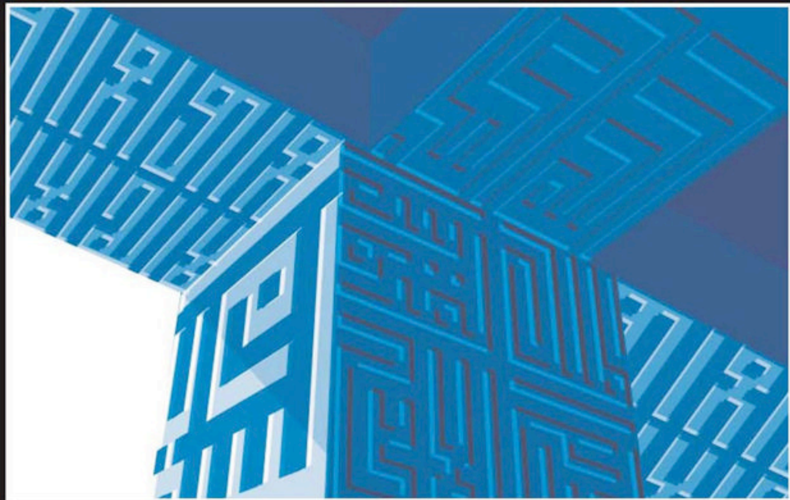
Euromoney Encyclopedia of Islamic Finance



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Aly Khorshid

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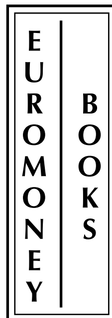
Euromoney Encyclopedia of Islamic Finance

Edited by
Aly Khorshid



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Foreword

In the last five years the world has witnessed a rising interest in Islamic finance. The Islamic fund industry, specifically in Asia, is undergoing significant growth. Most of it has been demonstrated strongly in Muslim countries such as Malaysia and in the Gulf region, but the principles are spreading into non-Muslim countries too.

Historically speaking, there have always been similar funds and investments that have kept within the rules of other religions such as Judaism and Christianity. Investments driven by religious values are considered 'ethical investments', and it can be argued that Islamic investment fits this category and has many aspects in common with secular ethical finance. Islamic investment as we know it today was driven in the 1960s and 1970s by consumer demand; nowadays it has expanded to organizations and institutions.

Surplus wealth derived from oil sales, especially in the Gulf region, meant there had to be ways to reinvest, which in turn led to this growing need in Islamic countries to focus on Islamic finance. Saudi Arabia and the United Arab Emirates have provided good examples of how to establish such markets. Once the infrastructure and regulations were set in place, the ambition to attract money from other international markets grew; and now the goal is to maintain and sustain interest in investment from within the originating countries.

The Malaysian government, under the Islamic Financial Centre, has led the way by presenting certain incentives to make Kuala Lumpur into a centre for Islamic finance. Malaysia currently represents the main source of Islamic bonds, *sukuk*, insurance and *takaful*, and is considered the second largest market after Saudi Arabia. Markets such as the United Arab Emirates and Bahrain are rapidly rising in stature. We have even witnessed interest in this particular sector in non-Muslim countries, such as Hong Kong, Singapore and Japan.

In recent years, technology, resources, infrastructure and indices have become vital transformation tools, driving further growth. While there is still the belief that rudimentary rules and restrictions may interfere with this market's growth, a large number of listed stocks are *Shari'a*-compliant and an integral part of Islamic finance.

Nonetheless, no one in the industry would deny that important challenges remain. Introducing instruments and tools was not straightforward, and methods of regulation need to be consistent with conventional financial instruments. This looks like increasing the demand for transparency, governance and regulation, which are critical in Islamic finance, and the industry should not be outside the boundaries of normal regulation.

Another reason to establish such markets was to avoid market volatility, especially in the Western market. The September 11 attacks in 2001 also put pressure on Muslim investments abroad, especially in the US, which drove investment back home to Muslim countries. Once these markets proved their successful performance and confidence, more interest from the West returned to these markets. As these markets grow, more interdependence develops,

leading to greater complexity. Market authorities need to pay attention to the impact of market volatilities to which Islamic markets are not immune, just like conventional markets.

Other current challenges for market growth stem from access to specialists: training and education are essential, and addressing this issue is one of the most pressing problems at present. The *Encyclopedia of Islamic Finance* is a collection of scholarly work and knowledge from this vibrant sector. Its purpose is to bring understanding and awareness of the importance of this fast-growing industry. The book demonstrates in easy and simple language the essentials of Islamic finance from the theoretical and ethical viewpoint of Islam to up-to-date capital market products, derivatives, securitization, *sukuk* and the development of secondary *sukuk* markets. All fundamentals of Islamic finance; *Shari'a* scholars' responsibilities and roles; tax issues; offshore companies; legal issues; indices; corporate governance; *takaful* and re-*takaful*; and womens' role in Islamic finance are dealt with in these pages.

The material included in this book was built upon depth of research and is intended to provide a valuable reference work for scholars, academics and specialists working in the field.

Lubna bint Khalid Al Qasimi
Minister of Foreign Trade to the United Arab Emirates
Former Chairperson of UAE Securities and Commodities Authority
October 2008

Preface

This *Euromoney Encyclopedia of Islamic Finance* is a collection of chapters from a number of diverse sources within the finance industry, governmental financial departments and academia. It aims to bring up-to-date, the debates surrounding Islamic finance, by tapping into the breadth of knowledge and expertise that is creating a hugely successful industry. Some of the chapters have already been published in other publications or online; some started their lives as academic papers, and a number were commissioned especially for this book. The authors themselves are of many nationalities, but the majority are from, or currently reside in, the Middle East, Malaysia, Pakistan, Europe or the USA. Each has been chosen for his or her expertise in a particular aspect of Islamic finance with the ultimate aim of producing a rounded, comprehensive encyclopedia on this vibrant and growing sector of the finance industry.

Readership

Islamic finance is continuing to draw attention and respect from at least two important groups.

First are the world's Muslims themselves. Saving and investing in Western-style banks has been out of the question for pious Muslims, although many were forced to use secular institutions as there was no alternative. For example, high street bank accounts would have been opened when an employer only paid wages electronically. Loans caused further problems because of interest, and links with pork, alcohol, pornography, weapons and other forbidden industries, placed immovable obstacles in the path of would-be investors who held their Islamic faith dear. The Islamic banking and finance industry, whose every instrument has been scrutinized, analyzed and often reconstructed by respected scholars, jurists and government-appointed bodies, gives investors the reassurance that every possible step has been taken to ensure *Shari'a* compliancy. Does *every* Muslim agree with the reliability of *every* instrument? Of course not. Controversy surrounds many of them, but rather than causing a defeatist attitude, it has forced the creators and proponents to argue their case more deeply. The industry as we know it today is in its infancy compared with secular banking; hopefully the arguments will soon be won and lost and anyone belonging to a particular branch of Islam will be able to invest in instruments with a completely clear conscience. This collection of works will hopefully play its part.

The second interested group has encompassed those within the conventional finance industry. To those versed in the orthodoxy of the free market, a system of finance that places *limitations* on business can at first glance inspire bewilderment. But there is something in Islamic finance that inherently creates stability and long-termism, and therefore opportunity. At the time of compiling this encyclopedia in 2008, the world's financial

institutions have been in turmoil, with several notable banks requiring help from central reserves, either being bought out or simply collapsing. Analysis of the causes is still ongoing, but most observers point the finger at rampant and often reckless speculative dealings and the provision of easy credit, particularly to individuals unable to service their debts. With the house of cards collapsing around us, governments and a somewhat reluctant finance industry are looking for solutions. They could do a lot worse than looking in the direction of Islamic finance; and indeed many of them already are. It has been convincingly argued that the so-called 'credit crunch' simply could not have happened if an Islamic attitude to responsible lending were followed. Without the inability to deal with pork, alcohol, et cetera, the two models would be cousins working in parallel; but the basis of Islamic finance and the natural aversion to excess might turn out to be a lifeline for western banking.

It is for these two groups detailed above, and indeed anyone interested in Islam, that this encyclopedia might be of interest.

A note on standardization and transliteration

When collecting together chapters from a number of diverse sources, one of the editor's first decisions is how to standardise spelling, annotation and transliterations.

As far as spelling English words is concerned, it was decided early on to minimise the editing by limiting it to standardizing spellings using the 'Mid-Atlantic' orthography, a mixture of British English (for example, *colour*, *centre* not *color*, *center*) and using -ize spellings instead of –ise, as is usual in academic works. Footnotes were changed to notes at each chapter's end. Figures and tables referred to as 'above' or 'below' were changed to numbered exhibits to allow for typographical differences between manuscript and printed page. Other than these minor changes and general editing, the chapters are exactly as their originals.

This also means that transliterations of Arabic words remain faithful to their authors' tastes and traditions. This does actually lead to a good deal of diversity, but the editor felt that demonstrating this diversity of spellings is beneficial to those studying the subject; in addition it was never the editors' intention to impose one system of presenting Arabic onto this English work's readers.

Some authors take a very European approach to transliterating Arabic, ignoring all diacritical marks; others do the same but insist on italicizing the words. Another group tries to faithfully reproduce the exact vocalization using the Roman alphabet, and within this group there is a degree of variation between spellings. Readers soon become accustomed to these various spellings, and it does reflect the usage in the outside world. In this work, hamzas are represented as apostrophes unless text in Arabic is presented.

Taking one example – *Shari'a* – it can be seen that spellings vary, but it is always obvious what the word is; this is typical of Arabic transliteration. A selection is: *Sharia*, *Shariah*, *Shari'a*, *Shari'ah*, *Syariah*, *Syaria*, *Syari'ah*, and this list is by no means exhaustive. Some writers do not capitalize the S, although as a proper noun it should start with a capital in written English. Retaining phonetic integrity between different languages and alphabets is probably impossible without writing entire books in the International Phonetic Alphabet (IPA), but no doubt there would still be conflicts caused by regional pronunciations.

About the editor

Aly Khorshid

Aly Khorshid has been involved with financial institutions for over two decades, and possesses comprehensive skills and knowledge on Islamic finance. He is a recognized expert on *Shari'a*-compliant finance within Islamic law, Islamic *moamlat* and Islamic contracts. He is partner and CEO of Islamic Finance with Elite Horizon economic consultancy, and has responsibilities for structuring, endorsing and advising on *Shari'a*-complaint products. He has particular experience in capital and stock market products. He served as consultant to the Central Bank on establishing an Islamic banking system within the Central Bank's regulatory policies and corporate governance. He is actively involved in structuring the Islamic home purchase scheme and Islamic capital market products. He is experienced in conducting comprehensive due-diligences on financial institutions to identify potential investment opportunities. He started his career with international marketing and trade: his first *Shari'a* board membership was with Bank Al-Baraka (the first Islamic bank in the UK). His roles include dealing with the UK Treasury and Bank of England departments in relation to the regulation of Islamic banking issues. He is now serving as a *Shari'a* board member in several Islamic institutions. He holds a PhD in Islamic studies and economics from the University of Leeds (UK), and studied *Fiqh* and *Shari'a* at Al-Azhar University (Egypt). He also holds a Masters degree in management (UK). His publications include *Islamic Insurance: A Modern Approach to Islamic Banking*, and the *Encyclopedia of Islamic Finance*. He has also had many articles published on Islamic finance. He is a trustee member of Academy UK; a member of the Institute of Management Consultancy (UK); and a visiting lecturer at El-Azhar University (Egypt), the School of Oriental and African Studies (SOAS), and the University of London in Islamic finance. He is a regular speaker on Islamic finance issues at conferences and on television.

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Failaka was established in 1996 and published its first report in 1997. Shortly after, the firm debuted its annual *Failaka Islamic Fund Awards*. While continuing to build Failaka, Al-Rifai became a partner in the London office of The International Investor, a Kuwait-based investment bank, where he was responsible for building distribution relationships with financial institutions in Europe and the Middle East. Al-Rifai went on to become Vice President of Islamic Banking at HSBC Bank in New York, where he was responsible for

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Al-Rifai earned his BS in International Finance at St Cloud State University in Minnesota, and earned his MBA in International Management at DePaul University in Chicago.

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Within PwC, Amin is also an elected member of PwC's Supervisory Board and serves on the firm's audit committee. Externally, Amin is a Council Member of the Chartered Institute of Taxation (CIOT); he serves on the Policy & Technical Committee of the Association of Corporate Treasurers (ACT); chairs the Business and Economics Committee of the Muslim Council of Britain. He is a member of the Editorial Advisory Board of *New Horizon*, the magazine of the Institute of Islamic Banking and Insurance, and is Vice-Chairman of the Conservative Muslim Forum.

Amin graduated in mathematics from Clare College, Cambridge, UK. He is a Fellow of the Institute of Chartered Accountants in England & Wales, an Associate Member of the ACT, and a Fellow of the CIOT.

Amin was recently included in the judging panel for the Muslim Power 100, a list of the hundred most influential Muslims in the UK, as well as being included in the list itself. Many of his articles and presentations can be found on his blog http://pwc.blogs.com/mohammed_amin/islamicfinance.

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Hari's commercial training began at Goldman Sachs in London where she was responsible for implementing and monitoring FSA systems and controls on behalf of the bank. After Goldman Sachs, Hari joined a boutique compliance consultancy in London as a Senior Consultant before moving to Dubai.

Hari has also been instrumental in seeking to remove barriers to cross-border marketing of Islamic products under the Mutual Recognition Arrangement signed by the SC and DFSA.

She was also appointed as the sole advisor by Financial Services Volunteer Corps US (FSVC) to advise the Central banking agency of a secular Islamic jurisdiction on the introduction of Islamic Financial products. In 2007, Hari left the DFSA and together with two strategic partners, established Praesidium LLP, a regulatory and client advisory firm.

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To date, she has undertaken research in Islamic finance with a principle focus on debt capital markets and *sukuks*. She has written and published numerous articles on Developing

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Andrew Henderson

Dr Andrew Henderson is counsel in the corporate department of the Dubai office of Clifford Chance LLP. He leads the financial services regulation group and advises on the United Arab Emirates, Dubai International Financial Centre and UK financial services and markets law and regulation; aspects of Bahrain, the Qatar Financial Centre and Saudi Arabia financial services and markets regulation as well as on local and international law aspects of derivatives and other financial products. Andrew has a particular interest in Islamic finance regulation, having advised firms who wish to carry out Islamic finance business. He also advises regulatory bodies on rules and policy for the regulation of *Shari'a*-compliant securities and investments. He holds a PhD in law from Cambridge University.

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From June 1998 until June 1999 he was Senior Vice President within the International Mutual Funds Group of Scudder, Stevens and Clark Ltd, based in London and responsible for their international product development in Europe and Japan.

From January 1989 until May 1998, Mr Jaffer was Vice President with Citibank London. He was with the Financial Institutions Group until 1996 and later joined Citibank's Alternative Investment Strategies (AIS) Group. He was a Director and his responsibilities included international business development and asset-gathering from institutional investors in Europe and the Middle East region. He was also a member of Citi's Hedge Funds Policy and Strategy Committee.

Mr Jaffer was an audit partner with the Price Waterhouse practice in Africa from July 1984 until September 1988. Mr Jaffer is a UK qualified certified accountant (FCCA). He is currently a Regional Advisory Council Member (EMEA) of the Alternative Investment Management Association (AIMA), was a Council member of AIMA for the period 2001 to September 2008 and past Chairman for the period 1997 to 2000. He has written extensively on alternative investments and has edited several Euromoney publications on hedge funds, multi-manager strategies, four Islamic books on retail banking, asset management, insurance (*takaful*), wealth management and a recent CPI publication on investing in the GCC markets. He is also a member of ALFI's Asset Management Advisory Committee, Middle East working group and their Hedge Fund Committee. ALFI is the Association of the Luxembourg Funds Industry. He is also a member of MIFC's Strategic Focus Group (SFG). MIFC is the 'Malaysia International Islamic Finance Center'.

Tahir Jawed

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Introduction

Rodney Wilson
Durham University

Producing a subject encyclopedia is always an ambitious task. A decade ago there was, arguably, insufficient breadth to Islamic finance to justify a specialist encyclopedia; as such a work might have been a rather slim volume. This work is therefore timely as there have been so many developments in Islamic finance that virtually all areas of banking, insurance, asset management and capital markets fall within the remit of the subject.

Work in this area is interdisciplinary, as it requires finance specialists, economists, commercial lawyers and Islamic scholars. Islamic finance brings together those with theological and historical interests and others focused on more worldly and immediate concerns involving money, profits and enterprise. The results have been remarkable, as it has not only resulted in the provision of *Shari'a*-compliant and *Shari'a*-based solutions for those wanting to manage their finance in accordance with their religious beliefs, but it has also contributed to the wider debate on the morality of much current financial practice.

Shari'a-compliant or *Shari'a*-based?

In an encyclopedia, it is usual to define basic concepts first; in this case the difference between financial transactions which are *Shari'a*-compliant and those which are *shari'a*-based. *Shari'a* itself refers to Islamic law which is derived from the teaching in the Holy *Qur'an* and the *Hadith*; the words and deeds of the Prophet, as recorded in the *Sunnah*. This has been constantly re-interpreted over the ages with respect to each field of human activity, including banking and finance. This process of re-interpretation or application is known as *ijtihad*; the effort of an Islamic scholar qualified in *fiqh*, Islamic jurisprudence, to give an opinion on what is permissible, *halal*, and what is not, *haram*, in the light of religious teaching. To provide such an opinion or *fatwa* on the legitimacy of financial transactions, requires some understanding of contemporary financial practices as well as knowledge of *fiqh*.

Shari'a is universal and applies at all times in all states, both to those that are predominately Muslim and to those where Muslims are in a minority. States are also governed by national laws which are jurisdiction-specific. Islamic financial contracts must comply with *Sharia'h*, but must also be enforceable under national laws. Therefore, Islamic finance contracts are usually drafted by the commercial law firms which serve the financial institutions, the role of the *Shari'a* scholars being to read the draft contracts and to suggest what revisions are needed to ensure the contracts comply with *Shari'a*.

Financial contracts are usually drafted under common law rather than civil law, as under the former, the signatories to the contract are bound by the terms and conditions specified. Under civil law, the validity of a contract can be more easily challenged by one of the signatories in a secular court, but this implies the judgement of the *Shari'a* scholars is being questioned. This is less likely under common law, where secular courts can withhold *Shari'a* principles, as long as these are reflected in the contract. Malaysia and the Indian subcontinent are governed under English common law, but in most Arab states and Indonesia civil law applies, apart from those designated financial centres such as the Dubai International Financial Centre or the Qatar Financial Centre, who have their own governing laws and regulations and are exempt from the national civil laws of the countries in which they are located. Both use common law and have become significant centres for Islamic financial activity.

If a contract is *Shari'a*-compliant or *Shari'a*-based, this implies different starting points from a legal perspective. *Shari'a* compliance is the most straightforward from a contemporary common law perspective, as it involves taking a conventional financial contract such as a mortgage, and changing the terms and conditions so that there is no reference to *riba* or interest and that there is no element of ambiguity or contractual uncertainty (*gharar*) that one of the parties could potentially exploit. Often the changes are relatively minor and the contract continues to serve the same function as it did before the revisions and amendments were undertaken. In support of this approach, it is argued that the financial needs of Muslims are no different from those of non-Muslims, the challenge for the scholars being to provide input into the contract specification that ensures they are *halal*. The legitimacy and validity of such contracts ultimately depends on the reputation and credibility of the scholars themselves, which is why they should be named in brochures and web-based material issued by the financial institutions, with details given of their qualifications and experience.

The alternative *Shari'a*-based approach implies starting from contracts developed by *fiqh* scholars over many centuries such as *mudarabah* or *musharakah* partnership contracts involving profit and loss sharing. There is no conventional financial equivalent of these contracts, although they may be drafted to comply with common law and be enforceable by national courts. All scholars agree that it is preferable to have *Shari'a*-compliant contracts to those that are non-compliant, but most would prefer to see *Shari'a*-based contracts, not least as they accord most closely to Islamic financial principles, which stress justice in commercial transactions and the rightful earning of rewards. Wages and salaries, for example, are seen as a legitimate return for work but rewards for inactivity are unjustified, apart from for those that cannot work and are in need.

Economic justice in Islamic finance

Islamic finance should not simply be viewed as being concerned with prohibitions but rather as a positive approach to ensure the parties to financial transactions are involved in a morally worthwhile endeavour. Financial systems should be designed to serve a wider social good, and not simply individual greed, all too often pursued at the expense of others. All rewards have to be justified in Islamic finance, with wages and salaries related to work and effort,

as already indicated, and rental income to landlords justified through their responsibilities for the properties leased. Financing leases are prohibited in *Shari'a* as the owner tries to pass on all responsibilities to the tenant, whereas to justify a rental income from a building, the owner must assume responsibilities for the external maintenance of the building as with an *ijara* operating lease.

Profit is also seen as a justifiable reward in Islamic finance, which rather than being related to work or ownership, is compensation for risk sharing. In business and finance there are always risks including credit, market and operational risk, but if risks are shared between the parties, this is more just than simply assigning all the risk to a single party. With conventional lending the borrower assumes all the risk, and is penalized further for payment delays or defaults. In contrast, in Islamic finance, the risks are shared between the bank and the client. Of course Islamic banks have to manage credit risk, and unscrupulous defaulters should not be treated leniently, otherwise moral hazard problems might arise.

Misselling of financing products is clearly immoral, as with the sub-prime mortgages in America and to a lesser extent in Britain, where borrowers were encouraged to take on debts they could not afford by mortgage brokers and bank sales teams, who earned up-front fees for each mortgage sold. When the inevitable defaults occurred this was of no concern to the mortgage brokers and sales teams who had moved on to other activities. Islamic banks have to adopt fair and transparent charging structures which do not exploit the ignorance of the client. Their staff must ensure, as far as possible, that clients can meet their financial obligations. So far, the record of Islamic home financing has been favourable, with none of the defaults that have characterized the sub-prime crisis.

Islamic finance is inherently participatory, with the financier getting involved with the client and taking an interest in how the funding is utilized. This is not only to ensure the financing is serving a moral purpose, although that is important, but also to help the client manage the funds received effectively. The financier can act as an agent for the client, as with *murabahah* where the financier purchases a good on behalf of the client and re-sells it to the client for a mark-up which makes the transaction profitable. What justifies the mark-up is the ownership responsibilities exercised by the bank, which serves as a trader rather than simply a financier. If the good is defective, the bank has a responsibility to remedy this, which is why it needs to check on the validity and transferability of warranties, thus taking a burden from the client.

Islamic and conventional banking: similar services but different financing methods

Critics of Islamic banks suggest that their remit should be different to conventional banks, with a focus on serving the poor and needy, rather than promoting the development of capitalism. The early experiments with Islamic finance in the 1960s in Pakistan and Egypt involved the establishment of credit unions in poor rural areas, enabling members to obtain interest free finance from the contributors' funds. The clients were similar to those of the Grameen Bank in Bangladesh, a microfinance institution which serves a poor rural constituency, but is not *Shari'a*-compliant as its lending involves interest.

The take-off for Islamic banking coincided with the oil boom of the 1970s in the Gulf, with institutions such as the Dubai Islamic Bank being established in 1975 and the Kuwait Finance House opening for business in 1977. These were oil-rich states, not poor developing countries, the initial clients of the new Islamic banks being wealthy merchant families wanting to finance their growing import and distribution businesses. *Murabahah* was the ideal tool for this, as not only was it *Shari'a*-compliant but also, as the bank acted as initial purchaser, no letter of credit was required to guarantee payment by the client. This resulted in significant cost savings for the client. Furthermore as the bank could bulk purchase on behalf of several clients it could often obtain discounts which could be shared with the client.

By the late 1980s, Islamic banks were seeking to diversify their asset portfolios and identify more profitable financing methods, as there was increasing competition in *murabahah* and mark-ups were being squeezed. *Ijara* leasing contracts were promoted, as these lengthened the period to asset maturity, reducing asset turnover and the resultant arrangement costs. Whereas *murabahah* financing was typically for periods of three to eighteen months, *ijara* contracts were for three to five years. Of course with *ijara* financing, liquidity was reduced and risks increased with the longer period to maturity, but this could be built into the rental, to provide an attractive risk and return profile for this category of asset.

Financial engineering involving *Shari'a*-based products

The 1990s witnessed further product development involving both short-term receivables financing using *salaam* and longer-term project finance with *istisna*. *Salaam* involves making a pre-payment for a good to be delivered in the future, usually after ninety days. As an up-front payment is made, the price paid will usually be at a discount to the anticipated spot price on delivery. The effect is similar to a forward transaction where the price is guaranteed. *Salaam* contracts cannot be traded, as such activity would be speculative; rather it can be regarded as a hedging instrument. To increase liquidity, however, a bank can enter a parallel or reverse *salaam* contract, under which the commodity or good will be delivered to a third party after, for example, sixty days. As the period is shorter to delivery, the third party will pay a higher price for the contract, the difference between this and the initial purchase price representing the bank's margin or profit.

Istisna finance can be for periods of five years or more with this traditional method of financing manufacturing being adapted to cover projects. Often an investment bank is involved as it covers payments by the project management company for supplies and wage costs. Once the project is completed, it is handed over to the operating company which pays the project management company. This revenue can then be used to repay the investment bank. Rather than having an illiquid asset for a five-year period or longer, the investment bank may enter a parallel *istisna* agreement to sell the right to the repayment to one or more Islamic banks or investment companies. This creates smaller tranches suitable for investors who want to place millions of dollars rather than billions. Rather than having a single large investment in a potentially high risk project, where there could be cost over-

runs or delays in construction, the Islamic banks and investment companies may prefer to have a diversified portfolio of *istisna* assets to spread risk.

The preponderance of Islamic retail banking

Most Islamic banking is retail rather than involving investment banking, with employees having their salaries paid into current accounts where the funds are restricted to financing *Shari'a*-compliant activities conducted without *riba*. Those with savings are encouraged by Islamic banks to open unrestricted investment *mudarabah* accounts which enables them to share in the bank's profits or restricted *mudarabah* accounts where the deposits are used for a specific project and the depositor shares in the profits from the project. The latter usually produces a higher return, but the risks from concentration are greater. Many Islamic banks have been promoting these accounts, which have proved popular with clients worldwide.

Retail banking products include car and housing finance, with the former usually involving *murabahah* or *ijara* and the latter *ijara wa iqtina*, a hire purchase contract, or diminishing *musharakah*. With diminishing *musharakah,* the client and an Islamic bank form a partnership, with the client providing ten per cent or more of the capital and the Islamic bank ninety per cent or less. This initial funding is used to purchase a property. Each year the client buys out part of the bank's share in the partnership, creating a repayments stream, with the client's share in the partnership gradually increasing. The client also pays rent for the share the bank owns. If each repayment instalment was equal, this would front-load the payments obligations of the client, as they have to make larger rental payments at the start to reflect the bank's higher ownership share. In order to avoid this scenario, the repayments are usually structured exponentially with lower repayments initially but higher repayments later. This may suit younger home buyers whose income will increase with career progression. It is worth noting that the property is not re-valued during the life of the financing. The client enjoys all the capital gain on the property if the market is rising. The bank only has its initial funding repaid, its gain accruing from the rent. Arrangement and management costs are covered by set up charges and the administrative fees. In other forms of *musharakah,* all parties share in any capital gains or losses, but this is not acceptable to most property buyers who anticipate long-term asset appreciation.

Shari'a-compliant capital market products

The major development in Islamic finance in the last decade has involved the issuance of *sukuk* Islamic securities and a methodology for ensuring that equity investment can be *Shari'a*-compliant.

Sukuk are based on Islamic financing structures such as *salaam*, *murabahah*, *ijara*, *mudarabah* and *musharakah* which are securitized so that apart from *salaam sukuk*, they can be traded in a market. All *sukuk* must be asset backed to be *Shari'a*-compliant and hence buyers and sellers are not merely trading financial instruments, but a title to a real asset such as piece of real estate, buildings or equipment. *Salaam sukuk* are similar to treasury bills but provide a mark-up for the investor rather than interest. Unlike treasury

bills, they cannot be traded as indicated above, as the asset is only delivered in ninety days when the *sukuk* matures and is not in possession of the investors. *Murabahah sukuk* have a fixed return and correspond to bonds, while with *ijara sukuk* returns vary which means they have the financial characteristics of floating rate notes. These have proved the most popular type of *sukuk*, not least because returns usually vary in line with changing market funding costs.

The main concerns of *Shari'a* scholars with *sukuk* is that the investors have a clear title to the underlying asset, and that in the case of *mudarabah* and *musharakah,* the assets themselves are re-valued so that the investors do not merely get the nominal value of their investment refunded as with a debt instrument. This creates a dilemma for the investors, as those wanting *Shari'a*-compliant debt instruments, do not wish to invest in assets subject to market risk, their preferred exposure being to default risk only. *Takaful* Islamic insurance operators, for example, cannot take too much exposure to market risk, as although a proportion of their holdings are in equities, most are in *sukuk* for the same reasons as insurance companies hold bonds and floating rate notes. If there were excessive holdings of equity instruments and the market value of these investments fell, *takaful* operators would no longer be able to fulfil their obligations to those policyholders making claims. This would mean a breach of contract and would be unfair to those in need of accident or other compensation. Those who argue for all *sukuk* being equity-based need to be aware of the wider social and legal consequences. Land or buildings may be used as the underlying assets for *sukuk*, but investors wanting exposure to real estate may prefer to invest directly in this rather than in *sukuk*. From a portfolio perspective, *sukuk* have to be viewed as one component of a multi-asset allocation strategy.

Implications of financial market volatility for Islamic investment

Sukuk issuance has increased enormously since 2000, with over 200 issues in 2007 alone worth $45 billion. Much of the activity was in the first seven months of the year however, as *sukuk* issuance after August was adversely affected by the crisis in securitized debt obligations resulting from the sub-prime defaults. The pricing of *sukuk* has been linked to that of conventional debt securities, as *sukuk* represents only a small proportion of the overall market, and therefore *sukuk* issuers and investors are price takers rather than price makers. The higher price which needs to be offered for *sukuk* financing has deterred many issuers, with funding plans either abandoned as projects are rethought, or postponed until market conditions become more certain.

The slow-down applied more especially to US dollar-denominated *sukuk*, the currency for most sub-prime debt, but issuance in other currencies has been less affected. Malaysian *sukuk* are mostly local currency denominated, and appear to be unaffected and in the Gulf, there has also been a trend in favour of local currencies. Only the Kuwaiti dinar has been allowed to appreciate against the US dollar so far, but investors in riyal- or dirham-denominated *sukuk* are expecting that these currencies are likely to be decoupled from the US dollar, possibly in 2010, when a new joint float might occur as part of a move towards monetary union in the Gulf Co-operation Council states. It is likely that there will be increasing currency diversification in *sukuk* issuance. The British government is planning a

series of sterling denominated sovereign *sukuk* issues, the pricing for which will provide a benchmark for subsequent sterling corporate *sukuk* issuance from London. There have already been several euro-denominated *sukuk*, including on behalf of the German state government, and many more are likely in the years ahead.

The volatility in equity markets worldwide does not seem to have constrained investor interest in *Shari'a*-compliant managed funds. By 2008, there were over 400 of these funds, most of which were equity based, although there were also 50 specialized real estate funds. Investment in equity is permissible, as long as the companies are involved in acceptable business activities and have limited debt-based leverage. A methodology has been developed to ascertain what is permissible by institutions such as the Dow Jones Islamic Indexes. Ideally, any company involved in interest-based transactions, especially conventional banks, should be excluded but the guidelines recognize that most companies may have some interest-based income and obligations. Borrowing up to one third of capital is permissible in line with the discretionary limits in Islamic inheritance law, but beyond that the financing is regarded as highly speculative and therefore not allowed.

The future for Islamic finance

A browse through this encyclopedia demonstrates how wide ranging the areas covered by Islamic finance have become. The scope extends to banking regulation and risk management as well as corporate and *Shari'a* governance. The coverage also includes *takaful* and wealth management, as well as retail open and closed funds. Product innovation is also discussed, as are tax issues and the role of Islamic finance in offshore centres. Aly Khorshid has succeeded in attracting an excellent group of contributors who are the leading academics and professionals in the field of Islamic finance and the reader can benefit from their knowledge.

The future will of course be determined partly by the choices made today, and in this, Islamic finance is no exception. Being *Shari'a*-compliant is not simply a substitute for being *Shari'a*-based; rather they represent different directions for Islamic product development. The industry is also changing as the economies of the Muslim world evolve. Some remain poor and underdeveloped, but many are highly developed and play an increasing role in the global economy, enhancing the prospects for Islamic finance. Some observers see a type of Islamic capitalism developing based on *riba*-free finance which challenges the assumptions underlying Western capitalism. There is an ideology implicit in Islamic finance that may ultimately shape the development of global finance, not least because there is increasing worldwide concern with moral and ethical issues and not simply with making money and material advance.

Part I

Overview of Islamic finance

Chapter 1

Basic elements of Islamic finance

Aly Khorshid
Elite Horizon

Introduction

There are differences between a capitalist economic system and an Islamic economic system, one of the most obvious being that capitalist economies are not governed by divine ruling. This has allowed practices such as excessive interest-accumulation and gambling, and these practices in turn concentrate wealth in the hands of the few. Monopolies are created, and these paralyse market forces. In Islam, divine restrictions are put onto economic activities, and these have the effect of maintaining balance, justice and equality.

The conventional concept of financing is that the banks and institutions deal in money only. Islam does not recognize money as a subject-matter of trade, except in some cases. Financing in Islam is always based on liquid assets, which creates real assets and inventories. Financing based on *musharakah*, *mudarabah*, *salaam* and *istisna'* creates real assets. These means of financing are criticized as having the same result as interest-based borrowing. However, they are backed by assets, and they can be distinguished from interest-based borrowing on the following grounds:

- In conventional financing, the financier has no concern about how the money is used by the client in an interest-bearing loan. In *murabahah*, the financier purchases the commodity required by the client, thus assets back the financing.
- In *murabahah* the purpose of the loan must be under *Shari'a*, but in conventional financing there is no such ruling.
- In *murabahah* the financier who purchases the commodity holds the risk, and the profit is reward for this risk. This risk is not assumed in an interest-based loan.
- In an interest-bearing loan, the amount to be repaid increases with time, but in *murabahah* the price is fixed once agreed.
- As the risk of a lease is placed on the financier, it is the financier who will suffer the loss if it is damaged.

Assets always underpin Islamic financial transactions; there is no gap between the supply of money and the production of real assets, which is the case in conventional economies that suffer inflation.

Islamic banks have been growing, and have had to contend with constraints in their respective countries, such as lack of support from the government and legal systems. Thus, they have not been able to abide by all the requirements of *Shari'a*. This is permitted through the rule in *Shari'a*, where some relaxations are given in exceptional circumstances. However, to keep within the realms of *Shari'a* rule, the aim should be to establish total Islamic order.

Musharakah

Musharakah literally means 'sharing'. In *musharakah*, the return is based on the actual profit earned by the joint venture. Interest is prohibited in Islam, as the rate of interest is the main cause for imbalances in the system of distribution. *Musharakah* favours the common people, as the financier must declare if the loan is to assist the debtor or to share the profits. Nothing can be claimed if the financier is assisting, and if the profits are shared, the losses (if any) are also shared. If the profits shared are large, they cannot all be secured by the financier, but will be shared among the depositors of the bank (the common people). *Musharakah*, however, is considered somewhat outdated, and there is no prescribed procedure, only a broad set of principles. New procedures can be accepted as long as they do not violate any basic principles.

Shirkah also means sharing, and is more commonly used in Islamic jurisprudence than *musharakah* because of its wider meaning. In the terminology of the Islamic *Fiqh*, *shirkah* has been divided into two kinds – Shirkat-ul-milk and Shirkat-ul-'aqd.

Shirkat-ul-milk

This is joint ownership of two or more persons in a property. This is used in two ways: firstly, optional – by the decision of the parties to purchase something jointly; and secondly, compulsory, such as after a death – in which property inherited will be jointly owned.

Shirkat-ul-'aqd

This is a partnership affected by a mutual contract, or joint enterprise. This is divided into three types:

- *Shirkat-ul-amwal*: Partners invest capital into a commercial enterprise.
- *Shirkat-ul-A'mal*: Partners provide a service and according to an agreed ratio; fees are distributed among them.
- *Shirkat-ul-wujooh*: Partnership in goodwill; partners purchase commodities and sell them on the spot, and distribute the profit to an agreed ratio.

Musharakah has been introduced recently by those who have written on the subject of Islamic modes of financing, and is restricted to this type of *Shirkah*: *Shirkat-ul-amwal*. However, in some cases it includes *Shirkat-ul-a'mal*.

Rules of *musharakah*

- The contract must be drawn up with free consent of all parties without fraud or misrepresentation.
- Distribution of profit must be agreed at the time of the contract.
- The distribution of profit is determined by the profit accrued, not the capital invested, that is an agreed percentage of the actual profit.
- The ratio of profit and loss has been debated among Muslim jurists. According to Imam Malik and Imam Shafi'i, each should get the profit in proportion to his investment; but according to Imam Ahmad, the ratio of profit may differ from the investment ratio if it is agreed between them. Imam Abu Hanifah argues that the ratio of profit may differ from the investment in normal conditions, but if the partner expresses in the agreement that he is a sleeping partner, then his share cannot be more than his investment. For the ratio of loss, there is a consensus that each partner shall suffer the loss according to the ratio of investment. The view of Imam Ahmad and Imam Abu Hanifah is a principle mentioned in the maxim: 'Profit is based on the agreement of the parties, but loss is always subject to the ratio of investment.'

If a partner wants to participate in a *musharakah* by contributing some commodities to it, he can do so (according to Imam Malik) without any restriction, and his share in the *musharakah* shall be determined on the basis of the current market value of the commodities at the time of contract. According to Imam al-Shafi'i, however, this can only be done if the commodity is from the category of *dhawat-ul-amthal* (a commodity which can be compensated with similar commodities such as wheat or rice). According to Imam Abu Hanifah, if the commodities are *dhawat-ul-amthal*, mixing the commodities of each partner together can do this. If the commodities are *dhawat-ul-qeemah* (commodities not able to be compensated with similar commodities such as cattle), they cannot form part of the share capital. The view of this Imam meets the needs of the modern business and is more reasonable.

Each person has a right to manage the principle of *musharakah*, and an agreement can be made for one person to carry out the management.

Termination of *musharakah*

The *musharakah* is deemed terminated under the following conditions:

- Each partner has a right to terminate the *musharakah* at any time after giving his partner notice. The assets, if in cash form, will be distributed between them. If they are not liquid, they may agree either to liquidate them or to distribute them as they are. If the assets are machinery, it will be sold and the profits shared.
- If one partner dies, then his part is terminated. His heirs will have the option to withdraw the share or continue.
- If a partner becomes insane or incapable of effecting commercial transactions, the *musharakah* will be terminated.

By mutual agreement, one of the partners can terminate the *musharakah* while the others continue. The others may purchase the share of the terminating partner. The price of the share is also determined by mutual consent.

Mudarabah

Mudarabah is a partnership where the investment comes from the first partner, '*rabb-ul-mal*', and the management and work is the responsibility of the second, '*mudarib*'. A summary of the differences between *musharakah* and *mudarabah* is as follows:

- In *musharakah*, investment comes from all partners, but in *mudarabah*, investment is the responsibility of the *rabb-ul-mal*.
- In *musharakah*, all partners participate in the management, but in *mudarabah*, the *mudarib* alone conducts the management.
- All partners in *musharakah* share the loss to the extent of their ratio of investment, but in *mudarabah* the loss is suffered by the *rabb-ul-mal* only as he is the sole investor. However, if the *mudarib* has been negligent, he will suffer the loss.
- The partners' liability in *musharakah* is unlimited. In *mudarabah* the liability of the *rabb-ul-mal* is limited to his investment, unless he has permitted the *mudarib* to incur debts on his behalf.
- In *musharakah*, the assets, once mixed in a joint pool, become jointly owned by them according to the proportion of investment. In *mudarabah* all goods purchased by the *mudarib* are solely owned by the *rabb-ul-mal*. The *mudarib* can earn his share in the profit should he sell the goods profitably. He is not entitled to claim his share of the assets.

Restricted *mudarabah* (*al-mudarabah al-muqayyadah*) is when the *rabb-ul-mal* specifies a particular business for the *mudarib* to invest the money in. Unrestricted *mudarabah* ('*al-mudarabah al-mutlaqah*) is when it is open for the *mudarib* to undertake whichever business he wishes.

In cases where the *rabb-ul-mal* contracts *mudarabah* with more than one person through a single transaction, the *mudarib* shall run the business as if they were partners.

The distribution of profit must be agreed upon at the beginning of the contract. The *mudarib* cannot claim any periodical salary, fee or remuneration for the work done by him for the *mudarabah*. This is agreed by most schools of Islamic *Fiqh*. However, Imam Ahmad has allowed for the *mudarib* to withdraw his daily expenses of food from the *mudarabah* account. The *Hanafi* jurists restrict this right of the *mudarib* only to a situation when he is on a business trip outside his city. Any profit will first be used to offset any loss, and the rest will be distributed according to the ratio.

Musharakah and *mudarabah* in combination

The two systems may be combined in order for the *mudarib* to contribute some money into the business. In this, the *mudarib* may allocate for himself a certain percentage of profit on

account of his investment as a *sharik*, and allocate another percentage for his management and work as a *mudarib*. The normal basis for allocation of the profit in the above example would be that the second party shall secure one third of the actual profit on account of his investment, and the remaining two thirds of the profit shall be distributed among them equally. However, the parties may agree on any other proportion. The one condition is that the sleeping partner should not receive a larger percentage than the proportion of his investment.

In the Islamic *Fiqh* partners cannot leave and join the enterprise without causing an affect to the continuity of business in some way. However, these were written before the modern age of large-scale commercial enterprises. This does not mean, however, that *musharakah* and *mudarabah* cannot be used for a running business. If the basic principles are followed, their application may be varied.

1 Financing through *musharakah* and *mudarabah* participation in the business, and in *musharakah* sharing the assets of the business to the extent of the ratio of financing.
2 An investor must share the loss incurred by the business to the extent of his financing.
3 The partners determine the ratio of profit.
4 The loss suffered by each partner must be exactly in proportion to his investment.

Musharakah securitization

In the case of large projects where huge amounts are required, every subscriber is given a *musharakah* certificate, which represents his proportionate ownership of the assets. After the project has begun, these certificates can be bought and sold in the secondary market, but not when all the assets are liquid. When there is a combination of liquid and non-liquid assets, it cannot be sold unless the non-liquid part of the business is separated and is sold independently.[1] However, the Hanafi school asserts that whenever there is a combination of liquid and non-liquid assets, it can be sold and purchased for an amount greater than the amount of liquid assets. For example, a *Musharakah* project contains 40% non-liquid assets, such as machinery, fixtures et cetera. and 60% liquid assets, such as cash and receivables. Each *musharakah* certificate having the face value of Rs. 100 represents Rs. 60 worth of liquid assets and Rs. 40 worth of non-liquid assets. This certificate may be sold at any price more than Rs. 60. If it is sold at Rs. 110 it will mean that Rs. 60 of the price is against Rs. 60 contained in the certificate and Rs. 50 is against the proportionate share in the non-liquid assets. But it will never be allowed to sell the certificate for a price of Rs. 60 or less, because in the case of Rs. 50 it will not set off the amount of Rs. 60.

Single transaction financing

Musharakah and *mudarabah* can be employed for financing imports and exports. For exporting, *musharakah* will be easier to use. As the price of the goods to be exported is known beforehand, the financier can calculate his profit. There may be a condition to secure the financier from any exporter negligence. The condition would be that it is the responsibility of the exporter to export the goods in conformity with the conditions of the letter of credit, and the exporter would be liable for any discrepancies. On the basis of *musharakah*

or *mudarabah*, an importer can approach a financier. If the letter of credit has been opened without any margin, the form of *mudarabah* is used; and if the letter of credit is opened with some margin, the form of *musharakah* is used (or a combination of both). The importer and financier, according to a pre-agreed ratio, might share the sale proceeds. The *musharakah* can be restricted to an agreed term, and the importer may purchase the financier's share if the goods are not sold in the market before expiry. However, this price would be at the current market value, and not at a pre-agreed price.

Objections to *musharakah* financing

Risk of loss

The arrangement of *musharakah* is more likely to pass on losses of the business to the financier bank or institution, and to the depositors. Investors will not want to deposit their money, and thus savings will remain idle. However, this misgiving is not entirely justified. The banks study the potential of the business and if they form the view that the business is not profitable, they refuse to advance a loan. No bank can restrict itself to a single *musharakah*. The profitable *musharakah* are expected to give more return than interest-based loans because the actual profit is supposed to be distributed between the client and the bank, and so the *musharakah* is not expected to make a loss. The theoretical loss is much less than the possibility of loss in a joint stock company whose business is restricted to a limited sector or commercial activities. Also, any possible loss in one *musharakah* will be compensated by the profits earned in another *musharakah*.

Dishonesty

Dishonest clients may exploit *musharakah* by not paying any return to the financiers. To overcome this, a well-designed system of auditing should be implemented where accounts of all clients are maintained and controlled. If profits were calculated on gross profits, the possibility of disputes would be minimized. If misconduct is established, the client will be deprived of using any facility in any bank in the country. This will serve as a deterrent. Also, the banks cannot afford to show artificial losses. Another failure is that Islamic banks work in isolation from conventional banks, and thus do not receive much support from central governments.

Secrecy

The financier who is made a partner in the business of the client may disclose the secrets of the business to the traders. To guard against this, the client may put a condition in the *musharakah* that the financier will not interfere with the management affairs, and will not disclose any information about the business.

Unwillingness to share profits

Clients are often unwilling to share the actual profits of their business with the banks. This is for two reasons.

- They think that the bank has no right to share in the actual profit, because the bank has nothing to do with the management or running of the business, and they question why they (the clients) should share the fruits of their labour with the bank that provides funds. The client also argues that conventional banks are content with a meager rate of interest and so should the Islamic banks.
- Clients are afraid to reveal their true profits to the banks, lest the information be passed on to the tax authorities and clients' tax liability increases.

Diminishing *musharakah*

This is another form of *musharakah*, in which a financier and client participate in a joint commercial enterprise (*Shirkat-al-Milk*). The purpose of diminishing *musharakah* is for the financier to get his money back in a specified period. The financier's share is divided into units, to be purchased by the client until he is the sole owner. This has mostly been used in house financing. In this example, the financier acquires rent according to the proportion of his ownership in the property, and as the client periodically purchases each portion, the rent decreases.

The following conditions are imposed for the house financing arrangement.

- The agreement of joint purchase, leasing and selling different units of the financier's share should not be tied up together in one single contract. However, the joint purchase and contract of lease may be contained in one document whereby the financier agrees to lease his share, after joint purchase, to the client. This is allowed through *ijarah*.
- At the time of purchase of each unit, sale must be affected by the exchange of offer and acceptance at that particular date.
- The purchase of different units by the client is affected based on the market value of the house as prevalent on the date of purchase of that unit. It is also permissible that a particular price is agreed in the promise of purchase signed by the client.

Diminishing *musharakah* can also be used for a service business and trade.

Murabahah

Murabahah is an Islamic mode of financing. In its original Islamic sense it is a sale, and it is distinguished from other forms of sale by the seller's telling the purchaser how much cost he has incurred and how much profit he is going to charge in addition. It is a mode of sale to avoid interest. *Musawamah* (bargaining) is a sale without any reference to cost, ratio or profit. The profit is an agreed ratio. The cost price will include all expenses such as freight and custom duty. Costs such as salaries of staff and rent cannot be included in *murabahah*. If the exact cost cannot be ascertained, the commodity cannot be sold on a *murabahah* basis, but under *musawamah*. The rules governing transactions of *murabahah* in financial institutions are as follows.

- The subject of sale must exist at the time of sale (the sale is void under *Shari'a* if a non-existent thing is sold, such as an unborn calf).

- The subject of sale must be in the ownership of the seller at the time of sale.
- The subject of sale must be in physical or constructive possession of the seller at the time of sale.
- The sale must be instant and absolute. A sale contingent on a later date is void.
- The subject of sale must be a property of value.
- The subject of sale should not be something which is not used except for a *haram* purpose, like pork, wine and so on.
- The subject of sale must be specifically known and identified to the buyer.
- The delivery of the sold commodity to the buyer must be certain and should not depend on a contingency.
- The certainty of price is a necessary condition for the validity of sale. If the price is uncertain, the sale is void.
- The sale must be unconditional, unless a condition is recognized as a part of the transaction, according to the usage of trade.

If the seller does not abide by his promise to sell, it may be enforceable in court.[2] The first three rules are relaxed under *bai' salaam* and *istisna'*.

Bai' Mu'ajjal

This is a sale on a deferred payment basis; the rules governing this sale are as follows:

- This type of sale is valid if the due date of payment is clearly fixed in an unambiguous manner.
- The date must be fixed, and cannot rest on an event with an unknown date.
- If a time period is decided upon for payment, it takes effect from the date of delivery, unless agreed otherwise by the parties.
- The price must be fixed at the time of sale, and this cannot be changed.
- There may be a promise for the buyer to donate a specified amount to a charity in case of default.
- In payment of installments, any failure to pay on its due date will require the full amount immediately.
- To secure the payment there may be a security, such as a mortgage or charge on existing assets. Another possibility is to sign a promissory note.

Murabahah as a form of financing

The ideal modes of financing, according to *Shari'a*, are *mudarabah* and *musharakah*. Due to practical difficulties in using these, *murabahah* has been allowed as a mode of financing, subject to certain conditions. As it is not an ideal financing instrument, it should be used as a transitory step in the process of Islamization of the economy, and its use restricted to cases where *musharakah* and *mudarabah* cannot be used. Some rules govern the use of *murabahah* as a mode of financing.

- It is not a loan, and so can only be used for the purchase of actual commodities, not for payment of goods already purchased or electricity bills.

- The financier must have owned the commodity before he sells it to the client.
- In cases where the financier cannot directly purchase the commodity from the supplier, it is permissible for him to make the customer his agent to buy the commodity on his behalf. The customer then purchases the commodity from the financier for a deferred price.
- The commodity must be purchased from a third party.

The financial institution, when using *murabahah* as a mode of finance, adopts the following procedure.

- The client and the institution sign an agreement whereby the institution promises to sell and the client promises to buy the commodities on an agreed profit ratio added to the cost.
- When a specific commodity is required by the customer, the institution appoints the client as his agent to purchase the commodity on its behalf and both parties sign an agreement of agency. The commodity remains the risk of the institution until the next stage (this is the only feature that distinguishes *murabahah* from an interest-based transaction).
- 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. At this stage, a promissory note may be signed to ensure payment to the institution.

The use of interest rate as a benchmark

Many institutions financing by way of *murabahah* determine their profit on the basis of the current interest rate, mostly using LIBOR (Inter-bank offered rate in London) as the criterion. This is often criticized on the grounds that profit based on a rate of interest should be as prohibited as is interest itself. However, a *murabahah* transaction is not rendered invalid if all the conditions are met and the rate of interest has been used only as a benchmark. Using this benchmark, however, is not ideal, as it takes the rate of interest as an ideal for a *halal* business, which is not desirable. Also, it does not advance the basic philosophy of the Islamic economy having no impact on the system of distribution. Islamic banks should strive to develop their own benchmark by creating their own inter-bank market based on Islamic principles. In this, a common pool can be created which invests in asset-backed instruments such as *musharakah* and *ijarah*.

Murabahah promise to purchase

At the stage when the financier has yet to acquire the commodity required by the client, the financier is at risk if the client is not bound to purchase the commodity at the time the financier purchases it. The client signing a promise to purchase solves this; this is distinguished from the bilateral forward contract by being a unilateral promise. This is however debated, as this promise is a moral obligation and cannot be enforced in *Shari'a*. Many scholars such as Imam Abu Hanifah, Imam al-Shafi'i, Imam Ahmad and some *Maliki* jurists are of the view that fulfilling a promise is a noble quality and it is advisable for the promissor

to observe it, and its violation is reproachable, but it is neither mandatory (*wajib*), nor enforceable through courts.

Murabahah security

In order to ensure that the price will be paid on time, the following conditions must be met.

- The security can be claimed where the transaction has created a liability or debt.
- The security is established after the commodity is sold to the client and the price has become due to the financier. However, there may be a security earlier to ensure the financier's liability while in possession of the commodity.
- It is also permissible that the sold commodity is given to the seller as security. According to *Hanafi* jurists the seller will have to bear the loss of the commodity to the extent of its market price or agreed sale price, whichever is the smaller. The *Shafi'i* and *Hanbali* jurists hold that if the commodity is destroyed by the negligence of the mortgagee, he will have to bear the loss according to its market price.[3] In this scenario, it is necessary that the point of time at which the commodity held by the mortgagee be defined.

Murabahah guarantor

The financier can ask for a guarantor in the event that the client cannot make payment. The classical *Fiqh* literature is unanimous that the guarantee is voluntary and no fee can be charged on a guarantee (although secretarial expenses may be incurred), otherwise it would be *riba*. However, in the modern age, in transactions such as those that are international, it has become difficult to find guarantors who will undertake transactions free of charge. Contemporary scholars argue that the prohibition of guarantee fee is not based on any specific injunction of the Holy *Qur'an* or *Sunnah*, only deduced from the prohibition of *riba*.

Penalty of default

The price cannot be increased if the client defaults. This is sometimes exploited by someone who deliberately avoids paying the price at its due date, as they know they will not have to pay any additional amount on account of default. This should not create a problem in a country with banks run on Islamic principles, because the government can create a system whereby defaulters are penalized. However, in countries where Islamic banks are working in isolation, even if the client is deprived of using an Islamic bank thereafter, he can approach conventional institutions. Some contemporary scholars have proposed that clients who deliberately default should be made liable to pay compensation to the Islamic bank for the loss. This amount may be equal to the profit given by the bank to its depositors during the period of default. Those who allow this, base it on the following conditions.

- The defaulter should be given a grace period of at least one month after the maturity date during which he must be given advance warning notices weekly.

- It must be proven, beyond doubt, that the client is defaulting without valid cause. If it is due to poverty, no compensation can be claimed. This is expressed in the Holy *Qur'an*, 'And if he [the debtor] is short of funds, then he must be given respite until he is well off.' (2:280).
- The compensation is allowed only if the investment account of the Islamic bank has earned some profit to be distributed to the depositors.

Extension of deferred payment

This is not allowed under *Shari'a* but has been implemented in some Islamic banks that have misunderstood *murabahah*. Extending the due date for another term is analogous with interest-based financing.

Early payment rebate

If the client pays earlier than the specified date, some jurists allow a discount on the price and some do not. The four recognized schools of Islamic jurisprudence do not allow this. Those who allow this, base their argument on a *hadith* in which Abdullah ibn 'Abbas is reported to have said that when the Jews belonging to the tribe of Banu Nadir were banished from Madinah (because of their conspiracies), some people came to the Holy Prophet and said, 'You have ordered them to be expelled, but some people owe them debts which have not yet matured.' Thereupon the Holy Prophet said to them [the Jews who were the creditors] 'Give discount and receive [your debts] soon.'[4] The majority of Muslim jurists do not accept this *hadith* as authentic. Even if it is, the exile of Banu Nadir was in the second year after *hijrah*, before *riba* was prohibited. However, if the creditor gives a rebate voluntarily, it is permissible.

Cost calculation in *murabahah*

The *murabahah* must be based on the same currency as that in which the seller has purchased the commodity from the original supplier. This may be difficult in international trade, but it can be solved in a number of ways. If the laws of the country allow, and the purchaser agrees, the price of the second sale may be determined in dollars. The cost price can include the cost of converting currency into dollars and the profit added subsequently. However, this is not valid because it results in the price being uncertain at the time of sale. There are some options open to the bank on this issue.

- The bank should purchase that commodity on the basis of letter of condition at sight, and should pay the price to the supplier before effecting a sale with the customer.
- The bank determines the *murabahah* price in US dollars rather than in Pak rupees, so that the deferred *murabahah* price is paid by the customer in dollars. The bank will be entitled to receive dollars from the customer and the risk of the price fluctuation in the dollar will be borne by the purchaser.
- Instead of *murabahah*, the deal may be on the basis of *musawamah* and the price may be fixed to cover any anticipated fluctuation in the currency rates.

Rescheduling of *murabahah* payments

If installments are rescheduled in *murabahah*, no additional amount can be charged as in conventional banks. Some Islamic banks proposed to reschedule the *murabahah* price in a hard currency different from the one of the original sale. However, rescheduling must always be on the basis of the same amount in the same currency.

Murabahah securitization

Murabahah cannot be securitized to create a negotiable instrument to be sold and purchased in a secondary market. A paper showing evidence of indebtedness towards the seller cannot be exchanged for money at a lower or higher price. However, if there is a mixed portfolio consisting of a number of transactions like *musharakah*, leasing and *murabahah*, then this portfolio may issue negotiable certificates subject to certain conditions.

Ijarah

This means to give something on rent. In Islamic jurisprudence it means 'to employ the services of a person on wages given to him as a consideration for his hired services'. The employer is '*musta'jur*' and the employee '*ajir*'. *Ijarah* in the second sense is 'to transfer the usufruct of a particular property to another person in exchange for a rent claimed from him'. This is analogous to leasing. The lessor is '*mu'jir*', the lessee '*musta'jir*' and the rent '*ujrah*'. This is the most relevant as it is used as a form of investment and a mode of financing. The rules are very similar to the rules of sale. However, the ownership of the property remains in the possession of the transferor, and the lessee only has the right to use it. Some stipulations of *ijarah* are:

- The subject of lease must have a usufruct otherwise it cannot be leased.
- The leased property remains under the ownership of the seller.
- The liabilities of ownership are borne by the lessor, but the liabilities of the use are borne by the lessee.
- The period and terms of lease must be clearly determined.
- The leased asset cannot be used for any other purpose than that specified in the lease agreement.
- The lessee is liable to compensate the lessor for harm to the leased asset caused by misuse or negligence.
- Any harm or loss beyond the control of the lessee shall be borne by the lessor.
- A property jointly owned can be leased out, and the rent distributed according to the proportion leased by each.
- A joint owner of a property can lease his proportionate share to his co-sharer only and not to any other person.
- The leased asset must be fully identifiable by the parties.
- The rent must be determined at the time of contract for the whole period of the lease. The lease is not valid if the rent for a phase of the lease period has not been determined or left at the option of the lessor.

- The lessor cannot increase the rent unilaterally and any agreement to this effect is void.
- The rent may be paid in advance of delivery of the asset to the lessee, but the amount will remain as an 'on account' payment and adjusted accordingly when the rent is due.
- The lease period shall commence from the date on which the leased asset has been delivered to the lessee, regardless of whether the lessee has started using it.
- The lease will terminate if the asset is no longer used for the purpose for which it was leased and no repair is possible. If this loss is caused by misuse by the lessee, he will be liable to compensate the lessor for the depreciated value of the loss.

Financial lease

This type of *ijarah* was not intended as a mode of financing, but certain financial institutions use it instead of long-term lending on the basis of interest. Leasing is a lawful transaction according to *Shari'a* and can be used as an interest-free mode of financing. However, there must be substantial difference between leasing and an interest-bearing loan. Some basic differences between contemporary financial leasing and actual leasing allowed by *Shari'a* are indicated below:

- The agreement can be effected for a future date on the condition that the rent will be payable after the leased asset is delivered to the lessee.
- There are two separate relationships between the institution and the client. In the first, the client is an agent of the institution to purchase the asset on the latter's behalf. The second begins from the date when the client takes delivery from the supplier, and the relationship of lessor and lessee comes into play. During the first stage, the client cannot be held liable for the obligations of a lessee.
- The lessor is liable to bear all expenses as the owner of the asset in the process of the purchase and import, such as freight and customs duty.
- A loss caused by factors beyond the lessee's control is not liable to the lessee; this factor is not differentiated between the losses caused by negligence of the lessee in traditional 'financial lease' agreements.
- In long-term leases, it is not to the benefit of the lessor to fix one amount of rent for the whole period of the lease, as market conditions change from time to time. If payment is late, the same solution comes into effect as in *murabahah*. The lessee will pay a certain amount to a charity.
- The lease may be terminated if the lessee contravenes the terms. In other cases, it can be terminated by mutual consent. In the 'financial lease' the lessor has unrestricted power to terminate the lease unilaterally according to his judgement; this is against the principles of *Shari'a*.
- The lessor is responsible for paying the insurance under the Islamic mode of *takaful*, not the lessee as is the case in financial leases.
- Contemporary scholars have suggested that the lessor may enter into a unilateral promise to sell the leased asset to the lessee at the end of the leased period.
- The lessee cannot sub-let the leased asset except with permission from the lessor. The schools of Islamic jurisprudence differ in opinion about the rent charged from the sub-lessee.

- The lessor can sell the leased property to a third party whereby the relation of lessor and lessee shall be established between the new owner and the lessee.

Murabahah and *ijarah* leasing

The differences between *murabahah* and leasing are subtle but significant. *Murabahah* cannot have a sale attributed to a future date, but leasing can. In *murabahah* the seller cannot claim a profit over a property that was not under his risk. In leasing, the asset remains under the risk of the lessor, and so does not violate the principle of *Shari'a*.

Securitization of *ijarah*

The lessor can sell the asset, in whole or part, to a third party. Some jurists are of the opinion that this sale will not take effect until the lease period is over. However, Imam Abu Yusuf and others argue that the sale is valid, even if purchaser replaces the seller and *ijarah* will continue.[5] The sale of a portion of the asset may be evidenced by an *ijarah* certificate, which also states the obligations of the lessor to the extent of his ownership. These certificates can be traded in the market and serve as an instrument easily convertible into cash. These may help solve the problems of liquidity management faced by Islamic banks. It is not allowed in *Shari'a* for *ijarah* certificates to represent the holder's right to claim a certain amount of rental only without assigning to him any kind of ownership in the asset.

Head leasing

Head leasing is an arrangement in the modern leasing business where the lessee sub-leases the property to a number of sub-lessees. Then, others are invited to share the rent received by his sub-lessees and charges them a specified amount for this. This is not in accordance with *Shari'a*, because the lessee does not own the property and only benefits from its usufruct. Trading in rent is a form of *riba*, which is prohibited.

Salaam and *istisna'*

As mentioned earlier, these are exceptions to the commodity having to be in the physical or constructive possession of the seller. These constitute two types of sale. In *salaam*, the seller (*muslam ilaih*) undertakes to supply some specific goods (*muslam fih*) to the buyer (*rabb-us-salaam*) at a future date, in exchange of an advanced price (*ra's-ul-mal*) fully paid at spot. The original purpose of this sale was to meet the needs of small farmers who needed money to grow crops and to feed their family up to the time of harvest.

Salaam as a form of financing

Modern banks and financial institutions can use this mode of financing, particularly to finance the agricultural sector. The only problem with *salaam* is that the banks will receive

certain commodities from their clients and not receive money. However, if they want to earn a halal profit they have to deal in commodities. There are a few ways of benefiting from the contract of *salaam*: firstly, after purchasing a commodity by way of *salaam*, the financial institutions may sell it through a parallel contract of *salaam* for the same date of delivery. Secondly, if a parallel contract of *salaam* is not feasible, they can obtain a promise to purchase from a third party. This should be unilateral from the expected buyer. Their buyers will not have to pay the price in advance. Thirdly, at the date of delivery the commodity is sold back to the seller at a higher price. But this is not in accordance with *Shari'a*.

Rules of parallel *salaam*

The rules of parallel *salaam* are as follows:

1. The bank enters into two different contracts. In one, the bank is the buyer and in the other, the bank is the seller. Each must be independent of the other, and its performance not contingent on the other.
2. It is allowed with a third party only. Otherwise, it will become a buy-back arrangement, which is not permissible in *Shari'a*.

Istisna'

Istisna' means a commodity is transacted before it comes into existence, such as ordering a manufacturer to manufacture a specific commodity for the purchaser. The price must be fixed between both parties and there must be a specification of the commodity. The contract is a moral obligation on the manufacturer, but before he starts work, any of the parties may cancel the contract by giving notice.[6] The contract cannot be cancelled unilaterally after the manufacturer has started work.

Differences between *Istisna'* and *salaam*

- *Salaam* can be effected on anything, but for *istisna'* something must be manufactured.
- The price must be paid in advance in *salaam* but not in *istisna'*.
- The *salaam* contract cannot be cancelled unilaterally once effected, but in *istisna'* it can be cancelled before the manufacturer starts work.
- The time of delivery is essential in *salaam* but in *istisna'* it does not need to be fixed.[7]

Differences between *istisna'* and *ijarah*

The transaction is not *istisna'* if the material used is provided by the customer and the manufacturer uses his labours and skill only. In this case, it is an *ijarah* transaction whereby the services of a person are hired for a fee.[8]

Imam Abu Hanifah is of the view that the purchaser can exercise his option of seeing (*Khiyar-ur-ru'yah*) the goods once manufactured, and if somebody purchases a thing which is not seen by him, he has the option to cancel the sale after seeing it. However, Imam

Abu Yousuf says that if the commodity conforms to the agreed specifications, the purchaser is bound to accept the goods and cannot exercise the option of seeing.

Time of delivery in *Istisna'*

The time of delivery is not fixed in *istisna'*, but there can be a maximum time for delivery. If this is exceeded, the purchaser is not bound to accept the goods.[9] If agreed by both parties in the case of late delivery, the price can be reduced by a specified amount each day.

Istisna' as a form of financing

This is very common in the house finance sector. It is not necessary for the financier to construct the house, as he can enter into a parallel contract of *istisna'* with a third party or hire the services of a contractor (other than the client). He can calculate the cost and fix the price of *istisna'* with his client. For security, the financier may keep the title deeds of the house or land until the client pays the last installment. In this case, the financier will be responsible for the construction of the house in conformity with the specifications in the agreement. If there is any discrepancy, the financier must correct it at his own cost.

