The International Handbook of

Islamic Banking and Finance

Elisabeth Jackson-Moore

GLOBAL
professional
publishing

Global Professional Publishing
Random Acres
Slip Mill Lane
Hawkhurst
Cranbrook
Kent TN18 5AD

Email: publishing@gppbooks.com

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Chapter 1

Introduction and Overview

Before describing, in later pages of this book, Islamic banking and finance as it is practiced today, this chapter will provide some background as to why special modes of finance are needed in the Islamic world. Of all the many religions, Islam is the only one today that requires that banking and other financial activities are carried out in a way that is compatible with its laws. Other religions, such as Judaism and Christianity, have similar ethical standards, but today the concept of interest goes largely unquestioned.

Many countries prohibited "usury" by law for many centuries. In the Middle Ages, while Catholic Canon Law forbade the use of interest, this did not apply to the Jews. Whilst the Torah condemns interest, this was interpreted as meaning between Jews, and Jews became renowned as moneylenders, even helping to fund many national purses.

Gradually the Christian church, led by Calvin among others, began to think that in changed times, there was no need to ban interest, but that moderate levels of interest allowed the lender to share in the wealth being generated by the borrower. As the years passed, the laws against usury were modified or abandoned and were replaced by interest rate caps. Today, as a result of deregulation, most of these caps have also disappeared.

There have been attempts in modern-day Judaism to design contracts that are interest free, but these do not appear to have been widely used or ultimately to have avoided the use of interest. Only a very few banks would claim a greater ethical stance than normal conventional banks and it is a recent vogue that has seen the development of "socially responsible" investing or ethical banking and finance, concepts that are at the foundation of Islamic banking and finance.

A Brief History

The Prophet Muhammad lived between the years 570AD and 632AD in the region now known as Saudi Arabia. He was born in Mecca and the Kabbah there was the focal point for idol worship across the whole of Arabia. Because Mecca was a holy city, the warring tribes would not fight there and it became a peaceful centre for trade, especially during religious festivals.

The prophet's father died before Muhammad was born and his mother died when Muhammad was six. His grandfather raised Muhammad for two years, but on his death, an uncle, Abu Talib, assumed responsibility for Muhammad's upbringing. Muhammad's first employment was as a herdsman, but he later worked for a wealthy widow, Khadijah, as a trader on the caravans between Mecca and Syria. When he was 25 he married Khadijah, who was then 40, and they remained married for 28 years until Khadijah's death. After this, the Prophet married several times and these marriages consolidated the ties between the various factions of the new Islamic community.

The Prophet received his first revelations when he was around 40 years old. His followers believe that he was an ordinary man who was chosen by God to convey the message of Islam to the world. The Prophet's mission to spread Islam was opposed through political and, ultimately, physical means by the Quraysh of Mecca. The Prophet eventually learned of a plot to kill him in Mecca and he fled with his closest friend, Abu Bakr, to Medina in 622AD. This departure became known as the *Hijra* and the Muslim calendar starts from this date.

During the Prophet's lifetime, mainly through a series of battles, Islam became an established force in the Arabian Peninsula, and beyond.

The book containing the message of Islam is the *Qur'an*. Muslims believe that it is the word of God as conveyed to the Prophet. As Muhammad was illiterate, his companions memorized the verses and some were written down during the Prophet's lifetime. All the verses were subsequently gathered together by Zeid ibn Thabit under the direction of Abu Bakr, with the help of several witnesses who had memorized the Qur'anic verses by heart. This version is the one generally accepted today as the definitive text and the *Qur'an* remains the primary source of Islamic teaching.

A further source is the *Sunnah* which is the collection of the words or acts of the Prophet or of the *Hadith* which Muhammad used to give moral guidance on many issues. A further important source is the *Ijma*, or consensus of the great jurists and finally, scholars turn to analogy and reasoning, or *Qiyas*, to relate modern situations to early teachings.

In the 30 years following the Prophet's death, four surviving companions of Muhammad led the Muslim community. However, there were disagreements as to which was the rightful successor with Ali ibn Abu Talib arguing that it should fall to him and his children through his wife, Fatimah, the one surviving child of

Muhammad and his first wife, Khadijah. The discord led to battles and ultimately, to Ali's assassination. After this, some of Ali's supporters founded the Rafidi sect, later to become the Shia sect. The remaining body of Muslims comprise the majority Sunni sect. The Shia sect gives a special status to Ali and his son, Hussein.

An Islamic Economy

Because Islam provides a holistic approach to life, the economic system that it incorporates cannot be separated from political, social or religious issues. The belief in the oneness of the Creator of the universe bestows a oneness on every facet of life.

This belief leads to an economic system that stresses that God has provided sufficient resources for the needs of all mankind and the economic problem arises because of both lack of effort and insatiable needs on the part of man.

Islam provides a basic set of values in the *Hudud Allah* (boundaries of God) that sets out the areas of permitted economic activity. It also provides general guidelines as well as specific ordinances, some of which promote activities that will lead to the well-being of humanity and others that warn against actions considered damaging.

The values underlying the economic framework include:

- Total commitment to God
- Appreciation of the wealth and resources provided by God

Wealth is recognized as a favour from God and a means not an end. It is to be used as a means of satisfying needs and not abused, destroyed or left idle. The real owner of wealth is God and man is merely a steward of all of God's creation. Resources have been provided in abundance and any perceived scarcity results from man's lack of knowledge of how to use these resources, or from his greed. An individual's efforts to satisfy his personal needs have to be set alongside his obligations to his family, neighbours, society and nation. All needs are interdependent.

According to Islam, all the resources that man needs have been provided by God, but many are wasted or misused on such activities as drinking, gambling, gluttony, and producing weapons of mass destruction. Although man may want them, they are neither needed nor necessary. It encourages better use of resources by making economic activity obligatory and encouraging hard work, thus easing the supply side.

This contrasts with the view of secular economics that says the economic problem arises because the resources available for meeting man's needs are limited. The emphasis is on easing the supply constraints in order to better meet the needs.

Two important norms that Muslims should observe in their dealings with others are *Al-adl* and *Al-ihsan*. The first requires man to observe honesty and fair play in all his dealings. The second requires people to go beyond their minimum obligations to others and achieve the highest standards of benevolence, kindness and sacrifice for others.

In addition, there are a number of more specific ordinances. These include:

- *Zakah:* A levy on many forms of wealth that is generally collected by the government and distributed to a number of beneficiaries that have needs.
- *Maintenance of family:* It is obligatory for a Muslim to provide for the needs of his family members.
- *Charitable assistance:* It is obligatory for a Muslim to extend charitable assistance to the needy, according to his means.
- *Application of Shari'a Law to business and financial transactions:* The aim of these laws is to make the transfer of goods safe and easy, and to facilitate the conclusion of economic contracts. The aim is to remove the causes of social tension or litigation and promote a climate of peace and goodwill.
- *Duty to produce more than one's needs:* Muslims are called upon to produce more than their own needs so they may help others.
- *Prohibition of Riba:* Islam forbids interest in all its forms. However most products in common use today by Islamic banks are "benchmarked" to market interest rates. A fuller discussion of this topic is to be found in Chapter 3 of this book.

In the Islamic framework, material pursuits are not independent of spiritual pursuits. Productive economic activity is seen as an act of worship when carried out in compliance with the *Shari'a*. The values that delineate the economic framework prescribed by Islam include total commitment to God and constant awareness of his presence.

Divine guidance for the economy is enshrined in the *Qur'an* and the *Sunnah* and has been summarized as:

- *Trusteeship* – meaning that all resources belong to God and man, as trustee, is accountable to God for the use he makes of resources.
- *Care for others* – as all human beings are dependent on each other and we gain through giving to each other.
- *Moderation in consumption* – as man should not use resources provided by God in a wasteful way.
- *Productive effort as a means of serving God* – by mobilizing all the resources provided by God in the most productive way possible for the good of all.
- *Mutual consultation as a method of collective choice* – in decisions concerning public welfare, in a way seen as just to all. At the same time, the links between self-interest and public interest are built through socially obligatory duties that have led to the establishment of many charitable endowments.
- *Treating wealth as a means and not an end* – the ultimate objectives of earning and spending money are moral and spiritual. Economic well-being is a means to peace and freedom.

Given all these ordinances and their importance to every Muslim, it may seem surprising that Islamic banking has taken so long to develop. Conducting all financial activity in a *Shari'a*-compliant way is as much a responsibility of every Muslim as care for the family and charitable giving. There are many reasons for the delay in the emergence of Islamic banks, some of which will be explored in the next chapter.

Chapter 2

Foundations of Islamic Finance

Framework for Islamic Banking

Modern western modes of banking mainly date back to the industrial revolution of more than two and a half centuries ago. Until then, the merchants, moneylenders and goldsmiths provided embryonic financial services. But the tremendous expansion that occurred in the number of traders, manufacturers, industrialists and other entrepreneurs who wanted to expand their businesses but lacked the financial resources to do so, led to a rapid development in banking.

When banks first started lending paper money they knew that they were taking huge risks. To minimize this they promoted the prudence of their institutions, persuading the public that their money was in safe keeping ("as good as money in the bank") and that they were respectable people who only wanted to conduct honest business and make a modest profit in the process. Initially the promise was that the paper could be exchanged for gold, but quickly this became an impossible promise as money supply quickly exceeded gold reserves. Banks had created money, based on trust, and used it to make profits by lending to the rest of the economy. This system is not Islamic in its concepts and it is hard to see it sitting alongside a truly Islamic economy.

However, the banking revolution largely bypassed the Muslim world. At the time many Muslim economies were managed by colonial powers and so western banking methods were imposed, despite the reservations of some of the population. Muslims had two choices: to accept the western concept of commercial banking and argue that the interest charged did not involve the usurious elements prohibited by the *Shari'a*; or, to accept that the interest charged was *Riba* and so attempt to develop an alternative system of banking. But at that time, little thought had been given as to how this might be achieved. It is only in the last few decades that attempts have been started to rectify this position.

That said, the origin of the modern Islamic bank can be traced back to the very birth of Islam when the Prophet Mohammad acted as an agent for his wife's trading activities. Islamic partnerships (*Mudaraba*) dominated the business world for centuries where partners provided capital, labour and entrepreneurship. This formed the basic structure of the modern Islamic bank where a group of individuals wishing to invest their capital placed deposits with a bank (which is the agent or *Mudarib*). The *Mudarib* then signed a contract with the entrepreneur, passing on the capital that was entrusted by the depositors. An alternative form of investment was *Musharaka*. In this case the agent (known as the *Musharik*) and the entrepreneur could also contribute to the capital and the *Musharik* could provide other support to the entrepreneur.

These two forms of partnership spread rapidly across the Middle East and beyond, but then appear to have lapsed in a period of inertia for Islamic finance.

Renewed interest in an Islamically acceptable form of finance only re-surfaced in the post-colonial era.

Early Banks and Their Activities

In the 1950s, a small rural co-operative bank was established in West Pakistan by a group of landlords who deposited their funds and also obtained *Mudaraba* finance. In Mit Ghamr, a small, rural delta town in Egypt, an Islamic savings bank was established in 1963 that provided savings accounts, investment accounts and *Zakah* accounts. It provided funds for agricultural investments on the basis of profit sharing and appears to have been very cautious in these investments and as a result, had no defaults. It had immediate success, but was abandoned for political reasons after the first few years. Bank Grameen expanded in Bangladesh soon after its independence from Pakistan in 1972. Again, its main role was in servicing the needs of the rural community. The bank and its founder, Muhammad Yunus, were jointly awarded the Nobel Peace Prize in 2006. While Bank Grameen does charge interest on its loans, this is simple interest and never exceeds the total amount of the loan. In addition, the bank does not take collateral and works closely with its borrowers to help them fight poverty, stay profitable and financially sound. If a borrower faces difficulties, the bank works extra hard to help them overcome these and reschedules loans as needed. These early examples are most easily classed as micro-finance institutions rather than true commercial banks.

A further early example was the establishment of Tabung Haji Malaysia in 1967. It had the very specific mission of providing a vehicle for Muslims wishing to save for their *Haj*. It also undertook the logistics for their journey to Mecca. Today it also operates as a diversified conglomerate with subsidiaries in the plantations, construction, real estate and services sectors.

The first Islamic bank in an urban setting was established in Cairo in 1971 as the Nasser Social Bank, a successor to the Mit Ghamr savings bank. The bank is a public authority with an autonomous status. Its objectives are mainly social and it provides loans for small businesses on a profit sharing basis, as well as interest free loans to the poor and needy. Because of its social role, in its early stages it was granted exemption from the requirements of the banking law.

Critical to the next stage of development was a decision taken in 1973 by the finance ministers of the Organization of the Islamic Conference to establish the Islamic Development Bank. This bank began operations in Jeddah in 1975. Although its role is primarily as a development assistance agency, it has been instrumental in founding and supporting many organizations, such as AAOIFI, (the Accounting and Auditing Organisation for Islamic Financial Institutions) that have in turn led to the development of Islamic finance. It has also, through various schemes, issued securities, backed by leasing and hire purchase assets, which are purchased by commercial Islamic banks, and conventional institutions, as (relatively) liquid assets.

The oil price rises of the early 70s also facilitated the development of Islamic banking in the Gulf because of the vastly increased financial resources that resulted. Dubai Islamic Bank was founded in 1975, Kuwait Finance House in 1977, Bahrain Islamic Bank in 1981 and Qatar Islamic Bank in 1983. These years also saw the birth of the Faisal Group, established by Prince Mohammed bin Faisal bin Saud, and the Dallah al-Baraka Group founded by Sheikh Saleh Kamel. In these years the focus of all the Islamic banks was on the retail market and their unique value proposition meant that they were able to persuade many devout Muslims to become customers.

These first Islamic banks were committed to partnership finance – both *Mudaraba* and *Musharaka* - though most of their operations consisted of cost-plus operations such as *Murabaha*. Current account holders received no remuneration, investment account holders shared in the profits or losses of specific investments while savings account holders shared in the bank's overall profits.

After a few years, Islamic finance began to look like no more than an exercise in semantics. Islamic banks were really no different from conventional banks but just used euphemisms to disguise interest. Attempts at profit and loss sharing were disappointing and were often abandoned. The image of Islamic finance was also damaged by the failure of Islamic money management companies in Egypt in 1988, which turned out to be pyramid schemes bearing no resemblance to true Islamic finance companies, and by the BCCI scandal in 1991. Although BCCI was not itself an Islamic bank, it was sympathetic to the cause and went out of its way to provide many services for Islamic banks. Many Islamic banks lost millions of dollars in the fallout.

However, the deregulation of the global markets helped to foster the growth of new Islamic products. Until the 1970s, financial institutions could sell only a narrow range of financial products. With the lifting of constraints on products that could be devised to meet every need, the way was opened for the creation of new

Islamic products. In contrast to the 1970s when literal, legalistic and scholastic interpretations dominated, the current tendency focuses on the spirit of Islam and on making modern financial instruments compatible with Islamic principles.

Organizational Forms Used Today

Today, Islamic services are offered in a number of different ways. The main structure is fully-fledged Islamic banks that only provide Shari'a compliant services. Many of these are retail banks, but a growing number of the larger institutions offer a full range of banking services, including retail, commercial and investment banking services. An example of a full service universal bank is Dubai Islamic Bank. It has a very broad service offering including a full range of retail and business products, finance and direct investments, real estate, treasury services and investment banking where it has been a leading arranger of Sukuk issues. While the current trend is to establish large universal banks or to grow to this model, there are still a number of smaller, more specialist institutions. Examples here are Venture Capital Bank, and First Energy Bank both of which are based in Bahrain.

In a number of cases, conventional banks have established Islamic subsidiaries. While many operate through their own dedicated delivery channels, many also use the channels of the conventional parent. This makes these operations quite similar to Islamic branches or windows, but they are required to produce their own financial statements and this goes a long way to ensuring that there is little co-mingling of assets and liabilities. Examples here would be CIMB Islamic in Malaysia and Emirates Islamic Bank in Dubai. CIMB Islamic is a subsidiary of CIMB and works closely with its parent. Emirates Islamic benefits from the dominance of its parent bank, Emirates NBD, in Dubai and across the United Arab Emirates.

Others have chosen to have dedicated Islamic branches. These only offer Islamic services through their Islamic branches, but the balance sheet of the conventional bank and the Islamic branches are added together for reporting purposes. While this helps the bank maintain separate performance information for both conventional and Islamic operations, it is not allowed by a number of regulators. An example of such a structure would be National Development Bank in Egypt, which has 19 of its 68 branches operating to Islamic principles. Following its acquisition by Abu Dhabi Islamic Bank, this ratio is expected to change.

On the other hand, many banks operate their financial services through "windows". These can be no more than separate counters within conventional branches. While some regulators have concerns about Islamic branches, even more have concerns about windows and do not allow them. Lebanon and Kuwait would be examples here. One of the concerns of the regulators is the inappropriate co-mingling of funds as it is extremely difficult to track that the Islamic operations are conducted according to strict Islamic principles. That said, it has been a successful route to conversion from conventional to Islamic-based banking for a number of institutions, perhaps most notably National Commercial Bank in Saudi Arabia.

A number of conventional banks have large Islamic operations. HSBC Amanah, a division of HSBC, has a balance sheet of around US$10 billion, making it one of the largest Islamic banks in the world. But in many cases, retail operations are hindered by the fact that these banks use conventional deposits to fund their Islamic loans.

Chapter 3
Operations of Islamic Banks

The Prophet outlined some major principles that should underlie all business transactions that reflect ethical concerns. There are also some major prohibitions. All banking operations must abide by these so, before discussing the products that have been developed, it is important to look at these teachings.

Business Ethics

All operations must be in line with the teachings found in the *Qur'an* and the *Sunnah*. These include the need for honesty and fair trade. For example, this means that practices such as hoarding, cheating, profiteering, concealing faults or misrepresenting goods are prohibited.

Riba

The prohibition which is most familiar is that of *Riba*. This is widely interpreted as the adding of any interest payments to a loan or other financing contract. It has been established in the *Qur'an*, the *Sunnah* and by the consensus of the Muslim community. However, from time to time, scholars have issued *fatwa* justifying the use of interest. The most notable recent example comes from Sheikh Muhammad Sayyid Tantawi when he was the Mufti of Egypt. In 1989 he said that bank depositors should be viewed as passive investors and the banks their investment agents. It was permissible for the profit distribution to these depositors to be pre-determined. This view was rebuffed by many other scholars. However, in 2002, the International Arab Banking Corporation asked him in his role as rector of Al-Azhar whether it was permissible to pre-determine profit distribution to depositors. The Council of the Islamic Research Institute, meeting on 31 October 2002, determined that "investing funds in banks that pre-specify profits is permissible under Islamic Law and there is no harm therein". The full text of the *fatwa* was presented to the Islamic Research Institute's Council on 28 November 2002 and was formally approved. The *fatwa* says that "no Canonical Text in the Book of Allah or the Prophetic *Sunnah* forbids this type of transaction within which profits or returns are pre-specified, as long as the transaction is concluded with mutual consent". It goes on to say:

> *"It is well known that banks only pre-specify profits or returns based on precise studies of international and domestic markets, and economic conditions in the society. In addition, returns are customized for each specific transaction type, given its average profitability."*
>
> *"Moreover, it is well known that pre-specified profits vary from one time period to another. For instance, investment certificates initially specified a return of 4%, which increased subsequently to more than 15%, now returning to near 10%."*
>
> *"The parties that specify those changing rates of returns are required to obey the regulations issued by the relevant government agencies."*
>
> *"This pre-specification of profits is beneficial, especially in this age, when deviations from truth and fair dealing have become rampant. Thus, pre-specification of profits provides benefits both to the providers of funds, as well as to the banks that invest those funds."*
>
> *"It is beneficial to the provider of funds since it allows him to know his rights without any uncertainty. Thus, he may arrange the affairs of his life accordingly."*
>
> *"It is also beneficial to those who manage those banks, since the pre-specification of profits gives them the incentive for working hard, since they keep all excess profits above what they promised the provider of funds. This excess profit compensation is justified by their hard work."*
>
> *"It may be said that banks may lose, thus wondering how they can pre-specify profits for the investors."*
>
> *"In reply, we say that if banks lose on one transaction, they win on many others, thus profits can cover losses."*
>
> *"In addition, if losses are indeed incurred, the dispute will have to be resolved in court."*
>
> *In summary, pre-specification of profits to those who forward their funds to banks and similar institutions through an investment agency is Legally permissible. There is no doubt regarding the Islamic Legality of this transaction, since it belongs to the general area judged according to benefits, ie. wherein there are no explicit Texts. In addition this type of transaction does not belong to the area of creed and ritual acts of worship, wherein changes and other innovations are not permitted."*[1]

[1] The translation of the *fatwa* is taken from the paper "Interest" and the Paradox of Contemporary Islamic Law and Finance, by Professor Mahmoud A El-Gamal of Rice University

A rebuttal to the *fatwa* came from the Islamic Fiqh Institute in Qatar in January of 2003. The *fatwa* covered many issues relating to interest and conventional banks and also commented on pre-specification of investment profits in amount, or as a percentage of the invested capital.

> *"Banks' interest on deposits is a form of riba that is forbidden in the Qur'an and Sunna, as previous decisions and fatawa have concurred since the second meeting of the Islamic Research Institute in Cairo, Muharram 1385 A.H., May 1965 A.D., attended by eighty-five of the greatest Muslim scholars and representatives of thirty-five Islamic countries. The first decision of that conference stated: "Interest on any type of loan is forbidden riba". The same decision was affirmed by later decisions of numerous conferences, including........."*
>
> *"It is universally accepted that interest-bearing loans differ from legal silent partnership (mudaraba). In loans, the borrower is entitled to profit and bears all losses. In contrast, mudaraba is a partnership in profits, and the principal bears financial losses if they occur, as per the Prophet's (P) saying: "Al-kharaju bi-l-daman profits are justified for the one bearing the liability for losses" (narrated by Ahmad and the authors of Sunan, with a valid chain of narration)....."*
>
> *"Thus, jurists of all schools have reached a consensus over the centuries that pre-specification of investment profits in any form of partnership is not allowed, be it pre-specified in amount, or as a percentage of the capital. This ruling is based on the view that such a pre-specification guarantees the principal capital, thus violating the essence of partnerships (silent or otherwise), which is sharing in profits and losses. This consensus is well established, and no dissent has been reported. In this regard, ibn Qudamah wrote in Al-Mughni (vol.3, p.34): "All scholars whose opinions were preserved are in consensus that silent partnership (qirad or mudaraba) is invalidated if one or both paties stipulate a known amount of money as profit". In this regard, consensus of religious scholars is a legal proof on its own."*
>
> *"The council urges Muslims, as it declares this unanimous decision, to earn money only through permissible means, and to avoid forbidden sources of income in obedience to Allah (S) and his Messenger (P)."* [2]

It is interesting to note that the Islamic Research Institute *fatwa* focuses on the relationship between the depositor and the bank but says nothing about the asset side of the balance sheet. In practice, while banks in theory have profit and loss sharing *mudaraba* agreements with investment account holders, they have moved away from *mudaraba* and *musharaka* transactions on the asset side of the balance sheet to transactions such as *murabaha* and *ijarah* that are functionally very similar to interest-bearing conventional transactions.

[2] ibid

The question about *riba* is sure to resurface, although in light of the current credit crisis, no scholar is likely to claim that "if banks lose on one transaction, they win on many others, thus profits can cover losses". Today we see this as an over-optimistic scenario! But the use of interest rates to benchmark transactions is growing and consequently it is becoming more acceptable.

However, it has proven difficult to find another equitable way of determining a price for many financial transactions such as leasing or renting, and many contracts are written, by agreement, using an interest rate such as Libor as a reference benchmark.

Gharar and *Maisir*

A further important prohibition is that of *Gharar*. It is one of the more difficult concepts to define but literally means uncertainty. It is particularly important in the drafting of contracts. There should be no ambiguities or omissions which might mislead. Some examples from well-known *Hadith* help. These would include:

- The sale of the fruit of a tree
- The sale of flowers before they appear on the plant
- The sale of fish caught in one throw of the net
- The sale of an unborn camel
- The sale of a bird in the air

This is clearly quite close to another forbidden activity, namely *Maisir* or gambling. With gambling, there is the possibility of making a huge return or losing everything. This prohibition has meant that Islamic derivative products have been difficult to structure and also it has created some issues for insurance products.

Any contract that is found to have a considerable element of *Gharar* or *Maisir* will be considered invalid.

Halal

Finally, a Muslim can only trade or invest in those goods or commodities that are *Halal*, or lawful. This means that Islamic banks cannot work with certain companies or finance certain transactions. Useful screens have been produced by Dow Jones[3] and the FTSE[4], among others, for use with their Islamic indexes. Companies involved in the following activities are considered *Haram*, or unlawful:

- Alcohol
- Tobacco

[3] Guide to the Dow Jones Islamic Market Indexes, June 2007 www.djindexes.com

[4] Ground rules for the Management of the FTSE Islamic Indices Series www.ftse.com

- Pork-related products
- Conventional financial services (banking, insurance, etc.)
- Weapons and defense
- Entertainment (hotels, casinos/gambling, cinema, pornography, music, etc.)

In its guide to the indexes, Dow Jones includes a list of sector codes defined by the Industry Classification Benchmark (ICB) and it excludes all companies whose primary business is in one of these areas. Some discretion is allowed when most of a company's business is *Halal* but some revenue may be earned from activities that are *Haram*.

Contracts

Within these various limitations, Islamic banks have created a range of products to meet the needs of their retail and corporate customers. Contracts are at the heart of all Islamic bank activities and help ensure that the business of the bank meets the highest *Shari'a* standards. This will be discussed further in the next chapter.

Chapter 4
Islamic Contracts

When Islamic banking reached the stage of revival during the mid-70s, it was important for the banks to define products that were seen to be compliant with the *Shari'a*, but it was not immediately obvious where to begin. The scholars of the day had little or no exposure to finance whilst bankers had no in-depth knowledge of the *Shari'a*. They turned to the classical system of nominate contracts and transactions for help. These were the contracts and transactions which were mainly derived as a result of the early trading activities of the Muslim world and had been given names, like *murabaha*, *ijarah*, *mudaraba*, and their structure was well known.

The *Shari'a* basically says that two parties can contract and do anything, so long as it is not *Haram*. However, this assumes a certain symmetry of information and understanding that may not automatically be present. It is this issue, among others, that has led to the conventional financial industry being one of the most regulated industries everywhere in the world. Yet even so, there have been financial disasters leading to near economic collapse on a global scale.

In the nominate contracts, there are certain principles that must be adhered to, but these can be incorporated in a contract written under either English law or New York law, for example, and many Islamic contracts have adopted this route, although they must also comply with local law. There have been some difficulties which will be discussed in the following chapter, but in general contracts are being used successfully. As scholars and bankers have become more skilled, new forms have been developed by combining two or more contracts to make another contract, often mimicking products available in conventional markets.

According to the majority of scholars, there should be certain elements in any contract:

- there must be contracting parties who should be adult and mentally sound;
- there must be a subject matter that is *Halal* and has value. It should also exist at

the time that the contract is agreed (although there are certain exceptions to this which will be discussed in a later chapter), and it should be owned by the seller who will have the ability to deliver it to the buyer at the agreed time. The subject matter should be described or identified so that there is no ambiguity, or *Gharar*, on the part of either the seller or buyer;

- the contract should not be conditional on a future event and both parties should agree the terms;
- finally, in a sale contract, a price should be agreed and certain.

More details can be found in the *Majalla*[1], the law encoded in Ottoman times which, while only following the views of one school, contains many principles that are widely accepted. The main underlying concept is that whatever is agreed should maximize benefit and minimize harm.

Within this broad framework, Islamic banks have developed many products to meet most of the financing and investment or savings needs of their customers. Understandably, as already mentioned, many of the products have been designed to mimic conventional banking products as these are the banking tools that have proven useful over many generations. However, it has proved difficult to ensure that products are all truly *Shari'a* compliant. A number of disputes between scholars and schools arise as to the validity of many, particularly so-called Islamic derivatives – futures, options, swaps and the like – all of which have been structured by using a number of acceptable contracts. The question remains though that if transaction A is prohibited, can one carry out transactions B and C say, knowing that the result that is achieved is the same as if one had carried out A, the prohibited one? Will two combined, *Shari'a*-compliant contracts always result in an acceptable outcome?

The AAOIFI *Shari'a* standards do address this issue in their standard on Combination of Contracts[2]. Certain combinations are allowed, but not if they are being used as a "trick" or an excuse for practicing *Riba*. However, they also describe "acceptable tricks" where, for instance, *Shari'a*-acceptable combinations are used to obtain *Shari'a* exits, without contradicting *Shari'a* objectives or resulting in any harm to others.

While the main nominate contracts and the way that they have been used to create financing instruments will be looked at in a later chapter, the way contracts can be classified are discussed here.

Wa'ad

The simplest form of contract is a promise, or *Wa'ad*. This is a one-sided contract where the promisor promises the promisee that he will do, or not do, something in

[1] www.ummah.com/Al_adaab/fiqh/majalla/introduction.html

[2] AAOIFI Shari'a Standard No. 25

the future. The Islamic Fiqh Academy has ruled that a promise is binding if certain conditions are met. In general, if the promisor changes his mind, a court may force him to make good any losses or expenses the promisee may have incurred.

Muwaada or *Mua'hida* Agreement

Muwaada means two unilateral agreements extended by two parties but on the same subject. So for example, if one party promises to sell his car to the other, and the other party promises to buy it. Some bankers have tried to use two unilateral promises to mimic a conventional forward contract, but not all scholars have accepted this approach.

Sahih and *Nafiz*

Sahih means valid, so the contract meets all the conditions set out in the *Shari'a*. If it is also *Nafiz*, it is enforceable, meaning that the parties have the ability and authority to enter into the contract.

Sahih but *Mawqoof*

This is a valid contract but one where at least one of the parties has the ability to enter into the contract but does not have the authority. This could arise if an agent has been appointed to negotiate the contract but has exceeded his authority in some way. The contract would become enforceable only when it has been authorized by the agent's principal.

Fasid

This refers to a contract that is voidable. While the contract has been concluded and is basically sound, it does not fulfill all the conditions for it to be valid. It can become a valid contract if the condition that was missing is included and agreed.

Bilateral Contracts

These include the nominate contracts that will be discussed more fully in a following chapter. They include contracts of exchange, or sale, which include *Murabaha*, *Salam* and *Istisna'a* contracts. There are also contracts where the usufruct is exchanged, of which *Ijarah* is the most common. There are partnership contracts (*Mudaraba* and *Musharaka)*; then contracts of security and contracts of safe custody.

Foreign Exchange Contracts

In the days when the Islamic commercial law was first defined, currencies of most countries were based on coins of gold, silver or copper and their value depended on the weight of the metal. It was thus relatively easy to transact in currencies. There are two famous *Hadith* that have been used to determine how currency transactions can be carried out today:

> *"Gold for gold, silver for silver......... equal for equal, like for like, hand to hand. If the kind of assets differ, you may sell them as you wish provided it is hand to hand."*[3]
>
> *"Do not sell gold for gold except equal for equal and do not sell what is deferred for a spot exchange."*[4]

The AAOIFI *Shari'a* standards examined this issue as their very first standard, reflecting its importance in so many transactions today. Their ruling on trading in currencies states:

> *"It is permissible to trade in currencies, provided that it is done in compliance with the following Shari'a rules and precepts:*
>
> *a) Both parties must take possession of the countervalues before dispersing, such possession being either actual or constructive.*
>
> *b) The countervalues of the same currency must be of equal amount, even if one of them is in paper money and the other is in coin of the same country, like a note of one pound for a coin of one pound.*
>
> *c) The contract shall not contain any conditional option or deferment clause regarding the delivery of one or both countervalues.*
>
> *d) The dealing in currencies shall not aim at establishing a monopoly position, nor should it entail any evil consequences to the interest of individuals or societies.*
>
> *e) Currency transactions shall not be carried out on the forward or futures market.*
>
> *It is prohibited to enter into forward currency contracts. This rule applies whether such contracts are effected through the exchange of deferred transfers of debt or through the execution of a deferred contract in which the concurrent possession of both of the countervalues by both parties does not take place.*

[3] Reported on the authority of 'Ubadah Ibn al-Samit by Muslim in his Sahih

[4] Reported on the authority of Abu Sa'id al-Khudri by al-Bukhari in his Sahih

It is also prohibited to deal in the forward currency market even if the purpose is hedging to avoid a loss of profit on a particular transaction effected in a currency whose value is expected to decline.

It is permissible for the institution to hedge against the future devaluation of the currency by recourse to the following:

a) To execute back to back interest free loans using different currencies without receiving or giving any extra benefit, provided these two loans are not contractually connected to each other.

b) Where the exposure is in respect of an account payable, to sell goods on credit or by Murabaha in the currency of the exposure.

It is permissible for the institution and the customer to agree, at the time of settlement of the installments of a credit transaction (such as a Murabaha*), that the payment shall be made in another currency applying the spot exchange rate on the day of the payment."*[5]

While the scholars have recognized that many transactions today involve currency trading, the prohibitions in this standard are aimed at avoiding any suggestion of *Riba*. At the same time, the scholars have suggested techniques that can be used to hedge currency exposure. While less convenient and, in the latter example, potentially more costly, than the conventional alternatives, there is a clear understanding of the need for such transactions.

The same *Shari'a* standard also sets out rules for the sale of currencies. The important elements are:

"When a contract is concluded for the sale of an amount of currency, possession must be taken for the whole amount that is the subject matter of the contract at the closing of the transaction.

Taking possession of one of the countervalues by one party without taking possession of the other is not enough to make a currency dealing transaction permissible. Likewise, taking partial possession is not sufficient. Taking possession of part of a countervalue is valid only in respect of the part, possession of which is complete, whereas the remaining part of the transaction remains invalid.

Possession may take place either physically or constructively. The form of taking possession of assets differs according to their nature and customary business practices."[6]

The standard then defines physical and constructive possession. It recognizes that constructive possession is just as secure as the "hand to hand" required by the

[5] AAOIFI Shari'a Standard No. 1 Trading in Currencies

[6] ibid

Hadith. It also recognizes that there are now "modern means of communication for currency trading" that would not have been possible in the past but should be equally acceptable today.

a) *"Bilateral contracting between two parties at different remote places using modern communication means has the same juristic consequences as execution of the contract in one and the same place.*

b) *An offer made for a stated period, which is transmitted by one of the prescribed means of communication, remains binding on the offeror during that period. The contract is not completed until acceptance by the offeree, and taking possession of the countervalues (either actual or constructive) by both parties has taken place."*

Some transactions do remain prohibited in particular bilateral promises:

a) *A bilateral promise to purchase and sell currencies is forbidden if the promise is binding, even for the purpose of hedging against currency devaluation risk. However, a promise from one party is permissible even if the promise is binding.*

b) *Parallel purchase and sale of currencies is not permissible as it incorporates one of the following invalidating factors:*

   1) *There is no delivery and receipt of the two currencies bought and sold, and thus the contract amounts to a deferred sale of currency.*

   2) *Making a contract of currency exchange conditional on another contract of currency exchange.*

   3) *A bilateral promise that is binding on both parties to the contract of currency exchange, and this is not permissible.*

c) *It is not permitted for one of the partners in Musharaka or Mudaraba to be a guarantor for the other partner, to protect the latter from the risks of dealing in currencies. However, it is permissible for a third party to volunteer being a guarantor for that purpose, provided this guarantee is not stated in the contract.*

Chapter 5

Shari'a Compliance and Legal Issues

Islamic Law

Islam is a complete code of life and encompasses everything in life. It influences families as much as international relations and certainly includes all financial matters. Its sources are the *Qur'an*, the *Sunnah* and *Hadith*, and the consensus of the opinion of the great jurists and interpreters of Islamic law, or *Ijma*. If none of these give a ruling on a particular matter, then there is *Qiyas* – or analogy – by which jurists and scholars compare an issue of today with a similar one described in the *Qur'an* or *Sunnah* and draw conclusions from the principles involved.

There are four major Sunni schools of *Shari'a* law: the Hanafi, Maliki, Shafi'i and Hanbali, and two main Shia schools, the Ithna Ashari's and the Ismaili's. Whilst the sects differ in some fundamental ways, they have endeavoured not to bring further division but to find new ways of studying existing guidance.

The Hanafi school is named after the Muslim jurist Imam abu Hanifa who originated from what is now Southern Iraq. He had two great followers, Abu Yusuf and Mohammed. The Hanafi school is based on the verdicts, legal thought and analysis of all three of these scholars and is the most liberal in its interpretation of the *Qur'an* and *Sunnah*. The school is said to be the most flexible and easiest to accept. It elevates belief over practice and is tolerant of differences within the Muslim community. One of Abu Hanifa's verdicts regarding interest is that a Muslim in a non-Muslim country may engage in the un-Islamic transactions of the indigenous people if: i) he has a valid need and reason to do so, ii) he has no intention of any deception or fraud, iii) he has no other course of action open to him. The Hanafi school does cater for diverse cultures, norms and circumstances. This is why it has been adopted primarily by non-Arabs (Iranians, Afghanis, Turks, Muslims in Russia and the sub-continent, and also in Syria).

The Hanbali school is named after the great traditionalist, Imam Ahmed ibn Hanbal. This school is said to be the most literal of all the schools. The approach is often said to be most suitable for those who have little inclination towards philosophy and other humanities. It is also the most demanding in terms of its social and personal rules. A substantial number of people in Saudi Arabia follow this school of thought today and much Saudi law follows this school. As a result, the testimony of Shias is often felt to be given less weight in the courts than that of Sunnis.

The Maliki school is named after another great traditionalist and jurist of Medina, Malik ibn Anas. He was renowned for his narration of *Hadith*. The Prophet, and many of his closest followers, spent most of their time in Medina and so Malik ibn Anas believed that the practices adopted by the people of Medina must be closest to those of the Prophet. Therefore his approach to jurisprudence was to follow the practice of these people and, if they agreed or sanctioned a certain act, their view should be given priority. Most of his verdicts have their origins in the collection of *Hadith* that he himself compiled. Many of his students traveled to North Africa and Spain and hence almost all of North Africa (excluding Egypt), Spain and Sudan follow the Maliki school.

The Shafi'i school is named after Mohammed ibn Idris as-Shafi'i who is credited with being the first Muslim jurist to form a legal doctrine and conduct systematic analysis. He is most remembered for his writing, bringing together a collection of *Hadith* and putting an end to many disputes among the scholars of his day. His school is the most relaxed in terms of social and personal rules. His jurisprudence falls into two phases of his life, the first before he moved to Egypt and second subsequent to this. After his move to Egypt he retracted a number of his earlier verdicts. His verdicts were usually based on giving priority to any sound *Hadith* over analogy. He did not accept the authority of the companions. His school is followed by most of the rest of the Muslim world (Egypt, Malaysia, Indonesia, Iraq, and some African countries).

The major Shia school is the Ithna Ashari's or "Twelvers", because they believe that there were twelve Imams. The last Imam, the Mahdi, is believed not to have died but to be in hiding to return at the end of time and bring victory for the Shia faith. There are three major legal schools with the dominant one being the Usuli school. It is liberal in its outlook and allows greater use of interpretation in reaching legal decisions; however none of the Shia schools have had the same influence as the Sunni schools. Twelvers constitute 90% of the population of Iran and 55-60% of the Shia population of Iraq. There are also substantial populations in Azerbaijan, Turkey, Pakistan, Lebanon, Syria, India, Afghanistan and Bahrain.

The Ismailis have had a long and eventful history but have acquired international prominence since the first of their Iman took on the hereditary title of Agha Khan, a title that was bestowed on Aga Hasan Ali Shah by the Persian Emperor. He left Iran in the 1840s because of political developments there and settled in Bombay. In the late 19th and 20th centuries Ismailis from India migrated to East Africa in significant numbers. The Ismailis are best known for their social and economic development projects and philanthropic institutions.

One of the problems today arises from the lack of any widely accepted legal codification based on Islamic jurisprudence. Some countries officially claim to be Islamic states (Iran, Sudan, for example) and their law is firmly rooted in Islamic law. Likewise, many other countries (Saudi Arabia, Egypt, Jordan, for example) claim to have laws whose main source is Islamic law. However they have other stronger ties, particularly to European law, mainly French but also British. This often depends on who was the past colonial ruler. In recent years there has been a desire to implement Islamic law, but there was no one authoritative source. As a result a number of international councils were established by governments and the views of these carry most weight. However, as seen in Chapter 3, the most prominent councils often issue conflicting *fatwas* and their rulings often contradict each other.

The three most important of the councils are probably:

1. The Institute of Islamic Research at Al-Azhar University in Cairo which was established in 1961.
2. The Islamic Jurisprudence Institute of the Islamic League which was established in Makkah in 1979.
3. The Fiqh Academy of the Organisation of Islamic Conference (OIC), based in Jeddah, Saudi Arabia and established in 1984. As the OIC has a broad membership of Islamic countries, the Fiqh Academy is probably the most highly regarded.

In all matters of finance, the essence of Islamic law is perhaps based on a verse from the *Qur'an* that says "Do not usurp one another's possessions" (2:128). The object of Islamic finance is to eliminate injustice and exploitation in financial dealings and to create an equitable distribution of wealth by encouraging effort and mutual co-operation. It is believed that this, in turn, will increase productivity and goodwill, alleviate economic hostility and inspire all the members of a society with a feeling of having common economic goals.

However, because the law is derived from writings that pre-date modern life, interpretations can be difficult. In the finance sector, the early banks called on the most noted scholars of the day for help. But these scholars were academics with no practical finance experience. They did though make great strides in connecting the *Shari'a* with the modern world of finance. Partly because of the demands made on scholars and partly because of a desire to have *Fatwa* acceptable at least to all of the four main Sunni schools, banks began to appoint boards of scholars to consider transactions that they wished to engage in and decide whether they met the *Shari'a* requirements. However, boards in different banks often came to different conclusions as the issues were complex, and this remains an issue to this day despite the great strides made by both scholars and bankers in understanding the issues.

As discussed in the previous chapter, almost all transactions entered into by banks are based on legal contracts that conform to local law (or, in many cases, English law and, to a lesser extent, New York law) and have often added *Shari'a* compliance as an additional requirement. This has not proven to be an easy legal basis for business. Although only a few cases have come to the English courts, they have ruled that only one law can be applied.

London Rulings

Two fairly recent cases are worth some attention: that of *Islamic Investment Company of the Gulf (Bahamas) Ltd v Symphony Gems NV and others* (London High Court 13.2.02) and *Beximco Pharmaceuticals Ltd & others v Shamil Bank of Bahrain EC* (Royal Courts of Justice, London 11/12 December 2003).

In the first case, Symphony Gems, a Belgium company, and IICG entered into a revolving purchase and sale facility under a *Murabaha* agreement in February 2000. The contract was written under English law. Symphony Gems wished to purchase diamonds with a value up to US$15mn. IICG appointed Symphony Gems as its agent and Symphony issued two irrevocable purchase orders for US$7.5mn. Symphony notified IICG that it had identified diamonds at a Hong Kong company, Precious (HK), and the bank transferred the payment to Precious's account with Credit Suisse in Zurich. Symphony was to pay the bank in three installments, but no payments were made. The defendant did not raise the issue of non-delivery of the diamonds until the bank took action in the English courts. While Symphony argued that they had not received the diamonds and therefore under *Shari'a* law they had no obligation to pay, the judge ruled that even if there had not been delivery, this was because Symphony Gems had not made the necessary arrangements.

The truth behind this transaction is somewhat ambiguous. Some diamonds may have been delivered to a Tokyo-based company that was owned by a branch of the family that owned Symphony Gems, but an on-going family dispute possibly led to the problems. However, under English law, because of the role that Symphony played in purchasing the diamonds and arranging for the delivery, it could not refuse its obligations to pay the bank, despite the fact that this might not seem to be the position under *Shari'a* law.

In the latter case, Beximco Pharmaceuticals, a Bangladeshi company, and a sister company entered into a *Murabaha* agreement with Shamil Bank in 1995/1996 to purchase goods. The contract contained the following clause:

> *"Subject to the principles of the Glorious Shari'a, this agreement shall be governed and construed in accordance with the laws of England."*

The bank appointed Beximco as agent for the purchase. By December 1999 some payments had been made, but more were due and Beximco had admitted in writing that they were due. So the two parties entered into new agreements: "Exchange in Satisfaction and User Agreements". Under these the bank would discharge the amounts due in exchange for unencumbered rights to certain assets. The bank granted the defendants the right to use the assets on payment of a user fee (an *Ijarah* arrangement). In addition there were compensation amounts and personal guarantees. Again, the company failed to pay the bank.

When it came to court, the defendants argued that the transactions were in truth disguised loans with interest. As such they amounted to unlawful agreements to pay *Riba* and were thus unenforceable. Beximco also said that the money was in fact required as working capital and that neither party was under any illusion as to the commercial realities of the transactions.

The bank's expert, Dr Lau, the former director of the Centre of Islamic and Middle Eastern Law, said:

> *"The precise scope and content of Islamic law in general, and Islamic banking in particular, are marked by a degree of controversy within the Islamic world, best exemplified by the fact that the actual practice of Islamic banking differs widely within the Islamic world. Even within particular jurisdictions such as Pakistan, which are committed and constitutionally obliged to introduce Islamic financial systems, the issue is subject to on-going debate and a high degree of uncertainty. In the absence of any agreement on the boundaries of 'Islamic banking' or, indeed, on what ought to be the precise ingredients of a Morabaha agreement, it is in practice up to individual banks to determine the issue. In the absence of any legal prescription as to what does and what does not constitute Islamic banking or finance, most Islamic banks, including those in Bahrain, seek the advice of Islamic scholars who examine and approve particular agreements and forms of agreement, the role of the Religious Supervisory Committee being to formulate the bank's interpretation of the Shari'ah."*
>
> *"Strictly interpreted "the Glorious Shari'a" refers to the divine law as contained in the Qur'an and Sunnah. However, most of the classical Islamic law on financial transactions is not contained as 'rules' or 'law' in the Qur'an and Sunnah but is based on the often divergent views held by established schools of law formed in a period roughly between 700 and 850 CE. The particular form and content of Morabaha agreements varies. If a bank's Religious Supervisory Board is satisfied that the bank's activities are in accordance with Shari'ah law, that concludes the matter, there being no provision in Bahrain law, or Islamic law generally, for an appeal by a customer of the bank against the Board's rulings and certifications. Finally, even if the relevant agreements amounted to agreements to pay Riba, the principal sums advanced could be validly claimed."*

In conclusion he said:

> *"In my opinion for the Morabaha Agreements to be in accordance with Islamic law all that is required is that they are certified as such by*

> *Shamil Bank's Religious Supervisory Board and the principal amounts are dispensed in accordance with the terms of the 1995 and 1996 Morabaha Agreements."*

The court concurred with these arguments. The judge said "it was improbable in the extreme" that the court was being asked "to get into matters of Islamic religion and orthodoxy". This was "especially so when the bank has its own religious supervisory board to monitor the compliance of the bank with the board's own perceptions of Islamic principles of law in an international banking context".

The court concluded that where parties agree that subject to *Shari'a* principles, English law shall govern the contract, provided that they can show that they have taken the normal steps to ensure *Shari'a* compliance, the English Court will not look at how that *Shari'a* decision was made nor find to the contrary, but will confine itself to applying English law.

The defendants took the case to appeal. They agreed that there could not be two governing laws in respect of the contracts but argued that the contract should be read as incorporating only those specific and non-controversial *Shari'a* rules that relate to interest and the nature of *Murabaha* and *Ijarah* contracts. However, the Court of Appeal held that a general reference to the principles of *Shari'a* afforded no reference to or identification of the specific aspects of *Shari'a* law that were intended to be incorporated into the contracts.

The Lord Justice said:

> *"English law is the law to be applied in ascertaining the liability of the parties under the terms of the agreement. English law is a law commonly adopted internationally as the governing law for banking and commercial contracts, having a well-known and well-developed jurisprudence in that respect, which is not open to doubt or disputation on the basis of religious or philosophical principles. I share the judge's view that, having chosen English law as the governing law, it would be both unusual and improbable for the parties to intend that the English Court should proceed to determine and apply the Shari'a in relation to the legality or enforceability of the obligations clearly set out in the contract."*

It could be that if there had been mention of the *specific* aspects of *Shari'a* law that were meant to apply, the decision might have been different. Also, if the *Shari'a* experts called in the case had the same interpretation on the requirements or indeed if there was just one recognized school of Islamic jurisprudence, the decision might have been different.

It is important that anyone who is party to a contract which includes reference to the *Shari'a* has some certainty that the terms of the contract will be enforceable in any circumstance, with respect to any structure or transaction and in any jurisdiction. We will see later that there are many questions over recent *Sukuk* issues concerning true sale of the underlying assets, insolvency and enforceability. Doubts over interpretation in these areas – the lack of legal certainty – has made it difficult to assign ratings in many cases and does mean that there is an additional legal risk in these transactions.

Further issues can arise because the legal framework in many Islamic countries does not follow English law. Judgements made in the English courts may be difficult to enforce. As an example, the following paragraph has been taken from the offering circular for a recent *Sukuk* issue by Tamweel, a Dubai company that finances real estate purchases. The *Sukuk* is listed in Dubai on the Dubai International Financial Exchange (DIFX).

> *"Currently, the majority of Tamweel's assets are located in the UAE. The Emirate of Dubai's courts are unlikely to enforce an English judgment without re-examining the merits of the claim and may not observe the choice by the parties of English law as the governing law of the transaction. In addition, even if English law is accepted as the governing law, this will only be applied to the extent that it is compatible with the Emirate of Dubai law and public policy. Moreover, judicial precedent in the UAE has no binding effect on subsequent decisions and there is no formal system of reporting court decisions in the UAE. These factors create greater judicial uncertainty than would be expected in certain other jurisdictions."*

The Role of *Shari'a* Boards

Religious *Shari'a* Boards have an important role to play. They have to safeguard the banking practices, ensuring that the principles of Islam are not violated.

The bankers, typically, are professionals who may not be very experienced or knowledgeable in the ways of Islamic banking. The Religious *Shari'a* Boards have to educate the bankers / institutions with which they are working.

Working closely with the professional bankers, they also have to play the role of innovators in developing the products and services in the Islamic financial institutions. Additionally, they have to be in communication with other *Shari'a* Boards, so that answers can be developed to the problems faced by the Islamic financial institutions.

In the first role the Board examines the transactions and operations of the bank to ensure that the day to day business is in compliance with the *Shari'a*. However, the second role gives it a proactive role within the institution. If it feels that a certain type of transaction should not be allowed, it needs to work with the bankers to arrive at a structure that meets the objectives of the transaction but would be in compliance with the law.

The boards have also been pragmatic, proposing for example the temporary use of cost-plus sales and leasing until true profit sharing products can be introduced.

Several boards have drafted model agreements for their banks to follow. They have also issued *Fatwas*, many of which have been published, and undertaken research which has resulted in articles which have added to the growing body of knowledge of Islamic banking.

However, there is still a shortage of scholars who also understand the principles of modern finance. This means that those who are most respected are in great demand and often serve on 20, 30, or even more, different *Shari'a* boards. The positive aspect of this is that it should lead to greater conformity in the industry with boards reaching similar conclusions. On the other hand, it introduces a number of governance issues that will be hard to address until there are more scholars. A particular challenge within a bank arises when the views of the management and board, with their focus on financial results, differs from the view of the *Shari'a* board.

It also poses a number of competitive difficulties for Islamic banks. When an Islamic bank develops a new product, it has to wait until the *Shari'a* board has given its opinion. Sometimes it has taken longer for this than for the development phase of the product and has been known to mean that a customer has turned to a conventional solution.

In its standard on Corporate Governance, the Islamic Financial Services Board (IFSB) examines some of the governance issues that arise in connection with compliance with *Shari'a* rules and principles, and makes a number of proposals. These include the need to make the rulings of *Shari'a* boards public and subject to internal and external audit. It also suggests that the supervisory authority might consider establishing a professional body for the scholars, or requiring banks in their jurisdiction to use an approved list of names. It further suggests that the supervisor might set "fit and proper" tests and criteria for members of bank's *Shari'a* boards. We will return to this issue in the later chapter on regulation.

Chapter 6

Financing Instruments.........

Several different models have been developed to provide various types of financing that are also *Shari'a* compliant. Many of these are based on the contracts used by traders in the early days of Islam, while others have been developed more recently and have been modeled on conventional products. *Mudaraba* and *Musharaka* probably come closest to the Islamic ideal of profit or loss sharing, others have been allowed by scholars on an interim basis until new products, based more fully on Islamic principles and laws, have emerged. Neither *Mudaraba* nor *Musharaka* are used extensively at present, partly because the risks are high but also because the regulatory requirement for capital adequacy recognizes these risks and the Basel II capital ratio requires a significant capital allocation for equity participations.

When banks develop a product, or wish to use one of the more established forms of financing, the structure will be presented to their *Shari'a* boards to ensure that it is in compliance with the law. Many banks have developed standard documentation for the most commonly used products and some regulators (for example, the State Bank of Pakistan) have produced formats for use by the banks that are subject to their supervision. Also, many *Fatwa* have been published giving a *Shari'a* opinion on the products. One of the criticisms of Islamic banking and finance arises from the lack of standardization in the products. Different *Shari'a* boards will often come to different decisions, creating a degree of uncertainty that is contrary to Islamic principles. Arguably the best assistance in this area has come from the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI). It has established a large *Shari'a* board that includes many eminent scholars from all the major schools. It has produced, *inter alia*, standards for all the commonly used products. The descriptions in this chapter are mainly based on these standards and the basis for the rulings.

Mudaraba Financing

In a *Mudaraba* contract, the bank supplies all the capital to an entrepreneur who contributes his management and experience. Profits are shared on an agreed basis, while any loss is borne by the bank.

The AAOIFI *Shari'a* standard for *Mudaraba*[1] sets out a number of rules that should be adhered to by the parties to this financing. These rules include the following key considerations. However it is advisable that any contract is passed as *Shari'a* compliant before conclusion.

The Agreement

The customer (who becomes the *Mudarib*) and the institution offering only Islamic financial services (IFI) (who becomes the *Rab al Mal*), as partners, can establish a *Mudaraba* contract via execution of a:

- Memorandum of Understanding (MOU) which is to be followed by execution of multiple *Mudaraba* contracts; or
- *Mudaraba* contract.

The MOU states:

- the intended mode of financing, i.e. restricted or unrestricted *Mudaraba* financing instrument;
- profit allocation ratio;
- type of guarantee that shall be presented by the *Mudarib* to cover losses arising from negligence, misconduct or breach of contract.

The *Mudaraba* Contract

The contract is non-binding and can be terminated unilaterally except in some specific situations, namely:

- when the *Mudarib* has already commenced the business; and/or
- if the parties have agreed on a duration for the contract. It cannot be terminated prior to this duration unless by mutual agreement.

Types of *Mudaraba*

There are two types of *Mudaraba*, unrestricted and restricted. In an unrestricted contract, the capital provider allows the *Mudarib* to manage the funds without any

[1] AAOIFI Shari'a Standards No.13

restrictions. The *Mudarib* is expected to utilise his expertise and skills to manage the funds in accordance with the investment objectives of the capital provider.

In a restricted contract, the capital provider (*Rab al Mal*) allows the *Mudarib* to manage funds subject to certain restrictions, such as type of investment, sector or country exposures.

Mudaraba Capital

The *Mudaraba* capital must be in the form of cash or tangible assets that have been valued by experts, or have a value agreed by the contracting parties. The capital cannot be in the form of debt owed by the *Mudarib* or another party to the capital provider. This is because the capital must be in a form that can be used in the *Mudaraba* operations.

A *Mudarib* invests the *Mudaraba* capital on a trust basis; hence, he is not liable for losses except in cases of misconduct, negligence or breach of the terms of the *Mudaraba* contract. In such circumstances, the *Mudarib* becomes liable for the amount of the capital. The capital provider is allowed to obtain guarantees from the *Mudarib* that are adequate and enforceable if this becomes necessary.

Rulings Regarding Profits

The profit allocation ratio and the way it is calculated must be clearly stated. The profit ratio must be on the basis of an agreed percentage of the profit and not a lump sum or a percentage of the capital. However, a lump sum profit is allowed when both parties agreed in the contract to distribute a lump sum if profits exceed a certain ceiling.

The profit allocation ratio should be determined when the contract is concluded, but the ratio can be changed at any time and the parties can define the duration for which the ratio should stand.

The *Mudarib* cannot earn fees in addition to his share of the profit from the *Mudaraba* operations. However, the *Mudarib* is entitled to claim for living or travelling expenses based on standard practice or up to an amount allowed by the capital provider.

