, the improved avenues for managing surplus liquidity through initiatives like IILM are likely to encourage IBIs to launch aggressive deposit mobilization drives.

While the growth is likely to continue at a reasonable pace, the dissenting voices and concerns about Shari'a permissibility of various products will stimulate discipline, transparency and maturity in the industry and overall Shari'a-compliance would further improve. This would however require strong commitment by the government and policy makers. The central bank has been demonstrating its strong resolve to help develop the sector through supportive legal, regulatory and Shari'a-compliance frameworks and capacity building and awareness creation initiatives. The commitment and ownership by other state institutions including Securities Commission, Taxation and Government Debt Management Departments/agencies however needs to be improved to develop a strong and vibrant Islamic finance industry in the country.

7 The present exposure of banks in agriculture sector is less than 5% with IBIs having no exposure at all
8 Only about 11% of the adult population is banked as per World Bank access to finance survey 2007
PHILIPPINES

The Philippines is made up of 7000 islands and famed for its culture and of course boxing sensation Manny Pacquiao. It has a population of roughly 93.6 Million inhabitants. The dominant religion is Christianity which was spread during the time the Philippines was a colony of Spain. Muslims make up 5%-10% of the total population and thus provide a sizable market for Islamic finance.

Before the establishment of the first Islamic bank, Dubai Islamic Bank, there was Philippine Al Amanah Bank founded in 1973. The mandate of the bank according to the Presidential Decree 264 was ‘to provide credit, commercial, development and savings banking facilities at reasonable terms to the people of the preliminary Muslim provinces of Mindanao, principally, the provinces of Cotabato, South Cotabato, Lanao del Sur, Lanao del Norte, Sulu, Basilan, Zamboanga del Sur, Zamboanga del Norte and Palawan for the establishment, acquisition, development and expansion of agricultural, commercial and industrial enterprises, there is hereby created a body corporate to be known as the Philippine Amanah Bank, which shall have its principal place of business at Marawi City and shall exist for fifty years.

However, it was not an Islamic finance bank; rather a bank serving the Muslim community but offering conventional finance. Things did not change, even after a decree was passed changing the name of the bank to Al-Amanah Islamic bank of the Philippines (AIBP) in 1990. The bank failed to take off the ground mainly because of a lack of public awareness and limited expertise in Islamic finance amongst staff. In 2006, the central bank allowed the bank to operate as conventional bank in order to stem the losses and to make it easier for the bank to be sold, which eventually occurred in 2008. Prior to the acquisition by Development Bank of the Philippines (DBP), efforts were made to attract investment from the Gulf and Malaysia. Currently the bank offers both Islamic and conventional products but it is hoped that by the end of DBP’s five year development plan in 2013, it will be a fully fledged Islamic bank. Amanah has USD 21 million of Islamic banking assets.

An overwhelming concern for the Philippines government has been the activities of the Abu Sayaf and Moro Islamic Liberation Front militants who operate from the predominately Muslim area of the Autonomous Region of Muslim Mindanao (ARMM). The region gained autonomy in 1989 and has its own government. However, the region is severely impoverished. According to the government’s National Statistical Coordination Board, per capita income in Muslim Mindanao is USD 78, the lowest among the 17 regions in the Philippines. The poverty strengthens the militant cause and the government are looking at means of alleviating the poverty. It is therefore no coincidence that eight of the nine AIBP branches are based in the ARMM.

The Development Bank of the Philippines (DBP) has been sending executives to Malaysia for courses on Islamic finance. Furthermore Al-Amanah Islamic Bank is planning on offering more innovative services, such as making it easier for Muslims working abroad to send money back home. Executives at Al Amanah Bank feel that the Bank is currently doing well and may even post a profit in 2011, before the 2014 deadline. As a sign of intent the bank recently appointed Enrique D.Bautista, Jr as its chairman and CEO, who brings with him much experience. The bank even has ambitious plans to expand to other countries such as Malaysia in the future.

Islamic finance can facilitate further improvements in relationships between the government and the Muslims but the legal framework requires changing in order to drive the industry forward. The regulatory system is not germane to the growth of Islamic finance in the country and without proper changes in the regulatory
infrastructure; there will be few developments in the next few years. The government had toyed with the idea of issuing a sukuk but decided against it. However, they are currently in the process of drafting a bill to facilitate the expansion of the Islamic finance industry in the Philippines. The central bank hopes that by doing so, this will open the country for investment especially from the Gulf States. Optimism is not high, however, as the central bank had alluded to changes in legislation in 2009.
PALESTINE

It is difficult for Palestine to embark on a course of economic development without having mind to the actions and strategy of Israel. Their looming presence is a constant source of concern for the newly formed Palestinian state, with sanctions and blockades offering little room for self-determination. What space there is however grants the Palestinians some measure of opportunity, but with political divisions between the two constituent territories of the Palestinian state, Gaza and the West Bank, there is unfortunately an economic disparity which has adverse effects for the state as a whole.

Demographics and economics

As of 2009, less than 4 million people live in Palestine of which roughly 62% live in the West Bank and East Jerusalem and the remainder in the Gaza strip. The size of the economy is approximately USD 6 billion. GDP has been increasing since 2006 (with a bumper year in 2009) and according to the IMF, the Palestinian economy will grow by 8% in 2010. The Palestinian Monetary Authority (PMA), the central bank in Palestine, put this down to private sector confidence, ease of movement of goods to the Palestinian regions and finally donor aid. The World Bank has commented however, that Palestine’s reliance on donor aid maybe precarious for the economy in the long run. Average annual donation since 2008 has been USD 1.6 billion. The World Bank advised increased focus on private investment to remove dependence. In this regard, the work of the Palestine Investment Fund in bringing private investment into the Palestinian state is a positive achievement. Recent figures suggest that it has USD 800 million AUM. The fund holds a 47 percent stake in Watania Telecom of Kuwait. The fund is also a partner in the Ersal financial centre, a planned 13-tower project in the West Bank with Riyadh-based Land Real Estate Investment and Development Co. As the name would suggest, the Palestinian Authority hopes that the centre will become a financial hub drawing in foreign investment and increasing commercial activity in area.

According to the PMA, there are currently 19 banks in the Palestinian territories, comprising of 17 commercial banks and two local Islamic banks: Palestine Islamic Bank and Arab Islamic Bank. There are currently two takaful companies in Palestine: Al-Takaful Palestine Insurance Company PLC and Palestine Takaful Insurance Co. The Palestinian Authority is looking to Islamic finance to bolster their economy and remove dependence on foreign aid. Consequently, the Palestinian central bank is attracting local banks to its first sale of sukuks, intended for 2011. It hopes to sell as much USD 50 million of sukuk. The Islamic notes are likely to be dollar dominated as the territories do not have a single currency.

Political division

Unfortunately, the prospect of Islamic finance in Palestine is likely to be hindered by political discord. After the 2007 elections, political power became divided. The West Bank remained under the jurisdiction of the Palestinian Authority, while Hamas took control of Gaza. This had adverse repercussions for the Palestinian economy especially for Gaza with tightening of sanctions by the international community and Israel. According to the PMA, GDP growth in the West Bank was 8.5% while Gaza registered 1%. Gaza also suffers from high unemployment (38.6%). Recent estimates in 2007 made by UNCTAD estimate that 80% of Gaza are under the poverty line whereas in the West Bank, the figure is 45%.

The economic disparity is further compounded by conflicts between the Palestinian Authority and Hamas. After Hamas seized control of Gaza in June 2007, Israel increased monetary restrictions against Hamas. Concurrently, the PMA tightened its money-laundering rules, making it harder for funds to flow into Gaza. As mentioned, the PMA recognise only two local Islamic
banks. They do not take into account Islamic National Bank, an Islamic bank set up in Gaza which the PMA and the International community believe to be a proxy for Hamas to channel investments to fund militant activities. The bank claims it is not politically affiliated with Hamas and has set up the bank to bring in foreign investment. However, by falling out of the purview of the PMA and the regulatory infrastructure, international banks are unlikely to deal with a bank which is believed to be affiliated with Hamas. In March, the US treasury put the bank (as well as a television station based in Gaza) on its terrorist financing list.

Conversely, Hamas does not recognise the PMA, arguing that a self styled central bank works within the parameters set out by the international community, and runs against Palestinian interest. By not recognising the PMA, Hamas have effectively set themselves up as a de facto regulatory authority in the Gaza strip. Hence, the raids on two PMA regulated banks, one being Palestine Islamic Bank, in March and June, emphasise the uneasy relationship Hamas has with the PMA.

**Progressing through uncertainty**

Islamic banks have been in Palestine for over 15 years and have done moderately well. The largest Islamic bank in Palestine, Palestine Islamic Bank, has over USD 350 million of assets. In a volatile economy, this is quite impressive. But the success of Islamic finance, and for that matter, the economy of Palestine will largely depend on political wrangling between Israel, the Palestinian Authority, Hamas, the EU Quartet and the USA. This creates a level of uncertainty for a nation that is still reeling from what they see as 70 years of oppression. While economic indicators are improving, the instability of the region could reverse progress and thus predicting the future for Islamic finance will be as difficult as achieving amity between Israel and Palestine.
QATAR

It has been a good year for Qatar. The economy is good, neighbouring Gulf States are stumbling and the world’s leading footballing nations will be coming to Qatar to kick a ball for the FIFA World Cup Trophy in 2022. One cannot be but impressed by Qatar’s more measured growth – as compared with the garish Dubai – from the desert tents to gilded heights of Al Fardan Residences in such a short period of time. It has built an economic infrastructure developed largely through returns from their sizable oil and gas reserves that is still driving the economy forward and represents 50% of the country’s GDP.

Qatarisation

Yet Qatar is well aware that for long term prosperity, reliance on hydrocarbon industries has to decrease and economic diversification is imperative. The Qatar National Vision 2030 (QNV) policy document launched in 2008 is a blueprint to achieve economic and social goals. The vision is based on four pillars and broadly represents the overarching focus of Qatar.

- human development
- social development
- economic development
- environmental development

On the path to achieve this goal, Qatar has embarked on a number of programmes including a policy of Qatarisation. This program is designed to increase the number of Qatari nationals in public and private sectors. Qatar has a population of only 1.6-1.7 million, of whom only 20% are nationals. In order to control the influx of expatriate workers, Qatar has tightened the administration of its foreign manpower programmes over the past several years. Growing numbers of foreign-educated Qataris, including many educated in the United States, are returning home to assume key positions formerly occupied by expatriates.

A leading exponent of Qatarisation has been Qatar Islamic Bank. It was honoured at the 27th session of the GCC Ministers of Labour Assembly in November for its initiatives in integrating Qatari into the local economy. QIB has signed an agreement with the Ministry of Labour to sponsor and support 30 Qatari students for three years during their studies. Last October, the institution signed another agreement with the ministry to send 13 Qatari students to the College of North Atlantic-Qatar for one year. The number of Qatari students sponsored by QIB will reach 43 by 2011, and will be well equipped to assist in QIB’s different departments especially banking services and corporate banking. Similarly, other Islamic banks are following suit. Masraf Al Rayan claim to have one of the highest Qatarisation rates in the country’s banking sector. The bank reports that the percentage of Qatari nationals working in the bank till July 2010 is approximately 35.5 per cent of 308 employees. Islamic bank Qinvest, Qatar’s largest investment bank designed and launched the “Qatari Development Program”, a 12 month intensive program to train Qatari nationals.

But the Qatar National Vision is more than just building up the local labour force. The aim is to be a market leader, independent and globally renowned. Policy makers understand that increasing global competition requires Qatar to create the right foundations and adapt in order to stay competitive. To this end, Islamic banks in Qatar are strongly committed to the initiative.

Growth and saturation

The IMF projects Qatar to have the world’s fastest growing economy in 2011. Signs are good. The Qatar Index has jumped to a two year high in December 2010. Qatar’s domestic and overseas investment portfolio is growing and the country is expected to spend tens of billions of dollars in the year ahead as it expands its investments around the world. Qatar Islamic Bank (QIB) signed an istisna agreement in May for the financing of
a QAR 300 million (USD 82 million) residential project to be built in Al Khor. This real estate project at Al Khor is one of the biggest in Qatar since the economic downturn. At the beginning of the year, Qatar Diar Real Estate, a subsidiary of Qatar Investment Authority, raised USD 1.1 billion through a murabaha, making it the largest syndication in Qatar. QIB was appointed as the sole initial mandated lead arranged and book runner – the first time that a local bank has assumed such a role.

However, the government have expressed concern at the large number of banks given the small size of the market and therefore has encouraged mergers between banks. There are 18 banks operating in a nation with a population of only 1.6 million, including four Islamic banks – Qatar Islamic Bank, Qatar International Islamic Bank (QIIb), Masraf Al Rayan and Barwa Bank - a number of Islamic investment banks and seven foreign-owned lenders. The country is overbanked, and this has already led to a few mergers and acquisitions in the sector since the beginning of 2010. Barwa Bank acquired First Finance Company and The First Investor in a bid to become a universal Islamic banking group. It is an ambitious aim for a bank that started in 2007 but in the last three years, Barwa bank has grown in assets and product portfolio. Their growth highlights that the potential Islamic banking market is huge in Qatar. Thus, in July, HSBC Amanah opened the first dedicated Islamic banking branch in the MENA region outside of Saudi Arabia; and will serve both retail and corporate customers.

Competition in the Islamic banking market is intense. Major commercial banks such as Qatar National Bank, the Commercial Bank of Qatar and Doha all have Islamic banking subsidiaries. Increasing competition has compelled Islamic banks to look abroad. In August QIB injected £20 million into the Islamic Bank of Britain, in order to stimulate growth in the foundering Islamic retail bank. It is also the founder of Syrian International Bank. Qatar First Investment Bank partnered with Dubai based asset management Gulfmena, to establish a unique, one-stop Shari’a-compliant asset management company. It will be the first of its kind in the region offering a range of Islamic investment products and services. QIB, the largest Islamic bank in Qatar, has a base in the UK and is a majority shareholder of Asian Finance House in Malaysia. Qirinvest, QIB’s investment banking arm, partnered with India’s leading financial services provider, to create Ambit Qirinvest India Fund. The fund is the regions first Shari’a-compliant fund. Qirinvest also acquired a 25% stake in Ambit Corporate Finance Pvt Ltd, an investment bank. Qirinvest also has a 47% stake in Pammure Gordon PLC, a 130 year old stockbroker and investment bank from the UK.

QIB certainly has a leading position in the market. Its network and portfolio make it one of the largest Islamic banks in the world. With such a stature, QIB has been able to stimulate innovation and market growth and has led other banks to follow. In September, QIB issued an international sukuk, the first to be offered by a Qatari financial institution. It was oversubscribed eight times, with demand reaching USD 6bn. After global downturn of the last two years, it is hoped that the sukuk will galvanise the market and now encourage corporates to issue sukuk.

Takaful begins to boom

In the Middle East, while banking is booming, insurance penetration remains low. This is slowly changing with Bahrain taking a leading role. Qatar hopes to capitalise, with the aim of becoming a regional insurance powerhouse by 2013. Latest figures show that insurance penetration as a percentage of GDP is just 1.1%. Of that small percentage, takaful has accounted for 25% in 2010, according to a survey released by Ernst & Young. The market is dominated by Qatar Islamic Insurance Company, which has long been the only dedicated takaful company. However, 2010 has seen the entry of a number of companies into the takaful market. Leading conventional insurer, Al Khaleej Insurance and Reinsurance company converted its operations fully into takaful in January. Damaan Insurance Company (Beema) also joined the market in January. Shareholders in the company include Islamic banks QIB and Masraf al Rayan, as well as Barwa Real Estate, Barwa’s parent company. Additionally, foreign takaful companies are coming into the market. In October, Doha Bank and Allianz Takaful announced a partnership to promote Islamic insurance products in Qatar, while in the Qatar Financial Centre (QFC), Bahrain based takaful operator, T’Azur, became the first general takaful company to undertake business in the QFC in 2009. The Qatar Financial Centre Regulatory Authority (QFCRA) had also authorised Allianz takaful to operate in the QFC in 2009.

Regulatory consolidation or attenuation?

Of late, Qatar regulatory authorities have taken an uncompromising stance towards the development of Islamic finance in the country, which has positive ramifications for full fledged Islamic banks but adverse consequences for conventional banks with an Islamic component. In August, the central bank issued new regulation which prohibited conventional banks allocating more than 10% of issued capital to Islamic banking operations and from opening additional branches for Islamic banking. In February of this year, the central bank issued a directive stating that conventional banks are required to close their Islamic banking units by the end of 2011. These moves are directed at ensuring a complete separation of the two systems and the avoidance of crowding of funds. But it has left conventional banks with Islamic banking units - including HSBC, Qatar National Bank, Commercial Bank of Qatar and Doha Bank – in a confused position. Options are available including acquiring a license from the QFCRA, the country’s second regulatory authority, but this will lead to a diminution of service offerings with more focus on corporate activities. The prospective closure of these units will be a positive impact for the Islamic banks in the country. Already, following the announcement, share prices for Islamic banks have increased. It will also ease the central bank’s supervisory responsibilities. However, since the directive was issued without extensive consultation, there is arbitrariness behind this move.