Istisna' can also be used as a mode of financing for large projects, such as building a bridge or highway. It can also be used for modern BOT (Buy, Operate and Transfer) agreements whereby a government wants to construct a highway and the cost of *istisna'* gives the right to the builder to operate the highway and collect tolls for a specified period.

Islamic investment funds

Islamic investment funds are joint pools where investors contribute their surplus money for the purpose of its investment to earn halal profits in conformity with the precepts of *Shari'a*. Their subscription may be certified, entitling them to pro-rata profits earned by the fund. These can be called certificates, units or shares. Their validity in terms of *Shari'a* is subject to two conditions.

- The subscribers must enter the fund with a clear understanding that the return on their subscription is tied up with the actual profit earned or loss suffered from the fund. If the loss is due to negligence or mismanagement, the management will be liable to compensate it.
- The amounts pooled together must be invested in a business acceptable to *Shari'a*. For example, the company neither borrows money on interest nor keeps it surplus in an interest-bearing account and its shares can be purchased, held and sold.

A variety of modes of investment may be accommodated that keep within these basic requisites. These are discussed below.

Equity funds

In equity funds, the amounts are invested in the shares of joint stock companies. The profits derive from capital gains by purchasing the shares and selling them when prices have increased, as well as from dividends. The following conditions must be met when dealing with equity shares for it to be acceptable in *Shari'a*.

- The main business is not in conflict with *Shari'a*.
- If the main business is *halal*, but they deposit their surplus amounts in an interest-bearing account or borrow money on interest, the shareholder must express his disapproval.
- If some income from interest-bearing accounts is included in the income of the company, the proportion of such income in the dividend paid to the shareholder must be given to charity.
- The shares of a company are negotiable only if the company owns some illiquid assets. If they are liquid, it cannot be purchased or sold except at par value, as money cannot be traded. Some scholars are of the view that illiquid assets must be at least 51%. They argue that if such assets are less than 50%, then most of the assets are in liquid form on the basis of the juristic principle that 'The majority deserves to be treated as the whole of a thing'. Other scholars argue that if the illiquid assets are 33%, its shares can be treated as negotiable.

Purification

This is the process whereby profits earned through dividends must be given to charity. The *Shari'a* scholars have different views about whether the purification is necessary where the profits are made through capital gain, that is, by purchasing the shares at a lower price and selling them at a higher price. Other scholars are of the opinion that even in this case purification is necessary, because the market price of the share may reflect an element of interest included in the assets of the company.

The management of funds

The management of the fund may be carried out in two ways. First, they may act as *mudarib*s for the subscribers, in which case a certain percentage of the annual profit accrued to the fund may be determined as the reward for the management. The second option is for the management to act as an agent for the subscribers. They may be given a pre-agreed fee for their services. This may be fixed in a lump sum or as a monthly/annual remuneration. Contemporary *Shari'a* scholars also argue that the fee can be based on a percentage of the net asset value of the fund. For example, it may be agreed that the management will receive 2% or 3% of the net asset value of the fund at the end of every financial year. This way may be justified by the analogy of a *Simsar* (broker) for whom the fee based on percentage is allowed. Which method is to be chosen must be determined before the launch of the fund and agreed upon by all subscribers.

Ijarah fund

Ijarah is leasing the detailed rules. In this fund, subscription amounts are used to purchase assets such as real estate, motor vehicles or other equipment for the purpose of leasing them to their ultimate users. The ownership of these remains with the fund and the rent are charged from the users. These rents are distributed among the subscribers. Certificates called *sukuk* are issued to evidence each subscriber's share. These can be bought and sold in the secondary market, and whoever has one, replaces the subscriber in the ownership of the relevant assets. The price of these are determined on the basis of market forces and are normally based on profitability. These must conform to the principles of *Shari'a*, as explained earlier under 'Leasing'. In this type of fund, the management should act as an agent of the subscribers and should be paid a fee for its services. Most Muslim jurists take the view that such a fund cannot be created on the basis of *mudarabah*, because this is restricted to the sale of commodities and not to leases or services. However, according to the Hanbali School, *mudarabah* can be effected in services and leases also. Contemporary scholars share this view.

Commodity fund

The subscription amounts in this type of fund are used to purchase different commodities for the purpose of their resale. The profits generated from these are the income of the fund and are distributed accordingly. All the rules governing the transactions of sale must be complied with to make this fund acceptable to *Shari'a*. These are outlined previously in transactions of sale rules. It is evident that the transactions in the contemporary commodity markets, especially in futures, do not comply with these conditions. Therefore, an Islamic commodity fund cannot enter into such transactions.

Mixed Islamic fund

This is where the subscription amounts are employed in different types of investments, such as equities, leasing, commodities et cetera. If the proportion of liquidity and debts exceeds 50%, its units cannot be traded according to the majority of the contemporary scholars. In this case, the fund must be a closed-end fund.

Murabahah fund

If a fund is created to undertake this kind of sale, it should be a closed-end fund and its units cannot be negotiable in a secondary market. This is because the portfolio of *murabahah* does not own any tangible assets.

Bai'-al-dain

This means a person has a debt receivable from a person and he wants to sell it at a discount. The traditional Muslim jurists (*fuqaha*) and many contemporary Muslim scholars agree that this discount is not allowed in *Shari'a*. The prohibition is a logical consequence of the prohibition of *riba*. However, some scholars of Malaysia have allowed this kind of sale.

They normally refer to the ruling of *Shafi'ite* School wherein it is held that the sale of debt is allowed; but they did not pay attention to the fact that the *Shafi'ite* jurists have allowed it only in a case where a debt is sold at its par value. Once a commodity is sold, its ownership is passed to the purchaser and the seller no longer owns it. What the seller owns is money; therefore, if he sells the debt, it is the sale of money, and this is prohibited.

Limited liability

This is an ingredient in large-scale enterprises of trade and industry in the modern world. It is a condition under which a partner or shareholder of a business secures himself from bearing a loss greater than the amount he has invested in a company with limited liability. This came about with the emergence of the corporate bodies and joint stock companies. The purpose was to attract the maximum number of investors to large-scale joint ventures and to assure them that their personal fortunes would not be at stake if they invested.

If the liabilities of a limited company exceed its assets, the company becomes insolvent and is liquidated. The creditors may lose a considerable amount of their claims, because they can only receive the liquidated value of the assets, and have no recourse to its shareholders for the rest of their claims.

Juridical personality

With this concept, a joint stock company enjoys the status of a separate entity as distinct from the individual entities of its shareholders. The separate entity as an effective person has legal personality and may sue and be sued, make contracts and hold property in its name, and has the legal status of a natural person in all its transactions entered into in the capacity of a juridical person. Whether a juridical person is acceptable in *Shari'a* is questionable. Once the judicial person is accepted, and it is admitted that despite its fictive nature, it can be treated as a natural person in respect of the legal consequences of the transactions made in its name, we will have to accept the concept of limited liability. If the creditors of a real person can suffer when he dies insolvent, the creditors of a juridical person may also suffer, when its legal life comes to an end by its liquidation. This has not been envisaged by the modern economic and legal systems and is not dealt with in the Islamic *Fiqh*, yet there are certain precedents from where the basic concept of a juridical person may be derived.

- ***Waqf*****:** This is a legal and religious institution where a person dedicates some of his properties for a religious or charitable purpose. After declared as *waqf*, these properties are owned by Allah and not the donor. The beneficiaries can benefit from the proceeds of the dedicated property. Muslim jurists have treated the *waqf* as a separate legal entity and ascribed to it, characteristics similar to those of a natural person. This is clear from two rulings given by the *fuqaha'* (Muslim jurists). Firstly, if a property is purchased with the income of a *waqf*, it cannot become a part of the *waqf* automatically. The property is owned by the *waqf*.[10]
- ***Baitul-Mal*****:** This is another example of a juridical person in the classical literature of

Fiqh. This is the exchequer of an Islamic state. Being public property, all the citizens of an Islamic state have some beneficial right over the *Baitul-mal*, yet nobody can claim to be its owner. Imam Al-Sarakhsi in his work *Al-Mabsut* says: 'The *Baitul-mal* has some rights and obligations which may possibly be undetermined.'

- **Inheritance under debt:** This is the property left by a deceased person whose liabilities exceed the value of all the property left by him.
- **Master of a Slave Limited Liability:** This is the closest example to the limited liability of a joint stock company.

The concept of limited liability can be justified from the *Shari'a* viewpoint in the public joint stock companies and those corporate bodies who issue their shares to the general public.

The performance of Islamic banks

Islamic banks have made great breakthroughs in the present banking system by establishing Islamic financial institutions following *Shari'a*. They present a living and practical example for the theoretical concept where it was claimed that no financial institution can work without interest. The Holy *Qur'an* and the Holy *Sunnah* of the Prophet have laid down broad principles in the light of which, scholars have deduced specific answers to the new situation arising in their age. This exercise is called *istinbat* or *ijtihad*. However, during the past few centuries, the political decline of Muslims stopped this process to a large extent. Another major contribution of the Islamic banks is that they have now asserted themselves in the international market.

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[1] This view is based on the famous principle of '*mudd-ul-'ajwah*' explained in the traditional books of Islamic *Fiqh*. See for example, al-Khattabi, Ma'alim al-Sunan 5:23.

[2] Resolution no. 2, 3 of the Fifth Session of the Islamic *Fiqh* Academy held in Kuwait in 1409 A.H.

[3] See Ibn Qudamah, *Almughni*, v. 4, p. 442; Alghazzali, *Al-Wasit* 3:509; Ibn 'Abidin, *Radd-al-Muhtar*, v. 5, p. 341.

[4] Albaihaqi, *Al-Sunan al-Kubra* 6:28.

[5] See *Radd-al-Muhtar* by Ibn 'Abidin v. 4, p. 57.

[6] Ibn 'Abidin, *Radd-ul-Muhtar* v. 5, p. 223.

[7] Ibid.

[8] Khalid al-Atasi, *Sharh-ul-Majallah*, v. 2, p. 403.

[9] Ibn 'Abidin, *Radd-ul-Muhtar*, v. 5, p. 225.

[10] Al-Fatawa al-Hindiyyah, *Waqf*, ch. 5, v. 2, p. 417.

Chapter 2

Fundamentals of Islamic finance

Aly Khorshid
Elite Horizon

Introduction

The term 'Islamic banking' refers to a system of banking or banking activity that is consistent with Islamic law (*Shari'a*) principles and guided by Islamic economics. In particular, Islamic law prohibits usury, the collection and payment of interest, also commonly called *riba* in Islamic discourse. In addition, Islamic law prohibits investing in businesses that are considered unlawful, or *haraam* (such as businesses that sell alcohol or pork, or businesses that produce media such as gossip columns or pornography, which are contrary to Islamic values). In the late twentieth century, a number of *Islamic banks* were created to cater for this particular banking market.

Usury

Usury means 'interest' or 'excessive interest'. The word means the charging of unreasonable or relatively high rates of interest.

Usury in Islam

The criticism of usury in Islam was well established during the Prophet Mohammed's life and reinforced by several of his teachings in the Holy *Qur'an* dating back to around 600 AD. The original word used for usury in this text was *riba*, which literally means 'excess' or 'addition'. This was accepted to refer directly to interest on loans so that, according to Islamic economists Choudhury and Malik (1992), by the time of Caliph Umar, the prohibition of interest was a well-established working principle integrated into the Islamic economic system. It is not true that this interpretation of usury has been universally accepted or applied in the Islamic world. Indeed, one school of Islamic thought which emerged in the nineteenth century, led by Sir Sayyed, still argues for an interpretative differentiation between usury, which it is claimed refers to consumptional lending, and interest which they say refers to lending for commercial investment (Ahmed, 1958). Nevertheless, there does seem to be evidence in modern times for what Choudhury and Malik describe as 'a gradual evolution of the institutions of interest-free financial enterprises across the world' (1992: 104). They cite, for instance, the current existence of financial institutions in Iran, Pakistan and Saudi Arabia, the Dar-al-Mal-al-Islami in Geneva and Islamic trust companies in North

America. This growing practice of Islamic banking will be discussed more fully in a later section as a modern application of usury prohibition.

Usury in the *Qur'an*

The following quotations are from the *Qur'an*:

> Those who charge usury are in the same position as those controlled by the devil's influence. This is because they claim that usury is the same as commerce. However, God permits commerce, and prohibits usury. Thus, whoever heeds this commandment from his Lord, and refrains from usury, he may keep his past earnings, and his judgment rests with God. As for those who persist in usury, they incur Hell, wherein they abide forever.
>
> (Al-Baqarah 2:275)

> God condemns usury, and blesses charities. God dislikes every disbeliever, guilty. Lo! those who believe and do good works and establish worship and pay the poor-due, their reward is with their Lord and there shall no fear come upon them neither shall they grieve. O you who believe, you shall observe God and refrain from all kinds of usury, if you are believers. If you do not, then expect a war from God and His messenger. But if you repent, you may keep your capitals, without inflicting injustice, or incurring injustice. If the debtor is unable to pay, wait for a better time. If you give up the loan as a charity, it would be better for you, if you only knew.
>
> (Al-Baqarah 2:276–280)

> O you who believe, you shall not take usury, compounded over and over. Observe God that you may succeed.
>
> (Al-'Imran 3:130)

> And for practicing usury, which was forbidden, and for consuming the people's money illicitly. We have prepared for the disbelievers among them painful retribution.
>
> (Al-Nisa 4:161)

> The usury that is practiced to increase some people's wealth, does not gain anything at God. But if people give to charity, seeking God's pleasure, these are the ones who receive their reward many fold.
>
> (Ar-Rum 30:39)

Usury in the *Sunnah 'Hadith'*

Riba is also mentioned in *hadith* and is considered one of the seven major sins: 'Jabir said that Allah's Messenger (may peace be upon him) cursed the accepter of usury and its payer,

and one who records it, and the two witnesses, and he said: They are all equal' (*Sahih Muslim*, Book 010, Number 3881).

It is reported on the authority of Abu Huraira that the Messenger of Allah (may peace be upon him) observed: Avoid the seven noxious things. It was said (by the hearers): What are they, Messenger of Allah? He (the Holy Prophet) replied: 'Associating anything with Allah, magic, killing of one whom God has declared inviolate without a just cause, consuming the property of an orphan, and consuming of usury, turning back when the army advances, and slandering chaste women who are believers, but unwary' (*Sahih Muslim*, Book 001, Number 0161).

Usury in Judaism

Criticism of usury in Judaism has its roots in several biblical passages in which the taking of interest is forbidden, discouraged or scorned. The Hebrew word for interest is *neshekh*, literally meaning 'a bite'. The prohibition is extended to include all money-lending, excluding only business dealings with foreigners. In the Levitical text, the words *tarbit* or *marbit* are also used to refer to the recovery of interest by the creditor.

The *Torah* (Hebrew Bible) regulates interest taking in that Israelites are forbidden to charge interest upon loans made to other Israelites, but allowed to charge interest on transactions with non-Israelites. However, the *Torah* itself gives numerous examples where this provision was evaded.

As local rulers, the Church and the society disliked the Jews. They were pushed from most professions into marginal occupations considered socially inferior, such as tax and rent collecting and money-lending. This made Jews appear to be disrespectful, greedy usurers. Natural tensions between creditors and debtors were added to social, political, religious and economic strains. Financial oppression of Jews tended to occur in areas where they were most disliked; and if Jews reacted by concentrating on money-lending to non-Jews, they were engaging in the one business where Christian laws actually discriminated in their favour, and so became identified with the hated trade of money-lending.

In other countries where other professions were open to them, such as Muslim Spain and the Ottoman Empire, Jews still engaged in money-lending with usury even before the fifteenth century. However, Jews' association with money-lending abated with the development of banking.

In 1275, King Edward I of England passed the Statute of Jewry that made usury illegal, and linked it to blasphemy, in order to seize the assets of the violators. Scores of English Jews were arrested, 300 were hanged and their property went to the Crown. In 1290, all Jews were expelled from England, and allowed to take only what they could carry; the rest of their property became the property of the Crown.

Usury in Christianity

The Christian Church's position on usury began with the First Council of Nicaea in the year 325, which forbade clergy from engaging in usury. Later ecumenical councils applied this regulation to any member of any religious faith. Lateran III decreed that persons who

accepted interest on loans could receive neither the sacraments nor a Christian burial. Pope Clement V condemned the practice of charging interest as ‘hateful to God and man, damned by the holy canons and contrary to Christian charity’.

The historical performance of usury as an evil enterprise stems not only from a spiritual view but also with social implications of perceived ‘unjust’ or ‘discriminatory’ practices. The Christians, on the basis of the Biblical rulings, condemned interest-taking absolutely, and from 1179 those who practised it were excommunicated.

Despite its Judaic roots, the critique of usury was most favourably taken up as a cause by the institutions of the Christian Church where the debate prevailed with great intensity for well over a thousand years. The Old Testament decrees were resurrected and a New Testament reference to usury added to fuel the case. Building on the authority of these texts, the Roman Catholic Church had, by the fourth century AD, prohibited the taking of interest by the clergy; a rule which they extended in the fifth century to the laity. In the eighth century under Charlemagne, they pressed further and declared usury to be a general criminal offence. This anti-usury movement continued to gain momentum during the early Middle Ages and perhaps reached its peak in 1311 when Pope Clement V made the ban on usury absolute and declared all secular legislation in its favour null and void. The rise of Protestantism and its pro-capitalism influence is also associated with this change. As a result of all these influences, sometime around 1620, according to the theologian Ruston, ‘usury passed from being an offence against public morality, which a Christian government was expected to suppress, to being a matter of private conscience and a new generation of Christian moralists redefined usury as excessive interest’.

This position has remained pervasive through to present-day thinking in the Church, as the indicative views of the Church of Scotland suggest when it declares in its study report on the ethics of investment and banking: ‘We accept that the practice of charging interest for business and personal loans is not, in itself, incompatible with Christian ethics. What is more difficult to determine is whether the interest rate charged is fair or excessive.’ Similarly, it is illustrative that, in contrast to the clear moral injunction against usury still expressed by the Church in Pope Leo XIII’s time as ‘voracious usury [. . .] an evil condemned frequently by the Church but nevertheless still practiced in deceptive ways by materialistic men’, Pope John Paul II’s 1989 *Sollicitude Rei Socialis* lacks any explicit mention of usury except the vaguest implication by way of acknowledging the Third World Debt crisis.

Usury in Hinduism and Buddhism

Hinduism and Buddhism have also been included in this chapter as they are holy religions. I have included their views because there are a large numbers of followers. References to usury in ancient Indian religions in which the ‘usurer’ (*kusidin*) are mentioned, occur several times and are interpreted as any lender at interest. It is during this latter period that the first sentiments of contempt for usury are expressed. For example, Vasishtha, a well-known Hindu law-maker of that time, made a special law which forbade the higher standing from being usurers or lenders at interest, and referred to those who practised it in a demeaning manner.

By the second century AD, however, usury had become a more relative term, as is implied in the *Laws of Manu* of that time: 'Stipulated interest beyond the legal rate being against the law, this dilution of the concept of usury seems to have continued through the remaining course of Indian history so that today, while it is still condemned in principle, usury refers only to interest charged above the prevailing socially accepted range and is no longer prohibited or controlled in any significant way.'

Usury in modern reformist thinking

Some may be surprised to discover that Adam Smith, despite his image as the 'Father of the free-market Capitalism' and his general advocacy of *laissez-faire* economics, came out strongly in support of controlling usury. While he opposed a complete prohibition of interest, he was in favour of the imposition of an interest rate ceiling. He felt it would ensure that low-risk borrowers who were likely to undertake socially beneficial investments were not deprived of funds as a result of 'the greater part of the money which was to be lent [being] lent to prodigals and projectors [investors in risky, speculative ventures], who alone would be willing to give [an unregulated] high interest rate'.

The economist John Maynard Keynes held a similar position, believing that 'the disquisitions of the schoolmen [on usury] were directed towards elucidation of a formula which should allow the schedule of the marginal efficiency to be high, whilst using rule and custom and the moral law to keep down the rate of interest, so that a wise Government is concerned to curb it by statute and custom and even by invoking the sanctions of the Moral Law'.

Another economic reformist Silvio Gesell condemned interest on the basis that sales were more often related to the 'price' of money (interest) than people's needs or the quality of products. His proposal of making money a public service, subject to a use, fee-, led to widespread experimentation in Austria, France, Germany, Spain, Switzerland and the United States, under the banner of the so-called 'stamp script movement', but these initiatives were all squashed when their success began to threaten the national banking monopolies. Margrit Kennedy, a German professor, posited that 'interest . . . acts like cancer in our social structure'. She took up the cause for 'interest and inflation-free money' by suggesting a modification of banking practice to incorporate a circulation fee on money, acting somewhat like a negative interest rate mechanism.

In another school of modern interest, critics' chief common premise was that it is completely wrong and unacceptable for commercial banks to hold a monopoly on the money or credit creation process. For banks to then charge interest (including to government) on money that they had in the first place created out of nothing, having suffered no opportunity cost or sacrifice, amounted to nothing less than immoral and fraudulent practice.

Usury and the law

'When money is lent on a contract to receive not only the principal sum again, but also an increase by way of compensation for the use, the increase is called interest by those who think it lawful, and usury by those who do not.'

In the US, usury laws are state laws that specify the maximum legal interest rate at which loans can be made. Congress has opted not to regulate interest rates on purely private transactions, but has opted to put a federal criminal limit on interest rates by the RICO (Racketeer Influenced and Corrupt Organizations Act) definitions of 'unlawful debt' which make it a federal felony to lend money at an interest rate more than two times the local state usury rate, and then to try to collect that 'unlawful debt'.

It is a federal offence to use violence or threats to collect usurious interest (or any other sort). Such activity is referred to as loan sharking, although that term is also applied to non-coercive usurious lending, or even to the practice of making consumer loans without a license in jurisdictions that require licenses.

Modern Islamic banking

The first modern experiment with Islamic banking was undertaken in Egypt. This pioneering effort, led by Ahmad El Najjar, took the form of a savings bank based on profit-sharing in the Egyptian town of Mit Ghamr in 1963 and was known as 'Nasser bank'. By 1967, there were nine banks in the country.

The Islamic bank has the same purpose as conventional banking except that it operates in accordance with the rules of *Shari'a*, known as *fiqh al-muamalat* (Islamic rules on transactions). The basic principle of Islamic banking is the sharing of profit and loss and the prohibition of *riba* (usury). Amongst the common Islamic concepts used in Islamic banking are profit sharing (*mudarabah*), safekeeping (*wadiah*), joint venture (*musharakah*), cost plus (*murabahah*), and leasing (*ijarah*).

In an Islamic mortgage transaction, instead of loaning the buyer money to purchase the item, a bank might buy the item itself from the seller, and re-sell it to the buyer at a profit, while allowing the buyer to pay the bank by installments. However, the fact that it is profit cannot be made explicit and therefore there are no additional penalties for late payment.

In order to protect itself against default, the bank asks for strict collateral. The goods or land is registered to the name of the buyer from the start of the transaction. This arrangement is called *murabahahh*. Another approach is *eijara wa eiqtina*, which is similar to real estate leasing.

There are several other approaches used in business deals. Islamic banks lend their money to companies by issuing floating rate interest loans. The floating rate of interest is pegged to the company's individual rate of return. Thus, the bank's profit on the loan is equal to a certain percentage of the company's profits. Once the principal amount of the loan is repaid, the profit-sharing arrangement is concluded. This practice is called *musharakah*. Further, *mudarabah* is venture capital funding of an entrepreneur who provides labour while the bank provides financing so that both profit and risk are shared. Such participatory arrangements between capital and labour reflect the Islamic view that the borrower must not bear all the risk/cost of a failure, resulting in both a balanced distribution of income and to prevent the lender monopolizing the economy.

Islamic banking is restricted to deals acceptable to Islam, which exclude those involving alcohol, pork, gambling, and so on. Thus ethical investing is the only acceptable form of investment, and moral purchasing is encouraged. Islamic banking is an example of full-reserve banking, with banks achieving a 100% reserve ratio.

Islamic banks have grown recently in the Muslim world but are a very small share of the global banking system. Micro-lending institutions founded by Muslims, notably Grameen Bank (see below), use conventional lending practices and are popular in some Muslim nations, especially Bangladesh, but some do not consider them true Islamic banking. However, Muhammad Yunus, the founder of Grameen Bank and microfinance banking, and other supporters of microfinance, argue that the lack of collateral or excessive interest in micro-lending is consistent with the Islamic prohibition of usury.

Grameen Bank

Founded in 1983 by Dr Mohammed Yunus as a corporate bank in Bangladesh, Grameem is a microfinance organization and community development bank that makes small loans without requiring collateral. The system of this bank is based on the idea that the poor have skills that are under-utilized. A group-based credit approach is applied which utilizes the peer-pressure within the group to ensure the borrowers follow credit discipline. The bank also accepts deposits, provides other services and runs several development-oriented businesses including fabric, telephone and energy companies. Another distinctive feature of the bank's credit programme is that a significant majority of its borrowers are women. In October 1983, the Grameen Bank Project was transformed into an independent bank by government legislation. The organization and its founder, Muhammad Yunus, were jointly awarded the Nobel Peace Prize in 2006.

Shari'a Advisory Council/Consultant

Islamic banks and banking institutions that offer Islamic banking products and services (IBS banks) are required to establish *Shari'a* advisory committees/consultants to advise them and to ensure that the operations and activities of the bank comply with *Shari'a* principles.

Investment principles

Bai' al-Inah (sale and buy-back agreement)

The financier sells an asset to the customer on a deferred-payment basis, and then the financier, for cash at a discount, immediately repurchases the asset. The buying back agreement allows the bank to assume ownership over the asset in order to protect against default, without explicitly charging interest, in the event of late payments or insolvency.

Bai' Bithaman Ajil (deferred payment sale)

This concept refers to the sale of goods on a deferred payment basis at a price, which includes a profit margin, agreed to by both parties. This is similar to *murabahah*, except that the debtor makes only one single installment on the maturity date of the loan. By the application of a discount rate, an Islamic bank can collect the market rate of interest.

Bai mu'ajjal (credit sale)

Literally, *Bai mu'ajjal* means a credit sale. Technically, it is a financing technique adopted by Islamic banks that takes the form of *murabahah mu'ajjal*. It is a contract in which the bank earns a profit margin on the purchase price, and allows the buyer to pay the price of the commodity at a future date, in a lump sum or in installments. It has to expressly mention the cost of the commodity, and the margin of profit is mutually agreed. The price fixed for the commodity in such a transaction can be the same as the spot price or higher or lower than the spot price.

Bai Salaam

Bai Salaam means a contract in which advance payment is made for goods to be delivered at a later date. The seller undertakes to supply some specific goods to the buyer at a future date, in exchange of an advance price, fully paid at the time of contract. It is necessary that the quality of the commodity intended to be purchased is fully specified leaving no ambiguity leading to dispute. The objects of this sale are goods and cannot be gold, silver or currencies. Apart from this, *Bai Salaam* covers almost everything that is capable of being definitely described as to quantity, quality, and workmanship.

Basic features and conditions of *Salaam*

- First of all, it is necessary for the validity of *salaam* that the buyer pays the price in full to the seller at the time of effecting the sale. This is necessary because, in the absence of full payment by the buyer, it will be tantamount to sale of a debt against a debt, which is prohibited, as the basic wisdom behind the permissibility of *salaam* is to fulfil the instant needs of the seller. If the price is not paid to him in full, the basic purpose of the transaction will be defeated. Therefore, Muslim jurists are unanimous on the point that full payment of the price is necessary in *salaam*. However, Imam Malik is of the view that the seller may give a concession of two or three days to the buyers, but this concession should not form part of the agreement.
- *Salaam* can be effected only in those commodities where the quality and quantity can be specified exactly. The things whose quality or quantity is not determined by specification cannot be sold through the contract of *salaam*. For example, precious stones cannot be sold on the basis of *salaam*, because every piece of precious stone is different from the others, either in its quality, size or weight and their exact specification is not generally possible.
- *Salaam* cannot be effected on a particular commodity or on a product of a particular field or farm. For example, if the seller undertakes to supply the wheat of a particular field, or the fruit of a particular tree, the *salaam* will not be valid, because there is a possibility that the crop of that particular field or the fruit of that tree is destroyed before delivery and, given such possibility, the delivery remains uncertain. The same rule is applicable to every commodity whose supply is not certain.

- It is necessary that the quality of the commodity (intended to be purchased through *salaam*) is fully specified leaving no ambiguity which may lead to a dispute. All possible details in this respect must be expressly mentioned.
- It is also necessary that the quantity of the commodity is agreed upon in unequivocal terms. If the commodity is quantified in weights according to the usage of its traders, its weight must be determined, and if it is quantified through measures, its exact measure should be known. What is normally weighed cannot be quantified in measures and vice versa.
- The exact date and place of delivery must be specified in the contract.
- *Salaam* cannot be effected in respect of things which must be delivered at spot. For example, if gold is purchased in exchange of silver, it is necessary, according to *Shariah*, that the delivery of both be simultaneous. Here, *salaam* cannot work. Similarly, if wheat is bartered for barley, the simultaneous delivery of both is necessary for the validity of sale. Therefore, the contract of *salaam* in this case is not allowed.

Hibah (gift)

This is a token given voluntarily by a creditor to a debtor in return for a loan. *Hibah* usually arises in practice when Islamic banks involuntarily pay their customers interest on savings account balances.

Ijarah

Ijarah means lease, rent or wage. Generally, the *ijarah* concept means selling benefit or use or service for a fixed price or wage. Under this concept, the bank makes available to the customer, the use or service of assets/equipments such as plant, offices or motor vehicles for a fixed period and price. Advantages of *Ijarah*:

- *Ijarah* conserves capital as it may provide 100% financing.
- *Ijarah* enables the lessee to have the use of the equipment on payment of the first rent, which is important as it is the use (and not ownership) of the equipment that generates income.
- *Ijarah* arrangements are flexible because the terms and rental provision may be tailored to suit the needs of the lessee. Therefore, it helps corporate planning and budgeting.
- *Ijarah* is not borrowing and therefore not required to be disclosed as a liability in the balance sheet of the lessee. Being ‘off-balance-sheet’ financing, it is not included in the computation of gearing ratios imposed by bankers.
- The borrowing capacity of the lessee is therefore not impaired when leasing is resorted to as a mean of financing.
- All payments of rent are treated as payment of operating expenses and are therefore fully tax-deductible. Leasing therefore offers tax advantages to profit-making concerns.
- There are many types of equipment that become obsolete before the end of their actual economic life. This is particularly true in high technology equipment such as computers.

A lessee may be willing to pay the said premium as an insurance against obsolescence. The risk is passed onto the lessor who will undoubtedly charge a premium into the lease rate to compensate for the risk.
- If the equipment use is for a relatively short period of time, it may be more profitable to lease than to buy.
- If the equipment is for use over a short duration and the equipment has a very poor second hand (resale) value, leasing would be the best method for acquisition.

Ijarah Thumma Al Bai' (hire purchase)

These are variations on a theme of purchase and lease back transactions. There are two contracts involved in this concept. The first contract, an *ijarah* contract (leasing/renting), and the second contract, a *bai* contract (purchase) are undertaken one after the other. For example, in a car financing facility, a customer enters into the first contract and leases the car from the owner (bank) at an agreed rent over a specific period. When the lease period expires, the second contract comes into effect, which enables the customer to purchase the car at an agreed price.

In effect, the bank sells the product to the debtor at an above market-price profit margin in return for agreeing to receive the payment over a period of time; the profit margin on the lease is equivalent to interest earned at a fixed rate of return.

This type of transaction is particularly suggestive of an open contract, a complicated legal trick used by European bankers and merchants during the Middle Ages, which involved combining three individual legal contracts in order to produce a transaction of an interest bearing loan (something that the Church made illegal). The combination of different contracts is also prohibited according to *Shari'a*.

Ijarah-wa iqtina

This is a contract under which an Islamic bank provides equipment, buildings or other assets to the client against an agreed rent, together with a unilateral undertaking by the bank or the client whereby at the end of the lease period, the ownership of the asset would be transferred to the lessee. The undertaking or the promise does not become an integral part of the lease contract to make it conditional. The rent, as well as the purchase price, are fixed in such manner that the bank gets back its principal sum along with profit over the period of the lease.

Mudarabah (profit sharing)

Mudarabah is an arrangement or agreement between the bank or a capital provider and an entrepreneur, whereby the entrepreneur can mobilize the funds of the former for its business activity. The entrepreneur provides expertise, labour and management. Profits made are shared between the bank and the entrepreneur according to a predetermined ratio. In case of loss, the bank loses the capital, while the entrepreneur loses his provision of labour. It is this financial risk, according to the *Shari'a*, that justifies the bank's claim to part of

the profit. The profit sharing continues until the loan is repaid. The bank is compensated for the time value of its money in the form of a floating interest rate that is pegged to the debtor's profits.

Murabahah (cost-plus)

This concept refers to the sale of goods at a price, which includes a profit margin agreed by both parties. The purchase and selling price, other costs and the profit margin must be clearly stated at the time of the sale agreement. The bank is compensated for the time value of its money in the form of the profit margin. This is a fixed-income loan for the purchase of a real asset (such as real estate or a vehicle), with a fixed rate of profit determined by the profit margin. The bank is not compensated for the time value of money outside the contracted term (so the bank cannot charge additional profit on late payments); however, the asset remains as a mortgage with the bank until the *murabahah* is paid in full.

Musawamah

Musawamah is a general and regular kind of sale in which the price of the commodity to be traded is bargained between the seller and the buyer without any reference to the price paid or cost incurred by the former. Thus, it is different from a *murabahah* in respect of pricing formula. Unlike a *murabahah*, however, the seller in a *musawamah* is not obliged to reveal his cost. Both parties negotiate on the price. All other conditions relevant to a *murabahah* are valid for a *musawamah* as well. A *musawamah* can be used where the seller is not in a position to determine precisely the costs of commodities that he is offering to sell.

Musharaka (joint venture)

Musharakah is a relationship between two parties, both of whom contribute capital to a business, and divide the net profit and loss pro rata. This is often used in investment projects, letters of credit and the purchase of real estate or property. In the case of real estate or property, the bank assesses an imputed rent and will share it as agreed in advance. All providers of capital are entitled to participate in management, but are not necessarily required to do so. The profit is distributed among the partners in pre-agreed ratios, while the loss is borne by each partner strictly in proportion to their respective capital contributions. This concept is distinct from fixed-income investing.

Qard hassan (interest-free loan)

This is a loan extended on a goodwill basis, and the debtor is only required to repay the amount borrowed. However, the debtor may, at his or her discretion, pay an extra amount beyond the principal amount of the loan (without promising it) as a token of appreciation

to the creditor. In the case that the debtor does not pay an extra amount to the creditor, this transaction is a true interest-free loan. Some Muslims consider this to be the only type of loan that does not violate the prohibition on *riba*, since it is the one type of loan that truly does not compensate the creditor for the time value of money.

Sukuk (Islamic bonds)

Sukuk is the (plural) Arabic name for financial certificates but can be seen as an Islamic equivalent of a bond. However, fixed-income, interest-bearing bonds are not permissible in Islam. Hence, *sukuk* are securities that comply with the Islamic law and its investment principles. Financial assets that comply with Islamic law can be classified in accordance with their tradability and non-tradability in the secondary markets.

Conservative estimates suggest that over $500 billion of assets are managed according to Islamic investment principles. Such principles form part of *Shari'a*, which is often understood to be Islamic law, but it is actually broader than this, in that it also encompasses the general body of spiritual and moral obligations and duties in Islam.

Takaful (Islamic insurance)

Takaful is an alternative form of cover with which a Muslim can avail himself against the risk of loss due to misfortunes. *Takaful* is based on the idea that what is uncertain with respect to an individual may cease to be uncertain with respect to a very large number of similar individuals. Insurance by combining the risks of many people enables each individual to enjoy the advantage provided by the law of large numbers.

In modern business, one of the ways to reduce the risk of loss due to misfortunes is through insurance that spreads the risk among many people. The concept of insurance where resources are pooled to help the needy does not contradict *Shari'a*. However, conventional insurance involves the elements of uncertainty (*al-gharar*) in the contract of insurance, gambling (*al-maisir*) as the consequences of the presence of uncertainty and interest (*al-riba*) in the investment activities of the conventional insurance companies that contravene the rules of *Shari'a*. It is generally accepted by Muslim jurists that the operation of conventional insurance does not conform to the rules and requirements of *Shari'a*.

Wadiah (safekeeping)

In *wadiah*, a bank is deemed as a keeper and trustee of funds. A person deposits funds in the bank and the bank guarantees refund of the entire amount of the deposit, or any part of the outstanding amount, when the depositor demands it. The depositor, at the bank's discretion, may be rewarded with a *hibah* (gift) as a form of appreciation for the use of funds by the bank. In this case, the bank compensates depositors for the time-value of their money (meaning that it pays interest) but refers to it as a gift because it does not officially guarantee payment of the gift.

Wakalah (agency)

This occurs when a person appoints a representative to undertake transactions on his/her behalf, similar to a power of attorney.

Islamic equity funds

The Islamic investment equity funds market is one of the fastest-growing sectors within the Islamic financial system. Currently, there are approximately 100 Islamic equity funds worldwide. The total assets managed through these funds currently exceed $5 billion and this figure is growing by 12–15% per annum. With growing awareness of the Islamic financial system, there are positive signs that more funds will be launched. Some major Western players have just joined the fray or are thinking of launching similar Islamic equity products.

Despite these successes, this market has seen a record of poor marketing as emphasis is on products and not on addressing the needs of investors. Over the last few years, quite a number of funds have closed down. Most of the funds tend to target high net worth individuals and corporate institutions, with minimum investments ranging from $50,000 to as high as $1 million. Target markets for Islamic funds vary; some cater for their local markets, such as Malaysia and Gulf-based investment funds. Others clearly target the Middle East and Gulf regions, neglecting local markets and many of these have been accused of failing to serve Muslim communities.

Since the launch of Islamic equity funds in the early 1990s, there has been the establishment of credible equity benchmarks by the Dow Jones Islamic market index and the FTSE Global Islamic Index Series. The website failaka.com monitors the performance of Islamic equity funds and provides a comprehensive list of the Islamic funds worldwide.

Islamic schools of thought

Shi'a

Shi'a Islam has its own school of law: Ja'far as-Sadiq, believed by Shi'a to be the sixth infallible Imam. He is highly regarded for his work in education, tutoring such people as Abu Hanifa and Malik Ibn Anas. Throughout his life, al-Sadiq lived and taught in Medina.

Sunni

There are four main schools of *Sunni* jurisprudence today, named after their founders. These are not generally seen as distinct sects as there has been harmony, for the most part, among their various scholars throughout Islamic history.

The *Hanafi Madhhab*

Imam Abu Hanifa, who was the 'founder' of the Hanafi school, lived in what is now Iraq, not long after the prophet Muhammad's death. It is reported that Imam Abu Hanifa studied under many teachers. He also met the 'companion' (*sahabi*) Anas Ibn Malik, making

Imam Abu Hanifa one of the followers or second generation in oral transmission from Muhammad.

The *Maliki Madhhab*

Imam Malik was born shortly after Imam Abu Hanifa in Medina. There are reports that they lived at the same time and, although Malik was much younger, their mutual respect is well-known. In fact, one of Abu Haifa's main students, on whose teaching much of the *Hanafi* school is based, studied under Imam Malik as well.

The *Shafi'i Madhhab*

Both Abu Haifa's students and Imam Malik also taught *Imam Shafi'i*, and his respect for both men is also well documented.

The *Hanbali Madhhab*

Imam Ahmad Ibn Hanbal studied under Imam Shafi'i, and consequently there are many similarities between the two *Madhhab*.

'Correct guidance'

The majority of *Sunni* Muslims believe that all four schools have 'correct guidance', and the differences between them lie not in the fundamentals of faith, but in finer judgments and jurisprudence, which are a result of the independent reasoning of the imams and the scholars who followed them. Because their individual methodologies of interpretation and extraction from the primary sources (*usul*) were different, they came to different judgments on particular matters. For example, there are subtle differences in the methods of prayer among the four schools, yet the differences are not so great as to require separate prayers by the followers of each school. In fact, a follower of any school can usually pray behind an imam of another school without any confusion.

Generally, *Sunni* Muslims prefer one *Madhhab* out of the four (normally a regional preference). Some, however, reject all four schools. Others (most notably the *Salafi*) accept the four *Madhhab* as legitimate, but also believe that *ijtihad* must be exercised by the contemporary scholars capable of doing so. Others insist on *taqlid*, or acceptance of religious rulings on matters of worship and personal affairs from a higher religious authority without necessarily asking for the technical proof as a requirement. This practice is very common among *Sufi*s, who follow an Islamic mystical order, *tariqah*.

Also, it should be noted that experts/scholars of *fiqh* follow the *usul* (principles) of their own native *Madhhab*, but they also study the *usul*, evidences and opinions of other *Madhhab*.

Islamic laws on trading

The *Qur'an* prohibits gambling (games of chance involving money). The *hadith*, in addition to prohibiting gambling, also prohibits *bayu al-gharar* (trading in risk, where the Arabic word *gharar* is taken to mean 'risk').

The *Hanafi Madhhab* legal school in Islam defines *gharar* as 'that whose consequences are hidden'. The *Shafi* legal school defined *gharar* as 'that whose nature and consequences are hidden' or 'that which admits two possibilities, with the less desirable one being more likely'. The *Hanbali* school defined it as 'that whose consequences are unknown' or 'that which is undeliverable, whether it exists or not'. Ibn Hazm of the *Zahiri* school wrote, '*Gharar* is where the buyer does not know what he bought, or the seller does not know what he sold.' A modern scholar of Islam wrote that 'Gharar is the sale of probable items whose existence or characteristics are not certain due to the risky nature that makes the trade similar to gambling'. There are a number of *hadith* who forbid trading in *gharar*, often giving specific examples of *gharar* transactions (for example, selling the birds in the sky or the fish in the water, the catch of the diver, an unborn calf in its mother's womb et cetera). Jurists have sought many complete definitions of the term. They also came up with the concept of *yasir* (minor risk); a financial transaction with a minor risk is deemed to be *halal* (permissible) while trading in non-minor risk (*bayu al-gharar*) is deemed to be *haram*.

What *gharar* is, exactly, has never fully been decided upon by Muslim jurists. This has mainly been due to the complication of having to decide what is and is not a minor risk. Derivatives instruments (such as stock options) have only become common relatively recently. Some Islamic banks do provide brokerage services for stock trading and perhaps even for derivatives trading.

Chapter 3

Shari'a standard asset wealth management and will-writing (*wasiyah*) mechanisms

Mohammed Ma'sum Billah

Introduction

Islamic asset management provides *Shari'a*-compliant investment structures through Islamic financial instruments and Islamic funds; this involves the innovative approaches taken by banks, asset managers, *Shari'a* scholars, service partners and distribution partners. Many business activities such as advising, retail, high net worth, corporate or sovereign investments, equity investments, *sukuk*, real estate investments, *Takaful* and alternative investment vehicles can be handled within the Islamic framework, which in turn is based on Islamic asset management.

Managing assets in an Islamic manner is certain to avoid interest-based activities and ensure avoidance of *riba*. This is in accordance with the Islamic business dealing principles that are based on the primary sources of *Al-Qur'an*,[1] followed by the *Sunnah*.[2] As the *Qur'an* says:

> Verily, We have sent down to you (O Muhammad SAW) the Book (this Qur'an) for mankind in truth. So whosoever accepts the guidance, it is only for his oneself, and whosoever goes astray, he goes astray only for his (own) loss. And you (O Muhammad SAW) are not a Wakîl (trustee or disposer of affairs, or keeper) over them.
>
> (Surah Al-Zumar: Ayah 41)[3]

In addition, this chapter will draw attention to some of the widely exercised Islamic instruments in managing assets, with the effective example of the related established organizations throughout the world, using those instruments efficiently in their daily business activities.

Components of Islamic asset management

Islamic financial instruments

Islamic asset management deals with the concept of Islamic financing. The concept involves the Islamic financial instruments such as cost-plus financing (*murabahahh*), profit-sharing (*mudarabahh*), leasing (*ijara*), partnership (*musharaka*) and forward sale (*bay' salaam*). These

instruments act efficiently as a means of Islamic asset management and serve as the basic building blocks for developing a wide array of more complex financial instruments, suggesting that there is great potential for financial innovation and expansion in Islamic financial markets. The explanation of those mentioned financial instruments are as follows.

- Trade with markup or cost-plus sale (*murabahah*) is one of the most widely used instruments for short-term financing. About 75 per cent of Islamic financial transactions are considered cost-plus sales. It is based on the traditional notion of purchase finance. In this transaction the seller informs the buyer of his cost of acquiring or producing the product and then a margin or a mark-up is negotiated between the buyer and the seller.[4]
- Leasing (*ijara*) is another popular instrument and accounts for about 10 per cent of Islamic financial transactions. It is designed for financing vehicles, machinery, equipment and aircraft. Different forms of leasing are permissible, including leases where a portion of the installment payment goes towards the final purchase (with the transfer of ownership to the lessee).
- The profit-sharing agreement (*mudarabah*) is a unique form of a joint venture capital transaction. Here, an entity contributes all the capital and the other party contributes the expertise and/or labour. In return, both parties agree to share any realized profits. The owner of the capital assumes any potential losses as part of the risk. Hence, it is suitable for trade activities as its maturity structure ranges from short- to medium-term.[5]
- Equity participation (*musharaka*) is similar to a classical joint venture. Both entrepreneur and investor contribute to the capital (assets, technical and managerial expertise, working capital and so on) of the operation in varying degrees and agree to share the returns, as well as the risks, in proportions agreed in advance. Traditionally, this form of transaction has been used for financing fixed assets and working capital of medium- and long-term duration.
- Sales contracts, or deferred-payment sales (*bay' mu'ajjal*) and deferred-delivery sales (*bay' salaam*) contracts, in addition to spot sales, are used for conducting credit sales. In a deferred-payment sale, delivery of the product is taken on the spot but delivery of the payment is delayed for an agreed period. Payment can be made in a lump sum or installments.

These are non-interest-bearing loans which the *Qur'an* exhorts Muslims to make available to those who need them. If there is the existence of interest (*riba*) in any transaction, Allah will certainly punish those people involved in the hereafter.[6]

As the *Qur'an* says,

> Allah hath blighted *riba* (usury) and made almsgiving fruitful. Allah loveth not the impious and guilty.
>
> (Surah Al-Baqarah: Ayah 276)[7]

> And of their taking riba (usury) when they were forbidden it, and of their devouring people's wealth by false pretences, we have prepared for those of them who disbelieve a painful doom.
>
> (Surah Al-Imran: Ayah 130)[8]

In addition, a deferred-delivery sale is similar to a forward contract where delivery of the product is in the future used in exchange for payment on the spot market.

Islamic funds

Islamic funds represent the initial application of securitization. The main purpose of securitization is to contribute higher liquidity-enhancing instruments in order to promote a large segment of potential investors. There are three types of Islamic funds: equity, commodity and leasing.

- Equity funds, which make up the majority of the Islamic funds market, are the same as conventional mutual funds but with an Islamic touch that requires a unique 'filtration' process to select appropriate shares. This ensures that the mode, operation and capital structure of each business the fund invests in are compatible with Islamic law, thus eliminating companies engaged in prohibited activities and those whose capital structure relies heavily on debt financing (to avoid dealing with interest). For this reason, companies with a negligible level of debt financing (10 per cent or less) may be selected, provided that the debt does not remain a permanent feature of the capital structure. The future of Islamic equity funds is bright because of a new wave of privatization in Muslim countries such as Egypt and Jordan, and in high-growth Islamic countries such as Indonesia and Malaysia.
- Commodity and leasing funds are other forms of Islamic funds. Commodity funds invest in base metals. Leasing funds pool auto, equipment, and aircraft leases and issue tradable certificates backed by the leases.

Objectives and purposes of Islamic asset management

The objectives and purposes of Islamic asset management are as follows:

- The need for fostering the wellbeing of the people of Muslim countries on the basis of Islamic principles and ideals and a practical expression of the unity and solidarity of the Muslim *ummah*.
- The need for mutual financial and economic co-operation among Muslim countries in economic, social and other fields of activity.
- The need for mobilizing financial and other resources from within and outside the countries, for promoting domestic savings and investment and a greater flow of development funds.
- To foster economic development and social progress of Muslim communities individually as well as jointly in accordance with the principles of *Shari'a.*
- To establish and operate special funds for specific purposes including a fund for assistance to Muslim communities.
- To operate trust funds.[9]

Bai' al inah

Bai' al inah refers to trading when a seller sells an asset to a buyer for a deferred price. The buyer then sells back the asset for a cash price.[10] This type of trading takes two forms.

- The seller sells to the buyer at a higher price to be paid later. After delivery to the buyer, the seller buys in cash at a much lower price.
- A third party is involved whereby the seller sells a product that is delivered later. For example, the seller sells the product for, RM200. After delivering it to the buyer, he sells it to the third party for a lower price, RM100. The latter then resells it to the first party (the original owner) for RM100. This means the original owner obtained RM100 from the trade.[11]

Arguments supporting the permissibility of *Bai' al inah*

Opinions of past Islamic jurists

Past Islamic jurists had differing views on determining the *hukm* (ruling) of *Bai' al inah*.

- The majority, *Hanafi*, *Maliki* and *Hanbali maz'hab* (cult) were of the opinion that *bai' al inah* was not permissible because it was a legal excuse to legitimize *riba* (usury).
- The *Hanafi maz'hab* (cult) was of the opinion that *bai' al inah* was permissible only if it involved a third party, who acted as an intermediary between the seller (creditor) and the buyer (debtor).
- The *Maliki* and *Hanbali maz'hab*, on the other hand, rejected *Bai' al inah* and considered it invalid. Their opinion was based on preventing practices that could lead to forbidden acts, in this case, *riba*.
- The basis for the opinion of the majority of Islamic jurists was the Hadith dialogue between Aishah (Prophet Muhammad's wife) and Zaid Al-Arqam, which explain the prohibition of *Bai' al inah*. They also held to the Prophet Muhammad (SAW) when he warned that those who practised *Bai' al inah* would suffer scorn.
- The *Shafie* and *Zahiri maz'hab* viewed *bai' al Inah* as permissible. A contract was valued by what is disclosed and one's intention was up to Allah to judge. They criticized the fact that the *Hadith* was used by the majority of Islamic jurists as the basis for their argument, saying that the *Hadith* was weak and therefore cannot be used.

Bai' ad dayn

Bai' ad dayn is the principle of selling the *dayn* (which encompasses a wide scope, for example a payment for a product, *qardh* (loan)) which results from the exchange contract such as *murabahah*, *bai' ajil*, *ijara*, *istisna'* and others.

Arguments that support the permissibility of *bai' ad dayn*

This principle is an issue that has always been an argument among past and present Islamic jurists. However, there is no general consensus among those who forbid it.[12] Islamic jurists are just short of being unanimous in allowing the selling of debts to the debtor.[13]

Opinions of past Islamic jurists

The *Hanafi maz'hab* looked at *bai' dayn* from the aspect of potential risks to the buyer and the debtor and the nature of the debt itself. They were unanimous in not permitting this instrument because the risk cannot be overcome in the context of debt selling. The debt is in the form of an intangible asset and the buyer takes on a great risk because he cannot own the item bought and the seller cannot deliver the item sold. The *Maliki maz'hab* had allowed debt selling to a third party, subject to certain conditions, to facilitate the use of this principle in the market. The conditions are as follows.

- Expedite the payment of the purchase.
- The debtor should be present at the place of sale.
- The debtor belongs to the group that is bound by law so that he is able to redeem his debt.
- Payment is not of the same type as *dayn*, and if it is so, the rate should be the same to avoid *riba*.
- The debt cannot be created from the sale of currency (gold and silver) to be delivered in the future.
- The *dayn* should not cause enmity between buyer and seller, which can create difficulties to the debtor.

The conditions set by *Maliki maz'hab* were threefold:[14]

- to protect the rights of the debt buyer.
- to avoid debt selling before receiving payment; and
- to avoid *riba*.

The *Shafie maz'hab* was of the opinion that selling the debt to a third party was allowed if the *dayn* was guaranteed[15] and was sold in exchange for goods that must be delivered immediately. When the debt was sold, it should be paid for by cash or tangible asset as agreed.

The Islamic will (*wasiyah*) and its writing mechanisms in wealth and asset management

Because Islam is a comprehensive religion and the only religion accepted by Allah, it provides guidelines to all fields of human activities, be they spiritual, material, social, political or economic. Therefore, Islam must also provide rules on the distribution of wealth.

Wills have been used since the Roman Empire, when only the head of a clan had the right to make one and he gave only to the people he wanted to give to, which oppressed other people who deserved it. In pre-Islamic days, males were the only rightful people to inherit wealth, females were denied this right. Therefore, Islam has laid down rules to regulate the distribution of wealth among family members, ensuring all in the family get their rightful share of inheritance, thus eliminating family disputes.

There are two types of wealth distribution. The first is to follow the *Faraid* (guidelines from the *Shari'a* inheritance system) and the second is by making a will, or *Wasiyah*, according to the *Shari'a* principle. The author has attempted to highlight the *wasiyah* distribution according to *Shari'a* principles and conditions of *wasiyah,* as was laid down in the Holy *Qur'an* and the *Sunnah* of the Prophet Muhammad, and it also includes the views of Islamic scholars. The author does not, however, attempt to make this a comprehensive research on the topic of *wasiyah*, which has been debated among Muslim scholars.

The meaning of *wasiyah*

A will or inheritance, according to the Oxford English Dictionary, is defined as the power by which one decides what to do; will-power; fixed desire or intention; arbitrary discretion; disposition towards others; usually written directions in legal form for disposition of one's property after death. Nearly everyone has heard of wills, where the main function is to divide the deceased's property between family members, but not many actually perform the task. It may be a lack of understanding regarding the importance of preparing the will or for some a failure to admit that death draws closer.

The Arabic word for will is *wasiyah* from the root word of *al-isha*, literally 'an agreement to others to execute an order or give ownership to others before or after the death'. There are two types of *wasiyah*: *mutlaqah* and *moqayyadah*. *Wasiyah mutlaqah* is a will without condition, for example where a person makes a *wasiyah* of his property to another person: 'I leave this house for you.' *Wasiyah moqayyadah* is a will with conditions, for example: 'I leave this house for you if I die on my journey to Mecca.'[16] Technically, *wasiyah* means the act of conferring a legal right in the usufruct of a thing after death.

There are different opinions among the scholars. For *Hanafi* schools, *wasiyah* is a gift from the testator to the beneficiaries upon his death. *Maliki* schools viewed *wasiyah* as compelling one-third of the testator's wealth to be distributed to others upon his death or through his agents. As for *Shafie* schools, *wasiyah* is a gift given voluntarily by the testator upon his death even though the testator does not mention when the *wasiyah* will execute, for example 'I leave this house to you' without stipulating that it is upon his death. *Hanbali* schools viewed a *wasiyah* as an order that should be fulfilled upon the testator's death, for example if a testator has ordered a person to take care of his child or his inheritance and his property to another person.[17]

According to *Hanafi* schools, there are two ingredients of *wasiyah*. One is the disposition by the testator and the second is its acceptance by the beneficiaries. This will only arise after the death of the testator. However, some jurists do not view acceptance as a vital ingredient for a *wasiyah* to come into effect upon the death of the testator. Islamic law does not emphasize that a will should be in writing or in any particular form of oral declaration to create a *wasiyah*. Even though writing a will is optional to Muslims, Islam encourages its followers to prepare a will in writing to ensure equitable disposal of wealth to avoid unforeseen hardships to the family members and to ease unnecessary problems for administrators.

A letter written by the testator comprising instructions as to disposition or distribution of his property to take effect after his death has been held to constitute a valid will. A will can be made when a person cannot speak because of illness, but can express his *wasiyah* by signs.

A bequest can only be extended to a third party of the testator's property but not to any further extent. In a *Hadith* narrated by Ibn 'Abbas, the Prophet Muhammad said:

> I recommend that people reduce the proportion of what they bequeath by will to the fourth (of the whole legacy), for Allah's Apostle said, 'One-third, yet even one-third is too much.'
>
> (Sahih Bukhari)

Wills in the *Qur'an* and as *Sunnah*

Wasiyah has derived its sanction and authority from the several ayahs (verses) in the Holy *Qur'an* and it is highly recommended as perceived from the sayings of Prophet Muhammad:

> It is prescribed, when death approaches any of you, if he leave any goods, that he make a bequest to parents and next of kin, according to reasonable usage; this is due from the God-fearing.
>
> (Al-Baqarah: 180)

> O ye who believe! When death approaches any of you, (take) witnesses among yourselves when making bequests, two just men of your own (brotherhood) or others from outside if ye are journeying through the earth and the chance of death befalls you (thus). If ye doubt (their truth), detain them both after prayer, and let them both swear by Allah: "We wish not in this for any worldly gain, even though the (beneficiary) be our near relation: we shall hide not the evidence before Allah: if we do, then behold! The sin be upon us."
>
> (Al-Maaidah: 106)

> Those of you who die and leave widows should bequeath for their widows a year's maintenance and residence; but if they leave (the residence), there is no blame on you for what they do with themselves, provided it is reasonable. And Allah is Exalted in Power, Wise.
>
> (Al-Baqarah: 240)

> It is not proper for a Muslim to pass two nights except that his/her (last) Will and Testament is near his/her pillow.
>
> (Sahih Bukhari)

Pillars of *wasiyah*

There are two basic pillars in making a will, something that almost all Muslim scholars agree.

- The testator, the one who has made a will, the testatee who will accept the will, the property or things to be bequeathed after the death of the testator and finally the offer and acceptance between the testator and testatee by two witnesses.[18] According to the *Shari'a*, *wasiyah* is permissible for non-heirs only. This is because the heirs inherit their

proportion of the deceased estate through the *Faraid* (guidelines from the *Shari'a* inheritance system) system. It is important to stress that the will is not merely specified on the estate of the deceased. From Islamic jurisprudence, a will can contain an order or request, either to the heirs or the testatee. For example, a father can include in a will any advice for his heirs to be more pious in dealing with the *Shari'a*, such as performing regular prayers. People nowadays are moving towards more hectic schedules, finding themselves too busy to obey the responsibility to perform the essential and basic pillars of Islam.

- The last pillars of making a will, which are the offer and the acceptance between the testator and two witnesses, have to comply with the Islamic guidelines to make it legal. For a written will to be recognized in the *Shari'a* court or court of law, it must be dated, handwritten or typed, signed by the testator and attested by two witnesses. The testator must sign the will in the presence of the two witnesses. It is not necessary for the witnesses to know the contents of the will and the witnesses can either be the executor or not. This is in line with the making of a contract, where the validity is made certain by the presence of two witnesses.

> (Take) witnesses among yourselves when making bequests – two just men of your own (brotherhood) or others from outside.
>
> (Al-Maaidah: 106)

It must be remembered that the witnesses must not be the heirs or beneficiaries of the testator otherwise the bequest to them could be invalid. In addition, the names and addresses of the witnesses must be recorded against the attestation signature of the testator at the time of signing, not at a deferred time.

Conditions of *wasiyah*

The *wasiyah* is exercised immediately after the death of the testator. It is not performed before the death of the testator, where it brings a different status, *hibah* (gift). There are some conditions that have to be fulfilled in order to render the *wasiyah* valid and legal.

- The testator or *wasi* must be a sane person, otherwise the *wasiyah* or the will is void. Another condition is that the testator must be at least at the age of puberty.
- The testator must also not be in debt to an extent that his debt is equivalent to the value of his whole estate because then the residual wealth will be nil.
- The testator should not make a will under compulsion or under the influence of others; making the *wasiyah* must be according to one's own will.

There are some additional opinions from scholars apart from those mentioned above. Among *Hanbali* schools, the emphasis on a testator is that he must have the right to make use of his wealth, not to deprive or restrain members of his heirs who are entitled to receive their portion when a will is made. A bequest to any amount exceeding a third of the testator's property is also not valid. The *Hadith* stated below indicates the condition for which the objects in which a will can be made. It is narrated by Saad bin Abu Waqqas:

> The Prophet came visiting me while I was [sick] in Mecca [Amir, the sub-narrator, said he disliked to die in the land whence he had already migrated]. He (the Prophet) said, 'May Allah bestow His Mercy on Ibn Afra (Sad bin Khaula).' I said, 'O Allah's Apostle! May I will all my proprty (in charity)?'He said, 'No.' I said, 'Then may I will half of it?'He said, 'No.' I said, 'One third?' He said: 'Yes, one third, yet even one third is too much. It is better for you to leave your inheritors wealthy than to leave them poor, begging others, and whatever you spend for Allah's sake will be considered as a charitable deed, even the handful of food you put in your wife's mouth. Allah may lengthen your age so that some people may benefit by you and some others are harmed by you.'
>
> (Sahih Bukhari)

The importance of making *wasiyah*

> Nor can a soul die except by God's leave, the term being fixed as by writing.
>
> (Ali Imran: 145)

The timing of death is uncertain, but death itself is certain. It is written in the *Luh Mahfudz* (Preserved book of Allah) even before a baby is born. Most people believe that their possessions will automatically pass on to their spouse, children and family with no complications and everyone will receive what the deceased wanted them to. The fact is that unless a will is made, there is no guarantee that this will be the case. Yet most people die without making a will. Even if one has no family, it is important to make a will so that what the deceased owns will pass to whomever they wish.

Muslims will no doubt want to be sure that when death approaches, the property and affairs will be dealt with in accordance with their wishes and in an efficient manner. The efficient manner here means using the wealth of the testator to guarantee his life in hereafter. One-third of the will can be contributed to the needy, either through the appointed and certified body or by giving personally to the needy. For those who cannot bear children and have only adopted children, a will is one way of ensuring that when one dies, he can leave a sufficient amount of his wealth for them. It shows that Islam is just in the rules of inheritance. The right of adopted children, even though not included in the *Faraid* system, is preserved by *wasiyah*.

Issues on *wasiyah*

In Islamic Law, the distribution of the wealth of a deceased person is the remaining balance after deducting the expenses incurred to settle all the debts of the deceased and the funeral expenses. Finally, the whole remainder is distributed among the heirs by right of inheritance. If the deceased person made a *wasiyah* during his lifetime, one-third or less of the remaining proportion can be exercised according to his own will. The other two-thirds will go to the heirs, which is the wife or wives, sons and daughters of the deceased in which the sons will receive two times compared with the daughters.

The issue arises when the heirs disagree with the distribution of *wasiyah* even though Islam encourages the making of *wasiyah*, because if the deceased person did not make a will, the one-third portion will also be distributed according to the *Faraid* system. To avoid disputes among family members, Islamic jurists have recommended that the portion of the *wasiyah* should be reduced to less than one-third. As we know, the *wasiyah* will be executed after the death of the testator and it is not permissible for the heirs to receive it. Although it can be exercised, if the testator still wishes to give the portion to one of his heirs, the consent and approval from all the heirs must be obtained or else the will is annulled.[19] So, to overcome this argument, one of the ways is to make it as a *hibah* (gift), to the heir during his lifetime. *Hibah* is treated as a gift where it involves the transfer of ownership from the owner of the wealth to one of his heirs.

But the disagreement between scholars brings further debate when referring to the following hadith. The Prophet had said:

> God has allotted to every heir his particular right. And that a bequest to particular heirs is unjust.
>
> (Sahih Muslim)

The argument about the disposition of wealth in Muslim society indicates that proportion is an important factor in materialism and worldly possessions.

> Your riches and your children may be but a trial; but in the Presence of God, is the highest reward. So fear God as much as you can; listen and obey and spend in charity for the benefit of your own soul and those saved from the covetousness of their own souls – they are the ones that achieve prosperity.
>
> (Al Taghabun: 15–16)

From the above *ayah*s (verse) it enlightens the purpose of being a *khalifah* (steward of the earth) in this world. The worldly possession is only lent to human beings as a temporary ownership of God to His servant. It will show the true self of each human being; the greed, ignorance, and also the pious and humble servant of Allah. It is not that the Muslim is denied the accumulation of wealth in this world; it is actually encouraged for the betterment of one's family and to contribute to society as a whole with the condition that it is performed in accordance with Islamic *Shari'a*.

The wealthy and pious Muslim is the best of beings for he can balance the worldly possessions and achievement in the hereafter. So the issue of distribution of *wasiyah* is not supposed to emerge in Muslim society. The *Faraid* system, which had been clearly stated in the *Qur'an*, is the most efficient means of dealing with inheritance, while the alternative of making a will for the one-third portion is supposed to enhance the involvement of Muslims in the charitable cause.

Conclusion

It can be concluded that Islamic asset management is an action to provide *Shari'a*-compliant investment structures through Islamic financial instruments and Islamic funds. Business

activities such as real estate investment, *takaful*, high net worth and so on are handled based on Islamic asset management. Some of the Islamic financial instruments that have been discussed are *murabahah*, leasing (*ijarah*), *mudarabah*, *musharakah* and sales contract. There are three kinds of Islamic fund: equity, commodity and leasing. Also stated are the objectives and purposes of Islamic asset management and *bai' al inah* and *bai' ad dayn*.

Wasiyah and the Islamic law of inheritance, which is *Faraid*, come from a different perspective. At first glance, people will usually assume that the *wasiyah* is *Faraid*. A testator who makes a *wasiyah* will clearly apportion all his wealth to his heirs. That is what happens to us. After a clear understanding of the topic, we can comprehend the differences. This chapter may broaden our understanding of the importance of inheritance, to increase the awareness of society as a whole and specifically Muslims. People need to know their rights and obligations to assess these rights.

In conclusion, every Muslim has to bear in mind that wealth is a temporary loan from Allah. When the time comes, everything will be left behind and will be useless for us.