Fees may be earned from activities that are not by custom part of the *Mudaraba* operations and must be executed in a separate agreement. The *Mudarib* is not allowed to make a loan, gift or donations out of the *mudaraba* funds.

Profit can only be claimed when it becomes clear that the *Mudaraba* operations have made a profit. Any losses must be compensated by the profits from future operations. If the losses are greater than profits at the time of liquidation, the net loss must be deducted from the capital, which is solely borne by the capital provider.

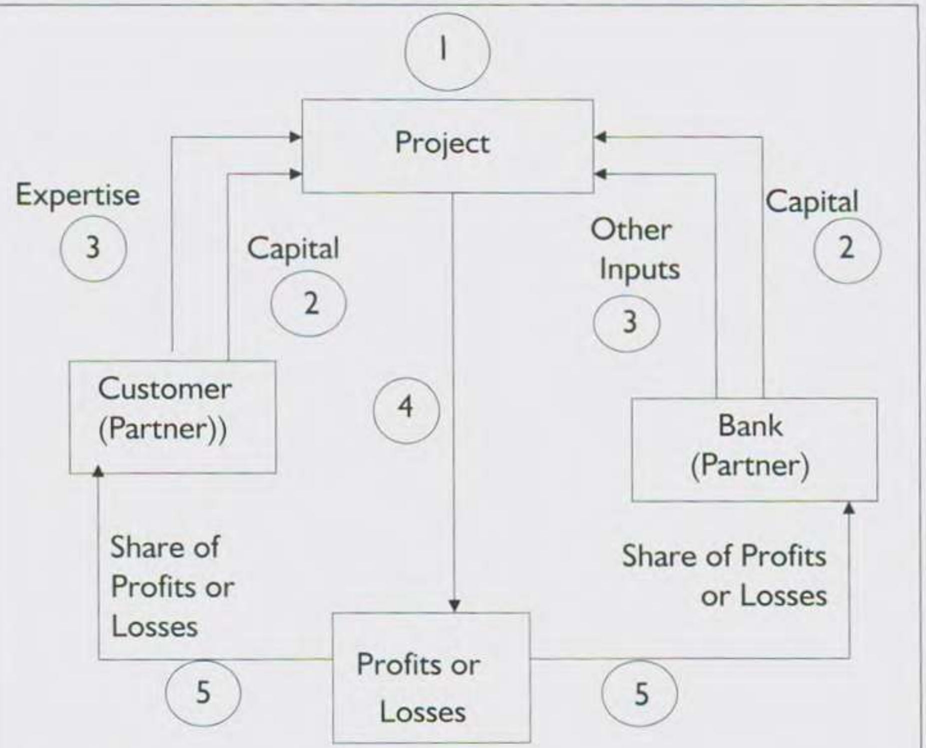

Figure 6.2: *Musharaka* contract

1. A customer of an Islamic bank identifies a project that it would like to undertake in a *Shari'a* compliant way on a *musharaka* basis in partnership with the bank.
2. The customer and the Islamic bank both contribute to the capital.
3. The customer contributes his expertise, the bank may also participate in other appropriate agreed ways, for example, in management.
4. The project returns either profits or losses.
5. If there are profits, these are distributed according to a pre-defined ratio agreed by both parties to the contract.
6. If there are losses, these are all borne by the partners in proportion to their contribution to the capital.

In medium and long term projects, the contract can be framed so that the bank gradually receives back part of its capital contribution in agreed installments as well as profits for the period concerned so that eventually the client has complete ownership. This is known as diminishing *Musharaka* or *Musharaka Mutanaqisa*.

The AAOIFI *Shari'a* standards cover many types of partnership that do not involve capital investment. The partnership that involves both parties contributing money is known as *Sharika al-Inan*. This is defined as a partnership between two or more parties whereby each partner contributes a specific amount of money in a manner that gives each one a right to deal in the assets of the partnership, on condition that the profit is distributed according to the partnership agreement and that the losses are borne in accordance with the contribution of each partner to the capital[2]. The key considerations in a *Musharaka* agreement include the following, points. However there are fewer specific requirements with this agreement than with *Mudaraba* because it has much greater flexibility:

The Agreement

The partners execute a partnership (*Musharaka*) agreement that specifies:

- offer and acceptance
- contracting parties
- capital amount and structure
- profit sharing ratio (the ratio can be amended from time to time)

An IFI can enter partnerships with non-Muslims or conventional institutions provided that such partners' capital is from permissible sources. The operations of the *Musharaka* must be in accordance with the *Shari'a* rules and principles.

The Capital

The capital can be in the form of cash, gold, silver or their equivalent in value and tangible assets. Debt (receivables) alone is not permissible as the capital unless the debt is inseparable from other assets that can be presented as a contribution to the capital.

Any contribution to the *Musharaka* capital in foreign currencies must be translated into the currency of the *Musharaka* at the current exchange rate.

A partner cannot guarantee the capital of another partner.

Management

The management of the *Musharaka* can be restricted to certain partners or a single partner. A fixed remuneration to such 'managing' partners is not allowed but the partners can earn a greater allocation of the profit at a ratio higher than his share of capital depending on his other contributions to the *Musharaka*.

[2] AAOIFI Shari'a Standards No. 12

A manager, other than the partners, can be appointed to manage the *Musharaka* at a fixed remuneration and a profit share, if any.

Profit and Loss Sharing

The profit will be finally allocated from the proceeds of selling existing assets (actual valuation) or based on the valuation of assets at fair value (constructive valuation). The allocation of profits must be based on actual profit.

Profits can be carried forward and set aside, subject to the provisions of the articles of association of the *Musharaka*, as reserves (investment risk reserve and/or profit equalization reserve).

The loss shall be borne periodically by the respective partners in accordance with their contribution of capital. It is not permitted to hold one partner or a group of partners liable for the entire loss or liable for a percentage of loss that does not match their share of ownership.

Maturity

A partner can withdraw from the partnership at any time after giving his partner(s) due notice to this effect. However, if the contract explicitly states that the partnership is to survive for a fixed period, termination prior to the agreed expiry date of the *Musharaka* is not allowed, unless all the partners agree to the termination.

The withdrawal of a partner does not necessitate the termination of the whole partnership.

A partner can enter into a binding promise to buy at any time, all assets of the *Musharaka* based on the market value as at the acquisition date, or at a price agreed by the partners. It is not permitted to buy the assets at face value.

Diminishing *Musharaka*

A partner is allowed to give a promise to buy the equity share of the other partner(s) gradually until the title to the equity is completely transferred. This promise must not be stated in the *Musharaka* contract but must be stated in a separate buying and selling agreement. It is permissible for a partner to rent or to lease the share of the other partner(s) for a specified amount and for whatever duration.

This mode of partnership has proved a popular tool and has been used by many Islamic institutions, particularly as a means of providing finance for home purchase. The cost of the property is divided into units with both parties owning a certain number of units at the outset. The customer promises to purchase the units not already owned by him and pays rent on those units. Under *Shari'a* law, the rental and acquisition agreements cannot be conditional one on the other.

Salam (Bay Salam)

Salam is a sale whereby the seller undertakes to supply some specific goods to the buyer at a future date in exchange for an advance price, fully paid at the time of the agreement. The basic purpose of this type of sale initially was to meet the needs of small farmers who needed money to grow their crops. They were allowed to sell their agricultural products in advance. *Salam* can be used only for those commodities where the quality and quantity of the product can be specified in advance. So, for instance, it cannot be used for the fruit of a particular tree as it is possible that the tree might be destroyed before harvest or yield no crop, so delivery is uncertain. However, the agreement could be for a given quantity and quality of fruit. It would then be for the farmer to supply, either from his own tree or from the market. (The Hanafi school says that the commodity should be available in the market from the day the agreement is struck, however the other schools say that it is acceptable if the commodity will be available when the term of the contract falls due.)

Although not all jurists are in agreement with the practice, in many cases parallel contracts are used as the financial institution does not usually want possession of the underlying commodity. Two methods are described in the literature: in the first the institution sells back to the original seller and in the second, the contract is with a third party. However, the *Shari'a* standard only talks of third party involvement. The obligations under the *Parallel Salam* cannot be conditional on the original *Salam* and, if the scholars have allowed an agreement with the original seller, the requirement is that the original transaction should not have been priced with the intention of doing a subsequent *Parallel Salam*.

The key considerations set out in the AAOIFI standard[3] are as follows:

The Contract

The customer as the seller and the IFI as the buyer, execute a *Salam* contract or a *Salam* Master Agreement (to be followed by execution of multiple *Salam* contracts).

Contract is binding and cannot be cancelled unilaterally.

The Contract specifies the:

- type of goods to be delivered by the customer or '*al-muslam fihi*'
- quantity and quality of the goods

[3] AAOIFI Shari'a Standard No. 10

- date, place and manner of delivery
- basis for determining the price
- mode of payment

Payment of *Salam* Capital

The IFI pays the capital of the *Salam* to the seller/customer when the contract is executed. Some *Shari'a* scholars allow a delay of payment by 2-3 days after the contract date.

The capital of the *Salam* can be in the form of cash, fungible goods or 'usufruct'. If the *Salam* capital is in the form of fungibles, its kind, type, specifications and quantity must be specified.

Delivery of the Goods

If goods are delivered which are not within the specifications they can be rejected by the IFI.

If the goods delivered are within the specifications or of higher quality, the IFI is obligated to accept them, unless a higher price is demanded by the seller (in the case of higher quality of goods being delivered).

Cancellation or Failure to Deliver

Cancellation of the delivery of all or part of the goods is allowed in return for repayment of the *Salam* capital for the portions that are yet to be delivered.

If the seller cannot deliver goods due to *insolvency*, the seller must be granted an extension of delivery.

If the goods are not available on the delivery date, the buyer can opt to wait until the goods become available, cancel the contract and recover the *Salam* capital, or mutually agree on replacement goods.

Contract Maturity

On maturity, the customer delivers the goods of the specified kind and quality to the IFI on the agreed date. No charges are allowed for any extension or rescheduling of the delivery.

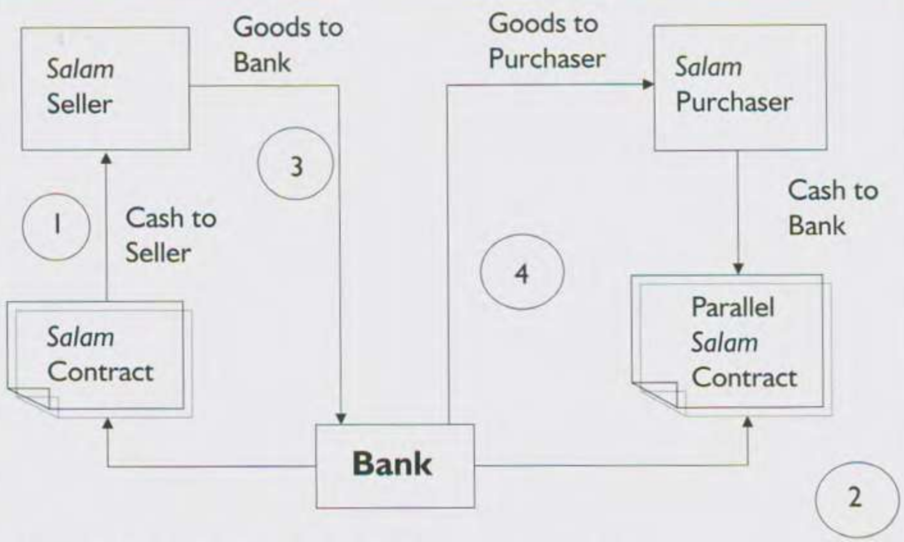

Figure 6.3: *Salam* and Parallel *Salam* Contracts

1. The bank enters a *Salam* contract with the seller and pays cash for future delivery of goods.
2. The bank enters a parallel *Salam* contract with the purchaser who will purchase the goods from the bank when they are delivered.
3. The goods are delivered to the bank.
4. The goods are delivered to the purchaser who pays the agreed price to the bank.

Parallel *Salam*

The IFI can sell the goods to a party other than the *Salam* customer (or a company which is owned less than 1/3 by the *Salam* customer).

The *Parallel Salam* contract must be independent of *Salam* contract. The obligation of the IFI to deliver the goods under the *Parallel Salam* is not conditional on the performance obligations under the original *Salam* contract.

Istisna'a

Like *Salam*, *Istisna'a* is a kind of sale where the goods being sold do not exist at the time of the contract. The subject goods of *Istisna'a* always need manufacturing.

The manufacturer agrees to produce the goods, with his materials, to an agreed specification. It is not necessary to pay the full price in advance and payments may be made in agreed installments over time. Nor is it necessary to fix an exact time of delivery, but the purchaser may fix a maximum time. If this time is exceeded, the purchaser may not be bound to accept the goods or pay the price. The contract is irrevocable after the commencement of manufacture unless the goods delivered do not meet the contracted terms.

When used by an IFI as a means of financing, the customer normally requires certain goods and enters into an *Istisna'a* agreement with the bank for their supply. The bank then enters into a *Parallel Istisna'a* agreement with a subcontractor that will manufacture the goods.

The key considerations taken from the AAOIFI *Shari'a* standard[4] include the following:

The Contract

The customer executes an *Istisna'a* contract with the Islamic institution requesting the latter to construct or manufacture a specified type of goods.

The contract specifies:

- the type of goods to be manufactured or constructed by the bank
- the price (that can be paid fully in advance, in deferred installments or upon full completion)
- date, place and manner of delivery (the delivery date is only required if this is necessary for the customer)
- mode of payment (cash, tangible goods or usufruct of an asset for a specified duration)

Delivery of the Goods

Goods delivered which are not within the specifications can be rejected by the ultimate buyer or be accepted by the buyer, with or without a price discount.

If the goods delivered are within the agreed specification or of higher quality, the buyer is obliged to accept unless a higher price is demanded by the seller (in the case of higher quality of goods being delivered).

If the goods are ready but the buyer delays in taking delivery, the goods in the possession of the manufacturer will be on a trust basis and the manufacturer is not liable for any loss or damage, unless at the negligence and misconduct of the

[4] AAOIFI Shari'a Standards No 11

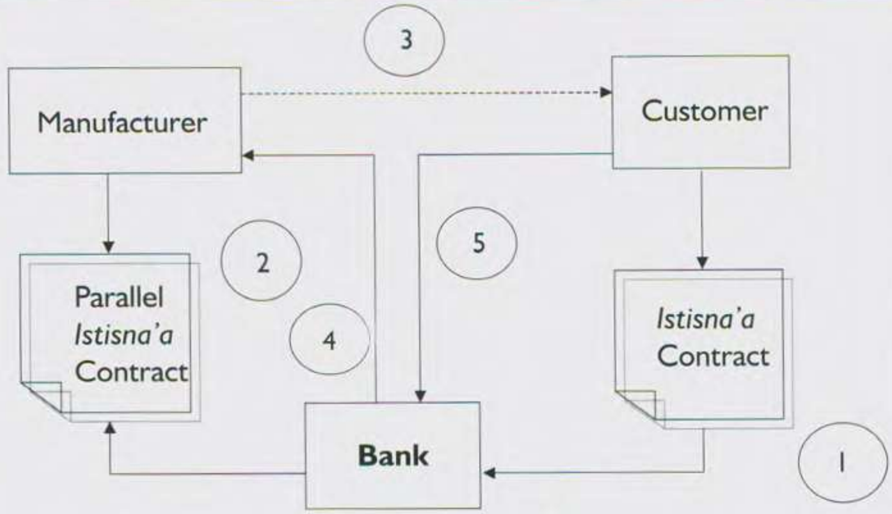

Figure 6.4: *Istisna'a* and Parallel *Istisna'a* Contracts

1. A customer enters into an *Istisna'a* contract with the bank asking the bank to manufacture some specified goods.
2. The bank enters into a Parallel *Istisna'a* contract with a manufacturer to produce the goods. (The customer may act as the bank's agent in this.)
3. The manufacturer delivers the goods to the bank to the agreed specification. (The goods are generally shipped directly to the customer.)
4. The bank gives the manufacturer the agreed payment(s).
5. The customer makes the agreed payment(s) to the bank.

manufacturer.

The manufacturer can sell the goods to a third party to recover its contract price and return the balance, if any, or have recourse against the buyer if the price is not sufficient.

Cancellation

Cancellation of the contract is allowed as long as the manufacturer (in this case, the Islamic bank) has not commenced work.

Parallel *Istisna'a*

The IFI may enter into a Parallel *Istisna'a* contract with a sub-contractor to manufacture the goods ordered. However, the Parallel *Istisna'a* contract must be independent of the *Istisna'a* contract.

The IFI assumes the liability of ownership risk plus maintenance and insurance expenses.

Ijarah

Ijarah literally means to give something on rent. It can be used for any transaction when the services of someone are hired by someone else. It could be used where the services of a doctor, lawyer or labourer were hired to provide a service, for instance. However, in a financing sense, it is used when a particular property is rented by someone. It is largely equivalent to leasing. The right to use the property is transferred, but the ownership remains with the transferor. There is an agreed period of the lease and an agreed consideration. All the liabilities relating to ownership remain with the lessor, but those that refer to the use of the property are transferred to the lessee.

Generally there are two contracts: one which specifies the rental to be paid for the duration of the lease and a second in which the lessor unilaterally promises to sell the asset to the lessee at the end of the lease period for an agreed price, or even to give the asset to the lessee. In the view of some scholars, this arrangement meets the principles of *Shari'a* that say that one transaction cannot be conditional on another. Others argue that there should just be the lease contract and after the lease period is over the lessor can decide what to do with the asset.

Leasing has become one of the main instruments in Islamic financing.

As with all these *Shari'a*-compliant contracts, while they often closely resemble conventional products there are some specific conditions that must be part of the agreement. The key considerations as described in the *Shari'a* standard[5] include the following:

Agreement to Lease

A customer enters into a memorandum of understanding (Agreement to Lease) with an IFI requesting the IFI to purchase a specified kind of asset with a promise to lease.

The IFI should first purchase the asset prior to execution of an *Ijarah* contract.

[5] AAOIFI Shari'a Standard No 9

The asset can be purchased from the customer and subsequently leased back to him (Sale & Leaseback).

The IFI obtains price quotations from suppliers or appoints a purchasing agent. The agent can be the customer or a person having blood or marital relationship with the customer. If the agent is a company owned by the customer, the company should not be owned more than one-third by the customer.

Contract

The contract can be drawn up with a Master Agreement that is followed by the execution of multiple confirmations of offer and acceptance of individual *Ijarah* transactions, or individual contracts.

The contract is binding and cannot be cancelled unilaterally.

The lease period should commence from the date of execution unless the parties agreed on a specified future commencement date (Future *Ijarah*). Future *Ijarah* is allowed provided that the lease rentals are only payable by the lessee after the leased asset is delivered to the lessee.

The contract should specify:

- the transfer of the usufruct to the lessee for an agreed period at an agreed consideration.
- the leased asset must have a valuable use.
- the leased asset must be fully identified by the contracting parties.
- the purpose or intended use of the leased asset by the lessee must be lawful and *Shari'a* compliant; the intention should be that it is used in the normal way for such an asset. Any other purpose, which is not within the normal course, requires the consent of the lessor.
- the lease rental must be determined at the time of contract for the whole period of the lease.

The lease rental may be paid by cash, kind (goods) or usufruct. The rental must be specified, either in a lump sum payment in advance or in arrears or in instalments over duration of the lease. The rental can be fixed or variable as long as it is clearly specified or benchmarked. A benchmark must be based on a clear formula which is not subject to dispute. LIBOR is commonly used as a well-defined benchmark.

Changes in the Contract

The lessor may sell the asset to a third party without the consent of the lessee. The new owner takes the place of the previous owner in the entitlement to lease payments for the remainder of the contract.

If the lessor sells the asset to the lessee or if the asset is completely destroyed, the *Ijarah* contract is terminated.

Damage to the Leased Asset

The lessor is responsible for defects throughout the *Ijarah* period unless such defects are due to the lessee's misconduct or negligence.

The leased asset in the possession of the lessee is held in a fiduciary capacity.

When the usufruct of a leased asset is wholly or partially destroyed due to nature and not to the lessee's misconduct or negligence, the lessee may terminate the *Ijarah* contract or re-negotiate the rental based on the prevailing market rate.

When the usufruct of a leased asset is wholly or partially destroyed as a result of the lessee's misconduct, the lessee is obliged to restore or repair the leased asset.

Early Settlement

The contract can be terminated by mutual consent.

Unilateral termination is allowed in cases of *force majeure*, defect in the leased asset that materially impairs its use, total destruction of the leased asset, or when a termination option is stipulated in the contract.

If the lessee stops using the leased asset or returns it to the owner without the lessor's consent, the rental will continue to be due for the remaining period of the *Ijarah*, and the lessor cannot lease the asset to another lessee.

Default

Default in payment is when the lessee who is in a *solvent* state fails to honour the payment when due.

In a situation where the IFI is legally allowed to repossess the goods without initiating bankruptcy order, the IFI can sell or lease the asset to a third party to recover the selling price of the goods.

Late payment, penalty charges or price increase are not allowed.

Any extension or rescheduling of payment can be done without additional charges or price increase.

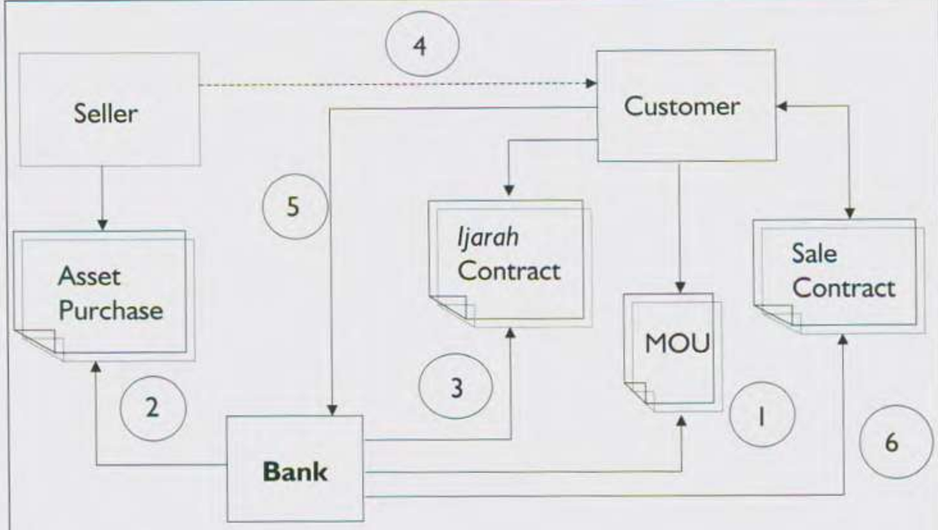

Diagram 6.5: *Ijarah* Contract

1. The bank and customer enter a Memorandum of Understanding with the customer asking the bank to purchase a specific kind of asset with its agreement to lease.
2. The bank purchases the asset from the seller. (The bank may appoint the customer as agent for this purchase.)
3. The bank enters an *Ijarah* Agreement with the customer for the lease of the asset.
4. The customer receives the asset (probably directly from the seller).
5. The customer makes regular lease payments during the course of the lease period.
6. At the end of the lease period, the ownership is transferred to the customer on the agreed terms.

Maturity

At maturity, the leased asset is returned to the lessor unless there is a separate contract of *Ijarah Muntahia Bittamleek*. In this case the lessee is not obligated but the lessor has a unilaterally binding obligation to transfer ownership in the leased asset to the lessee.

The option to transfer the legal title or ownership of the leased asset must be documented separately from the *Ijarah* contract and be effected by a gift or token consideration.

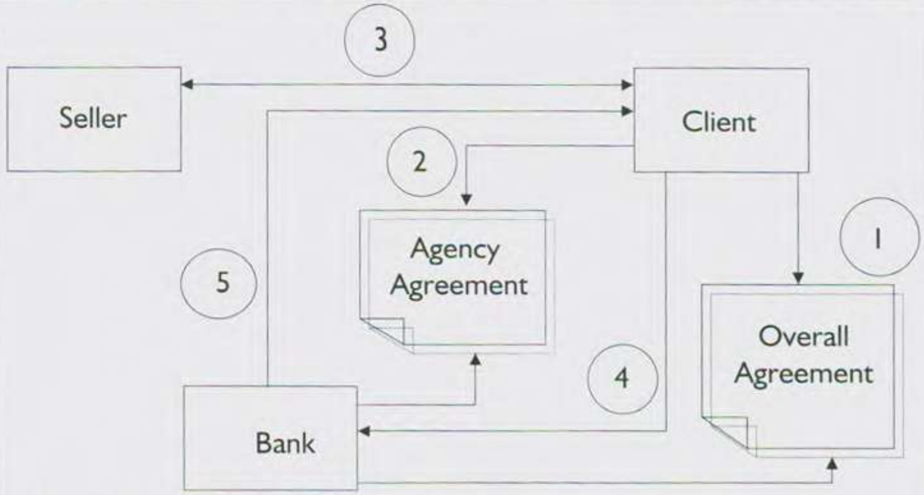

Figure 6.6: *Murabaha* Contract

1. The client and the bank sign an agreement whereby the client promises to buy and the bank promises to sell the required goods/commodity.
2. At the appropriate time, the bank appoints the client as its agent to purchase the goods and an agency agreement is signed.
3. The client, as agent for the bank, buys the goods and takes delivery of them.
4. The client informs the bank that he has purchased the goods and makes an offer to buy them.
5. The bank accepts the offer, ownership is transferred and the sale is concluded. The client pays the bank on the agreed terms.

Murabaha

Originally, *Murabaha* was a particular type of sale and not a mode of financing. The basic principle was, and is, that the seller and purchaser both know the cost price but the purchaser pays a profit or mark-up to the seller. The payment could be deferred, but this was not a necessary part of *Murabaha*. The ideal modes of financing are seen as *Mudaraba* or *Musharaka*, but it has been hard for banks and financial institutions to meet the needs of their clients through these transactions and today the great proportion of financing by Islamic banks can be classed as *Murabaha*. *Shari'a* scholars have generally allowed the use of *Murabaha* on deferred payment terms as a mode of financing but only as a transitory phase in the process of Islamization of the whole economy and only when *Mudaraba* or *Musharaka* are not feasible. Also, the scholars have attached certain conditions and unless these are fully met, the transaction becomes invalid. The following procedure is often followed by a financial institution to meet these conditions:

1. The client and the institution sign an overall agreement whereby the institution promises to sell and the client promises to buy the commodities from time to time on an agreed ratio of profit added to the cost. This agreement may specify the limit up to which the facility may be availed. (It may of course also be a one-off agreement.)
2. When a specific commodity is required by the customer, the institution appoints the client as its agent for purchasing the commodity on its behalf, and an agreement of agency is signed by both parties.
3. The client purchases the commodity on behalf of the institution and takes its possession as an agent of the institution.
4. The client informs the institution that he has purchased the commodity on his behalf, and at the same time, makes an offer to purchase it from the institution.
5. The institution accepts the offer and the sale is concluded whereby the ownership as well as the risk of the commodity is transferred to the client.

The most essential element of the transaction is that the commodity must remain in the risk of the institution during the period between the third and fifth stage.

If the institution buys the commodity directly from the supplier, there is no need for an agency agreement, but often the skills of the client are required to ensure that the purchased goods are of the right quality and specification.

Generally, there are two types of *Murabaha* agreement that have slightly different risk profiles.

In the first, normally just referred to as *Murabaha*, the institution purchases goods which it then sells, when it finds a client, for the agreed price and following all the rules. The other is generally referred to as *Murabaha to the Purchase Orderer*. In this case, the client asks the bank to purchase the goods for him and agrees to buy them from the bank at the agreed price.

A further aspect is that the contract with the client may be either revocable or irrevocable. The preference for the bank is to have irrevocable agreements as it does not wish to purchase goods which the customer then declines to buy.

Sheikh Taqi Usmani[6], who currently chairs the Shari'a board of AAOIFI, in his book on Islamic finance having accepted the use of Murabaha, but only where Musharaka or Mudaraba cannot work, says:

> *"It should be noted with care that Murabaha is a border-line transaction and a slight departure from the prescribed procedure makes it step on the prohibited area of interest-based financing. Therefore this transaction must be carried out with due diligence and no requirement of Shari'a should be taken lightly."*

[6] An introduction to Islamic Finance, Usmani, 1998; Karachi Idaratul Ma'arif ,

Banks use commodity *Murabaha* transactions to manage their liquidity. They buy spot and sell deferred. This and other cash management techniques will be discussed in the Chapter 8 on Liquidity Management. It is also used as a way of offering a treasury deposit to customers by banks.

The *Shari'a* standard for *Murabaha to the Purchase Orderer*[7] includes the following key considerations:

Agreement to Purchase

A customer enters into a verbal agreement or memorandum of understanding (Agreement to Purchase) with institutions offering Islamic financial services (IFI) requesting the IFI to purchase a specified kind of goods with an agreement to repurchase.

The agreement specifies:

- A detailed specification of the goods
- The quantity
- The supplier (this is optional)

The agreement can be **binding** or **non-binding** depending on the views of the *Shari'a* board.

The customer can request the IFI to purchase from a particular supplier; however, the IFI can decline the transaction if the customer refuses to purchase from another supplier that the institution prefers.

The IFI obtains price quotations from suppliers or appoints a purchasing agent. The IFI executes an agency contract with the agent.

The agent can be the customer or a person having blood or marital relationship with the customer. If the agent is a company owned by the customer, the company should not be owned more than one third by the customer.

The Goods

The goods must be purchased from a third party and not from the customer or his agent/company. However, the goods can be purchased from a party who has a blood or marital relationship with the customer.

The offer for sale by the supplier (which can be in the form of an invoice) must be addressed to the IFI and a sale is concluded once the offer is accepted by the IFI.

AAOIFI Shari'a Standard No 8

The supplier delivers goods to the IFI. The IFI takes possession or 'constructive possession' of the goods and subsequently offers the goods for sale to the customer.

The contract cannot stipulate that the ownership of the goods be transferred upon full payment of the selling price.

Constructive possession can take place by, *inter alia*, having the goods placed at the IFI's disposal, receipt of bill of lading by the IFI or its agent, or receipt of certificates of storage issued by a warehouse.

The IFI is responsible for the risks associated with the goods and is liable for any defects from this point onwards.

The Contract

The IFI and the customer execute a *Murabaha* contract if the customer agrees to purchase the goods.

The following *Shari'a* principles must be met for the contract to be valid:

- the goods are in existence at the time of sale
- ownership of goods must be with the seller (the IFI)
- the goods are in possession or constructive possession of the seller
- the goods must have a commercial value
- the goods are not to be used for a '*haram*' purpose
- the goods must be specifically identified and known
- the delivery of goods is certain and not conditional upon a certain event
- the selling price is fixed at cost plus mark-up or profit

The IFI is responsible for defects existing prior to the sale to customer.

Early Settlement

The IFI may give a discount to the customer if he wishes to pay before the due date even though there is no obligation in the contract as such provision is not allowed to be stated explicitly in the contract. Discount may be given based on market practice.

Default

Default in payment is when a customer who is in a *solvent* state fails to honour the payment when due.

In a situation where an IFI is legally allowed to repossess the goods without initiating a bankruptcy order, the IFI can sell the goods to a third party to recover the selling price of the goods.

A late payment penalty fee or price increase is not allowed. No charges or price increase is allowed for any extension or rescheduling of payment.

(Note: As in the Beximco case, discussed in an earlier chapter, some institutions cancel the defaulting contract and agree a new contract under different terms.)

In Malaysia, the regulator prefers banks to use the term *Bai' bi-thaman ajil* instead of *Murabaha*. For all practical considerations, the two can be regarded as the same.

Musawama

Musawama is a sale in which the price of the commodity to be traded is agreed between the seller and the buyer without any reference to the price paid or costs incurred by the seller. Indeed the seller has no obligation to disclose his costs. In every other way, the conditions that must be met in a *Murabaha* transaction must be met when using *Musawama*. There can be circumstances where, at the time of the agreement, the seller cannot determine his precise costs, in which case he may prefer to use *Musawama*.

Tawarruq

Tawarruq financing is becoming increasingly popular and is being used as the underlying contract for a number of credit cards that have been issued by Gulf banks as well as for personal loans. It can be thought of as being the opposite of *Murabaha*. The bank (or its customer) buys deferred and sells spot. Metals transactions on the London Metal Exchange are probably the most favoured transactions. The example over the page is taken from the Islamic Bank of Britain.

Islamic Bank of Britain Personal Finance Facility

Step One

Customer requires (for example) GBP1,000 for 12 months.

Step Two

Customer enters into agreement to buy a commodity from Islamic Bank of Britain on an agreed deferred payment period of 12 months.

Step Three

Islamic Bank of Britain sells the commodity to the customer at cost plus profit to be paid over the agreed period of time.

Step Four

Once in possession of the title to the commodity the customer appoints a third party broker to sell the commodity.

Step Five

The proceeds from the sale of the commodity is credited to the customer's account. The quantity of the commodity used in this transaction would enable the customer to generate the cash required.

Step Six

Customer has available funds of GBP1,000.

Step Seven

Customer makes monthly repayments.

As the customer is not present during the commodity transaction, an employee of Islamic Bank of Britain is appointed as the agent to act on behalf of the customer, under a restricted Power of Attorney, to agree that the commodity has been bought on behalf of the customer. As part of the agreement the customer gives an employee of Islamic Bank of Britain a restricted Power of Attorney, to sign the offer of sale agreement. The customer will have signed an agency agreement appointing the broker to sell the commodity. Islamic Bank of Britain acts for itself and also for the broker under a separate Power of Attorney.

In relation to the commodity transactions, both the purchase and the sale will be carried out at the same price to ensure there is no risk of price movement to protect the customer and Islamic Bank of Britain.

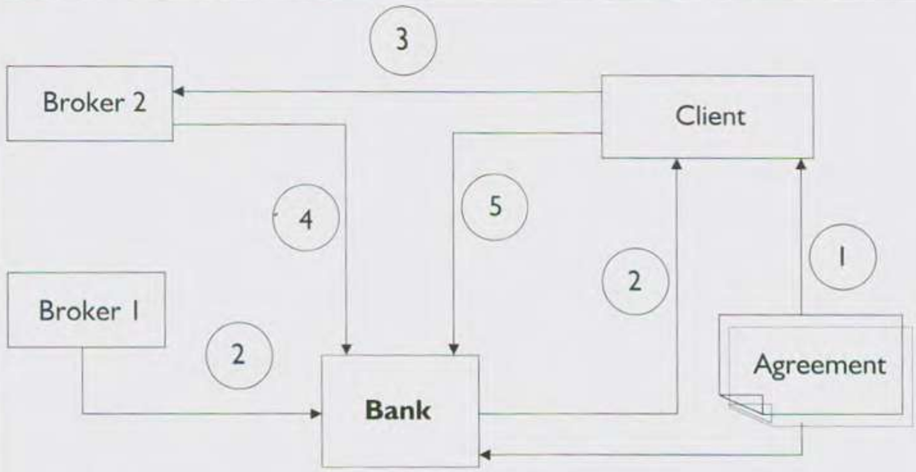

Figure 6.7: *Tawarruq* Transaction – Client 'borrows' cash using a commodity purchase on a deferred basis with a spot sale

1. The client of the bank wishes to borrow a cash sum and enters an agreement with the bank to purchase a commodity on a deferred basis and sell it for spot cash.
2. The bank, on behalf of the client purchases a commodity.
3. The client sells it spot to a third party broker.
4. The broker deposits the proceeds in the client's account with the bank.
5. The client pays the bank on the agreed terms.

While the product is now used extensively, a number of scholars continue to have many reservations about the structure. For example, in its instructions for *Shari'a* compliance, the State Bank of Pakistan says that *Tawarruq* may be used in exceptional cases but requires specific prior approval from the Islamic Banking Department of the SBP.

An AAOIFI *Shari'a* standard[8] was adopted in November 2006 after one of the longest gestation periods for any of the standards so far. The standard accepts *Tawarruq* – or Monetization but strictly forbids *Inah* (see below). Monetization refers to the process of purchasing a commodity for a deferred price and selling it to a third party for a spot price so as to obtain cash.

[8] AAOIFI Shari'a Standard No. 30

Conditions

There are two main conditions that apply to the transactions:

- the commodity purchased should be real and not fictitious,
- the client should not delegate the institution or its agent to sell, on his behalf, a commodity that he purchased from the same institution unless regulations do not permit the client to do otherwise. In this case the client can delegate the institution to do so after he receives, actually or implicitly, the commodity.

If the institution is the beneficiary, it should not use monetization as a main mode of investing or financing. It should make efforts to mobilize funds through more acceptable transactions and only use monetization when it faces danger of liquidity shortage.

Bai' Al-Inah

This contract is rejected by most *Shari'a* scholars, but is used by a number of institutions, especially in Malaysia, to create other products (see below). It is effectively a contract that involves the sale and repurchase of assets between the same counterparties. The seller sells the assets on a cash basis. He will later buy back the assets on a deferred payment basis where the price is higher than the cash price.

Qard Hassan

Qard Hassan is a loan that bears no remuneration. It is usually given as a charitable loan. The principal only has to be repaid to the bank.

Credit Cards

Over the last five or six years, a number of banks have developed ways of providing their customers with credit cards. They are examples of ways in which banks have used combinations of various *Shari'a*-compliant tools to produce new products.

AmBank and Bank Islam Malaysia launched cards in 2001 and 2002 respectively. Their chosen methods have not been readily accepted in the Gulf as they are felt to be based on contracts that are used inappropriately.

The AmBank card is based on the principle of *bai' al inah* that covers installment repayments over a fixed period. Cardholders are charged 1.25% per month on the outstanding balance with nothing to pay if the requested minimum payment is made on time. The underlying contract works on the basis of two agreements. In the first the bank agrees to sell an item to the customer at an agreed price and in the second, the customer agrees to sell it back to the bank at an agreed lower price, the difference being the bank's profit. The main difference between this card and a conventional one is that the customer does not pay the bank profit if the minimum payment is made on time.

Bank Islam says its card is based on three *Shari'a* compliant contracts. As with the AmBank card, it is based on *Bai' Al-Inah*, but also *Wadi'ah* (which is a safe custody or trust account where the depositor is guaranteed full repayment of his money on demand) and *Qard Hassan*. In the first instance, under the *Bai' Al-Inah* contract, the bank sells some land on a deferred payment basis and then buys it back for cash at a lower price. The cash is then placed in the cardholder's *Wadi'ah* account, where he guarantees safe custody and is able to use the cash. The *Qard Hassan* element comes into play if the cardholder goes over his limit. The cardholder is not levied with extra charges but is required to repay the over-limit amount used. The bank's profit is calculated on a monthly basis based on the outstanding balance.

Several different formulae have been used in the Gulf with the simplest being Kuwait Finance House's Al Tayseer card. Cardholders pay a fee that is up to five times that charged for conventional cards. The fee is paid in monthly installments. This gives the bank its profit. Cardholders pay 1/12 of the outstanding balance each month. They must also have either a salary account with the bank or a deposit equal to their credit limit. Despite the high fee charged, KFH shows in its literature how customers pay less than they would for a conventional card assuming that they utilise 75% of their credit limit.

The Al Rubban card issued by Shamil Bank uses the principle that in providing a credit card the bank is effectively giving a financial guarantee to the acquirer that is in place until the acquirer receives the funds for the cardholder's purchases. The bank is entitled to charge for this guarantee and levies a fee that appears on the cardholder's first statement containing the transaction. The payment system works by treating total card spend in any given month as being payable in 12 equal monthly installments.

Elsewhere, *Tawarruq*-based cards have been issued. The most usual practice entails the bank purchasing metals for the cardholder as each card purchase is made and selling the metals on a deferred basis – as described above for the Islamic Bank of Britain's personal finance facility.

Chapter 7

.... and Their Funding

Current Accounts

Current accounts in an Islamic bank seem very little different from current accounts in conventional institutions. Cash from the account is available to the customer on demand. However, no interest is paid by the bank and no interest is charged should the account holder become accidentally overdrawn. Also, the account does not have an overdraft facility and is a trust account, either *Wadia* or *Amanah*. The money placed in such an account is not available to the bank for its own business unless express permission is given by the account holder. If the bank is able to use the deposit, the customer does not share in any profit (or loss) that might be made and the capital of the deposit is guaranteed. Some banks do reward customers for the use of their money.

Profit Sharing Investment Accounts

All other customer accounts are referred to by various names – mainly so that they match the names given to similar accounts in conventional banks.

Some banks have savings accounts where there may be some element of capital guarantee and expectations of a lower return as a result. Others have what they term "unrestricted profit-sharing investment accounts (PSIAs)" which have a nominal term. In practice, customers are able to withdraw their funds as they require. The customer agrees that the bank should invest his money along with that of other PSIA holders, and maybe the bank's own funds, in a pool of investments. There is no guaranteed profit, but a sharing of the profit on an agreed basis. Most banks aim to match the return paid by conventional banks and will set up a profit equalization reserve (PER) as well as an investment risk reserve (IRR). These are used to smooth the returns to account holders. This practice is needed to prevent customers switching either to other investments available through the bank or even switching banks. In theory, customers share in any losses and their capital is not guaranteed. In practice, customers have not been asked to share losses and if the reserves are insufficient, shareholders have sacrificed their returns. The return due to PSIA holders is usually calculated annually when the IFI knows the returns that have been made on its investments – and also knows the deposit rates that have been paid by the conventional banks over the course of the year.

In some countries (Malaysia, Jordan, Qatar for example), unrestricted investment accounts look and behave very much like conventional deposits. In Bahrain, the profit sharing nature is more widely publicized, but banks do go out of their way to avoid losses to depositors. There is a need for greater transparency and by using their various reserves, banks often seem to hide the real return from their investment account holders.

Sometimes customers will be more precise as to how they wish their funds to be invested. This type of account is called a restricted PSIA. In general banks have set up a number of funds that focus on particular sectors or particular types of financing and it is in these funds that restricted PSIAs are usually invested, although they could be directed to specific projects. Again, customers share in any losses as well as the profits and this is on an agreed basis. Again, this does not usually happen in practice – although different investments do produce different returns.

The question arises as to how these investment accounts should be treated in the accounts. Some have argued that they are quasi-capital, although this is no longer postulated as forcefully as it was even five or six years ago. Others say that the bank has a simple fiduciary responsibility and all these accounts and the assets they fund should be off-balance sheet. The AAOIFI accounting standards say that restricted PSIAs and the associated investments should be off-balance sheet items while unrestricted PSIAs should be shown after liabilities and before capital. This has further implications for capital adequacy and also for corporate governance as we shall see later.

Islamic Bonds (*Sukuk*)

In the last few years, a number of banks have issued *Sukuk* to diversify their sources of funding. Conventional debt issues have not been possible because of interest payments. Likewise, syndicated loans from banks that have been popular in many developing markets have also been prohibited. But most Islamic banks have lease portfolios that can be used as the assets to back a *Sukuk* issue. The structures used for *Sukuk* will be discussed in a later chapter.

Chapter 8

Liquidity Management

Liquidity Concerns

One of the major management issues for all Islamic institutions is liquidity management. Conventional banks invest in liquid, tradable treasury instruments and place (and receive) deposits from correspondent banks. These are all interest bearing and so they are not available as tools for IFIs.

At the same time, Islamic institutions have balance sheets that are full of real assets that have long maturity and are illiquid. However most of the funding can be withdrawn on demand. As a result they generally also hold a high proportion of liquid assets that receive little or no remuneration.

As a result of continuing problems in this area, the IFSB was mandated to conduct a study of current practices and make recommendations for the developments of the Islamic money markets. Their study was published in March 2008[1] and made the following five main recommendations:

- Design Islamic money market and Islamic Government financing instruments with the desirable characteristics – i.e. relatively low risk, simply designed, regularly issued, widely held, and supported by a robust payment and settlement system.
- Incorporate Islamic Government finance instruments as an integral part of the overall public debt and financing programme, and foster the development of an Islamic Government securities market.
- Actively use Islamic Government finance instruments in market-based monetary operations of the central bank to manage liquidity in the Islamic money market.

[1] IFSB: Technical Note on The Development of Islamic Money Markets, March 2008

- Develop efficient trading arrangements and the associated market microstructure for Islamic money and Government finance instruments, and develop in parallel the foreign exchange markets.
- Provide supervisory guidance and incentives for effective liquidity risk and asset liability management by IFIS, and in parallel foster privately issued Islamic money market securities.

These are ambitious goals but ones for which the IFSB suggests that its working group could accept a further mandate to help see them through to reality.

Cash Management Solutions

Islamic banks maintain relations with correspondent banks as they need the facilities provided for their everyday business. However, the transactions are often done on a reciprocal basis with no interest being paid or given. In general, Islamic banks maintain credit balances that are slightly higher than any overdraft facility in order for the correspondent to gain some benefit from the arrangement. This process of compensating balances can be mutually beneficial and arranged so that, over a given period, the net balance will be zero. Limits will be put in place and managed carefully by the treasury.

An alternative way in which these accounts are managed is for the Islamic bank to gain credits for balances it maintains. These would then entitle it to borrow against these credits as and when required.

Other banks have established funds of *Shari'a*-compliant assets – mainly leased assets – and make a market in these. Islamic institutions can buy units in these funds and sell them back to the same bank at any time at the then current market price.

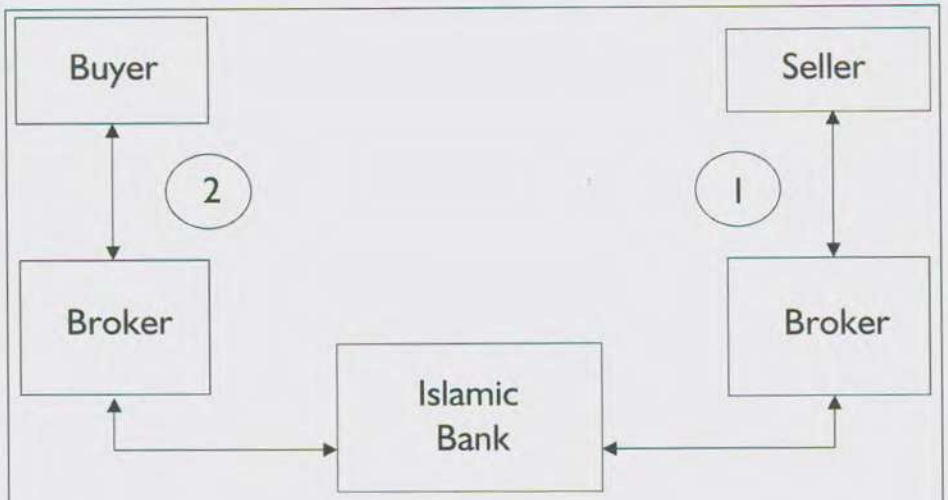

Figure 8.1: Commodity *Murabaha*

1. The Islamic bank buys a commodity from a seller through a broker for cash.
2. The Islamic bank sells the commodity to a buyer through a broker on agreed credit terms.

NB. Only one broker is needed but the seller and buyer should be different parties.

Money Market Solutions

As an alternative to treasury bills, many Islamic banks today use commodity *Murabaha*. Transactions are arranged through one of the commodity exchanges. The banks buy for cash and sell on credit for some defined period. The selling price reflects the interest rate prevailing for the period. For the transaction to be *Shari'a*-compliant, it is essential that there are three independent parties – the supplier, the Islamic bank and the buyer – although these transactions are often arranged through a broker. This approach is used extensively in Bahrain, the Kingdom of Saudi Arabia, Qatar, Malaysia, Pakistan, Kuwait, UAE and UK.

When the Islamic institution wishes to raise short-term financing, the favoured contract today is *Tawarruq*, despite the many concerns of the scholars. *Tawarruq* can be thought of as the opposite of *Murabaha*. Here the bank buys the commodity on credit and immediately sells it spot for cash. Again it is important for there to be three independent parties involved.

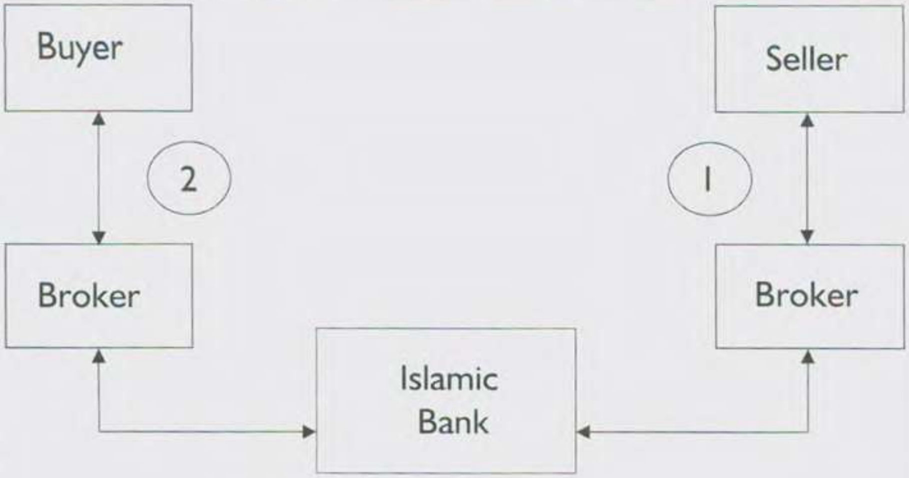

Figure 8.2: Commodity *Tawarruq*

1. The Islamic bank buys a commodity from a seller through a broker on agreed credit terms.
2. The Islamic bank sells the commodity to a buyer through a broker for cash.

NB. Only one broker is needed but the seller and buyer should be different parties.

Liquidity Management Centre (LMC)

The LMC was established in Bahrain in 2002, promoted by four Islamic institutions – Bahrain Islamic Bank, Kuwait Finance House, Dubai Islamic Bank and the Islamic Development Bank. Each of these institutions holds 25% of the shares.

The founding shareholders believed that an institution like the LMC could provide a valuable service for all Islamic banks. The principal vision of the LMC is stated as enabling Islamic financial institutions to manage their liquidity mismatch through short and medium term liquid investments structured in accordance with *Shari'a* principles.

It is committed to playing a key role in the creation of an active and geographically expansive Islamic inter-bank market which will assist Islamic financial institutions in managing their short-term liquidity. The shareholders believe that a deep interbank market will further accelerate the development of the Islamic banking sector.

In addition, the LMC aims to attract assets from governments, financial institutions and corporates from both private and public sectors in many countries. The sourced assets will be securitized into readily tradable securities or structured into other innovative investment instruments. Its aim is to provide short-term investment opportunities that have greater *Shari'a* credibility than the commodity *Murabaha* transactions currently used.

So far it has been an active manager of issues by regional banks, governments and companies. While it aims to create a secondary market for all the instruments, it rightly believes that it must create a primary market before this can become a reality. There are an increasing number of trades, but these are still just occasional. Further details are available on its website – www.lmcbahrain.com.

International Islamic Financial Market

The International Islamic Financial Market was also established in Bahrain in 2002. It was promoted by the IDB, BMA (now the Central Bank of Bahrain), the central banks of Indonesia and Sudan, the Labuan Offshore FSA and the Ministry of Finance of Brunei. Its primary purpose is to provide a cooperative framework for the development of an Islamic financial market. Its aim is to promote harmonization and convergence of *Shari'a* interpretations and to encourage the issuance of a range of *Shari'a* compliant products that can be actively traded on primary and secondary markets. Until recently, its main activity was to give a *Shari'a* endorsement to a number of *Sukuk* issues. However, under a new CEO the IIFM has adopted a more focused approach on high priority initiatives like contract standardization, product development and enhancement, cross-border trading and infrastructure development. At the beginning of 2007 it signed a MoU with ICMA to jointly develop standardized contracts and documentation as well as market practices for *Sukuk*. It is also looking to develop master agreements for a number of other products and is working with ISDA on the development of a hedging product.

It is close to finalizing its first Master Agreement that can be used by Islamic financial institutions around the world. This is the Master Agreement for Treasury Placement (MATP). This should facilitate commodity *Murabaha* transactions. It should cover over 90% of commodity *Murabaha* transactions around the world and, by using a standard agreement, it should enhance the transparency, robustness and consistency of these transactions, according to the IIFM Chairman. The one concern is that the IIFM is not a regulatory body and so has no say whether banks use the Master Agreement or not. As with so many other initiatives, the take-up will depend on the willingness of the banks and their regulators to do so.

More information can be found on their website www.iifm.net as well as in Central Bank of Bahrain publications[2].

[2] Islamic Finance Review Bahrain, April 2008; July 2008

Malaysia and Bahrain

Two countries have been at the forefront in developments aimed at supporting the development of the Islamic finance market and, in particular, in helping banks manage their liquidity – Malaysia and Bahrain. The instruments they have developed are outlined below. Scholars in Malaysia have allowed many tools that would not pass as *Shari'a* compliant in the Gulf. They involve trading debt or do not have the required number of independent parties. Nevertheless, they have allowed significant positive developments in Islamic finance in Malaysia over the past few decades.

Malaysia

Malaysia was one of the first countries to introduce an Act to regulate the activities of Islamic banks, a step it took in 1983. Since then it has developed a number of bonds and money market products. In 1993/4 it introduced Cagamas bonds backed by house finance debts and structured to be *Shari'a* compliant. Then in 1994 it also introduced the *Mudaraba* Interbank Acceptance, a tool for interbank players to manage daily liquidity. At the same time, it established the Islamic Interbank Money Market (IIMM) and today a number of instruments are available:

***Mudarabah* Interbank Investment (MII)** is a mechanism whereby a deficit bank (investee) obtains funds from a surplus bank (investor) based on profit sharing. The period of investment is from overnight to 12 months and the rate of return is based on the rate of gross profit for an investment of one year of the investee bank. The profit sharing ratio is negotiable between the parties.

***Wadiah* Acceptance** is a transaction between Bank Negara (BNM), the central bank, and the Islamic banks. The Islamic banks place their surplus funds with BNM based on the principal of *Wadiah*. BNM is the custodian of the funds and has no obligation to pay any return on the account. Any dividend paid is perceived as a gift. The *Wadiah* Acceptance facilitates BNM's liquidity management operation as it gives flexibility for BNM to declare a dividend without having invested the funds. BNM uses the *Wadiah* Acceptance to absorb excess liquidity from the IIMM by accepting overnight money or fixed term *Wadiah*.

Government Investment Issues (GII) are non-interest bearing instruments that are available to Islamic banks as a substitute for government securities or treasury bills. They were first issued in 1983 under the *Qard Hassan* concept. However this meant that they were not tradable in the secondary market, so BNM opened a window to allow the players to purchase or sell the papers from/to the central bank.

In 2001, the government issued a three-year GII under the concept of *Bai' Al-Inah*. In Malaysia, this type of instrument is tradable in the secondary market which made the GIIs more attractive. Then in 2005 the government issued a Profit-Based GII which is a coupon bearing paper paying half yearly profit to investors.

Bank Negara Monetary Notes-i (BNMN-i) are Islamic securities that replace an earlier instrument issued by BNM. The maturity of the issuances has been increased to three years and they will be issued on a discounted or coupon-bearing basis depending on demand. Discount-based BNMN-i will be traded using the same market convention as Bank Negara Negotiable Notes and Malaysian Islamic Treasury Bills while the profit-based notes will adopt the same convention as GIIs.

Sell and Buy Back Agreement (SBBA) is an Islamic money market transaction in which an SBBA seller sells assets to an SBBA buyer at an agreed price, and subsequently, both parties enter into a separate agreement in which the buyer promises to sell back the assets to the seller at an agreed price. Again, this type of transaction involving only two parties would not generally be accepted in the Gulf.

Cagamas Mudarabah Bonds (SMC) are issued by Cagamas Berhad to finance the purchase of Islamic housing debts from financial institutions. The bond is structured using the principal of *Mudarabah* where the bond-holders and Cagamas will share the profits according to agreed profit-sharing ratios.

When Issue (WI) is a transaction of sale and purchase of debt securities before the securities are issued. The National Shariah Advisory Council viewed that the WI transaction is allowed based on the permissibility (in Malaysia) to promise for sale and purchase transactions.

Islamic Accepted Bills (IAB) were introduced in 1991 to encourage and promote trade. There are two types of financing. For **imports and local purchases** the bank appoints the customer as agent for the purchase of the goods by the bank. The customer then buys the goods from the bank on a *Murabaha* basis of cost plus mark up on a deferred (up to 200 days) lump-sum basis. The debt to the bank is securitized in the form of a bill of exchange drawn by the bank on and accepted by the customer for the full amount of the selling price payable at maturity. The bank can then decide whether or not to sell the IAB to a third party under the concept of *Bai' Al-Dayn* (debt trading). This concept is not accepted by scholars in the Gulf where any trading of debt is prohibited. For **exports and local sales** the bills created are traded under the *Bai' Al-Dayn* concept. The exporter prepares the export documents which are sent to the importer's bank. The exporter then draws on the commercial bank a new bill of exchange and this is the IAB. The bank purchases the IAB at a mutually agreed price, again using the concept of *Bai' Al-Dayn*. The proceeds are credited to the exporter's account. Domestic sales are treated in the same way.