A strong base equals growth

The central bank’s move indicates the growing importance of Islamic finance in the economy.
Removing competition serves to increase the prominence of domestic Islamic banks in the market. Moreover, the country is overbanked especially with respect to its comparatively low population, and less service providers, will equal greater concentration leading to higher profits for domestic Islamic banks. The Islamic banks in the country are also quite active in their communities. Each bank has embarked on projects to develop community solidarity. Therefore, the central bank’s move may not be as great a surprise as initially felt. With a national policy directed to invigorating the local markets, a greater market share for Qatari banks can only be a good thing to achieve objectives. In the long run however, this is debateable.
RUSSIAN FEDERATION

The Russian Federation is a vast swath of land covering nine time zones. One could travel from Moscow, on land, through Russian territory and end up in China; and if they really feel adventurous, they can continue on into Alaska, USA, and enter the western hemisphere. There are an array of peoples coexisting as Russians but differing dramatically in their cultures and beliefs. 83 federal states constitute this leviathan nation, including 21 republics, with their own constitution and government. Cumulatively, the Federation is the 8th largest economy in the world and is home to some 150 million Muslims dispersed and scattered across the width and breadth of the nation. Eight of the 21 republics boast a majority Muslim population which would suggest that Islamic finance could play a major role. However, nothing is ever that simple with the ex-Soviet Union.

Moscow looks to the east

Russia has felt the pinch of the credit crisis and is exploring opportunities to boost their economy. A number of Islamic finance experts from across the world have visited Russia, discussing with senior officials and leading bankers the potential of Islamic finance for the country. This seems like a natural outcome of an ongoing interest in Islamic finance over the last few years. In May, members of the financial community gathered for the 3rd annual Moscow Forum on Islamic finance and investments: a platform on which Russian regulators and bankers would be able to brainstorm and collaborate with international experts in Islamic finance. At the end of the year, the Moscow Times, an English daily, hosted their second annual conference in Islamic finance whose roster of speakers were primarily Russian nationals working in domestic and international organisations acquainted with Shari’a-compliant transactions. While Vladislav Kudryashov, Deputy Director, Legal Department, Ministry of Finance of the Russian Federation may have spoken about the problems of accommodating Islamic finance products in a non-Islamic jurisdiction, his presence indicates an interest from the Kremlin.

Growing interest has led to the formation of groups dedicated to the promotion of Islamic finance in Russia. In February, a meeting was convened in Moscow between the members of the newly formed Russian Association of Islamic Finance Experts. The Association’s task is to explore ways in which Islamic finance can be harmonised into the Russian financial markets. It was set up by members of the Working Group on Alternative (Islamic) financial institutions and products, a task force set up in May 2009. Their mandate is to come up with a legal and regulatory framework which would facilitate Islamic finance. To this end, a Coordination Council consisting of senior members of the Union of Muftis of Russia (SMR), international tax experts, lawyers and bankers will oversee the work of the Association.

The small but growing cabal of bodies interested in Islamic finance has brought in the support of Islamic finance organisations such as AAOIFI to lend assistance if required. AAOIFI have translated key AAOIFI Shari’a standards into Russian; including sukuk, murabaha, Islamic insurance, ijarah, mudaraba and musharaka. In October, the Secretary General of AAOIFI, Dr. Mohamad Nedal Alchaar, met with members from the Ministry of Finance, the central bank, the Grand Mufti of the Shura Council of Russian Muftis, and the Russian Association of Experts in Islamic Finance in Moscow, to discuss prospects in Russia and to affirm their support to those interested in Islamic finance.

In October 2009, Moscow International Higher Business School, Mirbis, became the first Russian academic institution to introduce a short term course in Islamic finance.

The role of the private sector

Islamic finance is not alien to Russian banks who have
conducted Islamic finance transactions though mainly outside their borders. The German subsidiary of UK trade finance group, CCH International, arranged the first Islamic trade finance facility for a USD 20 million murabaha for Globexbank of Moscow, on behalf of a client of the bank in 2006. Major Russian banks such as VTB (Vneshtorgbank) and Gazprombank have worked on Sharia-compliant products. VTB Capital, a wholly owned subsidiary of VTB, has set up a branch in Dubai, channelling liquidity from cash-rich Gulf investors to Russia. They are looking to issue a sukuk and by signing an MoU with Liquidity Management House (a wholly owned subsidiary of Kuwait Finance House) to develop sukuk and other Islamic products for Russian corporate, the building blocks are in place. It was only due to the fallout following the default of the Nalheel sukuk, that the anticipated sukuk arranged by VTB Capital was put on hold.

But while these are conventional financial institutions with an interest in Islamic finance, Al Shams Capital is a fully fledged Sharia-compliant investment vehicle. Its mission statement, according to their home website is to promote and support the development of Sharia-compliant, ethical, value investments into CIS and Eastern European countries, and contribute to establishing and developing the Islamic financial infrastructure as a new reality in this region. The company is in the process of launching its first Islamic private equity fund for the CIS & Eastern Europe which will invest in regional IFIs, halal food industry and other Sharia-compliant sectors. The fund, which is likely to be launched in first quarter of 2011, is a joint project with Luxembourg entities Thiessen Law and Lux Global Trust Services.

Going through the back door

In 2006, the Russian central bank set up an Islamic finance advisory committee comprising representatives from the government to familiarize the various departments of the state with Islamic banking and finance. With no further development, the initiative can be regarded as a resounding failure. The government have expressed an interest in issuing a sovereign sukuk, but the legislative framework is not in place and currently there does not seem to be any signs that there will be a change in outlook.

At the end of 2006, the central bank revoked the license of Badre Forte, Russia’s first Islamic bank on the grounds of nefarious unconscionable activities undertaken by the bank including money laundering. The bank was founded in 1991, and offered customers deposit accounts, interest free debit cards and halal money transfers but it was limited. A small portfolio of products, outlet branches, a small customer base, and ignorance by most of the Muslim community gave the bank little credence. However, its major stumbling block was the mandatory deposit insurance scheme imposed by the central bank. Badre argued that the scheme flew against the tenets of the Sharia, but the central bank was unyielding. Justifying Badre’s demise, the central bank argued criminal activity whereas shareholders of Badre Forte inferred a hidden agenda.

One thing that the Badre Forte incident revealed is that with a lack of enabling legislation, IFIs, especially banks, will have to compromise. Lobbying the government to amend legislation will take a more confident and integrated Muslim community. The Muslim community are finding their voice in Russia, though it is intermittently subdued with every fresh incident of belligerence conducted by Muslim separatists in one of the Muslim majority republics. There is suspicion amongst certain members of the government and the central bank, that Islamic finance will be a means to fund militancy. However, the opening of the Arab Banking Corporation (ABC) branch in November made ABC the first Arab bank to open in Russia. Their move gives an opportunity for Islamic banks to eventually enter but this will rest on how facilitative the Russian government wish to be with Islamic finance.

The roaring republic

Government sluggishness on Islamic finance is countered by the dynamism of Russian federal states in bringing Islamic finance into their regions. The most active has been the Republic of Tartarstan, a Muslim majority republic who has been given presidential blessing to encourage an Islamic finance sector. In March 2010, several Islamic organisations gathered to create an Expert Council on Islamic Economy: an advisory body regulating the problems of Islamic finance, business, law etc. Scientific and practical assistance will be rendered by Non-profit Fund for the Development of Islamic Business and Finance (IBFD Fund), Russian Islamic University and Non-profit partnership of Muslim entrepreneurs known as the Tartan group. Tartarstan has hosted two major Islamic finance investment symposiums in the last two years. The international event attracted more than 500 representatives from South-East Asia, the Middle East, Europe, the CIS countries and Russia. This year, the keynote speaker was ex Malaysian President and keen exponent of Islamic finance, Mahathir Mohammed.

The conference was an indication of the strategy that the Republic of Tartarstan has adopted: attracting foreign investments. Delegations have been sent to Singapore, Malaysia, Hong Kong and South Korea to build productive ties with governments and institutions. According to Tartarstan’s President Rustam Minnikhanov, Tartarstan has built extensive contacts with Kuwait, Saudi Arabia, the United Arab Emirates and Egypt. In December 2010, the republic signed an MoU with Malaysian IFIs, Amanah Raya Berhad Group and Kuwait Finance House Malaysia, on deriving assistance in arranging the issuance of a sukuk originating from Tartarstan.

Yet, Tartarstan has a grander vision with Islamic finance being incorporated into its government. It wishes to promote halal industries and products. In November, the first Russian halal industrial park, Baltach, was launched in Kazan. The park will house small and medium-sized enterprises (SMEs) involved in the halal business industry. The main goal of the project is the processing and distribution of agriculture and livestock products produced by local farmers. The initial investment in the Baltach project is 150 million rubles and the project is managed by the holding company NHIDC, whose financing and investment activities of local companies and other partners will be exclusively under Islamic financial contracts.
For the project to get off the ground, a pivotal part was played by IFC Linova, an Islamic finance consultancy advising and promoting the industry. It became an observer of the International Islamic Financial Market (IIFM), granting it access to major IFIs across the Islamic world. IFC Linova has been instrumental in major projects which have contributed to the growth of an ‘Islamic’ sector in Tartarstan. This includes the development of guidelines for Islamic finance; the establishment of the Russian Centre of Islamic Economics and Finance at the Russian Islamic University based in Kazan; the founding of the non-profit Foundation for Development of Islamic business and finance; Islamic Investment Company of Tatarstan (IIC) and advising companies on conducting Shari’a-compliant transactions.

IFC Linova has been a luminary within this field and has drawn upon its network of partnerships to encourage investment into Tartarstan from multilateral organisations such as Islamic Development Bank. IDB has a USD 1 million equity stake in the Islamic Investment Company of Tatarstan. IIC hopes to act as a conduit between SMEs and the IDB, who will channel investments from member countries.

With Tartarstan actively promulgating Islamic finance, other federal subjects of Russia are showing interest in Islamic finance. The Republic of Ingushetia is looking to cooperate with Bahrain. A high level economic delegation led by the Deputy Prime Minister and the Minister of Economy went to Bahrain to discuss cooperation in Islamic finance. Moscow may wish to take note.
SAUDI ARABIA

To which country can the credit of creating Islamic finance as an alternative paradigm be accorded to? Egypt has a strong case, so does Pakistan, and one cannot forget to mention Iran. But they would all agree that the spiritual home of Islamic finance lays in Saudi Arabia, not only because it was the birthplace of Prophet Muhammad (peace be upon him). Rather, the efforts of King Faisal, ruler of Saudi Arabia between 1964 and 1975, and his son Prince Muhammad Al Faisal set the foundations on which the industry is built upon. After the embarrassment of the Six Day War and the perceived failure of Egypt’s General Nasser’s Pan Arabism, the Muslims of the Middle East looked towards Islam as a unifying force. King Faisal became the obliging leader, buoyed by the oil windfall his country had secured. Under his leadership, the Organisation of the Islamic Conference (OIC) was formed in 1970, bringing together Muslim countries committed to the preservation and promotion of Islamic social and economic values. From the OIC, two critical organisations in the Islamic finance narrative materialised: Islamic Fiqh Academy and IDB. The former has contributed to the intellectual framework of Islamic finance while the latter has been a vehicle for the spread of Islamic finance concepts and models throughout the Muslim world. Saudi Arabia therefore may have a basis to boast of being a progenitor of Islamic finance.

Domestic paradox

Yet, while Saudi Arabia has been proactive internationally, its domestic market has been comparably muted over the years, especially when compared to its Gulf neighbours and Malaysia. No reference is made to Islamic banking and finance in legislation and there have been very few, if any, guidance issued by the Saudi central bank, Saudi Arabia Monetary Authority (SAMA). For a long period of time, Saudi Arabia was not particularly supportive of the domestic Islamic finance market and it is notable that of the four licensed Islamic banks, none of them have the term ‘Islamic’ in their name.

SAMA, as regulator, makes no distinction between conventional and Islamic banks in terms supervising their financial activities. Equally, the Capitals Market Authority (CMA), even as regulator of the capital markets does not scrutinise the Shari’a credentials of a product, Shari’a governance is therefore upon the bank itself and thus classification can only be made if a particular bank has a Shari’a board or a product has gone through the necessary checks. The approach differs from other Islamic finance hubs but it is a system that has by and large operated without any significant glitches.

However, without a national Shari’a board or a binding set of rules, besides ruling legislation relating to conventional banking, it creates a plethora of opinions. Thus it is difficult to harmonise conflicts, weakening the veracity of Islamic finance transactions. IFSB and AAOIFI standards are used by Saudi Arabian Islamic banks, but they act as guidance as opposed to a binding set of laws. Saudi Islamic banks are in a position to map out their own individual path relating to Islamic finance.

Demand is increasing for Shari’a-compliant products in the Kingdom. Retail banking has become more or less Shari’a-compliant with many conventional banks offering Islamic finance products through. Corporate banking has also seen a rise of Shari’a-compliant financing, with estimates of 60-80% of transactions being undertaken according to Shari’a principles. Latest figures show that Saudi Arabia tops the chart for Islamic loan volumes, exceeding USD 5.66 billion as of May 2010.

Cooperative insurance

Takaful is also fettered by a lack of guidance, though there is legislation which places it on a different footing to banking. Prior to 2003, the insurance sector was unregulated. Insurance was considered impermissible under the Shari’a and therefore conventional insurance companies were excluded from Saudi Arabia. The void
was filled by offshore companies offering insurance that was unenforceable under Saudi law; and cooperative insurance provided by former state monopoly provider, the National Company for Cooperative Insurance.

In 2003, the Cooperative Insurance Regulations were passed providing the basis for insurance companies to operate. However, the insurance has to be conducted on a cooperative basis ‘in accordance with Islamic Shari’a’. Unfortunately, there was no detailed guidance as to what constitutes cooperative insurance though it is accepted that there are differences to the takaful model. Consequently, some scholars in Saudi Arabia have deemed several takaful products to be Shari’a repugnant, making certainty elusive and setting barriers to entry into the market. This is a shame as there is huge potential for takaful in the market. But even with ambiguity in the law there are 29 insurers in the Kingdom, both local and international. According to Swiss Re, a leading international insurer, premium income in life insurance soared 61 percent last year while non life grew 25 percent. Such growth indicates a strong demand for insurance products.

Legal changes needed

The growth of the Islamic finance market in Saudi Arabia is impressive given that there is an absence of enabling legislation. Strong demand buttressed by excess liquidity derived from oil wealth has driven the market forward, but there is a general feeling that the industry could have been far bigger provided legislative changes were made. The problem however, is that the legal system in Saudi Arabia is plagued with inefficiencies, which makes the passing of law somewhat of an ordeal.

No better example can be given than the protracted passing of the mortgage law. In Saudi Arabia, it is estimated that less than a third of Saudi nationals own their own home, partly because of wealth constraints. Finance is difficult to secure with some applicants for loans having to wait years on end. Islamic banks have attempted to fill this gap through Shari’a-compliant financing, but this is mainly for newly built houses and not for existing housing. Saudi Home Loans (SHL) on the other hand is the first specialised Shari’a-compliant home financing company in the Kingdom and has financed over 2500 units. The problem is that the Saudi property market is suffering from a shortage of housing units, which while shielding Saudi Arabia from the real estate corrections seen in neighbouring Gulf States, has put an upward pressure on Consumer Price Inflation. Inflation has been further compounded by high rental rates. In order to address this problem, Deutsche Bank estimated that Saudi Arabia needs 1.2 million additional houses by 2015. The potential housing boom has attracted several international companies to enter the market.

High inflation, low incomes, lack of houses and high initial outlay for mortgages has meant that a high proportion of the Muslim population is being excluded from owning homes. It has therefore become imperative for a mortgage law to be enacted. Expectations are that with a mortgage law, there will be a boost in the real estate industry and a diversification in a bank’s balance sheet. It will also give opportunities for the issuance of sukuk. However, a mortgage law has yet to be enacted, victim of filibustering in both the Shura council and the cabinet. Two years on, the mortgage law has yet to be passed.

Expectation for the imminent passing of the law has attracted investment banks and real estate companies to Saudi Arabia. The Islamic Corporation for the Development of the Private Sector (ICD) wishes to establish a real estate company, a finance company and a mortgage finance company. But delays in the enactment of the mortgage law have left the ICD and the rest of the market perplexed and wanting.

Expansion and growth

In 2005, Saudi Arabia joined the World Trade Organisation (WTO) which placed conditions of membership on the Kingdom. One was to affect an efficient legal system another was to open up the financial markets. The latter objective has proven to be a more successful endeavour. International institutions have come into Saudi, which has benefited the Islamic finance industry. At the end of August 2010, Tadawul, the Saudi stock exchange registered 153 Shari’a-compliant funds in 15 fund categories including international trade funds and real estate funds. Saudi based NCB Capital has claimed a 33% share making it the world’s largest Shari’a-compliant asset manager.

In March, the CMA approved the Kingdom’s first Exchange Trade Fund (ETF), both conventional and its Shari’a-compliant variant. The CMA approved the listing of Falcom Saudi Equity ETF which will invest in listed Saudi equities. ETFs have been slow to take off in the GCC due to the nascent financial markets, but it is hoped that this will lead to more interest. The creation of the fund and its tapping into the Saudi markets shows the opportunities available in Saudi Arabia. Being the world’s largest oil producer, Saudi Arabia is flushed with liquidity which makes it attractive for foreign investors.

High liquidity is stimulating the sukuk markets. In 2010, Saudi Arabia led the GCC in the issuance of sukuk and is only second to Malaysia in the global sukuk market. Saudi Arabian real estate and energy companies are leading sukuk sales in the nation, which has the secondary objective of spurring economic growth in order to meet the objectives of Saudi’s five year USD 400 billion stimulus plan for the economic growth of the country, and the financing of the construction projects. Increased issuance of sukuk enables local banks to tap into much needed liquidity, which they would be unable to get from conventional markets. Saudi Arabia does not have a Shari’a-compliant money market which hinders banks in managing their liquidity. The foundation of the IILM in Malaysia is a positive step in filling that void. Saudi Arabia has also issued innovative sukuk. Saudi Electricity Co.’s USD 1.87 billion sukuk sold earlier in 2010, is underwritten by the company’s income from fees, such as connection charges.