> Every soul shall have a taste of death.
>
> (Al-'Imran: 185)

Like charitable deeds, pious children and knowledge that could benefit others, a will as a charitable deed is one of our saviors for the life after death.

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[1] The *Qur'an* literally means 'the recitation' and is the central Muslim religious textbook of divine guidance and direction for mankind. The *Qur'an* was revealed to Prophet Muhammad by the angel Gabriel over a period of 23 years.

[2] *Sunnah* literally means 'trodden path', the way of the Prophet Muhammad during the 23 years of his ministry and which Muslims initially received through consensus of his companions.

[3] Abdullah Yusuf Ali, *The Holy* Qur'an – *Text and Translation*, p. 456.

[4] Abul Hasan M. Sadeq, *Financing Economic Development – Islamic and Mainstream Approaches*, p. 147.

[5] Dr Yahia Abdul Rahman, *Lariba Bank Islamic Banking – Foundations for a United & Prosperous Community*, p. 23.

[6] Abul Hasan M. Sadeq, *Financing Economic Development – Islamic and Mainstream Approaches*, p. 146.

[7] Dr. Yahia Abdul Rahman, *Lariba Bank Islamic Banking – Foundations for a United & Prosperous Community*, p. 121.

[8] Ibid, p. 122.

[9] S.A. Meenai, *The Islamic Development Bank*, p. 31.

[10] Samsuri Sharif, *Fiqh Manual for Economists* II, pp. 56, 57.

[11] *Principles of Muamalat in the Capital Market*, p. 20.

[12] Ibn Qayyim al-Jauziyyah, *I'lam al-Muwaqqi'in*, Dar al Fikr, Beirut, Vol. 1, p. 388.

[13] Al-Zuhaili, *Al-Fiqh al Islami*, Vol. 4, p. 433.

[14] Al-Dusuqi, *Hasyiah al-Dusuqi 'ala al Syarh al-Kabir*, p. 63.

[15] Al-Syirazi, *Dar al Fikr*, Vol. 1, p. 262.

[16] Wahbah Zuhaili, *Al-Fiqh al Islami WA Adilatu*, Dar alfikir, 1989. Damascus, 8th edn, p. 8.

[17] Aljaziri Abdurrahman, *Kitabul fiqih a'la almazahib al arba'ah*, Dar ihya atturath, Beirut, 1996, Vol. 3, pp. 250–251.

[18] H.Sulaiman Rasjid, *Fiqh Islam, Sinar Baru Algensindo*, 2000, 33rd edn, p. 371.

[19] Aljaziri Abdurrahman, *Kitabul fiqih a'la almazahib al arba'ah*, Dar ihya atturath, Beirut, 1996. Vol. 3, pp. 251–258.

Chapter 4

The role of *Shari'a* advisors in the development and enhancement of Islamic securities

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Introduction

Shari'a advice has long been accepted as one of the most important ingredients in the development of Islamic finance. Its importance is undeniable in ensuring the compliance of products and instruments to the *Shari'a* precepts. This has been demonstrated by the fact that the development of any Islamic financial products shall include, among other things, endorsement from *Shari'a* advisor(s), without which the compliance of the product to the *Shari'a* will be questionable. This critical role is indiscriminate of which financial product is being considered, be it banking, *takaful*, capital market or wealth management. It is anticipated that this role would continue to be crucial and, in the light of recent advancement of the products and further innovation in financial instruments, be expanded and developed further. It is the intention of this chapter to highlight the role played by *Shari'a* advisors in the development of Islamic financial instruments. It will also draw some attention to the methodological framework that has been utilized by the jurists in developing and enhancing Islamic financial products. This aspect of discussion is so important because further development and enhancement of Islamic financial products depend on the ability of the *Shari'a* advisors to embrace and practise this methodology for the sake of developing further Islamic financial products. Nevertheless, I must hasten to add that this present chapter will mainly make reference to the Islamic securities market.[1] Nevertheless, cross-reference to other segments of Islamic financial products, mainly banking products, will also be made as and when the need arises.

Shari'a advisors for Islamic securities: the regulatory framework

The endorsement of *Shari'a* advisor(s) has been one of the requirements for the issuance of Islamic securities. In a more regulated Islamic capital market institution, this requirement has been made compulsory by the promulgation of relevant laws. For instance, Para. 4.1 of the Central Bank of Bahrain's Debt Securities Guideline states that:[2]

> **4.1 Islamic Private Debt Securities:**
> **4.1.1** In relation to Islamic Private Debt Securities that come within the scope of these Guidelines, the issuer must appoint either:
>
> > a) An independent Shari'a advisor or committee who has been approved by the Agency, in case of an issuer who does not have an existing Shari'a advisor or committee.
> > b) An Islamic bank or a licensed institution approved by the Agency to carry out Islamic banking to advise on all aspects of the Islamic Private Debt Securities, including documentation, structuring, investment as well as other administrative and operational matters in relation to these securities.
>
> **4.1.2** Any Shari'a principle and concept adopted in order to structure Islamic Private Debt Securities must be based on such principles and concepts as accepted by the Agency.

Similarly, in the UAE, the Islamic Bonds Listing Resolution[3] requires that the Islamic Bonds to be issued shall be subject to approval from an acceptable *Shari'a* Board. In Malaysia, the Guidelines for the Issuance of Islamic Securities were made compulsory for the appointment of *Shari'a* advisors for any issuance of Islamic bonds.[4] When it comes to the definition of a *Shari'a* advisor, other than under the Malaysian framework, no classification has been made to the definition. However, in the Malaysian framework, a *Shari'a* advisor eligible for the issuance of bonds can be classified under three main categories:

- registered independent *Shari'a* advisors;
- registered Corporation;
- an Islamic bank or a licensed institution approved by Bank Negara Malaysia to carry out Islamic banking schemes, or *skim perbankan Islam.*

Para. 6.02 goes further by stating that in the case of a corporation, it must have at least one *Shari'a* expert who meets the criteria stipulated in paragraph 6.01 (a).

The role of *Shari'a* advisor(s) is clearly spelt out in the Guidelines.[5] This is:

> To advise on all aspects of the Islamic securities including documentation, structuring, investment as well as other administrative and operational matters in relation to the Islamic securities, and ensure compliance with applicable Syariah [Shari'a] principles and relevant resolutions and rulings made by the SAC from time to time.

Besides this very specific advisory role for a particular issuance, *Shari'a* advisors are also entrusted with a general duty towards the development of Islamic capital market products. These duties are, *inter alia*, to:

- Complement the SAC of SC in the developing and enhancing Islamic securities.
- Propose structures in line with the spirit and preference (if any) of the SC and the regulators in general.
- Research and study for further development of Islamic capital market.

One may argue that in view of the fact that the members of *Shari'a* Committee in financial institutions are also eligible to advise on the issuance of Islamic bonds, albeit collectively, the responsibility for further development and enhancement of the Islamic capital market should not be shouldered by the registered individual *Shari'a* advisors only, but also by financial institutions' *Shari'a* advisors. The author is of the opinion that this understanding, though it has a propensity to be neglected, is very much accurate. As such, all *Shari'a* advisors should play their own roles in the development and enhancement of Islamic capital market and this 'responsibility' has been indirectly sanctioned by the fact that they are advising and supervising activities of Islamic financial institutions including the issuance of Islamic securities.

An insight to the structuring of Islamic securities

The challenges in structuring Islamic securities are not easy. Based on personal experience, various matters including legal, taxation and investors' appetite, for example, must be given due consideration in the process of structuring Islamic bonds. The nature of each and every type of structure must be clearly understood at the outset of any structuring, whether the bond to be issued is a debt-based (like *murabahah* and bay' bi thaman ajil), asset-based (*ijarah*)[6] or equity-based (*musharakah* and *mudharabah*) bond.

Determining the nature of the bond to be issued is crucial in shaping the framework for the structure to be raised later. For instance, in the Malaysian context, the Asset Pricing Guidelines issued on December 31 2003 and April 30 2004 are only relevant when there is a purchase contract between the originator and the purchasing entity[7] in *murabahah*, BBA, *istisna'* and *ijarah*. The issuance of *sukuk* based on *musharakah* and *mudharabah* is not to be governed by these guidelines.

Nature of income stream payable to the bondholders is also different depending on the structures of the *sukuk*. While the payment to the investors in *murubahah*, BBA, *istisna'* and salam is in the form of selling price, the return in *ijarah* is in the form of rental payable on the *ijarah*, and in *musharakah* and *mudharabah* it is in the form of return arising out of the investment made via capital contribution by subscribing to the *sukuk*. Of course, in *musharakah* and *mudharabah*, the return also depends on the underlying business of the *sukuk*. If the business of the *sukuk* is to buy and sell commodities on London Metal Exchange (LME) (*tawarruq*), the return for the *sukuk* holders is in the form of selling price. If the business of the *sukuk* is to buy and lease an *ijarah* asset, then the return to the investors is in the form of rental payment due to them by the lessee. For this, it can be inferred that in actual fact, *mudharabah* and *musharakah* structures exist in all *sukuk* issuances, for at the first layer in which the proceeds is raised the conduit used to raise the proceeds are none other than the contracts of *musharakah* or *mudarabah*, as the case may be.

The determination of events of default is also different. In sale-based contracts, the inability to pay the selling price may trigger the event of default. This is not so in the case of *mudharabah* and *musharakah* because the ability of the Special Pursuit Vehicle (SPV) or issuing entity to channel the profit to the investors depends on the performance of the venture. As such, the SPV or issuing entity is not considered to have committed default if the inability to pay the profit results from non-generation of profit from the venture. Hence, no event of default is considered to have occurred. However, what has been practised so far in

mudharabah- and *musharakah*-based issuances is that the inability to generate certain 'expected profit' may trigger the dissolution event. It has to be stressed here that the event of default in debt-based *sukuk* issuance is different from dissolution events in cases of equity-based *sukuk* issuance (*sukuk musharakah*, *mudharabah* or *wakalah*). In the former, once event of default has been declared, the acceleration of payment will take place and the originator is liable to pay all the debt immediately. In the case of a dissolution event, the obligor, by virtue of the purchase undertaking given, is liable to purchase all the outstanding *sukuk* at a certain agreed price (normally known as the exercise price). Only when the purchase undertaking has been exercised does the outstanding amount due become debt over the obligor. The determination of exercise price is also different depending on the structure of *musharakah*. If the *sukuk* is to be structured based on a *shirkat al-milk* (co-ownership) basis, the exercise price can be made at par, or if it is structured based on *shirkat al-'aqd* (joint ownership), the exercise price must be at market value or at any price agreed upon by the parties at the time of purchase. It is beyond the scope of this chapter to investigate the nature of these two *shirkat*, why the ruling is made in that manner, the polemic whether *sukuk* can really be issued using co-ownership structure, and the like.

From this very brief explanation, it can be said that in debt-based *sukuk* issuance, the occurrence of an event of default itself will render all the outstanding debts payable immediately, whilst in *musharakah*- and *mudharabah*-based issuance, the occurrence of a dissolution event will trigger the right given to the investor under the purchase undertaking. Only when the obligor fails to pay the whole amount due under purchase undertaking (after the right has been exercised) does this become debt payable to the investors.

The intention of this section is to give an insight to *Shari'a* advisors that understanding the basic classification and nature of each and every issuance is crucial in determining the rulings of the *Shari'a* accordingly, or otherwise the advice will fall into a trap of allowing things which are not allowed, or vice versa. Any enhancement of the product must also observe this nature. For instance, in *murabahah*, it is permissible to obtain a guarantee from the originator that it will pay the selling price when it is due. A guarantee from a party related to the originator[8] is also allowed, and this guarantee can cover the whole selling price or part of it. In *musharakah* or *mudharabah*, if the *sukuk* is designed in the manner that if the issuer (SPV) who has obtained proceeds from the investors then channels the proceeds to the originator as its contribution to second tier *mudharabah* or *musharakah*, a guarantee of performance is not allowed to be obtained from the originator because the originator is a partner (in *musharakah*) or entrepreneur (in *mudharabah*) to the venture. Even when the guarantee is obtained from third party, the guarantee is only to cover the capital.[9] No guarantee is allowed to cover the profit.[10] Sometimes, for the purpose of obtaining a good rating, various enhancements are needed, or otherwise the cost of issuance will be high, or in certain circumstances, so difficult to sell. For the purpose of *Shari'a* compliance, any enhancement made to the product must also consider the very nature of the issuance so as to ensure its compliance to the *Shari'a*.

Shari'a paradigm in product structuring and development

It is undeniable that the texts of the *Shari'a* are limited; thus, finding a direct ruling prescribed by the texts on new and unprecedented issues occurring after the time of revelation is very

difficult, if not impossible. But this state of affairs has been remedied by various mechanisms of deducing new rulings known and practiced by classical jurists such as analogy, juristic preference, *istishab* (doctrine of original legal ruling) *maslahah* (considering public interest), *'urf* (custom) and such like. All these methods of deriving rules are not created by the jurists out of nothing. In fact all these mechanisms have been directly or indirectly shown and sanctioned by original legal text as having the authority to act as a medium in deducting legal rulings from the primary legal *nusus* (texts). This practice provides Islamic law with flexibility; hence, enables it to accommodate any changes that occur even after the revelation has been discontinued.

This flexibility is further manifested via the juristic division to the acts of human beings. The jurists in this regard divide the act of humans to act of devotion (*ibadah*), and dealings or transactions (*muamalat*). They uphold that in devotional acts, the original legal rule is impermissibility. Hence, in performing any acts classified under this category, certain legal injunction from the text is needed, otherwise it would be considered as an illegal invention (*bid'ah*). This, however, is different when the area of *muamalat* is considered. The vast majority of jurists (except the Zahiris) uphold that initial legal presumption in *muamalat* is permissibility (*ibahah*). Therefore, every practice within this sphere of law (*muamalat*), even though not directly mentioned by previous jurists or directly sanctioned by the text, should be considered valid as long as it does not contravene any legal text or violate any principle of Islamic law. This classification manages to provide a wider flexibility to application of Islamic law in the area of commercial practices. From this, innovation can be widely upheld and practiced. It is up to the limit of human intellect to engineer new financial products.

It should also be stressed that the classical books on Islamic law were written in an environment where the large-scale commercial activities were not as complex as they are in the current economic climate. Therefore, in the contemporary world it is difficult, if not impossible, to follow strictly the application of Islamic law laid down by the classical jurists. The needs of the people in doing business have changed tremendously. Failure to understand this state of affairs will lead to the inability of the *Shari'a* to meet the continuous changes of commercial practices. Also, to forbid any practice which is sufficient in realizing benefit to mankind and in its interests, without proof from the lawgiver, is tantamount to forbidding what has not been forbidden and contrary to the main purpose of the revelation: the removal of hardship and the bringing of benefit to mankind.

This statement does not mean to propagate that for the sake of developing new Islamic financial instruments and meeting the changes of modern practices, contemporary jurists should abandon all the *Shari'a* principles and regard the entire classical *fiqh* literature as having outlived its usefulness. Rather, it proposes that in the course of deriving rules of the *Shari'a*, the jurists should maintain the principles of the *Shari'a* and at the same time take into account the changing phenomena and practices, and the exigencies of time and needs. They should blend these together and advance rulings that are not only compatible with the *Shari'a*, but also competent to meet the modern needs of commercial practices.[11]

The concept of freedom of contract (*hurriyat al-ta'aqud*) is another area that gives impetus to the further enhancement and development of modern Islamic financial products. In this regard, the jurists divide the freedom to create new contracts or negotiate contractual terms and conditions to the contract into two main divisions, namely rights of God and right

of human. Rights of God are generally non-modifiable and cannot be negotiated. An easy example is the practice of '*riba*', which is something that cannot be accepted even though it has been agreed upon between the parties to contract. Besides this, there are also matters that can be negotiated between the parties to the contract. The most cited example is conditions imposed on parties to a contract. In this regard, Qadi Shuraih, in one of his celebrated judgments, remarked:[12] 'Whoever imposes a condition upon himself voluntarily, he is bound by that condition.'

Hence the majority of jurists agree that the classical nominate contracts as have been expounded by the classical jurists are not meant to be exhaustive. If the needs arise and the nominate contracts cannot serve the purpose, the invention of new contracts is not something against the *Shari'a* principle. As such, the notion of valid contracts, within this purview, should be understood as a contract, be it new or old, nominate or non-nominate, which does not contradict any legal text or legal principles and is able to serve benefit of, or preventing evil from, mankind.

Classical writings of *fiqh* literatures: what is the suitable approach in developing products in modern Islamic finance?

The previous discussion has brought to the fore another issue: what is the most suitable approach in dealing with the classical writing of jurists? Total rejection of these classical writings, claiming the non-relevance of their exposition, of course, cannot be accepted. On the other hand, blind application of all opinions, claiming that their expositions are everlasting in nature, hence relevant to all times and situations, is another extreme opinion that no human intellect can accept. The right approach towards this very rich literature is to look at it from various viewpoints. At the outset, it should be stressed that of these classical writings, part of them are interpretations of the primary sources of law. To extend further, it is undeniable that in the area of commercial law, the primary sources mainly deal with the principles without going into details. Even when the principles are highlighted, the explanation of the primary sources to these principles needs further elaboration, exploration and explanation. Take *gharar* as an example. Though the prohibition of *gharar* is unanimous among the jurists, the exact nature of *gharar*, its basic concept and its application have never been agreed in totality among jurists. A thorough investigation on the subject shows that this happens due to the very general position of the text itself on the matter. It is an accepted fact that no clear and direct prohibition of *gharar* has been made by the texts of al-Quran. A proper study to the prophetic tradition, on the other hand, shows that instead of drawing a clear line on the prohibition of *gharar*, all the sources on *gharar* relate mostly to the examples of contract disallowed by the Prophet for they are, in one way or another, fraught with *gharar*. Examples that can be cited are the touch sale (*al-mulamasa*), the sale of discarded items (*al-munabadha*), and the pebble sale (*bay 'al-hasah*). According to al-Saati, the difference among the jurists in determining the exact nature of *gharar*, its scope and its application attributed mainly to the unclear position of the text on the exact nature of *gharar*.[13] All that is available to us comes in the form of examples. Having studied the examples, the jurists have come up with certain guidelines and frameworks for the prohibition of *gharar*. The principles and guidelines that have been deduced regarding *gharar* are of course relevant even to our times.

On the other hand, these classical writings also contain various solutions provided by the jurists to solve the economic problems of their times, examples being, *bay' al-wafa'*, *bay' al-daman* among others. Though the application of these financial instruments may be significant mainly in solving the problems of their times, their usefulness can also be used as points of reference. Although they may no longer be relevant directly to our times, their indirect contribution to the modern practice of Islamic banking and finance, where some of their elements may be analogous in some of its aspects, is undeniable. For example, some scholars suggest that the practice of *sukuk ijarah* in modern times is in fact a sort of derivation from the original form of *bay' al-wafa'*.

This division is very important to the product development process in Islamic finance because it outlines the broad guideline on how to benefit from the classical writing qualitatively. Once a jurist makes his exploration to the classical writings, he has to decide whether a particular opinion that he encounters is of principle characteristic or is purely an application of law made by previous jurists to solve a problem of their time. If it is of principle character, he may need to follow the principle and cannot deviate from it in his process of innovation, or his innovation of a new product may raise *Shari'a* issues. On the other hand, if the case that he encounters during his exploration to the classical books is merely an opinion of a particular jurist in his quest to solve a particular problem of his time, that opinion may either be used as a point of reference or be modified to suit the modern practice, or even be put aside and considered to be irrelevant to his research.

Technique used in innovating modern Islamic financial products

Various techniques have been employed in developing Islamic financial products including Islamic bond issuance. The most popular techniques follow.

Modifying

In some structuring, the classical contract has been modified to suit the practice of modern financial systems. For instance, *murabahah* is one of the most important tools used by Islamic banking. In its original form, *murabahah* is simply a normal sale; nevertheless it differs from normal sale in the disclosure of the actual cost in acquiring the commodity plus some profit added thereon. For that reason, it is considered a kind of trust sales (*'uqud al-amanah*). In classical practice, the seller will own the commodity first before selling it to the buyer. This classical form of *murabahah* has been modified in the modern practices of Islamic finance.

The most important modification relates to the original form of *murabahah*. Classically, *murabahah* was never intended to be a mode of financing. Rather it was kind of sale contract, the only feature distinguishing it from normal sale (*musawamah*) being that the seller in *murabahah* explicitly disclosed to the purchaser his cost price and the profit that he gains from that particular transaction.[14] The contemporary practices, however, have modified this contract by adding some other features to it as a mode of financing on deferred payment basis. In the capital market sphere, the name *murabahah* is used to describe the second leg of *'inah*[15] or a *tawarruq* transaction.[16] Since it bears the name of *murabahah*, the core principles of a

sale contract should be duly observed to make them acceptable from a *Shari'a* point of view. These principles are basically the main requirements for a valid sale,[17] with some other requirements such as the disclosure of the cost price and the profit.

The *modus operandi* of classical *murabahah* is also different from modern *murabahah*. In classical *murabahah*, supply precedes demand, whereas in modern *murabahah*, demand precedes supply.

Other examples available in *sukuk* structuring are *musharakah* and *mudharabah* contracts. In its classical form, *shirkah*[18] was used as a pure equity financing, in which two or more parties enter into a *musharakah* agreement between themselves whereby capital will be contributed to the venture. Who will work and how they will work is something to be arranged between them. It can be that all parties or only some of them work with the capital, or even that a third party is appointed to work on an agency basis. This venture is intended to be perpetual and only terminable for certain reasons such as the death of a party to the contract or a breach of contractual terms and conditions. In modern *musharakah*, the parties will agree at the outset that the shares of the partners are to be redeemed at a particular period at a certain agreed price; hence the termination of a *musharakah* contract is determined upfront. Even in the issuance of *sukuk*, the purchase and sale undertakings have been used to ensure that the *sukuk* holders' *pro rata* ownership in the *sukuk* shall be redeemable at a particular point in time or where a dissolution event has occurred.

In classical *musharakah*, there was no determination of ceiling profit rate to any partner. As far as the author can research, the classical writings place more emphasis on the compulsory determination of the profit-sharing ratio at the outset of the venture, without putting any ceiling to the entitlement of any partner. There was literature that indicated the possibility of having this incentive in such contracts, but this was not a widespread practice, classically.[19] Most issuances of *sukuk musharakah*, on the other hand, keep the entitlement of the investors to a certain ceiling rate. If the venture manages to generate more that the expected profit rate, the excess will be channelled to the issuer as an incentive to the successful management of the venture. Also previously,[20] by virtue of purchase undertaking, the obligor agreed that if the venture failed to generate the expected profit rate, the obligor would purchase back the whole portfolio of *sukuk* at a certain price based on a formula. The intention is to reassure the investors that their investment is somehow 'secured'. In certain circumstances, a third party guarantee on the capital is obtained to add further reassurance.[21] All these enhancements aim to give the impression to the investors that though they are investing in these equity-based structures, their securities act almost the same way as conventional bond issuance. That is why the circular issued by the *Shari'a* Board of AAOIFI in February 2008 emphasises various standards issued regarding the purchase undertaking to purchase back the *sukuk* by *mudharib*, *musharik* or *wakil*. The circular reads:

> ... Fourth: It is not permissible for the mudarib (investment manager), sharik (partner), or wakil (investment agent) to agree to purchase assets from sukuk holders or from whoever represents them for a nominal value of those assets at the time the sukuk are extinguished at the end of their tenors. It is permissible, however, 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, in accordance with Shari'a Standard (12) on the

> subject of Partnership and modern partnerships, Article (2/6/1/3) and with Shari'a Standard (5) on the subject of Guarantees, Articles (1/2/2) and (2/2/2). It should be understood that the sukuk manager acts as guarantor of [investor] capital at its nominal value in cases of negligence or mala fides or non-compliance with stated conditions, regardless of whether the manager is a sharik (partner), wakil (agent), or mudarib (investment manager). If, however, the assets of a sukuk al-musharaka, or mudarabah, or wakalah, are of lesser value than assets leased by means of a lease ending in possession (ijarah muntahiya bi't-tamlik), then it will be permissible for the sukuk manager to agree to purchase those assets at the time the sukuk are extinguished for the remaining lease payments on the assets, by considering these payments to be the net value of those assets.

It is not the intention of this short chapter to elaborate further on this issue, as a whole book on its own may be needed to discuss this matter satisfactorily. What is intended is to demonstrate that in modern practices of equity-based contracts, certain modifications and enhancements have been made to ensure their viability and marketability. These enhancements, however, should not in any way contravene any *Shari'a* principles.

Amalgamation of two or more contracts

The practice of amalgamating two or more contracts has long been permeated into many products of Islamic finance. In certain contracts, the amalgamation is enhanced further by a binding promise to purchase. Let us take *ijarah* and *mudharabah sukuk* as examples. In *ijarah sukuk*, two contracts, namely sale and *ijarah*, are used to raise the structure. In normal *mudharabah sukuk*, an SPV will be established to facilitate the issuance of *sukuk*. The SPV will invite investors to participate in the *mudharabah* venture by channelling their proceeds to the SPV. A *mudharabah* venture will be established between the investors as capital providers and SPV as an entrepreneur. The SPV will issue *sukuk* evincing the *sukuk* holders' participation in that *mudharabah* venture. The SPV, on the other hand, will apply the proceeds in the prescribed business venture for the benefit of the *sukuk* holders. This venture can be another *mudharabah* venture entered into between the SPV and the originator, buying and selling of certain assets as in the case of commodities *murabahah*, *murabahah* or BBA or buying and leasing of leasable assets as in *sukuk ijarah*. In *sukuk mudharabah*, an indicative or expected profit rate will be given to the investors upfront. In all issuances of *sukuk mudharabah*, purchase and sale undertakings based on the concept of promise will be given and accepted between the issuer and an obligor. The *sukuk* holders' certificates would be redeemed back (purchased back) at maturity or at the occurrence of any dissolution event.

The practice of amalgamating contracts to form new Islamic instruments has been a subject of debate among scholars. The proponent of this practice upholds that it should be allowed as long as the hybrid is not created in the manner by which performance of one contract is made conditional to the performance of another, and various *Shari'a* principles on amalgamation of contracts are fully observed. On the other hand, critics express their concern that this practice is used as a cover to practise another conventional product using legitimate Islamic contracts.[22]

Again, it is not the intention of this chapter to discuss in detail arguments of both sides. It could be covered in a separate chapter of its own. The main point of this chapter is that the amalgamation of contracts has managed to facilitate the development of diverse structuring in various segments of modern Islamic finance, especially banking and capital market products.

Enhancing the relatively less-used classical concepts

The literature on Islamic law has witnessed the introduction of various new and unprecedented concepts throughout Muslim history. The usefulness of a concept is also relative as time goes by. A particular concept may be relatively unimportant at a particular time, but essential and with wide application at other times. A very good example to support this hypothesis is the utilization of *wa'd* (promise). Briefly, the issues of whether a promise is binding once given, and how it should be considered binding, are not new. The opinion of the Malikis states that though a promise is generally not binding,[23] if the promisor had caused the promisee to incur some expenses or undertake some labours or liability on the basis of the promise, the promise is mandatory upon him. The court may enforce the promise if sufficient evidence has been provided by the plaintiff that he has suffered losses as a result of the non-performance of the promise given to him by the defendant.[24] This opinion has been adopted by the Academy *Fiqh* of Jeddah in one of its resolutions, AAOIFI in its *Shari'a* Standard, and has been widely accepted by modern jurists. It is not the intention of this chapter to examine this issue in detail. It suffices to state here that the legality and enforceability of a promise in this manner has been used widely in structuring many Islamic financial products. In the sphere of Islamic securities, purchase undertakings which are structured based on this concept have been practiced in *sukuk ijarah*, *musharakah*, *mudharabah* as a reassurance to the investors in case of default or inability to distribute the expected profit rate.

The classical jurists have given some attention to the concept of *wa'd*, but the treatment is relatively minor. The modern practice of Islamic finance, on the other hand, has seen the potential to develop further the concept as it can mitigate various possibilities, such as the performance of contracts (as in the case of *murabahah* to the purchase orderer), the outcome of the venture (in *mudharabah* and *musharakah*), ability to pay the rental in *ijarah* contracts (as in the case of *sukuk ijarah*).

Besides *wa'ad*, the use of '*urbun* may also serve as an example on how the classical concept has been successfully enhanced to facilitate diverse structuring of modern Islamic financial instruments, including call options and conventional short selling.

Fresh *ijtihad* (legal reasoning)

At present, this practice is not so much carried out. In fact, it is very difficult to cite an example of fresh *ijtihad* being exercised by modern jurists. The tendency so far is to evaluate the existing rulings (precedents) in the *madhhab* and apply them to the new case/situation, by way of direct application or analogy. Sometimes, if there are differences of opinion among the *madhahib*, preference of certain views over the others are made (*tarjih madhhabi*). Even when there are no precedents in the madhahib, the jurists have been

generally hesitant to exercise aggressive original *ijtihad*. The fresh *ijtihad* in modern times can be seen by amalgamating various well-known nominate contracts to form new contracts, like *al-ijarah thumma al-bay'*, *musharakah* and *mutanaqisah*. There were attempts to devise new contracts to be used in modern times. Al-Zarqa', for instance, considered the contract of *wafa'* as neither sale nor *rahn*.[25] Instead, he proposed that *bay' al-wafa'* be considered as a new contract, hence should be allowed based on its own merit. Another scholar proposed that future contracts in which both the subject matter and the price are deferred should be considered as new contracts. However, the vast majority of modern jurists remain reluctant to consider these contracts as new. Rather, they feel more comfortable evaluating these contracts using the framework of existing nominate contracts expounded by classical jurists. Since they do not fit to any of the classical contract definitions, their Islamicity is still widely questionable.

It is the conviction of the author that the fast growing trend shown by Islamic finance must be enhanced and supplemented with rigorous work by the jurists to exercise new and fresh legal reasoning. Relying only on the contracts expounded by previous jurists may not be sufficient in later times and may distort further development of Islamic finance.

A sluggish growth for Islamic finance?

It has been said that the development of Islamic securities is very slow and innovation in this area is scarce. Given the relatively short time since the first Islamic securities was introduced in the early 1990s, the author tends to say that the situation is quite the contrary. The rapid development that can be seen proves that Islamic finance, including the issuance of Islamic securities, is aggressively catching up with conventional financial markets and using impressive creativity to do so, in spheres ranging from corporate finance to retail banking. At this juncture, credit should also be attributed to the constructive role played by thoughtful *Shari'a* advisors who participate in innovation with financial product developers. Some examples worth citing follow:

- The German state of Saxony-Anhalt became the first non-Muslim issuer of a *sukuk*, raising some US$120.93 million (€100 million) in August 2004 by tapping cross-cultural liquidity. The structure used a very innovative lease and lease back concept.
- Another remarkable issuance, Dubai Ports, raised some US$3.5 billion through a *sukuk* issuance, co-managed by Dubai Islamic Bank and Barclays. The convertibility feature of the structure offers favourable allotments to a planned future IPO and provides an indicative yield of some 250 to 350 basis points over LIBOR.
- In another part of the world, US-based Meyer Fund Management has developed a mechanism for adapting traditional hedge fund strategies into vehicles that are *Shari'a* compliant. Hedge funds have generally been avoided by Islamic investors because of a lack of equity vetting, as well as reliance on techniques such as short-selling, leverage and derivatives that do not meet *Shari'a* guidelines.
- At the retail level, Islamic banks have been aggressively developing consumer finance options. In Malaysia, for instance, Islamic banks offers three home financing plans: one

for fixed rate financing, one for floating rate finance and one for refinancing. Islamic credit cards have been in circulation using a combination of various contracts such as *wakalah* and/or *ujrah*, *bay' al-'inah*, *wadiah* and *qard*, or *tawarruq*.

Certainly, more development will be seen in the future. It is unfair to compare the level of sophistication achieved by the conventional financial system with the Islamic financial system. They are by no means comparable. Islamic finance business has a long way to improve and develop. Concerted efforts from various stakeholders are needed in growing the industry further, and *Shari'a* advisors play a very central role in this. The Islamicity of particular products should not be sacrificed in our quest for development and innovation.

Examples of innovation

To demonstrate further the rapid growth in the development and enhancement of Islamic Securities, the next discussion will focus on some examples of innovation in the issuance of Islamic securities.

The case of cash flow receivables

Securitization, in terms of its form, can broadly be divided into two types, namely debt securities and asset-backed securities. Asset-backed securities differ from debt-based securities because their issuance is backed by financial assets. Hence, unlike debt securities, ABSs are secured by collateral. These securities are said to be 'backed' by assets because the performance of asset-backed securities is dependent upon the performance of the underlying assets. Put another way, the cash flows generated from the underlying assets are the primary source of payments on asset-backed securities. The core feature of asset securitization is the separation of the underlying assets from the company. The use of these assets in the issuance of securities and the payment of these securities will be met with the generated cash flow from these assets. In the issuance of Islamic asset backed securities, three main issues remain at the crux:[26]

- The type of asset to be securitized.
- The structure of securitization itself.
- Credit enhancements being in permissible form.

In term of structure, Islamic asset-backed securities do not differ greatly from conventional asset-backed securities. The main concern lies with the asset to be used (which must be Islamic) and the structure to be used. As far as the main players are concerned, generally they are the same as in conventional structures. These are originator, trustee, servicer, SPV, underwriters and placement agents, credit enhancer and rating agencies.[27]

The issuance of Islamic ABSs can take various transactional forms. Present structuring of Islamic ABSs in Malaysia covers main *ijarah* structure,[28] cashflow receivables structure[29] and BBA structure.[30] This present study appreciates that the Islamicity of securitization is based on *ijarah* and would not be arguable on BBA structure; rather this study attempts to

explain the problem of securitization of only cash flow receivables portfolios and recent innovations and suggests new innovative structures to enhance the securitization of cashflow receivables to make it compliant with international *Shari'a* standards.

In terms of *Shari'a* compliance, securitization of cash flow receivables[31] receives two opinions on its Islamicity. The vast majority of modern scholars disallow securitization of portfolios of receivables. According to this opinion, though debt is considered *mal*, having the substance of *haq maliyy* and subjected to *haq al-milkiyyah*, it is not as good as *'ayn, manfa'ah* or even normal right (*haq*). According to this opinion, looking into the features of the right to receivables, it is upheld that this right is nothing but a new terminology to the old doctrine of sale of debt as discussed by classical jurists.[32] Given the fact that receivables are financial assets in the form of money or correspond to money, every time it is exchanged for money, the rule of *sarf* must be followed. Hence, the contract can only be done at par value and any increase or decrease from one side to the other will be tantamount to *riba*. Since the practice is to sell this portfolio of receivables at discount, this practice has violated the most celebrated ruling for the exchange of one currency for another: equality. This can be seen clearly in the *Mudharabah* Cagamas Bond, *Musyarakah* One Capital and MBS Cagamas. Innovation in this area can be seen in two main *sukuk* issuances by IDB (one in 2003, the other 2005).

Exhibit 4.1 depicts the structure of the 2005 trust certificate issued by IDB. In this structure the trust certificates issued represent undivided interests of the certificates holders of the trust asset held by Solidarity Trust Services Limited, which is a bankruptcy remote trustee created solely for the purpose of this s*ukuk*. The assets consist eventually of receivables arising out of *murabahah* and *istisna'* transactions,[33] and also leased asset or assets to be leased. The first issuance in 2003 requires that at all times the ratio between tangible assets and intangible assets must be at 51% for tangible assets and 49% for intangible assets. However, this ratio has been reduced in 2005's issuance where the ratio became 30% and 70% respectively. Even in exceptional circumstances, the composition of *ijarah* can be temporarily reduced to a minimum of 25% of the total pool of assets. If at any time the proportion of *ijarah* contracts falls below 25% then the arrangement will be dissolved and the IDB will be obliged to purchase all the assets held by the trustee.

In this structure, the non-compliance to the *Shari'a* to sell the portfolio of debt based on the supply and demand concept has been mitigated by mixing it with tangible assets; in this case the *ijarah* asset. This innovative structure allows not only for the selling of certificates in the primary market, but also allows for its trading in the secondary market. The limitation on this structure lies in the fact that the portfolio of receivables must be bundled together with tangible assets. Hence, the issuance of this kind of certificate can only be arranged if the issuing entity has that portfolio in its book.

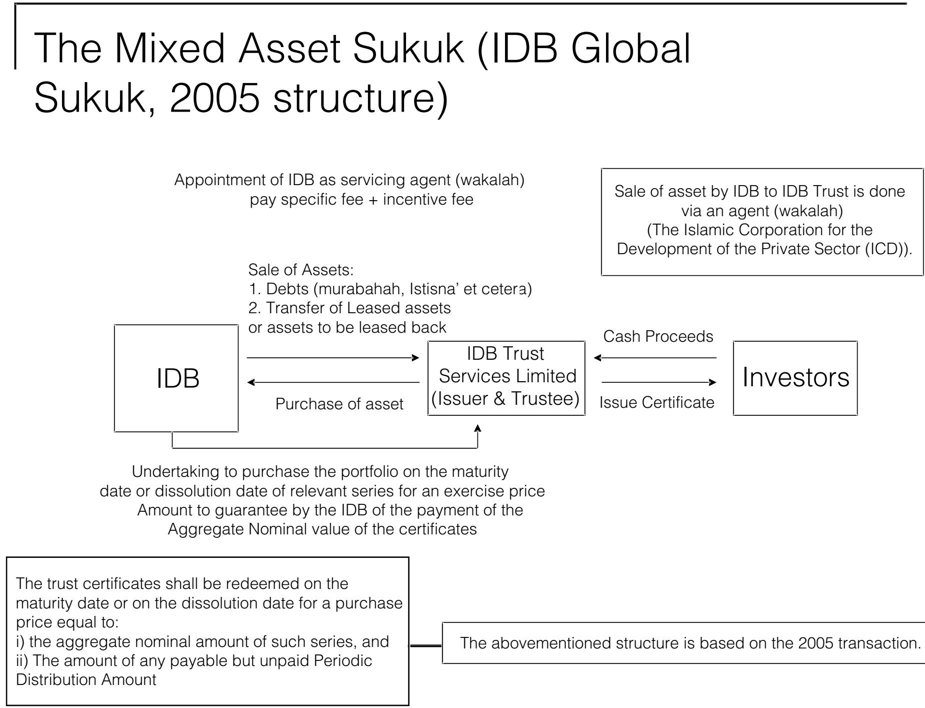
In the previous two structures, what have been used as assets are a mixture of tangible and intangible assets within certain acceptable percentages. As far as the author is concerned, another structure may also be proposed to facilitate the selling of cash flow receivables at primary level at least. Exhibit 4.2 depicts that structure.

Flow Process of this structuring can be summarized as follows.

The issuer of the SPV establishes a ***Mudarabah*** **Venture** ('Venture') to venture into business of exchanging commodities with an identified pool of Mortgage Assets originated by the Originator ('Portfolio').

Exhibit 4.1

The structure of the 2005 trust certificate issued by IDB



Source: Author's own.

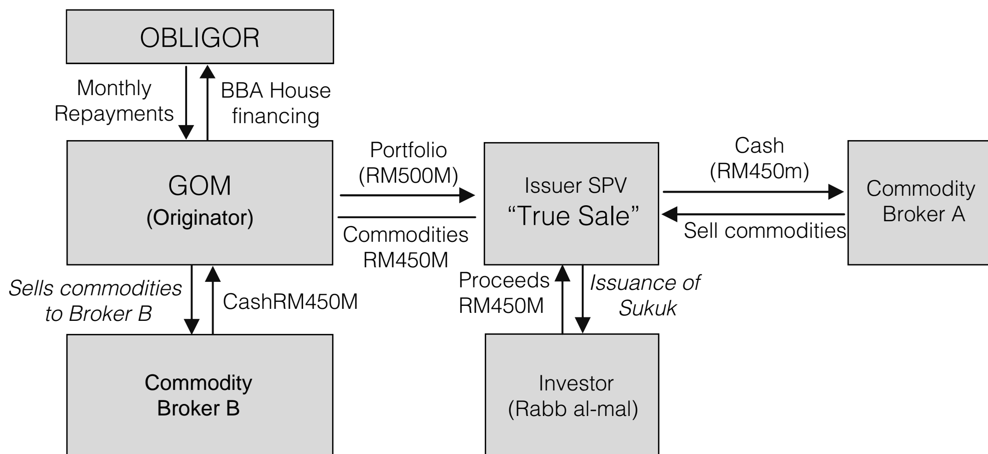
Sukuk Holders enter into the Venture with the SPV Issuer by subscribing to the ***Sukuk Mudarabah*** (*Sukuk*) and channel the proceeds to the SPV Issuer, who is appointed as the ***Mudarib*** ('Entrepreneur') for the Venture. The SPV Issuer issues *Sukuk* to the *Sukuk* Holders to evidence their participation in the Venture.

The proceeds raised from the *Sukuk* will be used by the SPV Issuer to purchase the commodities from Commodity Broker A ('Broker A'). Simultaneously, the SPV Issuer will enter into an Exchange Agreement with Originator to exchange the commodities purchased from Broker A with the Portfolio of receivables. Upon completion of the Exchange Agreement and with the commodities now transferred to the originator, the originator will then authorize the SPV to sell the commodities to Commodity Broker B ('Broker B'), where proceeds will be channelled to the Originator as payment.

In this way, the portfolio of the housing financing facility extended by the government to the government staff can be sold at a premium, at par or even at a discount based on the market demand.

Exhibit 4.2

Proposed structure to facilitate the selling of cash flow receivables at primary level



Source: Author's own

The advantage of this structure is that it allows for the securitization of 100% of the portfolio of receivables without having to mix it with tangible asset. This structure, however, has a shortcoming, for it is not tradable on the secondary market. To overcome this, a limited tradability option (as has been done in Arcapita *sukuk*) can be implicated to allow the existing *sukuk* holders the right to sell their *sukuk* in the secondary market and the price of selling the *sukuk* can be negotiated between the parties.

Juristic evaluation of the proposal

Jurists speak differently when it comes to the sale of debt to either the debtor or the third party. Perhaps the divergence of opinion is more when the debt is sold to a third party rather than to the debtor. As the present proposal deals with the sale of debt to a third party, this evaluation will only focus on that. In general, it can be said that the debt sold to a third party may be made at par value, at discount or at premium. The *Hanafis* and the *Zahiris* upheld that the sale of debt to a third party is disallowed regardless of the types of debt.[34] This opinion has been disputed by some other jurists. According to some *Shafi'is* (the prevailing opinion), the sale of debt is allowed if it is a confirmed debt (*dayn mustaqir*). Some other *Shafi'is* namely, *al-Subki* and *al-Nawawi*, maintained that this sale is permissible subject to three conditions.[35] Contradicting the opinion of the *Hanbalis*,[36] Ibn al-Qayyim, a *Hanbali* jurist, upheld that the sale of debt to a third party is completely in agreement with the principles of the *Shari'a*. To him, as far as there is no direct prohibition found in the text and no violation of any principles of the *Shari'a*, any contract should be considered as lawful because

the original basic rule in commercial transactions is permissibility.[37] Another opinion is also advanced by the Malikis. They advocated that the sale of debt is allowed with certain conditions to be followed. They used the same argument raised by Ibn al-Qayyim but included some conditions that must be fulfilled. Scrutinizing these conditions shows that these conditions are laid down simply to protect the rights of the third party – to avoid the selling of debt before *qabdh* (taking possession of it) – and also to avoid *riba* and *gharar* (uncertainty).[38]

The Islamic *Fiqh* Academy in Jeddah, in one of its declarations, decrees that the sale of debt is allowed to a debtor or to a third party provided that the rules of *riba* are followed.[39] This opinion had also been echoed by some eminent jurists. They maintain that the sale of debt to a third party (as practised in the sale of receivables) is allowed provided that the element of *gharar* and the regulation regarding the sale of one *riba'wi* item with another is observed.[40] When the debt is in the form of money, and is sold with the payment also in monetary form, then the rules of *riba* dictate that the payment must be at par and no deferment of delivery is allowed.

Applying this ruling on this structure, it can be said that since the consideration for the debt is not in monetary form (rather it is in commodity form), no issue of *riba* has been triggered. Hence, no issue of equality in exchange or immediate delivery arises. As for *gharar*, as rightly put forward by al-Darir, this can be mitigated by allowing the selling of only established and confirmed debt. However, this structure will still need to deal with the issue of *tawarruq*, which will not be discussed in this chapter.

Innovation in terms of tradability of the *sukuk*

The AAOIFI *Shari'a* Standard on Investment *sukuk* deals with two main matters: tradability of the *sukuk* and structuring and issuance of the *sukuk*. Some *sukuk* are not tradable at all times. *Murabahah sukuk*, for instance, are only tradable after the proceeds have been used by the SPV to purchase the commodities and before the commodities are sold to a third party (an entity which needs the funds), because at that time the *sukuk* represents ownership of the commodities. After the selling of the commodities to the entity, the *sukuk* is no longer tradable because it represents the debt owed by that entity to the *sukuk*holders and the ownership of the investors is ownership of the debt. In *istisna'*-based *sukuk*, the *sukuk* are not tradable unless the construction has been completed, because only in that situation does the *sukuk* represent the ownership of the building, whilst before that, it represents the obligation of the contractor to complete the construction of the building and the right of the investors to claim for the completion – and this right is not tradable. This structure has been used a number of times in *istisna' cum ijarah sukuk* issuances. Take Durrat al-Bahrain as an example. In that issuance, since the *sukuk* has been structured to be in the form of an *istisna' cum ijarah* concept, the *sukuk* are not tradable unless the construction has been completed and the physical asset has been delivered to the SPV. During the construction period, the *sukuk* are not tradable for they consist of no tangible asset. To mitigate this issue, the construction is broken into several phases with separate *istisna' cum ijarah* contracts and all are encapsulated by a master agreement. So it generates an early income stream for *sukuk*holders and also enables the secondary trading of the *sukuk* as the project progresses.

This situation of non-tradability during the initial phases of a transaction (that is, during the construction period) was later improved in Tabreed issuance (2006). In order to allow tradability of the *sukuk* even during the construction period, the issuer will purchase and hold on to the ownership of certain commodities (palladium). With that, the *sukuk* represents a certain percentage of tangible assets so as to enable the tradability of the *sukuk* even during the construction period.

Beside these innovations, there are also other innovations to show how the Islamic capital market has developed and advanced further, in structuring as well as giving new added value to the *sukuk*. Some other innovations, in brief, are:

- Convertibility (PCFC *Sukuk*, Aabar *sukuk*) and Exchangeability (Khazanah *sukuk*) features of *sukuk* issuances.
- Improvement in term of modes of payment from payment only in money to other kinds of payment. For instance, in Dubai Global *Sukuk* DMCC, the investors are given the option to redeem their bond in cash or in gold bullion. With the increasing value of gold at the time of writing, it is expected than at least 15% of the *sukuk*holders would prefer to be paid in gold bullion rather than cash when the redemption of the *sukuk* takes place.
- Non-tradability of *tawarruq-* based *sukuk* to limited tradability: ARC Multi Currency *Murabahah*.
- One Single Currency to Multi Currency: also in ARC Multi Currency *Murabahah*.

The traits of a high quality *Shari'a* advisor

The previous discussion argued that the role of *Shari'a* advisors in the development and enhancement of Islamic securities relates more to the ability of scholars to excavate the voluminous writings of the classical jurists and tailor their findings to suit the practice of the modern Islamic financial system. This exercise should be done using various mechanisms including modifying, amalgamating, moulding, enhancing and, of course, exercising new and fresh *ijtihad*. In doing so, assistance from various stakeholders of Islamic securities is tremendously important. Having acknowledged human shortcomings, the author is convinced that burdening the *Shari'a* scholar with all aspects of Islamic securities structuring is unwise. Trying to be rational, it is absurd to believe that a person is equipped with all aspects of Islamic securities issuance like legal, tax, *Shari'a* and marketing capability; this would be difficult if not impossible to be found in one person. Nevertheless, from personal experience, it has to be accepted that a certain level of knowledge relating to legal, regulatory and taxation framework, structuring skills and other related disciplines is inescapable for *Shari'a* advisors in carrying out their duty successfully. Besides that, certain qualities must also be possessed by *Shari'a* advisors. Below are some of necessary components which the author believes are a must for a high quality *Shari'a* advisor (this list is not meant to be exhaustive):

1 Academic criteria. A *Shari'a* advisor must enjoy these criteria:
   a. Mastery of Arabic, the language of the majority of primary sources of *Shari'a*.
   b. High competency in the area of Islamic commercial law.
   c. To a certain extent, relevant knowledge of other related disciplines.
   d. Quality and result-oriented research.

2 Sustainability criteria:
   a. Innovative and forward looking nature.
   b. Willingness to learn and share.
   c. Willingness to acknowledge *Shari'a* views.
   d. Ability to absorb pressure.
   e. High benchmark.
   f. Humble and able to admit shortcomings.

A quest for further development

Development and enhancement of human life in all spheres is a continuous process that will only stop once life itself stops. The same is true with regard to Islamic finance, including Islamic securities. The role of *Shari'a* advisors in this continuous development is also important, especially in guiding this development to meet not only the requirement of the modern financial system, but first and foremost to realize *maqasid Shari'a* (the ultimate purpose of *Shari'a*). Upholding and apprehending the ultimate purpose of *Shari'a* must always be of paramount importance in all developments of Islamic finance. The discussion on maqasid *Shari'a* is wide and beyond the scope of present chapter, but what is intended to be argued here is that the realization of maqasid *Shari'a* is also a continuous process.

The development of financial products is also driven by various factors. The changing needs of society are one of the factors for the changes in the rulings of Islamic law. One important maxim in Islamic law reads: 'It is an undeniable fact that the rules of law vary with the changes in times, places and individuals.' As time goes by, the need for further enhancement of products is a matter of dire necessity. If pronouncements of rulings are largely based on certain preferences in times or places, it is expected that rulings will change if new things which go against the original preferences emerge.

At present, there remain various conventional products that find no alternative under the Islamic umbrella. Before the question of finding the suitable alternative instruments can be raised, the first question is: 'Should we find alternatives for each and every conventional product?' The writer believes it is desirable that we have all alternative Islamic products that give the same economic benefits. The methods and mechanisms these products use may be different, but the same economic implication can be achieved with these alternative products. Some structured products (for example, CDO, CMO and CLO) and stapled securities are among those without alternative products offered.

Bearing this in mind, the author also points out that product development should also stress on origination and a shift from product replication and imitation to product innovation and origination. This very noble notion needs concerted effort from various stakeholders in IFIs, especially from the *Shari'a* advisor, who is, as described by Ibn al-Qayyim, 'a signatory on behalf of God'.

The issue of *maslahah* and *darurah* is another area that must not be neglected. The easy usage of *darurah*, without ascertaining whether or not the requirements of *darurah* have been fulfilled, poses a very direct threat to the practice of modern Islamic finance. It has to be noted in passing that the practice of *darurah* cannot be used easily. Certain prerequisites

and conditions must be totally adhered to before embarking on any pronouncement of rulings based on *darurah*. Based on personal experience, some cases were presented to the *Shari'a* committee as if they were of *darurah* situations and any altercation in allowing the practice would cause severe harm to Islamic banking as a whole; yet no concrete evidence is presented to the board in supporting this claim. Hence, the *Shari'a* advisors are always reminded to exercise extreme care in using *darurah* in approving any financial instruments. Besides *darurah*, the application of *maslahah* must also be done carefully, without neglecting the evidence of *Shari'a*. Among the very few jurists who treated the subject pleasingly, al-Shatibi made one of the more significant contributions to the discussion. His very interesting discussion on *bid'ah* (illegal innovation), *maslahah* and *istihsan* (juristic preference) can be found in his two main writings, namely *al-muwafaqat* and *al-I'itisam*, and the writer strongly suggests these two books accompany *Shari'a* advisors in their quest for innovation in modern Islamic finance.

Last but not least, it has to be reiterated that the notion of initial permissibility in areas of commercial law opens a very wide door for the process of innovation. Jurists should not be trapped within the ambit of nominate contracts only. Islamicity of a particular contract should be decided based on the merit of the contract itself, not on the premise that classical jurists have not mentioned it in their books. Though this has been said many times, it seems that notion of nominate contracts *vis-à-vis* valid contracts forms a very fertile area that needs further exploration and research.

Conclusion

It is not an exaggeration to say that the relatively successful acceleration and development of the Islamic securities market seen in recent times owes its success to, among other things, the ability of *Shari'a* advisors to interpret and integrate Islamic law into the practice of the modern financial system. Further enhancement of the market would of course require more input from *Shari'a* advisors. This is a privilege as well as a responsibility, and calls for more meaningful contributions on the part of *Shari'a* advisors. They have been tasked to explore the large field of Islamic literature and to engineer their exploration in innovating products that are not only Islamic in their letter and spirit, but also able to meet the needs of the time, be capable of competing with other conventional products and appealing to the market players. It has to be admitted that this is not an easy task. Understanding the *Shari'a* in its totality and ability to reflect this understanding to the structuring of Islamic securities would be a crucial point for *Shari'a* advisors. Knowledge of various related disciplines, though placed second, must not be forgotten too. Even with that ability, it is impossible for *Shari'a* advisors to work in isolation. Perhaps continuous interaction between the *Shari'a* advisors and various players is the only way of ensuring not only the accuracy of the rulings pronounced by *Shari'a* advisors but also their real application on the ground. It is the hope of various stakeholders that with the continuous interaction and full understanding of various players in the market, including *Shari'a* advisors, the issuance of Islamic securities will not only increase the number and size of issuances but also improve innovation in a financial world where the ability to compete and sustain is crucial for the further development of an economic system.

[1] For the purpose of discussion, the phrases *sukuk*, Islamic bond and Islamic securities will be used interchangeably.

[2] Paragraph 4.1, CBB Debt Securities Guidelines, visited on 10/5/2007.

[3] *The Resolution Concerning the Listing of Islamic Bonds* 2005, Article 9.

[4] *Guidelines on The Offering of Islamic Securities*, July 2004, para 6.01.

[5] *Guidelines on The Offering of Islamic Securities*, Para 6.01.

[6] Some call it equity biased.

[7] This entity may be the SPV or direct investors like primary subscriber, tender panel members (in case of MUNIF). If the purchasing entity is direct investor(s), the originator will be the issuer; if the purchasing entity is the SPV, then the SPV will be the issuer.

[8] For example, parent company to the subsidiary and vice versa.

[9] AAOIFI Shari'a *Standard*, p. 209.

[10] As far as the author can research, only Dr Monzer Kahf opines that this guarantee can also cover profit. See: Kahf, Monzer, Sanadat al-Qiradh wa Dhaman al-fariq al-Thalith wa Tatbiqatihima fi Tamwil al-Tanmiyyah fi al-Buldan l-Islamiyyah, Majallat Jami'ah Malik 'Abd 'Aziz, al-Iqtisad al-Islami, 1989M, p. 60.

[11] Al-'Alwani, Taha Jabir,'The Role of *Ijtihad* in the Development of Capital Markets', International Islamic Capital Market Conference, July 15–16 1997, p. 1.

[12] Ibn Hajar al-Asqalani, Fath al-Bari, Vol. 5, p. 707.

[13] Al-Saati, Abdul Rahim, The Permissible *Gharar* (Risk) in Classical Islamic Jurisprudence, *JKAU: Islamic Econ.* Vol. 16, No. 2, pp. 3–19, 1424 A.H./2003 A.D.

[14] al-Sarakhsi, *al-Mabsut*, Vol. 13, p. 78.

[15] *Murabahah* CP or MUNIFs.

[16] Commodities*, murabahah* as widely applied in Middle East.

[17] Such as the subject of the sale must be in existence, in ownership of the seller at the time of sale, must be in the physical or constructive possession of the seller when he sells it to another person.

[18] Various researches have shown that the more common word used to describe classical partnership is *shirkah*, not *musharakah* (some jurists like Ibn Taimiyyah did use the word *musharakah*, beside *shirkah*). However, for the purpose of this discussion, the writer will use the term 'classical *musharakah*' to differentiate it with modern *musharakah*.

[19] See, for instance, al-Bukhari's narration from Ibn Abbas on incentives given in the *wakalah* contract, and also discussion on this matter in Ibn Qudamah, al-Kafi, Vol. 2, p. 253, Ibn Hajar, Fath al-Bari, Vol. 4, p. 451, al-Badr al-'Aini, 'Umdat al-Qari, Vol 12, p. 133.

[20] Before the February 2008 Circular made by AAOIFI Shariah Board.

[21] There is more than one way in which the capital (or to certain situation, profit) is protected. For further study, please refer to: Hasan, Aznan, *al-Daman fi alMudharabah wa al-Musharakah wa al-Tatbiqat al-mu'asirah fi al-Muamalat al-Maliyyah al-Mu'asirah* (*Dhaman in Mudharabah and Musharakah: Their Application in Modern Islamic Financial System*), forthcoming.

[22] Tarek El Diwany, 'Travelling the wrong road patiently', in *Banker Middle East*, Sep. 2003, <http://www.islamic-finance.com> viewed on April 23 2005.

[23] Abu 'Umar Yusuf ibn 'Abdillah Ibn 'Abd al-Barr al-Nimri, *al-Tamhid*, al-Maghrib, Wazarah 'Umum al-Awqaf wa Shu'un al-Islamiyyah, 1387H, vol. 3, 208–209.

[24] See for details, Muhammad Taqi Usmani, *An Introduction to Islamic Finance*, 120–126, 87–89, Wahbah al-Zuhayli, *al-Fiqh al-Islāmi wa Adillatuh*, vol. 4, 2928–2930.

[25] Al-Zarqa, al-Madkhal al-Fiqh al-'Amm, Dar al-Fikr, Beirut, 1968, Vol. 1, p. 544.

[26] *Practical Aspects of Islamic Securitization*, Aseambankers Malaysia Berhad, Islamic Finance Bulletin, Rating Agency of Malaysia (RAM, June 2004), pp. 8–10.

[27] Ibid, p. 10, Leixner, Timothy C., 'Securitization of Financial Assets', *International Asset Securitization and Other Financial Tools*, edited by Susan Meek, pp. 4–6.

[28] Golden Crops Return.

[29] Mudharabah Cagamas Corporation, Musyarakah MBS and Musyarakah One Capital.

[30] ABS Plantation Asset Berhad, Ambang Sentosa Sdn Bhd.

[31] For Definition of Cashflow and the process for its securitization, please refer to: Aznan Hasan, 'Mitigating Juristic Objection to the Sale of Receivables', Paper presented at Colloquium on Islamic Bonds, jointly organised by the Securities Commission of Malaysia and International Islamic University Malaysia, Kuala Lumpur, June 24 2004.

[32] Usmani, Muhammad Taqi, *An Introduction to Islamic Finance*, Idaratul Ma'arif, Karachi, Pakistan, p. 216.

[33] After the transactions for *murabahah* and *istisna'* contracts have been completed, what is due to the investors are receivables arising out of these contracts.

[34] Al-Kasani, *al-Bada'i*, Vol. 5, p. 148, Ibn Hazm, *al-Muhalla*, Vol. 9, p. 7.

[35] Al-Shirazi, *al-Muhazzab*, Vol. 1, p. 263. These are: The debt must be a spot *dayn* (*dayn mu'ajjal*) in nature, the debtor must be a rich person and accept the selling, or there must be strong evidence to prove the existence of the *dayn* in case of denials from the debtor, and The buyer must pay the price of the debt on spot basis, Moustapha, Sano Koutob, *The Sale of Debt as Implemented by the Islamic Financial Institutions in Malaysia*, IIUM Press, Research Centre, International Islamic University, 1st edition, p. 51.

[36] According to the Hanbalis, the sale of debt is only allowed to the debtor, not to a third party.

[37] Al-Jawziyyah, Ibn al-Qayyim, *I'lam al-Muwaqqi'in*, Dar al-Fikr, Beirut, Vol. 1, p. 388.

[38] Al-Zuhayli, Wahbah, *Bay' al-Dayn fi al-Shariah al-Islamiyyah*, Dar al-Maktabi, 1st edition, pp. 43–44. See these conditions in Sano, *The Sale of Debts*, pp. 52–53.

[39] *Majallat Majma' al-Fiqh al-Islami*.

[40] See for instance: al-Qurrah Daghi, 'Ali Muhyiddin, *Buhuth fi Fiqh al-Mu'amalat al-Maliyyah al-Mu'asirah*, Dar al-Basha'ir al-Islamiyyah, p. 215, al-Darir, al-Siddiq Muhammad al-Amin, *al-Gharar wa Atharuhu fi al-'Uqud fi al-Fiqh al-Islami: Dirasah Muqaranah*, pp. 334–335.

Chapter 5

Development of the *Shari'a*-compliant fund market and the role *Shari'a* scholars played

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Introduction

Between 2003 and 2008, there was a growing interest in Islamic finance in general and Islamic investment in particular. With such interest in a small yet rapidly growing industry, there are also great demands on accessing market intelligence. This market intelligence is needed to enable financial institutions to make informed business decisions. High demand coupled with few research outlets has led to misconceptions of the industry and, in some cases, inaccuracies in the information reported.

This chapter aims to shed some light on how the Islamic equity fund industry has developed and where it is today. It will also briefly discuss the role of *Shari'a* boards and the part they have played in developing the Islamic fund industry.

Historical overview

The first modern *Shari'a*-compliant investment funds can be traced back to Malaysia in the early 1960s where pioneering funds were established for local investors to save for their eventual *Hajj*. Throughout the 1960s and 1970s there are other examples of similar efforts, but the next significant developments in this field did not occur until the 1980s when new-found oil wealth in the Arabian Gulf promoted a movement to develop funds which adhered to Islamic principles. While interesting as background, the real growth in the Islamic funds industry did not take place until the mid-1990s.

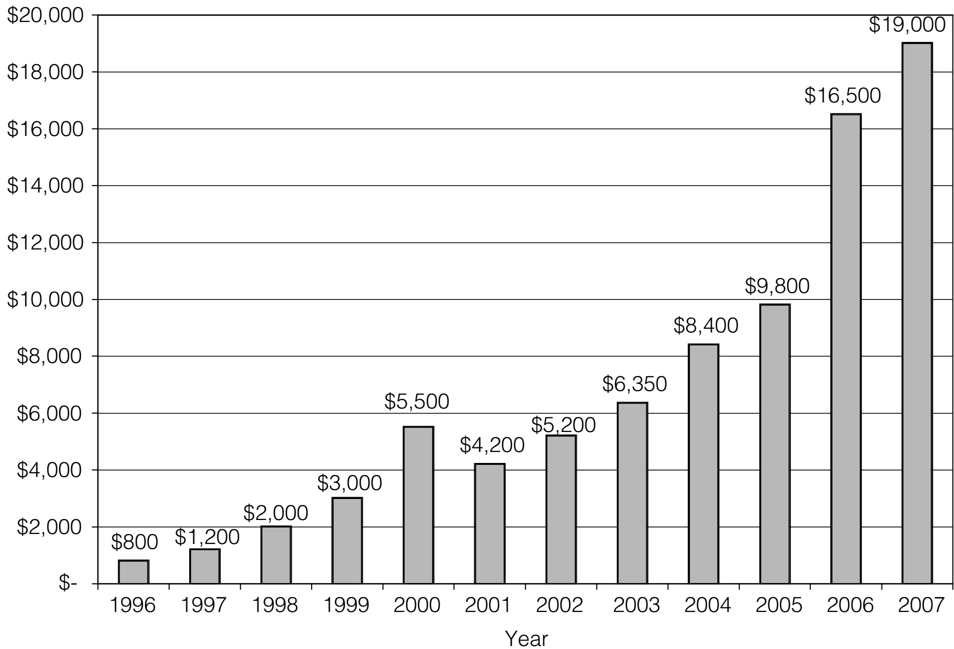
It was in the midst of the 1990s efficiency gains and prolonged bull markets that high-net-worth GCC-based investors began to push industry development. Concurrent efforts in Malaysia were also underway and by the end of the decade there existed clear consensus that Islamically acceptable, if not fully compliant, funds were a viable investment alternative for pious Muslims.

It can be seen from Exhibit 5.1 that consistent growth began in 1994 and tapered in the year 2000, largely in response to the 'tech bubble' which was particularly hard felt in the *Shari'a* sector, as many early funds were 'tech heavy' owing to a preference for equity

capital structures by technology firms. *Shari'a*-compliant funds are prohibited from investing in highly leveraged firms.

Exhibit 5.1

Total assets in Islamic equity and equity-related funds at year-end



Source: Author's own.

In the early 1990s there were only a few funds scattered across the globe. Today there are over 320 Islamic equity funds managed by some of the world's top fund management companies such as Citibank, Deutsche Bank, HSBC and UBS.

Before the 'tech bubble' of 2000, the preceding 'tech boom' helped facilitate mass acceptance of equity funds as an investment solution. This helped the Islamic industry (which tends to favour less debt-ridden technology firms) grow rapidly from just $800 million in total equity assets in 1996 to over $15 billion in 2005. One key reason for the second big lift in Islamic fund assets was the rapid growth of GCC[2] stock markets, which have in recent years been fuelled by a spate of widely popular initial public offerings (IPO), a heavy dose of speculative fever and a general increase in real estate prices. While capital flows from the region into foreign equity funds have slowly recovered from the early 2000s slump, flows into local markets have ballooned. The Saudi market in particular has experienced tremendous growth as a result of continued high liquidity. Naturally the prolonged rise in commodity prices has greatly enhanced GCC liquidity and helped spur regional growth and investment. Increasingly, local

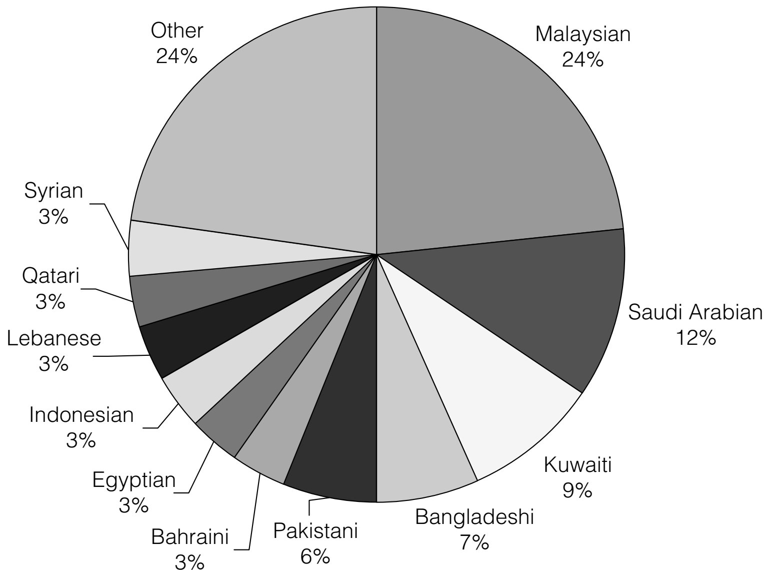
investors are becoming more aware and comfortable with the principles of *Shari'a*-compliant investment with a significant percentage expressing a preference for Islamic investments.