I**slamic Negotiable Instruments (INI)** covers two instruments. The first is the **Islamic Negotiable Instruments of Deposit (INID)** where a sum of money is deposited with the Islamic bank on a *Mudaraba* basis and is repayable to the *bearer* on a specified date at nominal value plus declared dividend. The second is the **Negotiable Islamic Debt Certificate (NIDC)** where the bank sells assets to the customer at an agreed price on a cash basis. Subsequently the assets are repurchased by the bank at principal value plus profit which is settled at an agreed future date.

Islamic Private Debt Securities (IPDS) were introduced in 1990. They use various concepts, but principally *Bai' Bithaman Ajil*, *Murabaha* and *Mudaraba*.

***Ar Rahnu* Agreement-i (RA-i)** is a further agreement based on *Qard Hassan*. The lender provides a loan to the borrower based on *Qard Hassan*. The borrower pledges securities as collateral and if he fails to repay at maturity, the lender has the right to sell the pledged securities. This agreement is used by BNM as a liquidity management tool in its money market operations. BNM pays a return as a gift based on the average interbank money market rates.

***Sukuk* Bank Negara Malaysia *Ijarah* (SBNMI)** is based on *Ijarah*, which is widely used in the Middle East as well as Malaysia. An SPV, BNM *Sukuk* Berhad, has been established to issue the *Sukuk Ijarah*. The proceeds from the issuance are used to purchase BNM assets which are then leased back to BNM for rental payments which are distributed to investors as a return on a semi-annual basis. At maturity, BNM *Sukuk* Berhad will sell the assets back to BNM at a pre-determined price. The first issue took place in February 2006 and BNM has issued this instrument on a regular basis since then.

More details can be found at the website of the Islamic Interbank Money Market whose address is http:/iim.bnm.gov.my.

Bahrain

The Bahrain Central Bank has not been involved for as long as Bank Negara in creating products for the Islamic market but it already has an impressive list of successful issues dating back to 2001 when it issued the first government *Ijara Sukuk*. As the agent of the Government of Bahrain, the Central Bank manages the government's *Sukuk* programme.

The short-term ***Sukuk Al-Salam*** were introduced in June 2001 and are issued every month, denominated in BHD with a maturity of 91 days. The issue amount is decided by the Ministry of Finance each year in advance but so far, every issue has been for BHD 6 million. By April 2008 the Central Bank had offered 84 issues of *Sukuk Al-Salam*. The funds raised are paid as an advance in return for a promise to deliver a commodity at maturity. Under a separate parallel *Salam* contract the commodities are sold to other parties. The difference between the prices is the profit paid to the *Sukuk* holders. The disadvantage of this structure is that it is illiquid. However, the demand for every issue far exceeds the amount sold.

In addition there are two types of ***Sukuk Al-Ijara*** – short-term (182 days) issues denominated in BHD and long term (between 3 and 10 years) issues denominated in US$ or BHD. All the issues are backed by government-owned properties as the underlying assets. The short-term *Sukuk* have been issued every month since August 2005 in an amount set by the Ministry at the start of each year. So far all the issues have been for BHD 5 million. By April 2008 the Central Bank had offered 32 issues of these short-term *Sukuk Al-Ijara*. The long-term *Sukuk* are issued on an ad hoc basis and are listed on the Bahrain Stock Exchange. In addition, the June 2004 issue for US$250 million that matures in June 2009 has also been listed in Luxembourg and Labuan. More recently, the April 2008 issue for US$350 million that matures in April 2013 has been listed on the London Stock Exchange.

While these issues have been used to boost the investment options for Islamic banks, they have seen very little trading. This has partly been because the demand for every issue has been strong and banks want to hold their allotment rather than trade.

This has encouraged the Central Bank to develop, jointly with the Bahrain-based Liquidity Management Centre, a new liquidity tool. Called the **Islamic *Sukuk* Liquidity Instrument**, it will allow banks to have access to liquidity against Government of Bahrain *Ijara Sukuk* issued by the Central Bank. This instrument, which is effectively a repo agreement, unlike the Malaysian equivalent that is a two-party agreement, will involve three parties, so achieving Shari'a compliance as practiced in the Gulf. In Bahrain's system, the bank seeking funding will sell its participation in a *Sukuk* to a broker who will then sell it to the Central Bank in a separate spot transaction. The bank selling the *Sukuk* promises to buy the bond back from the Central Bank at a specified date and price. The structure has met with the approval of the *Shari'a* boards of the Central Bank and the LMC.

Chapter 9

Risk Management in Islamic Financial Institutions

In many ways Islamic banks are just like any other bank. They are providing financial services to customers who have similar needs to the customers of conventional banks. The difference is that the products and services provided by Islamic banks are all *Shari'a* compliant. The main products have been discussed in an earlier chapter. Here the associated risks will be examined as well as other areas of Islamic operations that can have a significant impact on risk and credit issues.

Product Risks

It has been argued that because most of the financing products used by Islamic banks are based on real assets, they are less risky than conventional products. In fact most of the conventional risks are present and also additional risks that are quite specific to the Islamic structure.

In ***Murabaha* for the Purchase Orderer** the customer may choose a supplier who is not known to the bank and this could result in a higher risk for the delivery of the goods which might be of a low quality or late in delivery, or even not delivered at all. Also, if the Islamic bank appoints the customer as agent for the transaction there is a risk that it may not be conducted on an arms length basis.

If the purchase agreement is non-binding the bank may find itself left with goods to sell for which there is no ready market. Also, the goods may require storage and may also be perishable. The bank will incur additional costs and may well not recover the full purchase price.

There is also a *Shari'a* risk. The bank cannot sell the goods until it owns them and, especially if the customer is acting as agent, it could be difficult for the bank to know that ownership has been properly transferred.

There is of course the credit risk of the customer. As with a conventional transaction, the customer may not make the agreed payments in a timely way. In a conventional contract the bank may subject the customer to various penalties, but it is not possible with a *Murabaha* agreement. The Islamic bank may charge a penalty but cannot take this as income for the bank but should give the amount charged to charity.

There is also documentation risk, which is higher than for conventional banks partly as a result of the lack of standardization in the contracts but also because any deficiencies in the documentation could make the contract unenforceable.

In a ***Salam* contract** the bank is exposed to significant market risk as the price of the goods is fixed at the time the contract is agreed and delivery may be after a long period during which market prices can change. Also, whilst the time of delivery is specified, the bank must accept goods that are delivered early if they meet the quality and quantity specification. This could expose the bank to additional storage costs and/or the goods could deteriorate in storage. Alternatively, the goods may not be delivered on time or to the agreed specification, indeed the bank may not recognize that the specification has not been met as it may lack the expertise to judge this. In many cases the bank will have entered a parallel *Salam* agreement and if the delivered goods do not meet the specification in any way, the bank may have to buy acceptable goods in the open market. If the bank fails to do this it would run significant reputation risk. Again, the credit risk of the customer will be similar to the credit risk exposure in conventional products.

In an ***Istisna'a* contract** the customer usually asks the bank to manufacture some goods for it. In a parallel contract, the bank will sub-contract this manufacture. The customer may cancel the order before the manufacturing commences, but the bank may have committed to the manufacture or made an advance payment. It could end up with goods that it can only sell at a reduced price. Also, the manufacturer may fail to deliver the goods to the agreed specification or in the agreed time. The bank will be exposed to the credit risk of its customer and the manufacturer of the goods.

In an ***Ijarah* contract**, as with *Murabaha* the bank is exposed to supplier risk, particularly if the customer chooses a supplier that is not well known to the bank. Again, it may be that the customer acts as agent for the bank and this could lead to a conflict of interest. The *Ijarah* contract is also often used in a sale and lease back arrangement. Here the bank needs to ensure that the customer really does own the asset in question and that the transfer of ownership to the bank is completed satisfactorily. After the Islamic bank has taken possession – or constructive possession – of the goods, the customer may decide not to fulfill its promise to lease the goods and the bank could be left to find another customer who would either buy the goods from the bank or enter an *Ijarah* contract. It may not be easy for the bank to find such a customer and the bank may not recover all its costs in such a scenario.

Also, *Ijarah* contracts are often long term and do not always have a repricing option, leaving the bank exposed to rate of return risk. Alternatively, any repricing option in the contract may bring problems for the customer who may not be able to make higher rental payments. Regardless of any repricing, the customer may of course default on its payments. As with any conventional leasing agreement, the Islamic bank will be exposed to credit risk.

One of the greater risks could be ensuring that the customer uses the leased asset in a *Shari'a* compliant way. Any failure here could mean that the bank is unable to recognize the income it receives and also could bring reputation risk.

As the bank continues to own the assets throughout the lease period, it needs to ensure that they are properly maintained. It may mitigate this risk by assigning responsibility for maintenance to the lessee in a separate agreement, but if the goods are damaged or destroyed through no fault of the lessee, the bank needs to replace the asset or the lessee can terminate the contract.

At the termination of a lease agreement the goods can be transferred to the customer's ownership in a separate agreement that could be a gift – if the rental payments have covered the principal payment – or could be a sale for a token consideration. However, if this consideration is higher than the market value of the goods, the customer may decide not to complete this transaction leaving the bank with the goods. If the goods have been permanently damaged through no fault of the lessee, the bank may be required to repay the lessee the purchase price that has been part of the lease payments.

If the bank enters a ***Musharaka*** agreement it needs to ensure that the capital being provided by its partner comes from *Shari'a* compliant sources. The operations of the partnership must also be in compliance with the *Shari'a*. This may pose particular problems if the partnership is with a conventional institution. Indeed the whole structure of the partnership is vulnerable to *Shari'a*, and so reputation risk.

The bank as partner is subject to counterparty risk. The partner may not pay the profit that the bank is entitled to. The partner may also withdraw from the partnership at any time after giving due notice. This could leave the bank with significant losses. Whilst the project may still be viable, it may not be easy for the bank to find another partner nor find a buyer for the whole project.

Many of the same risks are present in ***Mudaraba*** agreements. However the position may be even more risky for the bank as it is just the provider of capital and has no place in the management of the business/project. In a *Musharaka* agreement the partner also contributes to the capital and so will generally share a higher proportion of the risk. With *Mudaraba*, the bank may not be fully aware of how the funds are invested, how the project is performing nor the true level of profits being generated.

Again, the agreement is usually for a fixed period. And this may not be coincident with an appropriate time to terminate the partnership. If the business is to be on-going, then there needs to be a viable strategy that allows for this possibility.

As has been discussed earlier, the *Mudaraba* agreement is the contract used by the bank when it accepts funds from investment account holders. These can be on an unrestricted *Mudaraba* basis where the customer allows the bank, as *Mudarib*, to manage the funds without any restrictions. The *Mudarib* is expected to use its skills to manage the funds effectively. In restricted *Mudaraba*, the fund provider imposes certain restrictions as to how the funds are invested. Here the risks for the bank are mainly fiduciary. It must ensure that all the investments it makes on behalf of customers are properly recorded and the profits allocated fairly. It may also have Profit Equalization Reserves and Investment Risk Reserves that it may choose to use when the true returns are lower than market rates. It bears an additional risk that customers may withdraw their funds at any time as the agreement is non-binding. This may leave the bank with investments that require funding in other ways. This risk is discussed further later in this chapter under Liquidity and Liability Risk.

Operating Environment

The overall health and structure of the economy is common for all financial players, but there are particular issues for Islamic banks, especially for those that operate in countries with dual systems including both conventional and Islamic institutions. To be able to operate efficiently and safely all banks need to be able to rely on the main pillars that support the environment – the regulatory system, the accounting standards and the legal system. In all these areas there are special concerns for Islamic banks.

In some countries there is a specific banking law for Islamic institutions, but this is not always the case. Some regulators believe that there should be one banking law that all banks are subject to and that problems start if there are different requirements for certain players. However, most Islamic products are not used by conventional banks and so are not covered by conventional banking legislation. Some banking laws restrict the ownership of tangible assets, such as real estate, but such ownership is an essential component of most Islamic products. In the chapter on liquidity we identified the lack of liquid instruments as an issue for Islamic banks. In addition, regulators may be limited in the way they can assist Islamic banks in case problems arise. They may not have a lender of last resort facility that is *Shari'a* compliant or may not be able to make short-term liquidity available. Further, not all regulators and supervisors will be familiar with the way Islamic products are structured, neither will they be aware of the impact that operating in an asset-backed way without interest-bearing products can have on balance sheet structures and risks. There are other issues concerning the current state of regulation and supervision and these will be discussed further in a later chapter, but there is a risk here that is of concern for Islamic banks.

Most countries use IFRS (or US GAAP) standards for their accounting, or some close local adaptation. These have limitations for good transparency of the operations of Islamic institutions and may lead to very poor disclosure of important aspects of their operations. However, many regulators believe that they need one set of accounting rules to be applied by all banks in their jurisdiction and so they are reluctant to depart from this practice. AAOIFI standards have been adopted in a growing number of countries where Islamic banks operate, but an increasing number of institutions produce financials that conform to both IFRS and AAOIFI standards. This may be the way to go, especially as AAOIFI has never wanted to reinvent the wheel but has stated that its standards should be used to give more appropriate presentation only when IFRS is not suitable.

Finally, we have already seen that there are special concerns for Islamic banks over the enforceability of contracts. Conventional banks use well-established products for which standard documentation has been developed over the years that is accepted globally. This gives comfort, despite any limitations that may exist in the legal systems of the countries where the banks are operating. This is not the case for Islamic products as yet. Some Islamic banks have produced their own documents, but some start afresh for every new transaction. If problems do arise and cases come to court, there is considerable uncertainty as to the court's decision. Some of these issues were discussed in Chapter 5 of this book.

Structure

Because all Islamic financial transactions have an underlying asset at their centre, Islamic banks tend to own many more physical assets than conventional banks – even if the ownership is only relatively transitory while they act as agent for a customer. The assets side of the balance sheet will typically show investments in securities, leased assets and real estate. It will also show equity investments in joint ventures or capital ventures and sales receivables, and also inventories of assets held for sale.

Many banks establish subsidiaries to hold these assets and it is not always clear how significant these may be. In some cases they are consolidated, in others they are not as they are said to be immaterial or under IFRS are held as "available for sale" investments. While they may not be material in a financial sense, they can be crucial for the successful operation of the institution, and so any problems that arise from the operations may outweigh the financial significance.

Regardless of where or how these assets are held they are not liquid and it is unlikely that any could be sold in a short space of time should this become necessary for any reason.

Also, there has been a build up of these assets during a benign period of credit risk and rising asset values; a time when the market has seen ample liquidity. The crisis that is currently impacting on markets around the world has still to be felt in many of the countries where Islamic institutions operate, but the particular concentrations seen in Islamic banks and the similarity of many of their operations is a cause for concern. There has been persistent talk in the Gulf States for the last two or three years of real estate bubbles. If this talk becomes a reality, it could be the Islamic banks that are most affected.

Unlike conventional banks that rely on a steady flow of lending and credit card business to underpin their operations throughout economic cycles, Islamic banks are largely project driven and so are more vulnerable to swings in the economy. Also, because many of them are exposed to the same few industries, any problems that arise in one will likely impact all the other Islamic institutions, particularly those in the same local market.

Many banks have established Islamic branches, windows or subsidiaries. Assets may be co-mingled with those of the conventional operation or transferred from one to the other for reasons that may not necessarily be for the customers' benefit. Disclosing these movements is the subject of one of the most recent AAOIFI accounting standards.[1]

Similarly, many banks establish a number of funds for their profit-and-loss-sharing investment account (PSIA) holders. Again, little may be disclosed about these funds – even under AAOIFI accounting standards – and assets may be transferred from one to the other – or even on and off the balance sheet of the bank, depending on how they perform.

Strategy

All banks need a viable strategy if they are to survive for the long term. For Islamic banks it seems even more critical. In most cases they will be competing with conventional institutions and, because Islamic products are less commoditized and require more tailoring and more oversight, it is hard for Islamic mark up or return to compete with conventional market rates. In addition most Islamic banks are quite small – although some of the newer banks have the potential to be regional powerhouses even though their asset size will continue to be dwarfed by the size of the global players. So Islamic banks need to identify quite clearly their potential customers and then provide the best possible products that will meet their needs. However, in a paper by Cihak and Hesse[2] the authors found that small Islamic banks were more stable than larger Islamic banks, taking total assets of US$1bn as the cut off point for distinguishing between large and small. They suggest that a plausible explanation for their findings is that it is significantly more complex for Islamic banks to adjust their credit risk monitoring system as they become bigger. Given their limitations on standardization in credit risk management, monitoring the various profit-loss-arrangements becomes rapidly much more complex as the scale of the banking operation grows, resulting in problems relating to adverse selection and moral hazard becoming more prominent. They also suggest that another possibility is that small banks concentrate on low-risk investments and fee income, while large banks do more PLS business.

[1] AAOIFI Financial Accounting Standards No. 21

[2] Islamic Banks and Financial Stability: An Empirical Analysis, Maryin Cihak and Heiko Hesse; IMF Working Paper WP/08/16 January 2008

Further, they need to ensure that they have all the resources necessary to implement their strategy. There may well be legal, regulatory or *Shari'a* obstacles in their way and it will not always be easy to develop products within the restrictions these bring. Further, and perhaps most importantly, they may find it difficult to find experienced staff that will ensure that all the *Shari'a* and other requirements are met in full. This is of particular concern because of the high growth that has been seen in Islamic finance over the last five or six years. Over-ambitious strategies that stretch the available resources will just introduce new elements of risk for the institution.

Corporate Governance and *Shari'a* Boards

Corporate governance has a particular importance for Islamic financial institutions because of the unique nature of their stakeholders. All banks, as a result of their role in national and local economies and financial systems have a broader group of stakeholders than other institutions, but, in the case of Islamic financial institutions, the group is even wider. In addition to owners, management, deposit holders, counter-parties, lenders, tax authorities, regulators and supervisors, must be added PSIA holders and the *Shari'a* boards. Here we will only look at the additional governance concerns of Islamic institutions while taking the others as read.

PSIA holders are concerned that there could be deterioration in the asset values of their investments and in the integrity, fairness and effectiveness of the bank, as *Mudarib*. They want to know that there is likely to be stability and growth in their assets and that they will meet their profit expectations. The *Shari'a* scholars are concerned that the bank should comply with the rules and *Fatwas* they have set and also handle *Zakah* requirements correctly.

Deposits in conventional banks are, by definition, capital protected. In addition, depositors often have the comfort of deposit insurance schemes and also the comfort that banks can turn to their lender of last resort to fend off any temporary problems. Regulators and supervisors do not want to see depositors lose money as it could have dire consequences for the whole financial system. However, the same protection is not afforded to PSIA holders, particularly unrestricted PSIAs. Here, not only do the account holders have no say in how their money is invested, it is often also co-mingled with the bank's own funds. It is easy to see that situations could arise where there is a conflict of interest between shareholders and investment account holders, while management could have a third agenda. This could be in the area of risk appetite or in the share of profits that would be allocated to the different parties. While shareholders can make their wishes heard through the board of directors, PSIA holders have no such voice. Assets can be transferred between unrestricted and restricted investment accounts, shareholders' equity and other funds, and, as disclosure requirements have stood, only management needed to know what had happened or why it had happened.

It has been suggested by many that the governance process would be significantly enhanced by allowing PSIA holders some representation on the board of directors and by an improvement in the transparency of financial reporting. Another proposal that has been put into practice by the Al Baraka Group is to have a separate investors' committee.

The IFSB produced its standard on corporate governance in December 2006.[3] One of its proposals is that each Islamic institution should establish a governance committee of its board, one of whose responsibilities should be to ensure that the interests of investment account holders are looked after. It should be the responsibility of the audit committee to protect shareholders' interests.

The *Shari'a* supervisory board has responsibility to direct, review and supervise the activities of the Islamic financial institution in order to ensure that it is in compliance with Islamic *Shari'a* Rules and Principles. The *Fatwas* and rulings of the *Shari'a* board are binding on the institution. As such, this board is a specific organ of governance within the bank and a critical one. AAOIFI[4] has set governance standards for Islamic institutions that cover the appointment, composition and report of the *Shari' a* board as well as the review it should undertake to ensure that the activities of the IFI do not contravene the *Shari'a*. Further, in an additional standard, AAOIFI[5] says that there should be an internal, independent *Shari'a* review of the IFI's activities.

The IFSB standard suggests that regulators should compile a list of acceptable scholars from which banks may choose their boards. It further suggests that the scholars themselves should form a group to discuss issues and come to collective decisions for the institutions in that market.

Liquidity and Liability Management

As discussed in an earlier chapter, Malaysia can be said to have provided the instruments and the market to help Islamic banks manage their liquidity position. Elsewhere the picture is more difficult. Despite the efforts of the Central Bank of Bahrain to provide a range of liquid instruments in which Islamic banks can place their surplus cash, there is still a great shortage of liquid instruments in the Gulf, which means IFIs will have non-earning assets on their books and also possible liquidity shortages in the face of unforeseen events. For instance, during the financial crisis in Turkey during 2000-2001, the Islamic institutions faced severe liquidity problems and one, Ihlas Finance, was closed.

As with assets, so the liabilities of Islamic banks may have very different profiles and need careful management. The biggest issue remains the position of the profit and loss sharing investment accounts. Because juristically, PSIA are not debt claims on the bank but a form of limited term equity, losses relating to the assets they

[3] IFSB: Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services, December 2006

[4] AAOIFI Governance Standard No.11

[5] AAOIFI Governance Standard No. 8

fund should not impact on the bank's own capital. However, Islamic banks are not immune from runs or panic withdrawals, and PSIA holders typically have the right to withdraw their funds at short notice, foregoing their share of the profit for the most recent period. While they should still share in any losses, if these have not been identified at the time of the withdrawal, it may be impossible to implement. For unrestricted investment accounts, where the bank's own funds are typically co-mingled with those of the PSIA, any losses may have an even greater impact on the bank. Also, investment account holders may have quite different risk appetites from those of the bank's shareholders, with PSIA holders generally looking for a safe investment similar to deposit accounts in conventional banks. This has led to the practice of smoothing investment returns using both a profit equalization reserve and an investment risk reserve and even, if necessary, to shareholders foregoing part, or all, of their share of the profit. This risk was termed by AAOIFI as "displaced commercial risk" when it framed its proposals for capital adequacy and this has become a widely used description of this risk.

Operational Risks

Operational risks are generally defined as the risks arising from failures in internal controls involving processes, people and systems. Islamic banks face similar risks to conventional banks, but probably more so as a result of the fact that Islamic products are relatively new and not commoditized in the same way as conventional bank products, meaning that there is a higher chance that something could go wrong. Most products are contract-based and in many cases these are structured for individual clients, leading to legal and documentation risks of a higher order than in other banks.

Also, even computer systems are probably less robust than those in conventional banks as they have been subjected to less use. They are generally either bespoke systems or ones that have been modified to handle Islamic products, but there are few systems that have been specifically designed for the use of Islamic banks and are in widespread use. (For example, Path Solutions from Kuwait claims some 30+ customers for its products, mainly in the wider Middle East region.)

We have already discussed the difficulties in finding experienced bankers who also understand Islamic finance and this contributes to the level of operational risk. Given the complexities in ensuring *Shari'a* compliance in most products, there is a requirement for skill and precision in the execution of all transactions.

But this is not all. As the IFSB has pointed out, Islamic banks also face additional risks, mainly relating to their PSIA holders and *Shari'a* compliance. These risks expose banks to possible withdrawal of funds, loss of income or voiding of contracts. In turn these could lead to loss of reputation and limit business opportunities.

In its Exposure Draft on Risk Management, the IFSB gave some examples of how fiduciary risks may arise. They do not appear in the final standard but give a useful indication of the sort of risks that can arise:

- A critical aspect of IFIs' activities relates to the potentially large availability of funds provided by current account holders whereby, as a result of inappropriate management decision, IFIs may increase disproportionately their investment portfolios' returns by excessively leveraging these funds without due regard to risks arising from sudden and unexpectedly high levels of withdrawals from current accounts.
- Where IFIs manage and invest various funds in longer-term investment projects, investment funds received over a more prolonged period may be commingled inappropriately. For example, if funds provided by more long standing investors are invested in a troubled project, there is a risk that the IFI could use other IAH funds received later on to invest in the same project in the hope that the project may be salvaged. Distortions may arise when the IFI reports an attractive return to longer standing fund providers when they are in fact being paid out of funds paid in by more recent investors.
- The reinvestment of profits rather than distributing them to investors may give rise to unfair advantages to the IFI, which may thereby extend the period of a poorly performing investment. This may unfairly increase the exposure of incoming IAH to losses, which may have already existed prior to their investment.
- The risk of conflicts of interest exists where poorly performing assets and/or restructured assets of the IFI may be transferred by the IFIs' management from on-balance sheet to off-balance sheet accounts where the restricted IAH would bear the risk of loss. Such misapplications of funds could result in the investment risk being removed from the IFIs' balance sheet but, based on an agency contract, the IFI may earn fees inappropriately on the investment management and would not share in any eventual losses recorded after the transfer.
- When purchasing assets at a very low price, IFIs may "park" them in a subsidiary or related company and, when the opportunity arises, sell them to IAH at a higher price.
- Other internal and operational issues may not be directly related to IAHs' investments but may give rise to exposures to losses for IAH. For example, the risks, derived from such elements as an excessive allocation of expenses and the hiring of less experienced staff, affect the quality of investment performance and oversight.

These indicate just some of the ways a less than scrupulous management could manipulate returns to suit their own purposes. There appear to be many ways management might conceal their errors, and lack of transparency means that their actions would be hard to discover.

Risk Assessment and Management

The IFSB released its standard on risk management in Islamic institutions in December 2005[6], and this clearly forms the basis for all discussion in this area. Islamic bank balance sheet structures indicate that there is a wide variety of classifications on both the asset and liability side and so it is unlikely that there could be just one appropriate risk management approach. Therefore the IFSB has adopted a principles-based approach.

The IFSB standard lists fifteen guiding principles for risk management in IFIs. There is a general requirement followed by a number covering credit, equity investment, market, liquidity, rate of return and operational risks. These principles are listed below:

"1. General Requirement

Principle 1.0: IFIs shall have in place a **comprehensive risk management and reporting process**, including appropriate board and senior management oversight, to identify, measure, monitor, report and control relevant categories of risks and, where appropriate, to hold adequate capital against these risks. The process shall take into account appropriate steps to comply with *Shari'ah* rules and principles and to ensure the adequacy of relevant risk reporting to the supervisory authority.

2. Credit Risk

Principle 2.1: IFIs shall have in place a **strategy** for financing, using the various Islamic instruments in compliance with *Shari'ah*, whereby it recognizes the potential credit exposures that may arise at different stages of the various financing agreements.

Principle 2.2: IFIs shall carry out a **due diligence review** in repect of counterparties prior to deciding on the choice of an appropriate Islamic financing instrument.

Principle 2.3: IFIs shall have in place appropriate **methodologies for measuring and reporting the credit risk exposures arising** under each Islamic financing instrument.

Principle 2.4: IFIs shall have in place *Shari'ah*-compliant **credit risk mitigating techniques** appropriate for each Islamic financing instrument.

3. Equity Investment Risk

Principle 3.1: IFIs shall have in place appropriate strategies, risk management and reporting processes in respect of the **risk characteristics of equity investments, including *Mudarabah* and *Musharakah* investments.**

[6] IFSB Guidance Principles of Risk Management for Institutions (Other than Insurance Institutions) Offering Only Islamic Financial Services

Principle 3.2: IFIs shall ensure that their **valuation methodologies** are appropriate and consistent and shall assess the potential impacts of their methods on profit calculations and allocations. The methods shall be mutually agreed between the IFI and the *Mudarib* and/or *Musharakah* partners.

Principle 3.3: IFIs shall define and establish the **exit strategies** in respect of their equity investment activities, including extension and redemption conditions for *Mudarabah* and *Musharakah* investments, subject to the approval of the institution's *Shari'ah* Board.

4. Market Risk

Principle 4.1: IFIs shall have in place an appropriate **framework for market risk management** (including reporting) in respect of all assets held, including those that do not have a ready market and/or are exposed to high price volatility.

5. Liquidity Risk

Principle 5.1: IFIs shall have in place a liquidity management framework (including reporting) taking into account separately and on an overall basis their **liquidity exposures in respect of each category** of current accounts, unrestricted and restricted investment accounts.

Principle 5.2: IFIs shall undertake liquidity risk commensurate with their ability to have sufficient **recourse to *Shari'ah*-compliant funds** to mitigate such risk.

6. Rate of Return Risk

Principle 6.1: IFIs shall establish a comprehensive risk management and reporting process to assess the potential impacts of market factors affecting **rates of return on assets in comparison with the expected rates of return for investment account holders (IAH).**

Principle 6.2: IFIs shall have in place an appropriate framework for managing **displaced commercial risk**, where applicable.

7. Operational Risk

Principle 7.1: IFIs shall have in place adequate **systems and controls**, including *Shari'ah* Board, to ensure compliance with *Shari'ah* rules and principles.

Principle 7.2: IFIs shall have in place appropriate **mechanisms to safeguard the interests of all fund providers**. Where IAH funds are commingled with the IFIs' own funds, the IFI shall ensure that the bases for asset, revenue, expense and profit allocations are established, applied and reported in a manner consistent with the IFIs' fiduciary responsibilities."

Overall, the main differences between these principles and those appropriate for a conventional bank relate to five things:

- the differences in the asset classes of Islamic banks,
- the relatively weak position of investment account holders, and
- the importance of the *Shari'a* board and the bank's ability to provide the board with adequate information as well as abide by its rulings
- rate of return risk
- new operational risks

Some of the differences between Islamic bank assets and those of conventional banks are asset-based receivables of a short term nature as opposed to loans and overdrafts; *Ijarah* style assets instead of longer term loans; *Salam* and *Istisna'a* transactions giving rise to positions in commodities; and investments through *Mudaraba* and *Musharaka* positions which are usually long term and most nearly equate to private equity. Also, non-binding orders arise through *Murabaha* transactions and expose banks to the risk of selling goods for lower prices and incurring costs relating to storage, sale and delivery. *Salam* contracts bind the bank to purchase a commodity on a future date at a pre-determined price. It is not always easy to hedge the risk of market price fluctuations. Islamic banks will always have more physical assets than their conventional counterparts and these give rise to liquidity risks, market risks, and potential costs relating to disposal.

Rate of return risk is associated with overall balance sheet exposures where mismatches arise between assets and balances from fund providers. Returns from investments are determined only at the end of the investment holding period. Banks may be under market pressure to pay a return to PSIA holders that exceeds the rate that has been earned on the assets they have financed. This has come to be known as displaced commercial risk.

Under operational risk, the IFSB also discusses *Shari'a* non-compliance risk and fiduciary risk. The first is of special importance as *Shari'a* compliance is central to the rationale for the bank's existence. Any non-compliance could not only lead to transactions being nullified but also any income earned cannot be recognized. In addition there is important reputation risk. All banks need to safeguard their reputation, but Islamic banks set out to operate to higher ethical and religious principles than others and any sign that they have had lapses in this area could all but destroy their franchise and their business.

Risk Management Tools

One of the major problems for Islamic banks is the absence of risk management tools. Those used by conventional banks are almost all interest bearing and so not appropriate. Liquidity has been discussed in the previous chapter and this remains one of the most challenging issues for Islamic institutions. However, as discussed here, all other risks are present in the operations of Islamic banks and there are only a few tools that they can use to mitigate these risks.

If customers fail to pay, banks cannot impose penalty interest – there is no interest in the first place - nor can they charge a late penalty fee. However, a number do charge a fee as an encouragement to their customer to pay, but this fee is then donated to charity.

If goods are received that are defective, it would normally be the bank that is responsible. To avoid this possibility, many banks will stipulate in the contract that they are not responsible for hidden defects but will assign to the customer the right of recourse to the supplier.

Banks will also ask for *Urboun* from their customers in the form of a third party guarantee (*Kafala*) or a pledge of assets (*Rahn*) or up-front deposit payment. In a *Salam* contract, banks may ask for a performance guarantee. In an *Ijarah* contract, the bank may take out insurance, but this cannot be passed on to the customer as a separate sum but must be covered as part of the rental.

Techniques have been developed to mimic various hedging instruments, but not all scholars have accepted that the approaches being used are *Shari'a* compliant. They mainly use commodity *Murabaha* or *Tawarruq* principals, but also *Urboun*. An *Urboun* payment is like a deposit. It is a payment made to show that you are serious in your intent to purchase. In the examples below the client is hedging his exposure, but the bank could use the same tools to hedge its own risk.

Risk Mitigating Tools

Hedging Currency Exposure

Suppose a client knows he will have an exposure to Euros in five years time and wants to hedge himself against the currency risk as his earnings will be in US dollars. He can enter the following transactions:

1. He buys a commodity from a broker against a deferred payment in Euros.
2. He sells the commodity to the bank against deferred payment in US dollars.
3. After five years he receives Euros from his known transaction which gives him his exposure and uses it to pay the broker. At the same time he receives US dollars from the bank.

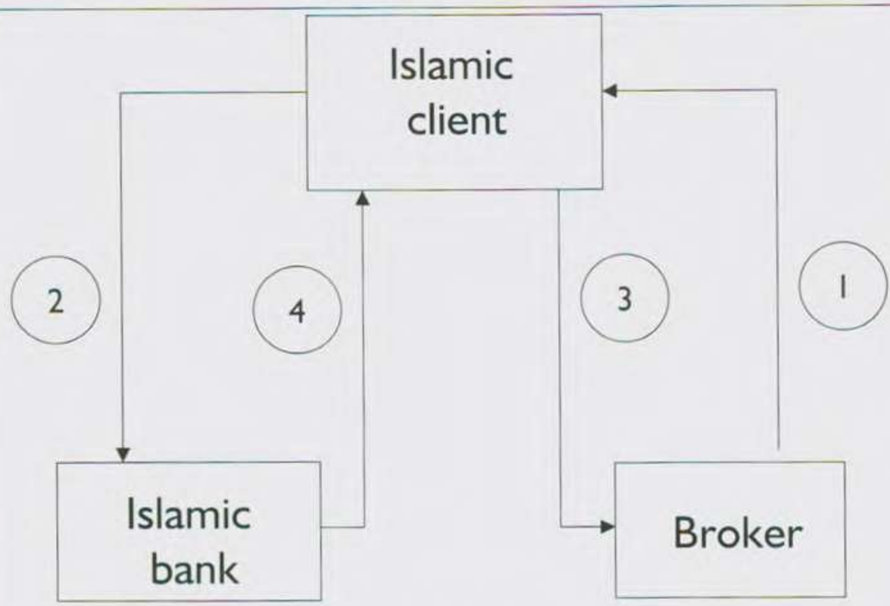

Figure 9.1: Hedging Currency Exposure

1. Client buys a commodity from a broker on deferred payment in Euros
2. Client sells the commodity to a bank on deferred payment in US dollars
3. At maturity, client receives Euros from his known transaction and uses it to pay the broker
4. Client receives US dollars from the bank in settlement of the sale transaction

Currency Option

In this example, the client makes an *Urboun* payment (option) to the bank for the purchase of *Shari'a* compliant assets (such as a portfolio of *Shari'a* compliant paper) to be paid in Euros at maturity. The bank unilaterally promises (*Wa'ad*) to buy back the portfolio on maturity of the agreement at par.

At maturity, if the Euro has weakened, and the put on Euros is in the money, the client will exercise his right to complete the purchase. He will sell the paper back to the bank for US dollars at par.

Alternatively, if the Euro has strengthened, the client will not complete the transaction as his put on Euros is out of the money.

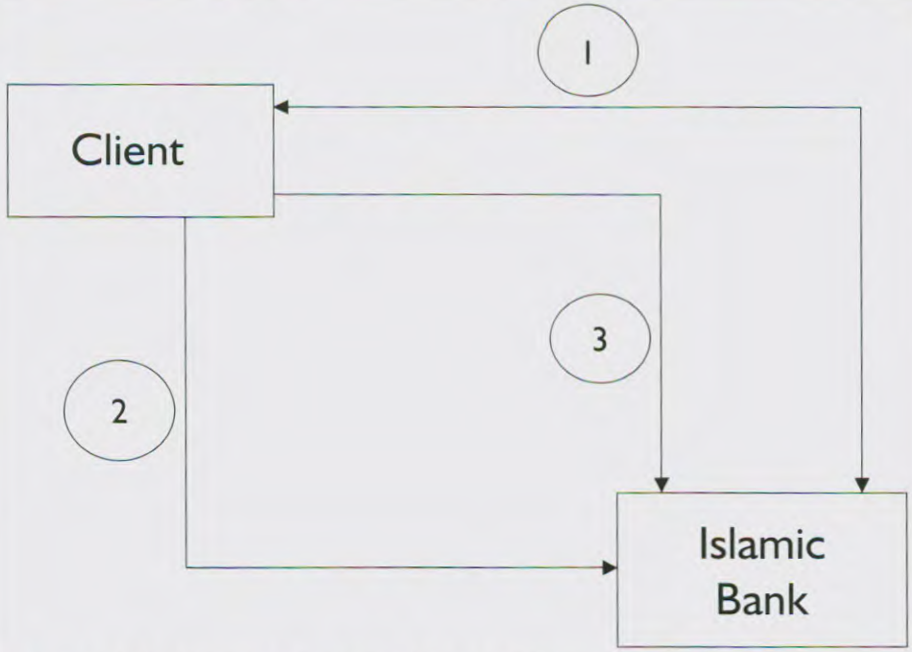

Figure 9.2a: Currency option – Euro weakens

1. Client makes an *Urboun* payment for *Shari'a* compliant assets, to be paid in full in Euros at maturity. The bank promises (*Wa'ad*) to buy back the portfolio at maturity at par in US dollars.
2. The Euro has weakened and the client exercises his right to complete the purchase the portfolio in Euros.
3. The client sells the portfolio back to the bank at par in US dollars

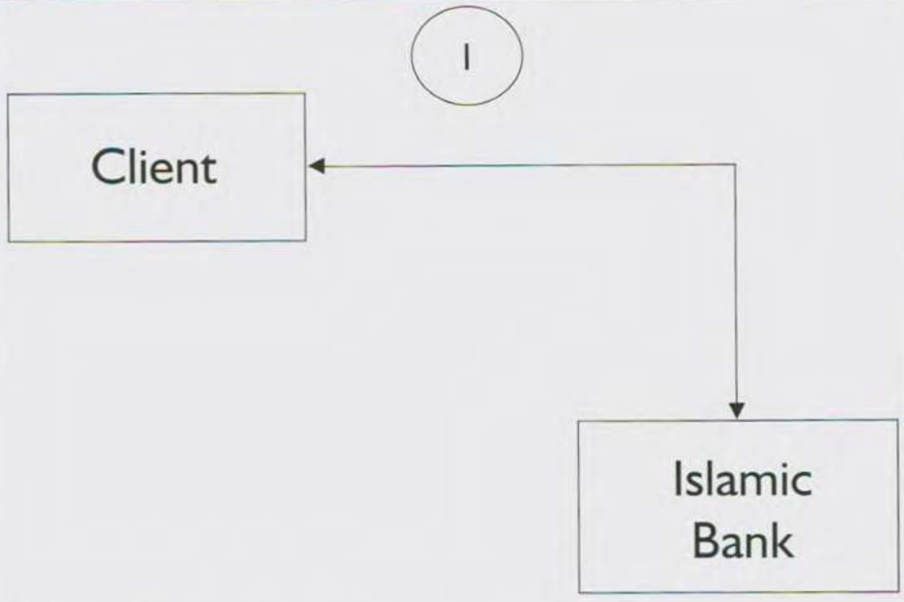

Figure 9.2b: Currency option – Euro strengthens

1. Client makes an *Urboun* payment for *Shari'a* compliant assets, to be paid in full in Euros at maturity. The bank promises (*Wa'ad*) to buy back the portfolio at maturity at par in US dollars.
2. The Euro has strengthened and so the client does not exercise his right.

The *Urboun* principle has also been used for a variety of swaps and options and also by hedge funds.

Profit Equalization Reserves and Investment Risk Reserves

As touched on earlier in this chapter, banks have established profit equalization reserves (PER) and investment risk reserves (IRR) to smooth the returns that they pay to investment account holders.

Some banking regulators have taken the view that this practice of smoothing returns results in a modification of the legal attributes of the PSIA such that Islamic banks have a "constructive obligation" to continue the practice. This means that the practice of smoothing becomes obligatory and unrestricted PSIA holders effectively have the same rights as conventional depositors.

On the other side, there are arguments that banks should not take these reserves at all as they penalize shorter term investors who do not receive their rightful share of profits earned in the period.

In theory, the PER and IRR "belong" to the investment account holders and so should not be counted as part of shareholders' equity. Practice varies. Some banks (the Islamic Bank of Britain for example) ask their investment account holders to waive all claims to these reserves. Some banks make no explicit statements as to how these reserves are used. It is another area where greater transparency would be helpful.

Chapter 10

Islamic Accounting Standards

In an ideal world, there would be one set of accounting standards that was accepted and implemented in a consistent way for every financial institution in the world. While there are significant moves in this direction, most notably the convergence of US GAAP and IFRS, there is still some way to go before the ideal is achieved. However, it may never be appropriate for IFIs to use exactly the same standards as conventional banks as this results in little transparency and poor disclosure of their true performance. In many ways, IFIs look like highly leveraged trading companies or alternatively, fund managers, rather than conventional banks!

IFIs have mainly used the *Mudaraba* instrument to fund themselves, through what are commonly termed profit and loss sharing investment accounts (PSIAs). However, they have mainly relied on *Shari'a* compliant sales contracts, such as *Murabaha* and *Ististn'a*, as well as *Ijarah*, or leasing, on the asset side. To a much lesser extent they engage in *Mudaraba* and *Musharaka* transactions, which most closely resemble joint ventures or equity investments, although the risks associated with these have deterred their wide adoption. This mix of instruments has resulted in structures that combine investment and commercial banking features without the Chinese walls that would be expected in a conventional universal bank. There is also the issue of *Zakah* and Islamic banks have an obligation to inform their shareholders of the value of their wealth and the amount of *Zakah* they should pay. Initially, IFIs were more concerned with *Shari'a* issues than accounting ones, and were content to follow the legal requirements in their country. However, the accounting issues did not go away and particularly after a number of Islamic institutions faced problems, IFIs felt that to increase their credibility they needed to improve their transparency.

Some of the main accounting issues can be summarized as:

- How should IFIs account for their PSIAs, both restricted and unrestricted?

- How should Islamic banks recognize the income generated from all the various asset classes?
- How should they measure the value of their various assets?
- How should IFIs account for prohibited income (for example, that part of dividend income that can be attributed to interest income)?
- What disclosures should IFIs make, particularly given their ethical stance and commitment to *Shari'a* compliance?
- How should IFIs account for provisions for doubtful debts or decline in value of impaired assets in case those assets are funded in whole or part by investment accounts?
- What role should the *Shari'a* board play in deciding on accounting policies?

International Financial Reporting Standards and local accounting standards offered no answers to these issues and so auditors and *Shari'a* Boards have reached various conclusions. While internally consistent this has meant that it has been extremely difficult to compare the results of different banks.

In some cases PSIAs have been treated as liabilities, in the same way as term deposits in a conventional bank, in others they have been treated as fiduciary investments and so off balance sheet.

Income from *Murabaha* contracts has been treated in many different ways. Some have recognized the income up-front, others when installments fall due, others when installments are paid, yet others have distributed income equally over the contract period, some have recognized it at the end of the period and others have used a constant rate of return. Some scholars believe that cash accounting is the best treatment so that profits may be allocated fairly between the bank and its investors.

A major issue is how banks calculate the income generated on investment accounts. What income and expense items should be allocated? The issue is further complicated by the comingling of bank and investor funds.

It was because of all the differences that were apparent and a desire to see better and more consistent disclosure and reporting that the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) was established in 1991. Based in Bahrain, it is registered as an international autonomous non-profit making corporate body. It was initially funded by its founding members (Islamic Development Bank, Dar al Maal al Islami Group, Al Rajhi Banking and Investment Corporation, Dallah Albaraka and Kuwait Finance House). Now funding mainly comes from membership fees, annual subscriptions, grants, donations and bequests. The original objectives were amended in 1998 to state that AAOIFI shall:

1. Develop the accounting, auditing and banking practices thought relating to the activities of Islamic financial institutions.

2. Disseminate the accounting and auditing thought relating to the activities of Islamic financial institutions and its applications through training, seminars, publication of periodical newsletters, preparation of research and other means.
3. Prepare, promulgate and interpret accounting and auditing standards for Islamic financial institutions in order to harmonise the accounting practices adopted by these institutions in the preparation of their financial statements, as well as to harmonise the auditing procedures adopted in auditing the financial statements prepared by Islamic financial institutions.
4. Review and amend the accounting and auditing standards for Islamic financial institutions to cope with developments in the accounting and auditing thought and practices.
5. Prepare, issue, review and adjust the statements and guidelines on the banking, investment and insurance practices of the Islamic financial institutions.
6. Approach the concerned regulatory bodies, Islamic financial institutions, other financial institutions that offer Islamic financial services, and accounting and auditing firms in order to implement the accounting and auditing standards, as well as the statements and guidelines on the banking, investment and insurance practices of Islamic financial institutions that are published by AAOIFI.

The structure now consists of a general assembly, a board of trustees, an accounting and auditing standards board, an executive committee, a *Shari'a* board and a general secretariat headed by a secretary-general. Membership consists of the founding members (to which list has been added Bukhary Foundation, Malaysia), non-founding members (now re-named associate members) and observer members.

In 2004 additional amendments were made to the statute which extended the categories of membership to include supporting members which category includes all users of financial statements of Islamic financial institutions.

AAOIFI was also empowered to offer a testing and certification programme in the areas of accounting, auditing, financial analysis, and Islamic banking, conducted either by AAOIFI or in cooperation with other parties.

The *Shari'a* board consists of not more than 20 members appointed by the Board of Trustees for a five-year term from among the *fiqh* scholars who represent *Shari'a* supervisory boards in the Islamic financial institutions that are members of AAOIFI, and *Shari'a* supervisory boards in central banks.

The powers of the board include:

1. Achieving harmonization and convergence in the concepts and application among the *Shari'a* supervisory boards of financial institutions to avoid contradiction or inconsistency between the *fatwas* and applications by these institutions, thereby providing a pro-active role for the *Shari'a* supervisory boards of Islamic financial institutions and central banks.

2. Helping in the development of *Shari'a* approved instruments, thereby enabling Islamic financial institutions to cope with the developments taking place in instruments and formulas in fields of finance, investment and other banking services.
3. Examining any inquiries referred to the *Shari'a* board from Islamic financial institutions or from their Shari'a supervisory boards, either to give the Shari'a opinion in matters requiring collective *Ijtihad* (reasoning), or to settle divergent points of view, or to act as an arbitrator.
4. Reviewing the standards which AAOIFI issues in accounting, auditing and code of ethics and related statements throughout the various stages of the due process, to ensure that these issues are in compliance with the rules and principles of Islamic *Shari'a*.

The Accounting and Auditing Standards Board is composed of 20 part-time members who are appointed by the Board of Trustees for a five-year term. Members of the board represent regulatory and supervisory bodies, IFIs, *Shari'a* supervisory boards, university professors, organizations and associations responsible for regulating the accounting profession and/or responsible for preparing accounting and auditing standards, certified accountants, and users of the financial statements if Islamic financial institutions.

The powers of the standards board include:

1. To prepare, adopt and interpret accounting and auditing statements, standards and guidelines for Islamic financial institutions.
2. To prepare and adopt codes of ethics and educational standards related to the activities of Islamic financial institutions.
3. To review with the aim of making additions, deletions or amendments to any accounting and auditing statements, standards and guidelines.
4. To prepare and adopt the due process for the preparation of standards, as well as regulations and by-laws of the Standards Board.

The accounting, auditing and governance standards already issued by AAOIFI have highlighted many of the ways in which IFIs have lacked transparency. While not yet adopted by all regulators and all Islamic institutions, they are either mandatory or used as a guideline in Bahrain, Sudan, Jordan, Malaysia, Qatar, Saudi Arabia, Dubai, Syria, Lebanon, Singapore, and South Africa.

However, perhaps the most encouraging aspect of AAOIFI's work has been the 30 *Shari'a* standards. These result from the work of *Shari'a* scholars representing almost all schools and from many countries. One of the greatest criticisms of Islamic banking has arisen from the diversity of standards that have been imposed by every *Shari'a* board. To many, these divergent views have devalued the religious basis for Islamic banking. This work has been crucial to finding a growing conformity of view.

AAOIFI has issued 23 Accounting Standards, five Auditing Standards, and six Governance Standards. It has also issued two codes of ethics.

New editions of the Accounting, Auditing and Governance Standards as well as the Shari'a Standards were published in 2008 in both Arabic and English versions reflecting standards in place as of June 2008[1] and November 2007[2] respectively.

A full list of the standards is shown below:

Accounting

Financial Accounting Statements

1. Objective of Financial Accounting for Islamic Banks and Financial Institutions
2. Concepts of Financial Accounting for Islamic Banks and Financial Institutions

Financial Accounting Standards

1. General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions
2. Murabaha and Murabaha to the Purchase Orderer
3. Mudaraba Financing
4. Musharaka Financing
5. Disclosure of Bases for Profit Allocation between Owners' Equity and Investment Account Holders
6. Equity of Investment Account Holders and Their Equivalent
7. Salam and Parallel Salam
8. Ijarah and Ijarah Muntahia Bittamleek
9. Zakah
10. Istisna'a and Parallel Istisna'a
11. Provisions and Reserves
12. General Presentation and Disclosure in the Financial Statements of Islamic Insurance Companies
13. Disclosure of Bases for Determining and Allocating Surplus or Deficit in Islamic Insurance Companies
14. Investment Funds
15. Provisions and Reserves in Islamic Insurance Companies
16. Foreign Currency Transactions and Foreign Operations
17. Investments
18. Islamic Financial Services offered by Conventional Financial Institutions

[1] Accounting, Auditing and Governance Standards for Islamic Financial Institutions, AAOIFI, 2008

[2] Shari'a Standards for Islamic Financial Institutions, AAOIFI, 2008

19. Contributions in Islamic Insurance Companies
20. Deferred Payment Sale
21. Disclosure on Transfer of Assets
22. Segment Reporting
23. Consolidation

Auditing

1. Objective and Principles of Auditing
2. The Auditor's Report
3. Terms of Audit Engagement
4. Testing by an External Auditor for Compliance with Shari'a Rules and Principles by an External Auditor
5. The Auditor's Responsibility to Consider Fraud and Error in an Audit to Financial Statements (New)

Governance

6. Shari'a Supervisory Board: Appointment, Composition and Report
7. Shari'a Review
8. Internal Shari'a Review
9. Audit and Governance Committee for Islamic Financial Institutions
10. Independence of Shari'a Supervisory Board
11. Statement on Governance Principles for Islamic Financial Institutions

Ethics

12. Code of Ethics for Accounting and Auditors of Islamic Financial Institutions
13. Code of Ethics for the Employees of Islamic Financial Institutions

Shari'a Standards

1. Trading in Currencies
2. Debit Card, Charge Card and Credit Card
3. Default in Payment by a Debtor
4. Settlement of Debts by Set-off
5. Guarantees
6. Conversion of a Conventional Bank to an Islamic Bank
7. Hawala
8. Murabaha to the Purchase Orderer
9. Ijarah and Ijarah Muntahia Bittamleek
10. Salam and Parallel Salam
11. Istisna'a and Parallel Istisna'a

12. Sharika (Musharaka) and Modern Corporations
13. Mudaraba
14. Documentary Credit
15. Jua'la
16. Commercial Papers
17. Investment Sukuk
18. Possession (Qabd)
19. Loan (Qard)
20. Commodities in Organised Markets
21. Financial Papers (Shares and Bonds)
22. Concession Contracts
23. Agency
24. Syndicated Financing
25. Combination of Contracts
26. Islamic Insurance
27. Indices
28. Banking Services
29. Stipulations and Ethics of Fatwa in the Institutional Framework
30. Monetization (Tawarruq)

It is beyond the scope of this handbook to discuss all these standards. They are well presented, and very readable, in the authorative presentation given by AAOIFI. However, earlier in this chapter a few of the important issues were highlighted and so some of the answers provided by AAOIFI are discussed here.

First, one of the questions on presentation is how to account for PSIAs, both restricted and unrestricted. AAOIFI addresses this in the second accounting statement – "Concepts of Financial Accounting for Islamic Banks and Financial Institutions". The position of unrestricted investment accounts is set out in paragraphs 24 to 29. It states that the relationship between the Islamic bank and holders of unrestricted investment accounts is based on an unrestricted *Mudaraba* contract because the bank has the right to commingle funds received from unrestricted investment account holders with shareholders' equity. It can also use the funds unconditionally, without any restrictions. As a result unrestricted investment accounts are considered as part of the financial position of the bank. However, the equity of unrestricted investment account holders is not considered a liability for the purpose of financial accounting. This is because the bank is not obliged, in case of loss, to return the original amount of funds received from the account holders. Likewise the funds are not regarded as part of the ownership equity in the bank as the holders of these accounts do not have ownership rights. This places these unrestricted investment accounts after liabilities but before shareholders' equity in the presentation of the accounts, as described in the first financial accounting standard – "General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions", paragraph 42.

The position of restricted investment accounts is different. They are not considered as part of the Islamic bank's financial position because the Islamic bank does not have an unconditional right to use or dispose of these funds. The funds are managed by the bank as an investment manager based on either a non-participating *Mudaraba* contract or agency contract. They are treated as fiduciary accounts. The first financial accounting standard describes the "Statement of Changes in Restricted Investments and their Equivalent" (paragraphs 50-54) which sets out the disclosures required, which include the value of the restricted investments, deposits and withdrawals, profits (losses) before the investment manager share in profits as *mudarib* or compensation as an investment agent, and the investment manager's share.

One of the most contentious issues on income recognition relates to *Murabaha* contracts. Many different approaches have been used by Islamic banks, some of which were listed earlier in this chapter. Financial Accounting Standard No. 2 addresses all the issues relating to *Murabaha* and *Murabaha* to the Purchase Orderer. If the sale is for cash or on credit not exceeding the current financial period, profit should be recognized at the time of contracting. If the sale will be paid for either by means of one payment due after the current financial period or by installments over several future financial periods, two methods of profit recognition can be used. First, profit can be recognized by proportionate allocation over the period of the credit whereby each period shall carry its portion of profits irrespective of whether or not cash is received. This is the preferred method. Alternatively, profit can be recognized as and when the installments are received. This method shall be used based on a decision of the *Shari'a* supervisory board of the bank or, if it is required, by the Supervisory authorities.

It is interesting that in a number of the standards, the *Shari'a* supervisory board has a role to play in deciding on the most appropriate approach. With its role in deciding whether particular financing structures are *Shari'a* compliant, in deciding how returns to investment account holders should be calculated, how assets should be valued and how profits should be recognized, it is clear that the role of the *Shari'a* board can be seen as more than just advisory. This leaves important questions for regulators to decide, mainly relating to the qualifications and experience *Shari'a* board members should possess.

Prohibited income is mentioned in the Statement of Financial Accounting No. 1 which defines the objectives of financial accounting and again in Financial Accounting Standard No. 1 which defines presentation and disclosure requirements. Here, in paragraph 15, it is stated:

> "The financial statements should disclose the amount and nature of earnings that have been realized from sources or by means which are not permitted by Shari'a. Likewise, disclosures should be made of the amount and nature of expenditure for purposes not permitted by Shari'a. The Islamic bank should also disclose how it intends to dispose of the assets generated by the prohibited earnings or acquired through prohibited expenditures."

Financial Accounting Standard No. 11 refers to Provisions and Reserves. In the discussion of the reason for the standard, it is said:

"The results of a field study, comprising fifteen Islamic banks and two central banks, reveal that there are major differences among Islamic banks in the methods they use to recognize, measure and present provisions. These differences are summarized below as follows:

1. Some Islamic banks deduct a specific percentage from the *Mudaraba* income as a provision, while other Islamic banks deduct the provision from their own *Mudarib* share by charging it to their expenses, after the allocation of profits between the *Mudarib* and the unrestricted investment account holders. A third set of Islamic banks deduct the provision entirely from the income of investment account holders.
2. Some Islamic banks use the term 'reserves' and 'provisions' interchangeably. They set aside specific amounts from their own profits and/or the profits of investment account holders for specific purposes and call these amounts 'provisions'.
3. Many Islamic banks form only one type of provision while others form two types, namely specific provision and general provision.
4. Some Islamic banks present the provisions as liabilities in the statement of financial position, while others present provisions as an asset valuation item (contra-asset).
5. Most Islamic banks do not disclose the methods they use to form provisions. Other Islamic banks do not give adequate disclosure on the changes that occur in the balance of provisions.