However, the sukuk market did take a turn for the worse after the credit crisis. Last year, Saudi based companies such as Saad Group defaulted on their sukuk.
Eighty banks, including BNP Paribas SA and Citigroup Inc., are owed at least USD 15.7 billion, sparking a flurry of litigation.

**Domestic banks**

Stringent bank rules have not hindered local banks. There are currently four Islamic banks in Saudi Arabia: Al Rajhi Bank, Bank Albilad, Alinma Bank and Bank Al Jazira. They offer a full range of retail, corporate and investment products and have benefited from the strong demand for Shari’a-compliant retail and business products. Al Rajhi remains the biggest, the most ubiquitous as well as the most innovative. It has adopted a similar model to Kuwait Finance House, blurring the lines between financing and trade. In 2009, it was reported that it had eleven car showrooms offering cars to be financed by Shari’a-compliant products. They have also expanded into Singapore, Malaysia and Indonesia, hoping to tap into the East Asian Markets.

As for IDB, they have continued their remarkable progress in both the commercial and development sectors. In 2009, they issued 3 sukuk and have issued a USD 3.5 billion sukuk under its Trust Issuance Program which is listed on the London Stock Exchange and also the Bursa Malaysia where it is listed in ringgit. The four offerings have totalled USD 2,750 million, making it the largest volume of sukuk issuance by a multi lateral company. But it is on the development side that the IDB has been particularly impressive. With 54 shareholding member states, the IDB has assisted in micro and macro economic development in most of these member states. From textile projects in Syria, to road building in Uzbekistan, the IDB is growing in stature as a multilateral development organisation.

**The dream of King Faisal**

With over 40 years experience in Islamic finance, Saudi Arabia has accomplished much. But there are still improvements that could be made. Commentators constantly allude to the untapped potential of Saudi Arabia and its failure to capitalise on opportunities. The government and the regulatory authorities need to be more proactive in building the necessary infrastructure for Islamic finance but hitherto there has been a general reticence. Opening the markets in 2005 attracted multinational organisations into the country, thereby creating value and efficiency in the private sector; but the private sector in general has been the pioneering force in creating a vibrant Islamic finance sector. It has worked so far but it could work so much better with ostensible government support. 40 years ago one man certainly stood up to the task.
Senegal is one of the few countries in Africa which has been relatively stable despite having a high incidence of poverty and unemployment. Unlike other countries in the continent in which dictatorships are the norm, Senegal has had relatively peaceful transfers of power. The country has a population of around 12.8 million, 95% of which is Muslim.

With the country being majority Muslim, together with the fact that the majority don’t have access to formal banking services, the country may prove to be a fertile ground for Islamic finance in the future. The leadership of the country has not failed to spot the potential and has thus begun to change legislation that would make it easier for banks to set up Islamic units. There is one Islamic bank in Senegal which was established in 1983, the Islamic Bank of Senegal. However with Islamic finance growth continuing to increase, more can be expected to open in the country.

According to IMF economists in the region, profit & risk sharing instruments would be useful for Muslim entrepreneurs within the country as they would be able to undertake projects which they would not normally consider. The country is also interested in issuing a sovereign sukuk this year with the input of Citibank. As was mentioned earlier, Senegal is relatively stable when compared to other countries in the region so this factor may see it emerge as a preferred destination for investors from the Gulf.

If Senegal manages to issue sovereign sukuk, it will pave the way for increased investment from the Gulf and elsewhere, which is something the leadership is keen to capitalise on. Dubai Ports World has already invested in a major Senegalese port and there has been investment from both Kuwait and Saudi Arabia in other sectors of the economy. Entrance of Islamic finance would no doubt help increase this investment.

One potential bottleneck is the lack of qualified personnel with the necessary knowledge of Islamic finance principles. However the Senegalese have realised this and begun taking steps to address the situation; a high ranking delegation of Senegalese visited Bahrain to learn more about Islamic finance and members of the delegation are going to be awarded diplomas in Islamic finance from the Bahrain Institute of Banking and Finance, after undergoing intense training. This continues Senegal’s tradition of engaging the Islamic finance industry in Bahrain for guidance due to its expertise. Furthermore Senegal would be an attractive place for Islamic banks in Bahrain to open branches as it could serve as a platform for them to penetrate other countries in the region with sizable Muslim populations. Thus we see that Senegal is another country in which there is huge potential for Islamic finance to expand. The signs are positive and we may expect Islamic finance to play a key role in Senegal’s future and hopefully help address the issues of poverty and unemployment within the country.
For 17 years, Bahrain has been the home of the World Islamic Banking Conference (WIbC), the largest congregation of market leaders, practitioners, thinkers and interested parties in Islamic finance. It has been a platform on which developments and challenges facing the industry can be discussed, appraised and resolved. In 2010, 1,200 delegates attended the event in Manama, an impressive figure especially when one considers the first WIbC had only 120 delegates.

Even with the litany of conferences, seminars and lectures that prevail within the industry, the WIbC is still unrivalled with Bahrain being regarded as home. But the tide is changing. The WIbC brand is expanding to the Far East; and if it can be considered as a weather vane for the industry, the inaugural conference of the World Islamic Banking Conference, Asia Summit, in Singapore, shows that the Asia Pacific region is as integral to the success of the Islamic finance industry as are the Gulf States.

Certainly, Malaysia has been at the forefront of Islamic finance for the last decade, but its gargantuan presence has overshadowed the subtle developments that have been occurring in Thailand, Brunei and of course Singapore. While nowhere near the size and influence of Malaysia, the next 10 years will be a formative period for the other Asian tigers.

Small but vocal

Speaking at the 16th WIbC in Bahrain in December 2009, H.E. Heng Swee Keat, Governor of the Monetary Authority of Singapore stated that “Islamic finance will provide an increasingly important bridge in the growing connectivity between the Middle East and Asia. Singapore is pleased to help catalyse deeper relations between these two high-growth regions.” Islamic finance therefore plays an important part in creating trade linkages, with Singapore looking to capitalise on the opportunities.

But its precocity will preclude this former British trading post to simply act as a conduit. Singapore is a small island but has a big voice. It has waded into debates assailing Islamic finance with Assistant Managing Director of the Monetary Authority of Singapore, commenting Ng Nam Sin at the WIbC in Bahrain on the issue of risk management and corporate governance standards and called for Shari’a-compliant banks to improve standards. Not content in simply commenting on the industry, Singapore have recognised that for mature and consolidated growth, there is a need to develop human resources. MAS said that it will sponsor eligible students for undergraduate courses in Islamic finance at the Singapore Management University (SMU). SMU has set up the Islamic Law and Finance Centre, a pioneering institution and the first of its kind to combine Islamic law, banking and finance programmes in a single, multidisciplinary university centre. Anticipated to being in the first quarter of 2012, SMU Law School will launch a post-graduate Masters programme in Islamic law and finance, which will be open to both lawyers and non-lawyers interested in pursuing a career in this field.

The zeitgeist has not escaped grass root Muslim organisations, whose traditional focus has been to cater to a Muslim’s spiritual and social requirements. The encroaching purview of finance and the flourishing of Islamic finance has encouraged the Singapore Islamic Scholars and Religious Teachers Association (Pergas) to develop a body of scholars that can consult on Islamic finance. They set up the Islamic Finance Consultation Unit (UKKI) in 2009, to advise Muslims on wealth and asset management and it is hoped that this unit will expand its focus. Thus, to develop further their capabilities in other aspects of Islamic finance, industry players are assisting. HSBC Insurance has start training members of Pergas on the technicalities of takaful. The takaful training programme began in December, with between 20 and 30 students in the first batch.
The role of the MAS

Islamic finance in Singapore has been commendably supported by Singapore’s de facto central bank, the Monetary Authority of Singapore. MAS joined the IFSB in December 2003 as an observer member and became a full member in April 2005. Singapore is the only non-Muslim country to be a full member of the IFSB. MAS currently participates in the Islamic Money Market Taskforce, the Supervisory Review Process Working Group and the Special Issues in Capital Adequacy Working Group.

While they have been clear that there will be no separate banking regulatory framework for Islamic finance, MAS have attempted to ensure that Islamic finance and conventional finance compete on the same plain, without any hindrances due to Islamic finance’s more peculiar features. In 2006, the Monetary Authority of Singapore (MAS) approved banks engaging in non-financial activities, such as commodity trading, to facilitate murabaha transactions. Tax treatments of Islamic contracts have been aligned with the treatment of conventional financing contracts that are economically equivalent. Double stamp duty has been removed in non-financial activities, such as commodity trading. Gradual amendments to regulations since 2005 have removed the costly barriers which had the potential to impede the growth of the industry.

Developments on the ground

The first Shari’a-compliant pan-Asian equity index was launched in Singapore in February 2006. This index served as a benchmark for Shari’a-compliant funds investing in Asian equities and paved the way for Islamic funds to be set up in Singapore. As of 2008, there were SGD 500 million takaful funds under management and approximately SGD 2 billion Shari’a-compliant real estate funds managed out of Singapore. In 2008, Daiwa Asset Management Co. Ltd.’s listed the first Shari’a-compliant exchange trading fund which offers an investment channel into Japanese companies that fully comply with Shari’a investment principles.

Singapore has been involved in a number of innovative transactions including several sukuk. The government started a SGD 200 million reverse enquiry ijara sukuk issuance program in January 2009, which was set up to provide “regulatory assets” to institutions offering Islamic services. The sukuk was designed to address concern relating to the lack of Shari’a-compliant products and brings stability to the Islamic finance system. The ijara asset happens to be the MAS building, regarded as first class real estate and consequently the sukuk marked the first issuance of a sukuk in the market by a triple A rated sovereign entity. With the issuance of this sukuk, Singapore became the first non-Muslim-majority country to establish a local currency sovereign sukuk.

In 2010, Singapore saw the launch of the first Shari’a-compliant REIT in Singapore. Sabana REIT is world’s largest Shari’a-compliant property trust which has raised SGD 664.4 million in its IPO through attracting local and foreign investors. The REIT is listed on the Singapore exchange with Bahrain being the cornerstone investor.

The developments in Singapore have attracted the attention of Gulf based IFIs looking to diversify. Saudi based Al Rajhi bank is a majority shareholder of AEP Investment Management, a Shari’a-compliant investment advisory firm which hopes to tap into the opportunities in the Asia Pacific region. In June, AEP Investment Management and Keppel Telecommunications & Transportation Ltd (Keppel T&T), as Joint Investment Managers, announced the initial closing of Securus Data Property Fund Pte. Ltd. (Securus Fund), the world’s first Shari’a-compliant data centre fund. Securus Fund’s initial closing was achieved at USD 100 million.

Progress will be slow...

In 2007, the Islamic bank of Asia, Singapore’s wholly owned fully licensed Islamic bank was set up to focus on capital markets, direct investment and corporate banking services. After the pomp and the fanfare of its establishment, the bank has suffered losses over the years, reporting a USD 77.1 million loss in June. DBS group, IB Asia’s majority shareholder has publicly stated their commitment to Islamic finance, but unconfirmed reports suggest that they may downsize IB Asia. Even leaving this aside, IB Asia is set to reduce its work face. Along with Kuwait Finance House, Singapore’s cut of its workforce – citing internal structuring – these developments do not bode well for Islamic finance in Singapore.

Market commentators are circumspect about the growth of Islamic finance in the next few years. Even though Singapore have issued sukus, issuances have been sporadic and compared to its neighbours, it has been a trivial amount - Singapore saw USD 123.6 million of sukuk issuance in 2009, compared with USD 8 billion for Malaysia and USD 1.2 billion for Indonesia, its nearest Islamic banking competitors, according to Thomson Reuters data. Most of the developments will occur in the wholesale sector as opposed to retail but progress will be slow and there is a pressing need to have a critical mass of trained professionals in Islamic finance, which is currently lacking.

...but growth will prevail

However, with the support of the MAS and growing economic strength of China, Malaysia and Indonesia, Singapore is perfectly placed to seize opportunities available within the Islamic finance market space. In 2010, there were a number of transactions which indicate in the horizon that there will be significant developments. Maybank, Malaysia’s biggest lender, set
up a dedicated Islamic banking hub in Singapore, a 3720 sq ft refurbished branch, offering Shari'a-compliant services to Muslims and to non-Muslims – who form the bulk of the branch’s customers. Maybank launched an Islamic finance package for small and medium enterprises (SMEs) seeking financing. So while retail is limited, with few products on offer, there are signs of development.

On Singapore’s Islamic finance journey, Malaysia’s role will be crucial. Geographical proximity along with their historic and cultural tie will play a major part in building productive relationships and structuring Shari’a-compliant transactions. Khazanah Holdings, Malaysia’s sovereign wealth fund, undertook a hostile takeover of Parkway Holdings, a Singapore-based health care firm. The takeover took place in June. In October, Parkway Holding concluded the largest Islamic financing deal in Singapore thus far entering into an SGD 750 million murabaha facilities agreement, which will be used to pay off other existing loans. It will be intriguing to see how much stronger the relationship will become at the corollary effect on Islamic finance. But presently, signs are encouraging.
South Korea has had strong trade links with the Middle East for four decades which has invariably meant working on Islamic finance structures. Since the early 1980s, Korean companies such as Lucky Goldstar, Hyundai and Daewoo have been accessing Islamic trade finance facilities, processed mainly through the London market. However, there is now a push to open up the domestic Islamic finance market. This is not necessarily for the domestic Muslim population. With less than 1% of the population being Muslims, the idea of an Islamic retail market is implausible for South Korea. There is no real desire to offer any Islamic finance retail products. The drive is rather to attract foreign investment especially when neighbouring countries such as Singapore and Hong Kong have expressed a desire to be an Islamic finance hub in the region. A more pertinent reason is the USD 38 billion trade deficit South Korea has with GCC countries arising from the trade of oil. Figures suggest that 68% of the South Korea’s oil and 53% of natural gas was pumped by GCC countries. By embracing Islamic finance, and therefore tapping into Middle East wealth, they hope to reduce the deficit.

Building the relationship

The Middle East supplies the energy; South Korea manufactures the goods. It is a convenient relationship that has worked well over the years and seems to be going strong as we head into the second decade of the 21st century. The rise and rise of the Gulf States from the desert plains to sporting high rise skyscrapers with the latest technologies supporting the associated glamour and sparkle, owes a considerable debt to South Korea’s preeminent role in the manufacturing and electronics industry. Samsung C&T Corp., the second-biggest contractor in South Korea, built the world’s largest tower in Dubai. In 2010, Gulf States continued to procure the engineering expertise of the South Koreans. Korea Electric Power Corp., the nation’s biggest supplier, won a USD 20 billion contract to build nuclear power plants in the UAE in December. Samsung Engineering Co., South Korea’s biggest engineering company, won a USD 1.5 billion contract in April to build utility and offsite facilities for a gas project in Abu Dhabi.

With more transactions likely to occur between South Korean companies and the Middle East, Islamic banks will have greater opportunities to act as a financier and advisor. Cross border transactions will require Islamic banks to cooperate with their South Korean counterparts. Already we are seeing relationships forming. In March, Woori Investment & Securities Co, a unit of South Korea’s third-largest financial company, signed an MoU with Qatar Islamic Bank to cooperate in investment banking services and according to QIB, facilitate ‘mutual cooperation between the two parties in the search for suitable financial and investment opportunities in the Korean, Asian and Qatari markets’. The South Korean market offers investment opportunities in Korea’s high-tech sector with companies more than likely to pass the first stage of the Shari’a screening process, namely ensuring that activities undertaken are Shari’a-compliant. Investment into South Korea will fuel innovation and increase the product portfolio. South Korean financial regulator, Financial Supervisory Service (FSS) are keen to encourage strong relationships with Islamic banks and help the environment for Islamic finance to flourish. In May, the South Korean Financial Services Commission approved the country’s first Islamic investment fund, the Yurie Shari’a-compliance Korea Index which invests in 78 local Korean blue chip companies. This builds on successful Islamic funds such as STIC Pioneer Fund 2 (USD 200 million), Oryx/STIC Korean Technology Fund (USD 150 million), and the Private Equity Pre-IPO Buyout Fund by STIC Investment, a venture fund.

Proactive and vibrant relationships in the building up of South Korea’s capabilities extend to near neighbour Malaysia. Malaysia sought the assistance of the Korea
Exchange (KRX) in the development of the Bursa Commodity House system for Bursa Malaysia. Two years later, Bursa Malaysia and KRX hosted the inaugural KRX-Bursa Malaysia Islamic Capital Market Conference in Seoul. Discussions centred on the growth of Islamic finance and the liberalisation of Islamic financial markets. South Korea has been mulling over the issuance of sukuk for a few years now and have gathered assistance from Kuala Lumpur based consultants Amanie Business Solutions, led by the reputed Shari’a scholar Dr. Daud Baker.

Legislative hurdles and the Christian dismay

Typical of any country looking to issue a sukuk or to develop their Islamic finance capacity, legislation has proven to be a stumbling block for South Korea. The government would like to remove impediments and ensure tax neutrality. Major South Korean companies agree, throwing support into the government’s plan to issue sukuk. But things are not so simple, with opposition to the prospect of legislative changes to account for Islamic finance nuances gaining credence.

The tax subcommittee had already approved the bill for tax breaks for sukuk earlier in the year but in December 2010, The Strategy and Finance Committee of the National Assembly rejected the bill. Vocal opposition came from the church that represents approximately 30% of the population and fear is that the funds will be used for terrorist funding and money laundering. It is no secret that some National Assembly parliamentarians have been aggressively lobbied to reject the bill by powerful Christian evangelical groups such as the prominent Korean Association of Church Communication. This is a shame. The amendments to the tax law would have given tax neutrality to a sukuk issue while exempting foreign sukuk investors from paying withholding income taxes subject to a number of conditions.