As with any industry, however, not all players have succeeded. With many new funds on the market, it is easy to forget those who did not make it. A number of fund managers have lost interest in the Islamic market over the years. Very often it is distribution that is cited as the greatest obstacle. Just as in the conventional fund business, finding the right mix of basic success factors remains a challenge. Devising a new and demand-driven product, finding the right managers, obtaining *Shari'a* approval, securing adequate distribution and, naturally, achieving noteworthy results are challenges that must always be met. Simply branding a fund 'Islamic' is by no means a guarantee of future success.

At one time, Flemings was considered a pioneer in the industry for having launched their Oasis International Equity Fund. The Oasis Fund, however, was closed and its assets liquidated in 2000 as a result of a lack of interest and poor distribution. At its highest point the Fund had approximately $35 million in assets under management.

Exhibit 5.2

***Shari'a* scholars by nationality**



Source: Author's own.

PFM, a small London-based asset manager, was also one of the first to launch an Islamic global equity fund back in 1996, the Ibn Khaldoun International Equity Fund. The fund never managed to attract more than $20 million in assets and closed down a few years later just as world equity markets were in the middle of a huge bull market.

Geographic Focus

The earliest funds were broad in their focus. Funds offered in the Middle East tended to be global, US or European equity funds. Early funds also tended to stick with the shares listed in either New York or London. Today we see a universe of funds dealing in virtually every major and emerging market. Increasingly, and especially in light of the prolonged commodity bull-market, we have seen renewed interest in local Arab markets as well as a pronounced shift in emphasis towards the East, including China and emerging Asia. At present there are *Shari'a*-compliant specific sector funds (telecommunications and technology), country-specific funds (Saudi Arabia, Malaysia, US), and a host of regional and global equity offerings.

Indices

Arguably the biggest boost to fund managers came when Dow Jones launched its Islamic indices in 1999. This development not only gave credibility to the industry by having their global brand affiliated with Islamic finance, but it also spawned a new and viable investment category – index funds. Though others had come before, these basic rules formed what the industry and wider world began to recognize as the standard for establishing *Shari'a* funds.

In present form the Dow Jones rules are as follows.

Excluded are companies that represent the following lines of business: alcohol, tobacco, pork-related products, financial services, defence/weapons and entertainment.

Additionally, excluded are companies whose:

- total debt divided by trailing 12-month average market capitalization is 33% or more;
- cash plus interest-bearing securities divided by trailing 12-month average market capitalization is 33% or more; or
- accounts receivables divided by 12-month average market capitalization is 33% or more.

The current competitive landscape contains suites of Islamic products from all of the major international index providers. These include FTSE, S&P, MSCI-Barra, as well as a number of smaller regional index providers like Kuwait's Al-Madar. While the basic prohibitions remain the same, innovation is ongoing in this space with market participants actively finding ways to push the industry further. One such innovation currently under discussion is how to incorporate 'positive screens' that mandate firms to adhere to higher levels of corporate responsibility. There is also an interest in including greener environmental characteristics to new index products.

The role of *Shari'a* boards

As Islam is a faith without central authority, it is often debated what is and is not *Shari'a* compliant. In the current environment it is generally felt that terms like *Shari'a* 'permissible' or 'acceptable' are more accurate than 'compliant'. This implies a level of adherence not yet practiced, as some leverage is tolerated when in fact all *Riba* or interest is disallowed, strictly speaking.

In current practice, most fund managers engage a *Shari'a* board to assure compliance with issues related to Islamic teaching. A *Shari'a* board composed of prominent scholars lends a new fund a high degree of credibility with respect to Islamic legitimacy. It is also common practice to engage a *Shari'a* board composed of members from different geographical regions within the Islamic World. Such a practice assists the marketability of the fund, but perhaps more fundamentally it assures the inclusion of a variety of schools of thought into the fund's Islamic credentials. It is a general consensus that scholars from the GCC, Sub-continent and Asia agree on 95% of the issues and disagree only on fine points, but nonetheless having a regionally diverse *Shari'a* board is now standard practice among global fund managers.

Exhibit 5.3

Shari'a scholars most active in Islamic finance

	Name	Nationality
1	Dr Abdul Sattar Kareem Abu Ghuddah	Syrian
2	Sh. Abdullah bin Sulaiman Al-Manea	Saudi Arabian
3	Dr Ajeel Jassem Al-Nashmi	Kuwaiti
4	Sh. Dr. Ali Muhyealdin Al-Quradaghi	Qatari
5	Dr Mohammad Daud Bakar	Malaysian
6	Sh. Yusuf Talal DeLorenzo	American
7	Dr Mohammed Ali El-Gari	Saudi Arabian
8	Dr Hussain Hamid Hassan	Egyptian
9	Justice Muhammad Taqi Usmani	Pakistani
10	Sh. Nizam Mohammad Saleh Yaquby	Bahraini

Source: Failaka, *The* Shari'a *Report*.

While a number of successful funds do not have their own boards, it is generally felt that having a board consisting of recognized experts can improve a new fund's chances of success. In 2008, Failaka published the world's first book to profile the scholars who serve on these boards. In their publication, the *Shari'a Report 2000*,[3] profiles of the leading scholars are presented along with a listing of their articles and board affiliations (see Exhibit 5.3). It is notable that many scholars serve on multiple boards, while others have become exclusive officers of management firms.

The cost of a *Shari'a* board can vary widely depending on the complexity of the transaction, but generally the annual retainer will cost between $75,000 and $200,000 plus travel expenses. This additional cost, if passed on to investors in the form of higher fees, can result in a slight premium being attached to the pricing of Islamic funds, which is a controversial notion within the industry. With many practitioners of the opinion that Islamic products must provide similar returns to conventional products in order to be competitive, the additional costs of *Shari'a* boards present a strategic challenge for managers.

At the time of writing (2008), there exist roughly 260 *Shari'a* scholars actively working with banks on financial matters. In order to be included on Failaka's list the scholar must serve on at least one board. Additionally, Malaysian-based scholars must be certified by the Securities Commission in Malaysia before being able to serve as a scholar on a board.

Exhibit 5.4

A short list of Islamic equity funds that have closed down

Fund	Sponsor	Year closed
Ibn Khaldoun International Equity	PFM	1999
Islamic Multi-Investment Fund	American Express Bank and Faisal Finance	1999
Oasis International Equity	Flemings	2000
Egyptian Equity Fund	Faisal Finance	2000
AlKawthar Global Equity Fund	GAM	2001
Ibn Majid Emerging Markets	The International Investor	2002
Global Equity 2000 Sub-Fund	First Investment Company	2002

Source: Author's own.

Diversity of opinion

A long-standing debate about so-called 'standardization' continues to be discussed at Islamic banking conferences around the world. Scholars tend to reject this notion, often dismissing this 'bankers' idea' as impractical. While many of the basic premises of Islamic banking (for example, the prohibition of interest) have achieved near universal acceptance, in basic terms, the more complex the transaction, the more diverse the scholarly opinion and the more difficult the ideal of a universal standard.

Much time and effort will be required before anything approaching global standards are established, recognized, routinely applied and enforced. In the meantime, institutions exist that aim to become the checks and balances, if not the definitive word, on issues of financial *Shari'a* rulings. The difficult process of establishing norms is being addressed both by AAIOFI (the Accounting and Auditing Organization for Islamic Financial Institutions) and the Malaysia-based Islamic Financial Services Board. In the meantime as the industry continues to press ahead and until these standards are established, the role of *Shari'a* boards will continue to be crucial to fund managers.

In basic terms, *Shari'a* scholars apply a jurisprudence that draws from the *Qur'an* (the Muslim holy book), *ijtehad* (scholarly reasoning), *Ijmaa* (consensus of the Muslim *ummah*), *qiyas* (analytical comparison) and *Sunnah* (practices and sayings of the prophet Muhammad). Finding scholars well-versed in both traditional scholarship and complex modern financial instruments is a pronounced industry challenge. A more practical, but no less important, challenge is finding a board that is able to communicate effectively and fully understand fund documentation that may be prepared in English, French or German.

Aside from the standard exclusions (avoidance of interest and prohibited industries), *Shari'a*-compliant managers must also be mindful that their custodians and administrators keep compliance with Islamic principles. While this level of scrutiny is relatively new, the areas of concern include certifying that excess cash is kept in segregated accounts that do not earn interest and that securities held by the fund are not used in short-selling transactions.

Also of concern for managers is the permissibility of hedging foreign currency exposure. As the world of *Shari'a*-compliant funds is now a truly global one with funds domiciled all

Exhibit 5.5

Top universities for studying *Shari'a*, based on where current universities of scholars received their degrees

Rank	Institution	Country
1	Al-Azhar University	Egypt
2	Damascus University	Syria
3	Darul Uloom University	Pakistan
4	Imam Mohammed ibn Saud Islamic University	Saudi Arabia
5	International Islamic University Malaysia	Malaysia
6	Islamic University at Al-Madinah Al-Munawwarah	Saudi Arabia
7	Kuwait University	Kuwait
8	Umm Al-Qura University	Saudi Arabia
9	University of Jordan	Jordan
10	University of Malaya	Malaysia

Source: Failaka, *The* Shari'a *Report.*

over the world and comprising many currencies, including those not tied to the US dollar, FX exposure can be a pressing concern. While the methods are not universally accepted, various structured products have been developed to manage this risk. Although standard swaps, forwards, futures and options have been deemed non-compliant, various alternative methods that utilize the so-called 'double' or 'un-even' *Wad* (promise) have been adopted by money mangers. CIMB Islamic Bank and Deutsche Bank are two firms offering to devise *Shari'a*-compliant FX strategies for their clients.

Basic statistics

At the time of writing there is roughly $19 billion invested globally in *Shari'a*-compliant equity funds. The number is naturally much larger when bank deposits, *murabahah* funds and closed-end (real estate and private equity) funds are added to the mix.

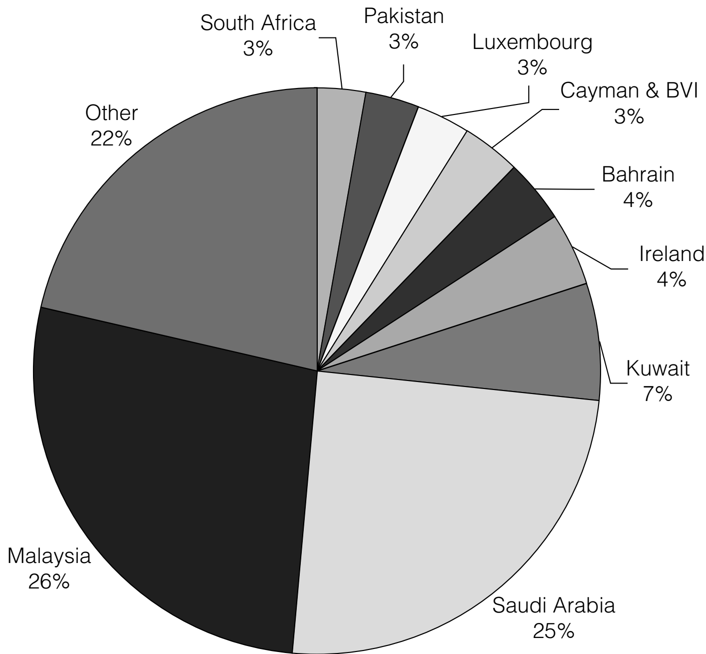
There are roughly 320 individual funds spread across the globe with over a third based in Malaysia. The remainder are predominately in the GCC with a small number spread across Europe, North America and other parts of Asia (see Exhibit 5.6).

Distribution

The main complaint by managers has traditionally been problems with distribution. The other challenges of creating an Islamically compliant fund have largely been figured out. Securities conforming to the established guidelines are generally found in sufficient quantities to allow for the creation of viable funds. In fact, for many years there has been wide consensus that one can structure a *Shari'a*-compliant fund on nearly all of the major world bourses. By way of example, it is claimed that 90% of shares on the KLSE in Malaysia are *Shari'a*-compliant and therefore eligible investments for a *Shari'a* fund; and not long ago the DFM (Dubai

Exhibit 5.6

Domicile of Islamic equity and equity-related funds



Source: Failaka, *The* Shari'a *Report*.

Financial Market) in Dubai became the world's first *Shari'a*-compliant stock exchange. In short, the knowledge and experience is there, but very often the monies do not follow . . . or do not follow quickly enough. This may be changing.

The cause for optimism is twofold: the rise of *takaful* or Islamic insurance and the first sign of government support.

For many industry observers the least developed and therefore the area with the most potential within Islamic finance is *takaful*. By comparison, Islamic funds are in many ways a mature product in the field with a history stretching back to the 1960s and 1970s (although the major push came in the 1990s). However, *takaful* has one key similarity in that its potential market is composed of both retail and institutional clients that span the globe. While the past five years have seen Islamic private equity, investment banking, and most especially *sukuk*, making headlines, it is quite possible that the next five years may belong to the expanding number of *takaful* houses springing up across the globe.

The point of *takaful* is simply that just like conventional insurance companies, *takaful* companies should become large buyers of funds for their excess premiums. The catch is that an Islamic *takaful* company should not be investing in conventional funds, but rather in one of the relatively few *Shari'a*-compliant funds. Although they will probably have a

markedly low risk/reward profile, their growth could provide an additional area of support for eager fund managers.

The second encouraging factor is the involvement of governments. It is fair to say that thus far, assets in Islamic funds have grown organically, primarily through the greater awareness and acceptance of retail investors. While many of these especially early investors, may have been high-net-worth, Islamic funds have been primarily supported by grass-roots individual investors. This is particularly so in the major markets of Saudi Arabia and Malaysia. While the growth has been steady, total assets in *Shari'a*-compliant equity and balanced funds (listed shares) stand at a mere $19 billion. While it may be an unfair comparison, it is illustrative that the total for socially-responsible fund assets stands at roughly €49 billion ($76 billion) from a universe of nearly 500 funds.[4]

Given this state of affairs and with the GCC especially flush in recent years, many have questioned why the regional governments have not been major investors. Surely they have their reasons, but recently the Dubai government announced a $250 million commitment to invest into an Islamic-compliant hedge fund product, a sub-set of the Islamic funds industry that has found it especially difficult to attract investment. Might this be the tip of the iceberg? With most GCC governments solidly behind the industry in terms of establishing regulatory regimes and supporting development initiatives and with oil now in its sixth year of a bull market, perhaps actual investment is the next step. If we are indeed in the midst of Goldman Sach's 'super spike' in oil prices with $200 per barrel the next stop, just think of what would happen if even a percentage of this sovereign wealth were diverted into this gradualist industry. It could grow tenfold overnight.

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1 Founder and Chairman of Failaka Advisors and Vice President of UIB Capital Inc. in Chicago.

2 Gulf Cooperation Council (GCC) member countries include Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.

3 Failaka, *The Shari'a report 2008*, profile of the world's scholars, www.failaka.com.

4 See www.responsible-investor.com.

Chapter 6

Corporate governance in Islamic finance[1]

Nasser Saidi[2]
Hawkamah

Introduction

Islamic finance is a nascent industry, with a small share of the global market – about one per cent. However, Islamic finance is benefiting from a number of favourable structural and cyclical drivers: strong growth in the GCC and Emerging Market Economies (EMEs) of Asia, positive demographics of young and rapidly growing populations and a shift of preferences of savers/investors towards Islamic finance in Muslim countries reflecting, in part, a self-reaffirmation or awakening of cultural and religious identity.

The economic renaissance of the GCC and EMEs has been accompanied by a surge in Islamic finance, which has grown by about 15–20 per cent in each of the past four years with some forecasts estimating the potential size of Islamic finance at $4 trillion, over four times its current size, over the next decade. Since the inception of modern Islamic banking, the number and reach of Islamic financial institutions worldwide has risen from one institution in one country in 1975 to more than 300 institutions operating in more than 75 countries. Product and service innovation through the development of *Shari'a*-compliant mortgages, leasing, securitization, *sukuk* and *Takaful* have also contributed to growth in Islamic finance. The other major factor is that *Shari'a* products have yielded higher returns compared with conventional assets in countries pegged to the US dollar.

Islamic finance has transcended borders and regions but many challenges lie ahead before it can make that crucial leap from being an interesting but niche market to being an integral part of the global financial market. These challenges include: a lack of product standardization resulting in higher costs and lengthier time faced by financial institutions offering *Shari'a*-compliant products; ensuring convergence of legal and regulatory frameworks; risk/liquidity management due to prohibition from investing in hedging instruments and the lack of instruments with short-term maturities; a need for innovation both in terms of retail products and services, but also for liquidity management; development and implementation of a corporate governance framework for *Shari'a*-compliant finance; a shortage of professionals and expert talent; and a lack of reliable statistical data.[3]

However, standard-setting agencies are actively trying to address these very fundamental issues facing the industry. The Accounting and Auditing Organization for Islmanic Financial Institutions (AAOIFI) has been actively seeking to reconcile international accounting standards with the specific Islamic accounting standards, and provides useful

guidance on *Shari'a* standards. The IFSB provides very valuable standards setting out the regulatory framework and capital issues which are relevant to Islamic Finance, again drawing upon the international standards. The efforts of the Islamic Financial Services Board (IFSB), the Islamic Development Board (IDB) and AAOIFI facilitate the move towards greater alignment, standardization and harmonization in Islamic Finance. This chapter focuses on a neglected but important area: corporate governance in Islamic finance.

Corporate governance

The definition of corporate governance has evolved and broadened over the past decade as a result of experience with corporate 'malgovernance' and policy reactions, as in the case of the Sarbanes Oxley Act of 2002.[4] Corporate governance aims to provide institutions with a body of rules and principles with a view to ensuring that good practices guide overall management of an institution. It has now come to mean the whole process of managing a company and the incentive structure to address principal-agent issues and ensure that executive management serves the long-term best interests of the shareholders and sustainable value of the company in conformity with the laws and ethics of the country. All of the complex factors that are involved in balancing the power between the Chief Executive Officer (CEO), the board and the shareholders are now considered to be a part of the corporate governance framework, including auditing, balance sheet and off-balance disclosure and transparency.

The Organization for Economic Co-operation and Development (OECD) Principles of Corporate Governance, first endorsed by OECD ministers in 1999, and subsequently revised in 2004, have become an international benchmark for policy makers, investors, corporations and other stakeholders worldwide. The Financial Stability Forum (FSF)[5] has designated these Principles as one of the 12 key standards for sound financial systems.

The OECD Principles of Corporate Governance are intended to assist OECD and non-OECD governments in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries. Over the years, several institutions have developed their own sets of codes and principles such as the Institute of International Finance's Policies of Corporate Governance and Transparency in Emerging Markets,[6] which established a code based on criteria that are considered important to international investors.

Box 1

The OECD Principles of Corporate Governance

I. Ensuring the Basis for an Effective Corporate Governance Framework
II. The Rights of Shareholders and Key Ownership Functions
III. The Equitable Treatment of Shareholders
IV. The Role of Stakeholders in Corporate Governance
V. Disclosure and Transparency
VI. The Responsibilities of the Board

Source: www.oecd.org

Both the OECD principles (see Box 1) and the IIF Code broadly assess five elements of corporate governance: (1) minority shareholder protection; (2) responsibilities of the board of directors; (3) accounting and auditing; (4) transparency of ownership and control; and (5) the regulatory environment. The OECD has issued a revised set of Principles of Corporate Governance aiming to provide a framework for sound corporate governance.

Hence, corporate governance refers to the method by which a corporation is directed, administered and controlled. It includes the laws and customs affecting that direction, as well as the goals for which it is governed. Corporate governance mechanisms, incentives and controls are designed to reduce the inefficiencies that arise from moral hazard and adverse selection. Corporate governance is also viewed as a process of monitoring performance by applying appropriate counter-measures and dealing with transparency, integrity and accountability. It organizes the way corporations are accountable to shareholders and the public, and also the monitoring of the executive management of organisations in running their businesses.

Islamic banking

Islamic banking refers to a system of banking or banking activity which is consistent with Islamic law (*Shari'a*) principles and guided by Islamic economics. In particular, Islamic law prohibits usury, the collection and payment of interest, also commonly called *riba* in Islamic discourse. Instead, profit-and-loss sharing arrangements (PLS) or purchase and resale of goods and services form the basis of contracts. In PLS modes, the rate of return on financial assets is not known or fixed prior to undertaking the transaction. Islamic law also generally prohibits trading in financial risk (which is seen as a form of gambling). In addition, Islamic law prohibits investing in businesses that are considered *haram* (such as businesses that sell alcohol or pork, or businesses that produce un-Islamic media).[7]

In countries where Islamic banking operates, its coverage and extent vary significantly from situations where the whole financial sector is entirely Islamic (Iran) to others where conventional and Islamic systems co-exist (Indonesia, Malaysia, Pakistan and the United Arab Emirates), to countries where there are one or two Islamic banks, or countries where 'Islamic windows' exist within conventional banks. The current trend seems to be towards separation between Islamic and conventional banks.

In recent years, many new Islamic financial products have been developed and they are increasingly used in financial market activities, including equity and bond (*sukuk* and Certificate of Investment) trading and investment, *takaful* and re-*takaful*, Islamic syndicated lending and investment in Islamic collective investment schemes and other wealth and asset management products including Islamic trust services (*waqf*).[8]

Corporate governance framework of Islamic banks and financial institutions

Corporate governance is not new to Islamic finance. Indeed, Islamic finance embeds the basic tenets of good corporate governance, stressing the three main areas of accountability, transparency and trustworthiness.[9]

Corporate governance in Islamic finance necessitates Islamic financial institutions abiding by a set of rules called the Islamic law or *Shari'a*. The *Shari'a* governs the bank's operations and transactions in accordance with Islamic principles derived from the *Qur'an* and *Hadith*.

Box 2

Regulatory and Corporate Governance (CG) framework of Banks

I. National CG Framework

- Banking Sector Specific Laws/Codes/Guidelines
- Stock Exchanges Listing Rules and Regulations
- Listed Companies Regulatory Authorities Laws, Rules and Regulations

II. Islamic Finance and *Shari'a* Specific Codes & Standards

- IFSB Guiding Principles on Corporate Governance for Institutions Offering Islamic Financial Services 2006[a]
- Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) Accounting, Auditing & Governance Standards (for Islamic financial institutions)[b]
- Islamic Financial Services Board (IFSB) published Standards including Guidance on Key Elements in the Supervisory Review Process of Institutions offering Islamic Financial Services (excluding Islamic Insurance (*Takaful*) Institutions and Islamic Mutual Funds)

III. International Standards and Codes

- The OECD Principles of Corporate Governance[c]
- Guidance by the Basel Committee on Banking Supervision on Enhancing Corporate Governance for Banking Organisations 2006[d]

Sources

[a] http://www.ifsb.org/index.php?ch=4&pg=140
[b] www.aaoifi.com
[c] http://www.oecd.org/document/49/0,2340,en_2649_34813_31530865_1_1_1_1,00.html
[d] http://www.bis.org/publ/bcbs122.htm

Having established a broad understanding of the notion of corporate governance, let us now fit this into an Islamic banking paradigm. Box 2 suggests the build-up of a corporate governance framework for Islamic financial institutions. To ensure that a national- or sector-specific CG framework is consistent with international best practice, the framework should incorporate the OECD principles and the Bank for International Settlements (BIS) Guidelines.

The guidelines issued by the BIS, entitled 'Enhancing corporate governance for banking organizations', builds on a paper originally published by the Committee in 1999, as well as the OECD principles for corporate governance. The intent is to help ensure the adoption and implementation of sound corporate governance practices by banking organizations worldwide, whether conventional or *Shari'a* compliant. As the accompanying box displays, the guidelines focus on: (a) the roles of boards of directors and the important role of

independent directors, and senior management; (b) effective management of conflicts of interest; (c) the roles of internal and external auditors, as well as internal control functions; (d) governing in a transparent manner, especially where a bank operates in jurisdictions, or through structures, that may impede transparency; and (e) the role of bank supervisors in promoting and assessing sound corporate governance practices.

Box 3

Guidance by the Basel Committee on Banking Supervision on Enhancing Corporate Governance for Banking Organisations, 2006

Principle 1: Board members should be qualified for their positions, have a clear understanding of their role in corporate governance and be able to exercise sound judgment about the affairs of the bank

Principle 2: The board of directors should approve and oversee the bank's strategic objectives and corporate values that are communicated throughout the banking organization

Principle 3: The board of directors should set and enforce clear lines of responsibility and accountability throughout the organization

Principle 4: The board should ensure that there is appropriate oversight by senior management consistent with board policy

Principle 5: The board and senior management should effectively utilize the work conducted by the internal audit function, external auditors, and internal control functions

Principle 6: The board should ensure that compensation policies and practices are consistent with the bank's corporate culture, long-term objectives and strategy, and control environment

Principle 7: The bank should be governed in a transparent manner

Principle 8: The board and senior management should understand the bank's operational structure, including where the bank operates in jurisdictions, or through structures, that impede transparency ('know-your-structure')

IFSB principles and AAOIFI governance standards

Islamic banking offers a different paradigm from conventional banking, and from the viewpoint of corporate governance, it embodies a number of interesting features since equity participation, risk and profit-and-loss sharing arrangements form the basis of Islamic financing. These financial arrangements imply different stakeholder relationships, and by corollary governance structures, from the conventional model since depositors have a direct financial stake in the bank's investment and equity participations. In addition, the Islamic bank is subject to an extra layer of governance since the suitability of its investment and financing must be in strict conformity with Islamic law and the expectations of the Muslim community.

In December 2006, the Islamic Financial Services Board (IFSB) published the 'Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services

(Excluding Islamic Insurance (*takaful*) Institutions and Islamic Mutual Funds)' and has since set up a working group to address implementation issues.

The IFSB document sets out seven guiding principles (the Guiding Principles) of prudential requirements in the area of corporate governance for institutions offering only International Islamic financial services (IIFS) (excluding (a) Islamic insurance (*takaful*) institutions and (b) Islamic mutual funds). The Guiding Principles are divided into four parts:

- General governance approach of IIFS;
- Rights of investment account holders (IAH);
- Compliance with Islamic *Shari'a* rules and principles; and
- Transparency of financial reporting in respect of investment accounts.

The Guiding Principles are designed to help IIFS establish and implement effective corporate governance practices. The Guiding Principles are applicable to commercial banks, investment banks, finance houses and other fund-mobilizing institutions that offer only financial services and products complying with Islamic *Shari'a* rules and principles, as determined by the respective supervisory authorities.[10]

A number of corporate governance issues are of equal concern to all institutions offering financial services, whether IIFS or others. The IFSB acknowledges that many bodies that are concerned with the promotion of good corporate governance have issued codes of corporate governance best practices, which have been widely accepted as the international standards, and would be relevant and useful for IIFS. On this premise, the Guiding Principles do not intend to reinvent the wheel by proposing a wholly new corporate governance framework. Instead, the Guiding Principles aim to complement the existing internationally recognized standards of good corporate governance by particularly addressing the specifics of IIFS (see Box 4). Indeed, the IFSB's Guiding Principles complement those of the OECD and the BIS. As shown in Box 2, the CG framework for IIFS stands on top of, and builds on, the international codes and standards and forms the basis for national codes, guidelines and regulations to be issued by bank supervisors and central banks.

The IFSB in its guiding principles places the focus on IAHs and protecting their rights. Conceptually, under the principle of *mudarabah*, IAHs as *rabb al-mal* bear the risk of losing their capital invested by the IIFS as *mudarib*. Effectively, this means the IAH's investment risk is similar to that of the shareholders of IIFS who bear the risk of losing their capital as investors in the IIFS. However, the IIFS as *mudarib* owes a fiduciary duty to the IAH under the *mudarabah* contract, which is parallel with their duty to their shareholders. In this context, the IIFS as *mudarib* refer to both their management and their shareholders, not the management alone. Therefore, for the purpose of the Guiding Principles, discussions on the fiduciary duties of IIFS to the IAH shall always be understood as the fiduciary duties of both the management and shareholders of IIFS as *mudarib* towards the IAH as *rabb al-mal*.

In this respect, whether the investment mandate is restricted[11] or unrestricted,[12] under a *mudarabah* contract, the IIFS have a fiduciary duty to the IAH to uphold their interests no less than those of the IIFS's own shareholders. In other words, although as investors in the IIFS's assets the shareholders would rank *pari passu* with the IAH, the IIFS's as a party in the *mudarib* side of the *mudarabah* contract also owe a fiduciary duty to the IAH and would have to ensure the protection of the IAH's interests.

Box 4

The Seven Guiding Principles of IFSB

Principle 1.1: IIFS shall establish a comprehensive governance policy framework which sets out the strategic roles and functions of each organ of governance and mechanisms for balancing the IIFS's accountabilities to various stakeholders. Ensuring the basis for an Effective Corporate Governance Framework.
Principle 1.2: IIFS shall ensure that the reporting of their financial and non-financial information meets the requirements of internationally recognized accounting standards which are in compliance with *Shari'a* rules and principles and are applicable to the Islamic financial services industry as recognized by the supervisory authorities of the country.[a]
Principle 2.1: IIFS shall acknowledge IAH's right to monitor the performance of their investments and the associated risks, and put into place adequate means to ensure that these rights are observed and exercised.
Principle 2.2: IIFS shall adopt a sound investment strategy which is appropriately aligned to the risk and return expectations of IAH (bearing in mind the distinction between restricted and unrestricted IAH), and be transparent in smoothing any returns.
Principle 3.1: IIFS shall have in place an appropriate mechanism for obtaining rulings from *Shari'a* scholars, applying *fatwa* and monitoring *Shari'a* compliance in all aspects of their products, operations and activities.
Principle 3.2: IIFS shall comply with the *Shari'a* rules and principles as expressed in the rulings of the IIFS's *Shari'a* scholars. The IIFS shall make these rulings available to the public.
Principle 4: IIFS shall make adequate and timely disclosure to IAH and the public of material and relevant information on the investment accounts that they manage.

Note
[a] Note the special focus in the IFSB principles no 1.2, 2.1, 2.2 and 4 on IAH

Hence, it is appropriate that IIFS put IAHs on an equal footing with the IIFS's own shareholders by duly acknowledging the IAH's right to access all relevant information in relation to their investment accounts. This would assist the IAH in making an informed decision on their selection or choice of the investment accounts in which to place their funds with the IIFS. In a situation where the local legal framework is not yet capable of facilitating the exercise of these rights by the IAH, the supervisory authorities should play a role in protecting the interests of the IAH *vis-à-vis* the shareholders of IIFS with regard to their rights, provided that they are in compliance with *Shari'a* rules and principles.

The IAH's right to monitor the performance of their investment should not be misconstrued as a right to intervene in the management of the investments by the IIFS. It shall be noted that shareholders of IIFS who are entitled to vote in general meetings, to pass resolutions on the appointment of directors and auditors, and to access the documents of the IIFS are also not considered as intervening in the management of the IIFS. Therefore, it is only

appropriate that IIFS disclose to the IAH, their policies and practices in respect of the investment accounts which they offer.

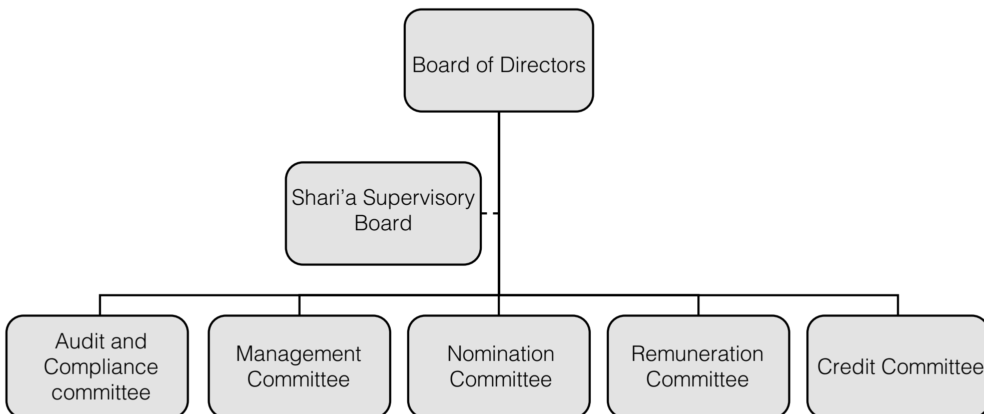
The Accounting and Auditing Organizations for Islamic Financial Institutions (AAOIFI) has also issued 35 standards on accounting, auditing, governance, ethical and a *Shari'a* governance pronouncement. The AAOIFI explains the role of the Audit and Governance Committee as being responsible for overall monitoring of business covering internal control, compliance with *Shari'a* laws and principles and adherence to code of ethics. In 2008, AAOIFI revised the Accounting, Auditing & Governance Standards (for Islamic Financial Institutions) to take account of changes in international accounting and auditing standards and their impact for IIFs.

Internal and external *Shari'a* compliance for IFIs

To ensure *Shari'a* compliance, Islamic banks employ an individual *Shari'a* Advisor and/or Board. Central to such a framework is the *Shari'a* Supervisory Board (SSB) and the internal controls which support it. In some countries the SSB is established at central banks while in others *Shari'a* advisors are established at commercial banks. In the latter case, their independence from bank management is an issue. On occasions, a number of banks might use the advice of the same *Shari'a* advisor (SA), which could raise an issue of conflict of interest. Establishing guidelines for, and coordinating the advice of, an SA appears to be an issue of concern that has drawn the attention of regulators. Similarly, cross-country coordination among SSB's interventions/guidance is also an issue that has led the authorities in a number of countries to call for harmonization.

Exhibit 6.1

Sample organizational chart of an Islamic bank



Source: Author's own.

In principle, the role of the SSB covers five main areas: ensuring compliance with overall Islamic banking fundamentals, certifying permissible financial instruments through

Fatwas, verifying that transactions comply with issued *Fatwas*, calculating and paying *Zakat*, disposing of non-*Shari'a*-compliant earnings and advising on the distribution of income or expenses among shareholders and investment account holders. The SSB issues a report to certify that all financial transactions (including investments) comply with the abovementioned principles. This report is often an integral part of the Annual Report of the Islamic financial institution. In practice an SSB's tasks may vary according to provisions stipulated in the Articles of Association of the financial institution or those stipulated by national regulators.[13]

The SSB can also issue recommendations on how the institution could best fulfill its social role as well as promote Islamic finance. In addition to internal corporate arrangements, national regulators and international standard setters have developed guidelines for SSBs. These often refer to the SSBs' general duty to ensure *Shari'a* compliance of transactions and, less frequently, indicate areas of competence, composition and decision-making.

There are external arrangements in place as well; such arrangements, including mechanisms of market discipline, can provide complementary channels inducing compliance with rulings and their harmonization. Indeed these are similar to the Basel II Pillars, where the second and third pillars focus, respectively, on supervisory/regulatory review and market discipline.

Exhibit 6.2 illustrates the different roles and competencies of the internal *Shari'a* review unit as compared with the external *Shari'a* review and audit.

Good corporate governance practice should also specify the role, structure and composition of SSBs. Exhibit 6.3 shows the legal basis and nature of regulations on internal SSBs in selected countries as promulgated by the respective regulatory bodies.

Many countries with important Islamic finance sectors have also sought to organize the role of external *Shari'a* review and, in some cases, have established a central *Shari'a* Board or Council (Indonesia, Kuwait, Malaysia, Sudan, Pakistan and the UAE). Having a central SSB or *Shari'a* Council can help in the standardization of *Shari'a* opinions across the jurisdiction and also helps reduce costs. However, it may also stifle innovation and impose a regulatory burden on the growth of the industry. Exhibit 6.4 shows the external *Shari'a* corporate governance institutions by country.

Corporate governance in *Takaful* and re-*Takaful* industry[14]

This underdevelopment and low penetration rates of the insurance industry, both conventional and *Shari'a* compliant, in the MENA region and countries with an important Islamic finance industry is attributable to a number of factors, including poor corporate governance, barriers to entry, restricted market access and protection of local insurers. The near absence of competition, restrictions on entry of foreign insurers and the dominance of government-owned insurers and regulatory control of insurance pricing and products, has led to expensive insurance and an absence of new products and innovation.

The guidelines laid down by the OECD and The International Association of Insurance Supervisors (IAIS)[15] for corporate governance in the insurance sector serve as an industry benchmark for standard setting. These guidelines emphasize the importance of sound risk management and decision-making processes. They also include setting out the roles and responsibilities of directors and ensuring that the rights of policyholders and shareholders are

Exhibit 6.2

Comparison between internal and external *Shari'a* arrangements

	Internal *Shari'a* review unit	External *Shari'a* review and audit
Focus	Provides exhaustive internal review, and trains employees on *Shari'a* related matters. It responds to managerial concerns over upholding *Shari'a* conformance of all transactions.	Primarily provides an independent certification as to the reasonableness of financial information provided to shareholders and stakeholders. It responds to regulators' and stakeholders' desire for an independent appraisal of *Shari'a* compliance.
Activities	Assesses compliance of *all* transactions with the *fatwas* issued by the SSB. To this effect, it creates systems of control and assessment.	Assesses the information provided by the managers and presents statements according to relevant *Shari'a* accounting standards. It uses *samples* of transactions to evaluate truthfulness of compliance and expresses an opinion on financial statements.
Management	Reports to management administratively. Builds relationships throughout the organization to ensure concerns are identified and resolved in a timely manner.	Primarily reports to the Board/audit committee on financials and internal control.
Board of Directors/ Committee	Reports directly to the audit committee. Provides opinions on the organization's business risks, financial statements, system of internal control and level of compliance with laws, regulations, and policies.	Attests to the audit committee the accuracy of the financial reports and attests on management's assessment on internal controls over financial reporting. Provides updates on pending accounting pronouncements and their potential impact on the organization.
Independence	Should demonstrate organizational independence and objectivity in work approach, but is managerially dependent on the organization.	It is organizationally and managerially independent of the organization.
Results	Identifies problems, makes recommendations and helps facilitate resolutions.	Meets statutory requirements and provides necessary adjustments to meet financial accuracy.

Risk	Identifies and qualifies key business risks to estimate probability of occurrence and impact on business. Makes appropriate recommendations as a result of the risk assessment.	Identifies key transactions and exposures for financial statements.
Fraud	Includes fraud detection steps in audit programmes. Investigates any allegations of fraud. Reviews fraud prevention controls and detection processes put in place by management and makes recommendations for improvement.	Includes fraud detection steps in audit plan. Gathers information necessary to identify risks of material misstatement due to fraud, by enquiring of management and others within the entity about the risks of fraud. Considers the results of the analytical procedures performed in planning the audit and fraud risk factors.
Recommendations	Communicates to management in the audit reports recommendations for corrective action.	Communicates recommendations for corrective action to the Board Audit Committee.

Source: Wafik Grais and Matteo Pellegrini (2006), 'Corporate Governance and *Shari'a* Compliance in Institutions Offering Islamic Financial Services', World Bank Policy Research Working Paper 4054, November, 2006.

Exhibit 6.3

Legal basis and nature of regulations on internal SSBs in selected countries as of November 2006

Country	Legal base for SSB	SSB competences as spelled out by existing laws	SSB composition	SSB decision-making	SSB Appointment and Dismissal rules	Fit and proper criteria for SSB members
Bahrain	*BMA Rulebook - Volume 2- Islamic Banks - The BMA (2005) and all AAOIFI standards.*	General duty to verify *Shari'a* compliance and issue an annual report. Binding advice. The shareholders shall decide how SSB will discharge this duty.	At least three members (according to AAOIFI).	Unspecified (to be decided by shareholders).	Appointed by Shareholders. Dismissal is proposed by Board and approved by shareholders (according to AAOIFI standards).	Conflict of interest and competence clauses (According to AAOIFI governance standards).
DIFC*	*Law regulating Islamic financial business, DIFC Law No. 13 of 2004 and the Islamic Financial Business Module of the DFSA Rulebook.*	Oversees and advises on *Shari'a* compliance. Specific duties to be established and documented by the BIFS.	No fewer than three members.	Unspecified.	Appointed and dismissed by the bank's governing body.	They must be competent (based on previous experience and qualifica-tions) and are not directors or controllers of the BIFS.
Indonesia	*Act No. 7 of 1992 as amended by Act 10 of 1998, Regulation 4/1/PBI/2002.*	General obligation to verify *Shari'a* compliance (duties as stipulated by National *Shari'a* Board and established by in bank's Articles of Association).	Unspecified.	Unspecified.	Any appointment or replacement of SSB members must be reported to Bank of Indonesia and approved by the National *Shari'a* Board.	Documentary evidence on SSB members' previous experience to be submitted to Bank of Indonesia's Board of Governors.

Jordan	*Art. 58 of Law 28 of 2000 as amended by temporary Law No. 46 of 2003.*	Ex ante audit (*fatwas*), ex-post audit, opinions on *Shari'a* matters referred to it.	No fewer than three members.	By unanimous or majority vote. Its votes are valid only if a majority of members is present.	Appointed by the general assembly of shareholders. Discharged only through a reasoned decision taken by 2/3 of the Board of Directors and endorsed by the general assembly. Changes have to be notified to the Central Bank.	Unspecified.
Kuwait	*Art 93 of Law No. 32 of 1968*	General obligations to verify *Shari'a* compliance of banking operations.	No fewer than three members.	By unanimity. In case of conflict the matter is referred to the *Fatwa* Board.	Unspecified.	Unspecified.
Lebanon	*Law No. 575 on 'Establishing Islamic Banks in Lebanon'.*	Certification of *Shari'a* compliance and proposals for properly achieving bank's objectives pursuant to the *Shari'a*.	Three members.	Unspecified.	Appointment for a renewable three-year period.	Unspecified (experts' background must be in Islamic law, doctrine and banking and financial operations).
Malaysia	*Islamic Banking Act of 1983 and Central Bank of Malaysia Act 1958 (Revised 1994) and Guidelines on the Governance of* Shari'a *Committees (2004).*	Binding *Shari'a* advice on compliance of banking operations for Islamic Banks. The Central *Shari'a* Advisory Council is the ultimate arbiter.	Unspecified.	Unspecified.	Unspecified.	There are several incompatibility clauses.

Pakistan	*IBD Circular No. 02 of 2004.*	General obligation to verify *Shari'a* compliance of banking operations. The SSB must submit an annual report to shareholders.	Only one advisor required. A board may be set up at the bank's discretion.	Unspecified.	Appointment must be approved by the State Bank of Pakistan.	They are compulsory and relate to minimum qualification and experience, track record, solvency, financial integrity, honesty and reputation and conflicts of interest.
Philippines	*Republic Act No. 6848 and Manual of Regulations for Banks Implementing Rules and Regulations of Republic Act No. 848.*	It offers advice and undertakes reviews on matters relating to *Shari'a* compliance.	At least three but no more than five members.	Unspecified.	Unspecified.	SSB members must be Islamic scholars and jurists of comparative law.
Thailand	*Islamic Bank of Thailand Act B.E. 2545.*	It has 'the authority and duty to give advice and recommendations to the Board of Directors concerning Islamic principles related to the operation of the bank'.	Not more than 4 members.	At least half of the SSB members form a quorum and decisions are taken by majority vote.	SSB members have a two-year tenure and may be reappointed. They are appointed and removed by the Board of Directors.	Financial integrity, competence, honesty and conflicts of interests.
UAE	*Federal Law No. 6 of 1985.*	General obligations to verify *Shari'a* compliance of banking operations. Detailed competences to be established by the bank.	No fewer than three.	To be decided in the articles of association of the bank.	SSB members must be approved by the Higher *Shari'a* Authority.	Unspecified.

* Dubai International Financial Centre

Source: Official country websites and central bank Annual Reports, see also Annex III of W.Grais and M. Pellegrini (2006), 'Corporate Governance and *Shari'a* Compliance In Institutions Offering Islamic Financial Services', World Bank Policy Research Working Paper 4054, November.

Original Source: Wafik Grais and Matteo Pellegrini (2006), 'Corporate Governance and *Shari'a* Compliance in Institutions Offering Islamic Financial Services', World Bank Policy Research Working Paper 4054, November, 2006.

Exhibit 6.4

External *Shari'a* CG institutions by country as of November 2006

Country	Separate Islamic Banking & Takaful Department at CB or at Bank Supervisor.	Centralized SSB or High *Shari'a* Authority or *Fatwa* Board.	Islamic Rating Agency.	Separate Islamic Capital Market Department within Securities regulator.
Bahrain	Yes, Islamic Financial Institutions Supervision Directorate.	No, but the International Islamic Financial Market is to promote the harmonization and convergence of *Shari'a* interpretations in developing Islamic banking products and practices which are universally acceptable.	No, but International Islamic Rating Agency operates in Bahrain.	No.
Indonesia	Yes, the Directorate of *Shari'a* Banking.	Yes, the *National Shari'a Board* is authorized to issue *Fatwas* concerning products, services and operations of BIFS. It also recommends *Shari'a* advisors to BIFS.	No.	?[a]
Jordan	No.	No.	No.	No.
Kuwait	No.	The *Fatwa Board* in the Ministry of *Awqaf* and Islamic Affairs is the final authority on *Shari'a* disputes. Its advice is binding when it arbitrates on disputes between members of the same SSB.	No.	No.
Malaysia	Yes, Regulation Department – Islamic Banking and *takaful.*	Yes. The *Shari'a Council* advises central bank on *Shari'a* matters and is the ultimate arbiter in *Shari'a* interpretation disputes. The directives issued by BNM in consultation with the *Shari'a* Council have binding authority over Banks with Islamic windows.	Yes, Malaysian Rating Corporation – Islamic Capital Market Department.	Yes, Malaysian SEC – Islamic Capital Market Department. The SEC also has its own *Shari'a* Advisory Board.

Sudan	N/A, the whole financial regulatory system is Islamic.	Yes, the *Shari'a* High Supervisory Board is responsible for *Fatwas*, contract specimen, arbitrage, consultations relating to Islamic legal aspects, training, research, lectures, and seminars.	No.	N/A, the whole financial regulatory system is Islamic.
Pakistan	Yes, Islamic Banking Department.	Yes, the *Shari'a Board* of the State Bank is to advise the central banks on matters of *Shari'a*. It also produces specimen of permissible Islamic Financial contract to ensure compliance with minimum *Shari'a* standards.	No.	No, but several departments share Islamic finance portfolios.
UAE	No.	Yes, the Higher *Shari'a* Authority, attached to the Ministry of Justice and Islamic Affairs, is the final arbiter on *Shari'a* matters. It is also responsible of *Shari'a* supervision.	No.	No.

Note

[a] Indonesia's House of Representatives has passed an Islamic bank law in 2008 that may result in changes to the current regulatory structure. See: http://www.thaindian.com/newsportal/business/indonesian-parliament-passes-islamic-banking-bill-into-law_10061212.html.

Source: Official country websites and central bank Annual Reports and Wafik Grais and Matteo Pellegrini (2006) 'Corporate Governance and *Shari'a* Compliance in Institutions Offering Islamic Financial Services', World Bank Policy Research Working Paper 4054, November 2006.

protected. Transparency, disclosure and regular reviews are also key requirements to facilitate good decision-making as well as protecting stakeholder rights.

The IAIS has also developed insurance core principles and methodology stating the essential principles that need to be in place for a supervisory system to be effective. In particular, ICP 9[16] deals with corporate governance and emphasizes that the corporate governance framework should recognize and protect rights of all interested parties. The board is the focal point of the corporate governance systems and is ultimately accountable and responsible for the performance and conduct of the insurer. The delegation of authority to board committees, *Shari'a* committees or executive management does not in any way mitigate or dissipate the discharge by the board of directors of its duties and responsibilities.

In August 2006, the IFSB and IAIS published an informative, 'Issues in Regulation and Supervision of *Takaful*' which touched on corporate governance, noting that international corporate governance principles extend to the *Shari'a* board/committee. The latter should be an integral part of the internal governance structure of the insurer and ensure compliance with the *Shari'a*.

Consideration also needs to be given to the relationship between the *Shari'a* committee and other governance structures of the company to ensure that responsibilities are clearly and appropriately allocated.

The corporate governance framework should ensure the independence, confidentiality and competence of *Shari'a* scholars, as well as the consistency of *Shari'a* scholars' *fatwas* (rulings).

There are additional specific challenges faced by the *takaful* industry in terms of corporate governance. Governance issues to be addressed include the protection of minority shareholders, improved disclosure of risks, commingling of resources, balancing UIA holders' risks and rights, and the rules for the utilization of reserve funds. More generally, regulators need to impose mandatory, uniform financial reporting standards and disclosure requirements.

Concluding observations

Increasingly, good corporate governance practices are integral to creating and sustaining the long term value of firms, whether or not *Shari'a*-compliant. Empirical evidence suggests that more than 84% of the global institutional investors are willing to pay a premium for the shares of a well governed company over one considered poorly governed but with a comparable financial record.[17] Similarly, a study of S&P 500 firms by Deutsche Bank showed that companies with strong or improving corporate governance outperformed those with poor or deteriorating governance practices by about 19% over a two-year period.[18]

Transparency and disclosure are key elements of corporate governance (CG). Good CG practices not only impact a company's performance in terms of its equity, but better corporate governance standards make banks and rating agencies lead to improved credit ratings, thereby reducing the cost of borrowing for well governed companies. It also improves an institution's market perception and rating and positively affects its market value.

The international Corporate Governance frameworks mentioned in this chapter including the OECD and BIS Principles set out the broad Corporate Governance framework for Islamic

Banks. IFSB and AAOIFI standards have developed Corporate Governance standards and principles specifically for *Shari'a*-compliant institutions that complement and extend good corporate governance principles to IIFS. All these standards complement the national and organization specific CG practice prevalent in *Shari'a*-compliant institutions and help them to integrate with the mainstream financial services industry.

Today, good corporate governance is considered vital as it promotes morality, honesty, integrity, trust, openness, performance orientation, responsibility and accountability, as well as mutual respect and commitment to the organization from all parties in an organization. Corporate governance does not apply only to directors and executives, but to all players in the organization. Indeed the values underlying good corporate governance are fully consistent with and embedded in the principles of Islamic finance.

Strong corporate and bank governance are essential ingredients for the development of a vibrant and sound Islamic finance industry. The time is ripe for action on two broad fronts: the mainstreaming of Islamic financial services and products, and the creation of an international Islamic financial market. The egalitarian nature of Islamic finance and its risk-sharing characteristics are ideal for incorporation in access to finance programmes in Africa, MENA, Asia and elsewhere. Islamic finance is a viable and credible complement to conventional financing. Governments, central banks and regulators must take concerted action with the banking and financial industry to create the enabling environment, including corporate governance frameworks in order to build an integrated Islamic capital market and mainstream *Shari'a*-compliant products and services to improve access to finance as well as develop a sound, well-functioning Islamic financial system and achieve banking and financial deepening.

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[2] Dr Nasser Saidi is Executive Director of Hawkamah, the Institute for Corporate Governance.

[3] See the discussion in Nasser Saidi, "Leading Islamic Finance across Borders", speech at Leaders in Islamic Finance conference, Istanbul, May, 2008.

[4] This is available in www.soxlaw.com.

[5] www.fsforum.org.

[6] http://www.iif.com/emr/corpgov/code/ For the OECD principles and discussion thereof, see http://www.oecd.org/document/56/0,2340,en_2649_34813_31530865_1_1_1_1,00.html.

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[8] See IMF Finance and Development Quarterly magazine, Dec 2005.

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[10] IFSB is producing a CG code for Takaful and for Collective Investment Schemes that would parallel the CG Guidelines for collective investment vehicles issued by the International Organization of Securities Commissions (IOSCO) www.iosco.org.

[11] Restricted Investment Account means that the Islamic Bank can invest the depositors' funds in specified investments only. As those funds are invested according to clients' directives and are not at the discretion of the banks, they cannot be part of a bank's source of funds. In this context, AAOIFI recommends that restricted investment accounts be included as off-balance sheet items.

[12] Unrestricted Investment Account means that the Islamic Bank has the discretion of investing the depositors' funds in any investment. *Source:* http://www.palgrave-journals.com/jbr/journal/v9/n1/full/2350059a.html.

[13] See also Wafik Grais and Matteo Pellegrini (2006), "Corporate Governance in Institutions Offering Islamic Financial Services Issues and Options", World Bank Policy Research Working Paper 4052, November.

[14] Article by Dr Nasser Saidi, Middle East Insurance Review March 2008. See also http://www.hawkamah.org/bridging_the_gap/networks/regional_task_forces/.

[15] www.iaisweb.org.

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Chapter 7

Islamic finance: can it contribute something worthwhile to global finance?

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Introduction

The conventional financial system has evolved over the last two centuries and has contributed a great deal to the development of not only the western world but also to that of a substantial number of developing countries. It is, accordingly, well-established by now. Mention of Islamic finance thus raises the question of whether there is a strong rationale for the establishment of a parallel system. The rationale would exist only if it can be shown convincingly that the Islamic system is capable of addressing successfully some problems that the conventional system has been unable to solve.

There is a general agreement that every system must ultimately lead to the optimum well-being of all people. This is in essence the objective behind all human activity. Such well-being can be attained by optimizing both efficiency and equity in the use of resources. Optimum efficiency would be realized if the resources mobilized by financial institutions were utilized in such a way that there is an optimum contribution to the growth of total output. This may be difficult to realize if the financial system is persistently plagued by severe financial crises. Optimum equity would be realized if the resources mobilized from a large spectrum of depositors also benefited a large spectrum of users.

While the conventional financial system has generally been considered to be superior on account of efficiency, it has rarely been commended for its contribution to equity. However, the serious crises that it has experienced over the last few decades have dented its claim for even optimum efficiency. It is estimated that there have been more than a hundred crises over the last four decades (Stiglitz, 2003, p. 54). Not one single geographical area or major country has been spared the effect of these crises. Even some of the countries that have followed sound fiscal and monetary policies have also faced crises. These crises have adversely affected the total output of the world economy and, thus, its overall efficiency.

The ultimate cause of the crises

These crises have led to a call for comprehensive reform of the international financial system with a view to helping prevent their outbreak and spread or, at least, to minimize their

frequency and severity. It may not, however, be possible to formulate a comprehensive reform programme until the primary cause of the crises is determined. A number of economists have made an effort to determine the causes of these crises, but no consensus seems to have developed so far about the ultimate cause or the cause of the crises.

The contention of this chapter is that the primary cause of the crises is inadequate market discipline in the financial system. Instead of making both depositors and bankers share in the risks of business, it assures them of the repayment of their deposits or loans with interest. This shifts the entire risk onto the shoulders of entrepreneurs. If there is a loss, the depositors as well as the bankers, who have not done anything more than make their surplus funds available, receive a positive return in the form of interest, while the entrepreneur, who has applied a great deal of his time, energy and skill to the project to make it successful, bears the entire loss himself. In addition to being unjust, this makes the depositors complacent and makes them take little interest in the affairs of their financial institutions. It also makes the banks rely on the crutches of collateral to extend financing for practically any purpose, including speculation. Speculation is a zero sum game. It only transfers resources from one person to another without adding anything of value to the total output. The larger the amount used for speculative purposes, the smaller will be the contribution to total output.

Even though the collateral is indispensable for minimizing risk, it cannot be a substitute for a more careful evaluation of the project financed. This is because the value of the collateral can rise or fall as a result of the instability that now prevails in the financial markets. If the value rises, the banks are naturally motivated to extend more credit, thereby creating heat in asset prices. However, if the value falls, the banks demand either additional collateral or the repayment of the loan. This leads to a chain of defaults and also to a decline in the volume of credit. The whole cycle generates instability in commodity and asset prices and also in the economy. If the banks get into difficulty as a result of such defaults, central banks are generally ready to bail them out. The Federal Reserve has recently even bailed out an investment bank while the Bank of England has bailed out a mortgage bank.

It is but natural for banks to try to maximize their profit. The more they lend, the higher their profit. It is the risk of loss that can serve as a check on lending by making the banks cautious. It is this possibility of suffering a loss that strengthens market discipline. The false assurance provided to them that they will not suffer losses, impairs the ability of the market to impose discipline and leads to an unhealthy expansion in the overall volume of credit, to excessive leverage and to people and organizations living beyond their means. Jean Claude Trichet, president of the European Central Bank, has rightly pointed out that ‘a bubble is more likely to develop when investors can leverage their positions by investing borrowed funds’ (2005, p. 4). The IMF also acknowledged this fact in its May 1998 World Economic Outlook by stating that countries with high levels of short-term debt are ‘likely to be particularly vulnerable to internal and external shocks and thus susceptible to financial crises’ (p. 83).

While a reasonable amount of debt is necessary for financing the purchase and sale of real goods and services by households, firms and governments, an excess of it tends to be diverted to unproductive uses, as well as speculation in the foreign exchange, stock, and property markets and generates instability in these markets as well as the economy. One may wish to pause here to ask why a rise in debt, and particularly short-term debt, should accentuate instability? One of the major reasons for this is the close link between easy

availability of credit, macroeconomic imbalances and financial instability. The easy availability of credit makes it possible for the public sector to have a high debt profile and for the private sector to live beyond its means and to have a high leverage. If the debt is not used productively, the ability to service the debt does not rise in proportion to the debt and leads to financial fragility and debt crises. The greater the reliance on short-term debt and the higher the leverage, the more severe the crises may be. This is because short-term debt is easily reversible as far as the lender is concerned, but repayment is difficult for the borrower if the amount is locked up in loss-making speculative assets or medium- and long-term investments with long gestation periods.

It would be useful to give a few examples to show how the easy availability of credit and the resultant steep rise in debt, particularly short-term debt, are the result of inadequate discipline in the financial markets due to the absence of risk-sharing. One could choose a number of cases but for brevity we confine ourselves to only three. These are: foreign exchange market instability, collapse of the Long-Term Capital Management (LTCM) hedge fund and the prevailing sub-prime mortgage crisis in the US financial system.

Foreign exchange market instability

The heavy reliance on short-term borrowing has injected a substantial degree of instability into the international foreign exchange markets. According to a survey conducted by the Bank for International Settlements, the daily turnover in traditional foreign exchange markets, adjusted for double-counting, escalated by an unprecedented 71 per cent in April 2007 to $3,210 billion, compared with $1,880 billion in April 2004 (BIS, September 2007). The total amount of world trade in April 2007 was $ 2,196.8 billion compared with $1,489.7 billion in April 2004 (IMF, International Financial Statistics, IFS, online database). This comes to a daily average merchandise trade (exports plus imports) of $73.2 billion. The daily foreign exchange turnover in April 2007 was, thus, 43.9 times the daily volume of world merchandise trade (exports plus imports).

Only 31 per cent of the 2007 turnover was related to spot transactions, which have risen at the compounded annual rate of about 17.4 percent per annum since April 2004. The balance of the turnover (69 per cent) was related largely to outright forwards and foreign exchange swaps, which have registered a compounded growth of 20.5 per cent per annum. While the growth of 17.6 per cent per annum in daily spot transactions may be warranted if an allowance is made for services, unilateral transfers, and non-speculative capital flows, the growth of 20.5 per cent in forwards and swaps seems to be far more than warranted compared with the growth of only 13.8 per cent per annum in world trade over this period. If the assertion normally made by bankers that they give due consideration to the end use of funds had been correct, such a high degree of leveraged credit extension for speculative transactions may not have taken place. High leverage has had the effect of driving foreign exchange markets by short-term speculation rather than long-run fundamentals. This has made these markets highly volatile, injected excessive instability into them and adversely affected their efficient operation. The effort by central banks to overcome this instability through small changes in interest rates or the intervention of a few hundred million dollars a day has generally not proved to be significantly effective.

The collapse of LTCM

The collapse of the US hedge fund LTCM in 1998 was also due to highly leveraged short-term lending. Even though the name hedge fund brings to mind the idea of risk reduction, 'hedge funds typically do just the opposite of what their name implies: they speculate' (Edwards, 1999, p. 189). They are 'nothing more than rapacious speculators, borrowing heavily to beef up their bets' (*The Economist*, 1998, p. 21). These hedge funds are mostly unregulated and are not encumbered by restrictions on leverage or short sales and are free to take concentrated positions in a single firm, industry, or sector – positions that might be considered 'imprudent' if taken by other institutional fund managers (Edwards, 1999, p. 190; Sulz, 2007, p. 175). They are, therefore, able to pursue the investment or trading strategies they choose in their own interest without due regard to the impact that this may have on others. They now account for close to half the trading on the New York and London stock exchanges (Sulz, 2007, p. 175).

The LTCM had a leverage of 25:1 in mid-1998 (BIS, 1999, p. 108; Sulz, 2007, p. 179), but the losses that it suffered reduced its equity (net asset value) from the initial $4.8 billion to $2.3 billion in August 1998. Its leverage, therefore, rose to 50:1 on its balance-sheet positions alone. However, its equity continued to be eroded further by losses, reaching just $600 million, or one-eighth its original value, on September 23, 1998. Since its balance-sheet positions were in excess of $100 billion on that date, its leverage rose to 167 times capital (IMF, December 1998, p. 55). There was thus tier upon tier of debt, which became difficult to manage. The Federal Reserve had to come to its rescue because its default would have posed risks of systemic proportions. Many of the top commercial banks, which are supervised by the Federal Reserve and considered to be healthy and sound, had lent huge amounts to these funds. If the Federal Reserve had not come to their rescue, there may have been a serious crisis in the US financial system, with spillover and contagion effects around the world. If the misadventure of a single hedge fund with an initial equity of only $4.8 billion could take the US and the world economy to the precipice of a financial disaster, then it would be perfectly legitimate to raise the question of what would happen if a number of the 9,000 hedge funds managing more than $2.8 trillion of assets got into trouble.

A hedge fund is able to pursue its operations in secrecy because, as explained by Alan Greenspan, former Chairman of the Board of Governors of the Federal Reserve System, it is 'structured to avoid regulation by limiting its clientele to a small number of highly sophisticated, very wealthy individuals' (1998, p. 1046). He did not, however, explain how the banks found it possible, in a supposedly very well regulated and supervised banking system, to provide excessively leveraged lending to such 'highly sophisticated, very wealthy individuals' for risky speculation when it is well known that the higher the leverage, the greater the risk of default. The unwinding of leveraged positions can cause major disruptions in financial markets by exaggerating market movements and generating knock-on effects (IMF, December 1998, pp. 51–53).

This shows that a crisis can arise not merely because of improper regulation of banks, as it did in East Asia, but also in a properly regulated and supervised system, as it did in the US. Even though the hedge funds were not regulated, the banks were. So why did the banks lend huge amounts to the LTCM and other funds? What were the supervisors doing, and why were they unable to detect and correct this problem before the crisis? Is there any assurance that

the regulation of hedge funds would, without any risk sharing by banks, stop excessive flow of funds to other speculators?

The sub-prime mortgage crisis

The sub-prime mortgage crisis in the grip of which the US finds itself at the time of writing (2008) is also a reflection of excessive lending. Securitization or the 'originate-to-distribute' model of financing has played a crucial role in this. There is no doubt that securitization is a useful innovation. It has provided lenders with greater access to capital markets, lowered transaction costs and made it possible to share risks more widely. The resulting increase in the supply of mortgage credit contributed to a rise in the homeownership rate from 64 per cent in 1994 to 68 per cent in 2007 (Bernanke, 20 September 2007, p. 1). However, even a useful innovation can have a negative impact if it is used in a way that reduces market discipline. Mortgage originators passed the entire risk of default to the ultimate purchaser of the loan security. They had, therefore, less incentive to undertake careful underwriting (Mian and Sufi, January 2008, p. 4; Keys *et al.*, January 2008). Consequently, loan volume gained greater priority over loan quality and the amount of lending to sub-prime borrowers increased (see also BIS, 2008, p. 8). According to Mr Bernanke, Chairman of the Board of Governors of the Federal Reserve System, 'far too much of the lending in recent years was neither responsible nor prudent. . . . In addition, abusive, unfair or deceptive lending practices led some borrowers into mortgages that they would not have chosen knowingly' (Bernanke, March 14 2008, p. 1). The check that market discipline could have exercised on the serving of self-interest did not, thus, come into play. This sowed the seeds of the sub-prime debt crisis and led not only to the financial distress of subprime borrowers but also a crisis in the US financial system which has had spillover effects on other countries. Thus, we can see clearly that the lack of market discipline leads first to excessive lending and then to financial crises and the suffering of a number of people.

When the system has reached a crisis point, it becomes difficult to apply the brakes. Central banks have no choice other than to lower interest rates and provide liquidity to avoid a recession. The Federal Reserve has also done the same. It has lowered interest rates and provided liquidity to the market 'to help alleviate concerns about funding' (Bernanke, 31 April 2007). While this will help reduce the intensity of the current crisis, it will also tend to aggravate the future crises by enabling a vicious circle to continue. The liquidity made available now will enable the loose funding to continue. This will be followed by a financial crisis, which will again necessitate the pumping of further liquidity into the system to overcome the crisis. Therefore, the more sensible thing to do is to simultaneously think of some effective way of introducing greater discipline into the financial system with a view to check excessive and loose lending. *The Economist* has rightly observed that 'the world needs new ways of thinking about finance and the risks it involves' (2008, p. 25). It is here that Islamic finance can make a valuable contribution to the international financial system.