Such differences in the accounting treatments and disclosure of provisions have several effects. It may be difficult to compare the profits realized by one Islamic bank with those of another or to compare the returns on investment accounts realized by an Islamic bank with those of another Islamic bank. This is likely to render the information produced by Islamic banks less useful to users of their financial statements. Such differences may also affect the fair bases on which profits are allocated between the Islamic bank (*Mudarib*) and holders of unrestricted and restricted investment accounts, thereby defeating one of the important *Shari'a* objectives.

The reserves that are covered in this standard are of a type that is unique to Islamic banks and has no equivalent in conventional banks. The field study indicated several differences among Islamic banks in the methods they use to form and disclose the profit equalization reserve and the investment risk reserve. These differences are summarized as follows:

1. Some Islamic banks set aside the above mentioned reserves from the *mudaraba* income, before allocating the profit, while other Islamic banks form the reserves from the income of investment account holders after allocation of profit.

2. Most Islamic banks regard these reserves as provisions and therefore apply the accounting policies used for provisions.
3. Most Islamic banks do not disclose details of the above mentioned reserves. Instead they only include a condition related thereto in the *mudaraba* contract."

Having explained so clearly the need for greater uniformity in this area, the standard says that specific provision is the amount needed to write the asset down to its estimated cash equivalent value in the case of receivables and in the case of financing and investment assets to estimated cash equivalent value if lower than cost. The amount needed to bring the balance in respect of such assets funded by **unrestricted account holders' funds and/or shareholders' funds** (*emphasis added*) to the required level is charged to the income statement. If the balance exceeds the amount necessary, the amount needed to reduce it to the required level shall be credited to the income of the relevant parties.

A general provision is the amount needed to cover a potential loss that might occur from currently unspecified risk. Again, it only relates to assets funded by unrestricted investment account holders' funds and/or shareholders' equity,

The standard also covers the two types of reserves, unique to Islamic finance, namely the profit equalization reserve and the investment risk reserve.

The profit equalization reserve is the amount appropriated by the Islamic bank out of the *Mudaraba* income, **before** allocating the *Mudarib* share, in order to maintain a certain level of return on investment for investment account holders and increase owners' equity.

The investment risk reserve is the amount appropriated by the Islamic bank out of the income of investment account holders, **after** allocating the *Mudarib* share, in order to cater against future losses for investment account holders.

The important point to note is that this latter type of reserve is part of investment account holders' equity and not shareholders' equity. The profit equalization reserve is partly allocated to shareholders' equity and part to investment account holders' equity. So in the presentation of the accounts, only part of the reserves should be part of shareholders' equity.

The Islamic Bank of Britain asks its investment account holders to relinquish all rights to these reserves, having explained their purpose. Clear disclosure of the treatment is not always apparent in the financial statements of other Islamic banks at present.

While AAOIFI has been adding new standards, it has stated that it only wishes to have separate standards for Islamic institutions where international standards (particularly IFRS) are inappropriate. AAOIFI standards were originally meant to complement IFRS, not replace them, and this wish continues. However in the last few years significant changes have been made to the international standards and it seems to have been hard for AAOIFI to keep pace with these. One very obvious example of this is in the area of fair value accounting. As mentioned in the chapter on risk management, a number of banks do try to present their financials to both IFRS and AAOIFI standards and so far this has proved possible. Hopefully this will continue to be so. In order for the financial statements of Islamic institutions to be transparent and present the results in a true and fair way, AAOIFI standards should require additional disclosures and presentation while keeping the overall framework consistent with IFRS.

Chapter 11

Regulation of Islamic Financial Institutions

The global standards and structures that exist for regulating banks were not designed with Islamic banks in mind and, in most countries, what has happened as a result is that Islamic products have been shoehorned in to a regulatory environment that is inappropriate. That said, many regulators argue that it would be even more inappropriate to have separate legislation for Islamic banks as this would mean that there was no level playing field and competition would be distorted. As a result, Islamic institutions have been subject to different approaches to regulation and supervision in the various jurisdictions in which they operate.

The issues are not straightforward. Islamic banks have very different profiles and today offer a wide range of products with risk profiles that may not be fully understood. Almost all have their own *Shari'a* board and each board may come to different conclusions about very similar products and contracts.

Shari'a Regulation?

I am indebted to Dr Ishrat Husain, former governor of the State Bank of Pakistan, for the original of the following table that has been updated to show the current position in the jurisdictions that host the most Islamic institutions.

	Legal Authority	**Regulatory, Supervisory and Monitoring Arrangements**	***Shariah* Boards**
Bahrain	CBB Law	Dual system of banking with Islamic banking law. CBB sole supervisor for banks, mutual funds, investment advisory services	Each Islamic bank must have a *Shari'a* board
Indonesia	Act No. 10 1998 & Act No. 23 1999 and other amendments	BOI – the Central Bank OJK – responsible for regulation and supervision of banks, insurance companies and pension funds	Separate *Shari'a* board required
Iran	Law for Usury Free Banking 1983	BMJII – Single banking system based on *Shari'a* principles Separate regulator for insurance	No *Shari'a* board
Kuwait	Law No.30 of 2003 that amended Law No. 32 of 1968	CBK monitors Islamic banks under dual investment system of banking Separate regulator for insurance	Separate *Shari'a* board for each bank
Malaysia	Islamic Banking Act 1983	BNM is responsible for Islamic banks, leasing companies, *takaful* companies, investment banks and conventional institutions operating in these areas. The MOF is closely involved in the supervision of Islamic banks SEC is responsible for securities markets, investment banks	Separate *Shari'a* boards at institutional level and in the BNM and SEC
Pakistan	Banking Companies Ordinance (BCO) 1962 as amended	SBP for Islamic banks SECP for *takafuls*, securities markets, investment banks, modarabas, leasing companies	At the SBP level At each Islamic banking institution

	Legal Authority	**Regulatory, Supervisory and Monitoring Arrangements**	***Shariah* Boards**
Sudan	Bank of Sudan Act (BSA) 2002	Bank of Sudan – a single banking system based on *Shari'a* principles applied in the North of the country and, most recently, a system for conventional banks to serve the South of the country.	Central Bank has a *Shari'a* supervisory board. Separate Shari'a boards for banks

The column on *Shari'a* boards is interesting in that it shows that a number of different approaches have been taken by regulators. The fundamental question of course is whether *Shari'a* compliance should be a matter of regulatory interest or whether the regulator should be solely concerned with financial issues within its own legal and social environment.

As touched on in an earlier chapter, the need to refer product structures to the *Shari'a* board can introduce delays that place Islamic banks at a disadvantage when competing with conventional peers. It can also mean that there are contradictory rulings from the boards of different banks. Where the central bank convenes its own *Shari'a* board, it holds the ultimate decision on the validity of any new product. One of the main advantages of this regulatory approach is that it creates a level playing field in *Shari'a* compliance, or sets a minimum standard, as banks can still decide to follow a stricter course. It also mitigates some of the governance tensions that may arise between bank management and their in-house *Shari'a* board. The success of a central board will depend on the ability of the central bank to attract top *Shari'a* scholars with financial expertise. It would be a more demanding appointment for any scholar than working with one specific bank, but the board's decisions should be more transparent and it should lead to faster and more consistent decisions. On the other hand, the scholars serving at the bank level would have a diminished role. While still involved in product development, their main emphasis would shift towards compliance and auditing. The system does seem to have been successful in Malaysia where the central board discusses new concepts openly and issues public judgements.

Accounting

AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions) has been trying to introduce some standardization in accounting rules and has been instrumental in improving transparency and disclosure where its standards have been adopted, but at present, these standards have not been widely used. AAOIFI is not a regulatory body and it is up to regulators to decide whether or not to adopt

AAOIFI standards for Islamic banks in their jurisdictions. Again, there are regulatory concerns over adopting different standards for conventional and Islamic banks.

Regulatory Challenges

For regulators and supervisors, the capital treatment of some Islamic products is difficult. Should *Mudaraba* and *Musharaka* investments attract the weight proposed in Basel II for equity investments? Should *Ijarah* mortgages be treated in the same way as conventional mortgages? Are those regulators correct who say that banks have a constructive obligation to PSIA holders that warrants treating them in the same way as conventional deposits? If not, what protection should there be for PSIA holders? Indeed, under most current regulatory structures, the interests of PSIA holders are not considered. They need some protection from managers adopting inappropriate strategies – either too much or too little risk taking – catering to shareholders' interests that may well be in conflict with those of PSIA holders.

Liquidity is a further concern. What liquidity requirements should regulators and supervisors place on Islamic banks, given the structure of their balance sheets and also the lack of a range of liquid products in which the banks may invest?

Although some hedging products are being developed, these are still in their early stages and *Shari'a* boards are not all convinced of their legitimacy. While regulators may not be too concerned by this divergence in view, it complicates the risk management framework that they might adopt and the whole supervisory process.

Also, how should regulators take account of the fact that, although growing, Islamic finance is still a very small component of the global financial market? It is also much less developed and is not supported by the huge body of research that underpins the conventional system. This also means that there is a lack of management skills within the Islamic institutions to understand the growing complexity of their operations. This on its own increases the inherent risk.

Islamic banking, in its current form, is as much like trading as banking. The banks have real assets on their balance sheets and assume far more risks of ownership than conventional institutions. Even if these "trading" activities are carried out by subsidiaries, should regulators limit the scale of these operations?

Finally, but by no means least, Islamic banks do not have banking books and trading books in the way seen in universal banks. There are no "Chinese walls" between operations and very little disclosure. Banks routinely transfer assets between unrestricted investment accounts, restricted investment accounts, shareholders equity, investment funds and SPVs without adequate disclosure being provided, although an AAOIFI standard introduced from 2005 does stipulate that these disclosures should be provided along with accounting policies and valuations. Should regulators and supervisors put limits on this and monitor compliance? Is disclosure alone an adequate safeguard?

This is not an exhaustive list, but is meant to convey the scale of the issues facing regulators and supervisors that go beyond the issues covered in the banking law for conventional banks. AAOIFI standards would go a long way towards improving the financial disclosures and governance standards of Islamic institutions if more banks were to adopt them. The current preference would be for banks to use AAOIFI standards, for the additional disclosures they provide, but to use them in combination with IFRS. It was always the intention of AAOIFI that they would accept international standards where these fit with Islamic operations – they would not try to reinvent the wheel. The difficulty comes when there is a conflict between the standards. In many cases there is a choice of accounting policies and banks will choose the most appropriate one for their own operations. However sometimes the choice made may lead to less than optimal disclosure.

Islamic Financial Services Board

The more recently established Islamic Financial Services Board (IFSB) which is based in Kuala Lumpur could have a more dramatic impact on the industry than AAOIFI has done so far. This will depend on whether the standards it is developing become widely accepted. It has been working quickly, but with considerable consultation, to produce the most important standards. Established in 2002, its remit was to provide prudential standards and guidelines for international application by banking supervisors in the supervision of Islamic banks. In December 2005, its mandate was extended to include insurance and securities market supervisors and regulators.

Its first standards were on capital adequacy[1] and risk management[2] and these were followed by corporate governance[3], the supervisory review process[4] and transparency[5]. It has also published additional documents, including a compilation guide on prudential and structural Islamic finance indicators[6], which is the first step towards the compilation of comprehensive and consistent data on the Islamic finance industry.

In addition it has published two guidance notes, one on the recognition of external ratings for capital adequacy purposes[7], and a second on the key elements in the supervisory review process[8]. At the time of writing, two further exposure drafts are near to finalization, one on capital adequacy requirements for *sukuk* securitizations and real estate investment[9] and the second on guiding principles on governance for Islamic collective investment schemes[10]. It has also produced a technical note

[1] Capital Adequacy IFSB December 2005
[2] Risk Management IFSB December 2005
[3] Corporate Governance IFSB December 2006
[4] The Supervisory Review Process IFSB December 2007
[5] Transparency IFSB December 2007
[6] Compilation Guide
[7] Use of ratings
[8] Key Elements in the Supervisory Review Process
[9] Capital Adequacy for sukuk securitisations
[10] ED Collective Investment Schemes

on the issues in strengthening liquidity management in institutions offering Islamic financial services[11]. This was referred to in this handbook in the chapter on liquidity management.

One other document has been published (and will be referred to more in a later chapter), this time in collaboration with the IRTI, the research and training arm of the Islamic Development Bank. This is a 10 year framework and strategy for the development of the Islamic finance industry[12]. As stated at the beginning of its executive summary:

> *"This document, which will be revised and updated periodically by its initiators, aims to provide a general framework that national authorities may find beneficial for designing Islamic financial services industry (IFSI) development initiatives and integrating these in their national financial sector development policies. The document also aims to offer an integrated basis for promoting international policy dialogue among stakeholders and fostering the orderly development of an efficient, sound, resilient and sustainable IFSI in the rapidly changing global market, technological and regulatory environments."*

One of the many challenges faced by the IFSB is to develop a framework that is applicable in all jurisdictions, given the current divergence in the views of *Shari'a* scholars and regulators. In addition, as mentioned by Simon Archer and Rifaat Ahmed Abdel Karim[13], unlike the Basel Committee, the IFSB does not have the privilege of borrowing ideas from a large number of countries that have developed robust regulatory frameworks specifically for Islamic banks.

The standard on capital adequacy raises several important issues that regulators need to consider. The first question is to ask why an Islamic bank requires capital. In a conventional bank, capital is there to protect against unforeseen losses. In an Islamic bank funding is largely provided by profit and loss sharing investment accounts so any loss should be borne by the investment account holders. It could be argued that the risk for an Islamic bank is that the investment accounts are withdrawn for some reason leaving the bank with a funding gap and so liquidity risk. However, as has been discussed earlier, banks are aware of competition for deposits. They are also aware that their investment account holders are generally risk averse and are looking for returns that closely match those available from conventional banks. For this reason banks take profit equalization reserves (PER) and investment risk reserves (IRR) so that they can match the expectations of their customers. It also means that if the reserves are inadequate, Islamic banks would probably turn to shareholders funds to provide the expected return.

A number of regulators have argued that by taking reserves, the investment accounts held by the Islamic banks are very like conventional deposits. The capital of the

[11] Issues in strengthening liquidity

[12] 10 Year framework

[13] Islamic Finance: The Regulatory Challenge edited by Simon Archer and Rifaat Ahmed Abdel Karim, Wiley, 2007

bank could be at risk if the assets funded by investment accounts failed to perform. Also, if banks routinely use profit equalization reserves and investment risk reserves to smooth the returns to investment account holders, they have a constructive obligation to continue the practice.

The IFSB capital adequacy standard comes in two versions. The first says that losses from the assets funded by investment accounts are borne by the account holders and so these assets should not be included in the capital adequacy calculation. The second option says that assets funded by unrestricted investment accounts, because they are probably commingled with the bank's own funds, should be included in the calculation, up to a certain proportion, with this proportion determined by the regulator. The IFSB feels that it should be no more than 30%. While in early drafts restricted investment accounts were treated in the same way, the final standard says that these accounts can be treated as purely fiduciary.

The other main issue addressed by the IFSB in its capital adequacy standard is the risk weighting of assets. As discussed earlier, the risks associated with Islamic products are not exactly like those seen in their conventional counterparts. For example, where a conventional bank may hold the debt of its customer having provided a loan, an Islamic bank may own real estate or a car, or some other asset, which is being purchased by its customer. It is when Islamic banks have engaged in *Mudaraba* or *Musharaka* financing transactions with customers, that the most difficult issues arise. The banks are exposed to possible gains but also to potential losses from the businesses funded in this way where they provide all or part of the capital. In some ways this is similar to the risks that equity investors bear. Basel II does not provide for this type of financing explicitly. It does have a category termed "equity position risk not in the trading book" and this could be the most appropriate treatment. It is meant to cover cases where banks hold equity in companies as part of their relationship with that client. However, it does require a high risk weighting that would be a considerable disincentive for an Islamic bank engaging in such transactions. As a more acceptable alternative, the IFSB suggests that this type of financing could be regarded as a form of "specialized lending", and under this option Basel II provides for "regulatory slotting" to arrive at the risk weightings. While these weightings, determined by the regulator, are still high, and could discourage banks from using these *Shari'a* preferred modes of financing, they probably do more fairly reflect the risks to the bank.

Bahrain

At present, many regulators are committed to implementing IFSB standards in full or in part. Bahrain is probably most advanced in this and it has added to its law on Islamic banking so that it follows IFSB standards. As the single regulator in Bahrain, it has an advantage over many other regulators. Also, as the host to AAOIFI, it was the first regulator to specify that Islamic banks should report to AAOIFI standards.

It has implemented the IFSB standard on capital adequacy but has opted to require a capital allocation for assets funded by unrestricted investment accounts at the maximum level suggested by the IFSB of 30%. For *Mudaraba* and *Musharaka* exposures, the CBB has chosen to use regulatory slotting criteria and will expect risk weights between 90% and 270%, depending on the details of the transactions. Banks can use external credit assessment institutions (ECAIs) to determine risk weightings and the CBB recognizes ratings assigned by Standard & Poors, Moody's, Fitch, Capital Intelligence and the Islamic International Rating Agency. Importantly banks must use the chosen ECAIs and their ratings consistently for each type of claim, for both risk weighting and risk management purposes. Banks will not be allowed to "cherry pick" the assessments provided by different eligible ECAIs.

For liquidity, the most significant rule relates to the permitted level of negative maturity mismatch and this rule must be applied to funds from unrestricted and restricted investment account holders as well as other sources of funds.

One of the most recently added sections to the rule book relates to operational risk management. The rules are mainly principles-based and banks have the option of using the basic indicator or standardized approach for capital adequacy purposes.

Other points of note include:

Murabaha revenue must be recognized on an accrual basis.

Mudaraba revenue can only be recognized when it is distributed.

Each *Salam* and *Ististna'a* contract must have a parallel contract.

The CBB allows conventional banks to provide Islamic services through specific distribution channels, such as Islamic windows or branches, but subject to a number of conditions, prime amongst which is the need to avoid commingling of funds. Islamic transactions must be carried out at dedicated windows or branches and separate accounts must be kept and reported using AAOIFI standards. In addition, certain staff must be dedicated to Islamic business, including a treasurer or senior trader. The bank must also appoint a *Shari'a* board with a minimum of three members.

Pakistan

Pakistan is much less advanced than Bahrain in developing a truly Islamic system and the first of the circulars from the Islamic Banking Department (IBD) was issued in 2003. Prior to 2002 there were just four branches offering Islamic banking services, by the end of 2007 there were 231. The State Bank (SBP) has said that it wants to implement IFSB standards. It has been a full member of the IFSB since its inception and believes that it therefore has a responsibility to adopt/adapt the standards.

It is also anxious for the Islamic banks and branches to work to common standards. One of the first tasks undertaken by the IBD was to produce model agreements for the various modes of Islamic financing.

In 2008 it has produced risk management guidelines, based on the IFSB standard. These guidelines are to be implemented in addition to the guidelines already issued by the SBP and follow the 15 principles of the IFSB standard. Also in 2008, the IBD has issued instructions and guidelines for *Shari'a* compliance. The instructions cover various areas related to the appointment, removal and working of *Shari'a* advisors; conflict resolution in *Shari'a* rulings; the introduction of new products, and several other issues. The circular also discusses risk management practices associated with specific modes of Islamic financing.

Pakistan is a country where there is a *Shari'a* board at the SBP and boards at every institution offering Islamic products. The SBP board has a unique structure in that it consists of members drawn from Islamic scholars, bankers, accountants, lawyers and other relevant fields. It has a minimum of five members of whom at least two must be *Shari'a* scholars. One member should be an accountant, one a lawyer and one should represent bankers. The Director of the IBD is also a member. The SBP believes this structure means that no issues are overlooked when the board has to give a ruling. The role of the SBP board is to advise on the procedures, laws and regulations pertaining to Islamic banking in the light of *Shari'a* principles. The banks' own boards can make many decisions without reference to the SBP board, but any disagreements either between a bank's *Shari'a* board and management, or between the scholars themselves, can be referred to the SBP board for a final decision. Earlier guidelines have established "fit and proper" qualifications for members of *Shari'a* boards and also stated that scholars may only sit on the board of one bank (or that bank and its mutual fund subsidiary) and may not hold an executive or non-executive position in another institution.

SBP is in the process of implementing the IFSB standard on capital adequacy but has been conducting an "impact study" to identify any issues that may arise in Pakistan and to decide on a reporting format.

Final Comment

Many challenges remain before there is a comprehensive regulatory and supervisory framework in all the markets where Islamic banking is practiced. The IFSB is working quickly, but the waters are uncharted and it will take time to resolve all the issues and develop a robust system that can be easily adapted to each market. The commitment is there, the debate is lively but always constructive.

Chapter 12

International Islamic Banking

In this chapter the aim is to explore the interest in Islamic banking in markets around the world where the Muslim population is a minority but where regulators have recognized that allowing Islamic banking products provides opportunities. However, while there are opportunities, there are also regulatory challenges that have been approached in several different ways.

The countries covered are the UK, USA, Switzerland, Hong Kong and Singapore. These are the markets where regulators have been most active and have taken, or are beginning to take, steps to ensure that Islamic banking products can be provided in their markets. While the pace of development may seem slow, in other countries where the potential may seem even greater, the pace has been markedly slower. This is particularly so in continental Europe where there has been no swell of activity, although there do seem to be opportunities, given the sizeable Muslim populations in many markets. For example, the Muslim population of France has been estimated to be between 4.2mn[1] and 6.0mn[2] while the Muslim population of the United Arab Emirates is only between 2.7mn and 3.4mn[3]. While France has yet to open its first Islamic bank, the UAE has seven national banks offering only Islamic services and any number of foreign banks also providing *Shari'a* compliant products.

[1] Wikipedia estimate

[2] www.factbook.net

[3] Wikipedia estimate, 2.9mn according to www.factbook.net

Switzerland

In Switzerland, with its history in private banking, only the Faisal Group has established a fully Islamic bank, although UBS and Credit Suisse do offer Islamic products. Interestingly, in 2002 UBS established Noriba Bank, an Islamic banking subsidiary, in Bahrain but, in 2006, it took the operations of this unit back into the wealth management division of the bank as it claimed that customers preferred to work directly with UBS. Of the well-known private banks, Pictet & Co. does offer *Shari'a* compliant products for high net worth customers. There have been no significant pronouncements from the central bank, as regulator.

Hong Kong

The Hong Kong Monetary Authority (HKMA) has been making comments recently about its desire to embrace Islamic banking and, in particular, see Islamic bonds listed on its exchange. The 2006 Annual Report of the HKMA contained the following comment:

> *"Although domestic demand for such products is likely to be modest, Hong Kong's position as an international financial centre creates an opportunity for it to develop wholesale markets in Shariah-compliant instruments as a complement to those in London and elsewhere in Asia. Hong Kong's legal system and regulatory structure is likely to be sufficiently flexible for the regulation of most Islamic capital products in the same way as other similar wholesale and retail financial products. The HKMA will work with the Government and other regulators to understand more about Islamic finance, and will develop policies to create the framework that would allow Islamic financial business to be transacted efficiently and to help maintain financial stability."*[4]

From this, it seemed as though Hong Kong's ambitions might embrace the full range of Islamic products, however after conducting a study, the ambitions seem more focussed on providing a framework for the listing of Islamic bonds on the Hong Kong Exchange. The 2007 Annual Report contained the following:

> *"The HKMA also initiated a study on developing an Islamic finance platform in Hong Kong drawing on the expertise of the Treasury Markets Association (TMA). The study was designed to assess the market potential and identify existing hurdles to the development of an Islamic bond market in Hong Kong, and to make recommendations on any changes that might be needed in the taxation, legal and regulatory framework. The findings suggest that Hong Kong's existing legal and regulatory infrastructure can*

[4] HKMA Annual Report 2006 Banking Stability p20

readily support the development of an Islamic bond market. However, Hong Kong's tax laws need to be changed or clarified to provide a level playing field for the issuance of Islamic bonds in Hong Kong. A report containing policy recommendations was submitted to the Government in late 2007."[5]

The potential role for Hong Kong as a centre for international Islamic finance will be explored further in a later chapter.

Singapore

Singapore sees itself as the financial hub of Asia and as such it wants to be able to provide a full range of banking and capital market products. It took a major step towards embracing Islamic banking in 2005 when it announced that all banks would be able to offer *Murabaha* finance. Previously it had described such financing as a non-financial activity, because banks have to purchase the goods and then sell them to their customer. It also said that it would not develop a separate regulatory regime for Islamic banks as it regards many of the supervisory processes and prudential measures as common to both conventional and Islamic banking activities. It will level the playing field by ensuring the neutrality of MAS' rules where Islamic financing is similar to conventional financing in economic substance and risks. Where there are specific risks or impediments, MAS will refine rules to address those specific areas. One of these was also addressed in 2005 when it announced the removal of the double stamp duties on Islamic transactions involving real estate.

Mr Tai Boon Leong, Executive Director, Monetary Authority of Singapore, in his opening remarks at the Singapore Islamic Finance News Forum 2008[6], said:

"In 2006, MAS clarified income tax and GST treatments for Shariah compliant financing arrangements involving the cost-plus, investment-partnership, and lease-with-option-to-purchase concepts, which are based on the Murabaha, Mudaraba, and Ijara wa Igtina structures respectively. At the same time, we also clarified treatment for Sukuks based on the concept of sale-and-leaseback. These treatments were enacted so that Shariah compliant deals based on these structures would not be disadvantaged vis-à-vis their conventional counterparts. That year, MAS also allowed banks to offer Murabaha investments, and in 2007, we accorded retail Murabaha investors the same regulatory protection under the Banking Act as conventional depositors, for example in priority of claims ahead of general unsecured creditors."

"More recently, the Finance Minister in his February budget announced that we will offer a 5% concessionary tax rate on the income derived

[5] HKMA Annual Report 2007 p86

[6] www.mas.gov.sg/news_room/statements/2008/Opening_Remarks_by_Tai_Boon_Leong_at_the_Singapore_Islamic_Finance_News_Forum.htm

> *from qualifying Shariah compliant financial activities such as lending, fund management, insurance, and reinsurance businesses. In addition, all investors will receive tax exemption on income derived from qualifying Sukuks. The details are being prepared and will be issued in due course, and they shall be aligned with existing concessions to create a seamless framework for the Islamic finance industry in Singapore."*

The conventional banks in Singapore have offered deposit accounts and various financing schemes to their Islamic customers for some time. Most notably, OCBC has a significant volume of Islamic business. It calls its deposit accounts *Wadi'ah* accounts, where customers are called on to trust the bank to provide a return. No interest is paid, but the bank may share its profits with *Wadi'ah* account customers by making them a gift, although it has no obligation to do so. It also offers various types of financing which generally involve customers paying a fixed rate for the duration of the loan.

DBS has been the first bank to establish an Islamic bank subsidiary. The Islamic Bank of Asia, with a paid up capital of US$500mn, was incorporated in May 2007. Its shareholders are DBS, which holds 50% plus one share, and 34 investors from prominent families and corporate groups in the GCC. The bank focuses on wholesale commercial banking, corporate finance, capital markets and wealth management services.

United States of America

Many observers have claimed that the USA and its banking regulators are Islamaphobic, but this is not the case. However, the regulatory system in the US is complex and, depending on the products that an institution wishes to offer and its location in the US, it may need the approval of several regulatory bodies before it is allowed to commence operations, and this can seem unweloming. The Federal Reserve approved *Shari'a* compliant products as long ago as 1985 when Citibank, Chase and Bank of America were allowed to offer Islamic products in overseas markets where such products were becoming widely used and accepted. Most notably this applied to operations in Saudi Arabia, Bahrain, Malaysia and Pakistan.

In 1997 and 1999, the OCC issued "Interpretive Letters"[7] describing in some detail how they could accept mortgage products using the concepts of *Ijarah*, *Wadiah* and *Murabaha*. The US regulators will not change the banking law, but always try to be flexible in their approach. The main issue with Islamic mortgages is that they require a retail commercial bank to take title to real estate and this is not allowed, except in foreclosure of a mortgage. Here the OCC focused on the economic substance over form and concluded that the risks involved in these Islamic products were not the ones that the regulation was trying to prevent.

[7] OCC Interpretive Letter #806, December 1997; Interpretive Letter #867 November 1999

Today there are a few banks offering *Shari'a* compliant services, mainly home, auto and business finance products. There are also a few finance houses with similar offerings. Although the banks aim to expand their operations, they are still small community banks. The main players are a subsidiary of University Bank in Ann Arbor, Michigan[8] and Devon Bank in Chicago, Illinois[9]. The other main participants are LARIBA-American Finance House[10] and the Guidance Financial Group[11]. The Shape Financial Corp.[12] with offices in Virginia and Kuwait has been the advisor to a number of institutions that have considered offering *Shari'a* compliant products in the US. Another similar company is Shariah Capital[13]. Based in Connecticut, and with an office in Dubai, it is listed on London's AIM. Eric Meyer, who is President and Chief Executive, has been fully involved in Islamic finance for the last eight years and lays claim to have developed the first *Shari'a* compliant hedge fund. Always working closely with some of the top *Shari'a* scholars, in 2006 Shariah Capital appointed Sheikh Yusuf Talal DeLorenzo as its full time Chief Shariah Officer and a member of its Board of Directors. Sheikh Yusuf comes with a formidable reputation as the foremost *Shari'a* scholar in the US. Shariah Capital creates *Shari'a* compliant products and provides consulting services mainly for financial institutions and investment management funds. It has also built its own software engine to screen equities.

The issue of profit and loss sharing deposit accounts is still unresolved. University Islamic, for example, has a profit sharing deposit product, but customers do not share in any losses. The *Shari'a* board has accepted that it is a regulatory requirement that a deposit is a capital guaranteed product and subject to FDIC requirements. There are also restrictions on partnerships that make *Mudaraba* and *Musharaka* products unacceptable.

United Kingdom

The involvement of the London markets with Islamic products probably dates back at least to the 1980s when commodity Murabaha transactions became the favoured source of liquid assets for Middle East Islamic institutions. The desire of the UK financial community to go further and attract Islamic financial institutions to its shores goes back to a speech made by Lord Edward George in 1995 when he was Governor of the Bank of England. At that time the Bank was the UK banking regulator. He spoke of the issues that would need to be addressed but also of his conviction that these could be resolved.

During the 1990s there were limited scale retail offerings by Middle East and South East Asian banks, most particularly in the area of home finance. However these products were not competitively priced and were outside of the existing regulatory

[8] www.universityislamicfinancial.com

[9] www.devonbank.com/islamic

[10] www.lariba.com

[11] www.guidanceresidential.com

[12] www.shapefinancial.com

[13] www.shariahcap.com

framework. More recently, other banks such as HSBC Amanah and Ahli United Bank have offered home purchase plans that are largely funded conventionally and so have not been fully accepted by the *Shari'a* scholars.

In 2001, the government showed its commitment by establishing a high level working group chaired by Lord George and including representatives from the city, government, Muslim community and the Financial Services Authority (FSA), which by then had taken on the role of the UK's single regulator for all financial services.

Sir Howard Davies, when he was chairman of the FSA, spoke at an Islamic banking conference in Bahrain in September 2003. He said that there was no objection to having an Islamic bank in the UK but it would have to meet FSA requirements. He said that such a move would be good for Muslim customers, good for innovation and diversity in financial markets and good for London as an international financial centre. He further said that there would be no obstacles, but no special favours.

The government has recognized some of the tax problems encountered when structuring Islamic products. In the 2003 Finance Act, it changed the regulation on the Stamp Duty Land Tax so that there was no need for double payment when *Shari'a* compliant products were offered. Further minor changes were made in 2005 and 2006 and in 2007 clarifications were made over the treatment of *Sukuk*, and *Ijara*-based contracts for home purchase were brought within the FSA's regulatory framework.

The flexible approach adopted by the government and the FSA has led to the establishment of a number of wholly Islamic financial institutions with as many as 50 conventional banks also having obtained permission to offer Islamic products. The first Islamic bank was the Islamic Bank of Britain[14] which was established as a retail Islamic bank in 2004. This bank has not been profitable so far and the uptake of its products has perhaps been slower than anticipated, but the growth is positive. It offers treasury financing products and savings products as well as housing finance. Next to follow came two wholesale banks, European Islamic Investment Bank[15] in 2006 and The Bank of London and the Middle East[16] in 2007. The most recent initiatives have seen the establishment of an Islamic hedge fund manager, Amiri Capital and an Islamic *Takaful* provider, British Islamic Insurance Holdings[17], which in turn operates through Principle Insurance Holdings under the brand name of Salaam Halal Insurance[18] offering *Shari'a* compliant car insurance with home insurance promised soon. The two most recent wholesale banks, launched in 2008, are European Finance House[19] and Gatehouse Bank[20]. The promoter of European Finance House is Qatar Islamic Bank while Gatehouse Bank is a subsidiary of Kuwait's The Securities House.

[14] www.islamic-bank.com

[15] www.eiib.co.uk

[16] www.blme.com

[17] www.biih.co.uk

[18] www.salaaminsurance.com

[19] www.europeanfh.com

[20] www.gatehousebank.com

While the FSA wishes to accommodate Islamic finance, it has to abide by the terms of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (RAO). There have been three main issues that the FSA has needed to resolve: first, all products offered need to come under one of the regulatory definitions of a product and meet all the requirements of that definition; second, the role of the *Shari'a* advisors needed clarification; and third there could be issues over financial promotions.

If a product falls outside the Regulated Activities Order, there may be restrictions on whom it may be sold to and so it is important for banks to ensure that they can fit their products within the regulatory definitions. One such requirement relates to deposits. The regulatory definition includes capital protection. This makes it impossible for banks to offer profit and loss sharing accounts under the name "deposit". The Islamic Bank of Britain has got around this restriction by having its deposit product capital guaranteed but, if there is a loss, it has given its customers the option of giving to charity the amount that they receive over and above the amount due under *Shari'a*-compliant profit and loss sharing terms. This device has been accepted by the bank's *Shari'a* board. A further example is the Islamic mortgage product. It cannot be sold as a mortgage as it does not possess all the features of a mortgage, but it can be sold as a "Home Purchase Plan" (HPP) and any bank offering the product must make certain disclosures about the product so that customers can have no misunderstanding of their rights. The FSA has also produced a brochure describing the Home Purchase Plan and highlighting the information that should be provided by the bank. This is part of the FSA's efforts to ensure that customers fully understand all banking products. These brochures are available on the FSA-developed website "money made clear"[21].

The role of the *Shari'a* board is also of concern. If the board has more than a simple advisory role, board members could be seen as executive directors of the bank. There are certain qualifications that must be met by anyone becoming such a director. At present, many *Shari'a* scholars would not meet these requirements. So far all the banks have been able to show the FSA that the role of their *Shari'a* board is indeed just advisory. In view of the role that AAOIFI and the IFSB see for *Shari'a* boards that were discussed in earlier chapters, many of the potential functions could go beyond those of simple advice, so this remains an area where diligence is required by all concerned.

One of the principles that the FSA has set is to ensure that all firms "treat customers fairly" (TCF). Under this principle they look at all financial promotions. The FSA wants to be sure that no promotions are misleading and that customers will understand all the costs, risks and other aspects of any products being offered. While this is no different for Islamic banks than for conventional banks, Islamic products are new to the market and may not be understood fully by potential customers. So far there do not seem to have been particular issues in this regard, but again, careful diligence is required by all.

[21] www.moneymadeclear.fsa.gov.uk

More detail on the current position in the UK can be found in various FSA publications, most notably in the document "Islamic Finance in the UK: Regulation and Challenges"[22]

[22] www.fsa.gov.uk/pubs/other/islamic_finance.pdf

Chapter 13

Islamic Equity Investments and Islamic Funds

Equity Investments

If a company's business is legitimate, and if its conduct is in compliance with the *Shari'a* rules, Muslims are allowed to invest in its equity. There are close parallels with the ethical investment industry which has growing significance in conventional markets. However, for the Muslim investor, there are additional concerns over the legitimacy of investing in stock markets given the inherent uncertainty over stock prices, the element of *Gharar*, or ambiguity in the information provided to investors, and also worries about the speculative element.

Many Muslim investors choose to invest through mutual funds that comprise acceptable stocks. There are only limited services available to assist investors identify suitable stocks or to offer portfolio management services. Al Rajhi in Saudi Arabia and the Al Baraka group offer a partial service, but they do not claim to be specialists. As a result, mutual funds offer a convenient alternative as well as some additional advantages. Within the pool of permitted equities, a variety of funds can be established, such as technology, high-growth, blue-chip, regional, etc. etc. The broad diversification provided by a fund helps reduce risk and the scale of the investments reduces costs. In some cases mutual fund managers also pay *Zakah* on behalf of investors as well as screen all the stocks.

However, a number of compromises have been made by jurists in allowing Islamic mutual funds and Islamic stock indices. If strict *Shari'a* rules were applied, the pool of permitted stocks would be too small for any diversification to be possible. Most listed companies either borrow to some extent – of course with interest – or they are cash rich and so invest – again with interest – and then trade in the instruments purchased. Also, in many countries, taxation rules encourage debt financing.

So, mutual fund companies and those who prepare Islamic indices employ *Shari'a* boards who determine a set of rules for selecting an eligible pool of stocks. Nevertheless, it is still seen as the responsibility of every individual investor to accept responsibility for their own investment decisions.

The two principle groups of indices are those produced by Dow Jones – the Dow Jones Islamic Market Index[1] – and the FT – the FTSE Global Islamic Index Series[2]. The FTSE Index is produced in conjunction with The International Investor. Both use similar filters. The first set is relatively straightforward. All companies whose primary business involves alcohol, pork, tobacco, financial services, weapons & defence, and entertainment (hotels, casinos/gambling, cinema, pornography, music, etc.) are excluded. Companies that obtain some of their income from *haram* activities may be included on a case by case basis as there is no reference in *Qur'anic* teaching to percentages. So, for instance, airlines may be included even though some of their revenue is derived from the sale of alcohol. The second set of filters is based on financial filters but is somewhat subjective. It aims to exclude companies that carry excessive interest-bearing debt, receive interest or other impure income or trade in debt instruments. Most *Shari'a* boards have reached similar compromises, but there are differences. The following is the list of rules used by the Dow Jones Islamic Market Index at present:

All of the following must be less than 33%:

1. Total debt divided by trailing 12-month average market capitalization
2. The sum of a company's cash and interest-bearing securities divided by trailing 12-month average market capitalization
3. Accounts receivables divided by trailing 12-month average market capitalization

These compromises have been established by the *Shari'a* Supervisory Board and are designed to remove companies with unacceptable levels of debt or impure interest income, or are illiquid. They are based on a famous *hadith* where Sa'd asked the Prophet how much of his wealth he should give to charity, and the Prophet said "one-third, and one-third is plenty". Jurists do not claim that this is a legal proof, rather a comforting rule of thumb.

These compromises may seem extremely arbitrary. It is unlikely that such fixed cut-off rates will ever be appropriate. In addition, managers and investors need to continually monitor companies in case their ratios change, or even their business mix changes. Most boards have allowed managers a period of time in which to sell stock in companies that no longer pass through the filters, so the disposal may be orderly and not subject the investors to unnecessary losses.

However, at present the Islamic equity funds industry is reactive and disinvests from companies once they no longer pass the screens. This can prove costly for investors.

[1] www.djindexes.com/mdsidx/?show=eventIslamic/

[2] www.ftse.com/Indices/FTSE_Shariah_Global_Equity_Index_Series/index.jsp

By contrast, the ethical investment industry is now largely proactive and uses its financial muscle to engage with companies and encourage change. As the Islamic industry grows in size and importance, it may also be able to consider a similar approach.

Funds

For some time, funds have been a significant component of the Islamic financial market. They have provided convenient vehicles for *Shari'a* compliant investing and have been used by asset management companies and also by banks that are looking for ways of investing the funds of their investment account holders.

The 1990s saw a burgeoning of companies, mainly offering mutual fund products to Islamic customers. They continue to have a strong presence today. Some use their own analytical resources, others have joint ventures with major international names who provide this expertise. The funds have had mixed results with some significantly underperforming the Dow Jones Islamic Index or the FTSE Islamic Index. Others have consistently outperformed the market. There seems to be significant volatility in performance when compared with conventional funds. In part this is attributed to the fact that many of the funds are much smaller than their conventional counterparts and this alone makes their performance more volatile.

The first Islamic fund dates back to 1971 when the Asia Unit Trust Berhad was established. Based in Malaysia it is an open-ended fund investing in equities.

No other record is available until 1986 when The Amana Income Fund, an Islamic equity fund, was formed in the US by members of the North American Islamic Trust. In that same year, four other funds were established in Saudi Arabia by Samba – then known as Saudi American Bank. Three of these funds were equity funds while the fourth invested in commodities. A database of Islamic funds was developed by Failaka[3] and today that fund lists 326 funds. IFIS[4] has its own database and this lists 490 funds. The numbers referred to here have been derived from the IFIS data. After a somewhat hesitant start, with four or five new funds being offered most years, growth took off in the late 1990s/ early 2000s when the number of new funds increased by the teens. In 2005 there were as many as 58 new funds, 77 in 2006, and a peak of 112 in 2007. At the time of writing, growth seems to have been impacted by global financial concerns and as of October 2008 only 48 new funds had been established in 2008. Nevertheless, the market has clearly seen significant impetus over the last decade.

In 1987 the AlBaraka Group established two companies in Bahrain, Al-Tawfeek and Al-Amin, which were specifically dedicated to the development of Islamic equity funds. They have subsequently successfully diversified their operations to other types of fund.

[3] www.failaka.com

[4] www.securities.com/ifis

One interesting development was in Pakistan in the early 1980s with the establishment of *Mudaraba* Companies. Strict regulations were laid down as to minimum capital, a limit on management charges to 10% of profits and restrictions on related parties. There were attractive tax advantages and, at their peak, there were over 50 companies. In the early days there were one or two scandals and companies that had been offering high returns were found to be fraudulent. To help protect investors, all of these companies now must obtain ratings from a local rating agency.

While initially most funds were targeted at institutional and professional investors, many now serve the retail market. Indeed at present, sovereign wealth funds and other large institutional investors seem happy to place their wealth in conventional markets. However, the more growth there is at the retail level, and the more retail customers see that *Shari'a* compliant investment options are available, the more they will expect *Shari'a* compliance from the top end of the market.

Table Appendix 1.1 in Appendix 1, using data from the IFIS database, gives a breakdown by type of fund and location. It also includes the number of fund managers in each country. A further table, Table Appendix 1.2 gives some information on those fund managers who manage more than 10 funds. Nearly half of the funds are equity funds and many of these are domiciled in Malaysia or Saudi Arabia. One of Malaysia's traditional strengths is its range of listed companies operating in many diverse industries, from plantations to properties and natural resources to technology. According to the Chairman of the Securities Commission Malaysia[5], 85% of the listed securities on Bursa Malaysia and nearly 66% of total market capitalization are *Shari'a* compliant. More and more companies are having their *Shari'a* compliant status determined by the Shariah Advisory Council prior to going for an IPO because of the premium that *Shari'a* compliance places on them. This gives considerable scope to CIMB-Principal, as the leading fund manager, and others, to establish equity-based funds.

Almost all the bond funds are in Malaysia while almost all the real estate funds are domiciled in the GCC. This latter split reflects the fact that Malaysia has been at the forefront in listing Islamic bonds, with a high proportion of all listings being *Shari'a* compliant. On the other hand, the boom in real estate development in the Gulf markets accounts for the preponderance of real estate funds in the GCC.

Hedge Funds

There is still a lot of debate about whether hedge funds can be *Shari'a* compliant and whether the devices used to mimic the strategies used by conventional hedge funds are legitimate. That said there have been a number of significant efforts to develop such funds.

[5] Paper given by YBhg Dato' Zarinah Anwar at the Malaysian Islamic Finance Issuers and Investors Forum 2008, August 2008.

The International Investor (TII) launched the Al-Khawarizmi Market Neutral Fund in 1997. It was managed by Axa Rosenberg. A market neutral fund uses a mix of long and short positions to neutralize market risk.

The Alfanar US Equity Hedge Fund was launched in 2003 by the Saudi Economic and Development Company (SEDCO) and the Permal Group and it claimed to be the world's first Islamic hedge fund. It used a long-short strategy based on *Salam* contracts.

Noriba Bank was the Special Advisor to the Shariah Equity Opportunity Fund Ltd that launched its fund of hedge funds in October 2004. It was managed by Connecticut-based Meyer Capital, a US investment management firm. It targeted institutional investors and high net worth individuals in the Muslim world, focusing on the Gulf States. It is said to have taken a team of Islamic scholars, legal experts and brokers more than two-and-a-half years to overcome the barriers imposed by *Shari'a* compliance. The biggest challenge is said to have been finding an equivalent of short-selling. While in conventional hedge funds investors place money towards borrowing shares, in the Islamic fund they advance money towards buying them, using the *Urboun* concept with transactions that are detailed in writing. However, of equal significance has been the software that Meyer Capital developed to screen stocks for *Shari'a* compliance. The fund managers have been able to increase the number of Islamically acceptable US equities from 550 companies to more than 5,500 companies.

Since the launch of this fund, Meyer Capital and Noriba Bank have parted company, partly because Noriba has been absorbed back into the wealth management division of UBS, but Meyer, through its subsidiary Shariah Capital, is promoting two funds with more under construction. The Shariah Long/Short Master Fund Ltd claims to be the first multi-manager *Shari'a* compliant fund of separately managed accounts comprised of best-of-breed hedge fund managers following predominantly long/short strategies. The Shariah Market Neutral Master Fund is similar in structure to the long/short fund and uses managers who follow market neutral strategies. It targets to produce returns superior to those from short-term *Murabaha*. The new funds will invest in real estate.

Eurekahedge[6] now has a database of Islamic funds, including hedge funds, that tracks the performance of nearly 670 funds. It is a growth business! However, many funds have been announced but never taken up by investors, and while hedge fund investments remain controversial, this is likely to continue.

[6] www.eurekahedge.com

Chapter 14

Islamic Bonds

Sukuk – Underlying Principles

Islamic financiers have long been trying to develop Islamic bonds that would be tradable on global markets and in recent years they have developed a range of *Sukuk* products that have proved extremely successful. They are based on the idea of making a non-permissible transaction permissible by introducing degrees of separation. This idea is not new and underlies many of the strategies that have been adopted to circumvent prohibitions.

Here we quote from a paper[1] by Professor El-Gamal of Rice University, who has been one of the foremost writers on Islamic finance, although over the last few years he seems to have become increasingly skeptical about the way Islamic finance has been developing.

> *"Consider the progression of juristic opinions on various lending practices:*
>
> - *A lends B $100 today. B to repay $105 in one year. All jurists are unanimous that this practice is a form of the forbidden riba.*
>
> - *B sells a stapler to A, for the cash price of $100. A turns around and sells the stapler to B for a credit price of $105 payable in one year. This practice is called "bay' al-ina" (same item sale resale). Some jurists (e.g. the Hanbalis) forbade it based on the principle of sadd al-dhara'i (prevention of stratagems to achieve illegal ends through legal means). However, some others (e.g. the Hanafi jurist Abu Yusuf and Al-Shafi'i) allowed the contract, ruling on each of the two separate valid sales separately. Provided that the second sale is not stipulated*

[1] Limits and Dangers of Shari'a Arbitrage, Mahmoud A. El-Gamal, Rice University

in the first, they reasoned, one cannot forbid the practice based on speculation about the contracting parties' unobservable intentions.

- *C sells a stapler to A, for the cash price of $100. A sells the stapler to B for the credit price of $105 payable in one year. B sells stapler to C for the cash price of $100. This practice is called Tawarruq (literally, monetization – of the stapler in this example). Abu Hanifa contemplated this contract as a variation on the previous one, with a third party serving as intermediary (muhallil). While he forbade the simple 'inah (without a third party), he was more accommodative of Tawarruq. Most jurists considered Tawarruq, defective or reprehensible. However, there are two reports on ibn Hanbal's opinion on this contract, thus allowing a faction of the Hanbali school to approve the contract, which is quickly replacing Murabaha as the favorite mode of financing in the GCC.*

- *C sells stapler to A, for the cash price of $100. A sells stapler to B for the credit price of $105 payable in one year. B sells stapler to D for cash price of $100. D sells stapler to C for cash price of $100. Now, we have added two intermediary entities (C and D) between lender (A in all examples) and borrower (B). Contracts with larger numbers of intermediaries do not have explicit names in classical jurisprudence, and were not discussed in their writings.*

It is easy to see how we can keep adding degrees of separation until eventually it would become impossible for any jurists, however strict, to prohibit the practice as merely a trick to subvert the substance of Islamic Law (avoidance of interest-bearing loans from A to B) while adhering to its medieval forms. When bankers wish to practice their standard lending practices, but cater to the captive clientele of Islamic finance, they need at least one degree of separation. Since multiple degrees of separation typically add transaction costs (legal fees, sales taxes, etc.), bankers prefer to keep the number of degrees of separation to the bare minimum. Oftentimes, one degree of separation is sufficient.

In this regard, it is worthwhile examining the degrees of separation most recently utilized in Islamic finance:

- *For issuances of bond-alternatives (usually called Sukuk, which is an Arabic word for bonds, albeit different from the more conventional Sanadat), governments and corporations have recently opted for a variation on 'inah, which also incorporates lease-financing in a manner very reminiscent of the decade-old leveraged buy-out methodologies of conventional finance:*

    - *A special purpose vehicle (SPV) is created for the sole purpose of issuing the sukuk.*

- *SPV sells certificates/ bonds (sukuk) and receives proceeds.*
- *SPV uses proceeds to buy land, equipment, etc. from government or corporation wishing to issue bond-alternatives.*
- *SPV leases land, equipment, etc. back to government or corporation, collecting interest-only or principal + interest in the form of rent, which is passed through to sukuk holders.*
- *At lease end, SPV sells land, equipment, etc. back to government (or as in one variation for the Qatar sukuk, if the principal was fully paid along with interest as part of rental payments, gives it back as gift).*

In this practice there is one intermediary entity (SPV) and one intermediary property (land, equipment, etc.) to distinguish the sukuk from conventional bonds. The actual legal difference (e.g. how much real ownership sukuk-holders have through the SPV) may not be revealed until we observe the first round of lawsuits associated with those sukuk issuances. In the meantime, the "benchmark" argument is commonly invoked, to list the "rate of return" sukuk pay in terms of market interest rates (e.g. LIBOR) plus the appropriate risk spread (e.g. 45 basis points above LIBOR for the June 2004 issuance of $250 million Bahrain sukuk rated A- by S&P)."

One of the concerns about the *Sukuk* structures that have been popular so far is that they come close to the methods used for money laundering and criminal financing by adding layers of financial intermediation so that the true origin of the funds or their use is difficult to determine. Additional concerns have come from the use of off-shore centres for the location of the special purpose companies involved in the structures. The fact that these centres and structures have been commonplace in conventional finance does not remove the concerns but rather emphasises them, especially following all that has been learned during the recent collapse of many structured vehicles. The association of Islamic finance with some "dubious" techniques in structuring *Sukuk* tarnishes the ethical position that they aim to promote. Other issues are discussed later in this chapter.

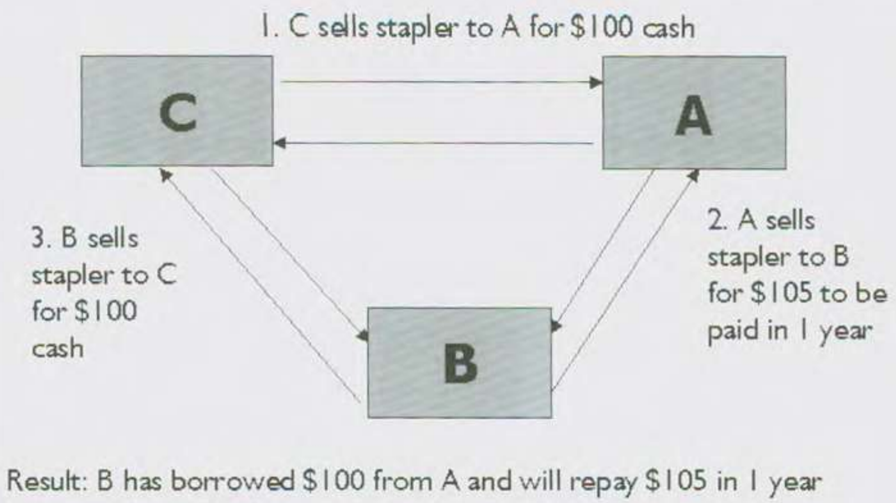

Figure 14.1: Acceptable Separation

Early and Notable *Sukuk* Issues

Significant issues of *Sukuk* date back to 2001 and were issued by the Bahrain Monetary Authority (now the Bahrain Central Bank) and several sovereign-related issuers in Malaysia. Possibly the most noteworthy was the US$150mn two tranche issue by First Global Sukuk Inc. for Kumpulan Guthrie. The principal shareholder in this plantation company was a government investment fund and, following 2007 mergers, it is now part of Sime Darby, the largest listed company in Malaysia. This 2001 issue is of special interest because it was the first rated corporate bond and was listed on the Labuan Exchange in January 2002 and available to global investors. The company wanted to refinance the cost of its expansion in to Indonesia.

However, the Malaysian Global Sukuk of 2002 was the most newsworthy. The government of Malaysia issued trust certificates worth US$600 million that were due in 2007. Each of the trust certificates represented an undivided beneficial ownership of the trust assets that were land parcels. The proceeds from the issuance were implemented to develop the land parcels that consisted of four areas of construction:

- Selayang Hospital, a government owned hospital operated by the Ministry of Health.
- Tengku Ampuan Rahimah Hospital, a government owned hospital operated by the Ministry of Health.
- Government living headquarters in Jalan Duta.
- Jalan Duta Government Office Complex (including Ministry of Finance, Ministry of International Trade and Industry, and Inland Revenue Board offices).

The Malaysia Global Sukuk company was incorporated in Labuan, Malaysia as a Special Purpose Vehicle solely for the purpose of participating in the *Sukuk* issuance transactions. The SPV was created to buy the land parcels from the government which were then leased back to the government that paid out rental payments matching the semi-annual distribution amounts to the *Sukuk*. Indeed, this structure follows the generic arrangement of *Ijarah Sukuk* issuances.

Under the framework of the Malaysian prospectus, the "Master *Ijarah*" agreement entitled the government to distribute semi-annual lease payments with reference to LIBOR + 0.95% that exactly matched the distributions to the *Sukuk* holders.

After the expiry of the agreement in 2007, the government bought back the properties at face value, and the commitment to do this effectively protected the bond issue from any variations in the value of the underlying assets. This was one of the first examples of an asset-based transaction as the government retained title to the properties and the SPV owned the usufruct. The rental return was guaranteed by the government of Malaysia, and the trust certificates were thus equivalent to floating rate Malaysian sovereign debt instruments. The certificates were rated "Baa2" by Moody's Investor Services and "BBB" by Standard & Poor's, both ratings at the then ceiling for Malaysian government issues.

The size of this issue, the fact that it was rated by both Moody's and S&P and also was then listed on the Bahrain Stock Exchange and Kuala Lumpur Stock Exchange made this a landmark issue.

The following year another significant issue came from Qatar. The Qatar Global Sukuk was another *Ijarah Sukuk* with the government selling land parcels to the *Sukuk* company and leasing the land back for a seven year period. The *Sukuk* was listed in Luxembourg and Labuan. In this case the land parcels were bought by the *Sukuk* company on a true sale basis.

That same year, another groundbreaking issue came from the Islamic Development Bank (IDB). This *Sukuk* was IDB's first foray into the global capital markets and the first issue that included a range of instruments in the pool of assets supporting the *Sukuk*. Both the Malaysian government offering and the offering by the State of Qatar relied for cash flow on the revenue from leases of real estate assets. In the case of the IDB *Sukuk*, the asset base included *Ijarah* contracts, *Murabaha* contracts and *Istisna'a* contracts. This structure was approved by the *Shari'a* boards of the IDB, Citi Islamic Investment Bank and The Islamic Corporation for the Development of the Private Sector. In approving the structure, the boards expressly took into consideration "(i) the legal constraints under which the product is being developed; (ii) the need to further develop the emerging Islamic finance industry as an alternative and viable financing system; (iii) the need to facilitate and bring ease to Islamic financial institutions and others who are determined to raise financing according to *Shari'a* principles..."