According to the Korean Muslim Federation, there are approximately 35,000 Muslim residents in South Korea and more than 100,000 Muslim foreign workers. In a country which has a population of about 49 million, any prospect of being an effective lobbying group and a countervailing force to strong Christian lobby, is inconceivable. The support for Islamic finance is coming from the government and the business community. Any pressure for the bill to be approved will depend on them. Judging by the positivity thus far shown, the current impasse seems to be a bump rather than a barrier to bringing in legislative changes to enable the issuance of sukuk.
On 17th June 2010, at the Palacio de la Bolsa de Madrid, it was time for introspection for the Spanish. Key figures from the Spanish government, banks and financial institutions gathered to discuss with leading figures from the world of Islamic finance, whether Shari’a-compliant financing could assist Spain in recovering from the tumult caused by the global recession. The conference tackled issues such as financing public and private projects, regulatory amendments, tax, Islamic banking and insurance; and of course, the financial crisis over the course of three days. The outcome of this conference has yet to be felt, but this may represent a beginning for a country that has so far shied away from Islamic finance.

If Islamic finance should grow in Spain over the coming years, then 2010 will be looked back as the year the ball started rolling. The experience of European countries such as UK and France in bringing in Islamic finance models has presented Spain with a learning curve, one which they are taking notes from. In order to grow, expertise is required to educate and navigate through the hurdles that may be present on the journey. Consequently, Madrid Centro Financiero, (MCF), an association committed to promoting Madrid as an International financial centre, signed a MoU with Dubai International Financial Centre (DIFC) to support bilateral relations and encourage investment. Also addressed was fostering Islamic finance activities in Spain and amending legal and regulatory frameworks which will reduce cost barriers for Shari’a-compliant products.

The MoU followed another Memorandum signed in April between the UAE’s Securities and Commodities Authority and its Spanish counterpart, Comisión Nacional del Mercado de Valores (CNMV). The parties envisage extensive cooperation between the two regulators in opening up capital markets for joint listing, development of Islamic finance products, the sharing of experience and unlocking other opportunities within the securities market. The two MoUs are thus tentative steps forward in bringing Islamic finance into the country.

Time will tell how committed Spain is to incorporating Islamic finance into the country and it is difficult to make any clear predictions. However, there are signs of optimism especially as Spain looks eastwards to bolster their economy. Spanish financial institutions are also taking the opportunities available. Allfunds bank, jointly owned by Spanish financial groups Santander and Intesa Sanpaolo is a leading business to business fund platform. It launched an Islamic Services unit in September 2010. Clients would have direct access to the largest available range of Islamic funds through an automated platform. This was not the first venture into Islamic finance made by Allfunds Bank. It already offers more than 80 Shari’a-compliant funds, sourced from 15 fund promoters based in Luxembourg, Ireland, UAE and Saudi. In November, leading UAE takaful company, Salama-Islamic Arab insurance, partnered with Allfunds Bank to offer takaful and Shari’a-compliant funds across the Middle East through their automated platform.

It is however a mistake to assume that Islamic finance had not entered the Spanish shores earlier to 2010. Leading Islamic investment bank, Gulf Finance House (GFH) had opened a fund in 2005, aptly titled Al-Andulus House, to invest in residential real estate development projects along the Costa del Sol. The fund was structured according to the Shari’a and leveraged on the experience of local professional advisory firm, Aguirre Newman. In 2008, KFH was invited by members of the Spanish business and finance community to Barcelona to discuss Islamic finance: its growth and opportunities it provides. There were no immediate results but the interest was there. It remains to be seen how far this interest will go.
For some countries, Islamic finance is an alternative choice to meet an individual’s financing needs; for others, Islamic finance is a tool to rejuvenate an economy. For Sri Lanka, Islamic finance represents a bit of both.

Sri Lanka is emerging from a 26 year civil war which officially ended in 2009. During this period, Sri Lanka showed strength and resilience which was reflected by a strong economy even in the face of weak investor confidence. The end of the war has improved confidence and provided opportunities for Sri Lanka to grow, and with it Islamic finance is playing a marginal, though increasing role.

Closing the loophole and opening the coffers.

Sri Lanka has 1.6 million Muslims which represents 7% of the nation’s 23 million population. There are many informal entities that offer Islamic financial products though in local areas with a high Muslim population. Various unregistered firms are taking deposits due to a loophole in Sri Lanka’s laws relating to finance businesses but this is expected to be closed with the Sri Lankan government presently discussing suitable legislation.

The black economy in taking deposits will whittle down and recognised IFIs will be sought by individuals in order to save. There are already a number of financial institutions offering Islamic products and services. There is yet to be a fully fledged Islamic bank, but this is likely to change in 2011 mainly due to the praiseworthy efforts of Amana Investment Ltd. The official story of Islamic finance in Sri Lanka begins with this company.

Amana Investment Ltd: pioneers of Islamic finance in Sri Lanka

In 1997, Amana investments Ltd was established, whose mission statement was to offer Islamic finance solutions. The company offers a range of products including amongst others, home musharaka, ijara vehicle leasing, mudaraba investment accounts and musawamma. Figures show that customer deposits in the company are over LKR 7.8 billion (USD 70 million), an impressive figure when considering the short time period of its existence and the broader conditions in the country.

Since its inception, they have branched out into Takaful (Amana Takaful Ltd) and the Securities and Capital Markets (Amana Securities, Amana Capital and Amana Asset management). In the capital markets, Amana were instrumental in creating the Dow Jones Islamic Market Amana Sri Lanka Index, which tracks the performance of Sri Lankan companies that comply with Shari’a based investment principles. Along with Namal unit trust, they formed Namal Amana Equity Fund. The fund has been successful over the last year, rising 71 percent and beating all the other 299 funds tracked by Bloomberg.

Amana Investments have also been instrumental in pushing for legislative changes. An amendment was made to the Banking Act 1998 in 2005. In the Act, banks are classified as Licensed Commercial Banks (LCBs) and Licensed Specialised Banks (LSBs) with Schedules known as Schedule II and Schedule IV detailing the permissible forms of businesses that could be undertaken by such banks. The amendment ensured that LCBs and LSBs were permitted to offer Islamic banking products. Additionally, there was an amendment to the definition of deposits in the act, recognising Islamic banking products.

In 1998, Amana Investment requested the Central Bank of Sri Lanka (CBSL) for a licence to set up a commercial Islamic bank, Amana Bank Ltd. 11 years later, CBRL granted a Letter of Provisional Approval which stipulated, inter alia, that the bank is required to have start up capital requirement of LKR3.2 billion (US 28.6 million). Over the course of the next two years, Amana Bank Ltd said it had raised 3.2 billion in capital through a private placement by selling 631.9 million
5.00 rupee shares to both foreign and local investors. In January 2011, the license for the first commercial Islamic bank in Sri Lanka was granted by the CBSL. According to Amana investment website, shareholders include Bank Islam, Malaysia Berhad (20%), AB Bank, Bangladesh (15%), IDB, Saudi Arabia (10%), and Sri Lanka’s leading tea exporter Akbar Brothers (10%). Amana bank hopes to attract funds from the cash-rich Middle East which is looking for investments for its surplus cash generated from oil to fund infrastructure projects on the island.

Success brings in the competition

On the back of the success of Amana, a number of other companies, both national and international have entered the market to varying success. Conventional banks such as Muslim Commercial Bank and the Bank of Ceylon have Islamic windows. The eponymously titled Peoples Leasing Company has rebranded their Islamic finance services unit to Al-Safa to reflect the growing interest in ijara services. Another leasing company, the LOLC group, was the first of its kind in Sri Lanka. In the mid 90s, LOLC experienced a reduction of their Muslim customer base as Muslim sought more Shari’a-compliant options. In order to recapture this market, LOLC set up its own Islamic business unit Al-Falaah in 2007. Al Falaah opened its 3rd Islamic Financial Services Centre in 2010 and offers Shari’a-compliant profit sharing and investments, leasing, trade financing and property/project financing.

However, it has not all been smooth sailing for the Islamic finance industry in Sri Lanka. ABC Baraka Investments entered the market in 2007 and was relatively successful. However, the global financial crisis had adverse ramifications for the investment management company. Depositors were entitled to a minimum of Rupee 50000, but as of 2010, the management has failed to make payment though they are planning to do so in 2011.

A more egregious case is the dissolution of the Islamic finance subsidiaries of Sri Lanka’s oldest and largest conglomerate, Ceylinco Group. Ceylinco had, in the early 2000s set up Ceylinco Takaful Ltd to capture the untapped takaful market, and also Ceylinco Profit Sharing Investment Company Ltd. Moreover, an Islamic finance faculty at Ceylinco Sussex Business School was established. In 2006, they signed a partnership agreement with Malaysian based INCEIF to develop human capital needs in the Islamic finance industry in Sri Lanka. In 2009, nearly 12,000 depositors with a total of Rs.800 million funds demanded their money back from Ceylinco Profit Sharing Investment Company Limited (CPSICL). Depositors of Ceylinco Profit Sharing had not been paid their profit shares nor were they able to withdraw their deposits. Investigations into the organisation resulted in the suspension of operations by Ceylinco Takaful Ltd in 2009. It was meant to last only a few weeks but the company never reopened. In November 2010, the Insurance Board of Sri Lanka (IBSL) called for quotations from persons with financial or legal background with insurance experience to be appointed as an administrator.

The cause of the crisis was the failure of an unregistered firm under Ceylinco group which had adverse ramifications on the whole group. Ceylinco Development Bank, a community finance entity, has recently changed its name to Citizens Development Business and has announced in December 2010, that it will offer Islamic financial services. As for the beleaguered depositors, they arrived to a mutually accepted repayment plan at the end of 2010.

Education, Education, Education

The precipitous fall of Ceylinco has not had a major impact on the Islamic finance market in Sri Lanka. Market commentators believe that the Islamic finance market in Sri Lanka is just below 5% but growing. To move forward a number of challenges need resolution. Under statutory regulations, Islamic institutions and conventional institutions have to invest 50% of their finances into treasury bonds which are not Shari’a-compliant. This is something that legislators need to address, especially with the forthcoming establishment of an Islamic bank. The government are not yet savvy to Islamic finance but are supportive and have been training officials in Islamic finance. There are number of Islamic finance training providers in Sri Lanka as well as Islamic finance promotion bodies. A number of them are accredited training providers for UK based Chartered Institute of Securities and Investment’s (CISI) who offer the Islamic Financial Qualification (IFQ). Additionally, it is notable that each Islamic finance entity has a Shari’a board which is comprised mostly of local scholars who have been educated in Sri Lankan madrasas. The strong scholar community facilitated the creation of All Ceylon Jama’yyatul Ulama, the governing body for certifying compliance with Islamic law in Sri Lanka. The body deals with all aspects relating to the Shari’a including finance, though it is not a central Shari’a board. Islamic finance in Sri Lanka is still in its infancy; maybe in the future it will be considered, but not now.
If proof was needed that Islamic banking is being viewed as an important contributor to the South African economy, it came in the 2010 budget speech of Finance Minister Pravin Gordhan, who said, “As an ongoing part of the process of simplifying our tax system, the government proposes further measures to reduce red tape and enhance our attractiveness as a viable and effective location from which businesses can extend their African and other worldwide operations. We will also review the tax treatment of financial instruments to ensure appropriate accommodation of Islamic-compliant finance.”

Minister Gordhan was true to his word and, in May 2010, the proposed tax amendments were issued. These were based on two years of collaboration by the National Treasury with a broad cross-section of Islamic finance sector stakeholders. The proposed amendments are undoubtedly the most important development in Islamic finance for the period under review.

The reason for the proposed amendments is that, under the current tax laws, the concept of form in Shari’a-compliant products works against taxpayers, who lack the full freedom of control because of their adherence to religious principles. Thus tax is currently a hindrance to a vibrant and growing Islamic finance market.

The proposal is that specific provisions be added to the current tax legislation so that Islamic finance is placed on an equal footing with conventional finance. The first three underlying structures that are to be accommodated from a tax perspective are mudaraba, murabaha and diminishing musharaka.

**Mudaraba**

Under current legislation tax payers are exempt from paying tax on the first R22 300 they earn in interest (this increases to R32 000 for people over 65 years). Investors who use the Shari’a-compliant mudaraba option don’t enjoy this tax exemption as they are earning a profit share rather than interest. The amendments propose that profit earned by individuals in terms of a mudaraba arrangement will be treated in the same way as interest for tax purposes, thus ensuring that the same tax exemptions apply to mudaraba investments.

**Murabaha**

The amendments propose that, for income tax, value-added tax and transfer duty purposes, the bank will be deemed not to be involved in the purchase or sale of assets/property but rather that the client will be deemed to be acquiring the assets/property directly from the seller. The outcome will be that the additional indirect taxes, which would not apply to conventional financing deals, will also not apply to murabaha financing. From a tax perspective, the mark-up applied by the bank will also be treated in the same way as interest.

**Diminishing musharaka**

For the purposes of income tax, value-added tax and transfer duty, the bank will be deemed not to be involved in the sale of the property. The client will be deemed to be acquiring the bank’s proportionate interest in the property directly from the seller. The rent paid is deemed to be a ‘premium payable.’

Industry stakeholders, through their specific industry bodies, have all given their comments on the proposed amendments and a revised version of the amendments, which takes this input into account, is being finalised.

**Islamic private banking**

Until 2010, Islamic banking was regarded as a segment and all Islamic banking customers were treated similarly and offered the same products. Absa Islamic Banking and FNB Islamic finance both launched Islamic private...
bank offerings during 2010, thus enabling a level of segmentation within the Islamic finance sector based on income. This development ensures that affluent Islamic banking customers receive the same levels of service as affluent people who choose the conventional banking offering. This is a further indication of the contribution of a relatively small sector of the South African population (Muslims are estimated to constitute 2% of the overall population) to the economy as a whole. The intention is to provide affluent Islamic banking customers with a private banking service that can compete with the best in the world. The next stage of the segmentation process will be the development of an Islamic wealth offering for affluent clients. This would extend to the weighting of portfolios according to Shari’ah principles and Shari’ah-compliant estate planning.

Product development

In addition to the private bank offering, new product development has continued to be a focus of local Islamic banks due to the demand from customers wanting to conduct the full spectrum of their financial affairs according to Shari’ah. The development of products for the business market has received particular attention. It can be confidently expected that, once the proposed tax amendments are passed into law, this product development process will increase.

Once the proposed tax amendments mentioned above are implemented, they will enable the development of more products such as a long term home finance that is competitively priced in comparison to a conventional home loan. Other products that will be enabled include Commercial Property Finance and Commercial Property Investments.

Launch of the BankSETA training material

South Africa shares a similar shortage of Shari’ah finance skills to that experienced by many other countries. The Banking Sector Education and Training Authority decided to fund an intervention to address this skills shortage. They commissioned the development of a training programme to be used by all Islamic banks in South Africa. This programme covers all of the most commonly used structures in Islamic finance. Senior Shari’ah scholars from Islamic banks in South Africa in consultation with the Shari’ah Financial consultancy were involved in reviewing the content of the training programme. BankSETA has attracted a great deal of recognition for being one of the first national training authorities in a country not governed under Shari’ah, to develop comprehensive Islamic banking training material of such a high standard.

Current South African Islamic finance landscape

There are 6 Islamic banks in South Africa that offer Islamic finance, one of which is a niche bank. They offer a wide range of Islamic retail banking products as well as Shari’ah-compliant investments.

South African investment houses offer Shari’ah-compliant investments including:

• Islamic Equity Funds - Shari’ah-compliant, equity-linked exchange traded fund that tracks the FTSEJSE (Johannesburg Stock Exchange) Shari’ah Top 40 Index, reflecting the Shari’ah-compliant companies listed among the top 40 companies on the main board of the JSE, as measured by market capitalisation
  • Retirement funds
  • Pension annuities
  • Unit trust funds
  • Endowment policies

Shari’ah-compliant insurance is offered for motor, household and business needs in accordance with Shari’ah.

Islamic finance is really about community development. The Banking Association of South Africa is working hard to build a culture of saving in the country. The “Teach a Child to Save Campaign” is an important part of this initiative. Teach a Child to Save encourages staff members of South African banks to give up a few hours to go into a local school to teach one of the carefully prepared lessons provided by the Banking Association. These lessons are designed to encourage children to understand the key elements of managing money and the importance of saving. Although Islamic banking has been part of this programme since 2007, the Banking Association established an Islamic Chapter of Teach a Child to Save in 2010, with a formal launch taking place at the Central Muslim School in Laudium, near Pretoria. Representatives from all levels of employment in South African Islamic banks went into their local Muslim schools to deliver lessons on how to draw up a budget and to manage and save money. This will be an annual activity that encourages banking employees to contribute their time and talents to the development of a culture of saving in the country.

The Head of Operations of Absa Islamic Banking has become a local champion of the global Pink Hijab Day initiative and 2010 was the third year of involvement. The focus is on raising awareness of breast cancer. During October of each year, pink hijabs are distributed to women of all faiths as part of developing a sisterhood who take responsibility for awareness of their own health. The focus for distribution of pink hijabs has been in schools and charitable community organisations, and business women’s organisations have also been reached. Another wide-reaching outreach programme is the recognition of the Fast during Ramadan. Absa Islamic banking provides bottled water to some mosques in poorer areas nationally for people to break their Fast at sunset.

Work is also done with Muslim charitable organisations that support needy people of all faiths. The focus is on supporting organisations that have a broad reach across many areas of need.