The remedy

If a curb on the heavy reliance on debt, particularly short-term debt, is desired, then the question is about the best way to achieve this goal. One of the ways suggested is greater

regulation. Regulation, even though necessary and unavoidable, cannot be relied upon totally because it may not be uniformly applied in all countries and to all institutional money managers, because of the off-balance-sheet accounts, bank secrecy standards and the difficulty faced by bank examiners in accurately evaluating the quality of banks' assets. The LTCM crisis, as well as the subprime mortgage crisis in the US, show how banks in an apparently well-regulated system can also get into difficulties as a result of overlending.

Regulation and supervision would be more effective if they were complemented by a paradigm shift in favour of greater discipline in the financial system by making investment depositors, as well as the banks, share in the risks of business. Just the bailing out of banks, as is being suggested by some analysts, may not be able to take us far enough (Calomiris, 1998; Meltzer, 1998; Yeager, 1998). What is necessary is not just to make the shareholders suffer when a bank fails, but also to strongly motivate, even the depositors, to be cautious in choosing their bank, and the bank management to be more careful in making their loans and investments.

It is therefore necessary to reinforce regulation and supervision of banks by the injection of self-discipline into the financial system. This could be accomplished by making banks, as well as shareholders and investment depositors (those who wish to get a return on their deposits), share in the risks of banking by increasing the reliance on equity and reducing that on debt. Making depositors, as well as banks, participate in the risk of business would motivate the depositors to take greater care in choosing their banks, and demand greater transparency and more effective management. Banks would also be motivated to assess the risks more carefully and to monitor the use of funds by the borrowers more effectively. The double assessment of investment proposals by both the borrower and the lender should help raise market discipline and introduce greater health into the financial system.

Greater reliance on equity financing has supporters even in mainstream economics. Rogoff, a Harvard professor of economics, states, 'In an ideal world, equity lending and direct investment would play a much bigger role.' He further asserts, 'with a better balance between debt and equity, risk-sharing would be greatly enhanced and financial crises sharply muted' (Rogoff, 1999, p. 40). The IMF has also thrown its weight behind equity financing by arguing that 'foreign direct investment, in contrast to debt-creating inflows, is often regarded as providing a safer and more stable way to finance development because it refers to ownership and control of plant, equipment and infrastructure and therefore funds the growth-creating capacity of an economy, whereas short-term foreign borrowing is more likely to be used to finance consumption. Furthermore, in the event of a crisis, while investors can divest themselves of domestic securities and banks can refuse to roll over loans, owners of physical capital cannot find buyers so easily' (IMF, May 1998, p. 82). However, if, in addition to a better balance between debt and equity, the debt is also linked to the purchase of real goods and services, it should take us a step further towards reducing instability in the financial markets by curbing excessive credit expansion for speculative transactions.

The importance of justice in Islam

> We have sent Our Messengers with Clear Signs as well as the Book and the Balance so that people may establish justice.
>
> (*Qur'an*, 57:25)

> Those who believe and do not impair their belief with injustice, for them there is peace and they are the guided ones.
>
> (6:82)

> We wish to favour those who have been oppressed, so as to make them leaders and heirs and to establish them firmly in the world.
>
> (28: 5–6)

This brings us to the imperative of ensuring justice in Islamic banking to validate its harmony with the Islamic worldview. While efficiency is important because of the contribution it can make to the optimum growth in real output of goods and services, justice is also crucially important because without it, output may not be equitably distributed, and the need fulfillment of all may not materialize. This may ultimately lead to a decline in efficiency and a slower growth of the economy.

Since all human beings are the *khalifah*s or vicegerents of God on earth, they all belong to the same human family and are related to each other as members of a brotherhood. However, brotherhood cannot be a meaningful goal unless there is social equality. This will again be an unrealized dream unless poverty is removed, inequalities of income and wealth are minimized and equality of opportunity becomes a reality. The financial system has a very crucial role to play if this goal is to be realized.

Justice is emphasized in several different places in the *Qur'an*. In the first of the three verses quoted above, it is clearly indicated that the very purpose for which God sent His Messengers to this world was to establish justice (57:25). This is understandable because life can be miserable in this world for a large number of people if there is no justice. It is exactly for this purpose that moral norms are crucial and need to be enforced by society as well as government. In the second verse, the *Qur'an* emphasizes that there can be no peace in this world without justice (6:82). In the third verse, the *Qur'an* lays down its objective of favouring people who have been oppressed, so as to not only enable them to attain positions of leadership but also to make it possible for them to sustain these positions (28:56). The Prophet, peace and blessings of God be on Him, went to the extent of emphasizing that injustice will lead to darkness on the Day of Judgment (Sahih Muslim, Vol. 4, p. 1996:56). This will be a reflection of the darkness we have spread in this world by our inequities, exploitation, aggression and high-handedness. Therefore, if we wish to avoid darkness and gloom in this world and to have peace and tranquility, we must try to ensure justice in human societies. All the different systems (moral, social, economic and political) of society must contribute optimally towards the realization of this goal. The financial system cannot be an exception.

The Islamic financial system

One of the measures that Islam has adopted for ensuring greater justice is to introduce the principle of risk–reward sharing instead of interest in financial intermediation. Islam is, of course, not unique in its prohibition of interest. Hinduism, Judaism and Christianity have done the same. (For the Judaic and Christian views on interest, see Johns *et al*., n.d. and Noonan, 1957; for the Hindu view, see Bokare, 1993, p. 168.) This is because of the injustice and exploitation to which interest leads. Islam is unique only in the sense that Muslims continue

to uphold this prohibition and are trying to establish a financial system that tries to abolish interest.

One of the basic principles that the prohibition of interest has led to in Islamic finance is 'No risk, no gain'. Everyone who wishes to have a return must also share in the risk. Since demand deposits do not participate in the risk and do not, therefore, earn any return, they must be guaranteed. In contrast with this, since investment deposits do participate in the risk, they must share in the profit or loss in an agreed proportion. What this will do is to turn investment depositors into temporary shareholders. Placing investment deposits in financial institutions will be like purchasing their shares, and withdrawing them will be like redeeming these shares. The same would be the case when these institutions lend to, and get repaid by, businesses. They will be sharing in the risks of businesses they finance. This will substantially raise the share of equity in total financing and reduce that of debt. Equity will take the form of shares in both joint stock companies and other businesses, or of profit and loss sharing (PLS), in projects and ventures through the *mudarabah* and *musharakah* modes of financing.

Greater reliance on equity in the Islamic financial system does not necessarily mean that debt financing is totally ruled out. This is because all the financial needs of individuals, firms or governments cannot be made amenable to PLS. Debt is, therefore, indispensable. Debt, however, gets created in the Islamic financial system through the sale or lease of real goods and services via the sales- and lease-based modes of financing (*murabahah*, *ijarah*, *salaam* and *istisna'*). In this case, the rate of return is stipulated in advance and becomes a part of the deferred payment price. Since the rate of return is fixed in advance and the debt is associated with real goods or services, it is less risky compared with equity or PLS financing.

The predetermined rate of return on sales- and lease-based modes of financing may make them appear like interest-based instruments. They are, however, not so because of significant differences between the two for a number of reasons. First, the sales- and lease-based modes do not involve direct lending and borrowing. Instead, they are purchase and sale or lease transactions involving real goods and services. The *Shari'a* has imposed a number of conditions for the validity of these transactions. One of these conditions is that the seller (or lessor) must also share a part of the risk to be able to receive a share in the return. He cannot avoid doing this because of the second condition which requires that the seller (financier) or lessor must own and possess the goods being sold or leased. The *Shari'a* does not allow a person to sell or lease what he does not own and possess. Once the seller (financier) acquires ownership and possession of the goods for sale or lease, he/she bears the risk. All speculative short sales, therefore, are automatically ruled out. Financing extended through the Islamic modes can thus expand only in step with the rise of the real economy. This should help curb excessive credit expansion, which is one of the major causes of instability in the international financial markets (BIS, 2008, pp. 1–10).

Second, it is the price of the good or service sold, and not the rate of interest, that is stipulated in the case of sales- or lease-based modes of finance. Once the price has been set, it cannot be altered, even if there is a delay in payment due to unforeseen circumstances. This helps protect the interest of the buyer in strained circumstances. However, it may also lead to a liquidity problem for the bank if the buyer willfully delays payment. This is a major unresolved problem in Islamic finance and discussions are in progress among the jurists to find a *Shari'a*-compliant solution.

The effort to introduce risk sharing in the financial system will help inject only one dimension of justice. It is also necessary to inject another. This is to enable a larger spectrum of the public to benefit from the pool of resources mobilized by banks. This pool is like a lake of fresh water which everyone needs. There is no reason why only a small proportion of the public should benefit from this pool. All necessary measures need to be taken to make credit available to as large a spectrum of the people as is feasible.

This is not the case at present. In the US, a substantial part of the total credit extended by banks goes to the largest non-financial corporations which exercise significant political power at both state and federal levels (Kotz, 1978, p. 143). The Patman Report and the Securities and Exchange Commission Report drew similar conclusions. Although financial institutions generally deny that they exercise significant influence over non-financial corporations to which they supply capital, one would tend to agree with Kotz's observation that 'historical experience indicates that such assurances cannot be taken at face value' (Kotz, 1978, p. 119). The position may perhaps be worse in developing countries because of greater political corruption and an ineffective judicial system. For example, while 61.3 per cent of commercial banks' total deposits in Pakistan came from 99.6 per cent of all depositors in 2002, 78 per cent of total advances went to less than 1 per cent of the borrowers (Chapra, 2008, p. 26). Small borrowers thus received far less than small depositors had contributed to the banks. It is even worse in nationalized banks where a number of politically well-connected borrowers are even able to have their loans written off (Khwaja and Mian, 2005). Such injustice prevails not only in Pakistan but also in almost all countries around the world, albeit in varying degrees. Given such an inequitable allocation of credit, along with corruption, one cannot but expect inequalities of income and wealth to continue to rise, rather than decline, in the future, an outcome which is contrary to the socio-economic objectives of Islam. This makes it necessary to introduce some mechanism in the financial system that would help divert more of the resources pool to micro- and small enterprises.

It should be possible to do this in the Muslim world by adopting two measures. One of these is to use the *zakah* and *awqaf* resources to make interest-free loans (*qurud hasanah*) available to the very poor who are unable to obtain credit from the conventional financial system and to those who are able to get it but the cost is too burdensome. The adoption of this measure should save them from the excruciating burden of interest. Even though the interest-based microfinance system has helped a number of borrowers, it has also crushed a significant number of others. A timely study by Dr Qazi Kholiquzzaman Ahmed, President of the Bangladesh Economic Association, has revealed that the effective rate of interest charged by microfinance institutions, including the Grameen Bank, turns out to be as high as 30 to 45 per cent. This causes serious hardship to the borrowers in servicing their debt. They are often constrained to not only sacrifice essential consumption but also to borrow from money-lenders. This engulfs them unwittingly into an unending debt cycle which will not only perpetuate poverty but also ultimately lead to a rise in unrest and social tensions (Ahmed, 2007, pp. xvii–xix; see also Sharma, 2002). No wonder the Minister of Finance for Bangladesh described micro-credit interest rates in that country as extortionate in an address he delivered at a micro-credit summit in Dhaka in 2004. It is therefore important that while the group lending method adopted by some microfinance institutions for ensuring repayment is retained, micro-credit is provided to the very poor on a humane, interest-free basis. This may be possible if the microfinance system is integrated with the *zakah* and *awqaf* institutions.

This will not, of course, be sufficient because the resources of *zakah* and *awqaf* institutions may not be adequate to extend credit to a large number of poor entrepreneurs. Therefore, the other measure that needs to be taken is to integrate the commercial banks with their vast resources into the microfinance network. Those who can afford to bear the cost of microfinance should go to the commercial banks or other specialized institutions established for this purpose, and borrow on the basis of the Islamic modes of profit and loss sharing and sales- and lease-based modes of finance, not only to avoid interest but also to prevent the misuse of credit for personal consumption. The two measures can together make it possible to satisfy the credit needs of the poor.

Integrating commercial banks into the microfinance network does not in any way mean that they should be forced to provide credit to the poor. Any attempt of this nature is bound to fail. However, an effort should be made to remove any obstacles that prevent the commercial banks from lending to the poor. This leads to the question of why the commercial banks do not lend to the poor. There are two major reasons for this. One of these is the higher cost of evaluating loan applications and the other is the greater risk. To enable the banks to give greater credit to the poor, it is necessary to reduce not only the cost but also the risk associated with such financing.

As far as the cost is concerned, it is very expensive and cumbersome for banks to deal with a large number of small borrowers. It is more economical for them to lend to a few people and not worry about the others. Consequently, as indicated earlier, credit goes primarily to the rich. This tends to make the rich richer and the poor poorer. To reduce the cost, it may be possible to use the *zakah* and *awqaf* resources for evaluating loan proposals of those poor people who are eligible for *zakah*. The extra cost of evaluation may come partly from the *zakah* fund, provided that the loan is extended in accordance with the Islamic modes of finance. One of the most important objectives of *zakah* is to enable the poor to stand on their own two feet. The more we help them in this manner, the greater will be our contribution to the reduction of inequalities of income and wealth in our societies.

The other thing that needs to be done is to reduce the risk of default. Even though experience around the world shows that poor people have generally been faithful in their repayments, it is necessary to reduce the risk of default even further. Since one of the objectives of *zakah* is to forgive the debt of those who are unable to repay because of difficult circumstances, *zakah* may be used partly to offset the losses from default on loans extended to such people, provided again that Islamic modes of finance are used for lending. Offsetting the entire amount may tend to lead to moral hazard. Therefore, only a part of the loss from default may be offset though the *zakah* fund. Minimizing the risk of default will eliminate the rationale for the high cost of credit to the poor. We should also introduce the loan guarantee scheme that exists in many countries provided we can prevent its misuse by politically-connected borrowers.

The dream and the reality

Thus, we see that the introduction of a new financial system which is not based on interest, in keeping with the teaching of most major world religions, can add a healthy dimension to the international financial system. In addition to injecting greater justice into the system it

can also help make the financial system healthier and more stable by injecting it with greater discipline. If the share of equity is increased and that of debt is reduced substantially, the volatility prevailing in the international financial markets at the time of writing will be substantially reduced. The result may be even better if credit is confined primarily to the purchase or lease of real goods and services. As a result of this, a great deal of the speculative expansion of credit may be eliminated.

A large number of Islamic financial institutions have been established worldwide over the last three decades and Islamic financial services are now available in most jurisdictions worldwide. These institutions are playing an important role in catering to the financial needs of a wide spectrum of society. The innovative products they have provided have not only widened the coverage of financial services but also deepened the financial markets. All these institutions are properly regulated not only by their respective regulatory authorities but also by their *Shari'a* boards.

Nevertheless, the system is still in its initial phase. The share of PLS modes is so far relatively small in the financing operations of Islamic banks, and that of sales- and lease-based modes is predominantly high. The reason may perhaps be that the task is difficult and in the initial phase of their operations these banks do not wish to become exposed to risks that they cannot manage effectively. They are not properly equipped for this in terms of skilled manpower as well as the necessary institutional infrastructure. Most scholars, however, feel that even though the sales- and lease-based modes are different from interest-based financing and are allowed by the *Shari'a*, the socio-economic benefits of the prohibition of interest argued above may not be realized fully until the share of PLS modes rises substantially in total financing. Moreover, it appears that even in the case of credit-creating sales- and lease-based modes, all the conditions laid down by the jurists for their permissibility are not being fully observed, as a result of a number of legal stratagems (*hiyal*) being used to make the task of banks relatively easier. Even in terms of spreading the benefit of banks' resources to a large spectrum of the people, the progress does not seem to have been significant.

The system, therefore, has a long way to go before it can help optimize both efficiency and equity in the financial system and thereby enable Muslims to say with confidence that they have made headway in the realization of the *maqasid al-Shari'a*. It is therefore imperative for them to always keep the goal in mind to ensure that movement in the future is in the right direction. This makes it necessary to evaluate the performance of Islamic financial institutions at least every five years to ensure progress in the direction of realizing the vision. Once progress has been made in this direction and the system has expanded adequately, the ultimate outcome will not only be a reduction in financial instability but also greater realization of both socio-economic justice and efficiency in the financial system.

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Part II

Application

Chapter 8

The prospects of Islamic banks within the Basel II Accord

Aly Khorshid
Elite Horizon

Introduction

The second of the Basel Accords recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision and initially published in June 2004 are more commonly known as Basel II. Its purposes are:

- to create an international standard for banking regulators detailing how much capital banks need to put aside to guard against likely types of financial and operational risks;
- to help protect the international financial system from the types of problems that might arise should a major bank or a series of banks collapse;
- to ensure that capital allocation is more risk sensitive;
- to separate operational risk from credit risk (and quantify both); and
- to align economic and regulatory capital more closely, thus reducing the scope for regulatory arbitrage.

This is all supposed to be accomplished via rigorous risk and capital management requirements, designed to ensure that a bank holds capital reserves appropriate to the risk the bank exposes itself to, through its lending and investment practices. The amount of risk to which the bank is exposed is proportional to the amount of capital the bank needs to hold to safeguard its solvency and overall economic stability.

The final Accord may have largely addressed the regulatory arbitrage issue, but areas remain where regulatory capital requirements diverge from the economic. Basel II has not attempted to substantively change the definition of bank capital from that used in Basel I, which diverges significantly from accounting equity.

The Accord in practice

Basel II uses a '**three pillars**' framework to promote greater stability in the financial system.

The pillars are:

1. Minimum capital requirements (addressing risk).
2. Supervisory review.
3. Market discipline.

The Basel I Accord dealt with these pillars in much less detail. The only risk to be dealt with in great detail was credit risk, and even then it was dealt with in a simple manner; market risk was only touched upon and operational risk was ignored completely.

Pillar 1: minimum capital requirements (addressing risk)

Pillar 1 covers the maintenance of regulatory capital for three major risks that a bank faces: credit risk, operational risk and market risk.

Credit risk can be calculated with varying degrees of sophistication, from the standardized approach, through Foundation Internal Rating-Based Approach (IRB) to Advanced IRB.

For operational risk, there are three different approaches: basic indicator approach (BIA), standardized approach (STA), and advanced measurement approach (AMA).

The approach used for market risk is VaR (value at risk).

Pillar 2

Regulatory responses to Pillar 1 are dealt with in Pillar 2, improving regulators' tools from those available to them under Basel I. It also provides a basis for dealing with all the other banking risks, such as systemic risk, pension risk, concentration risk, strategic risk, reputation risk, liquidity risk and legal risk (collectively known as residual risk).

Pillar 3

Pillar 3 greatly increases the disclosures that the bank must make, with the intention of giving the market a clearer picture of the overall risk position of the bank, and to allow the bank's counterparties to price and deal appropriately.

Evaluation of Basel II

The consultative committee approach to rule making has come under criticism, because it will result in a 'lowest common denominator' system, whose capital requirements are more unstable than those of Basel I. The financial crisis which began in August 2007 has highlighted the inadequacy of current international banking rules. Also, it is said that the more sophisticated risk measures give an unfair advantage to the larger banks who are better able to implement them and, in the same vein, that developing countries who do not have these banks could have their access to credit restricted by making it more expensive. This is a valid but problematic point. More sensitive risk measures were necessary for the larger banks and, while the less sophisticated measures are simpler to calculate, they need to be more conservative.

Better credit risks will be advantaged as banks develop true pricing for risk. In the US and the UK, however, banks have used their improved risk sensitivity to become more

willing to lend to high-risk borrowers, albeit with higher rates. Borrowers who did not meet the criteria previously to enter the banking system have been able to establish good credit histories.

Another problem with the operation of Basel II is that it may lead to a more pronounced business cycle because the credit models used for Pillar 1 compliance generally use a one-year time horizon. During a downturn in the business cycle, banks would need to reduce lending as their models forecast increased losses, thus making the downturn greater.

This gives rise to the familiar question of whether Probability of Default (an indicator for the probability of incurring loss (PD)) and Loss Given Default (an indicator of the severity of loss (LGD)) are really pairwise independent as the credit risk model, which Basel II is based on, does assume or if there are significant correlation effects to be observed, as part of the available research data on long running US debt seems to show. Settling this matter will remain on the agenda of researchers in the field for years to come.

Regulators should be aware of a risk that can be expected to be included in their assessment of the bank models used.

Basel II and the regulators

A difficult aspect of implementing an international agreement is accommodating differing cultures, varying structural models and the complexities of public policy and existing regulation. The senior management of banks will, in part, base corporate strategy (as well as the decision as to which country to base a particular type of business in) on how Basel II is ultimately interpreted by various countries' legislatures and regulators.

Several software applications are available to assist banks operating with multiple reporting requirements for different regulators according to geographic location. These include capital calculation engines and extend to automated reporting solutions that include the reports required under COREP/FINREP.

Implementation progress

Regulators in most jurisdictions worldwide plan to implement the new Accord, but with widely varying timelines. The US's regulators have agreed on a final approach for the Notice of Proposed Rulemaking. They have required the Internal Ratings-Based approach for the largest banks, and the standardized approach will not be available. In India, the Reserve Bank of India (RBI) has implemented the Basel II norms.

Responding to a Financial Stability Institute (FSI) questionnaire, 95 national regulators said they were going to implement Basel II in some form by 2015.

The EU has already implemented the Accord with the EU Capital Requirements Directives and many European banks already report their capital adequacy ratios in adherence to the new system.

Operational risk

An operational risk is a risk arising from a company's business activities. It is therefore a very broad concept including information risks, fraud risks, physical and environmental risks,

among others. The term 'operational risk' is often found in the risk management programmes of banks using Basel II, and here, risk management is divided into credit, market and operational. Strategic risks are not taken into account. Credit and market risks are often elements of a company's financial department's tasks, whereas operational risk management is usually a central concern albeit implemented across different departments.

Basel II defines operational risk as the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. Although the risks apply to any business, this particular way of framing risk management is of particular relevance to regulators who are responsible for providing safeguards against systemic failure of the banking system and whole economies. Whilst operational risks are covered in Basel II, strategic risk (risks arising from poor strategic business decisions) is excluded, as is reputational risk. Although it is accepted that a large operational loss could still have a negative impact on the organization's reputation.

Background

Credit risk and market risk have aroused much debate and research since the mid-1990s, which is why financial institutions have made significant progress in the identification, measurement and management of both. Globalization and deregulation in financial markets and increased sophistication in technology have made banks' activities – and therefore their risk profiles – more complex. These reasons highlight the growing attention by banks and supervisors on the identification and measurement of operational risk.

It is not only the kinds of rogue trading risk seen at Société Générale, Barings, AIB and National Australia Bank that can have profound effects on banking; major geopolitical events such as 9/11 and technological scares like the millennium bug, highlight the fact that market and credit risk are only parts of the risk management jigsaw. Include fraud, system failures, malicious intent and employee compensation claims, and it soon becomes clear why operational risk is so difficult to manage.

The identification and measurement of operational risk is a day-to-day issue for modern-day banks, especially since the Basel Committee on Banking Supervision (BCBS) decided to introduce a capital charge for this risk as part of the new capital adequacy framework.

Definition

Operational risk was originally defined as any form of risk that is not market or credit risk. This negative definition is vague and neither says much about the exact types of operational risks banks face today, nor does it provide banks with a useful basis for measuring risk and calculating capital requirements.

A better definition for operational risk is provided by the Basel Committee:

> The risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

This definition includes legal risk, but not strategic or reputational risk. However, the Basel Committee recognizes that operational risk has a number of meanings and therefore banks

are permitted to adopt their own definitions of operational risk, provided the minimum elements in the Committee's definition are included. Although the banking industry has, to a degree, adopted the definition, some analysts believe it to be flawed, describing it as opaque and open-ended. The way legal risk is incorporated into the definition and then left undeveloped has been the subject of criticism, as has the decision to exclude reputational and strategic risks.

Basel II event type categories

Here are the official Basel II defined event types (with examples):

- Internal Fraud – misappropriation of assets, tax evasion, intentional mismarking of positions, bribery.
- External Fraud – theft of information, hacking damage, third-party theft and forgery.
- Employment Practices and Workplace Safety – discrimination, workers compensation, employee health and safety.
- Clients, Products and Business Practice – market manipulation, antitrust, improper trade, product defects, fiduciary breaches, account churning.
- Damage to Physical Assets – terrorism, vandalism, natural disasters.
- Business Disruption and Systems Failure – utility disruptions, software and hardware failures.
- Execution, Delivery and Process Management – data entry errors, accounting errors, negligent loss of client assets, failed mandatory reporting.

Difficulties

It is simple enough for an organization to set and observe specific, measurable levels of market risk and credit risk, but it is difficult to identify or assess levels of operational risk and its many sources. Historically, organizations have accepted operational risk as unavoidable.

Methods of operational risk management

Basel II and various countries' supervisory bodies have prescribed various soundness standards for operational risk management for banks and other financial institutions. To complement these standards, Basel II has given guidance to three methods of capital calculation for operational risk:

1 Basic Indicator Approach – based on annual revenue of the financial institution.
2 Standardized Approach – based on annual revenue of each of the broad business lines of the financial institution.
3 Advanced Measurement Approaches – based on the internally developed risk measurement framework of the bank adhering to the standards prescribed (methods include IMA, LDA, scenario-based, scorecard, for example).

The operational risk management framework also includes identification, measurement, monitoring, reporting and control and mitigation frameworks.

Operational risk management (ORM)

The business term operational risk management (ORM) deals with many forms of everyday operational risks including the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. Operational risk does not include market risk or credit risk.

Benefits of ORM

ORM is useful because it:

- reduces operational loss;
- lowers compliance/auditing costs;
- allows early detection of unlawful activities; and
- reduces exposure to future risks.

Categories of risk

The Basel Committee on Banking Supervision breaks down loss events into seven categories as described below.

Internal fraud

Losses due to acts of a type intended to defraud, misappropriate property or circumvent regulations, the law or company policy, excluding diversity and discrimination events which involve at least one internal party.

External fraud

Losses due to acts of a type intended to defraud, misappropriate property or circumvent the law, by a third party. These activities include theft, robbery, hacking or phishing attacks.

Employment practices and workplace safety

Losses arising from acts inconsistent with employment, health or safety laws or agreements, from payment of personal injury claims, or from diversity or discrimination.

Clients, products and business practice

Losses arising from unintentional or negligent failure to meet a professional obligation to specific clients (including fiduciary and suitability requirements), or from the nature of the design of a product.

Damage to physical assets

Losses arising from loss or damage to physical assets from natural disaster or other events.

Business disruption and system failures

Losses arising from disruption of business or system failures. This includes losses due to failure of computer hardware or software, telecommunications failure or utility outage and disruptions.

Execution, delivery and process management

Losses from failed transaction processing or process management, from relations with trade suppliers and vendors. This includes transaction capture, execution and maintenance miscommunication, data entry, maintenance or loading error, missed deadline or responsibility, model or system misoperation, accounting error, entity attribution error, delivery failure, collateral management failure, reference data maintenance, monitoring and reporting, failed mandatory reporting obligations, inaccurate external report (loss incurred), customer intake and documentation client permissions or disclaimers missed, legal documents missing or incomplete, customer or client account management, unapproved access given to accounts, incorrect client records (loss incurred), negligent loss or damage of client assets, trade partners, non-client vendor misperformance and vendor disputes.

ORM Software

The impact of the Enron failure and the implementation of the Sarbanes-Oxley Act has led several software development companies to create enterprise-wide software packages to manage risk. These software systems allow the financial audit to be executed at lower cost.

Forrester Research has identified 115 governance, risk and compliance vendors that cover operational risk management projects.

Capital requirement

While Basel II significantly alters the calculation of the risk weights, it overlooks the calculation of the capital. The capital ratio is the percentage of a bank's capital to its risk-weighted assets. Weights are defined by risk-sensitivity ratios whose calculation is dictated under the relevant Accord.

Each national regulator normally has a slightly different way of calculating bank capital, designed to meet the common requirements within their individual national legal framework. Brazil limits bank lending to ten times the bank's capital, adjusted to inflation. Most developed countries and Basel I and II, stipulate lending limits as a multiple of a bank's capital eroded by the yearly inflation rate.

The 5 C's of Credit – Character, Cash Flow, Collateral, Conditions and Capital – have been substituted by one single criterion. While the international standards of bank capital

were laid down in the 1988 Basel I Accord, Basel II makes significant alterations to the interpretation, if not the calculation, of the capital requirement.

Examples of national regulators implementing Basel II include the FSA in the UK, BAFIN in Germany, and OSFI in Canada. An example of a national regulator implementing Basel I but not Basel II is the US. Depository institutions are subject to risk-based capital guidelines issued by the Board of Governors of the Federal Reserve System (FRB). These guidelines are used to evaluate capital adequacy based primarily on the perceived credit risk associated with balance sheet assets, as well as certain off-balance-sheet exposures such as unfunded loan commitments, letters of credit and derivatives and foreign exchange contracts. The risk-based capital guidelines are supplemented by an advantage ratio requirement. To be adequately capitalized under federal bank regulatory agency definitions, a bank holding company must have a Tier 1 capital ratio of at least 4%, a combined Tier 1 and Tier 2 capital ratio of at least 8%, and a leverage ratio of at least 4%, and not be subject to a directive, order or written agreement to meet and maintain specific capital levels. To be well-capitalized under federal bank regulatory agency definitions, a bank holding company must have a Tier 1 capital ratio of at least 6%, a combined Tier 1 and Tier 2 capital ratio of at least 10%, and a leverage ratio of at least 5%, and not be subject to a directive, order, or written agreement to meet and maintain specific capital levels. These capital ratios are reported quarterly on the Call Report or Thrift Financial Report.

Solvency II

Solvency II introduces a comprehensive framework for risk management to define the required capital levels and to implement procedures to identify, measure, and manage risk levels.

The rationale behind EU insurance legislation is to facilitate the development of a single market in insurance services in Europe, while at the same time securing an adequate level of consumer protection. The third-generation Insurance Directives established an EU passport for insurers based on the concept of minimum harmonization and mutual recognition. Many Member States have implemented their own reforms after reaching the conclusion that the current EU minimum requirements are insufficient, leading to a situation where there is no EU-wide consistency of regulatory requirements, hampering the functioning of the Single Market.

Solvency II will be based on economic principles for the measurement of assets and liabilities. It will also be a risk-based system, as risk will be measured on consistent principles and capital requirements will depend directly on this. While the Solvency I Directive was aimed at revising and updating the current EU Solvency regime, Solvency II has much wider scope.

A solvency capital requirement may have the following purposes.

- To reduce the risk of an insurer not being able to meet claims.
- To reduce the losses suffered by policyholders in the event that a firm is unable to meet all claims fully.
- To provide supervisors with early warning so that they can intervene promptly if capital falls below the required level.
- To promote confidence in the financial stability of the insurance sector.

Often called 'Basel for insurers', Solvency II is similar to the banking regulations of Basel II. For example, the proposed Solvency II framework has three main pillars:

- Pillar 1 consists of the quantitative requirements (such as the amount of capital an insurer should hold).
- Pillar 2 sets out requirements for the governance and risk management of insurers, as well as the effective supervision of insurers.
- Pillar 3 focuses on disclosure and transparency requirements.

Advantages and disadvantages of Basel II for Islamic banks

The Islamic banking industry does not need regulation and supervision. Essentially, however where the role of financial intermediaries are Islamic banks that take deposits, in the same way as their conventional counterparts, albeit using different techniques. Their soundness and stability is as important as that of conventional banks; however where risk sharing of Islamic banks is concerned, it can be said that they do need an even more effective system of regulation and supervision.

The A-IRB approach of Basel II offers a number of advantages to Islamic banks, as pointed out by Khan and Ahmad.[1] The products of Islamic banks are diverse and Islamic banks often tailor hybrid products to meet customers' specific demands. Since the A-IRB approach allows mapping the risk profile of each asset individually, it suits Islamic banks better than the standardized approach. In addition, risks faced by Islamic banks differ significantly from those risks faced by conventional banks in proportion to the diversity of products that they offer. The A-IRB approach also aligns the banks' risk exposure with their capital requirements. With the majority of Islamic banks being located in developing countries, where existing national regulatory and enforcement structures are weak, much work is required to improve the culture of risk management for efficiency and financial stability. The A-IRB approach will probably encourage Islamic banks to improve their mechanisms of risk management. It is hoped that the A-IRB approach will help generate reliable data and information, thus enhancing market discipline and transparency. The A-IRB approach will use external credit assessment as a benchmark, along with internal credit assessment, and so will combine the information access of the former with the objectivity of the latter. This should play a central role in controlling moral hazard and capital arbitrage.[2]

Disadvantages for Islamic banking of Pillar 1 of Basel II

While the approach of Basel II is proving to be in the long-term interest of Islamic banks, there may be subtle disadvantages that Islamic banks may face in its implementation.

Systemic risk in Islamic banks

As argued by Saidenberg,[3] there are two sets of reasons for capital regulation: the protection of the consumer and the prevention of systemic risk. Banks pose a high level of systemic risk because of the central role they play in the payment systems and the allocation of resources, along with the fact that they are highly leveraged.[4]

Since neither the profit nor the principal amount in the investment deposits of Islamic banks is guaranteed, they are well equipped to handle the systemic risk problem. Any loss on the asset side can theoretically be passed on to the liability side within the investment deposits. This two-way transmission of risk between demand and investment deposits, poses potential systemic risk for Islamic banks, and neutralizes their enhanced risk absorption capacity. In the case of a run on the bank, it is extremely unlikely that the Islamic banks would be in a position to repay the demand deposits. This effectively transfers the business risk from the investment deposits to demand deposits. Conversely, the demand deposits increase the leverage of Islamic banks and therefore their financial risk and overall stability. The risk of loss in the case of a run on the banks is a risk faced by all conventional banks. As for the unavailability of deposit insurance and lender of last resort (that is, reserves and share capital), these risk issues are not inherent within Islamic banking, and can be remedied as the sector picks up mainstream acceptability. Islamic banks may even be better equipped than conventional banks to deal with systemic risk.

Systemic risk has been a concern, and there are no statistics to suggest the extent to which it is taken into consideration in the calculation of capital adequacy. If the systemic risk reduction element of the Islamic banks can be quantified, it may be possible to offset some of the added credit, operational and market risk capital allocation within Islamic banks.

Retail banks vs investment banks

Along with their depositors, Islamic banks enter into a profit and loss sharing relationship. The investment depositors are participating in the risk of the business of the bank in the same way as corporate shareholders risk negative price movements of a share price. Islamic banks could therefore be treated as corporations, subject to a similar regulatory regime rather than being subject to banking sector regulation. Banks are at the heart of the payment system and therefore regulated; they are highly leveraged and can cause systemic risk. Therefore, the fact that Islamic banks perform some functions that resemble those performed by corporations does not mean that they do not need a banking regulatory system based on the potential risks of failure. Investment depositors in Islamic banks share the same risks as equity investors in conventional investment companies, but do not enjoy the same rights. Their protection further requires a greater level of supervision.

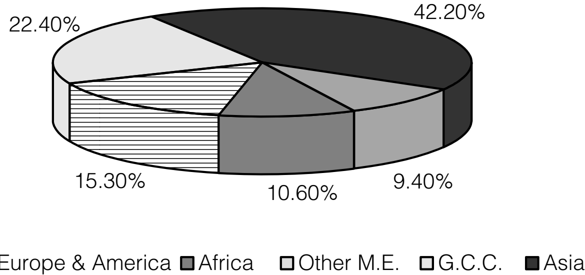
Banks from developing countries

A major criticism of Pillar 1 of Basel II is that it is disadvantageous to banks in developing countries. Most Islamic banks are based in the Middle East, Pakistan, Malaysia, Sudan, Iran and Indonesia. Exhibits 8.1 and 8.22 show the distribution of Islamic financial institutions by region with respect to their numbers and the funds managed by them.

Islamic financial institutions are concentrated in developing countries and are subject to certain disadvantages faced by banks in developing countries from the implementation of Basel II. The adoption of the IRB approach by internationally active banks would result in a decline in lending to developing countries, as it will be more expensive to lend money to them than to developed countries, according to Griffith-Jones, Segaviano and Spratt.[5] While such

Exhibit 8.1

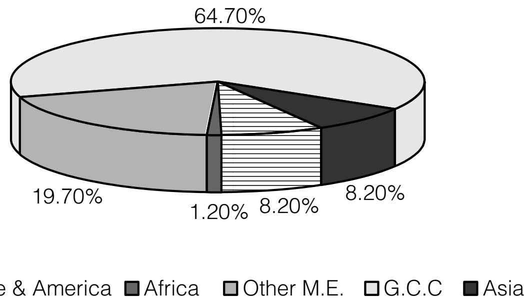
Islamic financial institutions by region (%)



Source: Author's own.

Exhibit 8.2

Funds managed by Islamic financial institutions by region (per cent)



Source: Author's own.

an outcome may be a simple realization of the existing risk, they counter that Basel II does not take into account international loan portfolio diversification and hence the risk calculation is not accurate, basing their argument on two hypotheses.

- The 'degree of correlation between the real and financial sectors of developed economies is greater than that which exists between developed and developing economies'.[6]
- 'An international loan portfolio which is diversified across the developed, emerging and developing regions enjoys a more efficient risk/return trade-off and therefore lower overall portfolio risk as measured by unexpected losses than one focused exclusively in developed markets.'[7]

They conclude that taking international loan diversification into account as a risk mitigating factor would allow internationally active banks to lend to developing countries.

However, the reduced lending to developing countries by internationally active banks will reduce the competition for domestic banks from developing countries and this will actually

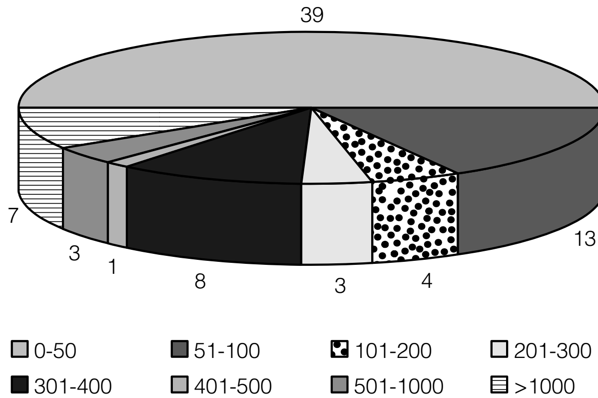
lead to a growth of the banking sector in the developing countries. However, the cost of lending/financing for domestic banks would be higher, offsetting the benefits brought by lack of international competition.

Pillar 1 of Basel II's disadvantages to small banks

Generally speaking, Islamic banks are smaller than their conventional counterparts, certainly by international standards. Although Islamic banking presents enormous growth prospects, some of which are beginning to be realized, there remains a gap between the amount of business they conduct and that of conventional international banks. Exhibits 8.3 and 8.4 illustrate that even large Islamic banks, in terms of both assets and capital, will still fall within the category of small banks.

Exhibit 8.3

Number of Islamic banks and financial institutions by size of assets ($ millions)



Source: Directory of Islamic Banks and Financial Institutions (Jedda: IAIB, 1996).

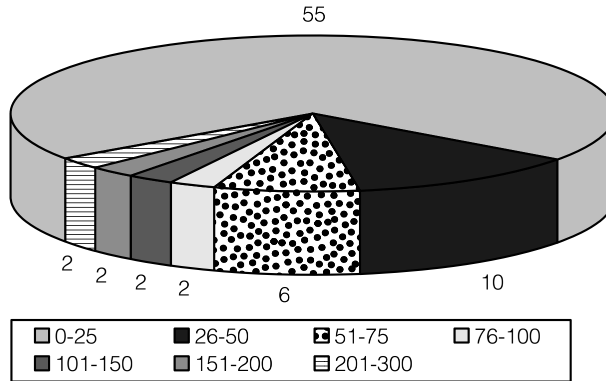
The cost of implementation, requisite technology and expertise that are required to implement the A-IRB and/or AMA approach, suggests that only the large banks have the ability to take up these approaches. By efficient calculation of risk, only the larger banks will be able to lower their capital requirements. This will further disadvantage the small- and medium-sized banks even further. Exhibit 8.5 shows data from the Quantative Impact Study 3 (QIS3) about how A-IRB methods changed capital requirements compared to the current rules for twenty large US banks.[8]

Exhibit 8.5 suggests that banks that follow the A-IRB approach will have significant advantages over other banks. The competitive disadvantage for small banks would be reflected in the stock market.

The Capital Asset Pricing Model has two drivers for valuing a stock: expected return on equity and expected growth rate. Both of these would be disadvantaged if small- and

Exhibit 8.4

Number of Islamic banks and financial institutions by size of capital ($ million)



Source: Author's own.

Exhibit 8.5

How A-IRB methods changed capital requirements compared to the current rules for twenty large US banks

Activity	Effect
Corporate loans	26% Reduction
Small to medium sized enterprise loans	39% Reduction
Residential mortgages	56% Reduction
Credit card receivable	16% Reduction
Other customer loans	25% Reduction

Source: Zions Bancorporation (2003). Comments submitted to FDIC.

medium-sized banks were required to hold more capital. This would lead to consolidation within the banking industry, which may indeed be acceptable but could create banking juggernauts which are too big to fail and could even risk systemic stability.[9] Bigger conventional international players entering the Islamic banking market will threaten small, indigenous Islamic banks.

Penalized lending to small- and medium-sized enterprises (SMEs)

In the treatment of loans to SMEs, the Basel Committee on Banking Supervision (BCBS) has made significant progress. A welcome improvement is under the third consultative document on the treatment of loan exposure to SMEs of up to one million euros as retail exposure.

However, there are still issues for concern. The granularity criterion for instance, which was proposed in the standardized approach in the QIS 3 Technical Guidance, that no aggregate exposure to one counterpart could exceed 0.2 percent of the overall regulatory retail portfolio, would discriminate against SME-retail customers of smaller banks.[10] Under the standardized approach, supervisors may determine higher risk weights for retail exposures. A lot of discretion has been left in this case to the supervisors and while they may increase the risk weights, no similar provision has been included for reduction of risk weights in light of changed circumstances.

Most of the Islamic banks' customer base is within SMEs and the banks may discover that under Basel II, lending to SMEs is not always preferable and may even discourage lending to them. This will affect both the Islamic banks and the economy of the countries; SMEs make up a large part of any country's economy but particularly in Islamic nations.[11]

Operational risk treatment

A key risk in Islamic banking is operational risk, as argued by Sundararajan and Errico,[12] who point out the peculiar nature of Islamic banks. The nature of investment for Islamic banks requires strict internal controls to monitor compliance of the investment with the objectives of Islamic banks, as well as proper accounting for their operations.[13] As there is neither an advanced mechanism for the analysis of operational risk nor any recognized standards for translating operational risk components into capital standards and, because the nature of operational risk in Islamic banks is such that there are almost no data or models available to follow, it will be appropriate if operational risk is moved to Pillar 2 until refined tools for calculating it are made available.

Pillar 2: supervisory review of capital adequacy

Under Pillar 2, supervisors ensure that each bank holds sufficient capital for its risk profile.[14] '[It] is inevitable that a capital adequacy framework, even [under] the more forward looking Basel II, will lag to some extent behind the changing risk profiles of complex banking organizations, particularly as they take advantage of newly available business opportunities. Accordingly this heightens the importance of and attention that supervisors must pay to pillar 2.'[15]

A thorough supervisory review and support in accordance with their specialized operations is one overlooked aspect of Islamic banks. Hopefully, they will receive more attention under Basel II, but there are areas of concern. Under Basel II, the burden on the regulators' responsibilities will increase enormously and they will be placed under pressure because of the manner of calculating operational risk. There is a wide variation of the capacities and resources of regulators in the GCC countries as well as in countries with a significant Islamic banking presence. Under Basel II, the inconsistency between regulatory regimes may increase, hurting the basic objective of Basel II of 'creating a level playing field'. It will also damage the Islamic banks that may, as a result, be subjected to a more rigorous regulatory regime compared to banks under regimes that may have more relaxed rules.[16]

Pillar 3: public disclosure

Developed by the Committee Pillar 3 is a minimum set of disclosure rules that will allow market participants to assess key information about a bank's risk profile and level of capitalization. This will help strengthen confidence in Islamic banks by requiring that they disclose information at an industry standard, in addition to banks' other existing avenues for disclosure of information. The minimum disclosure requirements may also help boost confidence in the two-tier *murabaha* model where the information imbalance places the investor at a disadvantage.

Conclusion

In view of what has been discussed above, Islamic banks are in just as much need of regulation and supervision as are their conventional counterparts. A regulatory and supervisory setup that is more sensitive to their unique characteristics, and more adaptive and responsive to their emergence, will more strongly address the underlying concern of BCBS – the stability of the banking system.

As argued by Khan and Ahmad, demand and investment deposits of Islamic banks should be completely segregated to prevent the two-way transmission of systemic risk between them. They propose separate capital adequacy standards for the demand and investment accounts and argue that this will 'serve the firewalls and new safety requirements of major regulatory and supervisory jurisdictions around the world'.[17]

They suggest three alternatives to the existing setup.

- To keep demand deposits in the banking book and investment deposits in the trading book, with separate capital adequacy requirements for both books. This will prevent the two-way transmission of systemic risk between demand and investment deposits and therefore enhance the stability of the overall banking system.
- Pooling the investment deposits of an Islamic bank into a securities subsidiary of the bank is the second alternative, with independent capital adequacy standards and consolidated supervision.[18]
- Setting up two tiers of Islamic banks. The first tier of banks would be responsible for the payment system of the country, while the second tier would comprise a number of specialized *mudarabah* banks in different sectors of the economy. The diversification would make the second-tier banks shockproof as a whole in case of an economic downturn. On the other hand, the complete separation between the two tiers of banks would ensure that any shock in the *mudarabah* banks is not transmitted to the banks responsible for the payment system, thus eliminating or at least reducing systemic risk; the major cause for banking regulation.

The proposed alternatives are more in line with the characteristics of Islamic banks, and would bring more stability to the Islamic banking system. It is hoped that they would enhance the credibility and acceptance of Islamic banks to the different regulatory regimes. Ishrat Hussain, governor of the State Bank of Pakistan, said at a conference that the objective of Islamic

banking regulators is 'to nurture a competitive dynamic, sustainable Islamic Financial Service Industry as an integral part of (the) Global Financial System'.[19] It is hoped that the proposed alternatives will help achieve this objective and will result in the further growth of Islamic finance.

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1 See Khan Tariqullah and Habib Ahmad (2001). Risk management, an analysis of issues in Islamic financial industries, Islamic Development Bank publications.
2 Ibid.
3 See Saidenberg, Marc, and Til Schuermann (2003), *The New Basel Capital Accord and Questions for Research*.
4 Ibid.
5 Griffith-Jones, Stephany, *et al.* (2002). Basel II and developing Countries: Diversification and Portfolio effects.
6 Ibid.
7 Ibid.
8 Zions Bancorporation (2003). Comments submitted to FDIC.
9 Ibid.
10 For a detailed discussion on the issue, see Basel Committee 2003.
11 Ibid.
12 See Sundararajan and Errico (2002), pp. 4–5.
13 Ibid.
14 Comment by America's Community Bankers (November 3, 2003) to FDIC on the New Basel Accord.
15 BCBS (2004).
16 The Basel II Capital Accord: Where Do Arab Banks Stand? *The Report of the Union of Arab Banks* (September 2003). One file with the author.
17 See Khan and Ahmad (2001).
18 Ibid.
19 Presentation made at the Annual General Assembly Meeting of IFSB held at Nusua Dua, Indonesia, on March 31 2004.

Chapter 9

Al-suyulah: the Islamic concept of liquidity[1]

Mohd Daud Bakar

Introduction

Liquidity – a conventional perspective

The classical legacy of Islamic commercial law is the concept of Islamic *suyulah*, but it was left underdeveloped as Muslim jurists did not expand it further. *Al-suyulah* has the potential to meet the highly complex financial challenges in the field of Islamic capital markets and remains feasible and workable in modern times. This chapter focuses on the conceptual meaning and *raison d'etre* of *al-suyulah* perceived from both classical and modern perspectives. Academic investigation in this Chapter is *ijtihadi* in character and its conclusion is intended to be persuasive rather than binding.

Arabic lexicographers tended not to know the word *al-suyulah* and so never gave a technical meaning in classical Arab dictionaries. The meaning has been agreed by modern Arabic lexicons who deal with banking and finance terms. A modern Arabic lexicon has defined *al-suyulah* as the capacity of an individual or a company to convert assets into cash or an immediate ability to meet one's financial obligations.[2] Liquidity is a process of converting assets into cash or cash equivalents and this process must not lead to significant loss[3] because otherwise the purpose of having the liquidity is defeated. Liquidity has varied meanings according to various perspectives and contexts. In the finance sector liquidity is the bank's ability to meet any unexpected demands for cash from its depositors. Liquidity is parallel to the term 'solvency', or the ability to meet debts as and when they are due, and this is achieved when the current assets of the bank exceed the current liabilities.[4] Liquidity is normally linked to the liquidity ratio or the reserve asset ratio, which the bank has to maintain with the Central Bank. The bank must maintain liquid assets, namely assets that are capable of being readily converted into cash. Usually the assets of an entity are considered to be most liquid when they are in cash or marketable securities[5] or accounts receivable.[6] Liquidity has some ties with liquidation, which is a process whereby a company realizes its assets to satisfy its liabilities.[7]

In the context of the capital market, a characteristic of a security or commodity is liquidity, with enough units outstanding to allow large transactions without a substantial

drop in price. Liquidity is when a stock, bond or commodity has many shares outstanding.[8] A security is said to be liquid if the spread between the bid and asked prices is narrow and reasonably large volumes can be made at those quotes.[9] These securities are not only large but also actively traded. The term liquidity also refers to the process of conversion of assets or illiquid assets into cash with the aim of having an immediate ability to meet one's financial obligations.

This chapter will exclude any discussion of liquidity which implies discharging or paying off indebtedness by maintaining the liquidity ratio as well as settling the accounts by apportioning assets and debts, or winding up. These concepts are not relevant to the *raison d'etre* of the capital market. It is concerned with liquidity of assets, which reflect the ease and ability of converting the asset into cash promptly under any conceivable circumstance with little loss in value and at very low transaction cost.[10]

Four aspects of the asset must be noted in determining the liquidity of an asset: its marketability, capital certainty, maturity, and legal status. Dependent on the existence of a regular transactions market, especially the secondary market, is the marketability of an asset. The regularity and breadth of a market requires that there exists a large number of buyers and sellers of a particular asset which is sufficiently attractive to investors. Secondly the transaction in the secondary market must not be prohibitive in terms of transaction costs and market procedures. The marketability of an asset will be enhanced if the Central Bank makes the assets eligible for its last resort rediscounting facilities. The attractiveness of an asset also depends on its capital certainty, which refers to the predictability of its expected market value. This will ensure that upon the sale of the asset, the investors may be able to anticipate the expected market value and incur minimum loss of value in the course of the transactions.[11] Liquidity, as perceived from its general and broad perspective and concept, is not necessarily confined to raising of funds by the sale of assets because the central meaning of liquidity is that it creates an immediate ability to meet one's financial obligation. Either converting assets into cash or cash equivalent or from other means that could satisfy the same obligation may achieve this.

Islamic liquidity: a historical perspective

The concept of liquidity was not known in classical Islamic law, although it was also needed in the past to meet one's financial obligation. The contract of *hiwalah*, the transfer of debt, is the best example. The contract of *hiwalah* is the basis of many modern transaction methods such as cheques, bank drafts, standing orders, money orders, bills of exchange or letters of credit for import and export. The concept of *hiwalah* was originally Islamic as transfer of debt was not permissible in Roman law since a debt cannot be transferred among the living under the law.[12] The leading orientalist, Joseph Schacht, has confirmed this:

> It *[Shari'a]* also used the *suftaja* and *hawalah* as a bill of exchange beyond the limits set to it by Islamic law; this made real banking activities, not only by Jewish bankers but by Muslim merchants, possible in the Middle Ages. Several institutions of this customary commercial law were transmitted to medieval Europe through the intermediary of the law

> merchant, the customary law of international trade, as is attested by medieval Latin *mohatra*, from the Arabic word *mukhatara*, a term for the evasion of the prohibition of interest by means of double sale; by the French term *aval*, from Arabic *hawalah*, for the endorsement on a bill of exchange, by the term cheque, from Arabic *sakk*, 'written document' and by the term *sensali (sensal)*, from the Arabic *simsar*, 'broker'.[13]

Not known in pre-Islamic times was the contract of *hiwalah*. In the *hadith* is evidence of *hiwala's* legality. The Prophet said: 'Procrastination in paying debts by a wealthy man is injustice. So, if your debt is transferred from your debtor or a trustworthy rich debtor (*mali*), you should agree.'[14] Such a contract is considered to be a worldly beneficial matter or a requirement of doing good and it is therefore regarded as the performance of a good deed (*ihsan*) to the debtor, by fulfilling his intention through transferring an obligation from him and releasing him from his indebtedness. The performance of a good deed is a commendable act (*mushtahab*).[15]

The principle of liquidity underlying *hiwalah* was not developed in the past. The ultimate aim of *hiwalah* is to liquidate the debt although it is generally meant to transfer the debt from the transferor to the transferee in favour of the principal creditor, as this will help to meet the financial obligation of both the transferor and the party in whose favour the *hiwalah* contract is concluded. The prospective transferee (debtor) who has delayed the payment in favour of his creditor (the prospective transferor) and the latter, due to certain personal and legal limitations, cannot demand the former to settle the debt. As this may lead to cash flow problems on the part of the creditor (as he is also equally indebted to another party), it is worthwhile transferring his debt to his debtor (transferee) because the principal creditor may be better able to collect the debt from the transferee. The practice of *hiwalah* may also assist the principal creditor to settle the outstanding loan or debt owed to him by asking his debtor (transferor) to transfer the debt due to his debtor (transferee). The transferee may be more ready and able to settle the debt directly to the principal creditor in whose favour the contract of *hiwalah* is concluded.[16]

To liquidate debt and to overcome cash flow problems of the respective principal creditor or transferor is the role of *hiwalah*, as is made more obvious by the legal conclusion established by the *Hanafi* school of law. The *Hanafi* school of law, apart from *hiwalah muqayyadah* (restricted transfer of debt), which is accepted by all schools of law,[17] allows the unrestricted version of *hiwalah* (*hiwalah mutlaqah*) where payment or settlement of debt is not restricted to be made from the property of the transferor in the hands of the transferee.[18] Under the practice of *hiwalah*, any third party can volunteer to settle the debt first in favour of the debtor but will then have recourse to the debtor for repayment purposes.

In classical Islamic commercial law when liquidating debts the contract of *hiwalah* is not the only contract available. *Muqassah* and *ibra'* are two other contracts useful for liquidity purposes. *Muqassah* refers to the action of debt settlement between two persons who are both creditor and debtor to each other; each of them agrees to renounce and offset the debt by the other by virtue of the contract of *Muqassah*. This is a passive way to liquidate debts. Islamic law also allows the practice of *ibra'*, to write off the debt outstanding for no consideration. This practice is a favour by the creditor to waive all the obligations owed by the debtor. For this reason the contract of *ibra'* (unlike the contracts of *hiwalah*

and *muqassah*) is unilaterally effected even without the consent of the debtor because under the unilateral contract, the consent of the recipient is not essential since there is no possibility of any injustice and unfair dealing. Apart from *muqassah* and *ibra'*, Islamic law has also developed the concept and practice of *da' wa ta 'ajjal* (the sooner paid, the less paid, or 'discounting' or 'rebate'). This practice is based on a few prophetic traditions, *inter alia* the *hadith* of *Ka'ab* in which *Ka'ab* was instructed by the Prophet, as the creditor, to reduce the amount of debt owed by the debtor so that the debtor could settle the debt immediately due to the discount given by the creditor. *Ka'ab* adhered this to and the debt was then settled based on the reduction of the original amount of the debt.[19]

The precedent in Islamic law of converting assets to cash or cash equivalents is more interesting. In the region of Bukhara this took pace in the fifth century of Hijrah. The people in Bukhara got into debt and could not liquidate these in the ordinary way. The Muslim jurists in that region had to resort to a well known maxim in Islamic law which stipulates that 'needs of men whether general or particular stand on the same footing as absolute necessity (*al-hajah tanzil manzilat al darurah*)'.[20] Compelled by the pressing needs, Muslim scholars invented the sale of *wafa'* which is a sale of a commodity on condition that the seller is allowed to get the commodity back upon paying its full price.[21] The reasoning that leads to this practice is the view of the *Hanafi* school of law, which disapproves of the long-term lease of certain types of agricultural land. Under *bay' al-wafa'* instead of being leased, an orchard may be sold on condition that the 'purchaser' maintains the right of its redemption.[22] According to Ibn Nujaym, one of the leading *Hanafi* scholars, *bay' al-wafa'* is nothing but a legal fiction (*hilah Fiqhiyyah*) to escape the rigours of law.[23]

Among early Muslims' thinking on liquidity is the example of *bay' al-wafa'*, particularly in Bukhara in the fifth century of Hijrah. A loan for usufruct where the debtor sells his property to the creditor is the very essence of *bay' al-wafa'*, on the condition that it is returned upon his repaying the price so that the debtor had use of the credit while the creditor had use of the property. The *Majallah al-Ahkam al-'Adliyyah* is more inclined to consider this practice under the contract of mortgage since the transfer of both the commodity and consideration is not final and irreversible simply because neither the seller nor the purchaser can sell a thing sold by *bay' al-wafa'*.[24] If we were to follow the reasoning of the drafters of the *Majallah al-Ahkam al-'Adliyyah*, the basic purpose of a mortgage (*rahn*) remains liquidity – to make cash available for the mortgagor to meet his financial obligation.

Prevalent in the seventh century of Hijrah is another similar precedent, known particularly through the writing of the most celebrated Hanbali jurists, Ibn Taymiyyah (590–652 A.H./1193–1254 A.D.). The case concerns the long-term lease of an orchard.[25] In the time of Ibn Taymiyyah the region surrounding Damascus consisted mainly of orchards.[26] A large number of Ibn Taymiyyah's *fatwa*s dealt with fruit and in this connection there is a special type of contract called '*daman*' which attracted the attention of Ibn Taymiyyah and other lawyers in Damascus.[27] Being construed as a combination of *musaqat* (partnership in fruit trees) and *ijarah* (rent), this contract provides for the rent of the ground, including the different fruit trees growing on it, in return for a fixed amount as a rent. Whereas the contract of *musaqat* belongs to the category of *musharakat* in which the contracting parties – the landowner (*rabb al-ard*) and the *'amil* who irrigates the fruit trees – get a stipulated percentage of the crop, *ijarah* is regarded as a kind of sale in which

the renter has to pay a fixed amount. The landowners of Damascus, whose ground was often partially covered with fruit trees and partially used as arable land, were interested in renting the ground together with the trees for a fixed price. Therefore the contract of *daman*, though controversially discussed among jurists, became part of the economic and legal practice in Damascus. The contract of *daman* would convert the land of the landowner into cash through rental payments while enabling the landowner to share the crop with the worker.

Extensively debated among the jurists was the case of *daman*. A *daman* contract would take place when A, the owner of an orchard in which different types of fruit were growing (such as apricots, grapes and pomegranates) wanted to sell the fruits together to B although the fruits were not yet ripe, was when a Daman contract would take place. Ibn Taymiyyah suggested that A let his ground with the fruit trees to B for a fixed amount, so that B himself could irrigate the trees and gather the fruit when they had ripened. In order to justify his conclusion, Ibn Taymiyyah resorted to both *ijma'* (consensus of the Companions) and *qiyas* (analogical reasoning). The *ijma'* refers to the practice of '*Umar*, the second Caliph, which was later followed by the Companions.[28] As for *qiyas*, he had striven to prove the legality of the *daman* contract on the basis of a few types of *qiyas*, *inter alia*, *qiyas al-tard*, *qiyas al-shaba*, *qiyas al-munasabah*, *ilhaq al-fariq* and *daman*. With regard to *qiyas al-tard*, which is normal procedure of analogical reasoning, he referred to a Qura'nic verse (65:6) according to which wet nurses have to get compensation for suckling a child. By making recourse to this verse, Ibn Taymiyyah attempted to refute the prevailing opinion;[29] as the usufruct is an essential element of the contract of hire (*ijarah*) it has to be understood in a narrow sense, namely using a thing without reducing its substance. By this restrictive definition of usufruct it is not possible to rent an orchard, because the contract of rent is only for consuming the fruit. However, as the Qura'nic verse allows the consumption of milk, which obviously forms part of the contract, and this element occurs also in other admissible contracts such as *'ariya* and *waqf*, Ibn Taymiyyah drew the legal inference that the contract of *ijarah* includes the consumption of at least parts of the object.[30] The view expressed by Mufti Mahmud Hamzah, then a mufti in Damascus (1236–1305 A.H.), was that the rules of *muzara'ah* (partnership in fruit trees) are very similar and equivalent to the features and rules of *ijarah*[31] and therefore this principle of law opens the possibility of creating liquidity instruments via *ijtihad*.

In the history of Islamic commercial activities, another interesting precedent related to the concept of liquidity is the case of a *mursad* or *khulu'* loan in the area of *waqf* (endowment) law. A perpetual trust created from one's private properties is *waqf* in Islamic law, the usufruct of which is pledged to recipients specified in the foundation deed (*waqfiyyah*) of the *waqf*. The type of recipient defines the category of *waqf*. For example, a *waqf* is public or charitable (*khayri*) if the recipients of its revenues are public institutions such as a mosque, library, *madrasah*, *sufi* centre, orphanage, hospital, public fountain or passageway named in the *waqfiyyah*. Conversely, a *waqf* is private or family (*ahli*) if its revenues are dedicated to specified individuals who often included the founder (*waqif*) himself and his descendants. A combination of public and private recipients results in a mixed *waqf* (*mushtarak*).[32] According to the Shari'a, *waqf* property is inalienable. It cannot be sold, purchased, bequeathed or given away as a gift, nor can its property be used as surety for a loan.[33] Equally, the Shari'a disallows the outright sale or purchase of *waqf* properties.

The exception to the rule against disposal is the institution of *istibdal*, the exchange of an unprofitable property in *waqf* for another more profitable one.[34]

The *waqf* property or structure might have fallen into ruin or disrepair and *waqf* revenues themselves could not cover the repair cost; this was a problem that arose in the past. With the *qadi*'s authorization the *waqf* administrator would try to obtain a *mursad* loan for the repair of the damaged *waqf* properties. In return, a contract for long-term rent would usually be offered on the grounds that the *waqf* structure had deteriorated to an extent that no one could be found to rent it on an annual or short-term basis. Only a long-term renter would be interested in repairing damaged *waqf* property and investing his own funds and time to render them productive again.[35]

The lender could be the tenant of that property or a member of the *waqf* administration under the purview of a *mursad* loan, such as a *nazir* or a *mutawalli*. In return for his favour the lender would receive several rights in the *waqf* revenue of which he was now a creditor. For example, he (or his heirs in the case of his death) would have the right to occupy the property until the loan was repaid in full. In this case the debt is not incurred on the *waqf* itself, but on its future revenues.[36] This practice was prevalent in nineteenth-century Damascus subject to one condition: that the *waqf*'s revenues were insufficient to pay for the necessary repairs because otherwise recourse to the *mursad* loan is not lawful.[37]

There are several ways a *mursad* loan could be repaid. Until the loan was repaid a *mursad* lender might receive a specified percentage of the income of the *waqf*. In this case the repayment period might be quite long. Alternatively the *mursad* lender might choose another option which is to deduct an amount from the rent that he paid on the *waqf* property.[38] A third type of repayment plan involved a subtenant. Part of the rent collected from the subtenant would go to the original renter in repayment of his *mursad*. If the subtenant paid a higher rent than the previous rent paid by the original tenant, the legal authorities decreed that any surplus from the subtenant should be paid to the *waqf* and not to the *mursad* lender, for profit (*ribh*) on *mursad* was not permitted.[39] A *mursad* lender could also sell his *mursad* by means of *hawalat al-mursad*, a legal transfer of *mursad*. A *hawalah* required the *waqf* administrator's permission. The purchaser of the *hawalat al-mursad* became the creditor and assumed all rights and conditions as the original lender.[40] Such transfers were apparently common in nineteenth-century Syria.[41]

With regard to the issue of liquidity in the early history of Muslims in Malaysia, it has been acknowledged that the Muslim society had practised a type of customary security transaction, known as *jual janji* (conditional sale).[42] In this system, in return for a loan the holder of the land, as a vendor, transfers the land to the creditor. The land will be registered in the name of the creditor. A collateral agreement will normally be made by the contracting parties in which the creditor promises to retransfer the land to its original holder/vendor/borrower upon the repayment of the money lent. Failure to repay the amount lent will convert the transaction into a *jual putus* (an outright sale).

The importance of making the asset liquid was obvious to the early Muslim jurists, in the sense that it is easily convertible to cash or cash equivalents. The concept was increasingly neglected in the past, as the commercial and economic circumstances were not so

pressing to have a general concept of liquidity. The absence of discussion on liquidity in Islamic law literature does not necessarily imply the absence of its conceptual meaning; it is an established fact that in all the sciences, the practice occurs first, then the theory.[43] There are many other contracts available in Islamic commercial law which serve the purpose of liquidity, or of obtaining easy and ready cash to meet one's financial obligations.