To implement the transaction, the IDB sold a portfolio of Islamic-compliant assets (at closing approximately 66% of the assets were *Ijarah* contracts) to The Islamic

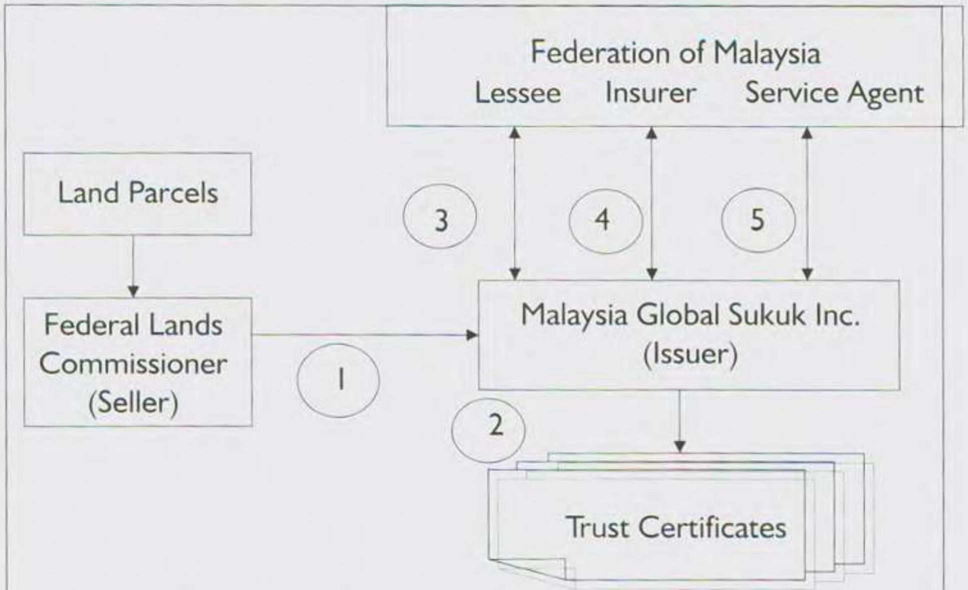

Figure 14.2: Malaysian Global Sukuk

1. Malaysia Global Sukuk Inc., a special purpose company whose shares are owned by the Minister of Finance, agrees to acquire the beneficial ownership in some parcels of land from the Federal Lands Commissioner.
2. The acquisition is financed by the issuance of trust certificates.
3. Under a Lease (*Ijarah*) Agreement, Malaysia makes rental payments equal to the periodic distribution amounts. Under the Purchase Undertaking, Malaysia is required to pay the exercise price at the scheduled dissolution date (or earlier in case of a dissolution event). Early redemption is covered by the Sale Undertaking where the issuer will sell the land to Malaysia if there is a tax event.
4. Under an Insurance Agreement Malaysia covers the issuer in case of total loss of the land parcels.
5. Under the lease, the issuer is responsible for any major maintenance required. The Service Agency Agreement appoints Malaysia as agent for the Issuer to ensure any maintenance is carried out.

Corporation for the Development of the Private Sector (ICD), which is a member of the IDB group. The ICD in turn assigned the portfolio to Solidarity Trust Services Limited (Trustee). The Trustee purchased the portfolio with the proceeds of the issue of *Sukuk* certificates.

The inclusion of *Murabaha* contracts and *Istisna'a* contracts would not have gained the approval of a number of *Shari'a* scholars as they are contracts which represent an interest in a stream of payments, unlike *Ijarah* contracts which represent an interest in some underlying assets. In this case, the boards were prepared to accept the inclusion of such assets in the pool assigned to the ICD as long as the pool was primarily made up of *Ijarah* contracts. Compliance with this requirement was achieved by including, as a dissolution event (which would trigger the IDB's repurchase obligation) if the *Ijarah* contracts ceased to constitute more than 25% of the portfolio held by the Trustee. It was generally contemplated that *Ijarah* contracts would at all times constitute more than 50% of the portfolio, although they could, in very specific cases and for very limited durations, drop to as low as 25%.

Having assigned the portfolio of assets to the ICD, the IDB guaranteed to the Trustee, through the ICD, the performance of the obligors under the various contracts constituting the portfolio. However, the IDB did not guarantee the payment by the Trustee of the profit participation to the certificate holders. The IDB also promised to repurchase the Trustee's portfolio for the original sale price upon the maturity date of the certificates or following certain "dissolution events". The certificates are not redeemable except at maturity or upon a dissolution event.

The IDB also provides a liquidity facility to the Trustee to ensure that the Trustee is able to make the required periodic distributions of profit shares to the certificate holders. If the IDB is required to provide funds to the Trustee under this facility, repayment to the IDB is made prior to further distributions to the certificate holders.

The ICD was appointed by the Trustee as *Wakeel* to manage the portfolio and the ICD in turn sub-delegated its obligations as *Wakeel* to the IDB.

In addition to the original portfolio, the Trustee is expected to acquire further *Shari'a*-compliant assets with profits in excess of required distributions to certificate holders and funds required to meet other costs. These assets are expected to principally be additional *Ijarah* contracts purchased from the IDB, through the ICD. However, if the IDB has insufficient *Ijarah* contracts that it can assign to the Trustee at any particular time, the Trustee may, on the advice of the ICD, directly enter into further *Murabaha* contracts, but it will not purchase them from the IDB.

This somewhat complicated structure appears to be working in practice and was well received by the market being over-subscribed from its originally planned amount.

One notable corporate issue was the CARAVAN I *Sukuk*, an inventory fleet securitization where BEMO Securitisation (BSEC), a small subsidiary of the Lebanese bank, was the arranger, Shamil Bank of Bahrain the underwriter and HANCO, a Saudi-based rent-a-car company was originator. The deal was for SR98mn. This transaction required two SPVs in its structure because no foreigner is allowed to directly own Saudi assets. The transaction allowed HANCO to become a service provider rather than a fleet owner and allowed it to manage its business effectively at a time when it had run out of bank-financing options. It was also notable because it was the first time that a *Sukuk* was issued where the underlying assets were moveable assets as opposed to land or buildings. It was not a rated *Sukuk*, although the agencies were invited to look at the deal, because the legal opinion included many uncertainties as to how the interests of the *Sukuk*-holders would be protected under Saudi law in case HANCO went into liquidation.

Current Favoured Structures

Most of the *Sukuk* in the market today are lease-based, with a smaller number being *Musharaka* based, although in 2007, the amount raised through *Musharaka* based *Sukuk* exceeded the amount raised through *Ijarah* based issues. Although AAOIFI in its standard for *Sukuk* lists 14 possible structures, only a few of these have been used, in part because some result in non-tradable *Sukuks*. Excerpts from the AAOIFI standard are given in Appendix 2. So far most *Sukuk* have been issued by governments, government-owned entities or multilateral agencies, although an increasing number of corporates and banks have come to the market. At present issuance has slowed as a result of the global slow down in financial markets. About half of all issues have been taken up by conventional institutions and in current market conditions, there are far fewer buyers.

Ijarah Sukuk

Under the lease structure, the originator seeking finance "sells" the assets to the *Sukuk* SPV for a value equal to the financing provided, and then leases it back. The lease payments provide the SPV with the income stream to service the *Sukuk* payments. This structure was used for the Malaysian Global Sukuk that was described earlier in this chapter. The payments have often been benchmarked to an index. At the maturity of the bond, the originator repurchases the leased assets for an amount equal to the principal of the bond. This second transaction is agreed at the time of issue as quite often, the assets are needed by the originator for the long term. Where this is the case, the actual market value of the asset is largely irrelevant and *Sukuk* holders are not exposed to market risk, but rather to the credit risk of the originator. Most of the *Ijarah Sukuk* that have been issued so far have not included a "true sale" of the assets and so the *Sukuk* is not a securitized bond but an asset-based bond. While most ratings have then been based on the credit risk of the underlying obligor rather than the assets, what is not certain is how the courts would look at these structures. Will an asset-*based* sukuk be ranked *pari passu* with conventional bonds issued by the same obligor?

Musharaka Sukuk

As with Musharaka financing, there is no generic structure for *Musharaka Sukuk*. Each case has a unique structure that depends on the contribution made by the originator to the project. The *Musharaka* structure was used in the Dubai Ports (Dubai Ports, Customs Free Zone Corporation PCFC) *Sukuk* in 2006. This structure works by setting up a joint venture, jointly owned by the *Sukuk* issuer and the originator. The issuer and originator's shareholdings in the venture are agreed at the start with the issuer generally providing the capital and the originator providing assets and management skills as well as capital, all to be invested according to a pre-defined business plan. In the Dubai Ports case, the structure incorporated a partial redemption in equity if an IPO took place before the *Sukuk* maturity. The *Sukuk* holders have the right to receive payments from the issuer's equity position in the joint venture. The nominal amount raised could be redeemed either through a number of pre-scheduled installments or at maturity. There was a purchase agreement at the outset that stated how the originator would buy out the issuer's shares at a price equal to the value of the *Sukuk*.

A further example was the Jebel Ali Free Zone (JAFZ) issue. The *Sukuk* was issued to facilitate the expansion of the Free Zone and link it with the Dubai World Central complex. A *Sukuk* company, JAFZ Sukuk Limited (JSL) was established in the Cayman Islands as the Issuer of the *Sukuk* certificates and Trustee for the certificate holders. The Trustee and JAFZ are partners in the *Musharaka* with JAFZ being the managing partner and making its contribution to the *Musharaka* in kind. On the closing date. The subscribers paid the issue price of the certificates to the Issuer which in turn paid the amount raised to the *Musharaka* as a cash contribution. The money was to be invested according to an agreed business plan.

The pre-agreed profit sharing agreement was Trustee 99% and Managing Partner 1% and the Managing Partner distributes the profit prior to each distribution date. If the profit payable to the Trustee exceeded the amount to be distributed it was to be recorded in the Musharaka Account as a credit to a line called the "Musharaka Profit Reserve Amount". Any amount in this item on the dissolution of the Musharaka will be due to the company as an incentive payment for its performance as Managing Partner. Prior to the End Date, the company may use the amount in the line as an advance payment but must re-credit the line if at any distribution date the profit amount due from the Musharaka plus the amount then standing in the Profit Reserve are insufficient to make the Periodic Distribution Amount. If the amount available is still less than the amount due, the Managing Partner will arrange for Shari'a compliant financing or provide an interest free loan.

On the scheduled redemption date the Issuer has the right to require the Obligor (under the Purchase Undertaking) to purchase all the Trustees Units in the Musharaka. The amount paid will reflect the amount needed to fund the Dissolution Distribution Amount payable to the certificate holders. Early redemption is possible for a number of reasons but in each case the Obligor is required to purchase all the Trustees Units.

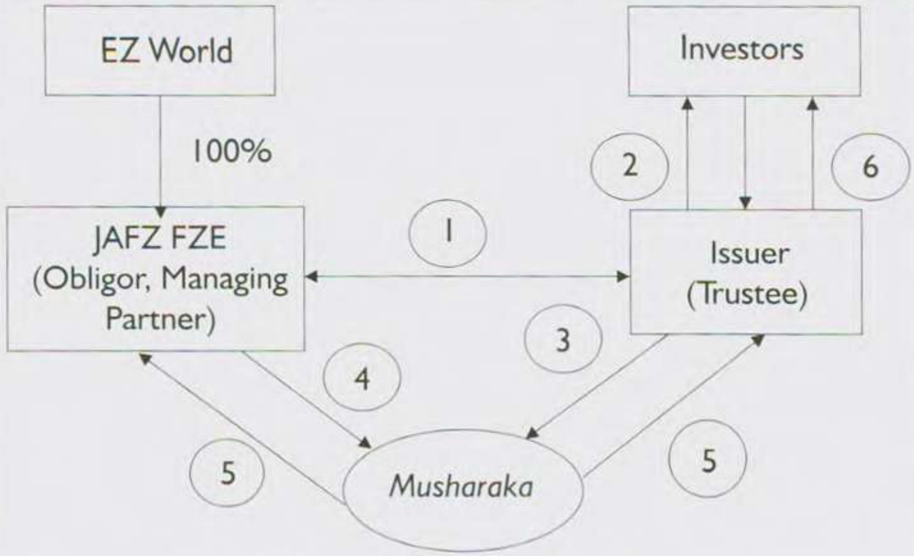

Figure 14.3: Jebel Ali Freezone *Musharaka Sukuk*

1. JAFZ FZE and The Issuer enter into a Management Agreement, *Musharaka* Agreement and Purchase/Sale Undertakings.
2. The Issuer issues certificates to the Investors in return for the issue proceeds.
3. The Issuer passes the proceeds to the *Musharaka*.
4. JAFZ FZE contributes assets to the *Musharaka* following an independent valuation.
5. Profits from the *Musharaka* are paid to the Issuer and to the Managing Partner to meet Periodic Distribution of Profit. Any excess amount not needed to pay investors is retained in an account by the *Musharaka* but is available to the Managing Partner. If the amount is insufficient, the Managing Partner provides an interest free loan or *Shari'a* compliant financing.
6. Periodic Profits are distributed to the Investors. A Dissolution Amount is paid at the End of the *Musharaka* Agreement. Any excess profit is paid to the Managing Partner as an incentive.

Mudaraba Sukuk

There have also been a number of issues that have adopted the *Mudaraba* structure, a notable one being that of DP World.

In this the capital for the *Mudaraba* was provided by investors to DP World Sukuk Limited, a Special Purpose Company set up with the sole purpose of issuing the *Sukuk*. DP World, as *Mudarib*, was responsible for investing the proceeds in its business activities in accordance with an agreed investment plan, where the investments were made in a *Shari'a* compliant way. The intention was essentially to fund the development of Terminal 2 at Jebel Ali Port. Through a Declaration of Trust the Issuer declared a trust under *Shari'a* in the *Mudaraba* Assets and certain of its rights, benefits and entitlements, present and future under each of the Transaction Documents.

Prior to each Periodic Distribution Date, the *Mudarib* distributes the profit generated by the *Mudaraba* to both the Issuer and the *Mudarib* in accordance with pre-arranged profit sharing percentages which are 99% to the Issuer, as *Raab al-Maal*, and 1% to the *Mudarib*. If the profit is in excess of the amount required to meet the Profit Distribution Amount, the *Mudarib* is entitled to the full amount of the excess as an incentive fee. If for any reason, the profits available are insufficient to meet the required distribution, the *Mudarib* will provide *Shari'a* compliant liquidity funding without recourse to the *Mudaraba* Assets or the Trustee.

On the Scheduled Redemption Date, the Issuer requires the Obligor, under the Purchase Undertaking, to buy all the Trustee's interests in the *Mudaraba* Assets. The price payable is expected to fund the Dissolution Distribution Amount as well as other obligations that may have been incurred. The certificates may be redeemed early for a number of reasons with the Obligor required to purchase all the Trustee's interests in the *Mudaraba* Assets.

See Figure 14.4 on the next page

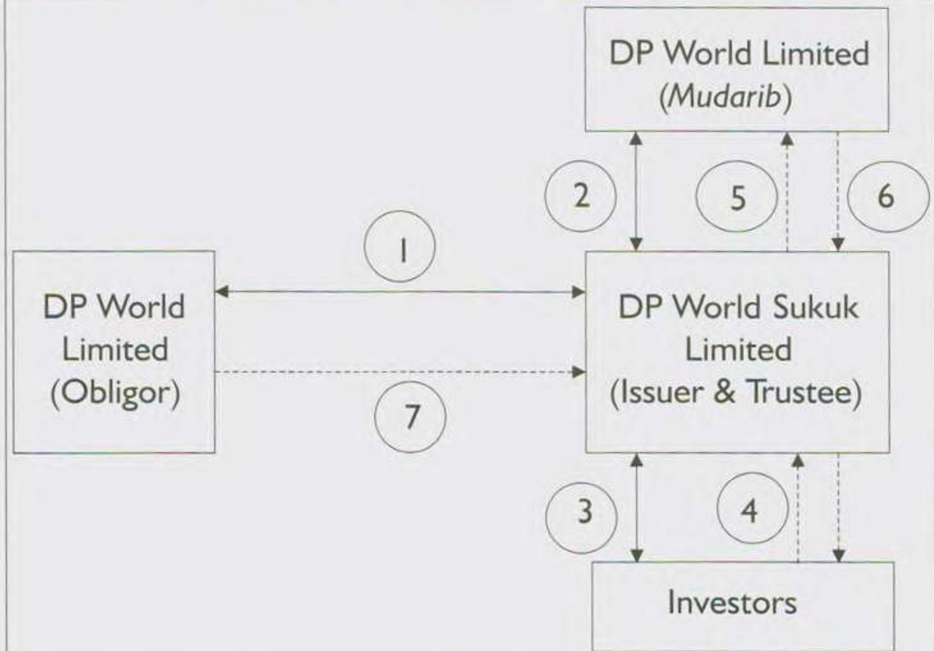

Figure 14.4: DP World *Mudaraba Sukuk*

1. DP World, as obligor, enters a purchase and sale agreement with the issuer over certain of DP World's business activities.
2. The issuer enters into a *Mudaraba* agreement with DP World, as *Mubarib*, that the proceeds from the issuance will be invested in a *Shari'a* compliant way.
3. The issuer declares a trust over its interests in the *Mudaraba* assets and certain of its rights, benefits and entitlements.
4. On the closing date, the initial investors pay the issue price to the issuer in return for the Certificates.
5. The issuer pays this amount to DP World, as *Mudarib*.
6. Prior to each distribution date, the *Mudarib* distributes the profit due to the Issuer and the *Mudarib*. In case the profit is insufficient to meet the required payments, the *Mudarib* will provide *Shari'a* compliant liquidity funding. If the profit available is in excess of the amount due to the Issuer, the *Mudarib* shall be entitled to it by way of an incentive fee.
7. At redemption, the Issuer may require the Obligor to purchase all the Trustee's interests in the *Mudaraba* assets. The amount payable is intended to fund the Dissolution Distribution Amount.

Future Trends

While one of the main objectives in issuing *Sukuk* is to create tradable instruments that can be listed on one or more exchanges, to date most issues have been sold to investors that wish to hold to maturity. In several cases there has been just one investor as the issues have been relatively small. Currently there are 18 *Sukuk* issues listed on NASDAQ Dubai (previously known as the Dubai International Financial Exchange or DIFX) but none of them is currently tradable.

There is increasing interest in mortgage securitization as Islamic mortgages become more commonplace and several acceptable structures are now available, generally either *Ijarah*, *Murabaha* or *Musharaka* based. While *Murabaha*-based mortgages may be hard to securitize outside of Malaysia, with the other structures units in property may be sold, leases or partnership agreements (along with the rental agreement) may be assigned, and notes or mortgages can be added.

The *Sukuk* market has been growing quickly in recent years, but has slowed in 2008. Total issuance in 2007 was just over US$47 billion, an increase of 73% over 2006 and this came from 207 *Sukuk*[2]. However, the number of issues in 2006 was 199, and so the growth in value came from an increase in the size of the *Sukuk* issued. While in 2006 there were 4 issues over US$1 billion, in 2007 there were 14 (See the table in Appendix 3).

In line with the global markets, there has been less issuance in 2008, and most issues have been in local currency rather than US dollars, probably reflecting a decrease in appetite from the international markets. Issuance in the first half of 2008 was US$11.56billion compared to US$13.99billion in 2006[3]. Nevertheless, interest remains strong, particularly with GCC issuers, and the Islamic market is expected to recover at least as quickly as the conventional market. This is in part because of the huge infrastructure requirements in the Middle East and Asia. Money needs to be raised to fund these projects and they in turn lend themselves to *Sukuk* issues. Financial institutions in the GCC are keen to issue residential mortgage backed *Sukuk* to fund their growing books from the international markets. The mortgage market has seen exceptional growth in the last few years, but there are still many doubts as to the sustainability of the housing market in the region. This, along with current problems in the sub-prime market, has dampened international interest in such issues.

One of the main issues remains the determination of whether a true sale has occurred. In some Gulf countries, the law prevents a true sale of assets to non-nationals. However, there can be differences between accounting treatment and legal treatment. If the originator has no rights to the income stream from the assets it is possible that they are no longer treated as balance sheet items, even if title to the assets remains. Such a case would not be classed as a securitization but can work well as a financing structure. A key question is whether the SPV structure

[2] IFIS SUKUK in 2007

[3] IFIS SUKUK in H1 2008

is bankruptcy remote so that investors in the bond would still have access to the income stream from the assets if the originator was declared bankrupt. If there has not been a true sale, even though the rights to the income stream have been sold, it is not clear how many courts in the Middle East would regard this in a bankruptcy. This is one reason why many *Sukuk* issues rely for their ratings on the creditworthiness of the originator and not the assets. True securitizations are still uncommon and most *Sukuk* have been asset-based rather than asset-backed.

Sheikh Taqi Usmani – AAOIFI's Comment

In 2007, the AAOIFI *Shari'a* board became increasingly concerned by some of the techniques being incorporated in *Sukuk* issues to make them similar to conventional bonds. Sheikh Taqi Usmani, as President of the AAOIFI *Shari'a* board, spoke at the AAOIFI conference held in Bahrain in November and said that as many as 85% of the *Sukuk* issued to date were non-Islamic in their structure. He also wrote a background paper[4] for the AAOIFI *Shari'a* board to consider. In this he expressed a number of his worries. These included the concern that a number of *Sukuk* do not confer true ownership of the underlying assets to the bond holders, concerns that most *Sukuk* return fixed percentages based on LIBOR rather than distribute a share of profits, also the fact that most *Sukuk* guarantee the return of the principal to *Sukuk* holders at maturity, regardless of the true or market value of the assets at maturity. He also questioned the way earnings in excess of the amount paid to bond holders are sometimes given to the managers as an incentive and also the commitment by managers to lend money to pay bond holders, if the actual profit is insufficient, and to recover such a loan from future profits or from the sale of the assets at maturity. These *Shari'a*-disputed mechanisms were used in both the JAFZ and DP World *Sukuks* that were discussed above. He summarized his thoughts and made recommendations as follows:

1. *Sukuk* should be issued for new commercial and industrial ventures. If they are issued for established businesses, then the *Sukuk* must ensure that *Sukuk* holders have complete ownership in real assets.
2. The returns of enterprises should be returned to *Sukuk* holders regardless of what amounts they reach after costs, including the managers' fees, or the share of the *mudarib* in profits. If there is to be an incentive for a manager, then let it be based on the profits expected from the enterprise and not on the basis of an interest rate.
3. It is unlawful for a manager to lend money when actual profits are less than expected.
4. It is unlawful for a manager, whether a *mudarib* or a partner or an agent, to commit to repurchase of assets at face value. Instead, their resale must be undertaken on the basis of the net value of the assets, or at a price that is agreed upon at the time of purchase.

[4] Sukuk and their Contemporary Applications, Mohammed Taqi Usmani

5. *Shariah* supervisory boards must abide by the *Shariah* Standards issued by the *Shariah* Council.

Following several meetings and having considered a number of papers that were presented, AAOIFI published the findings on its website[5]. This paper states, in summary:

> "**First:** Tradable *Sukuk* must represent ownership for *Sukuk* holders in real assets, whether tangible or usufructs or services. The assets must not remain on the books of the manager.
>
> **Second:** It is not permissible for tradable *Sukuk* to represent either revenue streams or debt.
>
> **Third:** It is not permissible for the manager of *Sukuk* to undertake to offer loans to *Sukuk* holders when actual earnings fall short of expected earnings. It is permissible to establish a reserve to cover such shortfalls on condition this is mentioned in the prospectus.
>
> **Fourth:** It is not permissible for the *mubarib* to agree to purchase assets from the *Sukuk* holders for a nominal value at maturity. It is permissible to agree to purchase the assets for their net value, or market value, or fair market value, or for a price agreed to at the time of their purchase.
>
> **Fifth:** It is permissible for the lessee in a *Sukuk al-Ijarah* to agree to purchase the leased assets when the *Sukuk* are extinguished for their nominal value.
>
> **Sixth:** *Shariah* supervisory boards must not consider their responsibility to be over when they issue a *fatwa* on the structure of *Sukuk*. Rather they must review all contracts and documentation related to the transaction and oversee implementation.
>
> In addition to all this, the *Shariah* Committee advises Islamic Financial Institutions to decrease their exposure to debt-related operations and to increase their operations based on true partnership and sharing of risk and reward."

It is not clear how much impact this ruling will have on *Sukuk* issuance in future. Indeed the final rulings were much less onerous than Sheikh Taqi Usmani set out in his paper, particularly with regard to how profits should be shared and permitting the use of a reserve account. The structures adopted in both the JAFZ and DP World issues do seem to return a fixed "interest" percentage to bond holders and do not resemble profit sharing transactions in the way that *Musharaka* and *Mudaraba* were intended to be. However, the scholars have accepted the possibility of setting up a reserve fund in case there is a shortfall for any distribution period, in much the same way that banks establish profit equalization reserves and investment risk reserves to cover any problems in making desirable payments to investment account holders.

[5] www.aaoifi.com

That said, many of the techniques that have been used for credit enhancement and liquidity support do remain controversial. AAOIFI softened the blow that its new rulings caused by stating that the *Sukuk* with questionable structures that were already in the market should be grandfathered.

A number of new structures have been proposed that seem to abide by the latest AAOIFI rulings and the impetus for continued growth is still strong.

Chapter 15

Islamic Financial Centres

One of the constraints on the growth of Islamic finance has been the lack of liquid instruments. While there are more and more *Shari'a* compliant bonds and funds, the markets are still relatively illiquid. This is the main reason that equity funds tend to invest in the US and European markets.

One further issue has been the lack of any specific regulations from capital market authorities governing the issuance of Islamic products. While many regulators do not believe that such regulation is needed, others think differently. While IOSCO regulations should apply, do there need to be additional disclosures relating to *Shari'a* compliance and the steps taken by *Shari'a* advisors to monitor and review each instrument? Until now there are no global best practices but, at the end of 2005, the IFSB's mandate was extended to include securities (and insurance) regulations and it will begin to complement the work of IOSCO in this area.

Malaysia and Bahrain have taken the lead in trying to develop a regulatory framework for Islamic instruments and an active market. Labuan (Malaysia's offshore financial centre) has a task force whose role is to develop the Islamic market, while the Malaysian Securities Commission has an Islamic Capital Market Department. Bahrain has been attempting to create a market by issuing its own *Sukuk* of varying size, maturity and underlying assets that are listed on the Bahrain Stock Exchange. NASDAQ Dubai also believes that Islamic instruments should be one of its main targets for listings and the associated DFSA has issued regulations. It has the largest volume (by US dollar amount) of listed Islamic securities.

After a year of trials, in 2007 the City of London, in association with Z/Yen, has been producing a Global Financial Centre Index. It asks financial services professionals to rate the centres they know by a number of factors. They also use information from a host of other sources, called instrumental factors. For example, evidence about the infrastructure competitiveness of a financial centre is drawn from a survey of property and an index of occupancy costs. Evidence about a fair and just business environment is drawn from a corruption perception index and an opacity index. Fifty-seven instrumental factors were used in the GFCI 4 model whose results were published in September 2008. They received 24,014 assessments from a total of 1,406 professionals. The ranking and scores of the financial centres discussed in this chapter are shown in the table below:

Centre	Rank	Points Score	Change since March 08
London	1	791	-4
Singapore	3	701	+26
Hong Kong	4	700	+5
Dubai	23	597	+12
Bahrain	43	529	+15
Qatar	45	525	+34

Kuala Lumpur scored an average of 600 points but only received 88 responses which was insufficient for its inclusion in the ranking.

London has been top of the rankings in all four surveys, closely followed by New York. These two centres stand out as being the only two truly global centres. For the first time, Singapore has overtaken Hong Kong in the ranking, although the two stand very close together in the number of points scored. Singapore has increased its position significantly scoring an additional 26 points since the March publication. All three Middle East Centres show good improvement with Qatar doing particularly well.

Respondents to the survey were asked which centres were likely to become more significant in the future and Dubai headed the list as it has done since the survey began. A further question asked where new offices might be established, and once more Dubai headed the list. The authors of the report suggest that the positive perception of Dubai is helping to pull Bahrain and Qatar along with it.

That the rankings and scores of all the centres most closely involved in promoting Islamic financial services are so high, bodes well for the future development of Islamic products around the globe.

An early initiative in evaluating the position of Islamic products was undertaken by IOSCO. It established a task force to look at the Islamic capital market and its report was issued in July 2004[1]. It concluded that there was a gap in the international regulatory arena regarding Islamic capital market issues but urged the adoption of its own objectives and principles as the basis for further development.

The following paragraphs are taken directly from the IOSCO report:

> *"In relation to Islamic capital market products and activities, regulators should begin to consider issues related to the clarity and consistency of*

[1] www.iosco.org

regulation and their application. Furthermore, regulators should consider and/or review its capital market law to ensure that it adequately deals with the risks associated with the new product structures based on the Shariah principles of Mudharabah (profit sharing), Musyarakah (profit and loss sharing) and Murabahah (trade with mark-up or cost plus sale). In this regard, some regulators have sought to mitigate these risks through enhanced disclosure requirements for specific Islamic products."

"Due to the unique aspects of Islamic capital market products and services, there is a view, which advocates that specialized regulation for the Islamic capital market may be more appropriate. Whilst most jurisdictions apply exactly the same set of regulations in terms of product approvals as well as standards for intermediaries and other regulated entities (such as collective investment schemes). Other jurisdictions have developed additional regulations, rules and guidelines catering to Islamic capital market activities. For example, Bahrain has recently issued Guidelines for Issuing, Offering and Listing of Debt Securities, which lay down clear requirements and conditions for issuers as well as for each class of debt securities, such as Islamic bonds. Malaysia also has in place additional requirements for Islamic bonds within its Guideline on the Offering of Private Debt Securities while Pakistan has specific legislation (Modaraba Companies and Modaraba (Flotation and Control) Ordinance 1980) to regulate Modaraba companies, which are the main issuers of Islamic equities. In many cases, these regulatory requirements relate to additional disclosures as a result of the structure of the product. In some cases, additional regulatory requirements are imposed on Islamic financial intermediaries such as requiring professionals to have adequate knowledge in Shariah law as well as requirements related to the internal controls of the intermediary."

"Whatever the approach taken by the regulator, it is crucial that regulators are well apprised of developments within this market segment, particularly where there is a significant level of activity occurring in the market. In the course of its work, the Task Force was informed by a statutory regulator that there were no Islamic capital market activities within its market, whereas subsequent follow up with private sector participants and a review of secondary information confirmed the existence of such activities in the market. As the pace of market evolution and development sometimes outstrips regulatory oversight, regulators face the constant challenge of optimizing its resources and capacity in a manner that enables adequate monitoring of the market and timely regulatory response."

As mentioned earlier, at the end of 2005, the mandate of the IFSB was extended to embrace securities markets (as well as *takaful* operations). Over time, it will propose standards that are appropriate for markets where Islamic securities are traded.

Malaysia

Malaysia stands today as the largest market for Islamic capital markets instruments. While by value Dubai overtook Malaysia for *Sukuk* issuance in 2007, there are still more issues in Malaysia and more trading. Malaysia has achieved this by making changes in the regulatory framework as well as the market infrastructure. It has made efforts to broaden the investor base and also regularly updates its guidelines in ways that encourage the development of the market.

One initiative was the establishment of The Malaysia International Islamic Financial Centre (MIFC) in 2006. Its aim is to promote Malaysia as the international hub for Islamic finance. The promotion of domestic and foreign currency *Sukuk* origination, distribution and trading is one of MIFC's main objectives. Its Secretariat and Promotion Unit is key to achieving this. It has made formal arrangements with the various regulators in Malaysia so it can be a smooth channel for raising *Sukuk* denominated in local and foreign currencies.

The demand for *Sukuk* has kept the cost of issuance below that of similarly rated conventional bonds while various tax and regulatory incentives have further reduced issuance costs.

- SPVs used for the issuance of *Sukuk* are not subject to the administrative tax procedures under the Income Tax Act 1967.
- Companies that establish SPVs are given tax deductions on the cost incurred by the SPV for the issuance of *Sukuk*.
- The issuance cost for all Islamic securities approved by the Securities Commission are also eligible for tax deduction, and
- Stamp duty exemption is given on instruments relating to Islamic Securities issued under the MIFC until 31 December 2016.

Closer links have been forged with other centres offering Islamic services including the Dubai Financial Services Authority and the Qatar Financial Centre Regulatory Authority.

Also, and equally important, because Malaysia has been active in Islamic finance for many years, it now boasts a large pool of talented and experienced people who are capable of handling the most sophisticated Islamic instruments.

As seen from the data in Chapter 13, Malaysia tops the list for the number of funds based in Malaysia and also the number of fund managers. Currently there are fourteen local and foreign Islamic banks operating in Malaysia, with Bank Islam Berhad and Bank Muamalat Berhad being the longest established local players. However CIMB Islamic Bank Berhad tops the list for those issuing Sukuk and, as CIMB-Principal Islamic Asset Management, tops the list of fund managers.

As discussed in Chapter 8 on Liquidity Management, Malaysia was one of the first countries to introduce an Act to regulate Islamic banks, a step it took in 1983.

Since then it has developed and introduced a number of bonds and money market instruments to the market so that today it is the most developed of all Islamic finance centres.

Singapore

As discussed in Chapter 12 on International Islamic Banking, Singapore sees itself as the financial hub of Asia and as such it wants to be able to provide a full range of banking and capital market products. That it now ranks behind only London and New York in the GCFI survey is proof that its perception of itself is not a foolish one.

Mr Tai Boon Leong, Executive Director, Monetary Authority of Singapore, some of whose remarks at the Singapore Islamic Finance News Forum 2008[2] have already been quoted in Chapter 12, also said:

> *"Moving forward, we will continue to provide clarity of the application of our banking laws to Islamic finance products and seek to ensure that Islamic products are not disadvantaged where they are similar in terms of economic substance and risks. We have already provided regulatory clarification on the most common Islamic financing structures with banks offering such products in Singapore. Regulations and guidance are currently being prepared to make more transparent the regulatory treatment across a whole range of Islamic finance products. We are also committed to continue reviewing our regulatory framework as new structures emerge in this highly dynamic industry."*

Singapore is an international finance market of some significance, serving the South-East Asian region. While Singapore itself hosts a relatively small Muslim population it is situated in the heart of South East Asia which boasts a Muslim population of some 240 million, including Indonesia which has the highest Muslim population in the world. It is thus ideally placed to develop financial services for the region, basing these around the sound regulatory framework it enjoys thanks to the efforts of the Monetary Authority of Singapore (MAS). While its small indigenous Muslim population leaves limited scope for retail banking, there are ample opportunities in the wholesale and capital market sectors.

To further its ambitions, the Finance Ministry has been aligning the tax treatment of Islamic products with those of their conventional counterparts. In December 2003, MAS joined the IFSB as an observer member and became a full member in April 2005. It is participating in a number of the task forces and working groups set up by the IFSB. It has also launched the first pan-Asian *Shari'a* compliant equity index. This serves as a benchmark for *Shari'a* compliant funds investing in Asian equities and paves the way for funds seeking Asian exposure.

[2] www.mas.gov.sg/news_room/statements/2008/Opening_Remarks_by_Tai_Boon_Leong_at_the_Singapore_Islamic_Finance_News_Forum.htm

Most recently, Singapore has seen the listing of a *Shari'a* compliant exchange traded fund (ETF) by Daiwa Asset Management. The fund, Daiwa FTSE Shariah Japan 100 ETF, provides an investment channel into leading Japanese companies that are *Shari'a* compliant.

Singapore also has two or three companies offering *Takaful* or *re-Takaful* products. MAS sees the development of Islamic insurance products as one of the opportunities for Singapore as it has a vibrant and well-regulated conventional insurance market that can accommodate Islamic products for marketing throughout South East Asia and beyond.

Hong Kong

In recent policy statements, the CEO of the HKSAR, Donald Tsang, talked of Hong Kong's ambition to become an important player in the Islamic finance arena. Several studies have been completed and, while Hong Kong's small indigenous Muslim population offers comparatively few opportunities, Hong Kong is recognized as one of the world's most important financial centres, although it has now been caught by Singapore according to the City of London survey. It has regulations in place to attract global players and this makes it ideally placed to spearhead the development of Islamic finance in Asia. Malaysia and Singapore may have a head start, but Hong Kong offers new opportunities.

Perhaps of most importance is the fact that when it comes to investing in China, Hong Kong is the obvious choice. It has the largest and deepest Chinese equity and debt market outside of the Mainland. This means that investors can gain exposure to China through Hong Kong. Huge investment into China is required and much of this lends itself to *Shari'a* compliant facilities. Projects already in the pipeline include power plants, transmission grids, refineries, pipelines, utilities and ports.

The first *Sukuk* to be listed in Hong Kong was a ground-breaking issue for other reasons. It was the first exchangeable *Sukuk* to be issued. Jointly managed by Malaysia's CIMB Islamic, HSBC Amanah and UBS Investment Bank, the issuer was Khazanah Nasional Berhad, the Malaysian government-owned investment vehicle. The US$750 million 5-year trust certificates are exchangeable into ordinary shares in Telekom Malaysia. The certificates were issued in October 2006 by a Labuan SPV with recourse to Khazanah Nasional and were listed on the Labuan International Financial Exchange as well as the Hong Kong Stock Exchange.

In November 2007, shortly after Hong Kong's policy for promoting Islamic finance was revealed, Hang Seng Bank launched a fund that tracks the performance of the Dow Jones Islamic Market China/Hong Kong Titans Index. In May 2008 a further index was launched by Dow Jones, named the DJIM China Offshore Hong Kong, it tracks the performance of companies that have been screened for *Shari'a* compliance whose primary operations are in Mainland China but trade on the Hong Kong Stock

Exchange. These two indexes provide new opportunities for funds looking for China exposure.

CIMB was also instrumental in another *Sukuk* issue in 2008. This was another exchangeable issue with the underlying company, Paxon, the operator of a number of departmental stores in Mainland China. Paxon is listed on the Hong Kong Exchange.

At present, interest payments do not incur tax in Hong Kong. However there is a tax on profits. This places *Sukuk* at a disadvantage to conventional bond issues. The government does plan to amend the tax laws, but has so far set no time frame for this. However, it has said that it will consider tax exemption applications for Islamic bonds on a case by case basis. This may pave the way for the government-owned airport operator, which has been considering issuing a *Sukuk* for some time, to press ahead. However, market conditions in late 2008 are not favourable.

Hong Kong is still in the early stages of establishing itself as an international Islamic finance centre, but the global standing of its market and its proximity to China bode well for its long term future.

Bahrain

Bahrain is the Middle East's most developed financial market and is widely regarded as having the best regulatory system. The Central Bank is now the single regulatory body and it has oversight of the banking system, the stock exchange, and all other forms of financial intermediation. It has also placed a special emphasis on the development of Islamic finance and plays host to a number of organizations that have been established to support the global expansion of Islamic markets. Some of these have already been mentioned, but they include the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), the Liquidity Management Centre (LMC), the International Islamic Financial Market (IIFM), the Islamic International Rating Agency, and the General Council for Islamic Banks and Financial Institutions (CIBFI).

Bahrain was one of the first to introduce separate regulations for Islamic institutions and today it has an extensive rule book covering most aspects of conventional and Islamic finance. It was the first to adopt the accounting standards promulgated by AAOIFI and has incorporated IFSB standards.

As of October 2008, Bahrain had licensed 412 banks and financial institutions. Of these, 88 had conventional banking licences for retail or wholesale banking while 26 had Islamic licences. The financial sector employs more than 12,000 people while the banking sector holds total assets of more than 17 times Bahrain's gross domestic product, and financial services makes up a quarter of the economy.

However, the assets of the Islamic banks at the end of 2007 were only around 6% of the total, at US$16.4 billion. As can be judged from these numbers, many of the banks are very small. Four only began operations in 2007 while one more, First Energy Bank, was licensed in June 2008.

Until recently, the stock markets in the Gulf States were restricted to investors who were nationals, then to nationals of all the Gulf States, and now increasingly to international investors. However the restrictions have largely limited the growth in the markets to local companies and traditionally, there has been very limited trading. Despite the more liberal approach today, trading is still limited and in Bahrain it is unusual to see trades in more than around 20 stocks each day. Five of the Islamic banks are listed and one *Takaful* company. In addition, 15 bonds are listed and of these, 10 are *Sukuks*.

It seems that in the Gulf, if you are to have a successful financial market you also need a successful real estate project! Bahrain has not been left behind in this respect and now boasts the Financial Harbour whose first phase of construction is complete. Giving 380,000 square metres of accommodation, the Harbour has been designed as a city within a city, offering not only prime office accommodation but also residential and leisure facilities.

Given its small population – around 750,000 at present – and all the limitations on the country's development, Bahrain has been remarkably successful in growing and supporting its financial market. It is now facing challenges in the region from Dubai, Qatar and even Saudi Arabia. While it will continue to have an important regional role, it seems unlikely that wider ambitions are realistic. However, it has welcomed supporting organizations to its shores – most notably AAOIFI but also LMC, IIFM, and IIRA. The presence of these important institutions and the role that they could play in the development of Islamic finance makes Bahrain an important centre.

Dubai

Sheikh Mohammed Bin Rashid Al Maktoum, the Prime Minister of the UAE and the Ruler of Dubai, has been the inspiration behind the growth and development of Dubai. With more limited oil resources than its neighbour, Abu Dhabi, Dubai has successfully set out to reduce its dependence on oil. While oil accounted for around 50% of GDP in 1985, today that has shrunk to around 5%. Emphasis has been placed on international trade, banking and finance, information and communication technology, tourism and real estate. Ambitious projects have transformed Dubai at a pace few felt possible or sustainable, but it has been achieved and Dubai continues to prosper.

Dubai unveiled its Dubai International Financial Centre (DIFC) project in February 2002 and it opened for business in 2004 with the first licence being awarded in September of that year. It is amongst the most ambitious of all Dubai's new ventures but is supported by a bold vision of the needs of the region and the opportunities for the development of Dubai as the regional finance centre.

The DIFC has been designed to:

- Attract regional liquidity back into investment opportunities within the region and contribute to its overall economic growth.
- Facilitate planned privatizations in the region and enable initial public offerings by privately owned companies, giving impetus to the programme of deregulation and market liberalization throughout the region.
- Create added insurance and reinsurance capacity.
- Develop a global centre for Islamic finance - this is now an over $400 billion international market serving large Islamic communities stretching from Malaysia and Indonesia to the United States.

But the vision goes beyond this. Dubai, by establishing its financial centre envisages it bridging the time gap between Asia and Europe. It sees Dubai at the centre of a region with growing financial power that should to be better integrated into the global markets. The most significant aspect was the realization that success would only come if the regulatory and business infrastructure met the international standards that have been hard to achieve so far in the Middle East.

Unlike 'offshore' tax havens, the DIFC is a fully fledged 'onshore' capital market. The DIFC focuses on several sectors of financial activity: Banking & Brokerage Services, Capital Markets, Re-insurance & Captives, Islamic Finance, Wealth Management and Ancillary Service Providers. Financial services in the DIFC are regulated to international standards by the Dubai Financial Services Authority (DFSA).

For all the Islamic products that may be provided by licenced organizations within the DIFC, the DFSA has kept by its approach to conventional institutions of being a risk-based regulator. In addition, it is a *Shari'a* systems regulator – not a *Shari'a* regulator. It does not regulate finite points of *Shari'a*, but the systems put in place to ensure compliance with *Shari'a*.

The DFSA's regulatory structure for Islamic finance is referred to as the *Shari'a* System. This means that the firm must implement appropriate systems, controls and processes to ensure that the financial services and products offered are in compliance with *Shari'a*. The *Shari'a* Systems model obliges DFSA authorized firms to implement adequate systems to ensure compliance with *Shari'a*. The DFSA provides detail on what such systems should include and also requires that the relevant provisions of AAOIFI's governance standards are implemented to ensure initial and ongoing Shari'a compliance.

Within the DIFC an exchange has been established – NASDAQ Dubai. Under the provisions of the DIFC Markets Law, and the DFSA Authorised Market Institution Rules (AMI Module), the DFSA requires NASDAQ Dubai to put in place appropriate listing requirements.

DIFC Markets Law

NASDAQ Dubai currently provides a platform for the listing and trading of securities which are admitted to the official list of securities maintained by the exchange. Currently it provides a platform for the listing and trading of:

- Equity
- Debentures
- Certificates
- Units of Funds
- Index products
- Islamic Securities
- Designated Investments

NASDAQ Dubai permits primary and secondary listings. When an issuer proposes to list securities the requirements of the DIFX must be adhered to. The DIFX is then under an obligation to notify the DFSA of its intention to list the securities at which point the DFSA may object to the admission of the securities to the official list of securities maintained by the exchange.

At present, 20 *Sukuk* are listed, including some of the largest ever issued. However none are currently traded, or tradable.

NASDAQ Dubai is also seeking to provide a conducive environment for Islamic Finance more generally and also offers products such as the Islamic Certificate Index products and recently developed a family of indices with HSBC, including the Sukuk Indices (SKBI).

DIFC has provided an impressive infrastructure for developing human capital in the field of Islamic finance with the introduction of training programmes for Islamic finance practitioners, including the CASS Executive MBA programme.

There are many organizations that have been established to help promote and standardize Islamic finance, most notably AAOIFI, the IIFM and LMC in Bahrain and the IFSB in Kuala Lumpur. There is a danger that too many of these organizations could become talking shops or publishing shops, promoting differing views. This leads to good conference material but little development in the practice of Islamic finance! Dubai has mainly taken the route of providing the infrastructure necessary for the development and implementation of Islamic finance products. Its aim is to promote an active market and, while this objective has not yet been achieved, good progress has been made.

Qatar

Qatar announced the creation of the Qatar Financial Centre in 2005. It too wanted to have a financial centre operating to the highest international standards. Its ambitions are probably more modest than those of Dubai, but it has proved to be ambitions that could be more easily achieved. It had the advantage of starting after Dubai and was able to recruit a number of experienced people who had also been with the DIFC and DFSA during their early years. They knew how to resolve some of the common issues that inevitably arose and so were able to move at a faster pace.

The main aim of the QFC has been to create an indigenous pool of financial institutions operating to the highest international standards. By encouraging companies to establish within the QFC it believes this will encourage the structuring and financing of the billions of dollars of projects that are envisaged for Qatar and the surrounding region.

Islamic finance and Islamic banking is a regulated activity within the QFC. The QFC Regulatory Authority has developed a rulebook governing the activities of licensed companies providing Islamic financial services. These rules allow for either wholly Islamic finance and Islamic banking institutions or Islamic windows for conventional financial institutions. The QFC Regulatory Authority is a member of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), and the Islamic Financial Services Board (IFSB).

At present 96 firms have been licensed, although two licences have been withdrawn. However, not all these firms wish to operate in the area of Islamic financial services.

While the QFC is a successful initiative that should encourage the financing of many projects in Qatar and the surrounding region, Qatar does not have the ambitions of Dubai, or even Bahrain, to become a global hub for Islamic finance.

United Kingdom

London has a stated aim of becoming a listing centre for *Sukuk* and it has already created the first secondary market and attracted a number of issuers. However, before the market can develop more fully there are a number of regulatory hurdles to overcome. As with many Islamic products, the first question is how to treat *Sukuk* under the act and what regulatory definition does it most closely resemble. One option would be to treat them as unregulated "Collective Investment Schemes" (CIS) but this would limit the potential market as there would be restrictions imposed. The second option would be to list them as debt instruments. It seems that it might be possible to treat them as CIS under the Regulated Activities Order but to treat them as debt instruments for listing purposes. At present, each structure needs to be carefully assessed.

The first *Sukuk* was listed on the London Stock Exchange in July 2006. A few more have been listed since then with the listing by Aldar Properties in 2007 of a US$2.5bn *Sukuk*, one of the largest to date. This issue was five-times over-subscribed.

The government has taken a number of important steps to promote the Islamic finance industry. In April 2007, the Treasury established an 'Islamic Finance Expert Group' representing a broad cross-section of opinion from the industry, the City, Muslim organizations and other bodies, including the FSA. The general objective is to advise the government on opportunities to help Islamic finance in the UK. More specifically, as confirmed in the Chancellor's pre-Budget Report in October 2007, the group has been overseeing an official study by the Treasury on the possibility of the UK government issuing a sovereign *Sukuk* in the wholesale market. The study has examined the practical, legal and tax implications of doing so as well as structural issues such as the need for primary legislation.

A consultative document was published in November 2007[3] and received responses from a broad cross-section of market participants. The government's response was published in June 2008[4] and presented to a meeting of the Islamic Finance Expert Group.

Kitty Ussher, the Economic Secretary to the Treasury, in her role as chairman of the Islamic Finance Expert Group, said:

> *"Today's discussion has emphasised both the importance of the Islamic finance sector to the City and the Government's commitment to ensuring the continued growth of this important sector in the future. The Government is determined to maintain its momentum on work on Islamic finance and to make clear to stakeholders its commitment to this industry."*
>
> *"As such, we want to reiterate our aim to publish a paper detailing the UK strategy on Islamic finance by the end of 2008. This paper would clarify the role of the Government in the development of this sector and importantly, the steps that industry will need to take to ensure that Islamic finance becomes one of the UK's success stories."*
>
> *"Responses to the consultation have enabled the Government to move forward in the evaluation of the costs, benefits and risks associated with a Government sukuk issuance. The key conclusions from the consultation were that:*
>
> - *the balance of advantages and risks lies with 'bill-like' sukuk rather than 'bond-like' sukuk;*
> - *a rolling programme of up to around £2 billion of bill-like sukuk issuance would be achievable over time;*
> - *a 'bill-like' sukuk programme would be fully integrated with the conventional Treasury bill programme, which has rolling issuance at 1, 3 and 6 month maturities; and*

[3] Government sterling sukuk issuance: a consultation. November 2007 www.hm-treasury.gov.uk

[4] Government sterling sukuk issuance: a response to the consultation, June 2008. www.hm-treasury.gov.uk

- *the Government would use a 'plain vanilla' Ijara-based structure to facilitate sukuk issuance.*

There are still, however, a number of outstanding issues that need answering before the Government would be in a position to announce a decision on whether or not it will issue sukuk. The Government will continue to work to resolve these outstanding issues and will publish an update of progress in the 2008 Pre-Budget Report."

Having stated its preference for an *Ijarah* structure for the "bill-like" *Sukuk* it has identified the main issues as:

- the transfer of an asset to a special purpose vehicle;
- the application of Stamp Duty Land Tax;
- the application of Value Added Tax;
- the regulatory regime for *Sukuk*;
- the eligibility of the Government's *Sukuk* as acceptable collateral for the Bank of England's open market operations; and
- the settlement of the *Sukuk* within the CREST system.

These are not straight-forward issues, and there are additional considerations too, but the government is committed to finding solutions and moving forward.

Chapter 16

Major Islamic Institutions

While many of the largest Islamic banks are based in Iran (six of the top 12 in *The Banker's* list of November 2007) because of political constraints, these banks do not have the global importance that they might otherwise have. In addition, it is not easy to obtain correct information about their current day operations. As a result, they have been excluded from this chapter. The objective here is to give a brief profile of the operations of some of the leading banks that have had a prominent role in the recent development of Islamic banking and finance.

Dubai Islamic Bank

With total assets of AED83.7 billion (USD22.8 billion) as of December 2007, DIB is the largest Islamic bank in the United Arab Emirates and one of the leading Islamic financial institutions worldwide. As recently as 2002, total assets were only USD5.3 billion. Established in 1975 as the world's first Islamic bank of the modern era, DIB is the fifth-largest bank in the UAE in terms of banking system assets and loans and the third-largest in terms of deposits.

DIB was rescued from near-collapse by the Dubai government in 1998, after the institution ran into difficulties following an embezzlement, involving two employees, to the tune of AED888 million. DIB received an injection of capital from the Dubai government, while a four-man committee was appointed to manage the institution. News of the need for the rescue package prompted a depositors run on DIB, though confidence was restored following assurances by the authorities that all of the bank's obligations would be met.

With the direct support of its controlling shareholder, the Dubai government, DIB underwent a major organizational transformation. With a new board and a new, experienced management team, the bank has been catapulted to the forefront of

Islamic banking in the UAE and the region. For at least the last five years it has won a number of "best bank" awards in several categories and seen its franchise grow, especially in the UAE.

Its operations are focused around five core units: retail and business banking; investment banking; real estate contracting, finance and direct equity investments; corporate banking; and treasury operations. The retail and business banking unit is the largest, but is less profitable than the investment banking business. The Millennium subsidiaries are incorporated within the DIFC and the bank has benefited from the huge growth in *Sukuk* issues in the last few years where it has been one of the leading managers of some of the largest issues. In part this has been because of the expertise it has developed in structuring the issues, but in part it could be because a number of *Sukuk* have been issued by entities owned by the Emirate of Dubai. Indeed, one of the problems that the bank faces arises because the Dubai government is its largest shareholder and also controls many of the customers most sought after by all the banks. Dubai and Dubai-owned companies play a dominant role in Dubai's economy. As a result, the bank has significant related party concentrations.

The bank is beginning to develop international operations, but this has had lower priority, given the extensive opportunities that were available in the UAE over the last few years. It does however have operations in Sudan and Pakistan and plans to seek opportunities in Jordan and Syria as well as other GCC countries. Along with Abu Dhabi Islamic Bank and the Islamic Development Bank, it also owns the only Islamic bank in Bosnia Herzegovina. The international expansion has fuelled the bank's growth. Real estate development used to be a significant part of the balance sheet but, in 2007, DIB sold Deyaar Development Company, which was a 99.5% owned subsidiary, to Deyaar Development PJSC, in which the bank's stake is just 43%. The sale gave a good boost to 2007 income. However, exposure to the real estate sector remains high.

Kuwait Finance House

Founded in 1977, KFH is one of the oldest Islamic banks of the modern era and one of the most influential. However, 30 years ago, banking regulation did not cover Islamic financial institutions and KFH obtained its licence to operate from the Ministry of Commerce. This effectively meant that KFH was self-regulated for much of its history. With the passing of new regulations, KFH obtained its Islamic banking licence from the Central Bank of Kuwait in 2004. It has benefited from its role as the first provider of Islamic-based deposit products in Kuwait. The new law heralded the start of new Islamic institutions, both as start-up banks and also conversions from conventional operations. Despite the increased competition, KFH still holds over 20% of the domestic banking system's total deposits, a position it has maintained for many years. At the same time, KFH has significant consumer finance operations, where it has the second-largest market share in Kuwait, a result of its dominant market share of above 30% in financing auto purchases – a franchise that is driven by its ownership of a retail auto distribution network that exhibits vehicles purchased at a discount from wholesale distributors and contains floor space dedicated to various auto distributors.

National and international expansion is central to KFH's diversification strategy. International operations are growing in importance, and have started to bring visible diversification benefits to the group. This has had a positive impact on KFH's culture. It has had a majority stake in Turk Evkaf Finance House for many years, but only since the Turkish regulations changed to permit "Participation Banks" has the potential begun to be realized. KFH established KFH Bahrain in 2002 and KFH Malaysia in 2006. Initially these banks were allowed great freedom and were able to operate with little oversight from Head Office. However, recently the group has begun to allocate resources more efficiently across the organization and become more involved in the business of its most important subsidiaries. However, it is still unable to consolidate full year performance into its own consolidated statements, in part because it lacks an integrated IT system.

KFH's strengths lie in its retail and corporate services and it has been much less involved in investment banking activities than Dubai Islamic Bank, for example.

Al Rajhi Bank

The origins of Al-Rajhi Bank date back to the late 1950s when four Al-Rajhi brothers (Saleh, Sulaiman, Abdullah and Mohammed), started bullion arbitrage and money-changing businesses. In 1978 they amalgamated their money-changing operations under Al-Rajhi Trading and Exchange Corporation, which in 1987 obtained a banking licence. The company was renamed to Al-Rajhi Banking and Investment Corp under the ministerial decision No. 1398, and again, in 2006, its name was changed to its current one, Al Rajhi Bank.

Al Rajhi Bank is still controlled by the founding Al-Rajhi family, with several members jointly owning approximately 46% of the share capital. The Al Rajhi family is considered, by most in Saudi Arabia, to be the country's wealthiest non-royals, and among the world's leading philanthropists. Saudi Arabia's Social Insurance Corporation owns an additional 9.9% of the bank which is listed on the Saudi Stock Exchange.