Launch of Islamic banking in Tanzania

In May 2010 NBC (National Bank of Commerce) of
Tanzania, which is 55% owned by Absa Bank Ltd., launched an Islamic banking offering in that country. This made NBC the first major Tanzanian bank to offer products designed to meet the needs of Muslims, who form approximately half of the Tanzanian population. The initial product take-up has driven plans to grow the offering to meet the business needs Muslims of Tanzania.

Looking Ahead

One of the other Islamic financial structures attracting attention is the sukuk. It is strongly believed that there is great scope for the development of sovereign sukuk in South Africa. South Africa has large infrastructure projects requiring the kind of funding for which sovereign sukuk could prove to be an ideal financing vehicle. The scope for introducing an alternative to existing conventional government debt by introducing instruments enjoying Shari’a acceptability is significant. This would be one of the first sovereign sukuk to be launched in Africa. This would support government infrastructure funding requirements, such as the need to extend the country’s power generation capacity and would position South Africa as a centre for Islamic banking on the African continent.

In summary, 2010 was a landmark year for Islamic finance in South Africa. The developments taking place will change the Islamic finance landscape permanently and will drive growth and development of the sector; hence we can expect more progress in 2011. It will also position South Africa powerfully as a financial hub on the African continent, as it becomes the incubator for Islamic financial product development for Africa.
Sudan

Sudan is in a transition period; or rather Sudan has been in a violent transition period since it gained independence in 1955. The conflict between the Muslim north and the Christian south has raged on for over 50 years in some form, resulting in massive casualties, a foundering economy, famine, poor infrastructure and deep antagonism between the North and South, Muslim and Christian. Secession of the South had to occur and in early 2011, thus began a new dawn for Sudan. Southerners voted overwhelmingly for independence and a break from the North. Independence will be declared formally in July, making Sudan the world’s 193rd state. It will be a truly momentous occasion for a country long ravaged with civil war. The North had held a tight grip on the South, attempting to impose its vision upon a less than open South. Politics in the North can be characterised by strong Islamist agendas. One policy was the islamisation of the economy.

Islamisation not for all

The Shari’a has been the de facto law in Sudan since 1981. However, it took just shy of 10 years for transformation to a totally Islamic based financial system, with the Banking Law of 1992 marking its completion. After Iran, Sudan was the only country who had attempted to convert its entire financial system into an Islamic but the jury is out as to whether this has been entirely successful. In the North, Islamic banks remain small reflecting the limited size of its economy and its low living standards.

The transformation certainly had little support from the south, by and large compelled to accept the dictates of its Northern superiors. The context changed after the signing of the Comprehensive Peace Agreement (CPA) in 2005 marking the end of the second Sudanese civil law. Under the terms of the agreement, it was stipulated the North would still govern according to the Shari’a but the South were permitted to create their own representative government. These terms had an impact on Islamic finance. In 2007, all banks were told to convert into conventional finance or leave. Most Islamic banks chose to leave resulting in capital outflow from the South. Conventional banks have been set and several banks from neighbouring countries have entered the markets. There are currently around 10 conventional banks in the South. The Central Bank of Sudan, based in Khartoum in North, created the Bank of Southern Sudan as a branch to regulate the financial markets in the South.

Well established system

Islamic finance in the North remains entrenched. While it was only in 1992 that there was complete transformation, Islamic finance had presence in the country since the late 1970s. Faisal Islamic Bank of Sudan was the first bespoke IFI set up in 1977 by a special Act of Parliament. Strong government support and valuable concessions resulted in dramatic growth in a short period of time. More Islamic banks entered the market. But due to corruption and bias amongst the management of banks to certain customer groups as well as an abuse of Islamic principles to circumvent payment, banks began to experience high default rates. Tighter restrictions on loans resulted. Moreover, in the period of 1999 – 2002, Sudan introduced Basel requirements and aligned them with Shari’a principles.

Faisal Islamic Bank was also pioneers of takaful in Sudan. They set up the Islamic Insurance Company of Sudan, which was given tax exemption on all assets and profits. Legislation took time to follow. After a series of insertions, amendments and decrees, it was only in 2003 that the government passed the Law of Insurance and Takaful.

With the islamisation of the financial system in 1992,
the state established the High Shari’a Supervisory Board to oversee compliance. The body comprised of Islamic scholars, bankers and economists. The Board has eleven members. While the Bank of Sudan sets rules for all Islamic banks, and the Shari’a boards of banks acts as a day to day monitor, the Board remains the authority on Shari’a matters. It is also the appeal authority for disputes relating to Islamic finance. Institutional Shari’a boards, in addition to their supervisory roles, act as in house law departments dealing with legal issues.

Capital Markets

In 1994, Khartoum Stock Exchange (KSE) was set up and comprises of shares of over Sudanese companies a number of investment funds and issues of government sukuk. The stock exchange has its own Shari’a board, which screens and approves products prior to their trading, thereby limiting speculation. In 2003, the KSE launched the Khartoum index which was developed with the assistance of the IMF. It is one of the top five exchanges in Africa.

Sudan is quite active in the issuance of sukuk. Shahama bonds, short term securities which are structured utilising the musharaka model, is used by the state to borrow money in domestic markets. The bonds are backed by shares of companies owned by the Ministry of finance. Thus, profitability is dependent on the success of the companies which produces volatility in returns. The government issues these bonds on a quarterly basis with revenue going to administration costs and little being funnelled for development purposes. Sudan issued its first sovereign sukuk of USD 147 million in 2008. It had planned to offer a USD 300 million sukuk by the third quarter of 2010. But the issuance failed due to investor concerns about the precarious political situation in Sudan.

Foreign Relations

Another problem for Sudan in issuing sovereign bonds has been its pariah status according to the International community. It has been classified as a sponsor of terrorism by the US and has been subject to economic sanctions. Sudan has however attempted to seek assistance from Arab nations such as Egypt, Kuwait and Saudi Arabia. Sudan central bank was also one of the signatories to the establishment of the International Islamic Liquidity Management Corporation (IILM) in Kuala Lumpur in October. The central bank is a full member of the IFSB. They have also been beneficiaries of IDB loans including a USD 120 million loan to help Sudan with the development of Khartoum New Airport. IDB have also stated that they would assist Southern Sudan with construction efforts.

A new dawn

Sudan’s foray into Islamic finance has been a long and productive one but one which is riled by internal and external conflict. Intentions were good and there have been a number of noteworthy achievements. But without political stability and crippling conflict, Sudan has been unable to reach its potential. This may change following the separation and dependent on whether gun totting militia harbour for peace. With years of violence marring opportunities for long standing peace, there is always that uncertainty which will prevail. But with the division, and with North Sudan coming out of the cold on the political arena, there are opportunities to grow. Sanctions may be lifted and this will serve to bring investment. It is just dependent on that delicate rope of peace to hold.
Switzerland is one of the most popular financial hubs in the world. It is known for its strict code of conduct with regards to confidentiality and its world class private banking services. Hence it has been a location of choice for wealthy individuals seeking to benefit from protection and secrecy offered.

With oil wealth creating more wealthy individuals in the Middle East, Switzerland has been quick to capitalise. Players in the country have been promoting Switzerland as a destination for high net worth individuals from the Muslim world to experience world class banking services However, there have been very few conventional private banks offering Islamic finance products. Bank Sarasin is one of the few conventional private banks which have fully fledged Islamic finance offerings which, is somewhat surprising given that private bank Pictet & Cie launched Islamic services way back in 1998. Notwithstanding this, Bank Sarasin is one of the few conventional private banks that have a complete set of Islamic finance offerings. In addition to Bank Sarasin, the first Islamic private bank to open in the country was Faisal Private Bank, opened in Geneva in 2006. The bank has not been doing as well as expected and recently went through a change in management.

One problem which has hindered the progression of Islamic finance in Switzerland according to insiders is the terminology. Many non-Muslims feel threatened when they hear the terms ‘Islamic’ and Shari’a, believing that Islamic finance is the initial step to the emergence of Shari’a law in Switzerland and Europe at large. This view was clearly indicated by the Swiss public’s view on banning minarets in the country.

However analysts are of the opinion that it is only a matter of time before Islamic finance makes further headway into the Swiss landscape as the industry continues to gain momentum globally.
SYRIA

Since the coming to power of Bashar Al Assad in 2000, Syria has embarked on a series of political and economic reforms. In the last five years, focus has moved towards just economic reforms, with liberalisation and the opening up of the markets being a broad based policy goal. His moves are a departure from the centralised planning which characterised his father’s regime; and has had important consequences for the banking industry and specifically Islamic finance.

A new phenomenon

After many years of a centrally planned socialist economy, it was unlikely that there would be a rapid move towards a market economy. Hope was high for there to be wholesale changes made to the Syrian economy, especially with President Bashar’s more liberal rhetoric. But today industry remains highly centralised and steady introduction of market reforms since 2005 has yet to make significant difference.

But in the financial sector there have been significant changes. Long populated with state owned banks, in 2004 Syria welcomed its first private bank. From there a number of private banks have formed thereby increasing the quantity and quality of financial products on offer leading to an increase in the customer base. Concomitantly Islamic banking also took shape, which has made Syria unique in the Islamic finance markets. Rather than edging into the market and competing with established players, Islamic banks were starting operations at the same time as their conventional counterparts.

The passing of Legislative Decree 35 in 2005 provided the legal footing for Islamic banks. The law is wide ranging addressing issues such as Islamic bank operations, Shari’a governance, capital adequacy, tax policy and a host of other concerns. Interestingly, the law directly mentions compliance with AAOIFI standards, a positive step in ensuring some level of standardisation within the domestic markets. Syrian authorities have also granted Islamic banks a range of investments activities including being able to enter as partners in a commercial transaction. Being able to act as an investment partner opens up a wider market for Islamic banks.

When compared to conventional institutions, these allowances grant Islamic banks competitive advantages. However at the same time, the capital requirement to establish an Islamic bank is higher than a conventional bank. In January, Decree No. 3 of 2010 was passed which increased the minimum capital requirement for conventional banks to 10bn Syrian pounds and 15bn Syrian pounds for Islamic banks. The government said the move was necessary in order to comply with Basel II standards and hedge against the risks posed by the growing integration of local banks into global markets. The higher capital requirements for Islamic banks acknowledge the liquidity problem which affects Islamic banks.

A growing market

There are currently 14 private banks operating in Syria. The first Islamic bank in Syria, Al Sham Islamic Bank started operations in 2007. It was followed by International Islamic bank (an affiliate of Qatar International Islamic Bank). In 2010, Al Baraka bank started operations. Kuwait Finance House has plans to open an Islamic bank in Syria in the near future and has partnered with number of prominent local Syrian business men. A key attraction of the Syrian market is the excess liquidity in the market. According to central bank figures deposits amounted to 41% of GDP in 2009. Consequently, analysts believe that there is a potential for more banks.

Recent estimates suggest that, as of April 2010, assets at Islamic banks stood at SYP 75.8 billion, making a 40% increase from the year before. Islamic banks hold
approximately 4% of all banking assets. Public banks still dominate while private banks hold just over 20%.

While Syria has two Islamic insurance companies, Al-Aqeelah Takaful and Syria Islamic Insurance Company, the market for insurance is not as conducive as it is for banking. Takaful companies are subject to the same regulatory guidelines as conventional insurance companies though the Syrian Insurance Supervisory Commission (SISC) has indicated that separate guidelines will be issued. Furthermore, SISC are looking to set up a Shari’a board to oversee takaful companies and to cooperate in drafting guidelines.

A key challenge for Syrian takaful companies is building up a strong consumer base. In a conservative Muslim country such as Syria, there are religious scruples over insurance. Thus we see that most premiums are generated from companies and not individuals. But takaful companies are seeking to build out their personal policy service lines, highlighting Islamic credentials. They have managed to overtake a number of conventional insurers in terms of income and there is general positivity that this success can be continued. However, the dissolution of a third insurance company, Noor insurance, indicates that the industry is still experiencing growing pains.

Challenges

However, for Islamic banks to prosper there needs to be a change in consumer perception. According to the Syrian Banking Monitor 2009, a survey on attitudes to banking in Syria conducted by local research firm Acumen, Syrians are generally cautious about the banking sector. Only 16% of urban Syrians have a bank account. As mentioned above, liquidity is high in the market but many are dealing with conventional institutions. However, the survey revealed that most respondents had a preference for Islamic banking services but choose a bank according to reputation and credibility. At the same time most depositors in Syria are not keen on long term deposits, narrowing the product portfolio for Islamic banks.

On the institutional side, Decree 35 of 2005 ensures that contracts concluded by Islamic banks are exempt from taxes on profit and stamp duty. Unfortunately, there have been complaints by Islamic banks that tax authorities are charging stamp duty and transfer fees on purchases, which add to the cost of the transactions. There is also the problem of a lack of qualified people in the industry. Support is required to educate and train staff.

The future looks good

The banking sector is doing well in Syria though there has been a slight slowdown in growth in the last year. Liberalisation of the markets is ongoing. Decree 3, mentioned above, permitted foreign companies to take majority ownership of Syrian banks for the first time, with ownership cap rising to 60%. At the end of July, Decree 56 of 2010 was issued allowing international investment banks to enter the market. With these moves, Islamic bank heavyweights such as Abu Dhabi Islamic Bank have expressed desire to open branches in Syria. The government and the central bank are also interested in issuing sukuk. This is likely, especially after the central bank of Syria began selling government debt for the first time in decades, only this December. An open market will benefit the Islamic finance industry. It is still in its nascent stages in Syria but all indicators suggest the sector will grow further in the next few years.
TANZANIA

Tanzania like many countries on the African continent is plagued by poverty. However, unlike other nations, the country has been relatively devoid of strife and internal conflict. Modern day Tanzania is made up of the mainland (former Tanganyika) and the idyllic island of Zanzibar. The population of Tanzania is estimated to be 45 million and what is interesting to note is that the populace of the island of Zanzibar is 99% Muslim. Whereas on the mainland Muslims make up 35% of the population.

With a sizable Muslim population, Tanzania may be the next frontier for Islamic finance to spread. Furthermore, there is a strong historical relationship between the Muslim Tanzanians and Arabs as Islam spread to the country through Arab traders from Yemen and Oman, and thus many Muslim Tanzanians are of Arab heritage as the traders intermarried with local women. Another reason why there is huge potential is that much of the population is under-banked, so Islamic banks can fulfil this gap.

In 2010, Islamic finance began penetrating Tanzania, with South African banks at the forefront. The response so far has exceeding expectations. Stanbic Bank Tanzania, under their Islamic finance window, had 5000 new customers opening bank accounts during the first three months of offering Shari'a-compliant financial services in 2010. The bank aims to provide more facilities this year due to the positive response and has submitted a proposal to the central bank outlining their future plans. Absa bank of South Africa also began offering Shari'a-compliant services in 2010, through its subsidiary, the National Bank of Commerce (NBC). The bank has been offering cheque accounts as well as savings accounts with innovative features such as an imbedded funeral plan. Furthermore the bank plans to offer other innovative products such as a Hajj and Umrah savings facility in future. However, the two windows were not the first to offer Islamic banking facilities, as Kenya Commercial Bank (KCB) also got the licence to offer Shari’a-compliant banking services back in 2008.

2011 could prove to be an eventful year for Islamic finance in Tanzania. There are rumours that a group of private investors have approached the Central Bank looking to establish an Islamic bank. Hence we may witness the birth of full fledged Islamic banks in Tanzania. However there are certain issues that need to be dealt with according to industry insiders, such as a general lack of awareness and capacity. If these issues can be effectively dealt with, Islamic finance will no doubt establish itself in Tanzania in the coming years.
It has become axiomatic that the ideologues of Islamic economics envisioned a holistic system which would eschew capitalist precepts in favour of an altruistic and ethical normative. Society would be lifted out of the mine of its own self indulgence and poverty will be alleviated giving opportunities to the less fortunate of society. Debates have erupted amongst academics and social commentators as to whether Islamic finance has realised such noble aims. Many non-Muslim countries have embarked into Islamic finance, not for philanthropic purposes, but for monetary gain and this fuels the arguments of the naysayers who opine that Islamic finance is underscored by the same motives as capitalism. However, certain non-Muslim countries would contest this opinion. One such country is Thailand.

Assisting the poor

The primary motives to develop Islamic finance in Thailand were to serve the economically weak Muslim community and to attract petrodollars from the Gulf. The community is mostly based in the South and consists of 9.5 million Muslims, over 10% of the population. It is the second largest religious group in Thailand but is burdened by the high incidence of poverty that pervades. The government have advocated more development aid for this region, hoping that increased affluence will scupper the intents of separatists who are fighting for an independent state. Political turmoil resulting from this conflict has had a negative impact in drawing in foreign investors.

Islamic finance in Thailand has its antecedents in the Pattani Islamic Saving Cooperative, a Shari'a-compliant saving cooperative set up in 1987. Since then a number of other saving operatives have been established in Southern Thailand which have successfully managed and mobilised Muslim funds in the region. The first Islamic window was established by Government Savings Bank in 1998. In 2001, Krung Thai bank set up an Islamic branch.

Pursuant to these developments, the government passed the Islamic Bank of Thailand Act in 2002 which led to the creation of the first Islamic bank in Thailand the following year, the Islamic Bank of Thailand (IBT). In 2005, in line with government policies, IBT acquired from Krung Thai Bank its Islamic branches. In 2008, IBT partnered with Muang Thai Group, a Thai Insurance company. Today the bank has over 60 branches spread across Thailand and is enjoying healthy profits with annual increases, including a bumper year in 2010, when net profits increased sharply from 355 million baht to 1.2 billion baht. This is largely due to the aggressive marketing adopted by the bank over the last few years. It has 131.32 billion baht worth of assets and is planning to open over 20 branches in the coming year.