Fiqh governing Islamic liquidity

Integral to the process of liquidity are a number of principles of Islamic law, but they were not mentioned by the Prophet or by the jurists in their *fatwa*s. To comply with the general requirements of Islamic commercial law these principles such as fairness, fair dealing and having no elements are important, as they are contrary to Islamic law such as *riba* and *gharar*. This part of the discussion will make an attempt to extract as many principles as possible. Every type of practice in Islamic commercial law is governed by a set of principles, some of which are clearly stated and some are not disclosed but open for human understanding and appreciation. The *hadith* on the contract of *hiwalah* for example mentions one principle regarding the financial status as well as the attitudinal transferee being trustworthy and rich. This principle is meant to protect and safeguard mainly the interest of the principal creditor in whose favour the contract of *hiwalah* is concluded. Since the principle contained in *hiwalah* is arguably a means of liquidity, this principle should be observed in all activities that lead to liquidity.

Under the purview of a *hiwalah* contract the practice of the transfer of debt as a means of liquidity also indicated that liquidity is relevant to the process of converting the rights (*huquq*) to cash or cash equivalents. To collect and receive repayment of either the loan or the debt from the transferee is the right of the transferor, as the former is the debtor to the latter. A *hiwalah* contract, unlike a *kafalah* (suretyship) contract, would release the liability of the transferor once concluded. The practice of *hiwalah* is concluded without any loss in value or extra cost to all parties involved in the contract. This is parallel to the modern feature of liquidity; as already explained, the liquidity process will incur only a small loss in value and very low transaction costs. The question of cost by having recourse to liquidity is another principle that should be seriously considered in classical and modern concepts of liquidity.

Other relevant principles or features of liquidity are seen in the cases and examples of both *bay' al-wafa'* and the *daman* contract (a combination of *ijarah* and *musaqarah* contracts). It is the existence of the asset element that marks the subject matter of the conversion process to get cash or cash equivalents. It may be said under the precedent of *bay' al-wafa'* that almost all types of assets can be converted to obtain necessary cash to meet one's financial obligation. The contract of *daman*, which was advocated by Ibn Taymiyyah, is applicable only to assets that can be rented (*ijarah*) and the end product of the services rendered in return for the above rent, can be shared under the principle of profit and loss sharing between the hirer and hiree. Islamic law also recognizes the practice of *mursad* loan which highlights another principle of Islamic law, namely that even the usufruct or services can be converted into cash or cash equivalents. A *mursad* loan may be sold to another interested party to purchase the rights to the long-term lease on the basis

of *hiwalah*. The above principles and features of classical Islamic liquidity resemble the modern principles and features of liquidity, particularly liquidity of an asset in the sense that liquidity of an asset depends on the four aspects already mentioned. This resemblance will be further discussed later.

Islamic law has historically been comprehensive and flexible enough to have accommodated people's liquidity needs based on certain *ijtihadi* efforts. The examples reflect the liquidity-premised thinking typical of Muslim jurists throughout history. The classical cases cited in this paper are in conformity with the *Shari'a* principles and they have some impact on the modern concept of Islamic liquidity.

Modern islamic liquidity

With regard to the prospect of Islamic liquidity in the field of the Islamic capital market it is relevant to relate the principle of liquidity in the classical case of Islamic *fiqh* to the modern activities and modus operandi of liquidity. To begin with, the framework of the capital market needs to be explained. The capital market in Malaysia, and perhaps elsewhere, refers to the market in longer-term financial assets, comprising all public and private debt instruments with maturities exceeding one year, corporate stocks and shares for which there is no fixed maturity period and commodity futures. The main purposes of the capital market in the country are to assist the process of economic development by mobilizing medium and long-term funds from a wide cross section of the population to finance public development programmes and to fund private investment, as well as to assist the banking system in securitizing their assets.[44] The capital market comprises the government securities market, the corporate securities market or the equity market, the private debt securities market and the futures market.[45] The issue of liquidity is more relevant to the area of private debt securities (PDS) as well as to government securities. The forthcoming discussion will be centred on the activities of private debt securities, as the government will be downsizing the operations of Malaysian Government Securities (MGS). This is because government activities are being consolidated and the privatization of Government enterprises is being intensified.[46]

The PDS market was insignificant and underdeveloped prior to the mid-1980s due to several factors including the constraints on major institutional investors to invest in unsecured corporate bonds; cumbersome administrative procedures required to issue PDS; tax disincentives to issuing, trading and holding of bonds; and the absence of a credit rating agency to rate the default risk of specified bonds issues. Issues by corporations are PDSs, defined as IOUs, with a promise to pay over a fixed time period and entitle the holder to payment of the principal value at the end of that period. The IOUs could be in the form of bonds, notes, Commercial Papers, and the like. There are two main forms of PDS, Equity-linked Debt Securities and Non-Equity Linked Debt Securities (Straight Debt Securities). The former differs from the latter in that the former incorporates an equity conversion feature, which would enable the holder of the debt securities to convert them into shares of the corporation issuing such debt securities. The latter types of debt securities are those without an equity conversion feature. It is under the latter type of debt securities that the

notes are issued which allow the issuer/borrower to tap the funds from the capital market by issuing short/medium term marketable promissory notes. The notes are debt instruments and are traded on the secondary market.

The need to have liquidity is shown by the creation of these notes. There are many advantages to issuing these notes. Firstly it provides flexibility as the issuer/borrower can 'repay' the loan any time during the tenure of the programme (by way of redemption of Notes outstanding on the maturity date). Secondly, if the notes are underwritten, the source of funds is assured up to the underwritten amount. The underwriters are committed to purchasing the Notes at a pre-agreed yield if bids by members of the Tender Panel are unsatisfactory and/or insufficient. Thirdly, the issuer/borrower will be accorded high credit standing and recognition in financial circles.[47]

There have been many recent developments in the area of Islamic private debt securities apart from the Islamic equity market which has already reached a reasonable level of sophistication and maturity by having a considerable number and volume of halal stocks and counters as well as the assistance of Islamic broking services, but the instruments are yet to be satisfactory in terms of volume and marketability. For the future Islamic market, there is a pressing need to develop Islamic instruments to complete the entire structure and framework of the Islamic capital market. The main issue in Islamic private debt securities would be the Islamic concept of liquidity (*al-suyulah*), as this concept will significantly guide practitioners to develop the instruments accordingly, to convert the assets into tradable securities and a source for daily liquidity. Before we proceed to present the Islamic perspective of liquidity as a principle of law in Islamic commercial law it would be better to shed some light on the contemporary instruments of liquidity, which are already in practice on the secondary market.[48]

Up to now, Islamic private debt securities in Malaysia have adopted the process of securitization, which is a process of transforming an illiquid asset into a tradeable security. A process that makes debt tradable on the secondary market is securitization.[49] Through this process, borrowers have direct access to the capital markets and lenders are able to liquidate their positions and opt for better investment opportunities.[50] Securitization is effected through two means, namely debt securitization and asset securitization. The former refers to the issuance of securities substituted for debt arising out of financing facilities; the latter refers to the issuance of asset-backed securities.[51] These two means of securitization, unlike conventional securitization, are based on an underlying Islamic transaction, which necessarily involves a commodity or the equivalent. An excellent example for the first type of Islamic securitization is the Islamic private debt securities that were issued in 1990 for Shell MDS is. This securitization arose from a *bay' bi thaman ajil* (BBA) transaction of RM125 million (US$50 million) between a syndicate of financiers and Shell MDS. Debt certificates or *shahadah al-dayn* evidenced the debt on the selling price arising from this contract. These securities thus represent the issuer's unconditional obligations to settle the debt in the manner as scheduled under the financing contract. The total face value of these securities represents the total sale price under the BBA contract.[52]

A good example of asset-based securities is the RM30 million Cagamas Mudarabah Bonds. Cagamas Berhad, a housing mortgage corporation, issued the securities in March

1994. The exercise involved two elements of debts. The first debt arose from the securitization of the Islamic house-financing assets purchased from the financial institution, with BBA financing extended by Bank Islam Malaysia Berhad (BIMB) to its customers. The second element was the issuance of *al-mudarabah bonds* by Cagamas to financial institutions participating in the mudarabah call for raising funds to finance the purchase of an identified pool of BIMB's house-financing debt. Under the concept of *mudarabah*, both the holders of Cagamas bonds and Cagamas itself will share the profit generated from the acquired pool of debt and the income earned from the reinvestment of reflow of funds from the pool based on a predetermined ratio.[53]

From the foregoing explanation of the process of securitization and from the definition of liquidity, one may infer that liquidity is the basis of the securitization itself. Unless there has been a need to meet one's financial obligation there will be no need for securitization, such as to settle the repayment arising either from a straight loan (*qard hasan*) or from deferred payment liabilities and in this regard, liquidity is arguably one of the most effective means of meeting this need. Securitization is not liquidity and vice versa, in the sense that liquidity comes before the need to securitize the deferred liabilities comes into the picture. Although the liquidity process might be essential in some cases, this does not necessarily imply that securitization is always a necessity. In meeting one's financial obligation, apart from securitization, solutions may be sought from other possible alternatives that are lawful and feasible according from the *Shari'a* perspective.

Should one understand the principles of Islamic *fiqh*, the above line of thinking can be easily appreciated with regard to liquidity as presented here. From the classical Islamic period, a few cases show that liquidity was effected through many 'instruments' such as *hiwalah* (both *hiwalah muqayyadah* and *hiwalah mutlaqah*), *bay' al-wafa*', *daman* contracts and *mursad* loans. These 'instruments' were managed effectively even without the assistance of 'securitization'. We are not in a position to discard the possibility that securitization can always be attached to the above 'instruments', which would render them more safe and 'liquid'.

To provide principles to accommodate and facilitate modern situations, the manuals of *fiqh* are rich. They can be considered as a *mal*, or 'property', which can be used to offset the obligation to settle the debt which is granted by the creditor on the basis of the pledge. The case involves a debtor who owns a *mudabbir* servant[54] and a creditor who accepts the servant as the pledge or security. The subject matter of the pledge is not the servant as a person but rather his services. Should the debtor fail to repay the loan, the creditor/pledgee is entitled to recover the loan owed to him by using the services of the pledged servant, and the value of such 'services' would be commensurate with the size of loan granted by the creditor/pledgee.[55] To develop this principle of *fiqh* further, it may be said that the master of the servant can apply for an amount of financing which would be commensurate with the value of the services that the servant could render in a given time frame. Services are not cash but may be converted into cash or cash equivalents through the borrowing with a pledge. To consider the services of the servant as a valid subject matter of *rahn* is problematic since it is exposed to many uncertainties, such as the death of either the master or the servant, which may lead to the termination of the pledge contract since the servant is then free. However we are not concerned with the details of the case but rather with the

principle of law that a service (*khidmah*) can be pledged to obtain cash to meet one's financial obligation.

That the pledge may be effected in contracts which create a future obligation is another interesting principle of *fiqh*. Examples are the delivery of a commodity under a *salaam* contract, settlement of loan under *qard hasan* and the value of compensation to be paid by a transgressor who inflicted bodily injury or damage to property.[56] Although the principle relates to the question of pledge, it gives the impression that future rights be in the form of a commodity to be delivered later, or cash to be credited later, and can be considered as property even though they are yet to materialize. Therefore future rights may be 'traded' to get cash for one reason or another.

The practical aspect of liquidity in the modern context can be clarified. It is only logical to discuss the practice of Islamic liquidity from the perspective of securitization as the current mode of liquidity is based on securitization. Securitization is a form of financing by converting the assets, tangible or otherwise, without increasing the leverage on the balance sheet by selling those assets to a Special Purpose Vehicle (SPV) which in turn issues debt securities to finance the purchase. The company that sells its assets will receive cash up front which could be utilized for business development, whilst to the investors of the debt securities issued by the SPV purchased from the company will be utilized, partly towards payment of the agreed coupon payment and partly towards the repayment of the principal amount of the debt securities. The practice of liquidity takes place when the company sells its assets to the SPV for a cash price as this will remove the company (bank) asset from the balance sheet and subsequently boost its capital ratios. What comes after that process is also related to liquidity with regard to the secondary market, in the sense that the buyer of the asset or illiquid assets, or the transferee of these rights and obligations, has still to convert these assets into cash or cash equivalents whereby this conversion process should comply with Shari'a principles.

The company seeking the liquidity owns many forms of assets, and each type of asset will determine the modus operandi of the Islamic liquidity process. Consisting of trade receivables, the assets of the company are due to the company from the debtors/buyers. In Malaysia the Islamic view is already established that the company may sell the debts to the SPV under the purview of *bay' al-dayn* (sale of debt).[57] The company would be able to get cash that might be needed for future profitable activities. The SPV needs to securitize the debts purchased to be sold later to the investors either on the basis of markup sale or on the basis of mudarabah by issuing *mudarabah* securities. It is also possible to securitize the debts purchased in the form of *musharakah mutanaqisah*[58] securities whereby under this practice the holders of the securities are paid periodically a certain amount of profit from the production turnover of the projects based on an agreed proportion, with added bonuses should turnover exceed certain levels.[59]

A tangible asset might be owned by the company and it might like to convert the asset into cash or a cash equivalent. The easiest situation seems to be for the company to have Islamic liquidity. This is simply because the asset that is sought to be securitized is not susceptible to any dispute from the *Shari'a* perspective. Viewed from the classical perspective, *bay' al-wafa*' would be practical enough to convert this asset into cash or cash equivalents. However in modern financing the Islamic bankers have developed the so-called

refinancing which is less problematic compared to *bay' al-wafa*'. Under the refinancing scheme the company as the holder of the asset will sell it to the SPV at cash sale and later the asset is sold back to the company at deferred payment level. For securitization the SPV may adopt the practice of *bay' al-murabahah* (or *mudarabah*) or *musharakah mutanaqisah* in dealing with the investors on the secondary market.

The SPV agreement could affect the purchase of aircraft through *bay' al-wafa*' assuming that the asset involved in the Islamic asset backed securitization is a commercial aircraft, in which case the seller will be given the discretion to repurchase the aircraft over an agreed time frame. Pending the repurchase, the SPV has ownership, title and usage of the aircraft while the seller has usage of purchase consideration paid by the SPV. In order to generate income from the aircraft to pay the agreed profit margin to the investors of either *mudarabah* securities or *musharakah mutanaqisah* securities, the SPV may lease the aircraft to other users or the seller himself. In the event that the aircraft is leased back to the seller it would be under an *al-ijarah* scheme wherein in consideration of payment of an agreed lease rental the seller would be allowed to use the aircraft within the parameters of the agreement reached between the seller and SPV.

The issue of securitization of infrastructure also has to be dealt with in the Islamic capital market, as this is currently practiced by conventional securitization. Under this practice (the transaction between the company, which is the concession holder, and the SPV), the subject matter is the income stream expected to be generated from the project. The income stream, unlike trade debts, is still contingent and has yet to crystallize. The income stream from the project would only crystallize upon the usage of the infrastructure project by the public. The right to receive income from the project has no underlying premise upon which such right could be determined with some certainty. Under the purview of *bay' al-dayn* pertaining to this situation the right to receive project income could be sold to the SPV at a price as negotiated between two parties. Alternatively the project could be sold to the SPV on the basis of *bay' al-istisna*' (sale of manufacture) in which case the SPV will make the payment in advance.[60] Normally under *bay' al-istisna*' the commodity is sold at a lower price compared to the current market value, as the commodity will only be delivered in the future. The PSV under these two possibilities needs to securitize the payment it has paid to the concession holder. The SPV could invite interested investors to share in the profit generated from the income stream by issuing murabahah securities or mudarabah securities respectively.

Conclusion

In the early history of Islamic law the concept of liquidity was already known and practised. As in the case of *hiwalah* the reasons behind this practice are sometimes reasonable, but on other occasions the reasons might be pressing as in the case of *bay' al-wafa'*, the *daman* contract and the *mursad* loan. The need for liquidity is more pressing in modern times and this compels both Muslim jurists and practitioners to develop liquidity instruments which are feasible and competitive with conventional western liquidity instruments. The chapter has critically discussed the modus operandi of Islamic liquidity with regard to

different subject matters such as trade receivables, asset backed securitization and income streams generated from infrastructural financing.[61]

To comply with the *Shari'a* requirements, Muslim practitioners have modified conventional securitization. It would have to be cost effective and efficient to the end users regardless of what variations and modifications are made to the conventional model of securitization. In the final analysis, securitization is an alternative means of raising financing through the capital market. For this reason it is necessary that the liquidity instruments are safe and this is normally achieved by having a financial guarantee. The financial guarantee company, which operates on the basis of *kafalah*, will ensure the commitment of the SPV to pay the agreed profit and redemption value of the securities to the investors. Perhaps the role of the Rating Agency Malaysia Berhad (RAM) is relevant to measure the safety of any instrument created by the Islamic capital market.[62] The other aspect pertaining to Islamic liquidity instruments is the question of yield. Of course the absence of proper market benchmarks will contribute to discrepancies in arriving at market prices and inactive trading. All the proposed modes of Islamic liquidity instruments would depend largely on the availability of the Islamic benchmark to make the trading of these instruments on the secondary market more active and protected.

The prospect of developing Islamic liquidity instruments is very promising. Using Islamic financing, large infrastructural projects in Malaysia have recently been financed, and the avenue for creating Islamic liquidity instruments is equally promising. Perhaps in the future, should the practice of Islamic hire purchase either by virtue of *al-ijarah thumma al-bay'* (AITAB) or *al-ijarah al-muntahiyyah bi al-tamlik* (AIMAT) be widely used to finance the purchase of cars, there will be a huge pool of debt created in the Islamic hire purchase portfolio. This pool of debt can later be securitized in terms of securities, which are backed by the hire purchase assets.

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1 Paper presented at the International Islamic Capital Market Conference 1997 (Developing Islamic Capital Market Instruments) organized by the Securities Commission of Malaysia, Istana Hotel, Kuala Lumpur, July 15–16 1997. This chapter was correct at the time of writing.

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[15] *Al-Zurqani, Sharh al-Muwatta'*, Vol. 3, p. 325.
[16] *Encyclopedia of Islamic Fiqh*, Ministry of Awqaf and Religious Matters, State of Kuwait, Vol. 18, pp. 172–173.
[17] Ibid., p. 179. Restricted *hiwalah* is a transfer of debt, which involves three different parties who are tied to each other on the basis of debt. The payment of debt is restricted to property of the transferor owed to him by the transferee.
[18] *The Mejelle*, p. 102 (Article 679).
[19] Al-Bukhari, *Sahih al-Bukhari* (*Kitab al-Salah-Bab al-Taqadi wa al-Mulazamah fi al Masjid*) Vol. 1, p. 134, hadith no. 71.
[20] Ali Haidar, *Durar al-Hukkam Sharh Majallah al-Ahkam, Dar al-Kutub al-'Ilmiyyah*, Beirut, n.d., Vol. 1, p. 38.
[21] Ibid.
[22] Ibd Qadi Samawinah (or Samawah) Jami' al-Fusulayn, Bulaq, Egypt, 1938–1984, Vol. 1, p. 169.
[23] Ibn Nujaym, *al-Ashbah wa al-Naza'ir*, Calcutta, 1926, p. 46.
[24] *The Mejelle*, article 397.
[25] Ibn Taimiyyah, Majma'at Fatawa Syakh al-Islam Ahmad Ibn Taymiyyah, ed. 'Abd. Rahman Ibn Muhammad Ibn Qasim al-'Asimi al-Najdi al-Hanbali. Ruyad, 1381–1386 H, vol. 29, pp. 478–483. (This *fatwa* has been analysed in relation to other Ibn Taymiyyah's *fatwa*s. See ibid., Vol. 20 pp. 346, 547–551: vol. 29 pp. 55–78: vol. 30, pp 151, 220, 240–340.)
[26] N. Elisseef, 'Ghuta', *Encyclopaedia of Islam* (New edition), Vol. 2, p. 1105.
[27] Ibn al-Salah. *Fatawa wa Masa'il Ibn al-Salah*, ed. 'Abd al-Mu'ti Amin Qal'aji, Dar al-Ma'rifa, Beirut, 1986, Vol. 1, pp. 327–328.
[28] Ibn Taymiyyah, *Fiqh al-Muamalat* (prepared by al-Shaykh Zuhair Shafiq al-Kabi), Dar al-Fikr al-Arabi, Beirut, 1995, p. 169.
[29] Al-Sarakhsi, *al-Mabsut, Idarah al-Qur'an wa al-'Ulum al-Islamiyyah*, Pakistan, 1987, Vol. 5, pp. 434–435.
[30] Ibn Taymiyyah, *Majmu'at al-Fatawa*, Vol. 29. pp. 478–483. For the details of other arguments, see Mohd. Daud Bakar, Law Making Process with Special Reference to Ratiocination in Islamic Law and Comparative Law: A Comparative Study, (forthcoming), pp. 72–75.
[31] Mahmud Hamzah, *al-Fara'id al Bahiyyah fi al-Qawa'id wa al-Fawa'id al-Fiqhiyyah*, Dar al-Fikr, 1989, p. 122.
[32] Randi Deguilhem-Schoem, "The Loan of *Mursad* on *Waqf* Properties", in *A Way Prepared: Essays on Islamic Cultures in Honour of Richard Baly Winder*, ed. Farhad Kazemi and R.D. McChesney, New York University Press, New York and London, 1988, p. 68. The author is grateful to Professor Syed Khalid Rasheed of the Kulliyyah of Laws, International Islamic University Malaysia for his kindness in highlighting this useful article in relation to the writer's research paper on Islamic liquidity.
[33] This fact makes the financiers reluctant to finance the development of *waqf* properties.
[34] The process of *istibdal* consisted of a *waqf* administrator declaring a property in the *waqf* under his jurisdiction unproductive and of negative benefit for that *waqf*. With the qadi's authorization, the property would then be sold and the proceeds used to purchase another piece of property established as *waqf* in place of the former. See Muhammad Qadr Pasha, *Qanun al-'Adl wa al-Insaf li al-Qada' 'ala Mushkilat al-Awqaf*, Cairo, 1928, articles 129–143, pp. 61–67.
[35] Randi Deguilhem-Schoem, 'The Loan of *Mursad*', p. 69.0
[36] Ibid.
[37] Ibid.
[38] Ibid., p. 70. The discount of al-Kubra Court in Damascus might suffice to illustrate the practice of the *mursad* loan. The document was dated on 26 Jumadi Thani 1207 H (February 8, 1793) and related to the *waqf* of Kamal a-Din Hamzah Zadah, a *waqf* which included extensive properties in Damascus and its environs. This document, which was registered according to the Hanafi School of law, mentioned that a *mursad* had been arranged two years previously on one of the houses (*dar*) in the *waqf*. It mentions that *waqf* revenues were inadequate to cover repair costs for this house. Consequently the tenants of this house loaned 5875 *qirsh* to pay for the necessary repairs. Their *mursad* was to be repaid by a reduction in the future rent. Instead of paying 6 *qurush* (plural of *qirsh*) annually, they were to repay only 5 *masari*. In the Damascus province at that time, 40 *masari* equalled 1 *qirsh*. Thus the renters now paid only 1/8 of a qirsh or 2.08 per cent of their former rent. It was further stated that the renters had another 56 years, 1 month, and 5 days left

on their lease. They (and their descendants) enjoyed the house almost rent-free in exchange for their loan. (See ibid. p. 71.)

[39] Ibid.

[40] Ibid.

[41] Sa'di Abu Jayb, *al-Qamus al-Fiqhi*, Damascus, 1982, pp. 105–106.

[42] W.E. Maxwell, 'The Law and Customs of the Malays with reference to the Tenure of Land' (1884) 13 JSMBRAS 75.

[43] See Makdisi, 'The Judicial Theology of Shafi'i: Origins and Significance', *Studia Islamica*, Vol. 29, 1984, p. 9.

[44] Money and Banking in Malaysia, bank Negara Malaysia (35th Anniversary Edition 1959–1994) Kuala Lumpur, 1994, p. 369.

[45] Ibid., pp. 369–406.

[46] The Malaysian Government introduced the Government Investment Certificates (GICs) on the basis of qard hasan. Such certificates were introduced to facilitate Islamic banks and Islamic windows of conventional banks to comply with Bank Negara Malaysia's liquidity requirements and for them to park their idle funds. The introduction of this scheme was not meant for the secondary market, as the certificates are not available to other investors, institutions or fund managers. The scheme is based on mudarabah and might be more suitable to contributing to the development of the Islamic secondary market. For more details see Nor Mohamed Yakcop, *Teori, Amalan dan Prospek Sistem Kewangan Islam di Malaysia*, Utusan Publications & Distributors SDn. Bhd., 1996, pp. 95–99.

[47] The writer has been led to understand that from actual statistics, the average successful rates for Bank-guaranteed Notes have been considered lower than the COF and BLR of merchants and commercial banks and closer to KLIBOR.

[48] The issue of liquidity on the principal market or level is not pressing as the notion of securitization has been developed for some years. The issue on liquidity is more focused on the secondary market.

[49] Wan Abdul Rahim Kamil, 'Securitization of Interest-Free Islamic Asset', paper presented at The Asian Dual Banking Conference, organised by the Asia Business Forum, Kuala Lumpur, September 26–27 1995, p. 2.

[50] Ibid.

[51] Ibid.

[52] Ibid. p. 8.

[53] Ibid p. 10.

[54] A mudabbir servant is a servant whose income generated from his works or services would belong to his master. However once his master died, he will be set free.

[55] Ahmad al-Dardir, r, Cairo, Vol. 3, p. 233.

[56] Ibn Rushd, *Bidayat al-Mujtahid wa Nihayat al-Muqtasid*, Vol. 2, p. 220.

[57] The Muslim scholars have eventually agreed on the practice of bay' al-dayn. However the contention amongst the scholars with respect to *bay' al-dayn* is whether the debt could be sold at a discount. That would depend upon whether trade debts could amount to assets and not a price represented by its monetary worth. Trade debts could amount to assets if it could be argued that the obligation of the trade debtors to pay forms their underlying premise which thereby renders the sale of debt at a discount permissible. If these trade debts could not be construed as assets but rather a price represented by its monetary worth, then the transfer of such debts could only be effected at their par value. This dispute is *ijtihad* in character and one may choose one view for the other. Even if we dispute the legitimacy of the sale of debt at a discount, another solution is always possible, namely *hiwalah bi al-ujr*, or transfer of debt for fees in the sense that the transferee (the SPV) is entitled to remit part of the total value of debt as fees for its services. The same process would equally apply to the transferee(s) on the secondary market.

[58] This is translated as decreasing partnership or partnership leading to full ownership to another partner. This type of partnership is of recent origin.

[59] Wan Abdul Rahim Kamil, 'Securitization of Islamic Assets', p. 9.

[60] Bay' al-istisna' consists of a 'flexi' method of payment.

[61] The paper does not discuss the process of liquidity with regard to securitization of Islamic bonds such as Government Investment Certificates and Islamic stocks.

[62] The minimum rating to qualify as an investment grade instrument is triple 'B' ('BBB') whereby anything below triple 'B' will be considered as a speculative grade investment. See Nor Mohamed Yakcop, 'Is the Islamic Banking System in Malaysia Ready to Meet the Challenges of the 21st Century?', paper presented at the Conference on Asian Dual Banking, organized by Asia Business Forum, Kuala Lumpur, September 26–27 1995, p. 5.

Chapter 10

Islamic finance across the GCC and cross-border considerations

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Introduction

This chapter seeks to provide an insight into the key Islamic finance markets in the Gulf Cooperation Council (GCC), focusing on the emergence, growth and potential of Islamic finance as well as an examination of the key regulatory standards in place to support this successful industry.

The aims are to explore Islamic finance across the GCC, the region in which Islamic finance really evolved and grew, driven principally by the oil boom in the 1970s, and to pose the question as to whether the current oil boom could see a similar growth and expansion of Islamic finance across the region.

History of development

Islamic finance is an industry which, although being based on the principles of the *Qur'an* and *Sunnah*[1] (which are over 1400 years old), is barely four decades old. Islamic finance may have emerged as one bank in the Middle East, but it has now become a feature in over 75 countries globally, with the greatest physical concentration being found in the Middle East and South East Asia. In many financial markets, Islamic finance is growing faster than in certain conventional sectors.[2] It is high on the agenda of several others and such rapid growth is now perpetuating a race amongst jurisdictions to become the financial 'hub' or 'centre' for Islamic finance.

Islamic finance in the GCC

When questions are asked about Islamic finance in the GCC, there are a few countries, such as Bahrain, the UAE and Qatar that stand out as having been key drivers in the field, and inspiration to many more such as Saudi Arabia and Kuwait.

The growth of Islamic finance across the Middle East has been seen as each country moves gradually towards diversification from oil revenues to other sectors such as tourism and financial services, with great advances being made in the Islamic financial services industry. The Islamic financial services industry blossomed across the Middle

East largely in a response to the oil boom in the early 1970s and continued to evolve to its current position.

Many of the Middle East states began looking towards other resources or industries to generate revenue, such as natural gas in Qatar, which led to growth and development in project finance, which has in turn lent itself very well to Islamic finance projects. The UAE has seen growth in trading, tourism and finance, emerging into a financial hub and boosting its position as home to the first Islamic commercial bank in the world.[3] Of course, Bahrain has perhaps been one of the early pioneers in Islamic finance. As financial markets and governments realize the potential and demand of Islamic finance, the industry has branched beyond the borders of the Middle East to the major financial centres across the world. Innovation in Islamic finance is being seen from all perspectives, but what is important is to consider whether the GCC will continue to be a leading light in Islamic finance or if this position will be assumed by one of the other financial markets.

Sectors

Traditionally the GCC has been host to Islamic finance across all core financial sectors: traditional banking (where Islamic contracts have been innovated to emulate equivalent yields and returns as are available from conventional banks[4]), funds, home financing, *takaful* (a form of mutual insurance) and of course *sukuk*, with the largest *sukuk* deals originating from the GCC.

Future opportunities exist across all sectors, but particular growth can be seen in Islamic funds. Recent comments in the WIBC McKinsey Competitiveness report on the industry indicated that the greatest opportunities in Islamic funds are in the GCC, with growing demand for capital to support the huge infrastructure projects across the GCC. *Sukuk* have been a traditional source of investment, but greater access to retail investors may see the emergence of a growing offering of funds, ranging from equity funds to property funds and REITs, all structured to meet the underlying tenets of Islam.

Recent announcements from across the GCC (specifically Dubai) have indicated that perhaps greater consolidation and acquisitions could take place leading to mega-Islamic banks encompassing a wider cross-section of services.

Regulation of Islamic finance

The manner in which any industry is regulated has an impact on the confidence and success of the industries within the relevant jurisdiction concerned. This is particularly true in the context of the relatively new Islamic financial services industry.

From a regulator's perspective, any financial sector must be well managed and regulated to promote soundness, stability and integrity. In the context of Islamic finance there are a number of considerations in this regard which are discussed at various points throughout this chapter, such as:

- the manner in which Islamic institutions are regulated and whether a unique regulatory model is specifically required for Islamic finance or whether an integrated approach can apply;

- how the *Shari'a* features will be regulated and by whom;
- *Shari'a* compliance through the product lifecycle, the role of internal compliance and scholars respectively;
- the level of disclosure required in Islamic finance; and
- the issue of enforceability.

The manner in which Islamic institutions are regulated

Across the GCC, in Bahrain, the Dubai International Financial Centre (DIFC), Dubai and Qatar Financial Centre (QFC), conventional banks and Islamic banks (including conventional banks offering Islamic finance) have been operating in parallel. Even though the GCC is a Muslim region it has integrated and permitted an open financial and banking system enabling Islamic finance to operate in many forms as pure Islamic banks or through Islamic windows. The regulatory regime across the GCC has varied as to the extent to which regulations were integrated, so applied across both Islamic banks and conventional banks, or as a separate regulatory regime developed for Islamic banks. Bahrain maintained a separate regulatory model for Islamic banks and has, within its overall integrated regulatory model, provided for a separate set of regulations for Islamic banks. By contrast, the DIFC as an integrated risk-based regulator has integrated the regulation of Islamic finance within the regulatory framework for conventional banks, and incorporated specific rulebooks applicable to Islamic financial business within the overall conventional framework. The QFC has adopted a similar approach to that operational in the DIFC.

With these subtle differences, what is consistent is that there are specific regulations developed to reflect the unique risks inherent in Islamic finance without compromising the commitment to adhering to international standards.

How are *Shari'a* features regulated?

Perhaps one of the most interesting challenges facing a regulator is how and to what extent they are obliged to regulate *Shari'a*. Across the GCC there is consistency that the *Shari'a* features are determined by appointed *Shari'a* scholars. The common standard adhered to across the GCC when making the appointment of *Shari'a* scholars is that defined in Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) governance standards.

The next key consideration is the role of the regulator. The DIFC has provided perhaps the most innovative model referred to as the '*Shari'a* Systems' regulatory model which defines the framework within which Islamic firms will operate, for example the requirements stipulate that an internal system must be in place to ensure compliance with *Shari'a*, including the appointment of scholars, the process for seeking *fatwa*s, the process for disseminating *fatwa*s and the ongoing process to ensure that product remains *Shari'a* compliant, drawing upon the Islamic firm's internal compliance or audit function. This unique model is based on international best practice and regulatory concepts found in the key financial markets, such as the UK, and therefore Islamic financial products which are regulated in or originate from the DIFC are subject to the same levels of oversight as would be expected in the UK; additionally the specific *Shari'a* features of the product must have been subject to well defined yet facilitating regulatory oversight requirements to ensure that

the product has the necessary credibility to be deemed *Shari'a* compliant. This model is being adapted in other financial centres such as the QFC.

A further consideration in the regulation of Islamic finance is the quality of general regulation in the jurisdiction concerned. Islamic finance has generally been introduced in emerging countries where the basic regulatory regime lacks key components to promote a sound financial system, such as weak disclosure requirements and weak internal control management procedures. In addition, the specific risks arising from Islamic finance will then be incorporated into the prevalent regulatory system which was perhaps not sufficiently robust for conventional finance, leaving aside Islamic finance.

The regulatory regime applicable to Islamic finance across the GCC has varied considerably, although there has more recently been a shift towards greater consistency of regulatory standards with international best practice. This has resulted in greater alignment of regulatory standards across the GCC, albeit driven by the desire to implement international best practices.

Of the jurisdictions selected in the chapter, Bahrain was perhaps one of the first GCC countries to develop a specific regulatory framework for Islamic finance, leading prudential risk management for Islamic finance with its PIRI framework (Prudential Information and Regulations for Islamic Banks) introducing specific capital charges for the unique risks arising in Islamic finance. The foresight demonstrated in Bahrain during the Islamic financial services industry's formative years has been a key driver in the development of other regulatory regimes for Islamic finance across the GCC and beyond. Some of the early regulations have stood the test of time, albeit modified to reflect modern practices.[5] The regulatory regime of the GCC is important in providing an insight into the manner in which risks within Islamic finance are perceived to arise and how they are to be managed. Recent innovations in the field of regulating Islamic finance have been seen in the DIFC, where a '*Shari'a* Systems' method of regulating Islamic finance has been seen, where well defined regulations are in place to ensure that Islamic financial products are subject to the appropriate degree of *Shari'a* oversight, initial and ongoing, to ensure that the product has the necessary features to be deemed (and remain) *Shari'a* compliant.

The key jurisdictions assessed in this chapter are Bahrain, UAE and DIFC[6] specifically, and Qatar and QFC.

With all the regimes covered in Box 1, specifically the DIFC, QFC and more recently Bahrain, there has been a clear commitment to ensure that the regulatory framework is based on international best practice and recognised international standards such as International Organization of Securities Commissions (IOSCO), Basel and Financial Action Task Force (FATF). Within this framework, the Islamic financial services industry has been integrated but modified to the extent required to reflect the specific and unique risks in Islamic finance. For example, regulators across the GCC, drawing upon the recommendations of the Islamic Financial Services Board (IFSB), have considered modifications to Basel II to reflect the specificities of Islamic finance, which would otherwise not have been accommodated if Basel II were to be applied solely from the conventional perspective. This approach is pragmatic because, unlike some western regulators, it recognizes that integration of Islamic finance into a regulatory framework, which may have been biased towards conventional finance, but which is capable of application to Islamic finance, subject to minor modifications to reflect the inherent risks in Islamic finance, which may not otherwise be identifiable from a purely conventional regulatory model, is possible. This does not adversely affect any secular policies of the jurisdiction concerned.

Box 1

Bahrain

Regulatory Snapshot

Formerly regulated by the Bahrain Monetary Agency which became the Central Bank of Bahrain (CBB) and an integrated regulatory model.

Core strengths of the regime

The CBB has developed an integrated rulebook and a sub-set specifically applicable to Islamic finance Institutions wishing to offer regulated Islamic banking activities which consist of three determinant activities. Additional guidance is provided to institutions seeking Islamic licences including the appointment of a *Shari'a* Supervisory Board. The three determinant categories are:

1 accepting *Shari'a* money;
2 managing Profit-sharing Investment accounts; and
3 offering *Shari'a* financing contracts.

Islamic bank licences can be offered to Islamic retail banks or Islamic wholesale banks. The general licensing standards of the CBB are based on international best practice, Basel and the IFSB. The accounting and auditing provisions of AAOIFI are applicable, but where AAOIFI does not provide sufficient coverage the relevant international accounting standard will apply.

Specific additional guidance has been issued for Islamic Leasing Companies.

Bahrain has a tried and tested regulatory regime which applies to Islamic finance. Its current regulatory developments have been undertaken to further enhance the application of international best practice into the overall regulatory framework.

UAE and DIFC

Regulatory Snapshot

- Central Bank of UAE
- Emirates Securities & Commodities Authority
- Ministry of Economy and Planning
- Dubai Financial Services Authority (DFSA) (with oversight over the Dubai International Financial Centre (DIFC)).

UAE

The UAE's regulators include the Central Bank of the UAE covering banking activities, the Securities Authority covering capital markets activities, and Ministries in respect of certain insurance-related activities.

General central bank regulations are applicable to conventional banks and apply to Islamic Banks as supported periodically through the issue of specific Central Bank circulars. Additional obligations apply to Islamic institutions, namely with regard to the obligation to appoint a *Shari'a* Supervisory Board. General accounting standards apply.

DIFC

In relation to the Dubai International Financial Centre, a financial free zone in the emirate of Dubai, the regulatory system is based on a single integrated regulator focused on risk-based supervision. The regulatory structure of the DIFC is represented by an integrated, cross-sectoral, risk-based regulator staffed by regulators from the key international markets. The integrated regulatory model allows the regulator to view regulatory issues across the market and across the financial sectors allowing financial institutions to flourish within the confines of regulatory parameters defined by international best practice.

The DFSA adopts a risk-based approach to the supervision of financial institutions and has successfully integrated the regulation of Islamic financial institutions (including Islamic windows) within the overall regulatory framework for conventional finance, with an appropriate degree of modification where required. This integrated approach applies across the DFSA's regime to ensure consistency and a level playing field; therefore the licensing regime, the supervisory review process and the ongoing relationship management between the DFSA and financial institutions is undertaken equally across all financial institutions, with a focus on the risk posed by the institution.

Specific obligations which apply in the context of Islamic financial institutions are:

- Requirement to appoint a three-member *Shari'a* supervisory board based on the standards of AAOIFI.
- Requirement to have well defined systems and controls in place to ensure *Shari'a* compliance.
- Use of AAOIFI as the accounting standards for wholly Islamic financial institutions and the International Financial Reporting Standards (IFRS) as supplemented by AAOIFI for Islamic windows.
- A process must be in place for the initial and ongoing *Shari'a* compliance, the ongoing *Shari'a* compliance being undertaken internally.
- Specific prudential framework reflecting the specific risks in Islamic finance drawing upon the recommendations of the IFSB's Capital Adequacy standard.

Qatar and QFC

Regulatory Snapshot

- Qatar Central Bank (QCB) covering Qatar.
- QFC Regulatory Authority (with oversight over the Qatar Financial Centre (QFC))

Qatar

The QCB has implemented a series of circulars setting out the basis upon which banks can offer Islamic products. In all cases there is an obligation to appoint a *Shari'a* committee consisting of a minimum of two members to provide the *Shari'a* oversight and authentication in relation to the products to be offered by the bank. Additionally, an internal *Shari'a* audit function must be implemented to ensure ongoing *Shari'a* compliance. Specific guidance is also provided to ensure that there is adequate risk management, specifically prudential risk management.

QFC

The QFC is regulated by the Qatar Financial Centre Regulatory Authority (QFCRA) which is an integrated risk-based regulatory model, similar to the model in place in the DIFC. The QFCRA's regulatory approach to Islamic finance is to provide a framework within which firms can operate Islamic financial business, including the appointment of the *Shari'a* Supervisory Board, implementation of adequate systems and controls to ensure *Shari'a* compliance and periodic reviews and validations by *Shari'a* scholars. Relevant aspects of AAOIFI are also mandated.

Given the emergence and growth of Islamic finance across the GCC, regulators may have acquired the skill to provide the most appropriate regulatory environment for Islamic finance which could serve as a model for some of the international markets now looking to introduce Islamic finance. The GCC is a Muslim region but the banking system in many of these countries has been based on a parallel financial model where conventional banks and Islamic banks have been successfully operating. The skills that GCC regulators have developed have not just ensured an appropriate framework for regulating Islamic finance, but perhaps more diplomatically, have integrated Islamic finance without discriminating or negatively impacting the continued growth and success of the conventional banks which operate within their markets. A delicate exercise which many regulators (in both secular markets and Islamic markets now introducing Islamic finance) are having to consider.

Another interesting point to note is that many regulators across the GCC, including the DIFC, QFC, Bahrain and others adhere to the highest standards of anti-money laundering

and counter-terrorist financing requirements. This is an important note to make in this chapter as the GCC is often criticized for having weak regulatory controls in this area. This is not always the case. Secondly, in the context of Islamic finance, there is no direct correlation between Islamic finance and money laundering or terrorist financing.

Enforceability

A critical component of every financial centre is the confidence which the users of that jurisdiction have in the relevant legal system. A legal environment which provides certainty and clarity of customer rights and obligations in respect of the products is fundamental to supporting financial transactions. This becomes further relevant when the financial transaction contains the added component of *Shari'a*, when users will need clarity as to how the legal system will address certain matters, particularly disputes over the extent of compliance with *Shari'a*.

The issue of disputes and legal and *Shari'a* risk will begin to emerge across the industry as it becomes more mature. The key consideration for markets is how Islamic finance disputes will be treated – as *Shari'a* disputes or as commercial disputes? In many jurisdictions across the GCC, in the first instance the dispute will be treated as a commercial dispute, because it is also an inherent *Shari'a* obligation to deliver on promises and contractual commitments.

Interesting enforceability issues could arise across the GCC. Commonly, although *Shari'a* is not a separate law of the country, rather a supporting code, contracts executed across the GCC may seek to invoke *Shari'a* as a governing law provision. Across the GCC, the *Shari'a* features will be given due consideration as part of the review. Across international regions, where Islamic structures, even those originating in the GCC, select English law and *Shari'a* as a governing law, the legal position becomes less clear. In such cases interesting judicial clarification by UK judges has been provided suggesting that from a legal perspective *Shari'a* may not constitute a valid governing law provision as it may not meet the necessary tenets of the Rome Convention. This is due to the fact that *Shari'a* is not confined to a geographical boundary or to the borders of any country. *Shari'a* can be invoked by anyone anywhere and hence it cannot be confined to a particular boundary, nor can a particular school of thought be confined to one jurisdiction (as opposed to a dominant school of thought in a particular jurisdiction). In the context of Islamic structures, *Shari'a* is instead an essential and intrinsic characteristic of the features of an Islamic contract[7] and from that perspective it should be upheld. UK judges have indicated that they will not opine on the validity of the *Shari'a* elements of the contract but will look at the *Shari'a* authentication process which would have been applied, namely the process of suitably qualified scholars issuing a *fatwa* to validate that the structure had the necessary elements to be deemed *Shari'a* compliant. Once a customer enters into such a transaction, it is not acceptable to use *Shari'a* to avoid any obligations under such a contract.

Interestingly, with the continued use of English Law as the governing provisions, future GCC based Islamic structures may be subject to interesting judicial interpretations, which may otherwise be addressed differently in the GCC where the place of *Shari'a* as a supporting code within the overall legal system is very different from the legal structure in those jurisdictions which are commonly invoked as the governing law.

Where is the growth?

Islamic finance has emerged across the globe, initially from within Islamic countries, and now it is emerging in non-Islamic countries, secular countries and Islamic secular countries. Clearly the demand and potential is captivating governments and regulators worldwide.

An interesting dimension in this growth can be seen in Islamic secular markets that are considering introducing Islamic finance for the first time. The demand is clearly driving the political agenda; however a number of interesting questions are being raised by this new dimension in Islamic finance and perhaps even solutions to some of the current issues and impediments facing the Islamic financial services industry may be found in such markets, as discussed below.

Islamic secular markets may, by legal prohibition, be unable to label products as having any particular religious association. Consequently, Islamic finance will be offered as a non-denominational product referred to either as an 'alternative product' or 'participation product'. There are clearly political sensitivities which exist in Islamic secular markets which will not be discussed in this chapter. However what is important in such markets is to ensure that there are no breaches of *Shari'a* for this could pose a serious political issue for the jurisdictions concerned. Therefore in order to offer Islamic finance into Islamic secular markets there may be a degree of evolution and innovation which may not yet exist in Islamic jurisdictions. For example Islamic secular markets may develop standardized contracts which meet the legal form required to ensure the product meets the requirements of *Shari'a* by ensuring that the structure is free from the prohibited elements of *Shari'a* and each feature of the contract is explained to potential customers so that they are fully aware of the issues in the event of default and of breach of contract. Furthermore, such jurisdictions are unable to use the term 'Islamic' or '*Shari'a*' so may revert to the essence of Islamic finance and utilize the terms 'participation' or 'profit and loss sharing' products. Such terminology is usually combined with a closer adherence and alignment with substance and form of profit and loss sharing, something which may not always be the case in other markets.

Whatever the perspectives in respect of Islamic secular markets, the introduction of Islamic finance is something to be witnessed as it may open up some interesting challenges.

Moral funds

Islamic finance may have emerged as a faith-based financial product for Muslims, but since then it has displayed growing interest among non-Muslims. This demand is driven by the attraction of the '*halal*' based aspect of Islamic finance which essentially filters out impermissible investments, such as the filtering of investments in weapons and the defence industry. Such filtering is attracting investments from non-Muslims from the major international financial markets into Islamic finance as a form of ethical finance.

Across the US, for example, ethical funds and a subclass of such funds, moral funds, are on the rise. Within the Catholic community moral funds have been a growing trend over the past 3–4 years, a growth that is set to continue. The appeal of Islamic finance as a form of moral fund is prominent and the question which remains to be answered is

whether greater market penetration of Islamic finance could be seen if Islamic products are re-packaged as a non-denominational moral or ethical fund?

From a GCC perspective, the scope and potential for originating Islamic funds is unlimited. The regulatory regime exists to provide the relevant framework for regulating Islamic funds, noting that Bahrain introduced a specific process for registering and offering funds. Similarly, the DIFC introduced a Collective Investment regime which was based on international best practice which integrated a specific framework for Islamic funds. Given the international regulatory framework which applies to Islamic funds originating from the GCC, their recognition and acceptability in the international markets is growing, which could lead to greater opportunities for the offering of *Shari'a* compliant funds across borders, both regional and international.

Islamic finance across borders: the benefits of regulatory convergence

The cross-border issue

When financial products seek to pass beyond domestic borders, a number of issues and considerations arise, principally whether the regulatory regime of the jurisdiction concerned will permit the incoming product. To further complicate matters, where the product is a *Shari'a*-compliant product, additional complexities in respect of whether the recipient jurisdiction will accept the *Shari'a* basis of the product is a further problem to overcome.

By analogy, when seeking to offer a new product into a new market, local advisers and experts can be appointed to ensure that the local requirements are satisfied. In the context of Islamic finance, does this correlate to seeking to ensure that local scholars are appointed to ensure that the local acceptability of the product will not be compromised? This is a situation commonly faced by many distributors who seek to minimize the cost of launching a product while optimizing the number of markets to be targeted. Across the GCC, the questions of *Shari'a* and the differences in interpretation due to difference across the schools of thought continue to plague certain financial institutions; although as awareness in the products and basis of the principles emerge, there is scope for greater cross-border market penetration of products without additional costs. One such solution was initiated in Dubai (DIFC) not across the GCC, but across to Malaysia, where *Shari'a* interpretations are often viewed less favourably than in the GCC. Such a model provides an interesting proposition for the expansion across the GCC, as discussed below.

Future growth opportunities across the GCC

As the facilitating legislation of Europe has seen a boom in the growth and passporting of funds across Europe, similar models for the cross-border flows, or 'passporting' of *Shari'a*-compliant funds, could further strengthen the Islamic financial services industry across the GCC. Unlike conventional funds the added *Shari'a* dimension raises some interesting challenges for the distribution and offering of products across borders, most notably whether

the *Shari'a* validation process and *fatwa* issued in one jurisdiction has application in another. This very issue was addressed in the First Mutual Recognition model entered into between two diverse schools of thought: Dubai and Malaysia. In 2007 the regulator of the DIFC and the SC, Malaysia, entered into an arrangement whereby *Shari'a*-compliant funds could flow across the borders of the DIFC and Malaysia with minimal regulatory intervention and most significantly, enhanced disclosures pertaining to the *Shari'a* basis of the acceptability of the product. This latter requirement was implemented to surmount the potential difficulty of seeking to align different religious perspectives, the alternative being to provide sufficient information to investors to enable them to make an informed decision about the *Shari'a* basis of the product.

This arrangement could be extended across the GCC, to develop a GCC Funds Passporting regime equivalent to Europe.

As GCC regulators demonstrate their commitment to the implementation of international standards which are being put into practice at various levels, from regulatory, accounting, and disclosure, this is raising the standard and quality of regulation. This in turn is raising the investment opportunities in those countries as a result of the increased confidence these regulatory developments are bringing. With greater implementation of international best practice, regulations across the GCC will become aligned, facilitating the opportunity to offer products across the GCC, and once the issue of *Shari'a* alignment can be agreed, the GCC could become a successful passporting region for financial products.

General areas of improvement

As with any financial sector or any major industry, improvement opportunities exist. Improvements in the area of regulation of Islamic finance have been discussed at many forums, and presented through various standard setting agencies such as IFSB and AAOIFI.

The key development opportunities exist in the area of disclosure and transparency in the regulation of Islamic finance, not just in the underlying *fatwa*s supporting the products but also greater disclosure of the markup and determination of profit ratios in certain Islamic structures.

Another major area for development is in the area of corporate governance for Islamic institutions. The IFSB released a standard recommending enhanced governance to protect specific customers of Islamic banks, notably profit sharing investment account holders.[8] The IFSB, in compliance with Islamic principles of ethics and transparency, encourage Islamic banks to define further the role of *Shari'a* scholars to enable them to form a committee, another organ of governance, to oversee the *Shari'a*-compliant activities of the bank to ensure the interests of account holders are protected.

Standard-setting agencies

As with any standard-setting agency, such as IOSCO, Basel and FATF, guidance and clarification to promote best practice is required to promulgate a benchmark for the relevant industry. Islamic finance is also an industry which requires a benchmark or set of standards for the regulation of the industry. In this regard the work of AAOIFI and the IFSB has been

a key factor in driving the Islamic finance industry forward and attaining the international recognition the industry now receives. The role of AAOIFI and IFSB will continue to become more and more significant as Islamic finance continues to pervade geographical boundaries. The key contribution being made by these agencies, specifically the IFSB, is that their work and recommendations seek to firstly ensure that international best practice is applied to Islamic finance, with an appropriate degree of modification, without compromising the very essence of Islamic finance: its adherence to *Shari'a*.

Conclusion

Islamic finance emerged as an industry which was targeting Muslim investors with specific financial needs that required alignment with religious beliefs; however, as the industry continues to pervade geographical boundaries, it has expanded beyond the portfolios of Muslim investors to non-Muslim investors.

Muslim investors were driven by a desire to seek financial products that had real economic interest and avoided investments in prohibited, unethical sectors denoted as *haram*; non-Muslim investors may not be drawn to the former reason, but the desire to avoid unethical sectors is fuelling the move by non-Muslims towards Islamic finance, noting the growing adaptation of *Shari'a*-compliant funds into moral funds, a sub-class of socially responsible funds, particularly in the US.[9]

Clearly this trend will continue, perhaps raising the pertinent question as to whether greater global market penetration can only be achieved by moving towards a non-denominational financial services industry. Only time will tell.

In conclusion, the GCC has been a key player in the introduction of Islamic finance and still retains significant level of expertise in the technicalities of Islamic finance notwithstanding that the regulatory regimes across the GCC may still be in need of improvement.[10] However most regulatory structures require constant development and attention, as the markets have recently witnessed in the US and UK. Given the commitment amongst the GCC governments to continue to find alternative routes for economic development and growth away from oil, it is possible for the GCC to continue to playing a leading role in the future growth and development of Islamic finance.

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[1] The *Qur'an* is the unequivocal word of God and the *Sunnah* is the consolidation of the words and deeds of the Prophet. Collectively this is referred to as *Shari'a*.

[2] WIBC McKinsey *Competitiveness Report* 2007–08.

[3] Dubai Islamic Bank.

[4] *Mudarabah* and profit and loss sharing offered as an investment deposit; instead of interest, a profit is generated.

[5] Displaced Commercial Risk Charge which has been incorporated, in a modified form, into the IFSB's Capital Adequacy Standard.

[6] The DIFC is the world's fastest growing global financial hub financial centre ideally located to bridge the gap between the existing financial canters of London and New York in the West and Hong Kong and Tokyo in the East and services a region with the largest untapped emerging market for financial services. What began as a vision of the leaders of Dubai in 2002 was declared open for business in 2004.

[7] Shamil Bank: Judgement of judge of Royal Courts of Justice.

[8] Profit-sharing account holders is a reference to customers of Islamic banks that enter into a *mudarabah* contract. The customer is the provider of capital and essentially becomes a *rabb ul maal*.

[9] Eva Maria Catholic Funds. In Catholicism as well as Islam, the religion is defined as a way of life. (George Weigel, Pope John Paul II's biographer indicated that Catholicism is not a hobby. Catholicism is not a lifestyle choice. Catholicism is a way of life.) Akin to the concept of vicegerency in Islam, Catholic investments are also reiterating the concept of 'Human Stewardship' and the role of mankind as a manager not an owner of resources and therefore the implicit moral responsibility associated with such a function is similar to principles in Islam.

In Catholicism as with Islam**,** both religious denominations seek to take their religious and moral beliefs into financial transactions. From the principles of Islam, *Shari'a* compliant funds have evolved which contain a series of financial as well as industry filters. Certain industries are prohibited such as pornography, tobacco and alcohol to name a few. Similarly Catholic investment vehicles have grown in the US such as the Eva Maria Funds which invest in accordance with moral principles and values avoiding investments in certain industries such as those which promote or facilitate abortion. Catholic funds are a form of socially responsible investments or morally responsible investments.

[10] Mohammed El Qorchi – Islamic finance Gears Up (IMF).

Chapter 11

Money laundering and Islamic banking

Aly Khorshid
Elite Horizon

Introduction

Money laundering involves engaging in financial transactions solely to conceal the identity, source or destination (or a combination of the three) of money, and is a main operation of the underground economy.

The term 'money laundering' has historically been applied only to financial transactions related to organized crime, but today its definition is often used by government regulators to encompass any financial transaction that generates an asset or a value through an illegal act, be it tax evasion, false accounting or the more 'traditional' routes. Money laundering is now recognized as being practised by individuals, small and large businesses, corrupt officials, members of organized crime and even organizations up to the level of the state. The increasing complexity of financial crime and value of so-called 'financial intelligence' in combating transnational crime and terrorism, and the speculated impact of capital extracted from the legitimate economy has led to an increased prominence of money laundering in political, economic, and legal debate.

Since the 9/11 terrorist attacks, anti-money laundering efforts have been stepped up in the eyes of governments and legislative bodies, and the public is becoming more aware of what money laundering entails. Terrorism needs financing, just like any other activity, and legitimate channels are much easier to stem, making laundering activities more attractive to the terrorist organizations. There have been a host of international initiatives, laws and regulations to combat money laundering, and these have become important tools in the fight.

The development of global financial systems has in a way made it much easier for launderers to move and hide their funds more or less anywhere in the world. The rapid globalization since the late 1980s has massively liberated financial markets, business, communication and movement of capital and people – both for legitimate and illicit purposes.

Criminals can now carry out their illegal activities away from their local geographic region, making them more confident, coordinated and powerful, even to the point where they can challenge the power of smaller states. Another difficult issue is prosecuting and investigating those who perpetrate financial crimes from foreign countries, where the laws surrounding money laundering might differ from the victim's country. The Basel Committee on Banking Supervision has attempted to set standards and the Financial Action Task Force

on Money Laundering (FATF) has been established to develop international standards and best practice in the fight against money laundering.

Process

Money laundering is often described as occurring in three stages: placement, layering, and integration.

- Placement: the initial point of entry for funds derived from criminal activities.
- Layering: the creation of complex networks of transactions that attempt to obscure the link between the initial entry point and the end of the laundering cycle.
- Integration: the return of funds to the legitimate economy for later extraction.

The Anti-Money Laundering Network has recommended the terms be renamed thus:

- **Hide** (because cash is usually introduced to the economy via commercial concerns which may not necessarily be aware of the laundering but still become the interface between the criminal and the financial sector)
- **Move** (since money launderers use transfers, sales and purchase of assets, and change the size of the payments to disguise the link between money and crime)
- **Invest** (as the money is eventually spent 'legitimately' on assets, business investments, lifestyle and more criminal activity)

Reporting suspicion

If a person is making large amounts of small change a week from a business (not unusual for a shop owner) and wishes to deposit that money in a bank, it cannot be done repeatedly without attracting suspicion. In the US, cash transactions and deposits greater than a certain amount are required to be reported to the Financial Crimes Enforcement Network (FinCEN) as 'significant cash transactions', along with any other suspicious financial activity. In other jurisdictions, financial service employees and firms are required to report suspicious activity to the authorities.

One way launderers would keep these transactions private would be for an individual to give money to an intermediary who is already legitimately taking in large amounts of cash and who would then deposit that money into an account and pay the launderer, even by cheque. This way the launderer draws no attention to himself. This works well if not overused, but if it occurs on a regular basis then the deposits themselves will form a paper trail and could raise suspicion.

UK legislation

The UK has long recognized the problem of money laundering and anti-money laundering legislation has been in place for many years. The money laundering legislation in the United

Kingdom, under Sections 327 to 340 of the Proceeds of Crime Act 2002, and all of the Money Laundering Regulations 2003 and 2007, is wide-ranging and encompasses mere possession of criminal or terrorist property as well as its acquisition, transfer, removal, use, conversion, concealment, or disguise. The UK legislation was relaxed slightly in 2005 to allow banks and financial institutions to proceed with low value transactions involving suspected criminal property without requiring specific consent for every transaction.

In response to international initiatives and EU directives, the UK legislation has evolved over recent years and is now contained in a number of statutes and regulations. These statutes create a number of criminal offences, namely:

- Assisting a money launderer.
- Tipping off a person suspected of involvement in money laundering that they are suspected or that they are the subject of a police investigation.
- Failing to report suspicion of money laundering (regulated activity).
- Acquiring, using or possessing criminal property.

For organizations involved in regulated activity the Money Laundering Regulations 2003, which came into force on June 1 2003, created a number of requirements for organizations to undertake and a failure to comply can result in criminal prosecution.

- Proceeds of Crime Act 2002. Under this Act, it is a criminal offence to be involved in any activity if there is the suspicion that it facilitates someone else in acquiring, retaining, using or controlling the proceeds of crime. Similarly, it is an offence for anyone who is working in a financial company not to report any act that they suspect involves the proceeds of crime.
- Financial Services Authority (FSA) Money Laundering Rules. The Financial Services Authority (FSA) has enhanced this legal framework with the introduction of 'Money Rules' that apply to regulated financial institutions. In relation to regulated financial institutions the Joint Money Laundering Steering Group (JMLSG) has published Guidance Notes on Money Laundering. The JMLSG Guidance Notes have no legal authority but are very detailed and cover all existing legislation and regulations providing a practical interpretation of UK money laundering legislation and an indication of good generic industry practice.

American legislation

The 1970 Bank Secrecy Act requires banks to report cash transactions of $10,000.01 or more. The Money Laundering Control Act of 1986 further defined money laundering as a federal crime. The USA PATRIOT Act of 2001 expanded existing laws to more types of financial institutions, focused on terrorist financing and introduced that 'know your customer' (KYC) guidelines for financial firms. In the US, Federal law provides (in part) that:

> Whoever . . . knowing[ly] . . . conducts or attempts to conduct . . . a financial transaction which in fact involves the proceeds of specified unlawful activity . . . with the intent to promote the carrying on of specified unlawful

> activity . . . shall be sentenced to a fine of not more than $500,000 or twice the value of the property involved in the transaction, whichever is greater, or imprisonment for not more than twenty years, or both.

Terrorist financing in some ways takes the opposite path to that of cash in more 'everyday' criminal laundering, where 'dirty' money flows into the 'clean' economy. With terrorism, ostensibly clean funds are sometimes used for dirty purposes.

The Currency and Foreign Transactions Reporting Act, also known as the Bank Secrecy Act (BSA), is used by the US government to fight drug trafficking, money laundering and other crimes. It was enacted to prevent banks and other financial service providers from being used as intermediaries in criminal activity.

The US Patriot Act, originally enacted in 2001 but amended in 2003, took anti-laundering efforts to new levels, especially in financial institutions where there are strengthened requirements to perform due diligence. The Patriot Act expanded upon existing anti-money laundering laws within the BSA by allowing institutions to share information about suspicious behaviour among themselves and with enforcement officials. These institutions are now forced (and indeed allowed) to know their customers like never before.

The OFAC (Office of Foreign Asset Control) has a compliance requirement that any new account being opened triggers a search of the OFAC specially designated national list, and that these searches continue throughout the life of the account. Transactions can be blocked if the list signals risk.

European anti-money laundering laws

Financial Action Task Force (FATF)

The G5 Nations established the FATF in 1989 and it has provided a lead in setting international standards on money laundering. In June 2003, the Financial Action Task Force (FATF) revised its 'Forty Recommendations' to give a wide-ranging framework for tackling money laundering and terrorist financing. Section B of the recommendations focuses particularly on measures that must be taken by financial institutions towards the establishment of customer due diligence and record-keeping systems. In practice, this will require automated compliance systems, although no such system is specified, except that all countries must bring their systems for combating money laundering and terrorist financing into compliance. The FATF also publishes an ever-changing list of countries and territories that have been deemed not to have been cooperative in efforts to combat money laundering.

The Basel Committee

In 1988, the Basel Committee on Banking Supervision initiated the concept of 'know your customer', and in 2001 it took this concept forward with the publication of its Customer due diligence document. Aimed at financial institutions, the document deals with the need to undertake adequate and enhanced customer due diligence and the associated risks of

not doing so. It states that without this due diligence, banks subject themselves to reputational, operational and legal risk, which can result in significant financial cost. Due diligence requires knowing the customer through proper identification, regular reviews of the customer base to maintain an understanding of the nature of the accounts on offer and their risks, and routine monitoring of account activity to check that it matches the customer's profile.

EU Directives

The EU has produced two directives on money laundering and all member states are required to implement the provisions of these directives within their legislation. The provisions of the First EU Directive are based primarily on the FATF Recommendations and apply specifically to financial institutions. The Second EU Directive has extended the provisions of the First Directive beyond the financial sector to 'regulated activity' within a broader group of businesses including lawyers, accountants, estate agents, casinos, auctioneers and all dealers in high value goods. Future directives will no doubt further extend this list.

International principles and anti-laundering requirements

Six anti-money laundering requirements are specific to regulated activity:

- Appointment of a compliance officer and determination of internal controls and procedures.
- Client due diligence ('know your customer').
- Reporting suspicious transactions.
- Training and awareness.
- Record keeping.
- Monitoring.

These provide a useful approach for organizations to consider when looking at how to manage money laundering risk.

Appointment of a compliance officer and determination of internal controls and procedures

It is vital that senior management focuses on anti-money laundering programmes. Banks can include in their organization structure a new role of compliance officer. The compliance officer should work independently of the business functions and be responsible for all issues pertaining to anti-laundering compliance and reporting. All internal controls, procedures and legal responsibilities should be documented and accessible to all employees. The FSA Money Laundering Rules require that in the case of regulated financial institutions, the compliance officer should provide the board with an annual report on the state of money laundering compliance within the organisation. This is a useful way to ensure that the Board does look at and consider the issue of money laundering.

Client due diligence ('know your customer')

Client due diligence is the cornerstone of anti-money laundering legislation. It is important to not only understand who the client or customer is, but also to understand why they want to do business with the organization in question. Documentation requested from the account holder can range from company documents to passports and identity cards, and any documentation obtained to support identification should be copied, certified and retained. It is also important to remember that documentation should be updated on a regular basis. Online transactions can make it very difficult to establish and verify a client's identity without any face-to-face contact, so extra care should be taken in this area, particularly with high-value transactions.

Reporting suspicious transactions

Every financial institution and bank is required to submit a Suspicious Activity Report (SAR) to the Economic Crime Branch at the National Criminal Intelligence Services. SARs might seem insignificant on their own but, in combination, they build up a general picture and contribute evidence about flows of illegal and illicit money within the UK economy. It is a criminal offence for those working within regulated activities to fail to report a transaction if there is a suspicion that it is related to money laundering.

Training and awareness

Managing the money laundering risk requires that all employees, including senior management, fully understand the money laundering risk and their legal obligations and responsibilities. This can be achieved through regular training and awareness sessions. The FSA Money Laundering Rules require that regulated financial organizations provide training and awareness sessions for their employees at least every two years, and this should include all relevant employees including senior management. Training can be delivered using a variety of different approaches. It is important to ensure that the training is relevant, up-to-date and tailored to an individuals needs. Effective and meaningful employee training is fundamental in managing the money laundering risk within an organization and it is important that it is delivered in a manner that employees will find interesting and informative. Training should be relevant and the content will need to be adapted for the various departments and levels. It is also important to record all training delivered and to maintain a register of employee attendance. New employees should receive anti-laundering training before undertaking their duties.