Al Rajhi is a fully fledged Islamic bank that provides wholesale, retail and commercial banking, and investment services. The bank is particularly strong in retail banking (serving both mass market and top-tier clients), in the remittance market where it is the dominant player with a market share of more than 50%, and in serving the SME market. The setting up of Al Rajhi Bank - Malaysia in 2006 is management's first major international venture. The Malaysian subsidiary operated from 19 branches in late 2008, and the number is projected to rise to 50 within three years.

The bank's operations have benefited from its very strong deposit base. It is perceived as the only "true" Islamic bank in the Kingdom and so has attracted a loyal and devout customer base. Around 80% of its deposits carry no return and so provide a cheap funding base for the bank.

Al Rajhi has rewarded its customers by providing competitive and convenient services. Al Rajhi has the largest branch network in the Kingdom while its alternative distribution channels (including more than 1,820 ATMs, internet banking and call centres) allow for 90% of financial transactions to be performed outside its branch network. The bank retains a leading market position in consumer loans, demand deposits, debit cards, and money transfers, while management is also taking steps to strengthen its corporate banking capabilities in order to take advantage of the growth opportunities in project finance, investment banking, and transactional banking services which are in great demand in the Kingdom and the GCC.

With total assets of over US$33 billion at the end of 2007, Al Rajhi is the third largest Islamic bank in the world after Bank Melli and Bank Saderat from Iran.

DMI (Faisal) Group

It is difficult to know whether to head this section as DMI (Dar Al-Maal Al-Islami) or Ithmaar Bank. Both are part of the group established by Prince Mohamed Al Faisal Al Saud but there have been significant movements in the group's structure over the last few years. The largest operating institutions now fall under Ithmaar Bank while DMI holds more of an overall administrative role.

Ithmaar, a 24 year-old financial institution, is now a full service investment bank licensed by the Central Bank of Bahrain, and has business spanning the MENASA region, as well as Asia Pacific and Europe. Ithmaar, which was listed on the Bahrain Stock Exchange following its successful IPO in March 2006, has also been listed on the Kuwait Stock Exchange since March 2008. Ithmaar and its various subsidiaries and affiliates (together the "Ithmaar Banking Group") cover a wide range of financial services, including investment banking, commercial and private banking, takaful (Islamic insurance), equipment leasing and real estate development. Total equity in Ithmaar was US$67mn at the end of 2003. By the end of 2007 it had reached US$1284.4 million and total assets were US$4.1 billion. While still making significant progress, Ithmaar has not been able to isolate itself from the global credit problems and reported a loss for the third quarter of 2008 which it attributed to the lack of liquidity in some of the markets where it operates. However, it was still able to report growing profits for the year to date. It has postponed the IPO for a real estate and construction company, Naseej, on the instructions of the Central Bank of Bahrain. While there are growing problems in the real estate sector in the Gulf, Ithmaar believes that there are still opportunities for Naseej, especially in the area of low and medium cost housing, and still hopes to move forward with the IPO.

The most significant acquisition in the restructuring of the DMI group was Ithmaar Bank's take over of Shamil Bank, also headquartered in Bahrain, which at the time of purchase had a much larger balance sheet than Ithmaar. Shamil Bank is now 100% owned by Ithmaar and this has broadened the scope of Ithmaar's activities as Shamil caters mainly to the retail and high net worth market. Ithmaar is now also the 65.7% owner of Faysal Bank Limited. This Pakistani bank now has over 100 branches and has been performing well in a market which is now trying to develop a more vibrant Islamic presence.

Further, as another part of the Group's restructuring, Ithmaar owns 100% of Faisal Private Bank, the only bank operating in Switzerland that only offers Islamic services. It also holds a minority 33.6% stake in Solidarity, one of the leading providers of *Takaful* products. It has been establishing joint ventures with insurance companies in the Middle East and Asia so they may offer *Shari'a* complaint insurance products.

Prince Mohamed Al Faisal Al Saud is regarded as one of the founding fathers of modern day Islamic finance. He has brought structure and vision to the industry and Ithmaar promises much in the future.

Al Baraka Banking Group

The head office of the AlBaraka Group is in Bahrain and the shares are listed in Bahrain and Dubai. That said, around 50% of the group's shares are held by Sheikh Saleh Kamel with most of the balance in the hands of Dallah AlBaraka Holding Company, although in July 2007, Dallah announced that it had entered an MOU with Saudi Investment Bank for the sale of a 50% stake in the banking group.

ABG claims, with some justification, to have the widest geographic coverage of all Islamic banks and this is in line with Sheikh Saleh's vision of large Islamic institutions able to compete with global conventional banks. With end 2007 total assets of just over US$10 billion, the ABG has some way to go, but is aiming for annual growth of around 30%. Total equity has reached over US$1.5 billion, leaving room for some expansion. At present the group has banking operations in Turkey, Jordan, Bahrain, Pakistan, Sudan, Egypt, Algeria, Tunisia, South Africa and Lebanon. It has a new banking licence in Syria and it opened a representative office in Indonesia during 2007. It aims to purchase an existing bank in Indonesia where it sees significant opportunities.

The bank has a broad focus, although the size of its operations in some countries could be a limiting factor. It does offer retail, commercial and investment banking as well as providing treasury facilities. Its largest bank by asset size is in Turkey where the Al Baraka Participation Bank had US$3.16 billion in total assets at the end of 2007. It recorded a profit of US$62.4 million. By contrast, operations in Tunisia, South Africa and Lebanon are small with total assets ranging from US$310 million to just US$144 million in Lebanon, where the bank continued to record a loss.

The Dallah AlBaraka Group that Sheikh Saleh founded has a broad scope of operations including agriculture, food, media, transport, real estate and trading with most operations in Saudi Arabia but with a significant presence elsewhere in the Arab world. The group is believed to employ over 60,000 people. While the banking operations are dwarfed by his other interests, Sheikh Saleh has shown great commitment to the development of Islamic banking and finance.

Like Prince Mohamed Al Faisal Al Saud, Sheikh Saleh is regarded as one of the founding fathers of modern day Islamic banking and his vision will be important for its future development.

Abu Dhabi Islamic Bank

Abu Dhabi Islamic Bank (ADIB) is a relative newcomer to the scene having only recently celebrated its tenth anniversary. Its founding shareholders were members of the ruling family, the Abu Dhabi Investment Authority and prominent UAE nationals. Together they still hold 39% of the shares while the balance is held by around 100,000 investors. The bank is listed on the Abu Dhabi Securities Market.

The bank continues to grow quickly and has an important place in the Abu Dhabi market. However, it has global ambitions and has begun to look for oversees opportunities. With Emirates International Investment Company as a partner, in 2007 it acquired a 51.29% stake in Egypt's National Bank for Development. NBD is a loss-making bank having accumulated a poor loan portfolio, but does have potential. It has 68 branches of which 19 already operate as Islamic branches and, in addition, it has been a successful provider of microfinance. ADIB has also applied for licences in Algeria and Libya and, along with Dubai Islamic Bank and the Islamic Development Bank, owns Bosna International Bank, the only Islamic bank operating in Bosnia Herzegivina.

With total assets now over US$13 billion, ADIB is one of the largest Islamic banks and has the financial backing to make it an even more important player in the future.

Bank Islam Malaysia

Bank Islam was established in 1983 as the first Islamic bank in Malaysia. Since then it has been one of the best known names in Islamic banking. As such it deserves a place in the bank profiles. It is also a useful reminder that Islamic banking, like conventional banking, needs to be run with clear strategies, skilled management and staff, and the right controls. With any of these elements missing, troubles can occur.

Bank Islam's holding company, BIMB Holdings, is controlled by Lembaga Tabung Haji – the Pilgrims Fund Board of Malaysia – which is government owned. As a result, it has often been said that Bank Islam received favourable treatment from the government, being the spoilt child of the Ministry of Finance. For many years, as the only Islamic bank in Malaysia, it did not have to worry about competition. Also, the board was made up of government appointees who were not bankers and seemed to give no meaningful oversight to the bank's operations. It has been said that by the year 2000, the bank was close to collapse. It had few internal controls and had built up a large portfolio of non-performing financings. In addition, its branches were said to be old and dilapidated and the bank was losing key staff. Bank Negara sent in as Chairman an experienced and well-respected banker, Dato Mohammad Yusoff Haji Nasir, with a mission to identify the problems. However, while he found a number of problems, management did not appear to be receptive to change. Things did not improve and, late in 2004, it became obvious that all was not well in the bank's Labuan subsidiary. It was decided to close the subsidiary and turn the operations into a branch of the bank, thus exerting more central control. In April 2005, the government appointed Datuk Noorazman Aziz as Managing Director to sort out the finances. When the 2005 results were announced in October of that year, the bank declared its first ever loss of RM473.4 million as a result of a RM2.2 billion (US$600 million) gross non-performing financing portfolio. A large part of that had been booked in Labuan, but the bank also had a sizeable non-performing consumer portfolio.

In 2006, Datuk Noorazaman Aziz moved to be Managing Director of the Holding company and Datuk Zukri Samat was appointed as Managing Director of the bank. He continued the radical restructuring that had already begun, including a recapitalization that saw the Dubai Islamic Investment Group (now the Dubai Banking Group) become a 40% stakeholder with a further 9% being taken up by Lembaga Tabung Haji. 51% remains in the ownership of BIMB Holdings which remains controlled by Lembaga Tabung Haji.

The 2006 results showed RM1.26 billion losses and provisioning of RM1.5 billion. The bank wrote off RM2.3 billion of bad financings in the space of two years. In October 2006 it suspended the car hire-purchase facility as Zukri said that for every three cars that they financed, one would be missing!

However, in 2007, the bank was able to record its highest ever profit and the new operating model is having a huge impact. Apart from the necessary recapitalization, the bank has begun to revamp its IT infrastructure and has put large store by human resource development. Procedures are now in place and loan approval officers are experienced and trained. Indeed nearly all the bank's staff have undergone training in the last 18 months. Yet the challenge is not over for the bank. It has to operate now in a much more competitive and sophisticated market.

In 1993 Bank Negara opened the door to competition by allowing the conventional banks to operate Islamic windows and in 1999, Bank Muamalat Malaysia was established. In 2004, conventional banks were allowed to open Islamic subsidiaries and then in 2005, licences were granted to three foreign Islamic banks – Kuwait Finance House, Al Rajhi Bank and Asian Finance Bank.

Bank Islam has responded very positively to the competition and is introducing new and innovative products. Its new treasury division is obtaining corporate mandates, and it is aggressively seeking business from the high end of the SME market. It is offering a full range of consumer banking products, including car financing again, although this time with a more carefully selected customer base. Perhaps most importantly, it is managing to reduce the non performing portfolio and is confident that the position is now under control. Recoveries were a major component in 2007's profits.

The bank has also formed a partnership with the European Islamic Investment Bank to offer products in Europe.

With a new logo and a new confidence, the bank has reasserted itself as a leader in Islamic banking in Malaysia. The challenges are not over, but the bank is now positioned for greater success.

CIMB Islamic Bank

While still a relatively young bank, CIMB Islamic has already made its mark on the industry, particularly for its investment banking activity where it has won many "best bank" awards.

The Malaysian banking system has seen significant consolidation over the 2001-2006 period, in the aftermath of the Asian financial crisis. Some 50 banks have been consolidated into nine groups today. CIMB, the parent of CIMB Islamic, is the result of the merger of some 12 institutions, and the Islamic services that were offered by these institutions have become part of CIMB Islamic Bank. Bumiputra Commerce Bank became the operating arm of Bumiputra-Commerce Holdings in 1999, a State-controlled holding company. Bank Bumiputra was the bank that probably had the highest non-performing portfolio prior to the Asian crisis, and the legacy problems are still being resolved. In June 2005, Bumiputra Commerce Bank was integrated with Commerce International Merchant Bankers (CIMB) and this led to the merging of Commerce Tijari with CIMB Islamic which was the Islamic investment banking franchise of CIMB. This merger meant that CIMB Islamic became a full Islamic universal bank. Then, in 2006, Southern Bank was acquired by Bumiputra-Commerce Holdings and its Islamic operations have since been merged with CIMB Islamic, an exercise that was completed by March 2007. As a result the retail and commercial banking activities of CIMB Islamic have been strengthened as it was in this area that CIMB Islamic lagged its peers. Today it is the fifth largest Islamic bank in Malaysia. That said, it maintains its leadership in Islamic investment banking and has topped just about every global table in this area, including the *Sukuk* league tables produced by Bloomberg, IFIS and Dealogic. While it won awards in 2006, the list for 2007 is even more impressive:

- Global Islamic Investment Bank of the Year

- Best Islamic Bank in Asia
- Best Islamic Finance House
- Best Islamic Retail Bank of the Year
- Best Islamic Bank - Malaysia
- Best Sukuk House
- Best Islamic Fund Management House in Malaysia
- Best Structured Product Solutions Provider in South East Asia
- Best Lead Arranger for a Sukuk Transaction
- No.1 Lead Manager Award (Issue Value & No. of Deals)

These accolades have come from many well-known sources, such as *The Banker* magazine, which is part of the Financial Times group, *Finance Asia*, Islamic Finance News Annual Poll and Islamic Business and Finance, which is based in Dubai.

Much of the effort over the last year has been taken up with full integration of all the component parts of the bank and implementing a "dual banking" model with its CIMB Bank parent. This has entailed IT developments allowing *Shari'a* compliant and conventional services to be accommodated in one system and the training of staff so that the bank's products are now available through over 380 branches, 28 business centres and 35 retail business centres. Three years ago, consumer banking was only available at the head office branch, so this has been quite a transformation. The "dual banking" model has enabled considerable cost savings and expansion of all the bank's activities. While such a system needs excellent controls and skilled staff, the rewards are there if success is achieved. The results for CIMB Islamic Bank suggest that it has been successful and that more can be achieved in the future.

HSBC Amanah

HSBC Amanah is the global Islamic banking division of the HSBC Group. Founded in 1998, it now has 300 professional in the Middle East, Asia-Pacific, Europe and the Americas, giving it one of the most international Islamic franchises. According to The Banker, it ranks as the fourteenth largest Islamic financial institution in the world – eighth if the Iranian banks are excluded. It is the only major banking name to appear on the list.

Whilst some products and services are widely available, the main thrust has been in Malaysia, Saudi Arabia, United Arab Emirates and the United Kingdom. The central teams for HSBC are based in London, Dubai and New York. In addition, HSBC Amanah operates through a subsidiary in Kuala Lumpur, Malaysia which is the regional centre for Islamic services.

Personal banking services available include private banking (using its Swiss expertise but also available in the United Arab Emirates and the United Kingdom), personal banking accounts (available in Malaysia, Saudi Arabia, United Arab Emirates and United Kingdom), debit cards (Malaysia, Saudi Arabia), home finance, using diminishing *Musharaka* (Malaysia, Saudi Arabia, United Arab Emirates, United Kingdom), personal finance using *Tawarruq* (Malaysia, Saudi Arabia, United Arab Emirates), vehicle finance using *Ijara* (Malaysia, Saudi Arabia, United Arab Emirates), investments (Malaysia, Saudi Arabia, United Arab Emirates and potentially other centres where the regulations allow), and *Takaful* using *Tabarru* which means a gift or donation (Malaysia, United Kingdom).

Corporates can use *Shari'a* compliant trade finance, project finance, structured finance, capital market activities, and corporate advisory services.

Treasury services include short term *Murabaha* where commodity trades are financed, and longer term *Murabaha* which offer higher returns depending on credit risk. The treasury is also a market maker in a number of *Sukuk*.

HSBC Amanah has also developed a suite of hedging structures that can be used by institutions for the management of rate and foreign exchange risk. Transaction banking and corporate advisory services are also available. Trade services use *Murabaha* contracts, working capital or term finance is based on *Tawarruq* or *Bai al Ina* while asset finance uses *Murabaha* or *Ijara* contracts. A full range of investment needs can also be met in a *Shari'a* compliant way.

While the personal banking accounts and the corporate accounts come with the assurance that the funds deposited will be invested in a *Shari'a* compliant way, there still seem to be concerns among potential customers in the UK in particular that the bank may be using conventional funds for their house or vehicle purchase transactions and this has limited the uptake.

The real attraction for customers is that HSBC Amanah can call on its considerable global expertise to develop products and to serve customer needs around the world, a claim that few other institutions can make.

Chapter 17

Islamic Microfinance

While early attempts at Islamic banking were largely in the field of microfinance, today there are only a few institutions involved and, apart from Grameen Bank which is not truly Shari'a compliant as it does charge interest, they are very small.

When Dr Muhammad Yunus of Bangladesh started in the mid to late 1970s he focused on people who generally did not have the means to fund a new business or craft. Inspired by the terrible Bangladesh famine of 1974, he made a loan of $27 to a group of 42 families enabling them to create small items for sale without the heavy burdens of repaying moneylenders who charged exorbitant rates of interest. Borrowers used loan proceeds to buy raw materials to manufacture products for sale in the market; purchase livestock to sell milk or eggs; or open small shops.

In recent years, some microfinance institutions (MFIs) have stepped in to service low-income Muslim clients who demand products consistent with Islamic financial principles – leading to the emergence of Islamic microfinance as a new market niche.

The need is most certainly there. The numbers suggest that around 35% of the world's 1.2 billion Muslims are poor. One of the issues for conventional microfinance is how it should be funded. Much of the money today comes from donor organizations. For Islamic microfinance, if *Zakah* and *Awqaf*[1] funds could be mobilized, the billions needed would be available. Islamic microfinance represents the confluence of two rapidly growing industries: microfinance and Islamic finance. It has the potential to not only respond to unmet demand but also to combine the Islamic social principle of caring for the less fortunate with microfinance's power to provide financial access to the poor.

In many countries, with notable examples coming from Afghanistan and Iran, millions of Muslim poor are currently rejecting microfinance products that do not

[1] Awqaf is the donation of land or money from rich Muslims

comply with Islamic law. The Foundation for International Community Assistance (FINCA) had this experience in Afghanistan. People would not accept their financing because it was not *Shari'a* compliant. As a result they have introduced *Murabaha* financing and purchase goods for their clients that are sold with a mutually agreed mark-up. At present FINCA Afghanistan has nearly 43,000 clients in 3,500 village banking groups. The average loan size is US$357 and the total amount outstanding is US$6.5 million. Clients are also encouraged to save with FINCA and these savings amount to US$130,000[2].

Islamic microfinance is still in its infancy, and business models are just emerging. Perhaps the most favoured is the route taken by Dr Yunus at Grameen Bank. In this case, the individual borrowers from a village form a group with around five members. Several groups come together in a centre that has weekly meetings. An official from the bank goes to these weekly meetings and collects the repayments. Loans are small, usually less than US$200 in Bangladesh, and repayable in weekly installments over five months to one year. The bank also provides social development programmes covering behavioural, ethical and social values. No collateral is available from the clients so the bank relies on social collateral. If one member of a group defaults, the others do not qualify for a loan until it is repaid. In many cases peer pressure is sufficient to avoid defaults and in other cases, the group members help each other to keep repayments up to date. Most clients are women – in some cases over 90% - and this is partly because the women are not out in the fields during the day as the men are, and so can attend meetings. It is also suggested that by training the women, you train the whole family.

Conventional banks do not fund offering microfinance economic. They can take no collateral and, although the loans are small, they are extremely risky because there is no information available on the clients and they have no track record. There are also moral hazard problems as clients will often divert funds from the intended project to meet everyday expenses. Further, the costs of offering microfinance are high in relation to the returns on the financing provided. These high costs are one of the reasons that most banks offering microfinance have to rely on charitable funding for their operations.

Many of the issues seem to cry out for *Shari'a*-based solutions and the reasons that these have not been forthcoming are unclear.

In a 2007 global survey on Islamic microfinance[3], carried out by CGAP (Consultative Group to Assist the Poor), which is a World Bank initiative, information was collected on over 125 institutions from 19 Muslim countries. The survey was used, alongside other available data, to estimate the impact that Islamic finance is having in the area of microfinance. The disappointing conclusion was that it has a total estimated global outreach of only 380,000 customers and accounts for an estimated one-half of one percent of total microfinance outreach.

[2] www.villagebanking.org

[3] Karim, Nimrah, Michael Tarazi, and Xavier Reille. 2008. "Islamic Microfinance: An Emerging Market Niche." Focus Note 49. Washington, D.C.: CGAP, August.

According to the survey, Bangladesh has the largest Islamic microcredit outreach, with over 100,000 clients and two active institutions. However, Bangladesh is also the country where conventional microfinance products have the largest outreach — nearly 8 million borrowers — and Islamic microfinance represents only 1% of its microfinance market.

In all Muslim countries, Islamic microfinance still accounts for a very small portion of the country's total microfinance outreach. For example, in Syria and Indonesia, Islamic financing instruments comprised only 3% and 2%, respectively, of outstanding microfinance loans in 2006. In addition, the average outreach of the 126 institutions covered by the CGAP survey is only 2,400 clients (and none has more than 50,000 clients).

The supply of Islamic microfinance is very concentrated in a few countries, with the top three countries (Indonesia, Bangladesh, and Afghanistan) accounting for 80% of the total. This is despite the fact that in predominantly Muslim countries such as Jordan, Algeria and Syria, many cite religious reasons for not accessing conventional microfinance.

Some Islamic countries, such as Indonesia and Pakistan, have a vibrant microfinance industry and CGAP reports that approximately 44% of conventional microfinance clients worldwide reside in Muslim countries. Yet conventional microfinance products do not fulfill the needs of many Muslim clients.

The CGAP survey identified that over 70 percent of the products offered are *Murabaha*. Islamic MFIs generally offer only one or two *Sharia*-complaint products. Concentrating primarily on asset financing, the industry still lacks product diversification to serve the various financial needs of the poor.

In Indonesia, the government has actively promoted Islamic microfinance. In 2002, Bank Indonesia prepared a "Blueprint of Islamic Banking Development in Indonesia" in which it developed a nine-year plan for development of the Islamic finance sector, including support for the 105 *Shari'a* rural banks. Indonesia now provides a supportive regulatory framework and has licensed 35 new Islamic rural banks in the past five years. Bank Indonesia also is spearheading efforts in capacity building by establishing a centre in Medan to offer training and certification on Islamic financial operations to *Shari'a* rural bank staff, managers, and directors. Despite these efforts, Islamic microfinance has not really been accepted, for reasons that are not clear and, despite the large Muslim population, people still turn to the conventional products that are available.

In 2007, the State Bank of Pakistan developed guidelines for the expansion of Islamic microfinance. Pakistan has had institutions successfully offering conventional microfinance for some time, but alongside the initiatives in place to promote the development of Islamic banking, it wished to see Islamic microfinance develop at a similar pace.

The guidelines stipulate institutional arrangements for offering Islamic microfinance and the requirements for licensing. They also talk of the appointment of *Shari'a* advisers and the segregation of Islamic funds by banks and microfinance institutions that offer both conventional and *Shari'a*-compliant products.

An encouraging development in the growth of Islamic microfinance is that some Islamic commercial banks have started to offer Islamic microfinance services. Yemen's Tadhamon Islamic Bank, for example, opened a micro and small enterprises division in late 2006. In addition, some Islamic banks are planning to offer Islamic microfinance products beyond just microcredit. Early in 2008, Noor Islamic Bank, a new, well-capitalized, Dubai government promoted Islamic bank, and Emirates Post Holding Group announced plans to establish a company that will offer *Shari'a*-compliant banking services to the low-income segment of the UAE population. The proposed company will provide a wide array of Islamic microfinance products, including microcredit, insurance, debit and credit cards, remittance and currency exchange, and salary payments. Also in January 2008, Allianz Life Indonesia announced that, after an 18-month pilot project, the *Shari'a*-compliant microinsurance "Family Umbrella" product is now an established line.

Another new initiative looks promising. In July 2008, HSBC Amanah, the global Islamic finance services arm of the HSBC Group, announced it has entered into a partnership with Islamic Relief, a major international relief and development charity, to offer a pilot Islamic microfinance scheme in Pakistan. HSBC Amanah will be providing funding towards Islamic Relief's microfinance projects in Rawalpindi, Pakistan. It will also assist Islamic Relief in developing the *Shari'a* structure for financing models and contracts and providing Islamic finance training to Islamic Relief staff. Islamic Relief will, in turn, manage microfinance projects, identify and screen beneficiaries, set out eligibility criteria, encourage entrepreneurs to come forward with lucrative business ideas for investment, and provide financial and social reports to HSBC Amanah. In announcing the scheme, the bank said that it is keen to encourage the development of the Islamic microfinance sector and to promote the production of a commercially viable microfinance business model with high social impact. Based on the results of this pilot project, it will be rolling out other *Shari'a* compliant microfinance schemes in other locations,

One further example comes from Sri Lanka where Daa'im Investments Ltd has been operating since 1982. It provides investment accounts on a *Mudaraba* basis and provides microcredit facilities.

The microcredit scheme is available to individuals who are gainfully employed residents in the area where Daa'im operates. Participants should be males below 55 years or females below 50 years. The amount of finance available ranges from Rs15,000 to Rs100,000 (US$135 to US$900). Each participant needs to become a shareholder in the company by purchasing 100 shares at a cost of Rs1000 (US$9). They will then open a *Mudaraba* investment account in the "Poverty Reduction Mudarabah Fund" in which they invest regularly over a period of twelve weeks. This is to inculcate a savings habit among the participants. They receive a share of profit related to their investment balance maintained on a monthly basis while the account remains intact. The profit sharing is calculated on a 50:50 basis.

By the thirteenth week, or later depending on the participant's needs, they will be provided with the assistance that they have requested initially using the *Murabaha* concept with Daa'im purchasing the required asset(s). The agreement allows for repayment of the agreed amount in 72 weekly installments. Repayment can be arranged for a period of 48 weeks or for a lump sum payment payable in a shorter period.

A second facility will be considered only after a lapse of three weeks from completing the previous assistance. A longer repayment period will also be considered.

If someone decides to leave the system, the shares can be sold at the prevailing market price. If the participant should die before completing the repayments, the outstanding amount is absorbed by Daa'im Investment Limited through a *Takaful* Scheme. The dependents will also receive a grant of Rs5000 to help meet the cost of funeral expenses. *Takaful* cover is also available at a cost of Rs600 that covers any stock against burglary, fire, lightning, and other natural perils.

Chapter 18

Takaful

Insurance in Islam is essentially a concept of mutual help. It is said that the operation of insurance was established in the Arab tribal custom of blood money, or *diyah*, where the victim would be compensated by those members of the community whose action had resulted in the loss of life or impairment of the victim. The principle of compensation and group responsibility was accepted and practised by the Muslims of Mecca and Medina, laying the foundation for mutual insurance over 1,400 years ago.

Further, as Arabs started to expand their trade to more distant countries, long journeys were involved, and there were many inherent dangers. In order to protect each other from losses arising from shipwrecks, robberies or other misfortunes, the traders got together and mutually agreed to contribute to a fund that would be used to compensate anyone in the group who suffered losses.

In modern times, a favourable *Fatwa* issued by the *Fiqh* Council of the Muslim World League in 1977 encouraged potential promoters to offer *Takaful* services. The first company to be established was the Sudanese Islamic Insurance Company that was set up by Faisal Islamic Bank in 1979. This was very soon followed by the Arab Islamic Insurance Company, established by Dubai Islamic Bank.

In 1984, the Malaysian Takaful Act was passed, the first regulations specifically designed for the *Takaful* industry. Takaful Malaysia was established soon after (1985) and remains a leading provider of *Takaful* services. Further approval for the development of the fledgling industry came in 1985 when a ruling from the *Fiqh* Council of the OIC said that conventional insurance was *Haram*, but insurance based on the application of cooperative principles, *Shari'a* compliance and charitable donations was *Halal*.

While a number of *Takaful* companies have followed – at the last count there were some 133 companies worldwide[1] - *re-takaful* companies have been slow to establish.

[1] According to the World Takaful Report 2008, Ernst & Young

The first active company, Asean Re-Takaful International Limited, began operations in 1997. In recent years, a number of new *Re-Takaful* companies have been established with perhaps the most significant move being the entry of some global re-insurance players such as Hannover-re and Munich-re which have established *Re-Takaful* operations.

Regulation has also been slow in coming. Today only Malaysia (1984), Pakistan (2005) and Bahrain (2005) have regulation in place that is specific to *Takaful*. Sudan and the Kingdom of Saudi Arabia refer simply to the need to comply with *Shari'a* Law.

Islamic insurance companies offer both life and general policies. Policies cover those risks that are covered by conventional insurance companies but all policies are written on a mutual basis.

Scholars have argued that there is an element of *Maisir* – or gambling – involved in Islamic insurance because a small amount of premium can lead to a huge return, if a certain event takes place. If the event does not occur, the insured loses all his premium.

Takaful companies have tried to minimize this element by adopting co-operative principles. Participants contribute to a fund that is collectively owned and used to help each participant in his time of need. Further, even if the event does not occur, an individual can benefit from sharing the profits arising from the pool.

An element of *Gharar*, or uncertainty, also exists in an insurance contract. G*harar* also implies that a contract favours one party over the other. Islamic insurance tries to minimize this through its co-operative principles. The premiums paid are jointly owned by the participants and returns from the pool are payable when a certain event occurs or as a share of the profits. While participants share the profits, they also face the possibility of sharing the losses, although safeguards are often incorporated to mean that this is a last resort (use of reserves and/or shareholders' loan would be the first recourse, although there is still some debate over the legitimacy of these safeguards).

In developing *Takaful* products it is firstly important to minimize the element of *Gharar* in the contract. The premiums paid should be clearly stated to be owned by the participants through a *Takaful* pool and not by the company. In this way it is clear that the participants share in any profits from the pool, but also the losses.

Second, participants should not look on insurance as a form of gambling. Even though some participants may receive large amounts in relation to the premium paid, at the time they join, they agree to give up their individual right in order to help each other in time of need.

The third element that is essential in Islamic insurance is to avoid *Riba*. This means that the investments made by the company must be in instruments or shares that comply with the *Shari'a*. At present this puts *Takaful* at a disadvantage when compared with conventional mutual insurance. Investments by *Takaful* companies are generally in *Shari'a* compliant equities, placements with financial institutions (in a *Shari'a* compliant way) and real estate, whereas conventional companies mainly invest in less risky bonds, but of course these are interest-bearing and so not an available investment option for *Takaful* companies.

Family *Takaful* and General *Takaful*

Family *Takaful* and General *Takaful* are the *Shari'a* compliant counterparts of conventional life and general insurance policies respectively. In family *Takaful*, the participant's contribution is apportioned into a donation representing a financial indemnity (*tabarru*) with the balance into an account for savings and long-term investments. Examples of family *Takaful* include individual family *Takaful* plan, mortgage *Takaful*, education *Takaful*, and health *Takaful*. Unlike conventional life insurance, there are generally no guarantees and the scheme is based on defined contribution rather than defined benefit. General *Takaful* is provided on a short-term mutual indemnity basis and has no savings component. Should there be a net surplus in the general *Takaful* fund, it is usually shared between the participants and the operator on an annual basis. Examples of general *Takaful* include fire *Takaful*, motor *Takaful*, marine, aviation & transport *Takaful*, home *Takaful*, and accident *Takaful*.

Takaful Models

Several different models are currently in use, but none is ideal. These are:

- *Wakala* or agency, where the operator acts as *wakeel* of the participants' funds. There is no profit/surplus sharing with the operator. The operator is remunerated from underwriting fees and investment management fees. Under this system, participant and shareholder investments are held separately. Shareholders' capital grows according to fees generated from the sale of products and investment income generated within the fund. Any surplus generated within the participants' fund is either paid out to participants or is retained in the shareholders' fund but is not paid to shareholders.
- *Wakala* (or agency) with sharing of investment profit and/or underwriting surplus with the operator. This is less common in practice and is more akin to the *Mudaraba* model.
- *Mudaraba* with sharing of investment profit and underwriting surplus with the operator.
- A hybrid of the two with the *Wakala* model used for the underwriting portion, with no surplus sharing, and *Mudaraba* for the investment portion with profit sharing.

This last hybrid model is favoured by AAOIFI in its *Shari'a* standards and as a result has been adopted by the Central Bank of Bahrain in its Rule Book.

To some extent, the model used depends on the local regulation for insurance operations, particularly regarding capital adequacy and solvency. Whatever is chosen, there are important issues of governance, solvency and disclosure that are particular to *Takaful* companies.

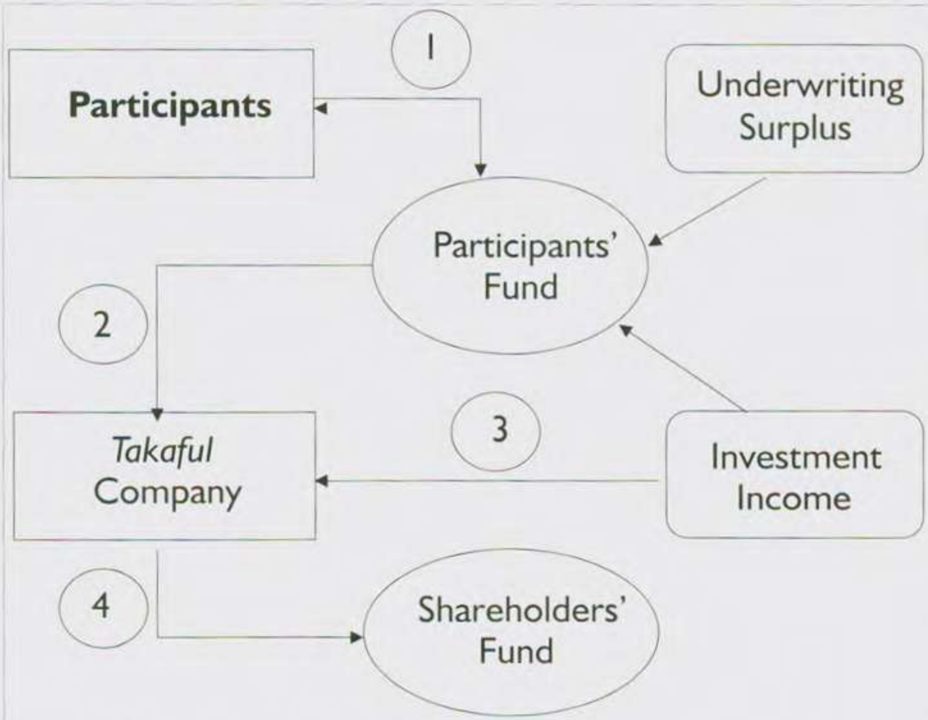

Figure 18.1: *Wakala* Model

1. Participants contribute to the Participants' Fund
2. A fee attributable to the *Takaful* Operator is deducted from the Participants' Fund to pay the Operator for underwriting and managing the operations
3. The Operator receives a fee for managing the investments made by the Paticipants' Fund
4. The shareholders funds of the company are managed separately from the Participants' Fund

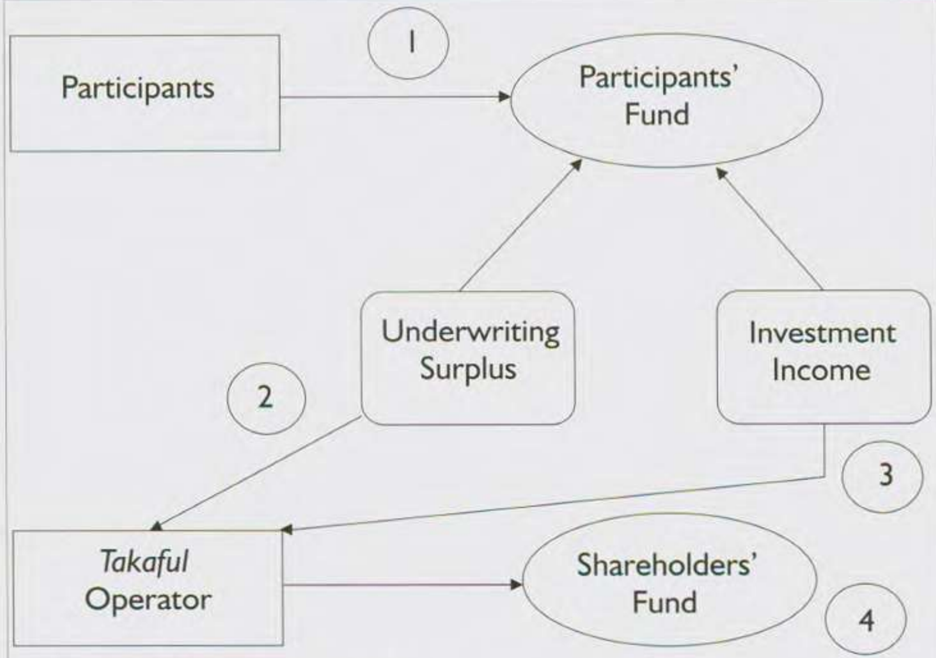

Figure 18.2: *Mudaraba* Model

1. Participants contribute to the Participants' Fund
2. The *Takaful* Operator receives a specified percentage of the underwriting surplus
3. The *Takaful* Operator receives a specified percentage of the investment income
4. Shareholders' funds are managed separately from the Participants' Fund

Governance Issues

There are special governance issues associated with *Takaful* because of its *Shari'a* compliance and also, if a *Mudaraba* model is adopted, how the risks are shared between the policy holders and the shareholders. The shareholders appoint management and also the *Shari'a* board. While management will be especially concerned with the technical issues of successful underwriting and investing in order to generate profits for shareholders and/or to meet policy-holders claims, the *Shari'a* board will be concerned to ensure that the operations are *Shari'a* compliant. It is easy to see that conflicts could arise and it is not always clear how these may be resolved. Underwriting policies could favour shareholders or policy holders, but who should decide these policies? The key performance indicators used by the *Shari'a* board to assess the management of the operating company may have a greater focus on compliance with Islamic law than technical issues, such as underwriting performance and risk management. In theory, any losses should be borne by the policy holders, but it is difficult to see how this could work practically. In reality, shareholders provide a *Qard Hassan* loan to cover the losses and this is recovered from subsequent profits.

Under existing business models, *Takaful* operators are not obliged to reimburse participants when a surplus emerges in a general *Takaful* pool. Industry stakeholders are currently debating the issue of equitable distribution of surplus, together with the need for participants' representation on the boards of *Takaful* operators, possibly through the appointment of independent directors.

In Sudan, policyholders have the right to monitor the performance of the company. Before the shareholders general assembly convenes, every company invites its policyholders to attend a special general assembly. In principle, every policyholder is a member of this assembly, but in practice, only policyholders with a minimum contribution, as fixed by the Board of Directors, are invited. The meeting agenda includes:

- The annual audited accounts and the directors' report.
- Comments and recommendations to the shareholders and Board of Directors on the performance of the company and all relevant matters.
- Board of Directors recommendation on the distribution of the surplus.
- Election of representatives to the shareholders general assembly and the Board of Directors.

The distribution of the surplus is always a hot item in the agenda of the policyholder assembly.

Attendance at the general assembly is fixed by the company, but policyholders elect one or two members from their general assembly for membership of the Board of Directors.

Solvency

Because in theory, participants could be asked to contribute to any losses in the fund, it has been questioned whether *Takaful* funds should require the same solvency margin as conventional mutual insurers.

Recently, the Central Bank of Bahrain consulted the industry on this topic. It is required to consult on all issues that might lead to changes in regulations. Current solvency margin requirements for *Takaful* funds have often been found to be too onerous for newly established funds. Until this time, regulations required all *Takaful* funds over a year old to fulfill the solvency margin requirements, or have shareholders make a free loan (*Qard Hassan*) to cover any shortfalls. Funds have one year to build up the necessary capital.

The consultation recommended that newly established funds be allowed one year of operation without having to fulfill the solvency margin requirements. Subsequent to this first year of operations, the calculation of the fund's capital available would be subject to valuation rules but not to deductions resulting from inadmissible assets for a period of five years from the start of the fund, or when the asset base of the fund reaches BD 5 million, whichever comes first. However, should the fund not fulfill solvency margin requirements, shareholders would be required to make a free loan to cover any shortfall. This amendment has been incorporated in the Rule Book as of October 2008.

Other issues in this area include how profits should be distributed and what reserves should be taken to cover potential future losses.

Life *Takaful*

Globally, life insurance counts for around 59% of total premiums according to the Ernst & Young report[2]. While this level is approached in Asia (Malaysia 65%, Indonesia 58%), much of the Middle East trails well behind (Saudi Arabia 1%, Qatar 5%, UAE 15%). The report postulates a number of religious, cultural, fiscal and demographic reasons for this including:

- *Shari'a* sensitivities have led to injunctions against conventional forms of insurance. This has severely restricted demand, for personal and life products lines.
- An extended family system has historically acted as the primary source of financial support to the dependent population, particularly the elderly.
- A lack of fiscal incentives aimed at encouraging savings, together with a high level of state support, have annulled the creation of corporate pension plans and reduced the demand for private sector annuity and savings products.
- Legislation aimed at increasing private sector savings is a response to ageing populations where retirement is outpacing taxable workforce expansion. Countries with a youthful population and rapidly expanding workforce do not yet face these problems.

These do appear to be serious issues that need to be addressed by the industry through education and by offering products that are both *Shari'a* compliant and meet some obvious needs of the population. Demographics might have been a limiting factor so far, but it will be an advantage going forward as the younger, well-educated population has an ever greater decision-making role.

[2] ibid

Re-Takaful

A further concern is the lack of *Re-Takaful* companies at present. In theory, it would be possible for *Takaful* companies to re-insure with a conventional counterparty, using the concession that conventional products can be used in case of need when an appropriate *Shari'a*-based product is not available. In practice, only a small percentage of total contributions are re-insured – mainly personal and commercial fire policies – with *Re-Takaful* taking a very minor share. However, as mentioned above, today there are a growing number of companies offering *re-takaful* and the problem now is as much a reluctance on the part of *Takaful* operators to use these services as their unavailability.

Human Resources

For the World Takaful Report 2008 produced by Ernst & Young, the authors questioned a number of *Takaful* companies about the challenges they faced. Top of the list was the issue of finding and retaining appropriate staff.

The demand for human resources across the entire Islamic financial services industry is high. However, the *Takaful* industry is expected to witness higher growth than other areas and so could be even more affected, particularly as specialist skills are required. Human resources are the single largest contributor to an Islamic financial institution's operating expenses and thus have the potential to greatly affect profitability. A *Takaful* operator's ability to attract and retain quality staff will ultimately become a competitive advantage. As recruitment costs increase, *Takaful* operators will need to shift their focus from recruitment to retention. Retaining human capital is cost-effective but requires a well-developed human resources function and financial incentives that lead to a vested interest in the operator.

IFSB and IAIS

In 2006, the IFSB and the International Association of Insurance Supervisors (IAIS) put out an "Issues" paper[3] which aims to identify the applicability of the existing IAIS core principles to the regulatory and supervisory standards for *Takaful* to be developed by the IFSB. Where IAIS standards would fit the *Takaful* model, the aim would be to adopt them, but the paper recognizes that in some cases, modification may be required. The main area identified was corporate governance, but many of the issues, including governance, relate to *Shari'a* oversight and operations.

For instance, does the supervisor need to have its own *Shari'a* board to examine the operations or is it sufficient for it to ensure that the company has its own

[3] Issues in Regulation and Supervision of Takaful (Islamic Insurance), August 2006

Shari'a board? The question that is still hotly debated is whether there should be a "*Shari'a* regulator" or a "*Shari'a* systems regulator" or neither? More specifically on governance, conflicts of interest can easily arise and there needs to be some mechanism in place to manage this possibility. Also, there should perhaps be some way of giving representation to policyholders, along the lines seen in Sudan.

In conventional insurance, there are limits on how the premiums from policy holders can be invested. There will be further restrictions in *Takaful* to ensure that the investments are *Shari'a* compliant, but they must also have an appropriate maturity and a risk level that matches the requirements of the company. The report says in this regard:

> *"There are numerous areas where regulatory standards may need to be different for Takaful, or to which supervisors will need to pay special attention. The requirements on the management of investments will need to cover the Shari`a compliant assets in which Takaful operators may invest, and there will need to be acceptable ways of valuing them. There may be issues in the overall risk profile of the assets, and the limited scope and depth of Islamic financial markets mean that there may also be difficulties in matching assets and liabilities, for example in duration or location."*

There are further concerns over the use of intermediaries. An essential area that needs consideration in regard to intermediaries is the risk of mis-selling. Intermediaries need to have a sufficient level of knowledge of *Shari'a* issues, and their implications for *Takaful*, in order to provide effective guidance for potential participants. They will need to have the competence to make the required disclosures and to explain their significance. These are tough requirements when one of the major concerns for the *Takaful* companies is the difficulty in finding and retaining suitably qualified staff. No matter who is selling the contract, disclosures must be made on what guarantees or lack thereof are included, and what liabilities may fall on policyholders. Also, certain costs or charges may fall on the policyholders' funds, which are not obvious. Because of the need to avoid uncertainty (*gharar*), for a *Takaful* operator, transparency is of utmost importance. While *Shari'a* boards will often mandate explicit inclusion of many of these points in the contract, there will still be a need to explain them to consumers and to bring out the key differences between Takaful and conventional insurance.

The paper concludes by identifying four areas that need reviewing – corporate governance; financial and prudential regulation; transparency, reporting and market conduct; and the supervisory review. It concludes by saying:

> *"Corporate governance embraces issues such as the Takaful models that are acceptable and the essential criteria or parameters for each model, the relationship between policyholders' and shareholders' funds, Shari'a governance, and how policyholders' and shareholders' interests are to be balanced in the governance model. These are substantial regulatory and*

supervisory issues in their own right, but their resolution is also fundamental to making an effective start in the other three areas. For example, it is unclear how to adapt capital adequacy principles for Takaful without having a clear view of the financial risks and where those are located. This in turn is strongly influenced by the model chosen and the relationship between shareholders' and policyholders' funds. Similarly, some of the disclosures to participants will depend heavily on the details of the model chosen. This does not imply that there will necessarily be a single model for Takaful, any more than there is in the conventional insurance world. However, if basic principles can be established, it will be much easier to make progress in the other areas."

Chapter 19

Organizations Involved in the Development of Islamic Finance

Throughout this book reference has been made to a number of organizations and regulators that have been directly involved in certain aspects of the development of Islamic finance. However, in addition to these, there are many more whose contribution should be mentioned, and in this chapter the role played by a number of them will be discussed. The list grows almost daily and so will inevitably be incomplete, but will hopefully give a flavour of the resources being devoted to the development of this growing industry. In the next chapter a number of the courses and qualifications in Islamic banking, *takaful* and Islamic finance will be described. Here the focus will be on the following:

- Organizations – other than those just offering courses and qualifications – that have been mentioned in earlier chapters
- Conference organizers
- Publishers – both print and web
- Other organizations

Organizations Mentioned in Earlier Chapters

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)

Two organizations have been referred to most often in the previous chapters, AAOIFI and IFSB. The reason for this is because of the excellent work that these organizations are doing. They have been introducing standards that are not only acceptable in the world of Islamic finance but also will ensure that the accounting and regulatory standards used in Islamic finance gain the acceptance of the global financial community, providing of course that they are accepted and implemented.

AAOIFI has produced *Shari'a* standards for many of the products that have been developed for Islamic finance. They have also produced accounting standards to complement those of the IFSB and ensure that relevant disclosure is provided. While many chapters mention the work of AAOIFI, most discussion of the *Shari'a* standards is presented in Chapter 5 and of the accounting standards in Chapter 9. In addition references can be found in Chapters 2, 7, 9, 11, 14 and 18 as well as Appendix 2 on *Sukuk*. Its own website is www.aaoifi.com.

While standards need constant updating to reflect new products and services, as well as changes and developments in established ones, the biggest challenge now for AAOIFI is to persuade regulators to implement their standards.

Islamic Financial Services Board (IFSB)

While the IFSB is a much younger organization than AAOIFI, its work is having a great impact on the operations of Islamic institutions. Set up to be the "Basle Committee" for the Islamic world, it has tackled some of the most difficult challenges in the regulation of Islamic organizations in its first few years and has produced some well thought out recommendations. Most information on the IFSB will be found in Chapter 11, but references to specific standards can be found in Chapters 5, 8, 9 and 18.

While its original remit was to develop regulatory standards for Islamic banks, this has been broadened to cover securities markets and insurance. This comprehensive role will be of great benefit to the industry overall.

However, as with AAOIFI, the biggest challenge for the IFSB is to have its standards incorporated into the regulations for Islamic operations worldwide. Whilst it is often said that it is the lack of standardization that is holding back the further development if Islamic services, it is perhaps just as much the relatively poor disclosure provided by institutions and the resulting difficulty in making realistic decisions on the riskiness of the operations that is perhaps more serious. Both AAOIFI and the IFSB have tackled these aspects.

More information on the IFSB, its standards and draft exposures can be found on its website www.ifsb.org.

Bahrain and Malaysia

Two countries stand out as being at the forefront it pushing for the development of Islamic financial services, namely Bahrain and Malaysia. Both host a number of Islamic banks, asset management companies and insurance companies; both host the leading organizations pushing for further development in Islamic finance, namely AAOIFI (Bahrain) and the IFSB (Malaysia); both have introduced regulations specifically for Islamic financial services and both have been active participants in the capital markets, issuing instruments that are *Shari'a* compliant. More can be found about developments in both countries in Chapter 8 and for Bahrain in Chapters 11 and 15 while information on *Takaful* in Malaysia is in Chapter 18. There are a number of websites that carry useful information, especially the Central Bank of Bahrain www.cbb.gov.bh, Bank Negara www.bnm.gov.my, and Malaysian International Islamic Financial Centre (MIFC) www.mifc.com.

Liquidity Management Centre (LMC)

The Liquidity Management Centre was an important initiative taken by four prominent Islamic banks to help promote the Islamic interbank market and also to help develop liquid instruments for the banks. Based in Bahrain, it has taken some successful initiatives, but the problems it is tackling are not easy to solve in the short term. Added to this, there is no common view among practitioners, particularly *Shari'a* scholars, as to the correct approaches. Their initiatives are discussed in Chapter 8 and the LMC website is www.lmcbahrain.com.

International Islamic Financial Market (IIFM)

Like the LMC, the IIFM is based in Bahrain and was set up to try and ease the liquidity problems faced by all Islamic institutions because of the lack of non-interest bearing liquid instruments. While the LMC was the initiative of a number of banks, the IIFM was promoted by a number of regulators. It is currently working on document standardization, among other tasks. A fuller description can be found in Chapter 8. The organizations' website is www.iifm.net.

Islamic Development Bank

While primarily a development bank, the Islamic Development Bank has seen its role as somewhat broader than that adopted by other development banks. This role has included the promotion and development of Islamic financial services and, as a result, IDB has been one of the main promoters of many important organizations, including AAOIFI, IFSB, LMC, Islamic International Rating Agency (IIRA) – discussed later in this chapter - and IIFM. The role of the Islamic Development Bank was discussed briefly in Chapter 4.

In 2006, it introduced a new vision and mission statement. This was in recognition of the fact that many Muslim countries remain among the most impoverished in the world and it, as an organization, should aim to tackle many of the outstanding problems. Its new mission statement says:

> *"The Mission of IDB is to promote comprehensive human development, with a focus on the priority areas of alleviating poverty, improving health, promoting education, improving governance and prospering the people."*

In stating this, it recognizes the challenges:

> *"The new Mission Statement requires that IDB transform its mandate and greatly widen and diversify its development focus. Its primary function hitherto, has been to provide banking and financial services based on Islamic principles for economic development. It must now become a development bank that is more expansive in its scope, focusing on spurring comprehensive development in the Muslim world that extends beyond economic development."*

It has identified nine strategic thrusts if it is to achieve its goals by 1440H (2020). These are:

1. Reform IDB
2. Alleviate poverty
3. Promote health
4. Universalize education
5. Prosper the people
6. Empower the Sisters of Islam without breaching the tenets of Islam
7. Expand the Islamic financial industry
8. Facilitate integration of IDB Member Country economies among themselves and with the world
9. Improve the image of the Muslim world

One of the Key Strategic Thrusts still remains to expand the Islamic financial industry. In discussing this further, the Vision document says:

> *"The dramatic growth of the Islamic financial industry in the last three decades is a success story that has not been sufficiently told. IDB can be justly proud of the part it has played in making this possible. Yet, the industry needs to improve in some critical areas if it is to remain capable of providing financial services at competitive rates in a globalized financial environment. At present, the industry is confined only to a few countries and regions. The legal and regulatory infrastructure at the national level is not sufficiently well developed. Global Shari'ah standards and rules also require standardization at the international level. Islamic capital markets and funds as well as financial product development are still limited in scope. Islamic financial institutions are not sufficiently diversified. And*

> *the industry's further expansion is constrained by inadequacies with regard to size and capital, cost, risk management, product mix and liquidity management. Islamic banking and finance is a signature product of IDB. They are virtually synonymous with each other. IDB also needs to dramatically increase its financial resources and operations if it is to successfully implement the many added responsibilities that are being contemplated for it. The expansion and improvement of the Islamic financial industry is, therefore, a matter of considerable urgency. A mature and globally competitive Islamic financial industry should be in place within five years."*

IDB has accepted the challenges that still remain if Islamic finance is to play a full role in the global economy. The path that IDB sees for itself in developing the industry will be discussed further in the last chapter when the future prospects of the industry are looked at from several perspectives.

The full version of the Vision 1440H document can be found on the IDB website which is www.isdb.org.

Conference Organizers

Only a few years ago, conferences on any aspect of Islamic banking or finance were a rarity. Today it seems as though one could attend a conference every week in one part of the world or other. A pattern has emerged where some conferences try to attract large numbers of delegates with one or two themes but featuring some of the better known speakers. While it can be appealing to hear some of these speakers, the main attraction is the networking opportunities and being able to visit a large number of stands for informal discussions. Other conferences focus on very specific areas of interest and they attract speakers who have been active in the development of these sectors or interests. They are more specialized, have a greater depth of discussion about what are often controversial issues, and attract people seriously interested in discussion and learning. There are still networking opportunities and as they have attracted delegates with more specific interests, the contacts made can be more beneficial. There is room for both styles of conference. The former are generally organized by companies whose primary activity is conference organization. The latter are often organized and/or sponsored by companies with other interests in the development of Islamic finance – such as AAOIFI, IFSB, and some law firms. Very often these companies turn to professional conference organizers to help with their events.

Of the more general conferences, some with the biggest attendance are organized by **Middle East Global Advisors (MEGA).** Their flagship event is The World Islamic Banking Conference which celebrated its fifteenth birthday in 2008 and is held in Bahrain. It currently attracts more than 1,000 delegates. In addition they organize a number of more specialized events. In 2008 these were:

- The World Islamic Banking Conference: European Summit (held in London)
- The World Islamic Infrastructure Finance Conference (held in Doha)
- The World Islamic Capital Markets Conference and The World Islamic Funds Conference (held in Bahrain)
- The World Takaful Conference (held in Dubai)

Their events are shown on their website www.megaevents.net.

Euromoney Institutional Investor

Euromoney Institutional Investor organizes two Islamic events. Their Annual Islamic Finance Summit, is part of their seminar programme. It covers a range of topical subjects and the London event in 2009 will be the eighth in the series. It will be preceded by an introductory workshop run by a number of very well-known professionals. The Conference arm of Euromoney has begun organizing events in Asia, most recently the Hong Kong Islamic Finance Forum, held in November 2008, brought together over 400 delegates to discuss the main theme - the development of Islamic finance in Asia, calling on the experience of Malaysia and looking towards the opportunities for Hong Kong. Euromoney events are always well attended and provide delegates with good networking opportunities as well as the chance to hear some of the leading practitioners in their field www.euromoneyplc.com. Links to the seminars and information on the conferences can be found at www.euromoneyconferences.com.

Terrapinn

Terrapinn is perhaps the leading global provider of conferences with an Islamic theme. In 2009 it has scheduled six conferences, mainly called "Investment World", and taking place in Dubai, Kuala Lumpur, Geneva, New York, Cape Town and somewhere in the Middle East. These conferences are organized by Terrapinn and have multiple sponsors. In addition, Terrapinn organizes conferences on behalf of single sponsors (www.terrapinn.com).

Islamic Conference Group (ICG)

However, the leader in organizing Islamic conferences on behalf of single sponsors seems to be the Islamic Conference Group (ICG). It has a wider remit than just conference organization and defines its mission as:

> *"to focus on delivering specialized services designed to promote the development of Islamic banking and finance."*

The Group provides complete turnkey solutions to those organizations wishing to:

- promote their services,
- expand their product range,
- launch new products,
- organize academic and industry related events, such as conferences - workshops – seminars – forums – product launches and training programmes.

They will help promote any conference with an Islamic finance theme and list most of the events organized by the Islamic Financial Services Board, for example. ICG has also organized many conferences on behalf of Dechert, and a seminar series in partnership with Ashurst. Dechert and Ashurst are two of the law firms most involved in Islamic finance (www.islamicconferences.com).