IBT plans to set up the country’s first Islamic property fund worth 1.4 billion baht. It has already signed an MoU with Finansa Asset Management, a leading wealth management company based in Bangkok, and hopes to start the fund by early 2011. While it would suggest that the bank has the objective of profit maximisation, the government would demur. IBT has been assigned to provide financial aid to Thailand’s southernmost provinces, areas with the highest concentration of Muslims. Consequently, the bank’s plan to list on the local bourse has been rebutted by the government as it runs contrary to the government’s strategy for the bank. However, strategies may have to change especially after Malaysia’s CIMb acquired Bank Thai in 2009. CIMb plans to open Islamic windows through its 125 windows, thereby acting as a direct competitor to IBT.

Building the infrastructure

On the other hand, the government is aware of the need to have a strong capital market to cater for the increasing demands of Thai Muslims. There are a few
products on the market which serve this purpose. One such product is the Shari'a-compliant retirement fund created by Krung Thai Asset Management in 2006. But it is in the stock markets that we are seeing a great deal of success for Islamic finance. In April 2009, the Stock Exchange of Thailand (SET) and the FTSE created the FTSE SET Shari'a Index, created for both domestic and international investors. The index can be used for an array of Islamic products. In 2010, Islamic stock funds provided higher returns than their counterparts. In December, the Securities and Exchange Commission (SEC) green lighted the sale of sukuk funds to be sold directly to investors. IBT is expected to be the first issuer. In order to create a robust capital market, the Thai government is currently reviewing legislation with the intention of issuing a sukuk. The government has already drafted regulation which will provide tax exemptions on the transfer of assets but have yet to release it. Currently, sukuk would be subject to high tax costs due to double transfers of assets. Thai Securities Commission is assisting by drafting regulation which permits both domestic and international issuances of sukuk. Ongoing drafting of regulation has delayed the issuance of a sukuk. IBT had hoped to issue sukuk worth 5 billion baht but have been thwarted by the sluggishness of the government in passing appropriate legislation.

Yet as the government delays, the private sector has moved forward. Trans Thai-Malaysia (Thailand) (TTM) raised USD 190.2 million through a sukuk murabaha. The proceeds will be used to fund capital costs and working capital for the Trans-Thailand Malaysia natural gas pipe line which has been operational since June 2010. The sukuk represents the first issued by Thailand. The Malaysian Rating Corporation (MARC) awarded it the highest rating due to the predictable cash flow and TTM’s low financial and operating risk profile. TTM is a mutually owned project company between the Petroleum Authority of Thailand and Petronas Nasional (PETRONAS), Malaysia’s national oil and gas company.

Rebels with or without a cause

Islamic finance in Thailand looks good. A relatively supportive government, a vibrant domestic market and strong ties with Malaysia can only bode well for the future. Ongoing insurgency in the South may provide obstacles, especially if the conflict intensifies. The government are keeping a close eye on developments but there is a hope that with increased affluence, it will pacify the rebels. In this regard, the IBT provides a medium through which conscientious Muslims can transact according to their beliefs. Government support for such endeavours may endear the rebels. At least this is the aim. But, at the same time, IBT is not relying on a change of heart. Its growth signifies that it has a greater ambition.
Tunisia is a country situated in North Africa, near the Mediterranean Sea and is bordered by Algeria and Libya. It has a population of between 10-11 million, the majority of whom are Muslim. The country has been in the news recently as the government was toppled when Tunisians took to the street to demonstrate their unhappiness with the Prime Minister Ben Ali, earlier this year. These events have had a direct impact on Islamic finance in Tunisia, but before discussing this, a history of Islamic finance in Tunisia will be given.

The entrance of Islamic finance into Tunisia has not been recent. In 1983, Tunisia saw the opening of the first, and for over 20 years, sole IFI, known as BEST Bank (Beit EtTamwil Saudi Tounsi), it failed to capture a robust market share. Arguably, this has as much to do with the lukewarm approach afforded to BEST Bank as it is due to poor strategic planning on the part of BEST. Part of the problem lay with fears of creeping Islamisation and the encroachment of political Islamists. Subsequently, the bank was formed with the government having partial ownership of the bank and officials playing an intrinsic role in the day to day operations of the bank. BEST was constituted as an offshore institution and therefore could not do business in Tunisian dinars – thus denying a customer base of indigenous Islamic investors and savers. This law was amended in 1985, thereby allowing offshore institutions the legal right to attract onshore deposits with a 1.5% total deposit ceiling.

Unfortunately, this pre-empted any real impact the bank might have on the financial sector. Additionally, the government’s hard-line stance on Islamist activity commuted into a raid by security forces searching for evidence of links to the Rachid Gannouchi led Mouvement de la Tendence Islamique (MTI). This negative publicity corresponded to a decrease and stagnation of saving accounts from which BEST Bank has failed to recover. BEST Bank, in face of an intrepid government, diversified its operations and played down its Islamic character. Throughout the 90s, this has been a successful strategy though market growth has not been particularly astounding.

However the year 2010 showed that the government was becoming more open to Islamic finance. The primary reason for this policy shift was due to the fact that the government was looking to attract funds from the oil rich Gulf States. Furthermore the domestic clamour for Shari’a-compliant financial services had grown louder. Hence the year 2010 was quite eventful in terms of Islamic finance development in Tunisia, with the opening of an Islamic bank as well as a major project with a Bahraini Islamic Investment Bank.

GFH, an Islamic investment bank based in Bahrain and the Tunisian government announced the launch of a USD 3 billion offshore financial centre, the first one of its kind in North Africa. The project will facilitate trade with the EU bloc and the Tunisian economy as well as other economies within the region. This showed that the Gulf countries were becoming more interested in Tunisia, as even before this, Noor Islamic Bank from the UAE opened an office in Tunisia to be used as a platform to expand into the North African market.

Azzitouna, the first fully fledged Islamic bank was opened in May 2010 by the son-in-law of the now former president, Ben Ali. Azzitouna offers Shari’a-compliant savings and financing facilities for businesses as well as individuals. The bank was started with a capital of USD 30 million and was expected to grow to USD 71 million in 2011. Princesse Holding contributed 51% of the start up capital with the remainder shared by local partners. Azzitouna started with 9 branches and the management expected it to grow to 20 this year (2011).

The year 2010 also saw Azzitouna implement Instant Issuance Solutions from the Dutch security specialist firm Gemalto. The implementation of such a service
made Azzitouna, the first bank within the country to offer Instant Issuance and on-the-spot delivery, which allowed the customers to use their new payment cards immediately.

News reports had shown that the executive level management of Azzitouna were planning ambitious expansions outside of Tunisia. At the recent French Forum on Islamic Finance, the chairman, Sakher El Materi stated how the bank planned to expand to other African countries and into the euro-Mediterranean region. Furthermore Azzitouna Takaful with a future subscribed capital of 15 000000 dinars, was opened to provide takaful and retakaful services.

Sadly, the recent political events in Tunisia may put a damper on Islamic finance in the country. As was mentioned earlier, the majority shareholders in Azzitouna bank are connected to the now disposed former prime minister. Thus the bank has been placed under the supervision and control of the central bank as the assets of the former regime are under investigation. There are reports that the bank has been losing 700 000 dollars a day since Ben Ali was toppled, due to a crisis in confidence. Hence Islamic finance in Tunisia seems to have taken the initial step forward and then two steps back.
Country Sketches

Turkey

On the 23rd July 1924, sovereign Turkey was recognised by the international community. The Treaty of Lausanne sealed the fate of the caliphate, which had lasted over 600 years; and with a few signatures, the once great Ottoman Empire was consigned to history. The ‘sick man of Europe’ was finally cured: and its cure was secularism. The aftermath resulted in a pathological desire to ensure secularism triumphed, with efforts undertaken to push Islam and the Shari’a to the wayside.

In some respects this has been quite successful but with a majority Muslim population, the spectre of Islam would always remain. Balancing the secular intents of the Turkish constitution and the religious needs of its people has not been easy. There have been recurring moments of self-reflection, when Islamic ideals and practices would assail policy makers. Thus Islamic finance has been a peculiar case of acceptance and caution in Turkey.

Fighting with words

The first Islamic bank in Turkey, Al Baraka Financial House, was established in 1985. It was given the status of ‘special finance house’ to distinguish it from conventional banks operating in Turkey. Thus from the onset of Islamic finance in Turkey, the dichotomy was embraced. Allusions to Islam disturbed ideological sensibilities. In 2005, the banking law legislated that Islamic banks should be known as ‘participation banks’, a subtle reference to the desired form of Islamic finance, i.e partnership contracts. But even though the ‘participation banks’ in the country operate according to the Shari’a, the Islamic aspect is not officially recognised. Today products do not have ‘Islamic’ names and no bank has a Shari’a board to oversee compliance. They are not considered as full banks and are not part of the Turkish Association of Banks, thereby reducing complete recognition. Thus, the Participation Banks Association of Turkey (TKBB) was created but this is a trade body set up to promote Participation banks.

Participation banking in Turkey

There are currently four participation banks in Turkey, three of which are foreign owned. Kuveyt Turk is the most proactive of Turkey’s four Islamic banks and is owned by Kuwait Finance House; Turkiye Bankasi, whose majority shareholder is Saudi Arabia’s National Commercial Bank (NCB); and Albaraka Turk Participation Bank, which is a subsidiary of the Albaraka Banking Group, which in turn is majority owned by Saudi Arabia’s Dallah Albaraka Group. The fourth bank is Asya Bank, set up in 1996 by over 200 businessmen from various industries. Many of these banks are branching off internationally into countries and areas such Kazakhstan, Germany and North Africa.

UniCredit Group has called Islamic banks the fastest growing segment in Turkish Banking. Credit volume grew by 9.7% between August 2008 and January 2010. However, the share in terms of overall credit volume is still low at 3.9%. Participation banks hold only 4% market share of total banking assets in the country. However, financial indicators suggest that there has been consistent and constant growth. According to the TKBB, net income went up 11% and total assets volume increased 34% in 2009. The four participation banks are in the top 65 of the top 500 IFIs compiled by the banks and for a number of years, participation banks have outperformed conventional banks.

There has also been significant activity within the Islamic finance markets. Bank Asya’s one year USD 255 million dual currency murabaha facility in 2010 was the largest ever in Turkey, and was subscribed by a consortium of 24 banks from 16 countries. The facility was more than three times oversubscribed at USD 255 million against the launch amount of USD 75 million.

For many years there has been talk of issuing a sukuk in Turkey but it has been tempered by the purview
of secularism which overshadows anything ostensibly defined as Islamic. This conundrum seems to have been avowed with the issuance of Kuveyt Turk Bank’s three year USD 100 Million sukuk in August. It was the first sukuk offered by Turkey as well as being the first bank sukuk offered by any financial institution based in Europe. The coupon rate was 5.25% and was oversubscribed. It is a mix of ijarah and murabaha structures. The sukuk deal won three awards from Islamic Finance News Magazine for Deal of the Year, Best Sukuk Deal in the world and Best Deal in Turkey in 2010.

The government is considering changes to its taxation laws to encourage more sales. Currently under existing rules, companies selling Islamic debt are taxed twice, and amendments to legislation are required in order to develop more sales of sukuk. The government do not have immediate plans to issue a sukuk – though Kuveyt Turk have expressed interest in issuing more – but they have recognised that to encourage more investment into the country, a sovereign sukuk would be beneficial.

In January 2011, the Istanbul Stock Exchange (ISE) launched a participation index to track 30 Shari’a-compliant companies in an effort to further develop the Islamic finance sector. The new participatory index is intended to bolster trade with the Gulf and MENA regions. Bizim Securities, a Turkish fund management company, will monitor the index, ensuring Shari’a-compliance.

Appraising the century

Thus there seems to be a growing interest in Islamic finance from the government. Participation banks are certainly attempting to lobby the government to address the regulatory obstacles that hinder Islamic finance in the country but they have not rested on their laurels and have sought to increase their profile. Kuwait Finance House (KFH) has grand ambitions of making Kuveyt Turk its hub for its takaful operations. Kuveyt Turk entered Turkey’s insurance sector by establishing Neova Insurance in its non-life branch in 2009. KFH is now looking to establish a life insurance and pension company in Turkey.

There has been a growing interest in Islamic finance in Turkey over the last few years. While Islamic banking started over 20 years ago, interest is building primarily to access the wealth in the Gulf regions. This is not a bad thing as it is has bolstered the industry. However, the ongoing conflict between secularism and Islamic normative still remain; and there is always a fine line on which participation banks walk. In 1997, Turkey’s National Security Council (NSC) banned the coalition government due to the fundamentalist stance adopted by one of the parties, the Welfare Party. This, in turn, led to legal measures against Islamic banks – then known as special finance houses – in which the banks could no longer open new branches. The decree was reversed soon after, with legislation issued in 1999 recognising Islamic banks as part of the financial system. But this incident exemplifies the fine balance that has to be undertaken by Islamic banks, or rather participation banks. In 2024, Turkey will celebrate 100 years. From now until then, Islamic banks are likely to grow in size and stature in the country though hopefully not to the chagrin of the die hard constitutionalists.
It is difficult to generalise with the UAE. An agglomeration of seven states (or emirates), each emirate is distinctive with its own set of policies and perspectives. Over the last decade, most of the world’s focus has been on Dubai for its incredible growth and determination to become a financial centre, competing with the likes of London, New York and Tokyo. Other emirate states were playing catch up to Dubai’s enviable precocity, slowly building their own infrastructure but unable to directly compete with its breadth of influence.

Things changed with the global downturn. Dubai faltered, unravelling on the global stage, revealing the level of unbridled risk taking, fostered by individuals and institutions looking to profit from the flow of funds coming into Dubai. The bubble had burst. Today, half built buildings stand as a testament to the collapse of an overheated economy, derelict and dissolute.

But while Dubai suffered, other emirates in the UAE were less affected. Crucially, Abu Dhabi withstood the economic crisis, largely due its oil reserves and more measured financial and economic management. When Nakheel defaulted on its sukuk, the Abu Dhabi government agreed to fund USD 10 billion to the Dubai Financial Support Fund that was used to satisfy obligations on Nakheel’s parent company, Dubai World. The bailout eased the anxiety of many investors but brought questions as to the strength and stability of the Dubai economy. It also represented a watershed moment for the Islamic finance industry. Sukuk structures were now under the spotlight and questioned as to whether they were secure for investors.

From the ashes

This question has not been sufficiently answered though drafting of contracts for sukuk contain more stringent clauses. This is natural, in order to counter future problems. Investors are seeking more security, ensuring that sukuk are asset backed, giving them ownership and a buttress in the event of default. Prior to the default, only 4% of Moody’s rated sukuk contained such provisions.

After the start of the global recession, demand in the global sukuk market fell and was compounded further in 2010 following the default. It was hoped that following Dubai World’s announcement in May, that it had reached an agreement with its main creditor to restructure its liabilities, apprehensive investors would return to the market. But falling property prices has inhibited investor appetite. Experts believe that sukuk demand is inextricably linked to property prices, especially as the underlying asset of a sukuk tends to be property. Moreover, with conventional bonds rebounding faster than sukuk, many Gulf issuers are choosing to sell the former to capitalise on the abundance of liquidity in the market. With the greater enforceability in the event of default and the higher cost of drafting sukuk documentation, cumulatively, conventional bonds hold greater appeal. Standard & Poor have confirmed that the costs of structuring and issuing sukuk remain high, relative to conventional bank loans and bond issuance. The DIFC are looking to reduce the costs of documentation and to promulgate a more efficient Islamic finance industry. It has started to create ‘Dubai docs’, a standardised document for anyone who wishes to list or raise a sukuk from the centre, a move that is aimed to reduce the cost of sukuk documentation.

With the quiet domestic sukuk markets, UAE banks are looking to outside markets such as Malaysia to issue sukuk. The National Bank of Abu Dhabi issued a 500 million ringgit sukuk in December. The issue was oversubscribed providing a way for Asian investors to diversify their portfolios. In fact Abu Dhabi is advancing in the market as its neighbour finds its feet. It too was affected by the credit crisis and property prices fell significantly, though not as sharply as Dubai. In any
event, Abu Dhabi Islamic Bank’s (ADIB) announcement that it would be issuing sukuk under its USD 5 billion trust programme established in November 2006. Fitch ratings assigned a rating of A+ to the issuance which suggests that vestiges of resurgence of the sukuk market are evident in the region.

State of the market

With the negative publicity resulting from the Nakheel default, less focus has been given to the Islamic banking industry as a whole in the UAE. However, generally, the Islamic banking industry is doing well. At the end of 2009, UAE’s eight Islamic banks held USD 49.8 billion of deposits at the end of 2009, or about 19 percent of the total, according to the central bank. UAE Islamic banks have not rested on their laurels and are continually improving their product portfolio. Sharjah Islamic Bank signed a strategic agreement with MasterCard Worldwide to issue debt and credit cards. DIb launched the world’s first Shari’a-compliant personal liquidity solution, Al Islami Salam Finance, allowing customers to take between DH 25000 and DH 1 million. ADIB is the official bank of the UAE football league and has launched a football fan visa card, which offers a number of benefits for the fan.

UAE Islamic banks also have presence in neighbouring countries. The oldest Islamic bank, Dubai Islamic Bank, has expanded its branch network to Pakistan. It has stakes in a number of foreign banks including Bosnia International Bank and Yemen’s Saba Islamic Bank. DIb has a wide ranging portfolio with investments in real estate companies in Turkey and United Kingdom. Equally, ADIB have expanded into Egypt, acquiring National Bank of Development and transforming it into an Islamic bank; there were also plans to open branches in Iraq following acquisition of licences from Iraq’s central bank.