Record keeping

Regulated organizations must maintain records for a period of five years and the general rule is that it must be possible to retrieve all information regarding any individual transaction. Should the police require information it will be by way of a court production order and the information will normally be required within one week. The purpose of this is to provide the police with information should it later be discovered that a particular transaction is related to money laundering. The information required would be:

- the type of transaction;
- persons or companies involved;
- values and quantities;
- source and destination; and
- times and dates.

Information can be stored in any format provided that it can be easily recovered. Client identification information should be retained for the life of the relationship and for five years after the relationship has ceased. A common problem that many organizations face is recovering documentation from off-site storage facilities in a timely manner.

Monitoring

Increasing numbers of transactions are being undertaken electronically, without any human intervention, providing those involved in money laundering with greater opportunities to launder money undetected. Electronic monitoring of transactions can provide some protection in dealing with this risk. For those involved in regulated activity it is highly probable that monitoring solutions will soon become a requirement.

Key trends in European anti-money laundering

The European Commission has recently issued a third directive to existing EU legislation. The Directive is applicable to the financial sector as well as lawyers, notaries, accountants, estate agents, casinos, trust and company service providers. Its scope also encompasses all providers of goods with cash payments in excess of €15,000. The Directive includes extra requirements and safeguards for situations of higher risk (for example, trading with banks situated outside the EU). There has also been an increase in the regulatory expectations of the quality of a bank's anti-laundering compliance programmes. Regulators are concentrating on the details of the compliance programmes, particularly on the processes in place to detect and report suspicious activity across all of the bank's activities.

Anti-money laundering is no longer an area of business that can be used to economize, and the commitment to provide resources must come from the top of the organization. These resources are not only in the shape of funding but also in personnel, internal and external systems and comprehensive, ongoing training. Banks should investigate what compliance support is available from their system vendors and how it can be used in their compliance programme. They should also review the level of expertise of the personnel assigned to their compliance efforts. A culture of compliance is critical in establishing a successful programme.

Using information technology

Information technology (IT) can never replace a trained investigator, but as laundering techniques become more sophisticated, so too must be the technology used to combat it. Before anti-money laundering programmes became commonplace, the Bank Secrecy Act required financial institutions to file Currency Transaction Reports for cash transactions of $10,000

or more in the US. These CTRs prove valuable for investigators, but money launderers began to structure their transactions to circumvent the reporting requirements. As a result, the US passed laws specifically against this structuring.

Historical roots of Islamic finance

The Canonical Texts of Islam forbade 'usury' under the name *riba* (equivalent to the Hebrew term *ribat*), usually interpreted as any interest charge on matured debts or loans. While some Islamic scholars have argued for more restrictive definitions of *riba*, the majority of contemporary Muslim jurists and scholars have equated the classical term *riba* with 'interest'. This equation has led to statements about Islamic finance being 'interest-free', when in fact Islamic finance replaces interest on loans and pure debt instruments (such as bonds) with interest characterized as rent in leases or price mark-up in sales.

As Islamic finance began to take shape in the mid 1970s, jurists also started to consider the less prominent prohibition of *gharar* (excessive risk or uncertainty), which impacts modern forms of insurance, credit and interest rate risks, derivatives, and the like. Islamic finance as practised today aims to mimic modern financial practices (such as banking products, insurance products, money and capital market instruments) with variations on classical (medieval) contract forms that were deemed devoid of forbidden *riba* and *gharar*.

Islamic finance dates back to the 1950s and 60s, and it is the literature from that period that continues to shape the industry's rhetoric to this day. Islamic finance was mainly envisioned by leaders of Islamist movements, such as Abu al-Mawdudi, Sayid Qutb, and M. Baqir al-Sadr. They created a field of study known as 'Islamic economics', which subsequently flourished in Pakistani and Muslim areas of India, and coincided with political independence movements in various Muslim countries. This literature inspired many hypotheses about how Islamic finance would operate within the kind of Islamic economy expected to thrive in an Islamic society such as newly independent nations like Pakistan. The main paradigm that emerged suggested that all finance would be interest free, based on the sharing of profits and losses. Bank alternatives would, it was assumed, function on an equity basis, like mutual funds, thus sharing in their profits and losses. The bank's funds would in turn be raised through equity participation in the bank's portfolios of investments, allowing depositors to share in the pooled profits (or losses) of the bank.

The oil boom of the 1970s made Islamic banking a reality, and emerging Islamic banks learned to abandon profit and loss sharing in favour of debt-based forms of financing. Thus, conventional bank loans were replaced in Islamic banks with receivables from credit sales or leases. More recently, other assets of conventional banks have been replicated through Islamized structures. On the liabilities side, however, Islamic banks have continued to maintain that 'investment depositors' must share in the banks' profits and losses, and Islamic finance promoters have continued to refer to profit and loss sharing as the ideal Islamic form of financing.

Contemporary methods of Islamic finance

Among the first Islamic financial institutions were Kuwait Finance House, Dubai Islamic Bank and Faisal Islamic Banks in Egypt and Sudan. The GCC region remains the primary

financier of Islamic finance worldwide. Countries such as Saudi Arabia, which had originally resisted the growth of Islamic finance within its own borders, have allowed the Islamization of some of their larger retail banks, including the National Commercial Bank of Saudi Arabia. It is ironic that although some of the earliest Islamic banks were pioneered and funded by Saudis (Prince Muhammad b. Faisal Al-Saud and Sheikh Saleh Kamel), those pioneers were not allowed to operate Islamic banks within Saudi Arabia. The first Islamic bank in Saudi Arabia was Al-Rajhi, which was only allowed to operate as long as it did not use the word 'Islamic' in its name. In recent years, excess liquidity in Saudi Arabia was migrating to Bahrain and Dubai which established themselves as competing Islamic banking centres in the region and attracting international financial providers such as Citi bank, Credit Suisse, HSBC and UBS to Islamic finance. To retain those funds, Saudi Arabia finally allowed the current trend of Islamization of its banking system to emerge. It is likely that banking systems within the GCC will become mostly, or completely, 'Islamized' within a few years.

Issues related to criminal financing

Investment Account Holders' Liability

Two questions about Islamic bank liability structure that relate to potential criminal financial abuses, especially in the aftermath of the 9/11 terrorist attacks, are:

- Are investment account holders (IAH) considered owners of the Islamic financial institutions? If so, how responsible can they be held for any criminal financial activities in which the institution may engage?
- In case of dissolution of an Islamic bank (perhaps due to its prior engagement in criminal financial activities), what is the seniority of investment account holders' claims on the bank?

The first question may at first seem rather straightforward. Because investment account holders lack operational control of the bank's activities, it would seem unlikely that they can be held responsible for the bank's illegal or criminal activities. On the other hand, complications might arise from differences of views on what constitutes criminal financial activities. For instance, an Islamic bank may be known to disburse charitable contributions on behalf of its customers in certain venues. In this regard, certain charitable organizations and destinations of funding can be viewed differently by different governments and different bankers.

The second question is difficult to answer and has been the subject of intense study at the Islamic Financial Services Board. It is clear that IAHs theoretically have lower seniority than fiduciary depositors, but higher seniority claims relative to shareholders. However, since management determines the magnitude of profits or losses disbursed to the IAHs, and consequently the amounts assigned to the residual claimant shareholders, it has never been made clear how liquidation would take place. The Islamic Financial Services Board and the

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) have attempted to reduce this problem by setting transparency standards for the mechanisms used to assign profit and loss distributions, but final standards have yet to be set on issues of ownership, control and seniority of claims to Islamic bank assets.

This issue is relevant for all customers of Islamic banks. It is also a valid concern for most Muslims whose charitable contributions are disbursed by specialized institutions. Solutions to this problem require addressing the issue of harmonizing standards of anti-money laundering and terrorist financing agencies worldwide, and establishing clear criteria on which Islamic charities and financial institutions can rely in their dealings.

Vulnerability to abuse

Would a group intent on committing criminal activities favour Islamic financial institutions, especially since they are likely to come under closer scrutiny post-9/11? Do the mechanics of Islamic finance make it particularly vulnerable to abuse by money launderers and terrorist financiers? It is a fact that regulatory arbitrage methods used in Islamic finance to hide interest bear a striking resemblance to methods used in criminal financial activity. The asset-based nature of Islamic finance, which the industry advertises as its main virtue, may in fact be viewed as a source of weakness, since commodity and asset trading at losses or profits is a standard method used to hide the source in money laundering or, in the case of terrorist financing, the destination and transmission route of funds.

The most sophisticated methods used by Islamic financiers to hide debt and by criminal financiers to hide sources or destinations of funds are simply a legacy of the regulatory-arbitrage structured finance period of the 1980s, meant to capitalize on various tax and regulatory advantages. Because of the increased use of those methods, bankers, regulators and law enforcement officials have become more sophisticated in investigating such dealings and uncovering the parties' underlying objectives. With offshore centres also applying increasingly better prudential standards, the risk of abuse has been diminished by a large amount. Regulators and law enforcement officials in the Middle East are relatively inexperienced in dealing with such complicated financial structures. Awareness has been increased via technical assistance through direct inter-government interactions and indirect private sector initiatives of multinational banks, as well as involvement of the World Bank and the International Monetary Fund.

No country has a comprehensive regulatory framework for Islamic financial institutions since such a comprehensive framework would have to take into account idiosyncrasies of Islamic finance such as assets and commodities being used as 'degrees of separation' in financial dealings (resembling the 'layering' methods of criminal financiers). Along with the *Shari'a* stipulations, many of the laws passed for regulation of Islamic banks in the GCC appear to be simple adaptations of conventional bank regulations.

However, central bankers in the GCC region, where the majority of Islamic finance takes place, are among the most sophisticated in the Middle East. Yet regulatory standards and talents in the region have yet to catch up with those in advanced countries, and Islamic finance exists in several countries with substandard regulatory infrastructures and does operate across borders.

Perhaps all Islamic finance should come under the standards applied to conventional financial practice through a simple conversion operation: reduce all Islamic transactions for regulatory and enforcement purposes to their conventional counterparts. This approach has successfully been used in Turkey. In the longer term, efforts by AAOIFI and IFSB need to be enhanced in order to develop a set of standards for Islamic finance that harmonize their accounting and regulatory methods with best accepted international standards.

Conclusion

The risk organizations face from money laundering depends on several key factors, chief among them being the products and services provided and the markets in which they operate. Senior management is responsible for ensuring that the risk from money laundering is effectively managed within the organization through robust controls and procedures and an effective training and awareness policy.

Regulators are concerned about criminals 'slipping through the cracks' and manual compliances systems are proving inadequate. It is becoming inevitable, therefore, that automated AML processes will become much more prevalent. The credibility of the industry depends on it.

The differences between Islamic finance and conventional finance are superficial, but that very superficiality involves degrees of separation through superfluous trades and leases that make regulation and law enforcement more difficult. However, Islamic finance is neither more nor less vulnerable to abuse by criminal financiers. But fighting criminal financing in the traditional banking sector of the Middle East is already a significant challenge due partly to limited human resources and partly to an inadequate regulatory infrastructure. The challenge faced by regulators and law enforcement agencies in the region is increased by the complexity of Islamic financial structures. The extreme measures that can be taken to eliminate criminal financing in that region must not hinder legitimate financial activity in a region that is teetering on the brink of a financial upsurge. It is crucial that there is increased coordination with regulators and enforcement agencies, including technical assistance and involvement in the development of standards.

Chapter 12

Globalization of the Islamic banking and finance industry

Dourria Souheil Mehyo[1]
Path Solutions

Introduction

In recent years, Islamic finance has been the fastest-growing sector in the global finance industry. In more than 50 countries from the GCC countries to Malaysia, from the UK to North America, currently more than 350 Islamic banks and financial institutions are operating, with total assets that top US$400 billion. The industry's operations and returns caught the attention of even non-Islamic banks that may have never considered offering such types of products; in addition, the industry's services are well accepted by Muslims as well as non-Muslims based on the 'ethical banking' concept.

Recent developments show that the industry is on a fast-track towards globalization. 'Looking ahead', stated Moody's 2007 report, 'the Islamic finance market shows no signs of slowing' (Moody's *2007 Review & 2008 Outlook: Islamic Finance* issued on February 26 2008). Future expectations are for continued high growth and great potential across the globe. For the next few years, Islamic banking is projected to grow by at least 20% per year. Islamic banking is here to grow and expand; with proven global operations, the joining of the industry by leading banks, and the offering of Islamic banking in new territories, globalization and growth is a fact.

Looking at the industry from a current point of view, it is important that certain areas are considered. Because the industry carries new concepts, rules and regulations and ways of operational processing, it is important to tackle the subject of how the global conventional banks accept Islamic banks within the global system. Demand for Islamic banking products and its impact on the conventional banks' strategic operational decisions also need to be looked at.

Finally, as in any growing industry, there are constraints and challenges that face the industry. The challenges are on many levels and in many areas. In the era of technology, as in any industry, and since Islamic banking operations are based on the same *Shari'a* principles (despite minor differences in specific areas) regardless of the bank's geographic location, the IT system to support such growth and globalization should also conform with the basics and specifics of the industry with enough flexibility to cater for country-specific regulations and practices. The globalization of an industry naturally leads to the need for the related IT system to sustain the globalization practices.

This chapter aims to present the facts about Islamic banking globalization and its growth over time, the constrains facing Islamic banking growth, how the global conventional banks accept Islamic banks within the global system, the demand for Islamic banking products and its impact on the conventional banks' strategic operational decisions. Finally, the chapter will address the IT related challenges that result from the industry's globalization and the requirements of the related supporting IT system.

The chapter will start with some historical highlights of the origins and growth of the industry.

Historical highlights of the origins and growth of the industry

Islamic banking, in the exact sense of the term, started in 1963 in the Egyptian town of Mit Ghamr, in the form of a savings bank based on profit sharing. By 1967, nine such banks were operating in the country, functioning as savings and investment institutions. In 1971, in Egypt, The Nasir Social Bank was declared an interest-free commercial bank. Its charter made no reference to Islam or *Shari'a* (Islamic law) and in l974, the IDB was established with the primary aim of providing funds for development projects in member countries (inter-governmental bank). These banks, which neither charged nor paid interest, invested mostly by engaging in trade and industry, directly or in partnership with others, and shared the profits with their depositors.

By 2005, according to the International Monetary Fund (IMF) yearly report, over 300 Islamic financial institutions were operating worldwide, with estimated total assets of US$250 billion and an annual growth rate of 15%. Citibank, HSBC, BNP Paribas, Barclays and UBS had begun offering Islamic financing products. The IMF report attributed the continued growth to three factors: increasing demand from a large number of Muslims (including Muslim immigrants to western countries), the growing oil wealth in jurisdictions such as Dubai and other countries of the UAE, and the attractiveness of *Shari'a*-compliant financial services to non-Muslim investors seeking 'ethical' investments and banking practices.

By 2007, The Euromoney *Islamic Finance Review* for 2007/08 stated that the estimated Islamic financial market size was US$700 billion to US$750 billion, with an annual growth rate of 15%.

After leading conventional banks such as Citibank and HSBC started offering Islamic financing products on a basic level, other leading conventional banks followed suit.

Amanah Finance (a subsidiary of HSBC) is operating in countries such as Malaysia, Saudi Arabia and the UK, offering personal products (such as private banking, home finance, personal finance, vehicle finance, investments and Islamic insurance or *takaful*); and business products (trade services, working capital finance and assets finance).

ABN Amro, operating in Pakistan, offers consumer financing products in Pakistan, and is considering consumer, corporate and institutional products in Malaysia. Citi Islamic has branches in South Korea, Turkey, Egypt, Mexico, South Africa, Pakistan, India and Bangladesh and offers term Islamic investment products and an open-ended global equity fund, among others.

During 2007, the burgeoning international footprint of Islamic finance became more apparent. Countries all over Europe, North America and in new areas of Asia have also witnessed the setting up of Islamic banking operations. These operations are offered either through Islamic windows created at existing banks or through newly established banks; both reap the benefits from local investments and deposits as well as cross-border capital flows. Regulatory bodies in these countries have also been set up, enabling regulatory environments that have set the industry on the path to major globalization.

GCC-based banks have also begun venturing into European countries. One example is Ahli United Bank, a Bahrain-based Islamic commercial bank. Its services are also available in Qatar and the UK. New emerging markets include the UK, France, Sudan and Kenya.

Aside from the facts stated above, the key areas of growth with respect to geographic distribution of new Islamic banks in 2007 included the UK, with at least five new investment banks offering mostly Islamic investment and treasury banking services; France, where a license for the first Islamic commercial bank has been applied for; and finally, Germany, which is listed as a potential base for new Islamic banks.

Other new geographic areas included Africa (where two Islamic commercial banks started operations in Kenya), Syria (where two Islamic commercial banks have opened) and Sri Lanka.

With respect to North America, until the development of a full Islamic bank *per se*, some 'alternative products and services' were – and still are – offered by a limited number of companies and finance houses offering home, auto and business financing; car and equipment leasing; interest-free deposits; and mutual funds management. In addition, equity indices were created by Dow Jones for investors who wish to invest according to the *Shari'a* guidelines. Canada is studying licensing for its first Islamic Investment bank.

At the time of writing (2008), it has been reported that the Islamic banking industry is growing at 20% per year and is expected to reach a level with total assets exceeding US$1 trillion by 2016.

A 'Promising Prospect in 2008' was listed in Moody's *2007 Review & 2008 Outlook: Islamic Finance* issued in February 2008. With Africa home to around 400 million Muslims, Moody's report expected 'huge market potential'. Based on these reports, Sudan, Egypt and Maghreb were listed. In reference to Asia Pacific, Moody's expects Singapore and Hong Kong to be 'stepping up their Islamic finance efforts' and Hong Kong to serve as an Islamic funding platform for mainland China. The report showed that in Europe, the City of London is home to a sizeable number of professionals and expertise that enable London to claim the title of 'Islamic finance centre of Europe'.

Demand for Islamic banking products and its impact on the conventional banks' strategic operational decisions

In light of the globalization trends shown above, and in an attempt to answer the question 'who are the customers of Islamic banking products', research results show the following:

- In the Islamic Bank of Britain, 'One in five applicants for some of our products are non-Muslim', according to its director of sales. (Source: *This is Money* UK Website, August 2006.)
- The Sharjah Islamic Bank's website states that 'more than half of our customers are non-Muslims'.
- In 2004, when HSBC Group began offering Islamic equivalent mortgages (more like leases), surprisingly more than half of the customers were non-Muslim. According to the bank's officials, what drew these customers is the 'competitive pricing' compared with traditional interest-based financing.
- In Malaysia, a 2003 study for Islamic Banking Lending for SMEs reported that more non-Muslims make up the Islamic banking customer base, at a ratio of 70:30. (Based on data for the Malaysian retail banking industry as at 2003.)

Usually demography is one of the factors to look at when considering a market's potential. However, while the primary criteria of demand is the presence of the Muslim population and their age bracket (as a secondary factor), these, as proven above, decrease in value. Many people, in many countries, look for 'alternative financial products' that are more ethical, more profitable that are, based on solid rules and principles, governed by transparency regulations and directly linked to sustainable growth and development. These include 'Islamic compliant products'.

The facts above, the presence of a Muslim population and people looking for 'ethical banking' alternative products, has directly affected, and continues to affect, many of the leading (and smaller) banks' strategic decisions in terms of Islamic banking products via various means, including Islamic windows and Islamic subsidiary banks in the same country of operation or in new territories of operations.

This is highlighted and proven by the fact that towards the end of 2007 there were more than 350 Islamic financial companies in more than 50 countries – numbers that are expected to grow. The global banking industry has witnessed a growth in Islamic banking amounting to 35% between 2003 and 2007.

How the global conventional banks accept Islamic banking within the global banking and finance system

Islamic banking has been accepted in an unprecedented manner. As the paragraphs above show, leading banks across the continents started offering Islamic banking products before the industry was even a quarter of a century old. The introduction and offering of Islamic financial services has proved to be of benefit to global banks in terms of finance and liquidity sources, targeted achievable growth and increased diversification of offered products.

Islamic banking allows access to wider funds, even cross-border funds. In order to gain access to liquidity, banks do not need to be based in a Muslim country. With the current cross-border movement of cash, increases of funds, and people's mobility for business or leisure, global banks have a great opportunity. Banks operating in non-Muslim

countries can reach and benefit from the high liquidity that the increase in oil prices brought – and are still bringing – to gulf countries.

Exhibit 12.1 summarizes how global conventional banks accepted Islamic banking within the global banking and finance system. The table lists major banks' strategic decisions to offer Islamic products and to go into new regions.

Exhibit 12.1

Expansion of Islamic banking: multinational banks that started offering Islamic products in different geographical locations

Bank	Currently Operating in	Types of operations
Amanah Finance (HSBC)	UK, Malaysia, UAE, Saudi Arabia	• Personal: private banking, Accounts, cards, home finance, personal finance, vehicle finance, Investments, *takaful* • Business: corporate institutions, trade services, working capital finance, assets finance, investments
ABN Amro	Malaysia, Pakistan	• In Pakistan: consumer financing products • In Malaysia: consumer, corporate and Institutional products
Citi Islamic	Brazil, Korea, Turkey, Egypt, Mexico, South Africa, Pakistan, India and Bangladesh	• Short-term Islamic investment products • Investment in various emerging markets • Open ended global equity funds
Noriba (UBS subsidiary)	UAE, Bahrain, Cairo	• Compliant deposit, Compliant FX BLOCs • Personal *Shari'a* trust
Standard Chartered	Malaysia , UAE, Pakistan, Bangladesh	• 10 Islamic consumer banking products • 16 wholesale banking products ranges

Source: Author's research, with information obtained from the following sources:

- Amana Finance (HSBC) http://www.hsbcamanah.com/1/2/hsbc-amanah/hsbc/amanah
- ABN Amro http://www.reuters.com/article/bankingfinancial-SP
- City: http://www.zawya.com/cm/profile.cfm/cid1003794
- Noriba: http://www.ubs.com/1/e/wealth_mgmt_ww/islamic_finance/trusts.html
- Standard Chartered: http://www.standardchartered.com/sustainability/access_islamic.html

Islamic banks are well accepted in conventional banking territories. Looking at the geographic distribution of newly established Islamic banks, key areas of growth include non-Muslim countries which are beginning to license actual operations. Examples of the key emerging markets (new Islamic banks in new markets) are as follows.

Europe

- UK: At least four new investment banks started operations in 2007.
- France: Licence for the first Islamic commercial bank already applied for and given serious consideration.
- Germany is listed as potential for new Islamic banks.

North America

- Canada is considering licensing the first Islamic Investment bank. It is expected Canada is a 'green field' for Islamic banking practices: once the OFSI gives the first licence, the number of applications for licensing will be unpredictable.

Others

- Sudan and Yemen.
- Africa: two in Kenya between 2007 and 2008.

Constraints facing Islamic banking growth

In this section, we look at the constraints that face the Islamic banking industry's growth in both new and existing markets.

When it comes to new markets in countries where Islamic banking is not yet offered, the first and utmost constraint is the legalization issue. While many markets have high demand and banks, and investors and entrepreneurs with high capital have the set strategy to seize the big opportunity, the constraints are at two levels: the legislative system lacking knowledge of the industry and thus delaying licenses (such as Canada), and flexible legislative systems hindered by political and social issues.

Due to the special rules, regulations, features and operations of Islamic banking practices, some legislative bodies prefer to have full knowledge and preparation before opening ground for the industry and starting licensing.

Another very critical area that hinders the growth Islamic banking offers is the social and political aspects in some countries, where Islamic finance is unable to break through the political and social perceptions. An example of this fact is France, as stated in an article published by Moody's in July 2008. Moody's stated in their report that while the French legal system is flexible, this is not enough in light of the social and political aspects of Islamic banking and its perception, in contrast to the concept of ethical banking that is taking place in the UK. Another example is Egypt where Islamic banking is not yet operating. Although in a Muslim region of the world, the country has not yet broken through to a 'non-religious' perception of Islamic finance.

Exhibit 12.2 briefly presents the major constraints and their impact on the growth and start up of Islamic banking.

Exhibit 12.2

Constraints on the growth and initiation of Islamic banking and their impacts

Constraint	Impact
Licensing and Regulatory Support and Control	• Hindering Islamic banking setup and licensing • Lack of existence of regulations and reporting controls by central banks and governmental institutions
Legislations in some countries	• Double stamp duty • Taxation of capital gains on property • Fiscal treatment of foreign beneficiaries • Tax-deduction on yields from *sukuk*
Political and social issues related to Islamic radicalism and association with terrorism	• Unjustly affects licensing of a banking practice that would bring benefits to banks and their countries.

Source: Author's research.

Challenges facing the industry

Despite the growth and the long way the industry has gone in a short period of time, there are challenges that face it in its day-to-day operations and practices and in legal and contracting aspects. To compete in this highly robust environment, financial institutions need to overcome the above challenges by raising the professional capabilities of their bankers.

Exhibit 12.3 presents in a simple manner the various challenges facing the industry. In an attempt to be more specific, three of the challenges are looked at in detail below.

Stakeholders and relations with them

In addition to customers, shareholders and regulators, Islamic financial institutions have the *Shari'a* Board as an additional stakeholder, whose authorization and control terms should be abided by. In addition, although conventional banks also have the first three stakeholders' interests to consider, Islamic banks also have different relations with each of the stakeholders in terms of risk sharing and reporting.

Shari'a scholars in an Islamic Bank have to ensure and confirm that the products are compatible with *Shari'a* concepts and principles before an Islamic bank can offer a product to the market.

In terms of the relations of Islamic banks with the stakeholders:

- Customer relationships are different from just depositor/borrower; they are more complex and have multiple aspects. The relationship ranges from that of a buyer and seller (*murabahah*); transferor and transferee; lessor and lessee (*ijara*); guarantor and guarantee; depositor and custodian; partner and partner (*musharakah*); investor and working manager (*mudarabah*).

Exhibit 12.3
Challenges facing the industry

Source: Author's own, including article in *Khaleeji Times*, July 2007.

- Shareholders and investors go through a risk premium that is relatively high while risk mitigation, risk allocation and risk transfer techniques are not that well developed; unless risk adjusted returns are equalized across the two market segments, the IFSI growth will remain stunted. Absence of hedging products places the Islamic products at a relative disadvantage as far as risk mitigation is concerned.
- Regulators set standards and codes, principles of corporate governance, internal controls, disclosure and transparency, but they have to be separated and made distinct from conventional banking to reflect the peculiar characteristics of Islamic banking. Some progress has been made but there remain a lot of issues to be settled.
- *Shari'a* compliance inspires conflicting pronouncements and continuing debate as to what is and what is not permissible under *Shari'a*. These controversies among scholars from different *fiqhs* in the interpretation of *Shari'a* precepts create much uncertainty among potential investors who then shy away from taking the plunge in Islamic products, keeping the overall size of the market small.

Dispute resolution and legal framework

In the case of the Islamic finance industry, there is both ambiguity and a lack of predictability about the enforceability of contracts under Islamic banking. In some countries, for example,

there is a dual judiciary system. In such cases, jurisdiction of courts is unclear as to whether civil or *Shari'a* courts will take cognizance and decide. Dispute resolution mechanisms such as mediation, conciliation and arbitration are not binding under the existing legal system and practices, although litigation is not the preferred mode of dispute resolution in Islam. Judges lack training in banking and *Shari'a*. Lawyers are not trained in Islamic banking and finance. Case law and precedents from one system, such as English law, are not binding. Enforcement mechanisms are found wanting. There are cases of legal disputes which relate to Islamic contracts in Australia and the UK, whereby both the court and the lawyers face a hard time learning about the industry and to which parts laws should apply.

Standardization

At the time of writing, there is no clear-cut standardization in terms of Islamic banking practices and what is allowed and not allowed; while *Shari'a* boards of banks in some countries do not allow a particular practice, other boards in other countries allow it. The lack of standardization also extends to the setup of *Shari'a* committees in banks; while Gulf countries set the number of *Shari'a* committees of six to seven, in Malaysia a different practice is applied.

It is very important to note that with the openness and willingness of regulators to address and understand such markets, the willingness of institutions to enter the markets, the efforts of regulators at industry level (such as AAOIFI and IFSB) and the existing and potential growing demand, there is significant potential for overcoming all of these challenges.

Islamic banking industry requirements from an IT system

As in any modern industry, going on a global drive must be supported by the concomitant IT backup. As such, the globalization of Islamic financial services leads to challenges including the need for specialized technology that meets the Islamic banking rules and regulations. These are the industry's distinguishing aspects that must be applied and followed regardless of a bank's geographic location, since the underlying rules of Islamic banking are the same across the globe. In addition, the supporting technology should also be flexible and innovative enough to meet a country's specific laws (such as accounting treatment, disclosure or circulars and tax issues).

The regulations and rules on which Islamic finance is based and which govern its operations are significantly different from those for conventional finance. The absence of interest is the most important differentiating aspect; this makes the structuring of Islamic financial products a complex task.

As a result, Islamic banks need to rely on efficient IT systems in order to handle their significant transaction nature and volumes, and to make available necessary information for the bank's management on an accurate and timely basis. This can only be achieved through advanced IT solutions that allow streamlining procedures, consolidating operations and efficient processing of transactions and provide proper risk management tools.

The first essential characteristic in the software is that it must be built on the *Shari'a* rules and regulations and have embedded the related information capturing features. The captured information must fully cater for the type of Islamic product; that is, in order to fully cover recording of a commodity *murabahah* transaction, the details to be captured must relate to the details of the bought and sold products and cover details related to the suppliers and down-payments made.

For Islamic banks to operate efficiently, the system must facilitate the setup and enable ease of tracking the restricted and unrestricted investment accounts of clients across the system and get the information on a timely basis.

Since Islamic banking is based on shared profits and risks, the operations, simply put, cover pooling of clients' funds and then distributing the profits based on revenues generated from this pool, after applying certain criteria that are pertinent to Islamic banking. In light of these transactions, the software must support proper recording, tracking and management of the pools of funds. Each pool must be easily tracked and computations must be made on an efficient, timely basis and be able to produce reports detailing the results of the computations.

As such, the system must also support the complex profit computation method for the unrestricted investment accounts and distribution of the computed profits to each account holder. The system must allow the tracking of the financial transactions, the contributors in these transactions and computations of profit to be received from funded (or partnership) parties. Computation of the profit shares to be distributed to the contributors based on each client's invested amount will also be required. This is important for restricted investment account holders.

Since Islamic banks are to abide by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) standards, the system must produce the standard accounting entries and booking methods of the transactions and bank profits and investments according to those standards.

Legal documents and confirmations are an essential part of Islamic banking. As such, the IT solution to be utilized must allow standardization and printing of the details pertaining to Islamic banking and financing transactions, the related confirmation and the related legal documents and contracts. Each type of Islamic financing product has its own legal documents, and the system must be able to support it. This applies to all transactions of the bank.

The logging of dates and times of a transaction is also an essential factor, as is being able to keep the signed contracts in their related transaction record, particularly since the *Shari'a* audit will be looking at those details. The possibility of being able to keep a copy of the signed contracts as a scanned document or other medium in the system would also be an important feature.

In the era of banking operations where customer service management concepts are becoming more and more essential for competitive advantage, 'customer centricity' is extremely important. Banks need to know, from a single screen or at the click of the mouse, the total balance and number of transactions done by a client. This is important for customer service, sales management, risk management and exposure analysis. The IT software to be utilized should be fully customer-centric in order to give a bank the competitive advantage in obtaining such information on an accurate and timely basis.

The system must also easily integrate with other applications for data mining and in order for the bank to obtain the requisite reports to support its operations. The software must also allow the bank to comply with Basel II requirements, identify the approaches to be followed and produce the needed risk management reports in a timely manner. The system must provide efficient 'decision support' features such as dashboards and various data analysis presentations (such as spider-web and correlation analysis).

IT challenges resulting from the industry's globalization

In addition to the industry specific requirements, the globalization of an industry raises the need for the supporting IT to be flexible enough to cater for the distinguishing aspects of a geographical area or specific country in a timely manner in such a way as to guarantee quick time-to-market and return on investment for any bank with efficient preparation and a strong basis of operation that is using the software. The following paragraphs present examples of the major areas of consideration.

While most, if not all, GCC countries do not have income tax and value-added tax (VAT), these are a given in some other geographic areas such as Europe. On the other hand, GCC countries do have the *zakat* requirement that must be paid. The IT solution to support the global Islamic banking industry must be able to cater for both areas (taxes, non-tax and *zakat*) in a timely manner as well as facilitate the automation and related computations and accounting-related reporting.

At some point, a bank operating on a global level (such as having operations in both the UK and Kuwait) will need to develop consolidated financial statements for its global operations; a task that is expected to be made efficiently using the IT system in place.

While the basic operations of Islamic financing products are the same across all banks, banks operating in a certain geographic areas may have different policies and procedures (that have been approved by the *Shari'a* boards) than their counterparts elsewhere. This includes policies with respect to profit structures and repayment terms. For example, Malysia, Jordan and the GCC countries differ in their policies of profit distribution on unrestricted investment accounts.

With the globalization of the industry, more sophisticated *Shari'a*-compliant products may be set up (hybrid/mixed products). This presents another challenge for the IT system supporting the industry's globalization drive.

In addition, regulatory reporting requirements differ between countries in the same geographical area, and the channel is bigger when the IT system is utilized across continents; the system should facilitate the extraction of the regulatory reporting requirements. The system should have open architecture that allows interfacing with local central banks or regulatory institutions where required and applicable. An example is the real-time gross settlements systems available in KSA (SADAD) and RENTAS (in Malaysia).

Finally, with the globalization of the Islamic banking industry, and since new countries will be working on new areas of operations, the IT related companies may be required to engage Islamic banking subject matter experts with strong and deep industry knowledge and enough exposure to the industry's specific operations, in addition to the technical staff.

The globalization of Islamic financial services with its opportunities and challenges naturally leads to potential returns to innovation and specialized technology.

Conclusion

Islamic banks are here to stay and Islamic banking services are set to expand geographically. Islamic banking has proven not to be a negligible or merely temporary phenomenon. These facts are evidenced by the current rise of Islamic financing services worldwide and the returns it is generating both for banks and clients.

Due to the globalization trend, areas that are starting to emerge in the Islamic banking industry are in terms of focus and innovations on expanding their delivery channels (such as stronger CRM, internet and mobile banking and innovation in the development of new hybrid-structured products). Naturally, this should be coupled with IT innovation and globalization of any related software services.

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Chapter 13

Standard & Poor's views on the growth and diversification of Islamic finance

Mohamed Damak[1]
Standard & Poor's

Introduction

Islamic finance is based on five pillars:

- Prohibition of interest. Interest must not be charged or paid on any financial transaction, as interest is deemed unlawful by *Shari'a*.
- Prohibition of uncertainty and speculation (*gharar*). Uncertainty in contractual terms and conditions is forbidden. However, risk taking is allowed when all the terms and conditions are clear and known to all parties.
- Prohibition of financing non-*Shari'a*-compliant sectors. Financing of industries deemed unlawful by *Shari'a* – such as weapons, pork, and gambling – is forbidden.
- Profit- and loss-sharing principle. Parties to a financial transaction must share in the risks and rewards attached to it.
- Asset-backing principle. Each financial transaction must refer to a tangible, identifiable underlying asset.

Mounting demand for *Shari'a*-compliant financial products and services around the world is fuelling the Islamic banking industry's buoyant expansion. Banking clients are increasingly choosing to invest in a broader range of Islamic financial instruments available through long-established Islamic banks in the Gulf Cooperation Council (GCC) states and Muslim Asia, the two main centres of Islamic finance. At the same time, growing interest in other Muslim and non-Muslim countries is contributing to the development of Islamic finance outside historical boundaries. To gain a foothold in these markets, conventional banks are creating Islamic windows, while in the UK the Financial Services Authority (FSA) has licensed fully-fledged Islamic banks.

Shari'a-compliant assets worldwide exceed $700 billion and have been growing at 10–15 per cent per year over the past decade, placing Islamic finance in a global asset class of its own. Islamic banks' market shares are growing in Malaysia and the six GCC

countries, driven by retail banking, the issuance of *sukuk* (*Shari'a*-compliant trust certificates) and a growing interest in sophisticated *Shari'a*-compliant investment banking products. Standard & Poor's expects Islamic finance to continue growing at a rapid pace, gaining in complexity and attracting additional interest from Muslim and non-Muslim countries. In this chapter, Standard & Poor's posits its views on the growth and diversification of Islamic finance. The first section deals with the historical perspective of the emergence of Islamic finance, putting into perspective geographic diversification and the role that Islamic finance is set to play within the development of the Muslim and non-Muslim worlds. In the second section, Standard & Poor's touches upon the diversification of Islamic finance by business line and product, and the increasing foray into business lines that were previously reserved only for conventional banks. Finally, Standard & Poor's explains its approach to rating Islamic financial institutions as well as *sukuk*, how it takes into account the specificities of operating in compliance with *Shari'a* in the rating process, and how its innovations have helped to meet market needs for independent and objective credit opinions.

The historical perspective: thirty years of modern Islamic finance provide a solid platform for expansion

Islamic finance began as a participative system, compatible with maximizing banks' profits and value, and mirroring the aims of conventional banks for over four centuries. The main differences between Islamic and conventional banking resided in the religious considerations embedded in operations that are compliant with *Shari'a*. The sharing of risk and returns, and the prohibition of financing certain illicit sectors are core to Islamic finance doctrine. Modern Islamic finance emerged in the mid-1970s with the founding of the first large Islamic banks, namely Islamic Development Bank (AAA/Stable/A-1+), Dubai Islamic Bank (A-/WatchNegative/A-2), and Albaraka Banking Group (B.S.C.) (ABG; BBB-/Stable/A-3). For many years, these banks relied on the gradual building of demand through the development and marketing of *Shari'a*-compliant financial instruments.

Signalling a departure from the slow growth of Islamic finance that took place through a steady flow of attractive offerings over two decades, demand for *Shari'a*-compliant investments and loans began to take off in the early 1990s. This fresh interest was sparked by a new geopolitical backdrop in the Gulf and abundant liquidity flows from the recycling of petrodollars in the region's economies. Today, demand rather than supply is driving the development of Islamic products and services, fulfilling the predictions of the pioneers of modern Islamic finance, who have long been convinced of the existence of untapped demand.

Islamic banking services are unfolding beyond historical boundaries

Support provided by the governments of the Gulf countries and certain Muslim states such as Malaysia – where track records in Islamic finance are long – has fostered favourable views of Islamic finance by regulators and supervisory agencies across the Muslim world. Regions with predominantly Muslim populations that were previously reluctant to open their

borders to Islamic banks, particularly North Africa, are now also showing an interest in Islamic finance. Western countries, led by the UK, are starting to do the same.

Exhibit 13.1
Geographic growth of Islamic finance

Source: Standard and Poor's.

Islamic finance in North Africa: A bridge between the Mashreq's financial capacity and the Maghreb's investment needs

Historically, disparities in interpretation of *Shari'a* among the different schools of Islamic thought, a lack of understanding of Islamic finance and high integration with Western countries were the major factors behind the perceived lack of attractiveness of Islamic finance that prevailed in North Africa. Islamic finance was for a long time quite foreign to the region's banking culture and largely imported from the eastern reaches of the Arab world, the Mashreq. For the most part, North Africa – in keeping with a good part of Muslim Asia – follows a less conservative interpretation of Islamic doctrine compared with the Gulf. Historically, the banking clientele of the Maghreb has never really demonstrated any reticence regarding the concept of interest; indeed, there exists a vast consensus that tolerates, even values, the transparency of conventional financing based on interest rates. In contrast, a large number of religious authorities in the Gulf have underscored the illicit nature of interest applied to bank credits.

However, the presence (very limited for the time being) of Islamic banks in certain countries of the Maghreb, notably in Tunisia and Algeria, has been accompanied by the gradual

development of the opinion of local regulators in its regard. Today the subject generates more interest: discussions are being refined, and market players are beginning to see in it an interesting alternative. In 2006, following the example of a large number of its peers in the Muslim world, the Central Bank of Morocco (Bank Al-Maghrib) became a member of the International Financial Services Board (IFSB). Based in Malaysia, this 'club' of central banks serves as a trans-national regulatory body aiming to harmonize standards of prudential regulation applicable to Islamic banks. The recent interest expressed by Morocco, Algeria and Tunisia in Islamic finance comes as no surprise. In fact, the region is growing rapidly in real terms, generating large flows of investment in infrastructure and human capital needs, and the Mashreq is emerging as a natural partner with significant financial capacity. Europe and North America represent longstanding political partners, not only for economic reasons but also for motives of geopolitical influence within an Arab world in the throes of transformation. The insufficiency of current measures, however, in fulfilling the purely economic needs of the countries of the Maghreb has led the latter to approach the Mashreq.

Tourism, real estate and infrastructure constitute the three principle asset classes causing investors from the Mashreq to be attracted to the Maghreb. All three sectors are particularly attractive from the point of view of Islamic finance. In fact, one of the principles of Islamic finance holds that to conform to the rules of *Shari'a*, any financing activity must be supported by an underlying tangible asset. Hotel facilities, real estate and infrastructure projects therefore present an inherent conformity with *Shari'a*, and demand emanating from the Maghreb for financing these sectors fits naturally with *Shari'a*-compliant offers. Such offers are essentially being issued by *Shari'a*-compliant investment banks located in the Gulf, such as Gulf Finance House (GFH; BBB-/Negative/A-3), which has announced several infrastructure projects in Tunisia, Libya and Algeria. Banks such as GFH are set to continue capturing the capital that institutions and wealthy families are seeking to invest and recycling it in high-yielding industrial, real estate and infrastructure projects in the Maghreb. The emergence of Islamic investment banks allows a double objective to be met: on the one hand, it guarantees the recycling of liquidity from the Gulf in asset classes that rank as eligible among *Shari'a*-compliant investments and, on the other hand, it allows the surplus liquidity to be allocated to a cultural area considered to be close, insufficiently exploited economically and in need of foreign direct investment. As a consequence, Islamic finance could drive a significant portion of sustainable financing from the Mashreq to the Maghreb, particularly in the financing of infrastructure, tourism and real estate projects.

Retail banking represents another route for the potential development of Islamic finance in North Africa

The underdevelopment of Islamic finance in the countries of the Maghreb is particularly striking in the domain of individual banking. The proximity between Islamic finance and individual banking is however obvious: it is households first and foremost that are sensitive to religious arguments in matters of finance. In view of the spectacular growth in this line of business in the past three years, notably in Morocco and Tunisia, several Islamic banks in the Gulf that lack geographical diversification might find it interesting to gain a foothold in retail banking in the Maghreb.

In expanding the retail banking market, the social and thus political stakes are important. Local authorities responsible for the regulation and supervision of banking systems in the countries concerned will therefore undoubtedly play a role in the opening of their borders to Islamic financial institutions (IFIs) domiciled in the Gulf. In fact, we believe that the development of retail Islamic finance in the countries of the Maghreb will be very selective, and that North African regulators will certainly not authorize a massive entry of Islamic competitors into their territories. It should be pointed out, however, that banking competition within the most financially mature countries of the Maghreb (Morocco and Tunisia) is intensifying, and that, as a consequence, Islamic finance could represent a good means of achieving strategic differentiation beyond the classic strategies of pricing and quality. The introduction of Islamic finance into the Maghreb will probably be gradual. Bank Al-Maghrib announced on March 20 2007 that Moroccan banks were authorized to offer banking services that conform to *Shari'a*. At present, this authorization is limited to three products: ijara (lease financing), murabaha (cost-plus financing) and musharaka (profit and loss sharing contracts). To date, however, no official figures have been released on the size and growth of Islamic products in Morocco. In the same way, Tunisia for its part has made a significant advance in terms of Islamic finance by adopting, in February 2007, a law pertaining to the creation of an 'international Islamic institution', in partnership with the Islamic Development Bank (IDB), whose authorized capital would amount to $3.0 billion. The objective of this institution is to contribute, through its Islamic financing activities, to boosting business between the Arab countries of the Maghreb and the Mashreq. Finally, the existence of public-sector banks that could be privatized in each of the countries of the Maghreb may attract Islamic banks in the Mashreq inclined towards external growth.

Islamic finance development in the West is likely to be gradual

Outside the Muslim world, the global Islamic financial industry stands to benefit from the UK's initiatives to differentiate itself from other Western countries and emerge as a partner for the global development of Islamic finance. As some of Europe's Muslims do not use conventional banking facilities because interest, the cornerstone of conventional finance, is strictly forbidden under some schools of Islamic thought, a potential market for Islamic finance exists. In addition, non-Muslim customers may find in Islamic finance an ethical content. In August 2004, the UK regulator, the Financial Services Authority (FSA), approved a banking licence for the country's first Islamic bank, the Islamic Bank of Britain (IBB, not rated), to serve the retail market with *Shari'a*-compliant products and foster the financial integration of Muslim customers. Seeking to attract clients from Europe's Muslim population, Islamic banks are now starting to enter non-Muslim countries, focusing first on the retail segment. This development follows moves into Islamic finance by more and more conventional banks in the Gulf and Malaysia during the last decade, either through Islamic windows or by opening *Shari'a*-compliant subsidiaries.

Many non-Muslim countries have shown direct or indirect interest in Islamic finance. The UK government published a 'consultation' in November 2007, seeking views from the public about its potential issue of a wholesale sterling-denominated *sukuk*. Meanwhile, state-owned Japan Bank for International Cooperation announced its intention to issue $150–200

million of *sukuk*. In some other European countries, interest in Islamic finance is present, but players (including governments) are seeking more to understand this industry and to measure the feasibility and viability of this business model in their countries. In this sense, regulatory and political support could act as an accelerator or brake for the development of Islamic finance in Europe.

Islamic finance is increasingly diversified

Islamic finance has gained in complexity over the past decade with the emergence of more sophisticated wholesale *Shari'a*-compliant products compared with retail banking, which was the historical area of growth of Islamic finance in the past. This offer mainly related to the financing of assets in the real estate, industrial, infrastructure and tourism sectors, in mature, efficient and diversified Western economies and in emerging markets. Banks such as GFH, Arcapita Bank B.S.C. and Unicorn Investment Bank (not rated) are leading this trend. These banks are mainly wholesale, financing themselves chiefly through the interbank market or by issuing *sukuk*. They enjoy high returns on relatively risky activities that have long been reserved for conventional players. Capital investment, infrastructure project intermediation and direct real estate investment (usually through leveraged buyouts) have become part of Islamic finance in the past 10 years. Islamic investment banks, carrying inherently higher risk than retail banks, have been purchasing majority stakes in growth companies, which are often not listed, and attempting to extract higher returns through their capacity to unlock value at the level of the investee company over the medium term, as well as through systematic recourse to debt, while remaining *Shari'a* compliant. A key challenge is to continue innovating without crossing the line of *Shari'a* compliance.

New Islamic products are on the horizon

In response to increasingly complex demand, newly created *Shari'a*-compliant instruments are set to rival product offers at conventional banks. On the deposit side, profit-sharing investment accounts (PSIAs) offer depositors the right to share in Islamic banks' profits (and losses), which appear an attractive alternative for customers compared with fixed-rate conventional deposits at a time when Islamic banks are very profitable. As far as asset management is concerned, IFIs have been replicating in a *Shari'a*-compliant manner a number of money market, equity, real estate, private equity and infrastructure funds with comparable risk-return characteristics. Product diversification in large IFIs remains narrow, however. In most credit portfolios, ijara and murabaha dominate, accompanied to a lesser degree by *istisna*' (advance purchase agreements) exclusively for corporate borrowers – and more especially larger ones. The limited product diversification at IFIs comes as no surprise since Islamic finance and the banking needs of individuals are so closely interwoven. Islamic banks continue to target households above all, preferring them to companies, which scrutinize more closely the price and quality of a financial transaction. In light of the profits generated in the highly lucrative retail segment, both in the Gulf and in Muslim Asia, incentives to develop particularly risky financial offerings with hefty appetites for capital – either through partnerships, such as mudarabah, or musharakah – remain relatively minimal.

Already popular, *sukuk* are set to attain greater heights

The *sukuk* market more than doubled in 2007 to exceed $60 billion, continuing its explosive growth since 2001 when it totalled less than $500 million. The growth of the *sukuk* market declined sharply in 2008 because of market conditions, however, Standard & Poor's expects growth of this Islamic financial instrument to resume once market conditions return to normal and issues outstanding to top the symbolic $100 billion mark in the next few years, fuelled by huge investment and financing needs – notably in countries of the Gulf and Asia. *Sukuk* growth nevertheless has slowed in the past nine months as a result of depressed global market conditions. Some *sukuk* were postponed when liquidity dried up and credit spreads widened. But once market conditions return to normal, we expect issuance to resume double-digit growth. *Sukuk* issuance is taking off for several reasons:

- On the demand side, cash-rich investors from the Middle East and Muslim Asia are showing a growing interest for products that comply with their religious beliefs.
- On the supply side, massive infrastructure projects in the Gulf require huge amounts of funding. Banks there are also scrambling to balance the rapid increase in real estate lending with more long-term funding. Outside of the Gulf, conventional borrowers are willing to diversify their funding sources and attract deep-pocketed investors from the Middle East, especially under current tightened market conditions.
- Regulators and governments in the Gulf and in Muslim Asia, especially in Malaysia, support the development of Islamic finance, including the *sukuk* market, for religious, political, and business reasons.

The *sukuk* market is attracting issuers from a larger number of countries than ever before. This trend is set to continue. In the first half of 2008, the Republic of Gambia entered the league of countries issuing *sukuk* through a series of deals (very small in absolute terms) by its central bank. Entities in more than 15 countries, predominately non-Muslim, have expressed interest or announced their intention to issue *sukuk*. In the UK, the Treasury launched a consultation in November 2007 to seek views on the potential for the government to become an issuer of Islamic financial instruments denominated in British pound sterling. Several Asian countries, including Indonesia, are currently launching their *sukuk* or reviewing their options to do so. Therefore, Standard & Poor's expects the market to continue globalizing. Together with a widening interest in *sukuk* and Islamic securities in general, London has joined the list of major financial hubs to handle Islamic transactions, becoming the sole non-Muslim competitor of natural Islamic markets in Dubai, Kuala Lumpur, and Bahrain. As in the case of wholesale banking, London has the capacity to become a serious contender for *Shari'a*-compliant financial flows that seek recycling in Europe as competition heats up among the world's financial centres to attract Islamic issuers and investors. London, as a financial centre, has a number of competitive advantages compared with its emerging-market counterparts. Among those are:

- large size and international reach;
- deep, efficient markets, where investors can switch from one asset class to another (including in and out of *sukuk*);

- liquidity in the secondary market; and
- tremendous human resources and expertise (including research, analysis, operations and structuring capabilities).

In addition, the legal environment is robust. The tax regime applicable to *sukuk* coupons makes them deductible – no longer viewing them as rental payments but equivalent to interest. This *sukuk*-friendly amendment to tax law in the UK has made London more attractive, from a tax perspective, for issuing *sukuk*, although Dubai has been so far the most active trading centre for *sukuk* notes.

Standard & Poor's approach to Islamic finance

Standard & Poor's has built strong expertise in assessing the creditworthiness of *Shari'a*-compliant issuers and debt issues over the past decade. We apply the same criteria and ratings methodology to Islamic and non-Islamic financial institutions. In addition, we have developed analytical approaches that take into account the unique characteristics of Islamic banks. To factor in these features, we look carefully at assets, refinancing profiles, liquidity management and credit quality. Islamic banks can differ significantly from conventional banks in these domains. We do not formulate opinions on the *Shari'a* compliance of any IFI or *sukuk* issue. It is the responsibility of the *Shari'a* board of the originating institution to rule on compliance with Islamic law. Our role is to provide market participants with independent and objective opinions about the creditworthiness of issuers or issues.

Standard & Poor's stability ratings support Islamic finance development

In September 2007, Standard & Poor's launched a new product designed to encompass the specificities of IFIs and the way they fund themselves. Most Islamic banks offer PSIAs to their customers. These are financial instruments that are relatively similar to the time deposits of conventional banks. According to the terms and conditions of PSIAs, depositors are entitled to receive a share of the bank's profits, but are also obliged to bear all potential losses pertaining to their investment in the bank. This profit-sharing principle is core to Islamic finance, according to which investors and entrepreneurs must share the risks and rewards of a given venture. As PSIAs are loss absorbing, Standard & Poor's classic credit ratings are not applicable to this class of instrument. Instead, we have developed our stability ratings for PSIAs, which can provide PSIA depositors with a useful opinion about these instruments.

Stability ratings represent Standard & Poor's opinion about the expected stability of cash flows distributable to PSIA holders of an IFI. By stability, we specifically mean the relative sustainability and variability of a distributable cash flow, which underpins cash distributions. Stability ratings are neither opinions about an IFI's overall creditworthiness or profitability nor recommendations to buy, sell or hold a particular PSIA. Furthermore, they do not comment on the suitability of any investment for a given investor. Investors may find that stability ratings help them understand and compare the expected volatility of

the revenues served on PSIAs of different banks, particularly as stability ratings are subject more to changes in the characteristics of the institution than to the ebb and flow of market valuations or sentiments.

Standard & Poor's factors *Shari'a*-compliant issuer and issue specificities into its ratings

Standard & Poor's takes into account the specificities related to operating in compliance with *Shari'a* in its rating process. Fundamentally, the rating process and the criteria applied for Islamic banks are the same as those applied for conventional banks, with an additional analysis of the unique features – relating to credit, market, funding and liquidity, and other risks – attached to operating in compliance with *Shari'a*. For example, the obligation to back any transaction by a tangible, identifiable, underlying asset means that IFIs – at least in theory – back their transactions with collateral, resulting in higher collateral coverage than for conventional banks. In practice, however, there are two risks: higher collateral coverage could translate into a higher risk appetite and slacker risk management; and collateral foreclosure may be much more difficult in reality. With regard to exposure to market risk, investment in structured products is generally forbidden, which is good news in light of the current market dislocation. However, this also means that the availability of hedging instruments is limited, as speculation is forbidden. To date, only Dubai Islamic Bank has developed a profit rate swap to curb its exposure to profit rate swings. Other types of risks that can face IFIs relate to reputation and shortage of qualified staff. Reputation risk could arise from interpretation of *Shari'a* and differences between *fatwa* (opinions of *Shari'a* boards, in this case regarding the *Shari'a* compliance of specific transactions). The risk of being perceived as non-*Shari'a* compliant could severely damage the creditworthiness of an IFI. Muslim depositors might withdraw their funds from a bank, for instance, triggering liquidity problems. Retail customers that are mainly attracted by the Islamic nature of a bank might also stop requesting loans from this institution, triggering a downturn in profitability. Reputation risk can also arise from the perception of a link of an IFI with unlawful financing. Equally important, the shortage of skilled human resources is becoming a bigger concern for the industry. The strong growth in Islamic finance over the past decade and the creation of new IFIs means that having and maintaining qualified human resources is becoming very challenging. This risk may result in management discontinuity and ultimately damage the creditworthiness of an IFI.

Standard & Poor's approach to rating *sukuk*

There are various ways to structure *sukuk*: the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) lists 14 structures. In practice though, issuers have made use of only a handful of *sukuk* structures, including *ijara* deals and *musharaka* contracts.

Notwithstanding the potential variety of *sukuk* structures, we group them into three broad categories:

- *Sukuk* with full credit-enhancement mechanisms. Under this structure, *sukuk* receive an irrevocable third-party guarantee, usually by a parent or original owner of the underlying

collateral. The guarantor provides *Shari'a*-compliant shortfall amounts in cases when the issuing vehicle (usually a special-purpose entity or SPE) cannot make payment. The ratings on this type of *sukuk* are largely dependent on the creditworthiness of the guarantor or the entity providing the credit enhancement mechanisms, as well as the ranking of the *sukuk* (usually senior unsecured) among other financial obligations of the guarantor. To date, all the *sukuk* rated by Standard & Poor's (see Appendix 1) have benefited in one form or another from full credit enhancement mechanisms.

- *Sukuk* with no credit-enhancement mechanisms. Under this structure, *sukuk* resemble asset-backed securities in a securitization. The pool of underlying assets serves as the sole basis for coupon and principal payment. The ratings on these *sukuk* are largely based on the ability of the underlying assets to generate sufficient cash to meet, in a timely manner, the SPE's obligations. Standard & Poor's ratings, in this particular case, are based on the performance of the underlying assets under different stress scenarios along with the expected value of these assets at maturity.
- *Sukuk* with partial credit-enhancement mechanisms. This structure combines features of both of the first two categories, with a third-party guarantee absorbing limited shortfalls from an otherwise asset-backed transaction. Our ratings approach depends on our estimate of the capacity of the underlying assets to meet the SPE's financial obligations as well as the terms of the guarantee and the creditworthiness of the guarantor.

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Appendix I

List of Issuers and *Sukuk* Rated by Standard & Poor's

IIslamic Issues And Issuers Rated By Standard & Poor's*
Issue credit ratings

	Originator	Date of first rating	Issue amount (mil. $)	Long-term rating
1	Central Bank of Bahrain Sukuk	Various	995	A
2	DIB Sukuk Co. Ltd.	Feb. 15, 2007	750	A-
3	DP World Sukuk Ltd. (DP World)	June 27, 2007	1,500	A
4	Dubai Sukuk Centre Ltd.	May 25, 2007	1,250	A
5	EIB Sukuk Co. Ltd. (Emirates Bank International)	May 15, 2007	1,000	A
6	GFH Sukuk Ltd. (Gulf Finance House)	June 26, 2007	1,000	BBB-
7	Gold Sukuk dmcc (Dubai Multi Commodities Centre Authority)	April 11, 2005	200	A-
8	Golden Belt 1 B.S.C.	April 18, 2007	650	BBB+
9	IDB Trust Services Ltd. (Islamic Development Bank)	May 20, 2005	1,000	AAA
10	JAFZ Sukuk Ltd.	Nov. 8, 2007	AED7.5 billion	A
11	Loehmann's Capital Corp. (Loehmann's Holdings Inc.)	Sept. 22, 2004	110	CCC-
12	MBB Sukuk Inc.	April 11, 2007	300	BBB+
13	Pakistan International Sukuk Co.	Dec. 23, 2004	600	CCC+
14	Qatar Global Sukuk QSC	Sept. 10, 2003	700	AA-
15	RAK Capital (Emirates of Ras Al Khaimah)	May 6, 2008	2,000	A
16	Sarawak Corporate Sukuk Inc.	Nov. 30, 2004	350	A-
17	Saudi Basic Industries Corp.	Various	SAR16 billion	A+
18	Sharjah Islamic Bank Sukuk	Sept. 12, 2006	255	BBB
19	Stichting Sachsen-Anhalt Trust	July 9, 2004	130	AA-
20	Sukuk Funding (No.2) Ltd. (Aldar Properties PJSC)	May 22, 2008	AED3.8 billion	A-
21	Sun Finance Ltd. (Sorouh Abu Dhabi Real Estate LLC)	July 21, 2008	AED4 billion	A/BBB+/BBB-
22	Tabreed 06 Financing Corp. (National Central Cooling Co. PJSC)	June 15, 2006	200	BB
23	Tabreed 08 Financing Corp. (National Central Cooling Co. PJSC)	Dec. 2, 2008	AED1.7 billion	B
24	Tadamun Services Berhad (Islamic Development Bank)	July 17, 2008	MYR1 billion	AAA

Issuer credit ratings

	Issuer	Date of first rating	Country	Long-term rating
1	Albaraka Banking Group (B.S.C.)	March 21, 2007	Bahrain	BBB-
2	Al Rajhi Bank	Oct. 5, 2005	Saudi Arabia	A
3	Arcapita Bank B.S.C.	Nov. 16, 2006	Bahrain	BB+/Watch Neg
4	B.E.S.T. Reinsurance Co.	Sept. 2, 1997	Tunisia	BBB+
5	Dubai Islamic Bank	Oct. 18, 2006	United Arab Emirates	A-/Watch Neg
6	Dubai Islamic Insurance & Reinsurance Co. (Aman)	Nov. 17, 2008	United Arab Emirates	BBB
7	Gulf Finance House	Aug. 7, 2006	Bahrain	BBB-
8	Hannover ReTakaful B.S.C.	Dec. 4, 2007	Bahrain	A
9	Islamic Development Bank	Dec. 19, 2002	Saudi Arabia	AAA
10	Kuwait Finance House	Aug. 24, 2004	Kuwait	A-/Watch Neg
11	Salama/Islamic Arab Insurance Co. (P.S.C.)	May 24, 2007	United Arab Emirates	BBB+
12	Sharjah Islamic Bank	Sept. 6, 2006	United Arab Emirates	BBB
13	Takaful International Co. BSC	Dec. 22, 2008	Bahrain	BBB
14	Takaful Re Ltd.	Oct. 31, 2006	United Arab Emirates	BBB
15	Wethaq Takaful Insurance Co. K.S.C. (Closed)	Sept. 22, 2008	Kuwait	BBB-

*Data as of April 3, 2009. AED–United Arab Emirates dirham. SAR–Saudi Arabian riyal. MYR–Malaysian ringgit.

Islamic finance is set to continue growing and diversifying. It emerged in the mid-1970s, but its growth has accelerated over the past five years as a result of the new geopolitical backdrop in the Gulf, abundant liquidity flows from the recycling of petrodollars in the region's economies and the support provided by the governments of the Gulf countries and certain Muslim states such as Malaysia. A lot of countries, such as those in North Africa (predominantly with Muslim populations) and the UK, have shown their interest or provided support to the development of Islamic finance. The latter is set to act as a bridge between the Gulf's abundant liquidity and North Africa's investment needs, and to help the integration process of Muslim populations in Europe. Islamic finance has also gained in diversification. Financial institutions operating in compliance with Shari'a have developed a wide range of products that had been the preserve of conventional banks and private equity firms, notably funds and private equity transactions recycling the excess of liquidity available in the Gulf into asset classes that are compliant with *Shari'a*. Finally, the *sukuk* market is growing more rapidly than ever and attracting a lot of issuers from a variety of countries and economic sectors. Against a backdrop of these dynamics, Standard & Poor's has built strong expertise in assessing the creditworthiness of *Shari'a*-compliant issuers and debt issues over the past decade. We apply the same criteria and ratings methodology to Islamic and non-Islamic financial institutions. However, we take into account the unique characteristics of Islamic banks and issues in our rating process. Standard & Poor's has developed stability ratings to satisfy market hunger for independent and objective opinions on the credit quality of *Shari'a*-compliant issuers and issues. It has also developed a dedicated and well-defined methodology to rate *sukuk*.

Chapter 14

Roles and responsibilities of *Shari'a* scholars in *Shari'a* advisory services

Mohammed Akram Laldin

Introduction

The recent and rapid development of Islamic finance and banking is proof that it is no longer alien to the world and in fact, Islamic finance is sought everywhere. Such demands imply that Islamic banking and finance is here to stay and have a bright future to advance further. Its rapid advances are the result of the modern 'Islamic economics project' that started in the 1970s and in which many *Shari'a* scholars and Muslims from the finance and economics sector participated.[1] As a result, Islamic banking and finance emerged to become an alternative to the conventional system and it further developed until Muslims had their own takaful services, Islamic capital market and Islamic money market. It was assisted by the vast market, namely Muslims around the globe that have long sought such products. It is well known that acquiring, possessing and utilizing *halal* wealth is a significant part of Muslim belief.

However, it must be remembered that the actual aim of the system is to achieve *falah* (success) in the world and hereafter, as Muslims are to live according to Allah's commands and to seek His blessings in life. As Islam is the way of life, *Shari'a* scholars have struggled to create products, services and a system that are *Shari'a*-compliant, and this has given birth to the Islamic banking and finance industry. Such efforts were assisted by *Shari'a* scholars throughout history, whom have discussed and elaborated basic *muamalah* concepts. Modern *Shari'a* scholars have continued their efforts by exploring this subject further and examining both Islamic *muamalah* and the modern economic system.

Advisory services are common to all sectors, as it ensures health and successful operation, as well as preserving the integrity of the industry. Likewise, *Shari'a* advisory bodies are initiated to advise Islamic finance products and service providers on *Shari'a* compliance matters. It normally comprises a number of *Shari'a* scholars who provide advice and guidance on *Shari'a* matters. This body is highly important, as it sets the distinction factor of Islamic banks from conventional banks. In fact, it is the actual distinction factor[2] between Islamic institutions and other institutions. Most of all, it displays the credibility and legitimacy of the Islamic financial system, which will attract public confidence and support. Therefore, it is very significant that *Shari'a* scholars play their role, so that the *Shari'a* Advisory Body can effectively shape the Islamic finance system.