The Institute for International Research (IIR)

The Institute was founded in 1973 and has grown to be one of the largest organizations of its kind in the world. Its conference operations in Islamic finance are based in Dubai and its flagship conference is The International Islamic Finance Forum, a two day conference covering many topical subjects. It is followed by a number of workshops that give companies a chance to highlight their skills and product offerings. In addition to this conference, IIR organizes more specialized training programmes that can be run in-house on request. In 2009, the announced programmes cover "Islamic Finance and Structures for Real Estate Development" and "Islamic Product Development and Financial Engineering" (www.iirme.com).

GlobalPro Consulting

In Malaysia, GlobalPro is one of the leading conference organizer. It provide public training, in-house training and consultancy services in the areas of Management, Leadership, Islamic Finance, Business and Financial Planning. While it mainly attracts people from Malaysia, it also brings in those from other Asian countries as well as some from the Middle East. In the first half of 2009 it has scheduled seven conferences, including a summer school in June. Most conferences are called "The Global …….. " Topics include legal aspects, wealth management, trade finance and *Sukuk*. It also holds general conferences: "The 3rd Global Islamic Finance Conference" and "The International Conference on Islamic Economic and Finance" (www.globalpro.com.my).

CERT Events

Also based in Malaysia, CERT Events organizes a number of conferences, including KLIFF – Kuala Lumpur Islamic Finance Forum, which celebrated its fifth year in 2008. In addition it will organize conferences on *Shari'a* Legal Issues in Islamic Banking and Securities Products, Accounting and Auditing for Islamic Financial Institutions, Takaful, and Legal Documentation. All these events will be held in Kuala Lumpur in the first quarter of 2009 (www.cert.com.my).

AAOIFI and IFSB

Two conference organizers have been mentioned many times before for their role in promoting Islamic banking and finance, but their conference offerings make important contributions to their own work and to a better understanding of the current issues.

AAOIFI organizes two conferences each year, its Annual *Shari'a* Conference and its Annual Conference on Islamic Banking and Finance. They follow topical themes that reflect issues that are subject to new standards or could lead to new standards.

IFSB has a full programme of events which it classifies as part of an awareness programme or as a workshop where various standards are discussed. Since the IFSB was established in 2002 it has organized 83 conferences as part of its awareness programme and 10 workshops. The workshop series was inaugurated in 2008 and has become an important part of the work of the IFSB. The 2008 programme included three workshops on capital adequacy held in Iran, Malaysia and Egypt while the other seven workshops were on risk management and corporate governance held in Singapore, Syria, Kuwait, Saudi Arabia, Brunei, Qatar and Sudan. The awareness programme featured a variety of seminars and workshops in Hong Kong, Pakistan, Malaysia, Bahrain, Jordan, China and Qatar. The IFSB hosts three important summits. In 2008 these were the fifth IFSB Summit, and its theme was on "Financial Globalisation and Islamic Financial Services" and the "Fourth Seminar on the Regulation of Takaful". A more recent addition will be the "Third Islamic Financial Services Forum: The European Challenge". This will be held in France during March 2009. Further information is on their websites: www.aaoifi.com and www.ifsb.org.

Publishers – Both Print and Web

- **Euromoney Institutional Investor** publishes ten books on various aspects of Islamic banking and finance. Some are available for download at www.euromoneyplc.com.
- **Wiley Finance** currently has five relevant titles and these come with a much lower price tag than Euromoney (eu.wiley.com).

- **Edward Elgar Publishing** also has five relevant titles. Founded in 1986, it is a leading international publisher in economics, finance, business and management, law and public policy. It has over 3000 titles in print, publishing over 250 new books a year. Prices range from GB£28 for a paperback to GB£160 (www.e-elgar.co.uk).
- **Palgrave Macmillan** traces its origins back to 1843 when Macmillan Publishers was established in the UK. Headquartered in the USA, Palgrave publishes a wide range of books in the humanities and social sciences and presently has over 5,000 active titles. In subjects ranging from Political Science to History to Literature, the list contains original works by many of the foremost academic writers and editors in the world. It contains seven books on Islamic banking and finance (www.palgrave-usa.com).
- **Institute of Islamic Banking and Insurance,** which is based in the UK, claims to be the single largest publisher of literature on Islamic banking. Currently nine of its 18 titles are in print and these include a series of three volumes which together are a compendium of legal opinions on the operations of Islamic banks. The opinions are given in both Arabic and English (www.ilsamic-banking.com).

Magazine and journals are also a useful source of information and can address topical issues most successfully. Some are available to download and some are free, making their money from advertising. Some titles that mainly address the conventional market – such as *The Banker* and *Euromoney* - also have good coverage of Islamic finance. In addition there are a number of more academic journals that can give a deeper perspective on their subject.

Some of the leading magazines are:

- ***Islamic Banking and Finance*** was launched in 2003 and is published six times a year by New Millenium Publishing which is based in the UK. It carries some summaries or full articles on its website as well as news items. The magazine is available on subscription (www.islamicbankingandfinance.com).
- ***New Horizon*** is the magazine of the Institute of Islamic Banking and Insurance (www.islamic-banking.com).
- ***Islamic Business & Finance*** is published monthly by CPI Financial out of Dubai. The magazine will be delivered free of charge to qualifying professionals and is also available on-line from Zinio (www.zinio.com). The CPI website also gives access to a number of articles relating to Islamic banking and finance (www.cpifinancial.net).
- ***Islamic Banker*** is one of the longest established magazines and is not available online. It is published by Mushtaq Parker Associates in the UK and Mushtaq is the editor. He does however boast a long list of contributing editors who are well known names from the global Islamic finance industry. While many magazines and newsletters have come and gone, this one just goes and goes.

- ***Asia Insurance Review*** and ***Middle East Insurance Review*** while both covering conventional insurance have sections devoted to *Takaful*. They are published monthly but also produce weekly news electronically, called ***eWeekly Asia*** and ***eWeekly Middle East*** (www.asiainsurancereview.com and www.meinsurancereview.com).

Inevitably today most of us turn to the internet when looking for information and so it comes as no surprise that there are a number of useful websites offering a wide range of features on Islamic finance. A few of these would be:

- **www.securities.com/ifis**This is the site of the Islamic Finance Information Service which is a Euromoney production. It is an extensive source of information with sections covering news, institutions, league tables, capital markets, research, regulation and *Takaful*. The service includes a weekly newsletter sent by email and an alert service.
- **muslim-investor.com** is another useful source of information. Its mission is to provide Muslims world wide with useful and practical information about Islamic investment, Islamic banking, Islamic finance, and Islamic insurance. It achieves its aim with articles and references that can be illuminating even to professionals in the field.
- **www.failaka.com** This website was mentioned in an earlier chapter on investment funds and its early role was to provide research on Islamic funds, offering institutions and private investors access to a wealth of information on *Shari'a*-compliant investment funds. Established in 1996, Failaka was the first company to monitor the performance of *Shari'a*-compliant funds worldwide. Since that time, it has expanded its products and services to include an on-line database of *Shari'a*-compliant investment funds, research-based advisory services including *Shari'a* advisory services, and other related activities.
- **www.islamic-finance.com** was founded in 1997 as the world's first website dedicated exclusively to the field of Islamic finance. Since its inception, the site has maintained an independent editorial and sought to promote open debate on critical contemporary issues. It is a good source of articles covering a range of opinions.

Other Organizations

Finally in this chapter, there are a number of organizations that have escaped earlier mention in this book, despite the fact that they are providing an important impetus to the development of Islamic finance in many ways.

International Islamic Centre for Reconciliation and Commercial Arbitration (IICRCA)

The Centre was established in Dubai, UAE. in 2004. Promoted by the Islamic Development Bank (IsDB) and the General Council for Islamic Banks and Financial institutions (GCIBFI), it was funded by the IsDB and the government of the UAE. It conducts mediation of disputes and adjudicates on financial and commercial disputes which can arise between Islamic financial institutions, and between these institutions and/or third parties. Little has been published about its work. It will only be successful if its decisions are seen to be upheld and implemented.

General Council for Islamic Banks and Financial Institutions (GCIBFI)

The Council is the banks association for Islamic banks around the world. It aims to support the industry globally and has a useful website in Arabic. It was particularly active in the aftermath of 9/11 in trying to lend practical support to the industry at a time when it felt vulnerable to accusations of being involved in money laundering and other terrorist activities. It has also organized conferences and engaged in other promotional activities (www.cibfi.org).

Islamic International Rating Agency (IIRA)

The IIRA has been around, as a concept, for many years, but it has proven one of the more difficult organizations to bring to reality. The Islamic Development Bank, and many Islamic banking practitioners, had long believed that the conventional rating agencies did not understand Islamic banking. They felt that the rating agencies were only concerned to fit Islamic institutions into the models used for their ratings of conventional institutions. They also felt that what is needed for Islamic institutions are ratings that gave an assessment of *Shari'a* compliance.

The IIRA is now a reality and has produced credit ratings and credit rating reports on a number of institutions. These ratings could easily have been written by one of the main agencies and, where comparison is possible, the ratings are comparable with those produced by Standard & Poors, Moody's and Fitch. Of more interest has been the attempt to evaluate *Shari'a* compliance. The IIRA view seems to be that all institutions working with a *Shari'a* board and claiming to be *Shari'a* compliant shall be termed as *Shari'a* compliant, but some will be more so than others. The task is far from easy. As has been mentioned in earlier chapters, there are only a few scholars qualified to sit on *Shari'a* boards and all institutions want to have at least one of the top twenty names on their own board. This has led to some scholars lending their names to the operations of over thirty institutions. For the rating agency, there are clear conflicts of interest. The IIRA's own board includes a large number of top names. A few of these scholars will decide on the rating for an institution and these scholars will be selected for having no direct association with the institution being rated. However, the names of the institution's *Shari'a* board members will be well known and cannot fail to play a role in the rating decision. So far, not many institutions have a public rating for *Shari'a* compliance.

Since the early concerns expressed by the President of the IsDB, the rating agencies have all devoted significant resources to developing their expertise in Islamic finance. All now appear to have clear understanding of Islamic operations and are sensitive to the issues. Further, the Islamic Development Bank itself may have fewer doubts since being awarded the very highest rating by Standard & Poors and Moody's.

Other organizations

The other organizations that deserve reference are those organizations whose main focus is on conventional finance but who have recognized that Islamic finance has an important role in the global financial system. Foremost amongst these are the **International Monetary Fund** and the **World Bank**. They have departments dedicated to research and development of Islamic finance and produce many readable and important contributions towards understanding the issues and looking for solutions.

In addition, most of the organizations that have a role in conventional finance have partnered with those organizations that are involved in similar areas with Islamic finance. Such names would include the **Basle Committee and the BIS**, **IASB, IOSCO, ICMA, ISDA** and many others. The decision of the conventional finance organizations to willingly embrace collaboration with the Islamic sector is a clear indication that Islamic finance has come of age.

Chapter 20

Educational Institutions Offering Courses and/or Qualifications in Islamic Finance

One of the factors holding back the development of Islamic finance is often highlighted as the lack of qualified personnel. While a number of universities around the world have been offering courses and/or degrees for some time there are a growing number of other organizations putting together courses, course material, and qualifications. This chapter does not aim to rate the quality or usefulness of these different courses but will give an indication of the content, mode of study and qualification. It would seem as though today there are many opportunities for obtaining a qualification in Islamic banking and/or finance in all corners of the world. Indeed, the courses below do not represent a comprehensive list. A fuller list of some 56 organizations can be found on the website of The Association of Islamic Banking Institutions Malaysia: www.aibim.com.

American Universities

Many universities in the USA offer courses in Islamic finance. In some cases this is part of an economics programme, in others it is within the law faculty. In yet more cases, only postgraduate degrees or MBAs will include the subject. In most cases the teaching content on Islamic finance is minimal and limited to two or three hours of study, though several schools are active in research.

The most well known programme is at Harvard which has focused on the topic for some time and established the **Harvard Islamic Finance Project** in 1995. This brings together the law, divinity and business schools and provides broad opportunities for research. Each year the Project organizes the Harvard Islamic Finance Forum, a conference that brings together many eminent names in Islamic finance who are producing some of the most thought provoking work. More information may be found on the website of HIFP: www.hifip.harvard.edu.

Two postgraduate courses are available at Tufts University's **Fletcher School of Law and Diplomacy**. The Islamic Banking and Finance course provides a comprehensive introduction to the subject. It is divided into four parts: the first part is an introduction to Islam, with a special focus on economics and finance. The second part deals with the political economy of Islamic finance. The third part presents the full range of Islamic products and instruments, and discusses the issue of financial innovation with a specific focus on the role of Western institutions. The fourth and final part deals with political issues involving Islamic finance. A second course exposes students to the Arabic language, with a particular focus on Islamic finance vocabulary. More information about the courses offered will be found on the website: fletcher.tufts.edu/academic/.

Durham University

In the UK, Durham University provides the best-known Islamic Finance programme. The Durham Islamic Finance Programme (DIFP) is run under the auspices of the Institute for Middle Eastern and Islamic Studies at the University. As the Institute is part of the University's School of Government and International Affairs this enables it to draw on the School's disciplinary strengths in governance and regulation that have particular relevance for Islamic finance. Durham has been a centre for research in Islamic finance for over 25 years, but with the launching of the DIFP it has formalized its academic and professional activities. DIFP offers postgraduate research degrees in Islamic banking, finance, management and economics.

DIFP offers specialized MA by Research (MAR) and PhD research degrees in most areas of Islamic finance and banking. As part of the degree programme students normally attend a module on Islamic economics and *Shari'a* compliant finance. There are also weekly Research Support Workshops.

Since 2006, DIFP has hosted a week-long summer school. The themes for the 2009 programme are:

- The Philosophy of Islamic Banking and Finance
- Islamic Banking and Finance Experiences around the Globe
- Islamic Financial Operations and Services
- Islamic Financial Instruments
- Islamic Funds and Islamic Fund Management
- *Sukuk*: Islamic Bonds
- Islamic Retail Products
- Real Estate Management

- Islamic Home Financing
- *Takaful* and Cooperative Insurance
- Risk Management and Securitization in Islamic Finance
- Islamic Capital Markets
- Financial Engineering: Islamic Financial Products and Services Development
- Regulation and Financial Reporting in Islamic Financial Industry
- Islamic Management and Governance in Islamic Institutions
- Trends, Issues and Challenges In Islamic Finance

Again, their website gives more information: www.dur.ac.uk/sgia/difp.

Markfield Institute of Higher Education

The Markfield Institute of Higher Education (MIHE), Markfield, Leicestershire, which started in September 2000, is the first academic institution of its kind in the west. It presents a unique opportunity to study Islam in an Islamic institution within the context of higher education in the U.K.

The Islamic Banking, Finance and Management Programme aims to develop a critical and analytical approach to economics, banking and management informed by an Islamic perspective and provide a greater awareness of Islamic values and principles, through critical reflection on and appreciation of their application in management and financial institutions. Students are enabled to take a scholarly, Islamic approach to one or more specialist areas of economics, banking or management. The specific courses offered are:

- **Postgraduate Certificate** which focuses on the study of Islamic Economics and Islamic Banking and Finance together with study of one further module to attain a total of 60 credit points.
- **Postgraduate Diploma** which builds on these modules and allows students to study a choice of modules to attain 120 credit points.
- **MA Degree** which requires research into a specialist area of economics, banking or management of the student's choice and submission of a dissertation of 15,000 to 18,000 words.

As from 2009, the Masters Degree can be studied on a part-time basis at the London Campus of the University of Gloucestershire, and validated by that University.

As always, more details may be found on Markfield's website: www.mihe.org.uk/mihe

Cass Business School/Dubai International Financial Centre

The London-based Cass Business School has partnered with the Dubai International Financial Centre (DIFC) to offer an Executive MBA (EMBA) programme. This is a two year course with the first year focusing on the range of topics common to MBA programmes. In the second year students take one of three elective streams and one of these is Islamic Finance.

This stream is aimed at Fund Managers, Investment Consultants and Advisors, and a wide range of professions in banking or in the financial services sector more broadly, who take a close interest in Islamic Finance both at retail and wholesale levels. Whilst equipping students with the main tenets of *Shari'a*-compliant financial dealings, the three modules allow students to view Islamic Finance in a holistic fashion and in the context of the modern and global financial system, of which it is increasingly an important part.

The three modules are Islamic Economics, Islamic Law of Business Transactions and Islamic Banking and Finance.

The economics module provides an overview of the main tenets of Islamic Economics and various interpretations surrounding key public policy areas such as ownership, interest-free intermediation, and welfare and distribution. It provides a contextual framework for the subsequent two modules. The second module teaches how to scrutinize and endorse Islamic financial products and services from the point of view of their compliance with Islamic laws and customs governing business transactions. The final module provides a conceptual framework for the study of the principal Islamic banking and financial products. It also considers the experience of Islamic banking in countries with a history of operating interest-free banking systems. The main focus of the module is to create both awareness of, and practical experience in, working with Islamic financial products.

Finally, students also complete a Business Mastery Project which is a major piece of business analysis focusing on the area of specialization.

Lectures are held in the DIFC's state-of-the-art facilities in its Education Centre, but students also have access to Cass's on-line information resources (www.cass.city.ac.uk/mba/dubai/index.html).

The British University in Dubai

This is a research-based post-graduate university that partners with top-rated British universities to offer various courses. One of these is an MSc in Banking and Finance and this includes electives in Islamic banking. As BUiD partners with City University – and hence the Cass Business School – this course has some similarities to the course described above. The link is to the brochure for the MSc course: www.buid.ac.ae/buid/apadmin/img/upload/F&B English.jpg

Academy for International Modern Studies (AIMS)

Chartered by the UK government, AIMS offers a number of courses leading to certification in various aspects of Islamic banking and finance.

The Certified Islamic Finance Expert (CIFE) aims to produce highly skilled experts for the Islamic banking and finance industry, so they can perform a leading role in the establishment and management of Islamic financial institutions. The programme covers the areas of Islamic Economics, Islamic Finance, Product Development, Modes of Financing, Islamic Investment, *Shari'a* Standards & Rulings and Islamic Insurance. The course is arranged in five modules: the Islamic economic and financial system; Islamic modes of financing; Islamic commercial and investment banking; the Islamic insurance system; and, advanced areas in Islamic finance. A distance learning course, it is the equivalent of 150 hours of professional training.

The Certified Islamic Banker (CIB) programme gives an in-depth study of the Islamic financial and Islamic banking system. It is designed to produce highly skilled professionals and "Islamic Bankers" for the industry. On the successful completion of this course, participants are capable of designing, implementing, consulting, operating and administering *Riba*-free Islamic financial products and services. The course is arranged in three modules which are the first three modules of the CIFE programme. Again, this is a distance learning course equivalent to 90 hours of professional training.

The Certified *Takaful* Professional (CTP) is a specialized training programme in Islamic Insurance. Participants are awarded 30 hours of professional training. Topics covered include:

- Islamic law for Islamic insurance
- Major definitions associated with Islamic insurance.
- Sources of *Shari'a* for Insurance
- Foundation of insurance in the Islamic economy
- Philosophy and development scenario of *Takaful*
- Comparison of Islamic insurance with conventional insurance.
- *Re-takaful* and its working mechanism
- Philosophy of *Re-takaful* in Islam
- Forms of *Takaful*, which are adopted and implemented in different regions.
- Types and operational mechanism of *Mudaraba*, *Wakala* and *Wakala Waqf* Models.
- Types of *Takaful* business (family and general)

- Objectives, principals and operation flowcharts of family and general *Takaful* business
- Accounting standards for *Takaful* companies
- Comparison of accounting standards for conventional insurance and Islamic insurance
- Balance sheet, profit loss accounts and cash flow statements for *Takaful* business.
- Policies and role of agents in family and general *Takaful*
- Operations and management of motor, marine, fire & machine insurance.
- Issues and challenges in *Takaful* business

The Academy's website is: www.learnislamicfinance.com

Pebble Hills University and AIMS

AIMS has partnered with Pebble Hills University to offer an MBA in Islamic Banking and Finance. Students study for the AIMS CIFE programme, described above and also the Global Executive MBA programme offered by Pebble Hills.

Each Pebble Hills course uses a technology assisted delivery to provide students a more flexible, convenient learning environment to pursue a graduate degree while balancing the demands of work, travel, and personal responsibility.

The modules cover:

- Financial Accounting
- Corporate Finance
- Financial Management
- Project Management
- International Business
- Strategic Management
- Organizational Leadership
- Managerial Accounting
- Operations Management
- Market Research
- Research Method

Each of these modules gives three credits. Finally, students must complete a thesis which gains six credits. More information can be found at: www.pebblehill.edu/130.htm.

Bahrain Institute of Banking and Finance (BIBF)

The Bahrain Institute of Banking and Finance has an active Center for Islamic Finance and offers a wide variety of short courses. Already on the calendar for the coming months are 3-5 day courses in:

- Internal Credit Appraisal and Rating
- Real Estate Portfolio Concentration Management
- Islamic Trade Finance
- Islamic Documentation Structure
- Islamic Credit Cards
- London Metal Exchange
- Primary Markets Certificate
- Maximising Performance using Asset Management Strategies
- Introduction to Islamic Banking
- Islamic Mutual Funds
- Islamic Accounting Standards
- Islamic Liquidity and Treasury Management
- Islamic Leasing (*Ijarah*)

Many of the courses are offered in both English and Arabic.

In addition BIBF offers a number of qualifications, including a Diploma in Islamic Finance, an Advanced Diploma in Islamic Finance, a Diploma in Islamic Accounting and Compliance for which it has partnered with the **Association of International Accountants (AIA)**, and a Masters in Islamic Finance (MSIF) for which it has partnered with **DePaul University**.

The MSIF has seven finance courses and five Islamic finance courses. The finance courses are:

- Economics for Decision Making
- Financial Management
- Investment Analysis
- Financial Statement Analysis
- Commercial Banking
- Derivatives and Risk Management
- Advanced Derivatives and Risk Management

While the Islamic finance courses are:

- Islamic Economics, Jurisprudence and Ethics
- Accounting, Auditing and Governance for Islamic Financial Institutions
- Islamic Commercial Banking

- Islamic Investment Banking
- Islamic Treasury, Capital Markets and Risk Management

More details of the content of all these courses can be found on the website for the Center: www.bibf.com/cfif.

Emirates Institute of Banking and Financial Studies

The Institute offers short and longer term courses in Islamic banking with its show piece course being a Diploma course. The Islamic Banking Diploma Program introduced in 2003 is accredited by the Ministry of Higher Education & Scientific Research, UAE. The programme, which was the first of its kind in the country, was started to disseminate knowledge and information about Islamic banking and finance and produce high calibre professionals with the necessary technical skills and knowledge in Islamic finance.

The programme runs five days per week, Sunday to Thursday with morning and evening sessions. There are three theoretical semesters (16 weeks each), and a summer course (8 weeks), which involves "Field Training" at an Islamic bank for "non – banker" students, or a "Field Project" for "banker" students who have at least three years of work experience in the banking sector.

Preference is given to students who are UAE nationals, but those from other GCC or other Arab countries can apply. It is aimed at candidates who have obtained the UAE Secondary School Diploma (www.eibfs.com).

NASDAQ Dubai Academy

Until recently, this was the DIFX Academy, but since the partnership of the exchange with NASDAQ, it has been renamed. Its initial aim was to run courses that enabled investors to trade on the new exchange in an informed and professional way and the main listed instrument, other than equities, is Islamic *Sukuk*.

As a result, the Academy runs a one day workshop on *Sukuk* that helps participants to understand the differences between *Sukuk* and conventional bonds. It also provides the participants with an in depth knowledge of the 14 asset classes promulgated by the AAOIFI *Sukuk* standard. The workshop also covers *Sukuk* analysis, credit enhancement and rating methodologies.

In addition the Academy also runs a two-day course that provides participants with an understanding of the issues covered in the Islamic Finance Qualification that has been developed by the Securities and Investment Institute of the UK (SII). This is an examination based qualification that is being offered by a growing number of training organizations around the Islamic world and will be featured later in this section (www.nasdaqdubai.com).

Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI)

While AAOIFI has been mentioned many times in previous chapters, it has started providing qualifications and so deserves a mention here too. These are the Certified *Shari'a* Advisor and Auditor (CSAA) and the Certified Islamic Professional Accountant (CIPA). Both examinations can be taken without attending any training course, but AAOIFI does offer training for both.

For the CSAA, candidates who so choose can receive a study package and may attend training sessions given by *Shari'a* scholars, including members of the AAOIFI *Shari'a* board. Candidates for this certification should also speak Arabic. The programme covers technical subjects that are essential to *Shari'a* compliance and review processes for the international Islamic banking and finance industry, including:

- AAOIFI's *Shari'a* standards on Islamic finance products and practices, and *Shari'a* basis for those standards.
- AAOIFI's Governance standards on *Shari'a* compliance and review processes.
- Islamic banking and finance supervision (including regulatory and external supervision, internal review, and application of AAOIFI's standards).
- Operational structures for *Shari'a* compliance and review.
- *Shari'a* compliance and review procedures (including on planning, operations, documentation, and reporting).
- Application of *Shari'a* and *Fiqh* (Islamic jurisprudence) to Islamic banking and finance practices.

The CIPA programme follows a similar design. It covers technical subjects that are essential to accountancy for international Islamic banks and financial institutions, including:

- Development of international Islamic banking and financial systems, and functions of Islamic banks and financial institutions.
- Accounting concepts and principles for international Islamic banking and finance.
- Qualitative characteristics of accounting information for international Islamic banking and finance.
- AAOIFI's accounting standards on financial reporting for the international Islamic banking and finance industry.
- AAOIFI's Shari'a standards on Islamic finance products and practices, and Shari'a basis for those standards.
- AAOIFI's Governance standards on Shari'a compliance and review processes.

Brochures can be downloaded from the website (www.aaoifi.com).

University College of Bahrain

The University College of Bahrain offers a part-time evening course leading to an MBA in Islamic Finance. The course is targeted at the many bankers and others working in the growing number of Islamic financial institutions based in Bahrain.

The course is divided into seven modules covering:

- Organizational Behaviour
- Financial and Management Accounting
- Marketing Management
- Corporate and Managerial Finance
- Managerial Economics
- Islamic Economics
- Theories and Practices of Islamic Banking
- *Fiqh Muammalah*
- Islamic Accounting
- Islamic Financial Systems
- Islamic Insurance
- *Sukuk* and Mutual Funds
- Investment Management
- Financial Statement Analysis

As an alternative to the last two courses candidates may prepare a thesis. More details can be found at the website: www.ucb.edu.bh.

International Islamic University Malaysia (IIUM)

The IIUM Institute of Islamic Banking and Finance (II*i*BF) was officially established in September 2004 as a centre of excellence for education and research in Islamic banking and finance. II*i*BF is striving to provide education and produce competent graduates and scholars who have a combination of the knowledge of *Shari'ah* and the modern knowledge of economics, finance, management, accounting and other social aspects, as well as promoting theoretical and applied research on Islamic banking and finance. It offers a postgraduate diploma programme and students can also work towards a PhD. Both can be done as full time or part time courses. The modules included in the diploma programme are:

- Islamic Economics
- Introduction to Principles of Islamic Jurisprudence
- Transactions in Islamic Banking and Finance
- Financial Management and Analysis

- Islamic Banking Products and Services
- Ethics and Governance of Islamic Financial Institutions
- Accounting for Islamic Financial Institutions

As always, more details are available on the Institute's website: www.iiu.edu.my/iiibf.

The International Institute of Islamic Finance Inc. (IIIF)

The Institute aims to be a one-stop-centre in developing human resource capabilities in Islamic finance worldwide. It offers short courses in:

- *Shari'ah* Principles in Islamic Financial Institutions
- Islamic Capital Market
- Accounting, Auditing and Governance Standards in Islamic Financial Institutions
- Islamic Banking and Finance
- *Takaful* (Islamic Insurance)
- Product Development for Islamic Financial Services and *Takaful*
- Islamic Commercial and Corporate Law
- The *Shari'ah* principles of *zakat* and *waqf*.

It also offers four Continuing Professional Education (CPE) modules which lead to certification. These cover:

- *Shari'ah* Rules and Standards,
- Islamic Accounting and Auditing,
- Islamic Banking and Insurance and
- Islamic Capital Market.

There is also an Executive MBA (specializing in Islamic Finance) covering:

- Islamic Law in Banking & Finance
- Accounting, Auditing & Governance of Islamic Financial Institutions
- Financial System and Regulations of Financial Environment
- Financial Management & Islamic Financing Operations
- Issues on Risk Management in Islamic Financial Institutions
- Issues on Islamic Capital Market

An on-line Islamic banking course is said to be in progress. The website gives more details: www.iiif-inc.com

Chartered Institute of Management Accountants (CIMA)

CIMA has recently announced that it has introduced a new certificate in Islamic finance (CIMA CIF). It is a self-study distance learning programme organized in four modules:

- Islamic commercial law
- Banking and *Takaful*
- Islamic capital markets and instruments
- Accounting for Islamic financial institutions.

CIMA has produced a study guide for each module and students will be examined on each module using an electronic assessment. This can be taken at any CIMA accredited centre around the world. More information can be found at www.cimaglobal.com

International Centre for Education in Islamic Finance (INCEIF)

The International Centre for Education in Islamic Finance (INCEIF) was set up in 2006 by the central bank of Malaysia, Bank Negara Malaysia, to produce professionals for the Islamic financial services industry. It has University status and has already attracted students from some 46 countries.

Its flagship qualification is the Chartered Islamic Finance Professional (CIFP). It can be studied on-line or full-time. There are three modules, the first two covering theoretical topics and the third a six month internship for those students without experience. The first module is entitled "Building Knowledge" and the courses covered are:

- *Shariah* Aspects of Business and Finance
- *Shariah* Rules in Financial Transactions
- Islamic Economics
- Deposit and Financing Operations of Islamic Banks
- Accounting for Islamic Financial Transactions
- Islamic Financial Markets and Institutions
- Islamic Capital Market
- Introduction to Risk Management and *Takaful*

The second module is entitled "Building Skills" and the courses included are:

- *Shariah* Issues in Modern Islamic Finance
- Ethics and Governance

- Structuring Financial Requirements
- Treasury and Risk Management of Islamic Banks
- Managing Islamic Financial Institutions
- Wealth Planning and Management

The third part is entitled "Building Competency and Experience".

INCEIF also offers a Masters in Islamic Finance programme and takes students for research-based PhDs (www.inceif.org).

ICMA Centre University of Reading

The centre was established in 1991 by the International Capital Markets Association. Its aim is to provide quality undergraduate, postgraduate and professional programmes tailored to the capital markets industry.

It has tied up with INCEIF to provide a full time MSc in Investment Banking and Islamic Finance. In addition, students qualify for CIFP Part I if they pass the following modules:

Studied in Reading:

- Theory and Ethics in Islamic Economics and Finance
- Design, Implementation and Risk Aspects of Islamic Financial Products and Services
- The Principles of Islamic Commercial Jurisprudence and the Nominate Contracts

Studied in Kuala Lumpur:

- Islamic Financial Institutions and Markets
- Wealth Planning and Management
- Deposit Mobilization and Financial Management

More information can be found at the website: www.icmacentre.ac.uk.

Islamic Institute of Banking and Insurance

Founded in London in 1991, the IIBI offers one of the longer established distance learning courses leading to a postgraduate diploma. It claims to be the only organization of its kind in the West, and has made a significant contribution to the education and training of people in Islamic banking and insurance through its diploma course, publications, lectures, seminars, workshops, research, and *Shari'a* advisory services. The diploma syllabus consists of six modules each with a number of lessons. The modules are:

- Islamic Economics and Finance
- Islamic Commercial Law and Contract
- Islamic Banking Operations
- Treasury and Capital Market Operations
- Regulation, Supervision and Corporate Governance
- *Takaful* – Alternative to Insurance

Each lesson has questions for the student to answer and submit to his tutor. The tutor is also available to answer any questions. There is no final examination but the diploma is awarded when students have successfully submitted answers to all the questions. In addition to receiving a diploma, students become Associate Fellows of the Institute (www.islamic-banking.com).

Islamic Banking and Finance Institute Malaysia

The IBFI M was established by a group of Malaysia-based Islamic institutions in 2001. It is dedicated to producing well-trained, highly competent personnel and executives with the required talent for the Islamic finance industry.

The institute offers a number of skill-based practitioner programmes and also a number of Qualified Practitioner programmes. The main qualification is the Certified Credit Professional – Islamic, which can be awarded as CCP-i (business), CCP-i (consumer) or CCP-i (comprehensive). The programme has been designed to enhance the skills of existing CCP holders – a conventional finance qualification awarded by the IBBM (Institut Bank – Bank Malaysia) – with the necessary tools to carry out similar credit functions in Islamic banking. The programme is targeted for executives in Islamic banking institutions and those in Islamic banking windows of conventional banks.

The course covers:

- Highlights on the principles and philosophy of the Islamic financial system.
- *Shariah* issues and *Shariah* compliance for financing products.
- Types of contracts, products and documentation applicable in Islamic finance operations.
- Approaches to rescheduling and restructuring of Islamic financing products.

It is a distance-learning programme using materials provided by the Institute but students are encouraged to attend the skill based programmes offered by the institute. There are two examination papers, one being multiple choice questions and the other case study(ies).

A second qualification is that of Islamic Financial Planner (IFP). It is designed for professionals and executives serving the retail side of the Islamic financial market. The growing pace of innovation and the increased sophistication of retail customers requires a higher degree of competency on the part of financial planners that this programme aims to provide. Candidates are examined on six modules:

- Fundamentals of Islamic Financial Planning
- Risk Management and *Takaful* Planning
- Islamic Investment Planning
- *Zakat* and Tax Planning
- Islamic Estate, Retirement and *Waqf* Planning
- Financial Plan Construction and Professional Responsibilities

A further qualification is the SiSIP – the *Shariah* Scholars Induction Programme. It is specifically designed *for Shariah* officers and advisers serving the Islamic finance industry. The aim of the programme is to give exposure on the operational aspect of Islamic finance. This programme covers both the theoretical and practical aspects of *Shariah* in Islamic banking, Islamic capital market and *takaful* operations. The programme is endorsed by Bank Negara and is a necessary qualification for anyone working as a *Shariah* advisor in a bank or *takaful* provider.

The Institute also awards the *Takaful* Practice Qualification (TPQ) and the Islamic Banking Practice Qualification (IBPQ) (www.ibfim.com).

International Institute of Islamic Business and Finance, India (IIIBF)

The mission statement of the IIIBF says that: "it offers programmes of study and promotes research relating to global business and economy with a strong focus on Islamic values and ethics. It aims at cultivating an understanding of the spiritual and intellectual heritage of Islam and its contribution to organization and operation of business and economy. It seeks to create a new generation of business leaders, managers, academics and researchers throughout the world, who would successfully demonstrate the universality of Islam in dealing with the ever increasing complexities and challenges of modern business by imparting education and training using distance education methods."

It offers a number of certification courses.

Certified Islamic Banker (CeIB)

Candidates must pass all six courses in Level I and obtain six credits from Level 2, including two compulsory courses and at least one credit from a project. The Level I courses are:

- Sources of Islamic Financial Law
- Islamic Law of Financial Contracts – I
- Islamic Law of Financial Contracts – II
- Islamic Financial System – I
- Islamic Financial System – II
- Islamic Monetary and Macro-economic Management

While Level 2 courses are:

- Islamic Commercial Banking: Products & Services (compulsory)
- Islamic Commercial Banking: Operations & Management (compulsory)
- Islamic Microfinance
- Islamic Investment Banking and Fund Management
- Project Appraisal & Investment Decisions
- Accounting Standards & Regulations for Islamic Banks
- Information Technology for Islamic Financial Institutions
- Marketing of Islamic Financial Services
- TQM & BPR for Islamic Financial Institutions
- Principles of Islamic Insurance (Takaful)
- Islamic Insurance (Takaful): Organization and Management
- Accounting Standards & Regulations for Islamic Insurance Companies
- Supervised Project – I (One credit, approximately 3000 words)
- Supervised Project – II (Two credits, approximately 5000 words)

Certified Islamic Insurance Professional (CeIIP)

The format of this course is the same as that of the CeIB programme. Candidates must pass all courses in Level I and obtain six Level 2 credits where there are two compulsory courses and at least one credit must come from a project. The Level I courses are exactly the same as those for the CeIB course while Level 2 courses are:

- Islamic Insurance: Products & Services (compulsory)
- Islamic Insurance: Operations & Management (compulsory)
- Islamic Microfinance

- Islamic Investment Banking and Fund Management
- Project Appraisal & Investment Decisions
- Accounting Standards & Regulations for Islamic Insurance Companies
- Information Technology for Islamic Financial Institutions
- Marketing of Islamic Financial Services
- TQM & BPR for Islamic Financial Institutions
- Supervised Project – I (One credit, approximately 3000 words)
- Supervised Project – II (Two credits, approximately 5000 words)

Certified Islamic Investment Analyst (CeIIA)

Again, the format of this course is similar to that of the other two programmes. The Level I courses are the same and candidates must pass all of them. Also, candidates must obtain six credits under Level 2, three of which are compulsory while at least one credit must be from a project. The Level 2 courses are:

- Security Analysis & Portfolio Management (compulsory)
- Capital Market in Emerging Economies (compulsory)
- Islamic Microfinance
- Islamic Investment Banking and Fund Management
- Project Appraisal & Investment Decisions (compulsory)
- Accounting Standards & Regulations for Islamic Insurance Companies
- Information Technology for Islamic Financial Institutions
- Marketing of Islamic Financial Services
- TQM & BPR for Islamic Financial Institutions
- Supervised Project – I (One credit, approximately 3000 words)
- Supervised Project – II (Two credits, approximately 5000 words)

More details on the content of these courses can be found at the website.

IIIBF has also created IBF Net, a global online network of students, researchers and professionals. It currently claims over 5,000 members. It gives access to online discussions and an E-Library on Islamic Economics and Finance. The Institute also organizes training courses and workshops in various centres in India. The website address is: islamic-finance.net

Rating Agencies

Both Fitch and Moody's offer training courses in Islamic finance. Fitch describes its course as:

"A one-day introductory workshop for bankers and credit risk management professionals wishing to better understand Islamic Banking institutions and practices. A structured approach to the credit analysis of Islamic Banks. "

The course is designed to follow on from their Emerging Market Banks and Sovereigns or Intensive Bank Analysis courses that teach the core tools required. The course is scheduled to run in London and Singapore in 2009. More information is available at: www.fitchtraining.com.

Moody's Analytics offers a similar course. It defines its objectives as to help delegates:

- Understand the basis precepts and terminology of Islamic finance
- Assess the operating environment for an Islamic financial institution
- Understand the internal structure of an Islamic bank
- Explain the mechanics of Islamic financial products
- Assess the credit risks of Islamic banks
- Appreciate Moody's approach to rating an Islamic bank

Moody's course is run over two days and is scheduled for London and New York in 2009. Full details of the programme can be found at. v2.moodys.com

Both courses inevitably focus on the risks associated with Islamic banking and Islamic financial products while giving delegates the necessary understanding of the underlying requirements when operating according to *Shari'a* compliant principles. Both courses qualify delegates to receive CPE credits.

Global Association of Risk Professionals (GARP)

GARP has announced, but not yet run, a two day workshop on "The Fundamentals of Islamic Finance and Banking". It has also announced that it is developing a new programme, in association with the Banque du Liban, the *Certificate in Risk Management for Islamic Financial Institutions*. It is expected that full details with be available early in 2009 (www.garp.com).

Securities & Investment Institute (SII) with Ecole Supérieure des Affaires (ESA)

The SII announces itself as the professional qualifications and membership body for the securities and investment industry. It formally launched its Islamic Finance Qualification (IFQ) in October 2006. The programme has been jointly developed by the Securities & Investment Institute (SII) and the Ecole Supérieure des Affaires (ESA), to respond to the rapid expansion in the Islamic Finance and Banking sector.

The Advisory Council for Islamic Finance, responsible for the IFQ's development, is chaired by the First Vice-Governor of the Banque du Liban, Dr Ahmad Jachi, and comprises leading Sharia'a scholars and practitioners from around the Gulf and the UK. The press release announcing the programme said:

> *"There is no other qualification or unified standard practice which covers Islamic Finance from both a technical and Sharia'a aspect which will offer the degree of international portability and professional competence comparable to that offered by the IFQ.*
>
> *The IFQ provides the first international benchmark in the area of Islamic Finance and it is aimed at both existing employees, new employees as well as individuals seeking a career in Islamic Finance.*
>
> *The IFQ will be jobs-focused and will require candidates to demonstrate a practical understanding of Islamic Finance as opposed to discussing academic and theoretical issues."*

The syllabus is divided into *elements*. These are broken down into *sections* and then into a series of *learning objectives*. Each learning objective begins with one of the following prefixes: *know, understand, be able to calculate* or *be able to apply.* These words indicate the different levels of skill to be tested. The elements in the syllabus are:

1. Introduction to Islam
2. Introduction to Islamic Banking and Finance
3. Islamic Law of Contracts
4. Financial Techniques Applied by Islamic Banks
5. Financial Statements for Islamic Banks
6. Islamic Corporate Governance
7. Islamic Asset and Fund Management
8. The Islamic Bond Market – *Sukuk*
9. Islamic Co-operative Insurance – *Takaful*
10. Case Studies

Details of the sections and learning objectives can be found on the SII website, and candidates have to pass a multiple choice examination covering the elements. At present the weightings given to each element are:

ELEMENT	Questions
2	3
3	15
4	31
5	10
6	8
7	11
8	13
9	9
TOTAL	**100**

The weightings may change slightly from one examination to another, but the number of questions in each unit should not change by more than two. This flexibility is incorporated to ensure a consistent level of difficulty.

SII has produced a Workbook for candidates that covers all the elements of the course and includes questions and answers on each element. Also included are exam standard questions and answers and as these develop further examples will be included in the candidates' room on the website.

While SII has a number of offices around the world, it also accredits third party training providers. For the IFQ these are currently:

7city Learning	UK (London)
BPP Professional Education	UK (London)
CCL City Training Ltd	UK (London)
Financial News Limited – a Dow Jones Company	London
Gulf Insurance Institute	Bahrain & UAE
Ecole Supérieure des Affaires (ESA)	Lebanon
Institute for Financial Analysts, American University of Beirut	United Arab Emirates
Gulf University for Science and Technology (GUST)	Kuwait
Praesidium LLP	Dubai
Praesidium PTE	Singapore
Risk Reward Ltd	Europe, Middle East & Africa

The website address for the SII is: www.sii.org.uk.

Chapter 21

Future Prospects

While the earlier chapters of this book have tried to present the factual position of Islamic banking and finance as it exists today, when looking forward there are no more facts, only opinions on how things might develop. The opinions in this chapter are mine, although they are certainly influenced by many others. The Islamic Development Bank (IsDB) has set out the challenges it feels it should be tackling as has the Islamic Financial Services Board (IFSB). These have undoubtedly been two of my main influences and will be referred to as the chapter progresses, but first it is my opinions!

The Islamic financial sector has witnessed significant growth over the past decade, growth that has seen the institutions develop more quickly than the infrastructure that supports them. There are many new Islamic institutions and many new Islamic products. They have not been tested through the cycle or even through the courts. The development has all happened at a time of relatively benign issues in the global financial markets. In Malaysia, a fair degree of restructuring was necessary after the Asian crisis, but this provided the opportunity for new Islamic institutions to be formed and flourish – with the very positive support and encouragement of Bank Negara Malaysia, and of the governor in particular. In the Middle East, steady oil revenues have led to a stable funding base for all financial institutions. In the aftermath of 9/11, the Islamic institutions, while subjected to a certain amount of distrust from western institutions and regulators, have benefited from a solidarity that has seen funds repatriated to the region from western markets and a renewed interest from the region in Islam and Islamic banking.

Market conditions have changed today and no countries have escaped the global recession that has been exacerbated by the credit problems faced by almost all the major western banks. If one thing has been shown by the events of the last two years it is that banking is a truly global business and no corner of the world has escaped unscathed. The Islamic financial market will be tested to the full and the known weaknesses exposed, to the inevitable detriment of those institutions that have underdeveloped risk management systems and inadequate controls in place.

The problems in the markets today pose the greatest challenges to the Islamic financial institutions that most have ever faced and it is not certain that they have the capacity to survive. That Islamic financing is based on real assets should provide some comfort, but in effect, most of the risk is centred on the capacity and willingness of clients to pay. A further concern is that many of the assets are real estate assets and fair values of properties have been falling all over the world. In addition, *Shari'a* compliant equities have been subject to the same downturn in investor sentiment and news flow issues as have conventional equities. It is at times like this that all institutions need to have skilled and experienced employees who can understand the issues and take appropriate steps to insulate their institutions from the worst of the problems. The relative lack of skills and experience, so often expressed as a concern for Islamic institutions, will not help.

Today, the financial crisis that all are experiencing has placed Islamic institutions at an important turning point. It could put new momentum into the industry and persuade the players to make the changes all agree are necessary, thus creating a more stable foundation for further growth and development once the markets recover. Alternatively, there could be a further blurring of lines between Islamic and conventional products and services and so called Islamic banks will only succeed by abandoning their Islamic finance principles. This could lead to the demise of many institutions and stall progress for others, leaving Islamic finance on the fringes of the markets for a generation or more.

So, what are the challenges that so many practitioners agree must be resolved if Islamic finance is to continue to grow and play an important role in the global markets? What are the changes that must be made?

Profit and Loss Sharing Accounts

I would place near the top of my own personal list the issue of profit and loss sharing accounts. When Islamic banks first started to become players in the market, their belief was that their financing should be provided through *Musharaka* or *Mudaraba* agreements. They should be partners with their clients and share the risks of their business ventures. At the same time, they would act as intermediaries between fund providers and these clients so that the fund providers also became partners, sharing in the risks and rewards of the ventures. Quite quickly the banks discovered that the risks in this business model were huge and that they did not have the necessary skills to determine the likely success of their clients' new businesses. Not only was the problem linked to their own adverse selection of projects but also to the asymmetric availability of information. Quickly they looked to other ways of providing asset based financing, most often through *Murabaha* or *Ijarah* contracts. However, they still continued to ask fund providers to open profit and loss sharing accounts, subjecting these "deposit" clients to even more information asymmetry. At the same time they continued to compete with conventional institutions that offered capital certainty with their deposit products and these deposits are often supported further by deposit insurance schemes. As a result the Islamic banks started taking profit equalization reserves and investment risk reserves that they could use, when needed, to ensure that the returns to profit and loss sharing account holders matched the returns being provided by their conventional competitors. While this has worked in practice, it seems somewhat unsatisfactory. It is neither true profit and loss sharing, nor does it balance the asymmetries of information. Clients either receive more or less than they would be due if they truly did share. The all important public confidence comes from the *Shari'a* credibility of the bank's products and a better way of providing funding and giving some return to "depositors" still needs to be developed. Now is an ideal time to experiment as market interest rates are close to zero and little or no return is expected by customers.

Standardization

Is there a need for greater standardization? It can be argued that there is no reason to aim for this, that there is room for diversity of view. While this is true, there is a strong argument that by using some standard products, Islamic banks could achieve cost savings and have greater certainty in the *Shari'a* compliance and legal enforceability of many of their contracts – factors that would be welcomed by most clients. While efforts are proceeding in this area, particularly in the work of the IIFM, much remains to be done. The easiest part of the task is to create standards for the most widely used products, the hardest part is to persuade the banks to use them. Indeed standards are not only relevant for documentation but also for accounting and regulation. While AAOIFI and the IFSB have produced standards, most of which have been welcomed by the industry, only a few countries have adopted them as part of their regulatory system. These two organizations seem more like academic talking shops than standard setting bodies. That said, it must be recognized that many of the problems in the international markets today developed as a result of the fact that auditing firms, regulators and bankers themselves, despite adherence to accounting and regulatory standards, did not identify the developing problems sooner and take remedial action. Currently accepted practices fell short. If this is true for conventional institutions, the lack of accepted standards in the Islamic markets must be of great concern.

Regulation

Regulators are faced with significant problems. Should Islamic banks be held to different standards than conventional banks? Is there a need for this? Are their operations so different that new rules are required? Both the UK and USA regulators have said that Islamic operations should fit their regulations for conventional banks. So far, most of the products the banks wish to offer have been accepted. The one exception is profit and loss sharing accounts. This is yet another reason for the Islamic banks to find a new way to provide "deposit" facilities for their customers. The IFSB has stated that it wants to cooperate with all the standard setting organizations that work with the conventional markets and does not want to invent unnecessary rules. Does this perhaps mean that some issues should be self-regulated? So, for example, should *Shari'a* compliance be a regulatory issue? Regulators may wish to see that the Islamic banks have looked at the governance issues that arise and have systems in place to allow banks to work effectively with their *Shari'a* boards, but then allow the banks' boards to come to their own conclusions. This could mean that the industry needs to be self-regulating in this area. Is this a role that the General Council for Islamic banks and Financial Institutions (CIBFI) could play? Maybe it is a role for the Islamic Development Bank, given its broader vision for the development of Islamic finance? That said, the Malaysian system, with its central *Shari'a* board, appears to operate successfully. It also has led to the fact that the Malaysian banks have similar products and *Shari'a* decisions and this has brought greater certainty to clients and banks alike.

New Products for Liquidity Management

In addition to new products for resource mobilization, new products are also needed for liquidity management. Malaysia has been very active in providing a range of products for its banks, but most of these would not be accepted in the Gulf markets because of differences in *Shari'a* interpretation. Bahrain has a programme of *Sukuk* issues but, while these have been well received, the market has not been liquid. The new repo facility that the Central Bank has been developing is a positive move as this could ensure liquidity. If the product is fully accepted by the scholars, it could be repeated in other markets, but many Islamic countries are small and may not be able to provide the support required. Islamic banking needs active, deep, liquid money markets and these are not present today.

Sukuk Issuance

Sukuk issuance has stalled somewhat in the last 12 months, but, while this is in line with events in the conventional markets, the AAOIFI statement on the lack of *Shari'a* compliance for most of the earlier issues, has also had an impact. There is still a very thin market in *Shari'a* compliant bonds and, as a result, they are very sensitive to market sentiment and their pricing is volatile. However recently, a number of new issues have been announced that meet AAOIFI's concerns and have a robust structure that will give investors access to a range of asset classes without compromising on *Shari'a* compliance. This is a very positive development. If the issues are well received by the Islamic market and if there are a number of issues as part of planned programmes, they could be instrumental in bringing more liquidity to the market. Until this becomes a reality – and there still are a number of "ifs" - liquidity will remain a concern.

Asset Concentrations

Prospects also hinge on the availability of more *Shari'a* compliant assets. Unless these assets are found or developed, the banks will continue to have risky concentrations on their balance sheets. At present these centre round real estate, resources and energy. In some ways this does mean that the relatively small Islamic institutions can focus all their resources on understanding a few sectors, but greater diversification would almost certainly lead to a lower risk profile.

Qualified Human Resources

The need for more qualified staff is frequently highlighted as being one of the major reasons that Islamic finance has not developed any further or any faster. As noted in an earlier chapter, there are now a large number of courses and qualifications available. It is increasingly possible for institutions to send employees to these courses and there are also funds available to pay for students to study for higher degrees. What still remains is the concern over the lack of qualified *Shari'a* scholars. While there will probably always be some who become better known and whose opinion is most often sought, there needs to be a deeper pool of names. However the skills required can only be obtained after many years of study in law, *Shari'a* law and finance. This can be a daunting process. Central Shari'a boards could ease the pressures, but would this require Shari's regulation? Banks will continue to need people who can monitor *Shari'a* compliance in practice and ensure that there is a working system of governance in the institution.

Takaful and *Re-takaful*

Takaful and *Re-takaful* are still in their infancy and there are many issues that remain to be resolved. The whole concept is still seen as incompatible with *Shari'a* rules by many. Different models are being used and this can be confusing for customers. The relationship between shareholders and policy holders is not always clear. Who bears what risk and what happens if the fund is not large enough to meet the obligations? A supportive legal and regulatory framework still has to be developed, addressing such issues as corporate governance, financial and prudential regulations, transparency reporting, market conduct and supervisory review. There are still many views on how to proceed and this seems to be one area where more standardization is required. This is particularly so for life policies. These may be in place for 40 or more years and potential customers need to be assured that their policies will continue to be regarded as valid and *Shari'a* compliant throughout that period, and that the *Takaful* company will continue to exist. If there was more standardization, this would help. Also, companies need more long-dated financial products to bring greater certainty to expectations. While much needed by many, at present it seems that *Takaful* will be one of the harder products to develop. Customers are looking for long-term relationships and this seems near impossible with young companies offering new products that have still to gain a track record.

Development Issues

Finally, it must not be forgotten that many Islamic countries are among the poorest in the world and Islamic finance has a role to play in helping them develop. So far, apart from the work of the Islamic Development Bank, there appear to have been few significant efforts from the Islamic finance industry to introduce the products that are needed. Top of this list must be microfinance. As discussed in an earlier chapter, Islamic financing seems to lend itself to microfinance, yet it has not become an established product. Other areas where Islamic finance could play a role are housing and infrastructure finance and maybe even venture capital.

Islamic Development Bank

The new vision and mission that the Islamic Development Bank has announced (see Chapter 19) requires that many of the issues discussed above are solved. It has stated as immediate initiatives:

1. *"Strengthen the infrastructure for governance of Islamic financial institutions and bring it up to global standards. Standardize global* Shari'a *rules and develop stringent regulatory and supervisory rules for corporate governance, risk management and transparency. Institute effective checks against money laundering;*

2. *Significantly expand the non-bank financial sector of the Islamic financial industry;*

3. *Upgrade the knowledge capacity and skills required to effectively manage the operational aspects of the financial sector, in particular management of the risks in equity-based financing; and*

4. *Invest in a strong research and development facility to develop new financial products. Successful growth in the highly competitive global financial market will increasingly depend on the development*

of marketable new products. If the Islamic financial industry can effect this transformation quickly, it will be able to gain respect and credibility in the market. It will then have the potential to attract a fair amount of the very substantial funds presently kept in Western financial markets.

5. *Cooperate with financial institutions that offer "Islamic" financial services with the aim of facilitating their* Shari'ah *compliance."*

What is not clear from this is exactly what role IsDB itself will play. It has already been instrumental in establishing a framework for the development of the industry and has been the main promoter of many organizations such as AAOIFI, IFSB, IIFM and IIRA. It has a strong research arm that has looked at new products for the industry and it has made landmark *Sukuk* issues. The big jump that is required now is persuading the industry to use already available standards while pushing forward with the development of new and complementary ones. As suggested earlier, could the IsDB become the body that oversees the self-regulation of the industry? While at first sight the organization seems rooted in tradition, its *Sukuk* issues were groundbreaking in allowing a percentage of the underlying assets to be *Murabaha* contracts, and so effectively debt. This shows an open-mindedness to *Shari'a* interpretation that could have a positive impact on the industry. However, the *Shari'a* board of AAOIFI is perhaps more representative of the industry and will also look at documents in English as well as Arabic – which seems essential if new sophisticated products are to be introduced whose structure will not always translate well into Arabic. Could this board be the one that is empowered to be responsible for self-regulation? There are a number of options, but the IsDB is the one organization that already has global credibility and a AAA rating.

Islamic Financial Services Board and Islamic Research and Training Institute of the Islamic Development Bank

As mentioned in Chapter 11, the IFSB and IRTI have jointly published a document entitled "Islamic Financial Services Industry Development – Ten Year Framework and Strategies". In this they set out many of the challenges they see for the industry and identify some of the strategies that should be adopted. It is envisioned that this document will be updated on a regular basis.

The document sets out in great detail many of the challenges faced by the industry today. Reading this document alone shows how well the problems are understood. However, the best aspect is that, while it does make rather general recommendations, it also identifies a number of practical initiatives that need to be undertaken. These it divides in to three areas: institutional development; capital market development; and, infrastructure development

The prioritized initiatives it identifies for institutional development are:

A) *Balancing diversification and functional specialization*

It recognizes that society needs a diverse range of financial services many of which are not available today and which Islamic banks alone cannot provide. It therefore says that national priority interventions should have a two-pronged approach:

i) To ensure wide-ranging access to financial services and to meet the needs of the economy for various types of funds, the domestic markets should encourage and promote functional specialization of the various segments of the industry. This is expected to facilitate an extensive penetration of financial services without causing an unhealthy mixing of the various types of risks by relatively small and new institutions.

ii) At the same time, the process of market-driven mergers and consolidation should be encouraged, so that strongly capitalized IIFS can emerge within the framework period to safely offer a range of Islamic financial services as part of a single corporate group.