It is not only service provision that Islamic banks are thriving but also in service quality. In January, Ethos Consultancy released its 5th Annual UAE Service Quality Bank Benchmarking Study, which revealed that Islamic banks were outperforming non Islamic banks in all three service quality channels: branch services, call centre performance and website facileness. This was the first year that Islamic banks outperformed conventional banks and is a reflection of the improvement in services provided by Islamic banks.

In terms of takaful provision, there are six takaful firms in the UAE. Like other Gulf States, insurance penetration is quite low, with only 1% of per capita expenditure utilised. However, several applications for licenses have been given to the Securities and Commodities regulator for assessment and it is expected that five new takaful companies will be set up in 2011. Takaful coverage in the UAE is growing and according to a Booz & Company report, the growth rate between 2005 -2008 was 135 percent.

In September, the UAE Insurance Authority Board issued the Takaful Regulations, which for the first time in the UAE provides bespoke regulations for takaful operators (Resolution 4 of 2010). The Regulations are required to be read and complied in conjunction with the authoritative Insurance Law, Federal No. 6 of 2007, and the regulations pursuant to it. The Takaful Regulations provide guidance to structuring takaful products and corporate governance. A significant provision is that it expressly prohibits conventional insurers from offering takaful products through an Islamic window. Also, the regulations promulgate the creation of the Supreme Committee for Fatwa and Shari’a Supervision, i.e. a national Shari’a board for the takaful industry.

There have also been developments in the money markets which will assist Islamic banks in the UAE manage their liquidity. The central bank of UAE’s announcement in June to issue the first Shari’a-compliant Certificates of Deposit (CoD) in the Gulf, represents a move to create a dynamic and accessible money market. The Shari’a Coordination Committee, established two years ago to help standardize the industry in the Gulf nation, has worked closely with the central bank of the UAE to create Shari’a-compliant CoD. In December, it was reported that Islamic banks had invested some 3.5 billion dirhams in Shari’a-compliant CoDs that were issued by the central bank in December. The CoDs are based on murabaha and are designed to soak up the excess liquidity in the market.

Dynamism in an anxious market

An inspid sukuk market and a downturn in property prices convey the impression that the UAE economy is faltering. Investor confidence is low and creditors are still knocking on the doors of imperative companies. In November 2010, financial services firm Dubai Group missed payments on separate loans and a murabaha facility suggesting Dubai’s debt troubles are far from over.

But shoots of recovery are evident especially with the level of activity happening within the financial markets, as financial institutions – both conventional and Islamic– seek new opportunities to boost the economy. In November, DIb launched the first Shari’a-compliant REIT, in collaboration with France’s Eiffel Management, to lift the country’s real estate sector. The REIT will allow DIB to draw in foreign liquidity, thereby reigniting the property market. The REIT will be listed on the NASDAQ Dubai. DIB has also increased its stake in the debilitated property giant Tamweel and has enabled it to re-launch its financing activities after a two year absence.

It is unlikely that property will cease to be an important asset of choice but the last two years have emphasised the need to diversify away from property and to look at other ventures. Acknowledging this, there have been a number of interesting and innovative transactions. The private equity firm TVM Mena, specialising in health care, invested utilising Shari’a structures, into UK based Bourn Hall International. Bourn Hall was the world’s first in vitro fertilisation clinic. Its founder was awarded the 2010 Nobel Prize in Medicine for his pioneering work. This investment is only one example of the slow diversification of Islamic finance into broader activities. A more cosmic example of diversification took place in the takaful industry. Al Yah Satellite Communications (Yahsat) secured the first ever space takaful policy. Methaq Takaful is one of the providers of the insurance
coverage for Yahsat satellites scheduled to be launched in 2011. Technology, health care and energy are sectors offering lucrative opportunities for structuring Shari’a-compliant products. More focus on these areas will bring innovation and creativity into the industry.

**Improvement in time is likely**

Parochialism and comfort with property as the asset of choice proved to be a flawed strategy for the UAE. Diversification is integral to the success of any portfolio and Islamic banks have to look into innovative projects going forward. In the UAE, there is a move towards branching out and exploring wider opportunities. To sustain momentum however, they need to also be aware of human resource capacity. Building a broad, talented labour force, with a mix of skills and perspectives can invigorate this industry. Thus, Islamic banks in the UAE are looking to create a talent pool. ADiB has signed several MoUs with universities such as American University in Dubai and Abu Dhabi University in order to increase cooperation in strengthening their recruitment drive. The relationship allows increased networking and the exchange of knowledge, opinions and expertise. Ajman bank launched the “Sheikh Ammar Banking Excellence Program”, a UAE wide education program, which offers a select group of graduates to undertake rigorous training and expose them to the mechanisms of a bank. The programme will be a mix of classroom learning and departmental rotations.

These are positive steps which supplement academic qualifications offered by universities and private sector providers such as Ethica Institute. After a turbulent two years, the UAE, and especially Dubai, need to recapture the spark that catapulted them onto the world stage. This will take time as industry players learn from past mistakes. Equally, Islamic finance in the UAE is going through a rite of passage but has shown an admirable resilience to the tumult.
The UK has been leading the way amongst western nations in developing an indigenous Islamic finance market. It has 22 banks including five that are fully Shari’a-compliant, more than any other western country; 20 sukuk issues raising USD 11 billion listed on London Stock Exchange exceeded only by Dubai Nasdaq; seven Shari’a-compliant exchange-traded funds (ETFs); 20 law firms supplying services in Islamic finance; advisory services provided by Big Four professional service firms; institutions offering educational and training services in Islamic finance and an active presence on the London Metal Exchange which dates back to the 1980s. According to the International Financial Services London, UK has USD 19 billion of Islamic assets ranking it 8th among Islamic financial markets in the world.

Yet, all is not well in the country former Prime Minister Gordon Brown hoped would become a gateway to Islamic finance. The recession sapped some of the zest the Labour government had for Islamic finance; and with the new Conservative government at the helm and their accompanying mantra of cuts, more cuts and even more cuts, there is an uncertainty as to their commitment to Islamic finance.

Public sector leaves; private sector bereaves

An announcement by the government in January 2011 has left practitioners in the industry disconcerted. There was an expectation that the Labour government would issue a sovereign sukuk, thereby stamping their commitment to Islamic finance. It was not to be during Gordon Brown’s tenure and seemingly it will not be during the current Prime Minister, David Cameron’s residency at no.10 Downing Street. The Treasury revealed that the government will not issue a sovereign sukuk as it was not value for money. It would however ‘keep it under review’.

A collective sigh of disappointment was exhaled in the industry; frustrated by the fact that after three years of indicating that a sukuk was imminent, the matter had been so casually pushed aside. It potentially sent negative signals to neighbouring countries like France, who were looking to the UK for guidance. There was an expectation that the UK would lead the Islamic finance markets forward in Europe but it seems the UK has coiled into the corner.

On closer inspection of the Islamic finance market in the UK, maybe this is not surprising. The Islamic finance retail markets have not been as successful as was expected in the halcyon days of 2004, when Islamic Bank of Britain opened its first branch. Lloyds TSB have cut back offerings of Shari’a-compliant mortgages and HSBC Amanah has moved focus away from the UK towards the Middle East and Asia.

More worryingly, injection of GBP 20 million by Qatar International Islamic Bank in September exposed the fragile state of IBB, which had increased its customer base since the start of the recession in 2007, but had failed to attain profitability. Losses are currently at GBP 9.4 million: a sizable sum when considering the bank’s low customer base. Figures show that IBB has 50000 customers, mostly Muslim. This is far too low a figure relative to the size of the Muslim population in the UK, which according to Pew Research Center’s Forum on Religion & Public Life, is currently at 2.9 million.

Commentators are not at a loss to explain IBB’s failure to attract more customers. The U.K. Islamic mortgage market amounts to GBP 500 million, 0.3 percent of total home loans suggesting low demand. Sufficient work has not been done in attracting new customers. The range of products are limited and with eight branches located in predominately Muslim areas, IBB’s coverage is relatively narrow as compared to its conventional rivals. Additionally, capital constraints such as the FSA’s requirement for banks to increase their capital...
ratio, have restricted its ability to fund growth. It is also hampered by the weak Islamic interbank market preventing adequate liquidity.

With financial markets faltering due to the recession, both conventional and Islamic, the inevitable downturn has had an adverse effect on an industry still trying to find its feet. Thomas Cook, a leading travel company, was expected to issue a USD 50 million sukuk in July but pulled out due to the weakness of the sukuk markets. A more pertinent example of the effect of the recession on consumer spending is the closing of Principle Insurance, the UK’s first independent takaful company authorised by the FSA. Opened in 2008 to a fanfare of optimism, a year later it stopped taking new business due to running out of funds. In April 2010 it sold its subsidiaries, Principle Insurance Company Ltd and Principle Marketing Services Ltd to its largest shareholder, Al Salam. Currently, the only available takaful services in the UK are restricted to HSBC Amanah and Muslim Insurance Services (MIS). The latter has been particularly controversial with many industry players questioning its credentials of being Shari’a-compliant.

**It was going all so swimmingly**

The previous Labour government stated that they wished to be fair, collaborative and committed to the development of Islamic finance in the UK. Their measured approach to legislative changes has created an unencumbered regulatory environment in which Shari’a-compliant products could compete effectively with their conventional counterparts. A series of legislative changes have been enacted since 2003, which have removed double stamp duty land tax and have recognised the unique features of Shari’a-compliant products. Admittedly, the nomenclature within legislation makes no reference to Arabic terminology, preferring to lump the products into one umbrella group, labelling them ‘Alternative Financial Arrangements’; but the desired outcome has been achieved with more regulatory recognition of murabaha, ijarah, diminishing musharaka, wakala and sukuk. Government organs such as the Treasury and the FSA were issuing guidance notes on Islamic finance as well as promoting the UK markets and their capacity within Islamic finance at international conferences.

The supportive approach of the government stimulated the industry with the setting up of an Islamic retail bank and four wholesale Islamic banks – Bank of London and the Middle East, European Islamic Investment Bank, European Finance House (who have now adopted their parent company name, Qatar Islamic Bank (QIB)) and Gatehouse Bank. A number of high profiled transactions had also taken place including Kuwait’s Investment Dar’s acquisition of Aston Martin; and QIB’s financing of the Shard of Glass, a commercial property currently being built at the heart of London’s financial district.

To supplement the growing market, a number of bespoke Post Graduate Degrees in Islamic finance were offered, a first for a non-Muslim country. Durham and Loughborough were forerunners, offering degrees even before Islamic finance had taken off in the UK.

**It is not all bad**

Ultimately, the recession-stimulated government apathy has slowed the pace of Islamic finance in the UK. But there is still cause for optimism. In February, Parliament passed the Financial Services and Markets Act 2000 (Regulated Activities)(Amendment) Order 2010, which ensures that alternative finance investment bonds, such as sukuk, are broadly treated in a similar manner to conventional debt securities. The Order provides clarity on regulatory treatment of corporate sukuk, reduces legal costs and removes unnecessary obstacles to their issuance. By September, the UK witnessed the issuance of the first corporate sukuk within its jurisdiction. Issued by International Innovative Technologies Ltd, a milling design company, the musharaka sukuk pays 10% a year and will expire in 2014.

The previous government created a number of internal working groups to advise, appraise and promote UK’s Islamic finance capabilities. The Treasury had created the Islamic Finance Experts Group (IFEG) while the UK Trade and Investment (UKTI) had created the Islamic Finance Sub Group (IFSG). In March, these groups effectively merged, to create the UK Islamic Finance Secretariat (UKIFS), the UK’s first Islamic finance trade body, whose remit is to ‘coordinate and promote alternative finance in the UK and ‘to act as a primary contact point for UK government bodies’. The body will include experts from banks, law firms, accountants and those with extensive experience and knowledge in legislative, fiscal, regulatory and political matters. While the intention is good, there is doubt as to how successful the trade body will be, given government bureaucracy. The UKTI will be funding the UKIFS for one year, after which it will have to survive on its own membership and revenues.

Over the years, establishment stalwarts such as ex-Bank of England Governor, Eddie George, the Lord Mayor of London and of course the previous Prime Minister have lent support to the development of Islamic finance in the UK. In May at the World Islamic Economic Forum, Prince Andrew, the Duke of York, along with UK’s Special Representative for International Trade and Investment, commented that London was set to play a major role in the growth and further progress of the Islamic finance sector. Support from establishment representatives lends credibility to a nascent industry such as Islamic finance.

The Scottish government are expressing interest in employing Islamic finance to prop up the local economy. In 2008, Alex Salmond looked to Qatar for investment during the recession; even now Scottish enterprise and Scottish Development international are paying a close interest to Islamic finance. While no definitive move has been made to develop an Islamic finance market, a series of round table discussions and conferences over the last few years have alluded to the possibility that the Scottish government are taking a serious interest. The Scottish law firm Tods Murray LLP and the IBB created and launched an innovative Islamic mortgage model in 2009 to meet Scottish legal requirements while organisations such as the Islamic Finance Council UK (IFCUK) - quoted as being the ‘most proactive
entity in Islamic finance in the UK’ by Arab News - are collaborating closely with the UK government and the private sector to promote and strengthen the global Islamic finance market. In 2008, they partnered with CISI to launch the Shari’a Scholars Continual Professional Development Program. The programme intends to enhance and build upon the Shari’a knowledge of scholars, providing them with knowledge of the financial markets taught by leading practitioners and academics. The programme has branched out to Bahrain and Kuala Lumpur. Scottish Universities such as the University of Glamorgan and the University of Dundee are offering post graduate degrees in Islamic banking and finance; and Islamic accounting and finance, respectively.

Optimism in the private sector

Mixed signals are coming from the four Islamic investment banks. On the one hand, certain banks have suffered losses in the last few years, affected by weak demand: European Islamic Investment Bank (EIIb) has posted end of year losses in March of GBP 22.2 million. On the other hand, over the last few years, all four have been involved in profit generating and occasionally ground breaking transactions.

The Bank of London and the Middle East (BLME) launched a Shari’a-compliant money market fund, the first of its kind to be launched in Europe. BLME also launched its online Shari’a-compliant Premier Deposit Account, the first of its kind in the country. It unveiled BLMEFX, a Shari’a-compliant web-based FX trading platform to provide clients with direct access to multiple currencies for overseas transaction. Through BLMEFX, the bank’s corporate and private clients have instant access to a large number of currencies as easily as if they were using a conventional system, thereby making the process much simpler and more cost effective. Qatar Islamic Bank launched its Global Sukuk Plus Fund and formed a strategic partnership with Eden Rock Capital Management to scout for investment opportunities, especially in the small and medium (SME) enterprises in the UK. Gatehouse Bank and DDCAP announced the launch of a fund in early 2010 to invest capital in structured trade finance transactions. DDCAP is a wholesale Islamic market intermediary company. Gatehouse bank has reportedly seen an increase of transactions in the final two quarters of 2010, more than the cumulative number of the transactions in the previous three years. As of November 2010, their aggregate Real Estate portfolio was valued at USD 160 million. These are only a few of the developments within the wholesale banking sector but the four banks are strengthening their infrastructure, acquiring the necessary talent and entering new markets. As these banks have only started in the last few years, this is to be expected but after a fallow period following the global recession, the activity and the infrastructure building indicates progression rather than regression.

As for IBB, they are attempting to build up demand through increasing coverage of their Home Purchase Plan (HPP). They partnered with Legal and General, provider of risk, savings and investment management products in the UK, through their tailored mortgage club. IBB have also partnered with Independent Financial Advisors (IFAs) such as Alliance of Mortgage Packagers and Distributors to capitalise on their network. In December, IBB joined forces with Pramium, the investment management platform provider, to launch what they claim is the UK’s only Shari’a compliant retail Discretionary Portfolio Service (DPS). Discretionary Portfolio Services offer investors the chance to set up and interact with their investments through their Independent Financial Advisors (IFAs). IFAs can register for free to use the service and promote a wider range of investment options for their clients. IBB believe it will appeal to group pensions and employers with Islamic employees. The product will give investors the chance to set up Shari’a-compliant investments through IFAs.

UK based institutions are also contributing to the development of the global Islamic finance industry. Barclays Capital, the investment banking arm of London-based Barclays Plc, launched Shari’a- compliant repurchase agreements (Repos) in August, to assist liquidity management for Islamic banks and investors. UK Based Standard Chartered Bank, renowned for working within emerging markets, has introduced commodity derivatives in the Middle East and South East Asia as means to develop the risk management capacity within the Islamic finance market. Legal & General Gulf Takaful, a wholly-owned subsidiary of Legal & General Gulf (a joint venture between UK-based Legal & General Group and Ahli United Bank Group), set up in Bahrain in January offering life Takful products through Ahli United Bank branches in Bahrain.

English law prevails

Undoubtedly, key to the development of the global Islamic finance markets has been English law firms. With most Islamic finance contracts drafted under English law, this should not come as too much of a surprise. Several of the so called Magic and Silver circles have divisions dedicated to Islamic finance which are based in London and Islamic finance hubs such as Dubai and Saudi Arabia. These include Norton Rose and Clifford Chance.

The growth of Islamic finance has led to several court cases being heard in court. Of the few Islamic finance cases that have been heard, a number of principles can be ascertained. Judges have conceded that it is not expected, nor should it be expected, that they should judge the case from a Shari’a standpoint. English law therefore triumphs over Shari’a law and consequently disputes shall be judged according to English legal principles and the facts at hand. Any reference to Shari’a only indicates that the bank will conduct their business following Sharia precepts but this does not elevate it to the governing law of the contract. According to seminal case of Beximco, courts will judge according to the literal meaning of the words within the contract, without having recourse to the Shari’a.