The two-pronged approach is also expected to strike a balance between institutional efficiency, systemic stability, providing risk capital and ensuring a better social development role for Islamic financial institutions.

B) *Human resources and* Shari'a *governance systems*

Here it recognizes that many initiatives are under way, both providing funds for training and the development of new courses. It suggests that encouraging training institutes and universities to form strategic alliances could help develop well rounded talents in Islamic finance.

C) *Research and development*

Here it believes that institutions themselves need to allocate resources to undertake research to develop products that can enhance their resource mobilization, liquidity and risk management capabilities. It then suggests that policy intervention, in the form of the lead institutions within the industry combining their resources to carry out the R&D task, is required for a more dynamic product innovation drive. This may be harder to achieve as the lead institutions want to enhance their competitive position by being the first to be able to offer new products.

D) *Financial soundness indicators*

It identifies the lack of good data on the industry and says that a reliable and consistent database of global Islamic financial services statistics is important for the purpose of monitoring the operational efficiency and soundness of financial institutions and markets. Such a database is required for research and development, as well as for supervisory surveillance. Efforts are underway by a number of organizations to fill the gaps but, in particular, the IFSB has undertaken the initiative to design a global database of prudential and structural

Islamic finance statistics, with a Technical Assistance grant from the IsDB and the Asian Development Bank (ADB).

E) *Standardization of contracts, harmonization of* Shari'a *interpretations and settlement of unresolved issues*

The report comments "Unless there is a reasonable level of understanding, agreement and clarity about the Islamic financial contracts, the industry will be perceived as having higher contractual as well as systemic risks. Unless key pending issues are resolved from within the institutions, the integration of the Islamic financial services industry into the competitive mainstream financial markets and system will not be possible. Medium-term policy intervention needs to focus on meeting this challenge, and on developing contract structures that are not only widely acceptable from within the industry but also are recognized by the civil and common law regimes." Interestingly, the comment focuses on standardized documentation, an issue that the IIFM is addressing, but does not comment on the broader issue of harmonization of *Shari'a* interpretations, which will be much harder to achieve.

F) *Changing the perceptions about* Takaful

Here it emphasizes the fact that many still see *Takaful* as undesirable and incompatible with the *Shari'a* and urges the industry to do all it can to change these perceptions. However, until there is greater standardization and better tools for managing life policies, this will be hard to achieve. *Takaful* should provide a way of managing risk but at present, in many ways, it introduces more risk.

G) *Ensuring access of the poor to Islamic financial services*

This priority comes as a result of the fact that microfinance is very underdeveloped while being needed in many Islamic countries. The report gives no indication as to how the required change can come about, unless the final priority in this section shows a way.

H) *Equity support for the establishment of IIFS*

"As a multilateral initiative, the IsDB and IFSB member countries may consider establishing a multilateral organization with a mandate to provide equity support to set up new IIFS."

The next section looks at the needs of the capital markets and identifies four priorities for their development. The document was written before the impact of the global financial crisis was felt and also before the AAOIFI statement on *Shari'a* compliance of many *Sukuk* issues. These initiatives may well change as market conditions have changed, but the priority initiatives were:

A) *Develop the legal, regulatory and institutional framework*

Here, the first comments were on adapting the legal and regulatory framework to ownership-based financing and securitization. For each country, this includes removing regulatory obstacles (including achieving tax neutrality). It also includes eliminating uncertainty regarding such matters as the enforceability of contract clauses and tax treatment. These remain valid concerns that need to be addressed. However, the second priority relates to the development of a primary and secondary market for mortgages. While this may still be a valid objective in the 10 year horizon covered by the document, in the wake of the global problems over mortgage backed securities, it may be a lower priority today.

B) *Promote public sectors' participation in capital markets*

Here three priorities are identified and, despite the current market turmoil, would give a huge boost to the development of the Islamic financial markets. What the report asks for are:

i) Government participation in the capital market through the regular issuance of sovereign Islamic bonds, in international or domestic currencies, integrated within the national public debt management framework.

ii) Allocation of a target share of publicly controlled portfolios to investment in Islamic capital markets.

iii) Strategic commitment of a small share of foreign-currency reserves to investment in high-quality and liquid Islamic fixed-income instruments if and when they become available. Such instruments are unlikely to provide the same degree of liquidity and rating as conventional instruments, but they can correspond to the least liquid foreign exchange reserve tranche. A commitment from central banks would provide an extraordinary impetus for quality international issuers to participate in the Islamic capital market.

C) *Promote international cooperation*

While international cooperation does seem a desirable goal, it is suggested that this will happen by harmonizing standards. It calls on the investment banks and rating agencies to cooperate by harmonizing their approaches. While this could be seen as a way of minimizing risk and therefore encouraging broader involvement, it does not seem to be a practical or desirable route to this end.

D) *Enhance market openness*

Here the aim is to promote and encourage the participation of conventional issuers and investors in the Islamic capital market. It is stated that the Islamic capital market would be highly inefficient if it were to develop as a closed system in which only IIFS participated. It is then suggested that international issuers are "encouraged" to participate. This will only be successfully achieved if these players see value and transparency in the markets, some of which is lacking today. The market must to be seen to serve the needs not only of the Islamic institutions but also the international players. They can bring the liquidity and depth to the market that is lacking today.

The final set of initiatives focus on infrastructure development. Here the need is to develop a financial infrastructure that will allow the growth of a sound, diversified Islamic system that is integrated into the national and global markets and offers access to a wide range of customers. This goal is to be met over the medium term, by helping national authorities to develop:

i) a legal infrastructure underpinning laws, contracts, property rights, insolvency and creditor rights regime, as well as financial safety nets;

ii) a transparency, information and governance infrastructure, including monetary and financial policy transparency and neutrality, corporate governance, accounting and auditing framework, disclosure regime and market monitoring arrangements such as credit ratings, and credit reporting systems; and

iii) a systemic liquidity infrastructure, including monetary and exchange operations, payment and securities settlement systems, and microstructure of the money, exchange and securities markets.

Many initiatives at both the national and multilateral levels are proposed, most particularly at the national level in order to strengthen the legal, information and governance infrastructure for Islamic finance in order to develop efficient and liquid money and capital markets for Islamic financial instruments and securities, as well as to enhance public access to a wide range of financial services. The strategy needs to be supported by appropriate risk mitigation policies, in order to maintain stability.

At the multilateral level, the document stresses the roles that the IsDB, IRTI, IFSB, IIFM, AAOIFI and others, can play.

These initiatives are all commendable, but also show just how much work remains to be done if the Islamic financial market is to develop over the coming decade and integrate further into the global markets. They also show the need for cooperation among a large number of different players, none of whom can achieve the goals by working alone.

Final Comments

It was suggested in the early part of this chapter that Islamic finance was at a vital turning point and, unless many issues were addressed, it could remain on the fringes of the financial markets for many more years. Without exceptional efforts, we could see a further blurring of the lines between conventional and Islamic finance. This path could set back any further development of Islamic finance for a generation. The other route involves solving many problems that have long seemed intractable. If this route is followed, it will not be without pain and trauma. The exciting prospect is that there are a growing number of committed practitioners who have chosen this painful route. If they can win others to their path, the coming years can be very productive.

No-one doubts that an Islamic financial system that offered a full range of products for the whole Muslim world, both rich and poor, both individuals and large corporations, would be welcomed. However, at present, conventional products have been preferred as they have seemed to offer better value and little risk. That many of the presumptions about conventional products have proven to be false and that the embedded risk has not been transparent, may have changed views. In benign markets banks have not worried about potential risks and now rue many decisions. It would seem to be an ideal time for Islamic institutions to step up to the mark, but unfortunately, many of them have been less than transparent themselves and a number of the products that have been developed do not fully meet *Shari'a* ideals. As a result, the Islamic institutions may not be able to take advantage of the opportunity. All have a role to play now if the dreams of many are to become a reality – regulators, standard setters, bankers, professionals in the non-bank sector and others. It remains to be seen what can be achieved and which path will be taken.

Glossary

Adl

God's divine justice; also used to refer to a trusted person or trustee.

Al Ajr

A commission, fees or wages levied for services.

Amanah

Free will, or trust, trustworthiness, property held in trust for another.

Aql

Intellectual reasoning.

Aqila

Shared responsibility.

Arbun/Arboun/Urboun/Urboon

Down payment; a non-refundable deposit – *see also* ***bai al-Arbun***.

Bai al-Arbun

A sales contract where a small deposit is placed to secure the right to purchase in full at a later date. Is the Islamic equivalent of an option.

Bai al-Dayn

A transaction involving the sale or purchase of securities or debt certificates. To be *Shari'a* compliant and tradable, the securities should be trade documents arising from real commercial transactions.

Bai al-'Ina/Bai al-'Inah

A sale and repurchase agreement between two counterparties. An asset is sold on deferred payment terms and repurchased at a lower price for cash. This type of transaction is practised in Malaysia but is rejected as contrary to *Shari'a* rulings in most other countries.

Bai' Bithaman Ajil (BBA)

The sale of goods on a deferred payment basis. It is most commonly used in Malaysia where it is used for payments deferred over a long period in contrast to *Murabaha* which is seen as a short term contract.

Daman

A gift or surety.

Darura

Refers to the *Shari'a* principle of necessity that allows the use of non-*Shari'a* compliant tools where there is no *Shari'a* compliant one available.

Dayn

A debt that comes into being as a result of a contractual obligation to pay agreed amounts to another as a result of a purchase, or rent, or any other contract.

Fatwa (pl. Fatawa)

An authoritative legal opinion based on the *Shari'a.*

Fiqh

Islamic jurisprudence – the jurists' understanding of the *Shari'a* encompassing both law and ethics

Fiqh al-Muamalat

Shari'a rulings on finance specifically applying to commercial transactions

Gharar

Uncertainty in a contract, for instance, the availability of the subject matter of the contract is unknown, or its quantity or quality. Also means ambiguity or even deception. Gambling is a form of *gharar* as the gambler does not know the results of his gamble.

Hadith

The narrative record of the sayings and doings of the Prophet Mohammad, also reflecting His implicit approval or disapproval.

Halal

Allowed, lawful, permissible. There are activities, professions, contracts and transactions that are explicitly prohibited or *haram*. Barring these, all others are *halal*.

Hamish Gedyyah/Hamish Jeddiyah

A security deposit. The amount given by a purchaser to show the seller that he is serious about his order for the asset concerned.

Hanbali

One of the *Sunni* schools of jurisprudence

Hanafi

One of the *Sunni* schools of jurisprudence

Haram

Unlawful. Anything that is prohibited by the *Shari'a* (see ***Halal***)

Hawala/Hawalah

Literally means a transfer. An agreement by which a debtor is freed from a debt when another person agrees to receive a transfer of the obligation, shifting the responsibility of payment from one person to another. In developing countries it is often used to settle international transactions by book transfers.

Hiba/Hibah

A gift.

Ijara/Ijarah

The lease, hire or transfer of ownership or usufruct of any non-monetary asset for an agreed period and agreed payments. For more detail on *Ijarah*, *see Chapter 6*.

Ijara Mawsoofa Bilthimma

An agreement to lease an asset that will be delivered in the future. There may be a down payment or deposit.

Ijara Muntahia Bittamleek

A contract used by an Islamic institution, as lessor, to lease an asset to the lessee, including a promise to transfer the property to the lessee either at the end of the lease period or during the term of the contract.

Ijm'a

Consensus of the jurists, considered a binding indicator.

Ijtihad

Literally means toil, exertion, effort. Legally, means the endeavours of a qualified jurist to interpret, or reinterpret the true application of *Shari'a* in cases where the *Qur'an* and the *Sunnah* are not explicit or clear.

Ikhtilaf

A divergence of opinion among jurists – the opposite of *Ijm'a*.

Istisna'a

A contract for the manufacture of goods or commodities allowing payment in advance for future delivery. For more detail *see Chapter 6*.

Jahala

Ignorance, or lack of knowledge, ambiguity in a contract, leading to ***Gharar***.

Kafala/Kafalah

Responsibility, guarantee or suretyship. A pledge given to a creditor that a debtor will pay – *see also* ***Daman***.

Khiyar al-Shart

An option in a sales contract, included in the contract agreement, giving one of the parties the right to cancel the sale within a specified time period.

Manfaa

Usufruct or the benefit derived from the asset.

Maqasid

Literally means goals or purposes. The general objectives of Islamic law. It is used for a contract that is unenforceable until authorized.

Mawqoof

A contract that is unenforceable until authorized because it has been entered into by an agent who has exceeded his authority.

Maysir / Maisir

The forbidden act of gambling or playing a game of chance with the aim of making easy money.

Muamalat

Ways of worship that are not explicitly covered by the *Shari'a*.

Mudaraba

A financing agreement where the financier provides 100% of the capital but has no control over the management of the project. Profits are divided in a ratio agreed as part of the contract while any losses are borne by the financier only. *See Chapter 6* for more details.

Mudarib

The manager in a *mudaraba* contract. The *mudarib* does not contribute capital but his skills.

Murabaha

A contract between a bank and its customer for the sale of goods at a price that includes a profit margin for the bank. As a financing tool, the customer pays over an agreed period. *See Chapter 6* for more details.

Musawamah

Bargaining. A sale where the price paid is arrived at by bargaining between the parties without reference to the cost of the goods or the expenses incurred by the seller.

Musharaka

A partnership between two or more parties where there are no rules as to who provides the capital or the skills. The profits are shared on a pre-agreed basis but any losses are borne by the capital providers in proportion to the capital provided. *See Chapter 6* for more details.

Qard Hassan

A charitable loan. The borrower only repays the principal of the loan so there is no compensation to the lender for the time value of money.

Qiyas

Reasoning by analogy. Literally means measure, example, comparison or analogy. It is used by jurists to rule on an issue that is not part of existing law but can be said to be analogous to an issue that is.

Qur'an

The first source of Islamic jurisprudence and the Book of Divine Revelation as delivered by the Prophet Mohammad.

Rab al-Maal

The investor or owner of capital in a *Mudaraba* contract.

Rahn

A mortgage or a pledge.

Riba

Interest. Sometimes equated with usury, but its meaning is broader. Its literal meaning is increase, or excess. A fuller description can be found in *Chapter 3*.

Salam

A contract for the purchase of a commodity for deferred delivery in exchange for immediate payment. *See Chapter 6*.

Shari'a/Sharia'a/Shariah/Shari'ah

The term means "way" or "path to the water source". There is no strictly static set of laws of *Shari'a*. It is more a system of law, a consensus based on the *Qur'an*, the *Sunnah*, *Hadith*, *Ijma*, *Qiyas* and centuries of debate, interpretation and precedent. *Shari'a* deals with many aspects of day-to-day life, including politics, economics, banking, business, contracts, family, sexuality, hygiene and social issues.

Shirkah

An alternative term for ***Musharaka***.

Sukuk

A document or certificate giving a pro rata ownership in an underlying asset. The word has become synonymous with Islamic bonds.

Sunnah

The second source of revelation after the *Qur'an*. It literally means "trodden path," and therefore, the *Sunnah* of the prophet means "the way and the manners of the prophet" including his sayings, deeds and approvals as recorded by the companions in *Hadith*. (Not all schools accept all *Hadith*; for instance, the *Maliki* school rejects *Hadith* that do not follow the established practices of the people of Medina.)

Tabarru

A gift or donation. Often used to describe the money given to a *Takaful* fund.

Takaful

Shari'a compliant mutual insurance where the participants make a donation to a common fund which is used to pay claims for any damage suffered by any of the participants. *See Chapter 18* for details.

Tawarruq

The opposite of *Murabaha*. A way of borrowing money. The bank (or its customer) buys commodities deferred and sells spot, often through a metals exchange. It is not viewed positively by most scholars but has become very popular. *See Chapter 6* for a full description.

Ulema

Shari'a scholars or jurists.

Umma/Ummah

Used to refer to the worldwide community of Muslims.

Urboun

See ***Arbun***.

Wa'd

A promise made by one party committing him to some future action.

Wadia/Wadiah

Safe-keeping; trustee of funds.

Wakala/Wakalah

An agency contract. It often includes a fee for the agent.

Wakil/Wakeel

Agent. Appointed under an agency contract that gives the agent power to act in certain transactions.

Waqf

Charitable gifts or grants, often involving property or land and often used to fund hospitals, schools or other similar charitable institutions.

Zakah/Zakat

An annual tax that is a religious obligation on all Muslims having wealth above an exception limit at a rate that is prescribed in the *Shari'a*. It is given to one of eight categories of the needy, as set out in the *Qur'an*. In some countries it is collected by the state.

Appendix 1

Tables of Islamic Funds

Table Appendix 1.1: Fund Type by Domicile

Domicile	Type	Number
Bahrain	Balanced	2
16 Fund Managers	Bond	1
	Commodity	2
	Equity	11
	Income	1
	Index	1
	Leasing	1
	Private Equity	3
	Real Estate	10
	Total	32
BVI	Equity	2
3 Fund Managers	Income	1
	Private Equity	1
	Total	4
Brunei	Balanced	1
Canada	Balanced	3
Cayman Islands	Equity	3
8 Fund Managers	Income	1
	Leasing	4
	Real Estate	7
	Total	15

Domicile	Type	Number
Egypt 6 Fund Managers	Balanced	1
	Equity	6
	Total	7
Hong Kong	Equity	1
India 2 Fund Managers	Infrastructure	1
	Real Estate	1
	Total	2
Ireland 2 Fund Managers	Equity	5
Jersey 2 Fund Managers	Balanced	3
	Equity	1
	Hedge	2
	Income	2
	Real Estate	3
	Total	11
Kuwait 24 Fund Managers	Balanced	1
	Bond	1
	Equity	21
	Fund of Funds	2
	Income	10
	Index	1
	Leasing	7
	Private Equity	1
	Real Estate	10
	Total	54
Luxembourg 2 Fund Managers	Equity	2

Domicile	Type	Number
Malaysia	Balanced	23
24 Fund Managers	Bond	19
	Equity	72
	Growth	8
	Income	26
	Real Estate	1
	Total	149
Nigeria	Balanced	1
Pakistan	Balanced	1
2 Fund Managers	Equity	1
	Growth	1
	Hybrid	1
	Income	3
	Mutual	1
	Total	8
Qatar 2 Fund Managers	Equity	2
Saudi Arabia	Balanced	11
21 Fund Managers	Bond	2
	Commodity	11
	Equity	60
	Fund of Funds	13
	Hybrid	1
	Income	16
	Leasing	5
	Murabaha	8
	Real Estate	6
	Total	133
Singapore	Equity	3
3 Fund Managers	Real Estate	2
	Total	5

Domicile	Type	Number
South Africa	Balanced	1
	Bond	1
	Commodity	2
	Equity	4
	Fund of Funds	2
	Hybrid	1
	Total	11
UAE	Balanced	1
14 Fund Managers	Commodity	1
	Equity	11
	Fund of Funds	1
	Hybrid	1
	Income	1
	Index	1
	Real Estate	8
	Saving	2
	Shipping	1
	Total	28
United Kingdom	Bond	1
5 Fund Managers	Equity	3
	Index	3
	Real Estate	1
	Total	8
United States	Equity	6
5 Fund Managers	Real Estate	1
	Total	7

Note: Where no number is stated for fund managers there is only one

Table Appendix 1.2: Major Fund Managers

Fund Manager	Domicile	Type	Number
CIMB-Principal Islamic Asset Management Sdn. Bhd.	Malaysia	Balanced	6
		Bond	4
		Equity	18
		Growth	4
		Income	5
		Total	37
NCB Capital	BVI	Equity	1
		Income	1
		Total	2
	Saudi Arabia	Commodity	1
		Equity	11
		Fund of Funds	3
		Hybrid	1
		Income	7
		Leasing	2
		Real Estate	1
		Total	26
Public Mutual Bhd	Malaysia	Balanced	2
		Bond	4
		Equity	14
		Income	4
		Total	24
Al Rajhi Financial Services Co.	Saudi Arabia	Commodity	3
		Equity	8
		Fund of Funds	4
		Total	15

Fund Manager	Domicile	Type	Number
Wafra Investment Advisory Group	Cayman Islands	Leasing	4
		Real Estate	2
		Total	6
	Kuwait	Leasing	6
		Real Estate	2
		Total	8
Emirates Fund Managers	India	Real Estate	1
	Jersey	Balanced	2
		Equity	1
		Hedge	2
		Income	2
		Real Estate	2
		Total	9
	UAE	Balanced	1
		Real Estate	1
		Total	2
Jadwa Investment	Saudi Arabia	Bond	1
		Equity	6
		Fund of Funds	3
		Murabaha	2
		Total	12
Saudi British Bank	Saudi Arabia	Balanced	3
		Equity	6
		Income	2
		Total	11

Appendix 2

Excerpts from AAOIFI's *Shari'a* Standard No. 17 – Investment *Sukuk*

1. Definition of Investment Sukuk

Investment sukuk are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or in the ownership of the assets of particular projects or special investment activity.

2. Types of Investment Sukuk

Among the different types of investment sukuk are:

2/1 Certificates of Ownership in Leased Assets

These are certificates of equal value issued either by the owner of a leased asset or a tangible asset to be leased by promise, or they are issued by a financial intermediary acting on behalf of the owner with the aim of selling the asset and recovering its value through subscription so that the holders of the certificates become owners of the asset.

2/2 Certificates of Ownership of Usufructs

2/2/1 Certificates of Ownership of Usufructs of Existing Assets

There are two types:

2/2/1/1 Certificates of equal value issued by the owner of an existing asset either on his own or through a financial intermediary, with the aim of leasing the asset and receiving the rental from the revenue of subscription so that the usufruct of the assets passes into the ownership of the holders of the certificates.

2/2/1/2 Certificates of equal value issued by the owner of the usufruct of an existing asset (lessee), either on his own or through a financial intermediary, with the aim of subleasing the usufruct and receiving the rental from the revenue of the subscription so that the holders of the certificates become owners of the usufruct of the asset.

2/2/2 Certificates of Ownership of Usufructs of Described Future Assets

These are certificates of equal value issued for the purpose of leasing out tangible future assets and for collecting the rental from the subscription revenue so that the usufruct of the described future asset passes into the ownership of the holders of the certificates.

2/2/3 Certificates of Ownership of Services of a Specified Party

These are certificates of equal value issued for the purpose of providing services through a specified provider (such as educational benefits in a nominated university) and obtaining the service charges in the form of subscription income so that the holders of the certificates become owners of these services.

2/2/4 Certificates of Ownership of Described Future Services

These are certificates of equal value issued for the purpose of providing future services through a described provider (such as educational benefits from a university without naming the educational institution) and obtaining the fee in the form of subscription income so that the holders of the certificates become owners of the services.

2/3 Salam Certificates

These are certificates of equal value issued for the purpose of mobilising salam capital so that the goods to be delivered on the basis of salam come to be owned by the certificate holders.

2/4 Istisna'a Certificates

These are certificates of equal value issued with the aim of mobilising funds to be employed for the production of goods so that the goods produced come to be owned by the certificate holders.

2/5 Murabaha Certificates

These are certificates of equal value issued for the purpose of financing the purchase of goods through Murabaha so that the certificate holders become the owners of the Murabaha commodity.

2/6 Musharaka Certificates

These are certificates of equal value issued for the aim of using the mobilised funds for establishing a new project, developing an existing project or financing a business activity on the basis of any of partnership contracts so that the certificate holders become the owners of the project or the assets of the activity as per their respective shares, with the Musharaka certificates being managed on the basis of participation or Mudaraba or an investment agency.

2/6/1 Participation Certificates

These are certificates representing projects or activities managed on the basis of Musharaka by appointing one of the partners or another person to manage the operation.

2/6/2 Mudaraba Sukuk

These are certificates that represent projects or activities managed on the basis of *Mudaraba* by appointing one of the partners or another person as the mudarib for the management of the operation.

2/6/3 Investment Agency Sukuk

These are certificates that represent projects or activities managed on the basis of an investment agency by appointing an agent to manage the operation on behalf of the certificate holders.

2/7 Muzara'a (Sharecropping) Certificates

These are certificates of equal value issued for the purpose of using the funds mobilised through subscription for financing a project on the basis of Muzara'a so that the certificate holders become entitled to a share in the crop according to the agreement.

2/8 Musaqa (Irrigation) Certificates

These are certificates of equal value issued for the purpose of employing the funds mobilised through subscription for the irrigation of fruit bearing trees, spending on them and caring for them on the basis of a Musaqa contract so that the certificate holders become entitled to a share in the crop as per the agreement.

2/9 Mugharasa (Agricultural) Certificates

These are certificates of equal value issued on the basis of a Mugharasa contract for the purpose of employing the funds for planting trees and undertaking the work and expenses required by such plantation so that the certificate holders become entitled to a share in the land and plantation.

Source: *AAOIFI and IFIS*

Appendix 3

Sukuk Issuance

	US$mn	No. of Issues	No. >= US$1bn
2008 to 8/12	15189	139	2
2007	46650	205	13
2006	27167	199	4
2005	10758	88	0
2004	7210	67	1
2003	5817	36	1
2002	986	9	0
2001	780	4	0

Source: IFIS Sukuk Database

Appendix 4

Listing of Islamic Organizations and Institutions

A listing here does not constitute an endorsement of the organization or institution nor confirmation that it is compliant with *Shari'a* principles.

ACADEMIC

Al Fostat Academy
Knowledge Village
Abu Dhabi Office
38063 Abu Dhabi
Dubai, United Arab Emirates
E-mail wael_nyit@yahoo.com
Web www.fostacademy.com
Telephone +971506663874

Center for Islamic Economics Studies
Malang, Indonesia
E-mail ciesforstunibraw@yahoo.com
Telephone 0341-551396psw124

Center for Research in Islamic Economics
King Abdul Aziz University
Jeddah, 21474
PO Box 16711,
Jeddah, Saudi Arabia
E-mail info@islamiccenter.kaau.edu.sa
Web http://islamiccenter.kaau.edu.sa/english/index.htm

Centre for Islamic Studies
Lampeter
United Kingdom
E-mail cis@lamp.ac.uk
Web http://www.islamic-studies.net
Telephone +44 (0) 1570 422351

Department of Islamic Banking & Finance, International Institute of Islamic Economics.
Faisal Mosque Campus
PO Box 1243
Islamabad, Pakistan
E-mail iiie@isp.paknet.com.pk
Web iiu.edu.pk
Telephone + 92 519261761

Department of Shariah and Management, Academy of Islamic Studies, University of Malaya
Kuala Lumpur, Malaysia
E-mail api_pengurusan@um.edu.my
Web www.pengurusan.tk
Telephone +601379676013

Euromoney Training UK & Ireland
Nestor House, Playhouse Yard
London, United Kingdom
E-mail info@euromoneytraining.com
Web www.euromoneytraining.com/uk
Telephone +44 (0) 20 779 8780

European Institute for Human Sciences
Highmead Foundation
Llanybydder
Ceredigion SA40 9UL, United Kingdom
E-mail info@eihs.org.uk
Web http://www.eihs.org.uk/
Telephone +44 (0)1570 480166

Graduate School of Islamic and Social Sciences (Ashburn)
45150 Russell Branch Pwy.
Suite 303, Ashburn VA 20147
United States of America
E-mail school@siss.edu
Web http://www.siss.edu
Telephone (571) 223-0500

Graduate School of Islamic and Social Sciences (Leesburg)
750-A Miller Drive S.E.
Leesburg, VA 20175
United States of America
E-mail kaltomare@siss.edu
Web http://www.siss.edu
Telephone (703) 779-7477

Harvard University
Harvard Law School
1350 Massachusetts Avenue
347 Holyoke Center
Massachusettes, United States of America
E-mail ifp@law.harvard.edu
Web http://www.hifip.harvard.edu

IBF-NET
Kuala Lumpur, Malaysia
Web http://www.islamic-finance.net

Indian Association for Islamic Economics
202002 Aligarh, India
E-mail iebulletin@yahoo.com
Telephone 0091-571-503651

Institute for the Studies of Islamic Sciences
Kuala Lumpur, Malaysia
E-mail masud@tm.net.my
Telephone 603-89252392

Institute of Islamic Law and Economy
Moscow, Russia
E-mail bekkin@mail.ru
Web http://www.shariah.narod.ru
Telephone 7-095-1200719; 7-812-5542659

Institute of Islamic Studies
Delhi, India
E-mail ios@bol.net.in
Web http://www.iosminaret.org

International Centre for Education in Islamic Finance (INCEIF)
Second Floor, Annexe Block
Menara Tun Razak (Menara Tradewinds)
Jalan Raja Laut
Kuala Lumpur 50350, Malaysia
E-mail info@inceif.org
Web http://www.inceif.org/
Telephone +603 2781 4000

International Islamic University (Islamabad)
Faisal Mosque Campus
PO Box 1243
Islamabad, Pakistan
E-mail iiie@iiu.edu.pk
Web www.iiu.edu.pk
Telephone + (92) 051-9261761

International Islamic University (Kuala Lumpur)
Jalan Gombak 53100
Petaling Jaya PO Box 70,
Kuala Lumpur, Malaysia
E-mail info@iiu.edu.my
Web http://www.iiu.edu.my
Telephone + 60 3 755 5322

Islamic Economic Research Bureau
Dhaka, Bangladesh
E-mail ierb@bdcom.com
Telephone 9666601

Islamic Foundation
Markfield Conference Centre
Ratby Lane
LE67 9SY
Leicestershire
United Kingdom
E-mail i.foundation@islamic-foundation.org.uk
Web http://www.islamic-foundation.org.uk/

Islamic Institute of Toronto
1825 Markham Rd., Suite B101
Scarborough
Ontario
Toronto
Canada
E-mail iit@islam.ca
Web http://www.islam.ca
Telephone 416 335-9173

Islamic University of Indonesia
Gedung Rektorat
Jl Kaliurang KM 14,4 Besi Sleman
55584
Yogyakarta
Indonesia
E-mail rektorat@uii.ac.id
Web http://www.uii.ac.id
Telephone +62 274 898444

Kolej Dar al Hikmah
Kuala Lumpur
Malaysia
E-mail info@hikmah.edu.my
Telephone 603-89252392

LATIEF
57 Upper Montagu Street
WIH ISG
London
United Kingdom
E-mail info@latief.org
Web http://www.latief.org
Telephone +44 207 224 9912

London Open College
7 Bridges Place
London SW6 4HW, United Kingdom
E-mail info@londonoc.com
Web http://www.londonoc.com
Telephone +44(0)20 7471 8294 and +44(0)20 7471 8275

Loughborough University
Loughborough, Leicestershire
United Kingdom
E-mail J.R.Presley@Lboro.ac.uk
Web http://www.lboro.ac.uk/departments/ec/
Telephone +44 (0) 1509 222701

MKM&M Company
Bucharest, Romania
E-mail rose_gudrun@yahoo.com
Telephone 4092669992

Post Graduate Diplama in Islamic Economics and Banking
Al Jamia Al Islamia
Pattikkad Post
Santhapuram-679325
Perintalmanna, India
E-mail aljamia@rediffmail.com
Web www.aljamia.net
Telephone 914933270439

Shariah Economics and Banking Institute (SEBI)
Komplek Ciputat Indah Permai Blok C 25-26
Jl. Ir H. Juanda No. 50,
Ciputat, Indonesia
E-mail sgtpram@yahoo.com
Telephone + 62 21 741 6616

The Muslim College
20-22 Creffield Road
London W5 3RP, United Kingdom
E-mail registrar@muslimcollege.ac.uk
Web http://www.muslimcollege.ac.uk/
Telephone +44 (0)20 8992 6636

The Study Group of Islamic Economics - Diponegoro University - Indonesia
Kampus Tembalang
50239 Semarang, Indonesia
E-mail webmaster@undip.ac.id
Web http://www.undip.ac.id/
Telephone +62-24-7460038

Universiti Kebangsaan Malaysia
43600 Bangi, Malaysia
E-mail puspa@pkrisc.cc.ukm.my
Web www.ukm.my
Telephone (603) 89213370

University of Durham
Old Elvet
Durham DH1 3HP, United Kingdom
E-mail r.j.a.wilson@durham.ac.uk
Web http://www.durham.ac.uk
Telephone +44 191 334 2000

USC Islamic Server
Los Angeles, United States of America
Web http://www.usc.edu/dept/MSA/

BANKING

ABC International Bank plc
Arab Banking Corporation House
1-5 Moorgate
EC2R 6AB
London, United Kingdom
E-mail webmaster@arabbanking.com
Web www.arabbanking.com
Telephone + 44 20 7776 4000

ABC Islamic Bank E.C.
PO Box 2808
Manama, Bahrain
E-mail webmaster@arabbanking.com
Web www.arabbanking.com
Telephone + (973) 17 543000
Fax number + (973) 17 533163

Abu Dhabi Islamic Bank
Alnagdah Street
P.O. Box 313
Abu Dhabi, United Arab Emirates
E-mail khalid@adib.co.ae
Web http://www.adib.co.ae
Telephone + 971 2 6168314 / 6343000

Ahli United Bank (United Kingdom)
7 Baker Street
WIU 8EG
London, United Kingdom
E-mail info@ahliunited.com
Web www.ahliunited.com
Telephone + (44) 20 7487 6500

Al Amanah Islamic Banking Services
Saudi British Bank
P.O. Box 9084
11414
Riyadh, Saudi Arabia
E-mail alamanah@sabb.com
Telephone (966 1) 403 0087 ext. 5373

Al Baraka Islamic Bank
P.O.Box 1882
Manama, Bahrain
E-mail baraka@batelco.com.bh
Web www.barakaonline.com
Telephone (+973) 17535300

Al Baraka Islamic Bank b.s.c.(e.c.)
Karachi, Pakistan
E-mail shafqaat.ahmed@albaraka.com.pk
Web http://www.albaraka.com.pk
Telephone 0092-21-2636261 to 65

Al Baraka Islamic Investment Bank
PO Box 1882
Manama, Bahrain
E-mail baraka@batelco.com.bh
Web http://www.albaraka.com
Telephone + 973 250 363

Al Rajhi Commercial Foreign Exchange
Jeddah, Saudi Arabia
E-mail info@bankalrajhi.com
Web http://www.bankalrajhi.com
Telephone -6699296

Al Salam Bank
P.O. Box 18282
Manama, Bahrain
E-mail info@alsalambahrain.net
Web http://www.alsalambahrain.net
Telephone + 973 1 751 4404

Alhuda: Center for Islamic Banking and Finance
Suite # 9, 2nd floor, Gohar Centre
Wahdaat Road
Lahore, Pakistan
E-mail info@alhudacibe.com
Web www.alhudacibe.com
Telephone +92-42-5858990 - 8407850

Arab Banking Corporation (B.S.C)
ABC Tower
Diplomatic Area
PO Box 5698
Manama, Bahrain
E-mail webmaster@arabbanking.com
Web www.arabbanking.com
Telephone + (973) 17 543000

Arab Banking Corporation (Iran)
No. 114, 1st Floor (opposite 35th Street),
Khaled Eslamboli Avenue
15167
Tehran, Iran
E-mail arabbanking.teh@parsonline.net
Telephone (98) (21) 879 8452/3

Arab Islamic Bank
P.O Box: 631, AL-Bireh
Ramallah, Palestine
Web http://www.aibnk.com
Telephone 02-2407060

Arcapita Bank B.S.C. (c)
P.O. Box 1406
Manama, Bahrain
E-mail info@arcapita.com
Web http://www.arcapita.com/
Telephone + 973 17218333

Bahrain Islamic Bank
P.O.Box 5240,
Manama, Bahrain
E-mail help.desk@bahisl.com.bh
Web http://www.bahisl.com.bh/english/index.htm
Telephone +973 17535888

Bank Al Jazira (Jeddah)
Jeddah, 21442
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Web www.baj.com.sa
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Telephone + 62 21 526 7777

Bank Islam Malaysia Berhad
Darul Takaful
Jalan Sultan Ismail
50250
Kuala Lumpur, Malaysia
E-mail marketing@bankislam.com.my
Web http://www.bankislam.com.my
Telephone 03-2616 8000

Bank Jabar (Regional Development Bank)
Jalan Braga No. 12
Bandung, Indonesia
Telephone + 62 22 436 553

Bank Muamalat Malaysia Berhad
Menara Bumiputra, 21
Jalan Melaka
PO Box 10407 50913,
Kuala Lumpur
Malaysia
E-mail webmaster@muamalat.com.my
Web http://www.muamalat.com.my
Telephone (603) 2698 8787

Bank Negara Indonesia (Jakarta)
BNI Buliding 9th Floor
Jalan Jendral Sudirman Kavling 1
Jakarta 10220, Indonesia
E-mail bni@bni.co.id
Web http://www.bni.co.id/
Telephone + 62 21 251 1153 or 572 9004 or 572 8518

Barclays Capital
Canary Wharf
London, United Kingdom
E-mail corporate.communications@barclayscapital.com.
Web http://www.barcap.com/sites
Telephone +44 (0) 20 7623 2323

CIMBIslamic
10th Floor Bangunan CIMB
Jalan Semantan
Damansara Heights
50490 Kuala Lumpur Malaysia
Web http/www.cimb.com
Telephone 603 2084 8888

Citibank Islamic Investment Bank
Manama, Bahrain
E-mail info@citiislamic.com
Web http://www.citibank.com/ciib/homepage/index.htm
Telephone + 973 257 124

Dubai Islamic Bank
Dubai, United Arab Emirates
E-mail contactus@alislami.co.ae
Web www.alislami.co.ae
Telephone + 9714 2953000

Emirates Islamic Bank
2nd & 3rd Floor
Al Gurg Tower 1
Plot 372 - Riggat Al Buteen
P. O. Box 6564, Deira, Dubai, United Arab Emirates
E-mail info@emiratesislamicbank.ae
Web http://www.emiratesislamicbank.ae/eib
Telephone +9714 3160101

Faisal Islamic Bank (Sudan)
Ali Abdellatif Avenue
PO Box 10143
Khartoum, Sudan
E-mail info@faisalfinance.com
Telephone 249-11-781848

Faisal Islamic Bank of Bahrain
Chamber of Commerce Building
PO Box 3005, Manama, Bahrain
E-mail info@faisalfinance.com
Telephone + 973 227 040

Faisal Islamic Bank of Egypt
P.O.Box : 2446,
Cairo, Egypt
E-mail giza@faisalbank.com.eg
Web www.faisalbank.com.eg

First Pak Modaraba
Prudential House
Hasan Ali Street
Off I.I.Chudrigar Road
Karachi, Pakistan
E-mail iqbal_cisa@yahoo.com
Telephone 2628840, 2628833

GB Corp
Manama, Bahrain
E-mail zalshaker@gbcorponline.com
Telephone +973 17 540044

Gulf Finance House E.C.
Al Salam Tower (6,7,8,14 & 15Floor)
Diplomatic Area
P.O. Box 10006,
Manama, Bahrain
E-mail info@gfhouse.com
Web http://www.gfhouse.com
Telephone +973 17 538 538

Gulf International Bank, BSC
Al-Dowali Building
3 Palace Avenue
PO Box 17
Manama, Bahrain
E-mail info@gibbah.com
Web http://www.gibonline.com
Telephone + 973 534 000

Halal Financial Services Inc
HFS House
82-84 Niddrie Road
Glasgow, United Kingdom
E-mail enquiries@halalfinancialserv ices.com
Web www.HalalFinancialServices.com
Telephone 00 44 845 359 1 359

HSBC Amanah Finance
HSBC Bank plc
Level 17, 8 Canada Square
London E14 5HQ, United Kingdom
E-mail amanahfinanceuk@hsbcgro up.com
Web www.amanahfinance.hsbc.com
Telephone (44 800) 5877 786, (44 20) 7991 3722

HSBC Bank Malaysia Berhad
13th Floor Leboh Ampang
50100 Kuala Lumpur, Malaysia
E-mail islamic.banking@hsbc.com.my
Telephone (60 3) 230 0744

i-Management and Services
Klang, Selangor, Malaysia
E-mail myilmi@yahoo.com
Telephone 0060355227700

Investors Bank
Al Salam Tower, Building 722, Road 1708, Block 317
Diplomatic Area
P. O. Box 11818
Manama, Bahrain
E-mail investorsb@investorsb.com
Web http://www.investorsb.com
Telephone (973) 5333 14 - 533 777

Islamic Bank of Britain (Birmingham)
3 Duchess Place
Hagley Road
Birmingham B16 8NH, United Kingdom
E-mail info@islamic-bank.com
Web www.islamic-bank.com
Telephone + 44 (0)845 6060 786

Islamic Bank of Britain (London)
77-79 Edgware Road
London W2 2HZ, United Kingdom
E-mail info@islamic-bank.com
Web www.islamic-bank.com

Islamic Bank Brunei Berhad
Bangunan IBB, Lot 159
Jalan Pemancha
BS8711 Bandar Seri Begawan, Brunei Darussalam
E-mail ibb@brunet.bn
Web http://www.ibb.com.bn/
Telephone +673-2235687

Islamic banking, investment & takaful
The Hague, Netherlands
E-mail islamic-finance@hotmail.com
Web http://www.islamic-finance.startpagina.nl

Islamic Co-operative Development Bank
Khartoum, Sudan

Islamic International Bank for Investment and Development
4, Aly Ismail Street
Mesaha Square,
Dokki, Giza,
Cairo, Egypt
Telephone + 202 3489973

Islamic Mortgages
25 Eccleston Square
London SW1V 1NS, United Kingdom
E-mail enquiries@islamicmortgages.com
Web www.islamicmortgages.com
Telephone +44 20 7976 6966

Jordan Islamic Bank
Shmeisani 11 August Street
P.O. Box 926225
11190 Amman, Jordan
E-mail jib@islamicbank.com.jo
Web http://www.jordanislamicbank.com/
Telephone + 962-6 5677-377

Kausar Bank
Baku, Azerbaijan
E-mail bank@usal.baku.az
Telephone +99412 973034

Kuwait Finance House K.S.C.
Safat, Kuwait
E-mail info@kfh.com
Web http://www.kfh.com
Telephone + 965 244 5050

Meezan Bank Ltd.
3rd Floor, P.N.S.C. Building
Moulvi Tamizuddin Khan Road,
Karachi, Pakistan
E-mail khurram.hilal@meezanbank.com
Web http://www.meezanbank.com
Telephone 92-21-5610582 / 5610679

Muslim Commercial Bank Ltd
Karachi, Pakistan
E-mail infoislamic@mcb.com.pk
Web http://www.mcb.com.pk/
Telephone + 21 241 7831

National Bank of Sharjah
Al Boorj Avenue
Bank Street
P.O.Box 4, Sharjah, United Arab Emirates
E-mail joesal@nbs.co.ae
Web http://www.nbs.co.ae
Telephone (06) 5681000

Qatar International Islamic Bank
Doha, Qatar
Web http://www.qiib.com.qa/english/
Telephone + 974 436 776

Qatar Islamic Bank
Doha, Qatar
Web http://www.qib.com.qa/english/index.html
Telephone + 974 438 000

Shamil Bank of Bahrain E.C.
Manama, Bahrain
E-mail alshamil@shamilbank.net
Web http://www.shamilbank.net
Telephone +973 17585000

Sharjah Islamic Bank
P.O.Box 4
Al Boorj Avenue
Sharjah, United Arab Emirates
E-mail info@sib.ae
Web http://www.sib.ae
Telephone: +971 6 5680101

Tadamon Islamic Bank
Baladia Street
KJhartoum - Sudan
P. O. Box: 3154,
Khartoum, Sudan
E-mail tadamon2002@mail2arabia.com
Web http://www.tadamonbank-sd.com
Telephone (+249) 1 83771210, 1 83 771505

CONSULTANCY

Apptec Research
Berkenlaan 75
9741 JL
Groningen, Netherlands
E-mail abdul@islamicbanking.nl
Telephone +31-50-5775136

Centre For Research & Training (CERT)
289A Jalan Bandar 11
Metro Melawati
53100
Kuala Lumpur, Malaysia
E-mail ask@cert.com.my
Web www.cert.com.my
Telephone +603 4108 1439

Dar al-Istithmar
15 Austin Friars
London EC2N 2HE, United Kingdom
E-mail adnan.aziz@db.com
Web www.daralistithmar.com
Telephone +44 207 545 6737

Delphi Risk Management
3 Hyde Park Steps
Saint George's Fields
London W2 2YQ, United Kingdom
E-mail we@dc3.co.uk
Web http://dc3.co.uk
Telephone +44 20 7724 4606

ENAMEC
Office - **Europe**
Glockengasse 15
D-97070 Wrzburg, Germany
E-mail enamec@enamec.org
Web www.enamec.org
Telephone +49-931-2055940
Office - **Baku**
Aberon rayonu, Mehdiabad q?s?b?si,
Atatrk k., ev 51
0118 Baku, Azerbaijan
E-mail enamec@enamec.org
Web www.enamec.org
Telephone +49-450-4175370

Edraqi Knowledge Management Center
Kuala Lumpur, Malaysia
E-mail edraqi@myjaring.net
Telephone 603-4149 9199

First Hikmah
100A Mentari Suite J U16, Shah Alam
Selangor, Malaysia
E-mail ceo@1hikmah.com
Web www.1hikmah.com
Telephone +60126956998

ImtiyazCenter
Bp A 47, Oasis Nord
03000 Laghouat, Algeria
E-mail imtiyazcenter@maktoub.com
Web http://imtiyaz.1hh.com

International Global Consulting
41 Av. Kheireddine Pacha 1002
Tunis, Tunisia
E-mail global.consulting@planet.tn
Telephone +216 71 286 544

Islamic Banking and Finance Institute Malaysia Sdn. Bhd.
Kuala Lumpur, Malaysia
E-mail info@ibfim.com
Web www.ibfim.com
Telephone +603-20311010

Islamic Capital Partners (Pvt) Limited
Suite 223, The Forum
Block 9, Clifton
Karachi, Pakistan
E-mail namajid@capitalislami.com
Web www.islamiccapitalpartners.com
Telephone +92-21-5375965

LYNX Ventures Ltd
Paris, France
E-mail msharjeel@wanadoo.fr
Telephone 33 1 41 08 84 17

Master Management Consultants
108 Bank Saderat Iran Bldg.
Bank Street, Opp . UAE Exchange
Sharjaj, United Arab Emirates
E-mail mmc@eim.ae
Telephone 5684466

Sampark Technologies (P) Ltd
New Delhi, India
E-mail riazkhalid@hotmail.com
Telephone 919810147866

SHAPE Financial Corp
7600 Leesburg Pike
Suite 204 West, West Falls Church,
VA 22043, United States of America
E-mail info@shapefinancial.com
Web www.shapefinancial.com
Telephone 703-288-9050

Zest Advisory LLP
72 New Bond Street
London W1S 1RR, United Kingdom
E-mail info@zestadvisory.com
Web www.zestadvisory.com
Telephone + 44 (0)207 5180369

Zi Consultancy
Kuala Lumpur, Malaysia
E-mail zulkiflee@oicexchange.com
Telephone 603-90211021

INSURANCE

Dubai Islamic Insurance and Reinsurance Company (AMAN)
Gulf Tower
B1 Mezzanine Floor
P O Box: 157
Dubai, United Arab Emirates
E-mail aman@aman-diir.ae
Web http://www.aman.ae
Telephone +971 4 3193111

International Cooperative and Mutual Insurance Federation
Denzell House
Altrincham, PO Box 21
Cheshire WA14 4QE, United Kingdom
E-mail sabbir@icmif.org
Web www.icmif.org/takaful
Telephone + 44 161 929 5090

Islamic Arab Insurance Co. (IAIC)
P.O. Box 10214
Dubai, UAE

Islamic Insurance & Re-Insurance Co. (IIRCO)
P.O. Box 2948,
Manama, Bahrain
Telephone + 973 231402

Jordan Islamic Insurance Company
Jordan

Salama Islamic Arab Insurance Company
Al Makhawi Building, Suite 101
P.O.Box 10214
Dubai, United Arab Emirates
E-mail info@islamicarab.ae
Web http://www.islamicarab.ae/
Telephone + 971 4 3355300

Solidarity Takaful
Chamber of Commerce Building
3rd Floor, Seef Tower
Manama, Bahrain
E-mail mail@solidarity.cc
Web http://www.solidarity.cc
Telephone +973 17 578777

Takaful International Co. BSC
Building No. 6, Road 333
Gudaybia - 321
P.O.Box 3230,
Manama, Bahrain
Web http://www.takafulweb.com/
Telephone 17298298

Takaful USA
576 Valley Road, Ste 141, Wayne, NJ 07470
United States of America
E-mail info@takafulusa.com
Web http://www.takafulusa.com
Telephone + 1 (973) 942-5009

INVESTMENT

Ceylinco Profit Sharing Invesments Corporation Ltd.
Colombo, SriLanka
E-mail ceylincoprofit@yahoo.co.in
Telephone 0325290072

Crescent Capital Investments (Europe) Limited
53 Davies Street
London W1K 5JH, United Kingdom
E-mail info@crescentcapital.com
Telephone +44 20 7152 6421

Crescent Capital Investments, Inc.
75 Fourteenth Street, 24th Floor
Atlanta GA 30309, United States of America
E-mail info@crescentcapital.com
Web www.crescentcapital.com
Telephone +1 404 920 9000

Gidauniya Investment & Securities Limited
Kano, Nigeria
E-mail aminu_d2001@yahoo.com
Telephone +234 64 318561

Islamic Corporation for the Development of the Private Sector
P.O. Box 54069

Jeddah 21514, Saudi Arabia
E-mail icd@isdb.org.sa
Web http://www.icd-idb.org
Telephone + (966 - 2) 644 - 1644

Knightsbridge Credit and Banking Trust (Switzerland)
Level 41 Emirates Towers
Sheikh Zayed Road,
Dubai
United Arab Emirates
E-mail info@knightsbridgecredit.com
Web www.knightsbridgecredit.com
Telephone 97143197456

First Finance
C Ring Road
Opposite Labor Department
P.O.Box : 7258
Doha
Qatar
E-mail info@ffcqatar.com
Web http://www.ffc.com.qa
Telephone (+974) 4559999

Ningxia Islamic International Trust & Investment Corporation (NITIC)
Ningxia, People's Republic of China
E-mail nitic@public.yc.nx.cn
Telephone 951 6041873

Oasis Group
PO Box 1217
Cape Town 8000, South Africa
E-mail info@oasiscrescent.com
Web http://www.oasiscrescent.com/
Telephone +27 21 413 7860

Parsoli (Gujarat)
B 6-8, 4th Floor, Shalimar Complex
Mahalaxmi Five Roads, Paldi,
Ahmedabad -380007
Gujarat, India
E-mail corporation@parsoli.com
Web http://www.parsoli.com
Telephone + 91-79-26637144, 26631231,

Saturna Capital Corporation
1300, N. State Street
Bellingham,
WA 98227, P.O. Box N
United States of America
E-mail webmaster@saturna.com
Web www.amanafunds.com
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LAW

Al-Tamimi & Co.
Dubai World Trade Center
Sheikh Zayed Road
P.O. Box 9275
Dubai, United Arab Emirates
E-mail husam@tamimi.com
Web http://tamimi.com
Telephone 97143317090

Clifford Chance
10 Upper Bank Street, Canary Wharf
London E14 5JJ, United Kingdom
E-mail info@cliffordchance.com
Web www.cliffordchance.com
Telephone +44 (0)20 7006 1000

Dan-Fodio Law Group
900 N Hairston Rd Ste A-1
Stone Mountain
GA 30083-2857
Georgia
United States of America
E-mail MDanFodio@aol.com
Telephone (404) 292-6872

Denton Wilde Sapte LLP
One Fleet Place
EC4M 7WS
London
United Kingdom
E-mail info@dentonwildesapte.com
Web www.dentonwildesapte.com
Telephone +44 (0)20 7242 1212

HBJ Gateley Wareing LLP
Exchange Tower
19 Canning Street
Edinburgh, United Kingdom
E-mail islamic.finance@hbj-gw.com
Web www.hbjgateleywareing.com
Telephone 0131 228 2400

King & Spalding (New York)
King & Spalding LLP
1185 Avenue of the Americas
NY 10036
New York, United States of America
E-mail kingspalding@kslaw.com
Web www.kslaw.com/
Telephone 212.556.2100

Lovells
Atlantic House, 50 Holborn Viaduct
London, United Kingdom
E-mail islamic.finance@lovells.com
Web www.lovells.com
Telephone 020 7296 2000

Murtha Cullina LLP
Cityplace One
185 Asylum Avenue
Hartford, CT, United States of America
E-mail info@murthalaw.com
Web www.murthalaw.com
Telephone 860 240 6000

Norton Rose
Kempson House
Camomile Street,
London EC3A 7AN, United Kingdom
E-mail info@nortonrose.com
Web www.nortonrose.com
Telephone +44 (0)20 7283 6000

SS&R Legal Consultants
Ariobimo Sentral, 4th Floor
Jl. HR Rasuna Said Kav X-2 No. 5
12950 Jakarta Indonesia
E-mail srlegal@cbn.net.id
Web http://www.srlegals.com
Telephone 62-21-5264715

Taylor Wessing
Carmelite
50 Victoria Embankment, Blackfriars
London EC4Y 0DX
United Kingdom
E-mail london@taylorwessing.com
Web http://www.taylorwessing.com
Telephone +44 (0)20 7300 7000

Trowers and Hamlins
Sceptre Court
40 Tower Hill,
London EC3N 4DX, United Kingdom
E-mail info@trowers.com
Web www.trowers.com
Telephone + 44 20 7423 8000

MEDIA

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Kuwait
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Web www.amss.net/AJISS
Telephone + 1 703 471 1133

Arab Banker
London, United Kingdom
E-mail info@eapgroup.com
Telephone +44 208 392 1122

Asian Insurance Review
Ins Communications Pte Ltd
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Web http://www.newhorizon-islamicbanking.com/
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Manama, Bahrain
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Manama, Bahrain
E-mail gcibfi@batelco.com.bh
Web www.islamicfi.com
Telephone + 973 22 99 81

IFIS - Islamic Finance Information Service
London, United Kingdom
E-mail ifis@securities.com
Web www.securities.com/ifis
Telephone +44 (0) 20 7779 8100

International Islamic Financial Market
P.O. Box 11454, Bahrain Tower
Office No. 171, 17th Floor
Bldg No. 20, Al Khalifa Avenue
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Bahrain
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The Hague, Netherlands
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Web islamic-finance.startpagina.nl
Fax number +31847278284

Islamic Financial Services Board
P.O. Box 10591,
50714 Kuala Lumpur, Malaysia.
Email ifsb_sec@ifsb.org
Web http://www.ifsb.org/contact
Telephone 603 – 26984248

Liquidity Management Centre
Bahrain

Path Solutions
PO Box 592
Safat 13006, Kuwait
E-mail info@path-solutions.com
Web http://www.path-solutions.com
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Telephone +62-31 504 9633
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Al-Zamil Tower, 7th Floor,
Government Avenue

Manama 305, Bahrain
E-mail iira@iirating.com
Web www.iirating.com
Telephone +973 17211606

RESEARCH

Institut Kefahaman Islam Malaysia
Lot 26647
Jalan Langguk Tunku
Off Jalan Duta, 50480,
Kuala Lumpur, Malaysia
E-mail info@ikim.gov.my
Web http://www.ikim.gov.my/
Telephone + 603-62046200

Institute of Islamic Banking & Insurance
16 Grosvenor Crescent
London SW1X 7EP, United Kingdom
E-mail iibi@islamic-banking.com
Web http://www.islamic-banking.com
Telephone 020 72450404

Islamic Research and Training Institute
P.O.Box 9201
21432 Jeddah, Saudi Arabia
E-mail irti@isdb.org
Web http://www.irti.org
Telephone +(966)(2)636 1400

PUBLIC AND GOVERNMENT ORGANIZATIONS

Islamic Chamber of Commerce
United States of America
E-mail info@islamic-commerce.org
Web http://www.islamic-commerce.org

Islamic Development Bank
P.O. Box 5925
Jeddah 21432, Saudi Arabia
E-mail idbarchives@isdb.org
Web http://www.isdb.org/
Telephone + 966 2 636 1400

Islamic Development Bank of Brunei Berhad
Ground to 4th floor, Kompleks
Bandar Seri Begawan BS8675
Setia Kenangan, Kg. Kiulap, P.O.Box 3080
Gadong, Brunei Darussalam
Web http://www.idbb-bank.com/

Islamic Financial Services Board (IFSB)
3rd Floor, Block A
Bank Negara Malaysia Building
Jalan Dato Onn, 50480
Kuala Lumpur, Malaysia
E-mail Ifsb_sec@ifsb.org
Web www.ifsb.org
Telephone + 603 26984248

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