Interestingly, though courts have avoided adjudicating upon Shari’a principles when related to the contract, they seem willing to explore questions of Ultra Vires (i.e. a company working over and above what they have set out to do as according to their Articles of Association) according to the laws of the country in which the company was incorporated. Whilst in
litigation cases courts will not delve into Shari’a matters, they countenance arbitrations which have been based on Shari’a law and are willing to uphold the awards, provided parties are not disputing a point on English law or that the arbitration agreement itself (as opposed to the law applied by the arbitration) is not governed by English law.

**Educating the interested**

Aside from developments within the marketplace, the UK has been leading the line with regards to education initiatives in the western world. There is an overwhelming demand for Islamic finance courses, and several UK universities have offered MSc and PhD programmes, usually with the assistance of international investors from the Middle East and Malaysia, who have set up centres dedicated to Islamic finance. The CEO of Dubai based Surgi Tech Group endowed the El Shaarani Islamic Finance and Business Centre, the first dedicated Islamic finance centre in Europe. It will provide a suite of qualifications on Islamic finance, including undergraduate, postgraduate, PhD and executive programmes and conduct research into Islamic finance and Shari’a-compliant business. Reading University offers an MSc in Islamic Banking and Finance, which is to be jointly taught with the Malaysian based International Centre for Education in Islamic Finance (INCEIF). Cass Business School offers the Executive MBA Dubai which has a component in Islamic finance. The DIFC offers scholarships to students interested in the course. Surrey University has a PhD program largely concentrating on accounting and auditing issues in Islamic finance and in 2010. In September, the University of Bedfordshire offered two new courses: The MSc in Islamic Banking and Finance and the LLM in Islamic Commercial Law.

**Upwards and onwards**

So whilst there has been a growing chorus of discontent about the Islamic finance market in the UK, things are not as bleak as sometimes assumed. The UK regulatory system has been congenial to the growth of Islamic finance and the government have in the past shown a great deal of support. By not issuing a sovereign sukuk, this undoubtedly reflected a weakening of resolve, but this can be strengthened provided the private sector stimulates critical growth. In many respects, the groundwork has been set up and it has committed IFIs to capitalise on opportunities. Too much reliance on the government will be counterproductive. They have done their bit; it’s now up to private institutions to theirs.
These are strange times for the United States of America. Riding on the wave of optimism with slogans of change, the Obama administration has stuttered and staggered over the course of the last two years, finding their hands increasingly tied by the legacy of their predecessors. The deficit remains unmanageable; the economy is convulsing painfully; reforming the healthcare system has proved difficult and filibustering remains endemic in the corridors of power. Iraq and Afghanistan still rages on, Guantanamo is still open and peace in the Middle East is still about as elusive as garnering the support of an increasingly belligerent Right. Change is not as easy as the rose tinted, wide eyed, Obama enthusiasts had hoped for.

To change a point of view and a culture requires time and support with small steps leading forward. As the Irish Catholics, the Jews, the Italians and more controversially, the Afro-Americans, can attest minorities in America face a long and turbulent path to achieving assimilation. However, Muslim migrants have generally endured a painless transition into American society and have enjoyed relative success. But post 9/11, there has been a growing undercurrent of suspicion about all things Islamic, which has had an effect on the growth of Islamic finance in the USA. The prospect of Islamic finance making significant inroads into the US financial markets has by and large been curtailed.

Shari’a in the USA

The 2007 Pew Research Center survey on Muslims in America entitled ‘Muslim Americans: Middle Class and Mainstream’ revealed an integrated Muslim community. The community were generally educated to a high level and enjoyed a good standard of living. The survey concluded that Muslims were identified themselves as both Muslim and American. They did not see a conflict between the value systems of the two. However, over 50% of Muslim Americans say that since 9/11 it has become difficult to be a Muslim in the United States. This point of view was especially prevalent in the wealthier segments of the Muslim community. The report did not delve into underlying reasons but anecdotal evidence provides sufficient evidence: the most ostensible being protests against the transformation of an old coat factory near the site of the Ground Zero into a mosque. Irascible protests erupted, conveying a worrying inexactness in which protestors conflated terrorism with the establishment of the mosque.

The Center for Security Policy, a US think-tank, issued a report in September titled “Shariah: The Threat to America”, which said that practices promoting Shari’a were “incompatible with the constitution” and should be “proscribed.” The report contains an appendix focusing on Islamic finance, referring to it as a ‘stealthy jihadist practice’. The report was endorsed by some Republicans including former Speaker of the House of Representatives, Newt Gingrich, who has been calling for a federal law to ensure Shari’a, and by extension Islamic finance, is not recognised by any US court.

The move is extreme but it highlights the sensitivities that surround Islam in the USA; something the government and the US regulatory authorities has to be circumspect about. Too committed an approach, resulting in legislative changes to accommodate the peculiarities of Islamic finance products, is likely to lead to an impassioned outcry.

Far from suggesting that the government has not taken an interest in Islamic finance, it has maintained a measured approach to Islamic finance. A significant and lasting step undertaken by the government in Islamic finance occurred in the 1997, when the Bank of Kuwait requested interpretive letters from the Office of Comptroller of the Currency (OCC) on the jari'ah mode of house financing. This was followed by a second request by the bank on murabaha house
financing in 1999. Both products, viewed by the OCC, were legislatively recognised and permitted for banks to offer because the structure of the products was economically identical to its conventional counterparts. In 2002, the Treasury held an in house session on Islamic finance in order to raise awareness amongst the state department officials. In 2004, the Chair of the Islamic Economics, Finance and Management at Rice University, Mahmud El Gamal was appointed as scholar in residence to advise on Islamic finance. In November 2008 the Treasury convened another training session on Islamic finance to familiarise officials with what the Treasury termed “an increasingly important part of the global financial industry”.

Look to the private sector
Islamic finance’s ‘importance’ has been widely accepted by US financial institutions who have transacted with Shari'a-compliant products, though most of the investments and deals have occurred outside of the USA, mainly in the Middle East. As the economy recovery continues, the Middle East offers investors a lucrative market. Wall Street lynchpins such as Citigroup and JP Morgan Chase have Islamic banking divisions while other multinational banks including Goldman Sachs and Merrill Lynch have worked upon Islamic financing transactions. Citigroup arranged the USD 500 million GE capital sukuk in 2009.

AIG’s recent court appearance, mentioned earlier in this report, owes this dubious honour to their takafal division set up in 2006 in Bahrain. The insurance component of AIG is now known as Chartis with takafal remaining an important part of their product portfolio. In the UAE, Dubai Islamic Insurance and Reinsurance Company (Aman) and American Life Insurance Company (ALICO) reached an agreement in May, under which Aman will offer Alco’s Sharia-compliant products to its customers in the UAE.

Islamic mutual funds in the US are looking to diversify into emerging markets and have earmarked Malaysia as offering significant growth opportunities. Saturna Capital is the most prominent. Since 2005, it has won eight Islamic investment awards from Failaka Investors in Dubai. The company looks after USD 3 billion in assets via Amana Mutual Funds Trust, which includes Amana Growth Fund, Amana Income Fund and Amana Developing World Fund. Amana Income fund and Amana Growth fund are two of the largest Islamic equity funds in the world. It started the Amana Developing World Fund in the U.S. in September to invest in global emerging-market Islamic assets. The company bought Malaysia’s Alpha Asset Management in March and changed its name to Saturna Sdn.

Thus, the private sector has and continues to play a meaningful role in the global Islamic finance markets. Multilateral organisations such as the World Bank and IMF have recognised the importance of Islamic finance to the development of the global financial markets. The International Financial Corporation, a World Bank Group member focusing on private sector development, opened its Islamic finance working group in 2008 to conduct research and formulate an Islamic finance strategy. Consequently, in 2009, it listed the IFC Hilal sukuk on the Dubai and Bahrain stock exchanges. The USD 100 million denominated sukuk was intended to raise funds for infrastructure projects in Yemen and Egypt.

The domestic market
Broadly speaking, the Islamic finance industry within the US has remained focused on retail and fund management, two segments from which Islamic finance started from. The story of Islamic finance at the community level begins in the 80s with the establishment of Amana Funds, a mutual fund company in Bellingham, Washington and LARIBA in Pasadena, California. Both institutions remained small until the 2000s, after which they have grown remarkably.

A pivotal event for the Islamic retail markets, and more specifically home financing, occurred in 2001 with LARIBA partnering with the Federal Home Loan Mortgage Corporation (better known as Freddie Mac) to offer mortgages. It provided a huge source of liquidity for home financing transactions and enabled LARIBA to become the only IFI to offer ibra free mortgage securities. From virtually nothing in 2000, it is estimated that Islamic home loans will reach USD 5 billion by the end of 2010. A secondary development has been increasing efficiency, as customers do not have to wait several years to obtain financing due to a lack of capital, which had been the case prior to the entrance of Freddie Mac (and to a lesser extent Freddie Mae).

HSBC Amanah, offered Islamic home finance products in New York State in 2002. In their first year of operating, they financed home purchases worth USD 20 million. However, they left the Islamic finance market in the US in 2006 citing insufficient demand. Citigroup has also curtailed their Islamic finance retail provision and are moving towards corporate transactions. This has left grassroots organisations to fill the void. Currently, there are four main institutions that offer Islamic finance retail products namely LARIBA, Guidance Residential, Devon Bank and University Islamic finance corporation. The LARIBA system consists of a finance company and a national bank, Bank of Whittier. It serves all 50 states and has USD 400 million worth of assets. Devon Bank is a conventional bank with an Islamic finance window offering home and commercial financing while University Islamic Finance Corporation is a fully owned subsidiary of the Michigan based University Bank. Along with home and commercial financing, it also offers deposit products. The subsidiary was opened in 2005 and was the first of its kind in the USA Guidance Financial is a home finance provider, and according to the company, have provided USD 1.9 billion in Shari’a-compliant financing to more than 6,000 Islamic households since the company was started.

Domestic Islamic finance activity has mostly been in areas with a high percentage of Muslims. North Jersey has been particularly dynamic in this market due to the larger proportion of Muslims that reside there. North Jersey Federal Credit Union (NJFCU) opened an Islamic banking division in June. It claims to be the first credit union in the nation to offer Shari’a-compliant mortgages
in order to serve low income families. The mortgage loans are offered through Guidance Residential who also acts as the underwriter. NJFCU also offers Shari’a-compliant mutual funds and deposit accounts.

There has also been an increase in the number of smaller Islamic home finance companies that operate in different areas, targeting specific cultural groups. One provider that has grown rapidly since its founding in 2003 is the African Development Centre in Minneapolis. The Centre supports American Muslim immigrants, mostly Somalis, through offering a number of retail products including mortgages. The African Development Center, with support from the state’s housing agency, offers Islamic mortgages to low income families. In May, the ADC partnered with the Minneapolis City Administration to provide Islamic financing through an alternative finance program to Muslim business owners. Unfortunately, as Islamic finance still remains a small, niche industry serving the needs of the Muslims, it has the potential to be exploited. In Chicago, a local investment scheme defrauded hundreds of Muslim investors out of USD 30 million fraudulently misrepresenting the products as being Shari’a-compliant. In court it was revealed the scheme was a ponzi scheme which affected more than 300 investors. Intriguingly the majority shareholder was a member of the Shari’a board of America, a group of Islamic clerics that advises Muslim investors and certified that Sunrise Equities was Shari’a-compliant. Tighter regulation is required along with better education and information.

Behind closed doors

The history of Islamic finance will lay testament to the monumental role played by the Dow Jones Islamic Market Index created in 1998. It revolutionised the asset and wealth management sections of Islamic finance, making it easier for funds to invest and paving the way for the formation of other indexes. An honourable mention will be given to the Harvard Islamic Finance Project, founded in 1995, for its work on the legal aspects of Islamic finance. Yearly symposiums bringing in esteemed figures from the Islamic finance world has granted this initiative prestige and prominence and platform to discuss the issues assailing Islamic finance. One such issue was creating derivative like products which are Shari’a-compliant. This has been partly resolved with the collaboration between New York International Swaps and Derivatives Association (ISDA) and Bahrain’s International Islamic Financial Market (IIFC) to develop the Tahawwut hedging master agreement. This standardised agreement allows trade of Shari’a-compliant derivatives.

So while the Shari’a may evoke apprehension, suspicion and prejudice amongst certain groups, Islamic finance has been recognised by major multinational US financiers as a respectable and profitable form of conducting business. Some people may be aghast at such a statement, unable to see beyond a brutal and primeval version of Islam, but as the Muslim population grows and the private sector continues their involvement in Islamic finance, a change of opinion will surely come.
Yemen is a country steeped in tradition. It has one of the oldest civilizations and is home to a rich culture. The people of Yemen have been mentioned in numerous sayings of the Prophet Muhammad, and they are also known for their kindness. Sadly, the country has relatively high levels of poverty and unemployment. This has led to many of the Yemeni population being disenfranchised, causing tension between the north and south of Yemen as well as battles with Al Qaeda and the occasional Shi’a uprising. More recently there have been demonstrations in Yemen calling for the ousting of the President, caused by the sweeping wave of protests currently being experienced elsewhere in the Arab world.

An industry that exhales

Yemen has 17 banks, including four Islamic banks, Saba Islamic Bank, Tadhamon International Islamic Bank and Islamic Bank of Yemen for Finance and Investment, according to central bank data. Shamil Bank of Yemen and Bahrain is a subsidiary of Bahrain’s Shamil Bank, and provides Shari’a-compliant products. There is also one insurance company: Yemen Islamic Insurance Company. The four banks accounted for 31% of the total assets held in the Yemeni banking sector in 2008 as well as 27% of the deposits and 40% of total financial facilities. There are approximately 44 Islamic financial branches distributed across the various governates in Yemen. The focus of most Yemeni banks has been the domestic markets. To a large extent, this focus has insulated the financial system from the ravages of the global recession. Tadhamon International Islamic bank has a far more international exposure particularly in markets such as the UAE and Saudi Arabia. It set up a branch in Indonesia in 2009. However, the greater coverage has produced a downward pressure on asset quality, compounded by the general economic turmoil within Yemen, resulting in an increase of non performing finance. However, the bank has coped remarkably well, increasing liquidity through a rise in unrestricted investment and saving accounts. It is currently the biggest Islamic bank in Yemen.

Tadhamon set up Tadhamon Capital in Bahrain, gaining a licence from the Central Bank in 2009. Tadhamon Capital is the first investment company in Bahrain to be fully owned by Yemeni shareholders. The Company aims to structure, launch and manage new investments and products across its main business lines which include asset management, private equity, real estate, treasury and wealth management.

Besides the four commercial Islamic banks, Yemen is home to the first micro finance bank to offer only Shari’a-compliant products in the Arab world. Al Amal microfinance bank has captured an estimated 25% of the Yemeni microfinance market even though it has been in existence for a relatively short period of time. The bank was recently awarded USD 104000 for winning the Islamic microfinance challenge 2010, which was jointly sponsored by CGAP, Deutsche Bank, Grameen-Jameel Pan Arab microfinance and the IDB.

There have however been criticisms that Islamic banks have not done enough to support development and alleviate the socioeconomic problems that are endemic to Yemen. Small businesses have expressed difficulty in accessing loans due to tough and inaccessible regulations. The banks counter that central bank regulations are exculpatory for this as they draft stringent regulations which are required to be followed. Accusations of nepotism have been levelled against Islamic banks. The four banks are family owned business which affects loan approval and precludes disbursement of funds to more efficient projects.

Balancing the budget

In 2009, an IMF study on Yemen concluded that the environment was conducive to the issuing of Islamic instruments. In March 2010, participants at a
conference entitled “Yemeni Islamic Banks: Reality and Future Prospects” discussed the need to develop a regulatory infrastructure for the promulgation of Islamic finance industry in Yemen. Recommendations included a national Shari'a board, and the establishment of a payment fund to address liquidity needs of banks. Participants also suggested harmonising standards for the issuance of Islamic instruments because of the benefit to community development.

An Islamic finance industry in Yemen would be a means to tackle the growing economic problems within Yemen and tap into the excess liquidity. This is imperative for Yemen who has the largest budget deficit in the Arabian Peninsula, one that the government have made a priority to tackle. The government plan to fund the gap through domestic borrowing, utilising conventional bonds, sukuk and international loans.

Subsequently in February 2011, the first sukuk was issued in the country in February this year. The sukuk was issued by the central bank of Yemen which was the first part of a one year program aiming to issue sukuk worth YR 100 billion by the end of the year. Aside to contributing to the deficit, sukuk proceeds will be used to fund oil and road projects within the nation. A recurring problem is the weak infrastructure that plagues the country and more funding is required for public infrastructural projects. In addition to the sukuk, and the other forms of government spending, the IDB have been active investors.

In 2009, it was reported that IDB had provided USD 700 million to Yemen. Over the years, IDB have contributed to a number of development initiatives from improving literacy to enhancing the private sector. In November, the cabinet approved of a USD 12.5 million loan from the IDB to support rural development opportunities. The project hopes to increase the income of the impoverished men and women who work within the agricultural sector. The Islamic Corporation for the Development of the Private Sector (ICD) signed a MoU in May 2010 to promote and develop industrial and economic zones in the country.

Pesky politics

Yemen’s economic woes are compounded by domestic tension and militancy. Aside from the recent protests against the incumbent government, the US has been pressuring Yemen to crack down on Al-Qaeda operatives in the country. In addition, there is a north–south divide and occasional unrest from the minority Shi'a population. Cumulatively, this serves to weaken the economic potential of the country, with investors expressing anxiety.

Whilst there is no doubt that the Islamic finance industry in Yemen is making headway and contributing to the Yemeni society, the fact of the matter is that due to the instability, corruption and economic woes that are currently inherent in Yemen, there is still a long way to go before Islamic finance can make a significant impact.
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