Shari'a Advisory Board

A *Shari'a* Supervisory Board comprises several *Shari'a* advisors. *Shari'a* advisors are defined in the Accounting Standards of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), as follows:

> *Shari'a* advisors are specialized jurists, particularly in *Fiqh Muamalah* and Islamic Finance, entrusted with the duty of directing, reviewing and supervising the activities related to Islamic finance in order to ensure that they are in compliance with *Shari'a* rules and principles. The views of the *Shari'a* advisors shall be binding in the specific area of supervision.[3]

Therefore, unlike other advisory bodies, the decisions of *Shari'a* Advisory Boards are binding in relation to *Shari'a* matters. In this regard, they are not merely exercising an advisory role. Hence, because *Shari'a* is the backbone of the industry, in certain countries or institutions, this body is called a *Shari'a* Supervision Body as it better describes the actual and intended role of the body. For instance, the *Shari'a* Advisory Council of the Central Bank of Malaysia oversees and prevails over the *Shari'a* Advisory Committees of all other Islamic financial institutions in the country, and it is the highest authority and needs to be referred to in any adjudication and arbitration process that involves Islamic finance issues.[4]

Observations of the various *Shari'a* Advisory Boards around the globe will indicate that there are divergences in the *Shari'a* governance system. The variation exists in relation to procedures, extent of power and levels of *Shari'a* Advisory Bodies, composition of *Shari'a* Advisory Bodies, determination of qualification of *Shari'a* scholars, as well as *Shari'a* and accounting standards applied.[5] In certain countries, there is a *Shari'a* Advisory Council at the central level, apart from the financial institution's in-house *Shari'a* Advisory Board.[6] Therefore, the central *Shari'a* Advisory Council might review the decisions or *ijtihad* made by the *Shari'a* scholars in the respective financial institutions. Such an arrangement is not applicable in some jurisdictions, where the decisions or *ijtihad* of the *Shari'a* Advisory Board at the institution level are binding and not subject to the review of higher authority. Such a predicament is based on the argument that an *ijtihad* cannot be nullified by another *ijtihad* (*al-ijtihad la yanqudu bi al-ijtihad*). In addition, the decisions of *Shari'a* Advisory Bodies do not constitute an *ijma'* (consensus) and it operates on the basis of collective *ijtihad*, where *Shari'a* scholars decide as a group. However, in the event that they cannot reach a unanimous decision, the views of the majority will prevail.

Certain countries or institutions adopt the practice of including experts from other related fields of specializations in the *Shari'a* Advisory Board. However, they are considered to be a member who is without any power to decide on *Shari'a* matters. Thus, the composition of *Shari'a* Advisory Boards may include experts in *Shari'a*, legal, accounting and finance matters. It is said to be the best practice, as it will assist the *Shari'a* scholars in considering the macro and micro dimensions of the products and policies, and allowing them to reach better and more precise decisions.

As for the question of the number of scholars for any board, there is no strict or fixed number of members for *Shari'a* Advisory Boards, as it depends on the need and extensity of the services required. The AAOIFI Standard recommends that there be at least three members. The same is recommended by the Central Bank of Malaysia, through its Guidelines on

the Governance of *Shari'a* Committee for Islamic Financial Institutions. It is pertinent for Islamic financial institutions to be mindful in their selection of the members of the *Shari'a* Advisory Board, so that the members can complement each other in terms of experience, knowledge and qualification, in ensuring the effectiveness of the institutions and to preserve its integrity.[7]

Different *Shari'a* Advisory Bodies may have different designated roles or tasks. However, the normal tasks include to advise the financial institution in all matters that concern Islam, based on Islamic teachings, to ensure *Shari'a* compliance of the products and operations of the institution, to act as a reference body in relation to issues in the Islamic banking and finance industry, to supervise, monitor industry practices and align the practices with global standards, to represent the financial institution or the country in local or global conferences and dialogues and exchange ideas and present their country or financial institution's practices. These are, among others, the roles prescribed to the *Shari'a* Advisory Council of the Central Bank of Malaysia.

These roles can be played effectively by the Board, through the presence of a special secretariat or committee to assist them. Assistance provided can be in the form of finding or providing the necessary resources, references and research materials, collecting *fatwas* and banking reports, as well as other forms of assistance that may facilitate the Board in making decisions.

Shari'a scholars

Shari'a scholars are the main thrust of all *Shari'a* advisory bodies. A *Shari'a* scholar is commonly referred to as a person with *Shari'a* background or who possesses good knowledge in *fiqh*, *usul fiqh*, particularly *fiqh muamalat*, which explains Islamic commercial law and contracts. However, the current trend and situation requires them to have reasonable experience and significant knowledge about the modern conventional banking and finance system, so as to be able to lay down the distinction factor between the two systems. As Islamic finance is exploring the global market, *Shari'a* scholars need to equip themselves with good command of English and Arabic in order for them to understand, read, discuss, present and share more ideas or materials on *Shari'a* finance and Islamic finance globally.

Another important characteristic which is central is the fact that a *Shari'a* scholar has to be a person of good repute who upholds high ethical qualities. In addition to be free from any criminal record, the scholar must also possess noble characteristics, such as trustworthiness, honesty, responsibility and accountability.[8] This is because a *Shari'a* advisor must be seen to practice what he or she preaches and can be a good example to others.

Most importantly, the scholar has to be honest with the knowledge possessed and use this with the utmost professional integrity in order to assist the industry in solving any related issues. In addition, it is pertinent for the *Shari'a* scholars to develop their knowledge and skills by learning, reading and equipping themselves with adequate exposure to the subject. This is pertinent in order to demonstrate that *Shari'a* is flexible and suitable for mankind, regardless of location and time. In a nutshell, present *Shari'a* scholars have to be more dynamic and prepared to face additional challenges that may come their way.

On the other hand, *Shari'a* scholars are also responsible to the investors and the clients of Islamic financial institutions, as they are the principal stakeholders of the institutions. The

scholars shall perform their roles with due diligence, especially in ensuring the products and services offered are in compliance to the highest *Shari'a* standards and requirements. This is because the stakeholders usually have limited access to the details of the products and services or lack the experience and qualification to evaluate those products and services. In this respect, *Shari'a* scholars shall also act as the enabler for customer advocacy.[9]

It is well acknowledged that classical scholars have provided an abundance of literature that discusses commercial transactions and this literature is to be referred to by contemporary scholars. However, at present, challenges and circumstances require *Shari'a* scholars to go beyond those writings and embark on extensive research in order to discover the means and ways to apply the classical theories to modern financial instruments. In order to play their roles effectively, they need to be able to make *ijtihad* and explore new possibilities. Modern Islamic finance practices require the scholars to be alert to the different needs and ever-changing circumstances, be they legal, taxation or regulatory requirements and be innovative in overcoming all the hurdles in developing competitive Islamic financial products. It is indeed a challenge for the scholars to embark on such innovations and it requires them to be equipped with the necessary knowledge and experience.

In addition, apart from *Shari'a* compliance, *Shari'a* scholars have to push noble and Islamic agendas. They must drive more contributions from the industry and themselves for the benefit of the *ummah* as a whole. There have to be positive initiatives on the part of *Shari'a* scholars to do *islah* or reform and to educate the stakeholders, industry players and other *Shari'a* scholars, and make them aware that they are *khalifahs* (vicegerents) and the provision of Islamic financial products and services is a form of *ibadah*, as well as to seek Allah's blessings in this world and the hereafter. If they succeed in such reforms, all related parties in the development of Islamic finance will sense the responsibility to work harder for the betterment and success of the industry. In conclusion, it is vital for *Shari'a* scholars to play their role effectively, to shape *Shari'a* advisory bodies and ensure the success of the industry, so that *Shari'a* application will be expended in other areas of Islam. It is vital to demonstrate that *Shari'a* is workable, not only in financial matters but in all areas of life.

Roles of *Shari'a* scholars

The basic roles of the *Shari'a* scholars are: to advise on *Shar'ia* matters, issue *fatwas* and point to the *halal* and *haram* elements in banking and finance transactions. This was said to be the scholars' role at the initial stage of modern Islamic finance. Hence, they were commonly associated with an endorsement role, which enticed financial institutions to seek them. But now, their roles are more extensive than before, as it includes innovating new marketable products and exploring other financial contracts and instruments. Even today there are still many aspects of finance that need to be explored, such as Islamic risk management tools and *Shari'a* auditing. As the market and the scholars mature and advance beyond the phase of creation or laying the foundations, *Shari'a* scholars have to be involved in and contribute to a bigger perspective of finance, and not only provide basic products.

There are specific roles that need to be played by *Shari'a* scholars in *Shari'a* Advisory Bodies.

Firstly, they are to ensure that product development uses the acceptable principles of the *Shari'a* and follows acceptable *Shari'a* standards, be they locally or internationally developed standards. The rapid growth and advancement of Islamic finance has resulted in the development of *Shari'a* standards and frameworks for product development, by international bodies such as AAOIFI and the Islamic Financial Services Board (IFSB) or national bodies like the *Shari'a* Advisory Council of central banks and other financial institutions. Thus, the task of *Shari'a* scholars is to ensure that these standards are upheld and followed, in order to preserve the high level of integrity of their decisions.

Secondly, they are to ensure that the decisions of the *Shari'a* Boards are understood by the practitioners, for the purpose of its implementation, as they are responsible for applying the decisions of the *Shari'a* Boards.

Thirdly, *Shari'a* scholars need to be competent to scrutinize the documents related to products and transactions, as negligence will result in non-compliance and negative legal consequences. Therefore, *Shari'a* scholars must have sufficient knowledge about the *Shari'a*, legal and operational aspects of the products and transactions. It is highly desirable that *Shari'a* scholars be involved in product development from the early stages until the contract is concluded. These will definitely entail their having a good command of languages, as they need to read and examine all the terms, conditions, clauses and secondary contracts that are set out in the contract, as well as all the supporting documents.

Moreover, *Shari'a* scholars must have full knowledge of the purpose of the products and how it is operationalized. They have to ensure that the products have positive objectives and are not means to forbidden ends. It is also a big concern if the Islamic finance proceeds are not managed well or are channelled to non-compliant activities. If it is allowed, then efforts to build a *Shari'a*-compliant system will be fruitless, as a permissible matter that leads to a prohibited matter is also prohibited. *Shari'a* scholars must be firm and strict, so as not to be involved in forbidden, doubtful or any activity that contains trickery (*hiyal*).

In addition, *Shari'a* scholars must also assess the economic implications of the product to the *ummah*. This will require them to look at the *maqasid* approach. It must be remembered that Islamic finance products are supposed to provide facility to the people and not to burden them as, in Islam, wealth is one of the essentials of human life.[10] Therefore, Islamic finance has to be reviewed on a bigger scale, namely ensuring that it is serving the *ummah* effectively. For instance, retail products must not be neglected although wholesale products may derive more profits. The Islamic financial system, which is commonly attributed as a moral and ethical system, must contribute effectively to overall wealth creation, growth and development, and greater shared prosperity.[11]

Another aspect that needs to be considered by *Shari'a* scholars is strengthening the governance of Islamic financial institutions, as well as embedding Islamic values into the financial institutions' business operations and governance.[12] This will include facilitating *Shari'a* audits, ensuring Islamic and ethical management, protection of consumers' rights and ensuring the accountabilities of the financial institutions.

It must be mentioned that for those jurisdictions where there is a Central *Shari'a* Council at the central banks, their role is not confined to an advisory one. The central body needs to coordinate the issuance of *fatwas* and rulings, as well as products developed by the in-house advisory body and work closely with regulators, economists and financial experts to

contribute to the smooth implementation of *Shari'a* decisions under their respective jurisdictions. They are also to work towards the harmonization of *fatwas* and the global development of Islamic finance. As their opinions are seen as representing the opinions of other scholars in their jurisdiction, they need to be competent and accountable for their decisions.

Thus, the abovementioned roles of *Shari'a* scholars demonstrate the need for determination, alertness, commitment, seriousness and competency of *Shari'a* scholars. They must not be mere rubber stamps but professionals who endorse a product after full inspection and satisfaction that the product is *Shari'a*-compliant, as well as many other roles to be played, to ensure that the Islamic financial system is developed as intended by the Almighty. This will surely require strict observation of the *maqasid* of the *Shari'a*.

Challenges in *Shari'a* Advisory

As Islamic finance is still in a state of infancy and the system has not yet experienced any serious trials like the conventional system, the situation requires *Shari'a* scholars to equip themselves well and develop themselves fast, in line with the rapid advancement of the industry. Furthermore, there are still many challenges and weaknesses that need to be settled by contemporary *Shari'a* scholars.

First is to resolve the lack of knowledge and comprehension among *Shari'a* scholars about modern financial practices. It was observed that not many scholars have adequate knowledge about both aspects. It is vital to be well versed in both *Shari'a* and finance, as it affects the integrity of the Islamic financial industry. It may also give rise to doubts on whether decisions were issued based on sufficient understanding of the structure, objectives and implications of the products or policies, or it was decided as a mere *fatwa* on *fiqhi* matters.

Secondly, there is the issue of the shortage of new and young scholars. The absence of new *Shari'a* scholars is one of the industry's current concerns. This will require all the relevant authorities to invest in developing and training *Shari'a* scholars, as well as maximizing the efforts of the existing and senior scholars as mentors to guide the young talents to assume their role as catalysts for the further development of the Islamic finance industry. One of the ways is to expose the young talents to the modern operations of finance and the global practices of Islamic finance, apart from having a solid *Shari'a* background.[13] One of the suggested training methods is to allow a junior scholar to sit and participate in the meetings of *Shari'a* Advisory Bodies.[14]

The shortage of scholars is obvious as the current trend shows that many prominent *Shari'a* scholars have to sit in different advisory bodies at the same time. Moreover, it is said that existing *Shari'a* scholars have to embark on assignments over and above their capacity. This might affect the quality of supervision of Islamic financial institutions. In addition, it halts the big agenda, namely to reform (*islah*) the financial institutions, as it requires the *Shari'a* scholars to focus and foresee all the activities of the institutions. One suggestion worth considering is for Islamic financial institutions to have permanent *Shari'a* Boards that work on a full-time basis.

Thirdly, similar to other industries, innovation of products is the key to the development and survival of the Islamic financial system. As for now, compared with the Islamic financial system, the conventional system is still ahead and leading the innovation initiatives. Moreover,

the Islamic finance industry has been associated with the syndrome of imitation, rather than innovation. This poses a challenge to the *Shari'a* scholars and the financial institutions to pursue innovation in the development of products and services.[15] Hence, it is very important for scholars to keep up with recent industry developments and the demands of the clients, as well as mastering *Shari'a* knowledge. Furthermore, studies have shown that customer demands are not only motivated by their beliefs but also the gains that will be reaped.[16] Therefore, Islamic financial institutions have to strive to retain the loyalty of their customers.

Nevertheless, *Shari'a* scholars face the challenging task of synergizing between the *Shari'a*, regulatory, legal, financial and tax requirements in product development. More often, the products will face hurdles from any of those aspects. Therefore, there is a tendency to replicate conventional products and modify them to be *Shari'a*-compliant. This is not adequate as the development of Islamic finance requires bolder and more proactive actions on the part of the *Shari'a* scholars, to come up with alternative products that meet all the abovementioned requirements. There are certain scholars who ensure that they also memorize relevant legal and tax knowledge. However, the best way is for the scholars to be involved in the development of the product from day one and become aware of the issues and matters discussed by the practitioners, whether they are related to finance, risk, legality or taxation. With that, no time is wasted as the discussion is simultaneous and any hurdle that transpires can be overcome almost immediately.

As the Islamic financial system is a rapidly growing and moving system, the next challenge faced by *Shari'a* scholars is to reach decisions quickly, as delays would translate into lost opportunities. So, *Shari'a* scholars cannot afford to be laggards, since *Shari'a* is the backbone and the main drive of the industry. This requires competent scholars to sit on advisory bodies and financial institutions and to be willing to provide all facilities and assistance to speed up the process, including funds and assistance for their *Shari'a* scholars to do research and explore new avenues.

In addition to that, there is the increased challenge to balance between monetary and *Shari'a* objectives. The challenge is commonly known as achieving corporate social responsibility (CSR). CSR is defined as corporate activities beyond profit-making and it may involve protecting the environment and society, trading ethically and making significant contributions to society. Hence, Islam, with a comprehensive ethical system and emphasis on social justice, anticipates more than CSR. It goes back to the very concept of humans as servants and vicegerents of Allah and their duty to observe *taqwa* at all times, as well as the Islamic concept of preventing harm and ensuring justice. The observance of those postulates will further lead to the continuous excellence of business performance and corporate accountability. Therefore, such responsibilities should be realized and initiated by *Shari'a* scholars in the Islamic financial system. Such efforts will, however, fail without the firm support from the investors and industry players.

Then there is the challenge of secrecy and confidentiality, whereby absence of full disclosure on the part of the financial institutions can prove to be detrimental to the legitimacy of products and affect the rights of customers. Full disclosure on a certain product's operation, its purpose, market trend and legal requirements is pertinent in order for scholars to issue a proper and accurate decision as well as to facilitate their supervision. In addition to that, it is important to ensure clear and transparent procedures of decision-making, as well as the

independence of *Shari'a* scholars. Therefore, AAOIFI recommended that *Shari'a* supervision serves under the pleasure of a company's board of directors and not the management.[17] It is highly desirable that the *Shari'a* Board members be elected by the shareholders if such an arrangement is viable, in order to ensure the integrity of the Board. It must also be assured that scholars are able to play their role, free from fear or conflict of interest. In addition, it is important to highlight that the development of the banking system is highly associated with dissemination and accuracy of information,[18] which will invite confidence from the industry and the public. Therefore, this matter should not be taken lightly.

Moreover, scholars around the globe are facing the challenge of divergence of opinion, either in relation to the recognition of the existing products or in developing and coming up with new innovations. Comparatively, the latter 'attracts' more obstacles. They are actually the natural outcome of the exercise of *ijtihad* by jurists, as well as differences in the local circumstances and conditions, as considered by scholars across the globe. Active and aggressive *ijtihad* exercises are healthy, as they open up new horizons. Nevertheless, there is a need for a form of standardization and harmonization[19] of the issuance of *Shari'a* standards by international bodies, such as AAOIFI and IFSB or findings and resolutions of the Organisation of the Islamic Conference (OIC) Islamic Fiqh Academy or Dallah Al Baraka round table meetings are vital, apart from continuous dialogue between scholars across the globe.

However, it can be said that the greatest challenge of all is the knowledge gap that exists in the industry, as major players and those who are involved in this industry are not *Shari'a* savvy practitioners. This, to a certain extent, has affected the transformation to a pure Islamic finance system. It is a fact that most of the Islamic bankers are from the conventional banking and finance environment. This has led to the tendency of 'Islamizing' conventional products, without exploring the true potential and opportunities of *Shari'a*-compliant products. This gap needs to be addressed by providing more *Shari'a* training and exposure to the practitioners. In addition, the market, regulators and practitioners sometimes oppose the proposals of *Shari'a* scholars to introduce products that are truly Islamic, as they are reluctant to introduce a product that is alien to conventional practices as it may invite new problems with the current legal, tax or risk provisions.

As illustrated above, there are many challenges that are faced by *Shari'a* scholars in fulfilling their real and noble task of serving Islam, the *ummah* and the industry. They are required to be more proactive and need to be assisted by new, well-trained scholars. Nevertheless, the industry players, financial institutions, investors and the public need to be educated so as to be able to understand and appreciate the unique features of Islamic banking and finance. Hence, good relationships and collaborations with various parties in the industry need to be emphasized, as it facilitates and expedites the different tasks and efforts that are to be undertaken by the current and future *Shari'a* scholars.

Different approaches in *Shari'a* supervision

It is worth mentioning here the different approaches of *Shari'a* supervision, which to a certain extent affects the credibility of the decisions. Generally, in making *Shari'a* decisions, there are three different approaches. They are applicable to all rulings in Islamic law, including rulings related to banking and capital markets. These approaches are as follows:

- Rigidity and inflexibility (*al-tadyik wa al-tashaddud*) in making Shari'a decisions. Islam is a *deen* that teaches its followers to be moderate in all their undertakings. It also emphasizes the importance of making decisions which will serve the need of the people and at the same time is practical to be implemented. The concept of *al-yusr* (choosing the simple and accurate decision) is also very much emphasized, as the Prophet s.a.w. will always choose the easiest between two things, as long as it is allowed in Islam and he will always emphasize this to his followers, that is to facilitate the needs in life, without going through the difficulties, provided that it is allowed in Islam.[20] In addition, the Islamic system of life was revealed to bring blessings and not rigidity in life. This is evidenced in the following verse:

  > And We have sent you (O Muhammad s.a.w.) not but as a mercy for the '*Alamîn* (mankind, *jinns* and all that exists).[21]

  The factors that might lead a person to be rigid are as follows.

- Fanaticism towards a particular *mazhab*, views or scholars. Fanaticism towards particular views shall not be the driving factor in making any *Shari'a* decision, be it in matters related to *ibadah* or *muamalah*. This is because every scholar will give their views, based on the circumstances in which they are in and the issues posed to them. The requirements as well as the circumstances might change according to the passage of time. In this respect, Imam Ahmad is reported to have said, 'Whoever issues any *fatwa* shall not impose or force anyone to abide by their view'.[22]

  As for the views related to *muamalah*, Sheikh Yusuf al-Qardawi emphasized the following: '. . . some scholars when asked about a particular issue related to contemporary *muamalah* will always refer to a particular *mazhab* literature, if there are no similar instances in these literatures; they will disallow the referred *muamalah* issues on the ground that these issues do not exist in the classical literature; as though originally, matters in *muamalah* are impermissible, unless it is stipulated in the classical literatures.'[23]

  No doubt the classical scholars have expended tremendous efforts in developing different areas of Islamic *muamalah* and the contemporary scholars must refer to these works in order to further develop *fiqh al-muamalah*. However, it is also important for contemporary scholars to venture beyond the scope of the classical *ijtihad* in order to further develop and enhance Islamic products, particularly the Islamic capital market products.
- Depending on the literal meaning of the text (*Qur'an and Sunnah*), without referring to its objectives (*maqasid*)**.** It is important for a scholar to understand the objectives of the *Shari'a* in making any decision and not just rely on the literal meaning of the text. In this respect, Ibn Qayyim emphasized that it is not allowed for a *mufti* to quote the *Qur'an* or *Sunnah* literally and say this is permissible and this is forbidden, unless he is aware that what he said is what is intended by the Lawgiver.[24]
- Unnecessarily propagating the usage of *sadd al-dharai'i* (blocking the means to evil) in disputed issues. Some scholars will unnecessarily propagate the usage of the sadd al-dharai'i concept in Islamic law, which might lead to difficulties. This is evident when some scholars held the view that it is forbidden to plant grapes, as the grapes might

possibly be used to make wine. Similarly, some would go to the extent of disallowing Islamic products that imitate conventional products, on the grounds that it has no origin in *muamalah*. This approach is questionable, as nothing forbids such activity, as the benefits (*maslahah*) of such action supersedes its harm (*mafsadah*). The means that something which is allowed should not be disallowed if the benefits of such action is greater than its harm. Imam Ibn Qayyim clarifies the prohibitions of ways and means when he says, 'When Allah forbids a particular thing and there are means and ways to realize it, He will forbid these means and ways in order to reiterate the prohibition, so as to ensure no one will take any step towards the prohibited actions, if Allah allows the ways and means which leads to the prohibited things, this will lead to the assumption that the prohibition is incomplete and it will encourage people to dwell into the prohibitions'.[25]

- Excessive flexibility (*al-tasahul*) in making *Shar'iah* decisions. This approach is obvious among some of the scholars, who will agree and allow most, if not all, of what is brought to their attention. This approach is sometimes taken as a result of pressure from certain quarters for product approval or the negligence on the part of the scholars in their investigation on the given issues. The other factor that shall not be overruled is the tendency to please others and lack of much needed knowledge in arriving at the best decision.

  No doubt Islam propagates tolerance and taking the easy and simple decision, but this does not justify negligence in arriving at any decision. In this respect, it is important for all scholars to understand the true meaning of *ijtihad*. *Ijtihad*, as defined by Al-A'amidi, is: 'The total best effort in the search for an opinion, as to any legal rule in such manner that the individual senses (within himself) an inability to expend further effort.'[26] Therefore, *ijtihad* is the utilization of maximum effort by the *mujtahid*, in arriving at a certain decision, where he sees no possibility for him to further investigate the issue. If this is done by the scholars, then they will be qualified to obtain the reward, as mentioned by the Prophet s.a.w. in his *hadith*, which means, 'If a judge makes the right decision through *ijtihad*, he shall be doubly compensated. However, if he errs, he shall be compensated once'. In conclusion, it can be said that a scholar can be 'right' in his professional conduct as a scholar without necessarily being 'right' in his conclusions, provided that he has exercised all the means in arriving at the right decision.

Among the reasons for excessive flexibility are:

- Excessive utilisation of the principle of *maslahah* and *darurah*, which might lead to the misuse of these two principles. Among the examples of such usage in *muamalah* is the view which allows indulging in *riba* in order to generate economics activities. Practising *riba* as it is is against Quranic injunctions. It should be emphasized here that the utilization of *maslahah* is disallowed in the situation where it is against the explicit texts.[27] Similarly, the utilization of *darurah* has its limitations, as stipulated in the maxim which reads, 'Necessity should be estimated according to its required amount (*al-daruratu tuqaddaru bi-qadriha*)'.

- Choosing the facility (*tatabbu' al-rukhas*) and taking the easiest view of the *mazahib* (*al-talfiq bayn al-mazahib*). No doubt Islam allows its followers to utilize the facility given by Allah. However, there are limits to it, as stipulated in the legal maxim, 'Whatever is allowed because of an excuse, would be cancelled when the excuse disappears (*ma jaza li-`udhr batala bi-zawalih*)'. As for choosing the different views provided by the schools of Islamic thought, the method should be finding the strongest view and not the easiest, as the strongest view is the best view to be followed.
- Finding legal devices (*al-tahayul al-fiqhiyyah*) in order to justify certain rulings. In arriving at a particular decision, a scholar shall examine the available texts or exercise *ijtihad*, according to the prescribed acceptable methodology. The usage of legal devices, particularly to succumb to any prohibited matters, is not allowed. Imam Ibn Qayyim has elaborated on the approved legal devices and the disapproved ones when he said that it is not allowed for the scholars to engage the *haram* and *makruh* actions as legal devices. However, if he has a good intention in engaging the allowable legal devices, then it is allowed, as with the Prophet s.a.w. when he instructed Bilal r.a. to exchange dates with dirham and buy with the dirham the intended dates, so as to free himself from *ribawi* transactions.[28]
- The moderate approach in arriving at *Shari'a* decisions. Islam is a system that emphasizes the importance of moderation (*al-wasatiyyah*) in everything. Therefore, it is vital for *Shari'a* advisors to follow this method in resolving and arriving at *Shari'a* decisions, including tackling issues related to the Islamic capital market. This means the scholars shall investigate the issues and arrive at a decision, without compromising the fundamentals of the *Shari'a*. As for the interpretations, it might vary from one situation to another, depending on the circumstances and practices, as well as the needs of the society and the industry as a whole. Imam al-Shatibi emphasized the importance of moderation when he says, 'A vice mufti is the one who provides moderate and practical solutions for the public and will not burden them with unnecessary burdens (*al-shiddah*) and will not also be inclined towards excessive flexibility (up to the point of compromising *Shari'a* principles).'[29]

In the context of the development of the Islamic capital market, it is important for the *Shari'a* scholars to follow this method and the important factor is to study the suitable *Shari'a* principles to be applied in any product and to understand the needs of the market. *Shari'a* scholars must also assist those in the industry to come up with competitive products, which can be marketed locally and at the global level. All this has to be done without jeopardizing the fundamentals of the *Shari'a*.

Conclusion

The prospects for the Islamic banking and finance industry are very bright but the task ahead is challenging. It requires not only active participation of the *Shari'a* advisors, but also on the part of the regulators, practitioners, economists and legal experts, if a complete and comprehensive system is to be developed. Islamic finance, as one aspect of human life, is a form of *ibadah*, if it is conducted in accordance with the rule of the Almighty and as such, has to be upheld by all players in the Islamic finance industry. The ultimate reminder is the

Prophetic saying: 'Every one of you are guardian and each of you are responsible of the things or people that are under your care.'[30] And Allah knows best.

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[4] Bank Negara Malaysia, *Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions*, Kuala Lumpur at p. 3.

[5] Shamsad Akhtar, *Shari'a Compliant Corporate Governance*, a keynote address delivered at Annual Corporate Governance Conference Dubai on November 27, 2006. See the *Shari'a* Compliance Framework – Countrywise table at p. 7.

[6] Such arrangement can be found in Malaysia, Pakistan and Sudan where the Central *Shari'a* Advisory Council exists at the Central Bank level. However, the role of the Central SAC may vary from one country to another.

[7] Muhammad Yunus Al Birqdar, *Dhawabit Ikhtiyar A'adha' Hai'at Al Riqabah Al Shari'iyyah fil Muassasat Al Maliyah Al Islamiyah*, AAOIFI 7th *Shari'a* Conference, May 27–28 2008, Bahrain at p. 17.

[8] For further elaboration on the required characteristic of *Shari'a* advisor, see Amin Muhammad Ali Qattan, *Hai'at Riqabah: Ikhtiyar A'adhauha wa Dhawabituha*, AAOIFI 7th *Shari'a* Conference, May 27–28 2008, Bahrain at pp. 4–6.

[9] Yusuf Talal De Lorenzo at p. 1.

[10] Ali Muhyiddin Al Qurradaghi, *Al Muqaddimah fil Mal wal Iqtisad wal Milkiyyah wal 'Aqd*, Dar Al Basha'ir Al Islamiyyah: Beirut, 2006 at p. 5.

[11] See Zeti Akhtar Aziz, *Islamic banking and Finance Progress and prospects Collected Speeches: 2000–2005*, Bank Negara Malaysia: Kuala Lumpur, 2005 at p. 196.

[12] See Zeti Akhtar Aziz at p. 205.

[13] See Saiful Azhar Rosly, *Critical Issues in Islamic Banking and Financial Markets*, Dinamas: Kuala Lumpur, 2005 at pp. 340 and 347.

[14] Yusuf Talal DeLorenzo at p. 3.

[15] See Ab. Mumin Ab. Ghani, *Sistem Kewangan Islam dan Pelaksanaannya di Malaysia*, JAKIM: Kuala Lumpur 1999, at p. 5.

[16] Adnan Khalid al Turkumani, *Al Siyasah Al Naqdiyyah Al Masrifiyyah*, Muassasah Al Risalah: Beirut 1988, at p. 227.

[17] Yusuf Talal DeLorenzo at p. 3.

[18] Yusuf Kamal Muhammad, *Al Masrifiyyah Al Islamiyyah: Al Asas al Fikriy*, 3rd Edn, Dar Al Nashr Lil Jami'at, Cairo, 2002, at p. 116.

[19] For further discussion on divergence and jitihad, see Engku Rabiah Adawiah Engku Ali, *Development of Islamic Banking in Malaysia: Constraints and opportunities from the Jurisprudential Perspectives*, IIUM Law Journal, Vol. 11, No.2,IIUM: Gombak 2003 at pp. 241–249.

[20] See Kitab al-Jihad in Bukhari and Muslim.

[21] Al-Anbiya': 107.

[22] Ibn Mufleh, Al-Adab al-Shar'iyyah, Vol. 2, p. 45.

[23] Al-Qaradawi, Al-Ijtihad fi al-Islam, p. 175.

[24] Ibn Qayyim, I'lam al-Muwaqqi'in, Vol. 4, p. 134.

[25] Ibid, Vol.3, p. 109.

[26] Al-A'amidi. Al-Ahkam fi Usul al-Ahkam, Vol. 4, p. 169.

[27] Al-Ghazali, Al-Mustasfa, Vol. 2, p. 293.

[28] Op. cit, Vol. 4, pp. 170–171.

[29] Al-Shatibi, Al-Muwafaqat fi Usul al-*Shari'a*, Vol. 5, p. 276.

[30] Imam Al Bukhari, *Sahih Al Bukhari*, Volume 3, Book 41, Number 592.

Chapter 15

Islamic banking tolerates challenges to risk management

Aly Khorshid
Elite Horizon

Introduction

In all its forms, banking contains risks that pose a challenge to banks and supervisory authorities. Islamic banks, like their conventional counterparts, are financial institutions providing services to depositors and investors as well as financing to companies, the public sector and individuals. They are, therefore, subject to many risks similar to those confronted by conventional banks. In addition, *Shari'a*-compliant banking has its own risks. In principle, there is a range of activities through which Islamic banks can work in different ways enabling them to provide funds. These activities are adapted to meet the principles governing Islamic banking, the most important being the principle of risk sharing. There is therefore an urgent need to identify, measure, manage, monitor and control potential risks and mitigate them within a bank's capacity and capital adequacy.

Among the most important challenges confronting Islamic banks are risks arising from financing formulas and *Shari'a*-compliant banking, especially investment risks, the method of applying Basel II proposals, capital market and financial derivatives risks. In addition, Islamic banks bear a wide range of risks that differ in nature from those borne by commercial banks. It must be emphasized that the role entrusted to the supervisory authorities is to pursue a comprehensive control method based on the risk assessment process and not to discriminate in a way that suggests that *Shari'a*-compliant banks are being rated differently or confronting larger risks.

Risk management, corporate governance, transparency, disclosure and internal control requirements in the Islamic financial services industry must always be developed and adjusted to meet the needs specified for Islamic banks. An important part of the work of these banks surrounds the reputation of their work, especially with regard to ethical matters. These banks should be aware of the importance of the role entrusted to them.

Risks faced by Islamic banks raise issues in terms of assets and inventory assessment, regular income, investment costs, recognition of losses and adequacy of guarantees. Development of mechanisms to cover such risks must continue. This underlines the importance of integration into global financial markets, the encouragement of competition and provision of a proper climate for ongoing innovation so that Islamic banks can consoli-

date their positions in all markets and boost their ability to provide products for customers of all segments.

In essence, there are six ways to address risk: avoid it, share it, transfer it, reduce it, accept it and prevent it. When managing risk, organizations should have a risk management framework with policies on risk-appetite and a risk-tolerance threshold. Ultimately, managing risk is about ensuring that the risk is almost non-existent and even if it does exist, the negative impact or financial and non-financial loss would be minimal and within the bank's set tolerance limits.

Risk management tools to assist financial innovation

One of the most effective applications of financial engineering has been in the area of hedging, which has become an important risk management tool. Without hedging, financial and corporate institutions could suffer substantial losses with knock-on effects for the whole economy. For an example of this issue, let us assume that a businessman places an order for goods worth US$1m with a 3-month delivery. If the rate of exchange is €1.17 per US dollar and if the exchange rate remains stable, €1.17m will be due at the time of delivery of the goods. But exchange rates are *not* stable so if the euro appreciates over these three months by 5%, the businessman will have to pay $1.05m for the goods instead of $1m. The businessman will, therefore, incur an unforeseen loss of €170,000. One way to protect himself against such loss would be to purchase the yen total today to be payable three months later. This would freeze his financial resources unnecessarily and create a liquidity crunch for him. To avoid such liquidity tightness, the alternative solution available in the conventional financial system is to purchase €1.17m in the forward market at the current exchange rate of €1.17 per US dollar plus or minus a premium or discount. All that the importer has to do is perform a basic hedging transaction: to pay a small percentage of the total amount as deposit for this purpose.

The approach to risk management in Islamic finance

The Islamic finance industry must now investigate the permissibility of hedging to protect the importer from exchange rate fluctuations. The verdict of the *Shari'a* scholars so far is that hedging is not permissible, based on three objections: hedging involves *gharar* (excessive uncertainty), interest payment and receipt and forward sale of currencies, all three of which *Shari'a* law prohibits. As far as *gharar* is concerned, the objection may not be valid, but the other two objections are convincing.

Gharar can be overcome because hedging helps eliminate it by enabling the importer to buy the required foreign exchange at the current exchange rate. The bank, which sells forward yen, also does not get involved in *gharar* because it purchases the US dollar at spot price and invests until the time of delivery. The bank earns a return on the yen that it invests for three months but also loses the return that it would have earned on the Saudi riyals or the US dollars that were used to purchase the yen. The differential between the two rates of return determines the premium or the discount on the forward transaction.

Interest can be avoided by requiring the Islamic banks to invest the yen or other foreign currencies purchased by them in a *Shari'a*-compliant manner. Forward selling is a less easy problem to overcome; Islamic teaching prohibits forward transactions in currencies. However, we live in a world where instability in the foreign exchange markets has become unavoidable. Yet it must be possible for businessmen, as well as Islamic banks, to reduce their exposure to this risk. It is indeed risky for them to carry unheeded foreign exchange or other assets on their balance sheets, particularly in crisis situations when asset values plummet. Without resorting to hedging, exposure to *gharar* is actually increased. In addition, one of the important objectives of the *Shari'a*, the protection of wealth (*hifz al-mal*), would be compromised unnecessarily.

Financial institutions, which provide the required protection through hedging, are perfectly qualified for this service because of their greater resources and better knowledge of market conditions. The fee that they charge can be Islamized by using Islamic instruments. The question is whether hedging could be accepted when exchange rates are unstable. To curb speculation and misuse of this facility, hedging could be confined to foreign exchange receivables and payables related to real goods and services only. Plus, this facility may be allowed only as long as exchange rates and commodity prices remain volatile. If not, then is it possible for *Shari'a* scholars to suggest other permissible mechanisms whereby individuals and businesses may protect themselves against commodity price and exchange rate risks.

Substantial developments have been made in finding ways to apply derivatives to reduce certain risks such as currency and commodity risks. For example, in Malaysia, some *Shari'a*-compliant hedging instruments, such as profit rate swaps, have been introduced. However, further work is still required as much of this progress remains localized with limited scope for cross-border application.

Credit risk

Recovery of debt in a timely manner is critical for the success of Islamic financing. In general, debt is created with actualization of the obligations of a client. Payment defaults, whether in lieu of some instalment or the principal, can adversely affect business plans of Islamic banks, their working and, above all, settlement with different groups of depositors. *Shari'a* law stops creditors from charging for payment delays. The prohibition of indexation for inflation of loans and debts can make matters worse in inflationary regimes. In an Islamic environment, these problems will have to be addressed at several levels. The nature of Islamic financial instruments implies that Islamic banks face not only the traditional commercial credit risk of their clients but also other risks associated with the instruments. For example, market risk for *salaam* financing or claims due to ownership of assets in lease financing. Several risks can be addressed through design of financial contracts. As for commercial credit risk of the client, Islamic banks can reduce it in the following ways:

- Pioneering collateral arrangements, third-party guarantees and credit rating of clients by specialized institutions.
- Vigilant evaluation of financial requests including credit ratings.
- Availability of choice of appropriate Islamic financial instruments.

- Prudent pricing of Islamic financial products.
- Proper covering contracts and efficient machinery for enforcement of contracts.

Legal risk

Islamic banks are functioning in many Muslim countries without proper legal cover (notable exceptions being Iran, Sudan and Malaysia). In general, legislative needs for Islamic banking can be minimized by legislating *Shari'a* principles and restrictions for contracts, while leaving practical details to the courts. Despite this, some aspects of legal risk do need to be scrutinized and understood. *Murabahah* means purchase and resale, which represents two separate transactions. This need not be seen as such for sales tax purposes, because Islamic banks do not buy things under financing for their own needs. Registration requirements and associated agreements need to be simplified as the associated costs may impede lease financing. Special legal cover is required in order to facilitate and implement *musharakah* agreements by Islamic banks. Adjudication of recovery of bank receivables is currently interest-based. Its alternatives need to be legally developed and provided for. One issue that continues to be relevant for the future is the prospect of Islamic banks working in the prevalent interest-based framework. It is obvious that Islamic financial instruments and their documentation and accounting requirement would be different. Therefore, the capacity for putting Islamic financial norms into practice in the existing framework might be limited. This, in turn, implies that Muslim countries should consider providing separate legal cover for Islamic financing.

Islamic-specific ratings agencies

While there are several mainstream ratings agencies that also rate Islamic financial institutions, including Standard & Poor's, Moody's and Fitch, the need exists for an Islamic-specific ratings agency, for several reasons:

- The assessment of the risk profile of an institution or product.
- Rigorous, consistent analysis of quantitative and qualitative factors.
- Removal of asymmetry in information on the range of business operations.
- Because investors in Islamic countries want to find out the creditworthiness and *Shari'a* compliance of the institutions and products.

An Islamic agency would not only consider the creditworthiness, overall risk management abilities and governance structures of obligors, but also the systems, processes and methodologies in place within the institution to ensure demonstrable *Shari'a* compliance.

Managing risk

In a conventional or Islamic banking environment, risk management follows this process:

1. Identifying and isolating the risks for management awareness and action.
2. Evaluating or assessing the risks (magnitude, likelihood of occurrence).

3. Measuring the risk (the impact of the risks on business and the organization's bottom line).
4. Mitigating or putting in controls to mitigate/address the risks (which will overcome the inherent risks so that only residual risks will remain).
5. Reporting the risks as they surface in steps 1–4.
6. Monitoring the risks to assess effectiveness of control measures that have been instituted.
7. Follow-up on the risks intermittently to minimize the likelihood of occurrence.

The Basel II framework

The Basel II framework should be seen as a more favourable way to do business even in the absence of specific guidelines for the use of Islamic banking operations. This is because when adhering to Basel II fundamentals and guidelines, any financial institution is supposed to be able to manage and select or access its credit risk, market or treasury risk and operational risk. These risk groups are interrelated and each cannot be managed in isolation. That is why, today, risk management approaches cover the whole range of risk groups under a one-strategy approach or via enterprise risk management. As such, credible financial institutions ensure that they understand the dynamics of all three risk groups. By adhering to Basel II guidelines a financial institution will not only be flexible, resilient and sustainable but will also be better able to use its capital resources to circumvent any unnecessarily large provision to cover the risks. The Basel II framework is recognized by financial institutions worldwide and compliance provides its own assurances.

Corporate culture, the risk management framework and a bank's framework for managing operational risk should cover the bank's tolerance and appetite for risk. The extent of how this is executed depends on a bank's corporate culture. There has to be close oversight for a bank relating to governance, corporate culture, accounting practices and internal controls. Equally, corruption is a risk that must be managed and eradicated. Transparency International is a world body that looks into the issues of corruption and publishes its Corruption Perception Index (CPI) to show which countries have societies where corruption in business and work culture are predominant.

Control, including the checks and balances against undesired actions, is the main tool banks use to manage their operational risks. A control structure can be accomplished by adhering to adequate policies, rules, and standard operating procedures as well as documentation to show that those procedures have been properly followed. Control is essential for any bank to operate soundly and safely. The concept of risk management must be instilled into the organization's work and corporate culture. Risks must be considered in every aspect of operations and transactions. All employees' annual appraisals and performance-ratings should include how well the inherent and residual risks have been effectively addressed and credibly dealt with. The following can help influence risk management culture in the workplace:

- Operational risk self-assessment performed by each business line.
- Mapping high, low and medium risks and addressing inherent risks using controls so that the residual risks remain clearly defined and understood.

- Developing key risk indicators for business and support groups.
- Continuous risk awareness sharing forums and sessions for updates on how to manage risks well.
- Make operational risk management one of the key performance indicators in staff members' annual appraisals.
- Link performance bonuses to good operational risk management.
- Personal Integrity and Good Corporate Governance.

The overall onus of oversight and monitoring of risk management is linked to the board members, who have ultimate accountability for everything that is happening in the bank. Risk management is all about ensuring that an organization or a bank's corporate governance is seen to always be in place and there is no compromise or laxity. Having a strong risk management committee can support a good risk management team, and independent directors as board members could help too. Corporate governance in conventional and Islamic banking is based on integrity, honesty, openness, transparency, accountability and responsibility.

Tools employed by financial institutions to manage the risk and credit administration include:

- Credit and lending policies.
- Discretionary powers and power of attorney.
- Tolerance limits and thresholds.
- Management action activation.
- Credit ratings and credit scoring models.
- Customers behavioural scoring models.
- Risk awareness, training and work culture.
- Minimum controls instituted and observed in the treasury transactions and receipts.

Do global investment banks take bigger risks?

At first sight, investment banks have enjoyed decades of prosperity. They expanded rapidly, took on thousands of employees and spread around the world. Wall Street firms swept through the City of London in the 1990s, picking up smaller merchant banks on their way. But under the surface, they were stitching up their risk-taking, despite being pioneers in developing risk management. It was increasingly hard to sustain themselves by selling securities as the traditional core of their business because commissions had reduced in size to fractions of a percentage point per trade. They took the decision to look elsewhere to make quick profits, gambling with their own – and later others' – capital.

Salomon Brothers were first to see the benefit of having a proprietary trading desk that bet its own money on movements in markets while the bank simultaneously bought and sold securities on behalf of its customers. Banks insisted that their safeguards to stop inside information from their customers leaking to their proprietary traders were watertight. However, that helped to sustain making profits for a while, which gave investment banks' trading desks an edge. Investment banks also expanded into the underwriting and selling of complex financial securities, such as collateralized debt obligations. They were helped by the Federal

Reserve's decision to cut US interest rates sharply after September 11 2001 ('9/11'), kick-starting a housing and mortgage-related securities boom. But there was a drawback: investment banks were taking what turned out to be very serious gambles. They did not have sufficient capital to deal with a slowdown in the housing market or markets generally. Soon the US's five biggest banks ended up short of capital and confidence.

At the time of writing, with 2008 drawing to a close, banks are being forced to scale back heavily or abandon their broker-dealer arms and become more like large hedge funds or private equity funds. Alternatively, risk assessment modules based on Islamic investment systems are creeping into their investment portfolios.

Chapter 16

Risk structures of Islamic finance contracts

Sunil Kumar
IRIS Integrated Risk Management

Introduction

Equitable distribution of wealth and income has been an issue which has been on the global agenda for a long time. Several renowned experts have made the point that for sustainable development, equitable distribution of wealth and income are a necessity. Exploitative financing has been at the root of wealth accumulation in the hands of the few, and is also a chief reason for social unrest and clashes.

Conventionally, financing activity has been based on wealth maximization, and this can be considered the root cause of the widening gap between rich and poor. Moreover, increasing focus on improving profits has added to the existing exploitation. Lending without a cause has already raised concern among the social thinkers. Financing purely based on interest rates is a questionable act. Financing for the sake of financing, without a relationship with the performance of financing activity, can be considered a sort of unjust charge on debt. Lending when not related to the cause and performance of the financed activity is a contributor to increasing exploitation. When the returns are not linked to the results of financed activity, the lender enjoys returns which are not truly risk related. This brings a new dimension to the risks in conventional banking. A large part of risks are thus related to interest rates. The major types of risks which exist in conventional financial activities include, but are not limited to, credit risk (CR), market risk (MR), Liquidity Risk (LR) and Operational Risk (OpRisk).

The foundation of Islamic Banking is based on the principle of equitable distribution of wealth and income and avoidance of exploitation. The linking of social and ethical dimensions to financing, which otherwise has no place in finance, changes the landscape on which financiers operate. It brings in new dimensions of risk. However, Islamic banking faces almost all the risks faced by conventional banks and some additional risks. The structure of risk in Islamic banking is different from that of conventional banking. The present chapter attempts to look into the risk structure of Islamic financial contracts. The analysis presented is generic and does not claim to be complete. This is largely due to several interpretations of Islamic financial contracts and their validity and applicability. An attempt has been made to provide an overview of the risk structures in order to initiate further research in this new area of study.

Islamic banking: an overview

As discussed before, equitable distribution of wealth is at the core of Islamic finance. There is no justification for pure debt financing in Islamic finance. It is based on equity financing and thus believes in participative financing which is also called Profit and Loss Sharing (PLS). As most popularly known, Islamic finance is based on four important principles:

(1) Prohibition of interest (*riba*).

(2) Prohibition of financing certain activities (*halal*).

(3) Avoiding uncertainty in contracting (*gharar*) and contracts in gambling (*maisir*).

(4) Payment of social tax (*zakat*).

The aims of these responsibilities are as follows:

- The prohibition of *riba* is to prevent financial exploitation and link the benefits to the performance.
- The prohibition of investments in *halal* activities is to bring in ethical and social dimension into lending.
- Avoiding *gharar* is to prevent gambling and uncertainty.
- *Zakat* is to enable flow of wealth from rich to the poor.

It should be noted that the social objective of Islamic finance cannot be separated from the financial objective and hence there is a strong social dimension to financing activity in Islamic finance. Continuing from the last paragraph, in conventional banking, returns are not related to the performance and purpose of the financed activity. According to Verse 2:275 of the Holy *Qur'an*, risk-free return is prohibited in Islamic finance. However, Islamic finance permits trading and thus links the returns to the outcome of the financed activity.

The rationale behind Islamic banking

Islamic banking is an attempt to provide a socially acceptable form of financing which is not exploitative, but which is participative, receptive to the needs of the borrower and carries a moral dimension. Islamic banking is aimed at improving the cause and results of financing activity by linking the reasons for financing. Islamic finance does not permit financing activities considered as *haram*. Also, the method of financing has a direct link with the reason. When financing is done with the intention of helping the borrower from a difficult situation, there cannot be any extra payments other than the principal which can be received by the lender. Only when the money is lent for participating in a commercial activity can the lender share the part of the profits thus generated from the business. At the same time, the losses should also be shared. Before there is any discussion on Islamic banking and the risk involved, it is necessary to have a look into how Islamic finance is structured in terms of principles and practices. The major sources of Islamic law are the Holy *Qur'an*, *pbuh*, *qiyas* and *ijma*. In addition there are four major schools of thoughts which affect Islamic law: Hanafi, Maliki, Shaifi'i, and Hanbali. Each of these is practised in different geographical regions in

the world and any decision by one of them is acceptable by the others. There are four ways of interpreting the law: *ijtihad* (interpreting efforts), *ikhtiyas* (choice), *dururah* (necessity), and *hiyal* (legal artifice).

Islamic banking *vis-à-vis* conventional banking

A great deal has been written on the differences between conventional banking and Islamic banking, most which has focused on structural aspects. The most common differences which are generally referred to in the literature can be summarized as below:

- Conventional banking has focus on financial efficiency without linking to the purpose of lending whereas Islamic banking prefers to link to the cause of lending and not just the financial efficiency.
- Conventional banking usually rests on interest rates, whereas Islamic banking does not.
- Conventional banking has more formal and legalized structures, whereas Islamic banking is still in its formative stage, is practised informally and does not have strong legal support in all jurisdictions.
- The main aim of conventional banking is to facilitate financial activities whereas the fundamental principle of Islamic banking is based on equitable distribution of wealth and income and justifiable social finance.
- Conventional banks offer deposit insurance which does not exists in Islamic banking.
- Islamic banking is open on both sides, lower and higher in terms of returns since it is linked to profits and losses made from the project. This means that there can be above average returns for depositors and investors due to high profits but losses have to be shared should the project go into loss. Conventional banking is protected on the lower side but there is a fixed-income-based model where the maximum earning on a project is known in advance.
- Conventional banking does not have a moral or ethical dimension as far as the reasons and effects of financing are concerned, whereas Islamic banking rests on moral and ethical dimensions.
- Conventional banking is supported by highly active money markets and overnight borrowing facilities whereas Islamic banking is not yet fully supported by money markets.
- Risk management and other banking practices are highly developed, formalized and widespread in conventional banking whereas this is not so in the case of Islamic banking.
- There are several formal educational and research programmes available in the domain of conventional banking all over the world, which is not the case with Islamic banking. This results in conventional banking having a steady flow of qualified manpower whereas Islamic banking faces a severe shortage of skilled staff.
- Conventional banking is very well accepted whereas Islamic banking is still increasing its acceptance.
- Finally, conventional banking is well supported by governments whereas Islamic banking is still slowly moving towards being an accepted form of banking with governments.

These differences are however generic and may differ in their implications. The differences are a fundamental source of uniqueness and identity of Islamic banking.

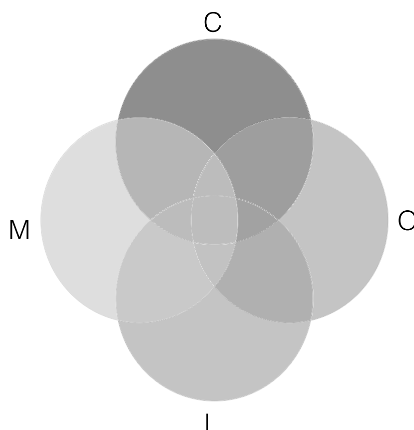
Risk profiling of Islamic banking

Intermediation leads to increased risk exposures in financial dealings. Conventional as well as Islamic banking are exposed to risks due to increased intermediation. Due to basic difference in form and purpose of lending, the risk profiles in Islamic banking are different from those in conventional banking. This section explores the risk profile of Islamic banking.

Important features of risks in Islamic banking

Islamic banking rests on participation and thus is based on sharing profit and loss as partners, so the funding and return on a project is not only on the amount and duration of the borrowing but also on the purpose and performance. The stress is on equity financing rather than debt financing. This changes the canvas of the risks. In conventional finance the canvas of the risk is narrower and carries only a financial dimension. In the case of Islamic finance, the canvas of risk is bigger and covers many extra elements due to participation, purpose and other restrictions attached to capability of payment. The most common risks, Credit Risk (CR), Market Risk (MR), Operational Risk (OpRisk) and Liquidity Risk (LR) exist in Islamic banking also (see Exhibit 16.1).

Exhibit 16.1
Risk overlap chart



Source: Author's own.

Credit Risk, conventionally a risk related to lending portfolio, exists in Islamic banking in the same way as in conventional banking. It refers to the non-performance of the counterparty as per the agreed terms. However, the reasons for the origin of the Credit Risk are different in Islamic banking. Market Risk which in conventional banking is based on four factors – interest rates, indices, derivatives and commodities – is based on only three in Islamic banking as it excludes interest rates. The Operational Risk is present in both, since it relates to systems, processes and people. In Islamic banking the additional dimension is *Shari'a*

Risk. Liquidity Risk exists in Islamic banking in the same way as in conventional banking; however the reasons for Liquidity Risk are different.

Issues related to risk management in Islamic banking

The risks behave differently in Islamic banking as compared with conventional banking. A few points which should be noted in relation to risks in Islamic banking are:

- Credit Risk is apparently higher in Islamic banking due to the non-availability of legal recourse for defaults, thus increasing the chances of defaults.
- Also, Credit Risk is higher in Islamic banking due to limited access to credit derivatives.
- Market Risk is through commodities, indices and foreign exchange.
- Operational Risk has another dimension of *Shari'a* Risk, which can be treated differently from Operational Risk.
- Liquidity Risk is perceivably higher due to non-availability of money markets, limited recourse to overnight borrowing and higher sensitivity of market and clients.
- Moreover, the additional factors such as deficient legal framework, standards, procedures, qualified manpower and qualified government support increases the risk exposures.

Thus risks in Islamic banking are far more complex than in conventional banking and need better understanding and analysis. Because they are more dynamic and are intermingled, they need special treatment. In order to understand the risks in Islamic banking, it is important to understand the structure of contracts in Islamic banking. An analysis on how contracts are structured and how risks exist in Islamic banking contracts is presented in the next section.

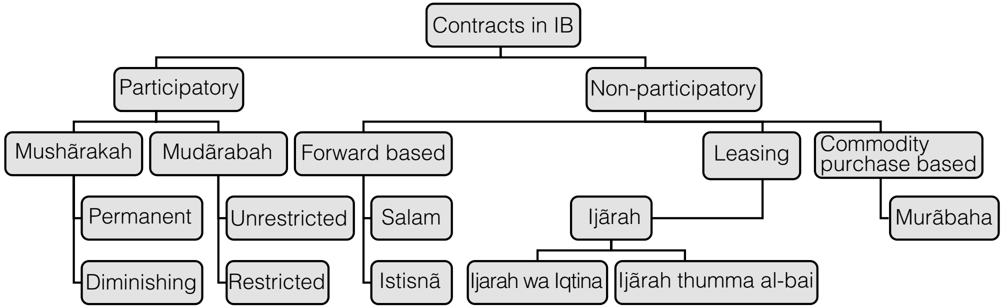
Islamic banking contracts and risk management

Islamic banking was originally practiced informally in several countries. The trade policies in the countries practising Islamic banking consisted of non-recognition of interest in business dealings and non-participation in prohibited activities. Hence Islamic banking contracts were structured with the objective of equitable distribution in mind, avoiding exploitation of the poor and non-recognition of interest as a factor. Trade practices were very similar all over the world as far as basic trade conditions are concerned. The common conditions of a valid contract are applicable in the case of Islamic banking also, namely free consent, consideration, no undue influence and so on. There is also an emphasis on clarity of the terms of contract to avoid *gharar*. The goods and services which are not owned by the contracting party cannot be a part of the contract.

There are six basic types of Islamic banking contract: *mudarabah*, *mushãrakah*, *murabaha*, *istisna'*, *ijarah* and *salaam*. Exhibit 16.2 shows the different types of contracts in Islamic banking. The two most common contracts in Islamic banking, *musharakah* and *mudarabah*, are thus based on participative financing where the bank lends money by way of participating in the business along with the client. Here the bank is not a mute financier who has no link to the business but is an active participant with profits and losses linked. The basic difference between the two is that in *musharakah* the bank takes part in the management with the financed

Exhibit 16.2

The types of Islamic finance contracts



Source: Author's own.

client, whereas in *mudarabah*, the bank is merely a financing partner having no active role in the management of the financed activity. However, in both cases, the bank shares the profits and losses and thus is not receiving fixed income from the financed project. The most popular, *murabahah*, commonly known as 'cost-plus' financing, is based on assisting with the current procurements in case of financial shortage. *Murabahah* has been dominating the scene for some time due to its large scale applicability over the product range. It is now used for financing consumer goods and often for small items of machinery and equipment to small and medium enterprises (SMEs). *Shari'a* scholars differ on validity of the use of *murabahah* and several of them request limited use of *murabahah*. *Salaam* was originally designed for assisting farmers in their business by assuring a forward price for the agricultural commodity. *Istisna'* is another exception along with *salaam*, where Islamic banking permits a forward contract; however, in *istisna'* the contract is used for manufactured (also constructed) products. And finally, *ijarah* is leasing (not financial). As a fundamental understanding, most of the Islamic banking products are a combination and variation of one of more of these contracts.

Structures of Islamic banking contracts

Islamic banking contracts have a unique structure which is not found in conventional banking. *Musharakah* and *mudarabah* have a cash flow pattern which is affected in a unique way. For example, under *musharakah* the bank may sell its share to the client on a regular basis, thus reducing his financing and finally terminating it. Also, the legal structure of an Islamic banking contract is different from the conventional counterpart and needs better structuring of terms and conditions. These six contracts have basic features and rules, which can be used in combination to create a required contract.

Risk profiling of Islamic banking contracts

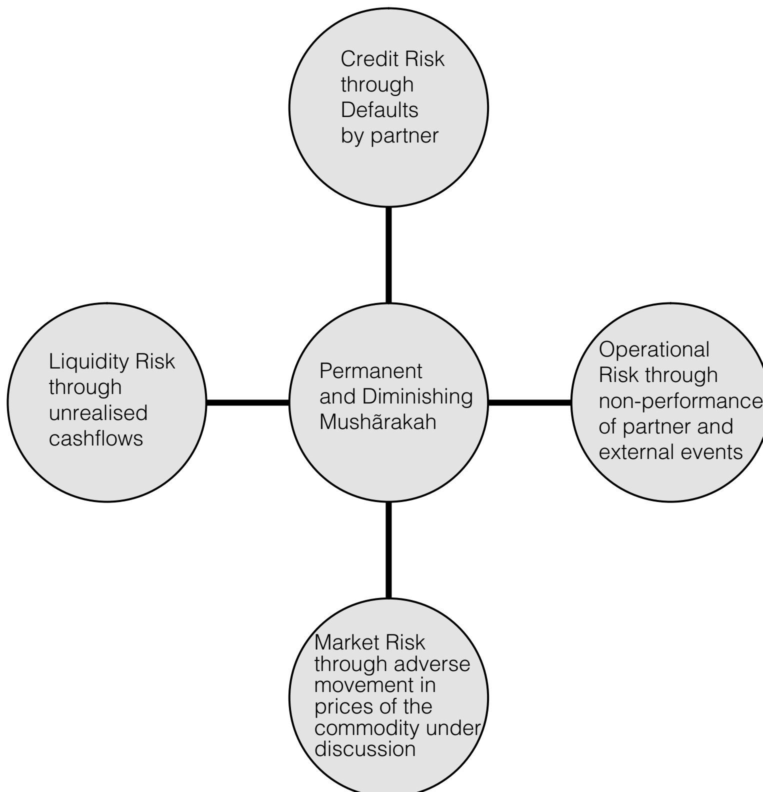
As discussed before, Islamic banking contracts carry a different risk profile. It is pertinent to notice and understand these in relation to the six basic contract types as presented in the

previous section. They carry different risk exposures based on the contract terms and fundamental rules of the contract. This analysis is generic and basic and a detailed study is needed in order to understand it in depth.[1]

Musharakah

Musharakah, which can also be termed equity participation, is one of the ways of financing projects under Islamic banking. Under *musharakah*, the bank enters into a joint venture with the client for a specific purpose. The bank participates in the management of the financed activity and is thus closely associated with the cause and effect of the project. This brings in a few additional dimensions such as monitoring and control. Thus on one hand the risk involved is less since the bank is associated with the management, but on the other hand, in cases of difficulty in monitoring and control, the bank may face higher risks. In this case the bank is not only a financier but also is a partner in the venture. The risk profile of the *musharakah* contract is shown in Exhibit 16.3.

Exhibit 16.3
Risk profile of the *musharakah*



Source: Author's own.

The bank is affected on all the four sides: Credit Risk, Market Risk, Operational Risk and Liquidity Risk. Since it is participative finance, the bank is exposed to Credit Risk from a failure to honour the commitment from the partner. Market Risk exposure is via the commodity prices in discussion. Within Operational Risk, the bank is exposed to several risks which can originate from the partner or outside forces. And Liquidity Risk is critical since if the bank uses *musharakah* to raise funds and cannot generate sufficient returns, there can be a call from the investors for their money, causing a liquidity crisis.

Since the profits are shared in agreed proportion but the losses are a proportion of the capital contribution, the bank is generally at a disadvantage since the capital contribution of the bank is higher. Also, if the project fails, most of the liability falls on the shoulders of the bank since it is a major capital contributor. In the case of a permanent *musharakah* whereby the bank keeps its share in the capital until termination of the contract, it is exposed to greater risk due to its long-term involvement.

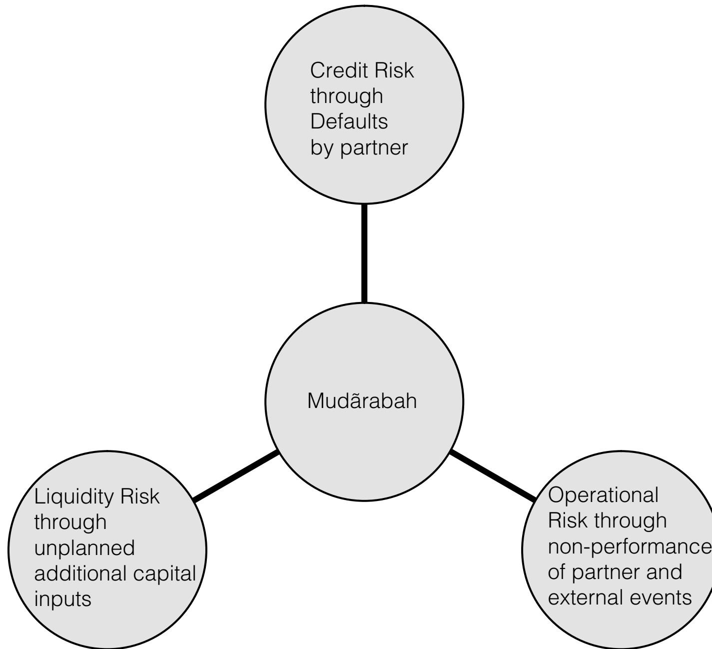
Mudarabah

This contract carries a higher risk as compared with *musharakah* since the involvement of the bank is only to the extent of capital contribution and has no role in the management of the financed project. Regular and detailed monitoring is not only difficult but also expensive. Moreover there is a danger of incorrect, insufficient and inconsistent information coming from the other partner. This form of financing is particularly useful by way of a two-tier *mudarabah*, whereby the bank accepts funds on the *mudarabah* account and then invests entrepreneurial activities. This form of financing is less preferable due to the inherent higher risk in the model. However, it provides the bank with an option to participate in financing activities without having the expertise and willingness to participate in the activities of the project (see Exhibit 16.4).

Murãbahah

Out of all the types of contracts in Islamic banking, *murabahah* is most popular due to its limited risk exposure for the bank. It is used widely for short- and medium-term financing through commodities. Conceptually, *murabahah* carries less risk since it involves a binding contract for the client to purchase the commodity under discussion as well as including security for the ownership of the commodity. The most common use of *murabahah* is for commodity financing. The bank first purchases the commodity for the customer at a cost then adds profit over it. The commodity is then sold to the client either for a fixed price, payable either immediately or in instalments. There are different risks at different stages of *murabahah*. Before the commodity is sold to the customer, the bank faces the Market Risk and Operational Risk due to changes in the prices of the commodity and due to ownership risks. After selling, if repayment is on an instalment basis, the bank faces Credit Risk through non-payment of instalments. This can further lead to Liquidity Risk due to changes in expected cash-flows.

Exhibit 16.4
***Mudãrabah* risks**



Source: Author's own.

Salaam

Salaam and *istisna'* (detailed in the next section) are the two exceptions to forward trading, which is not permitted in Islamic banking. *Salaam* has been extensively used for financing in-process inventory as well as for financing working capital requirements. The payment is spot and the delivery of the commodity under contract is in future. There are diverse views about the validity of the s*alaam* contract for commodities other than agricultural goods. The risk profile of *saalam* is similar to a commodity future contract, whereby the usual risks of unfavourable changes in the future scenario may affect the contract. When a bank promises to receive a commodity in future it is exposed to market risk through commodity prices when the contract matures. To overcome this, parallel *salaam* is used, whereby the bank enters into a parallel sell agreement at an agreed price, thus sealing the exposure. Nonetheless it should be noted that this reduces the bank's profit margin significantly.

Istisna'

A forward contract for manufactured goods (as well for construction projects) is managed using *istisna'*. It can be used for linking payments based on the progress of the project. It is commonly used for medium- and long-term purposes. In many cases the bank enters into parallel *istisna'* contracts whereby it agrees to manufacture a particular commodity for a

client based on one contract and passes on this to a manufacturer by another contract. *Istisna'* carries extensive risk in terms of non-performance as per the agreed terms, defaults and delays and several legal entanglements. It is exposed to Credit Risk through non-payments and delays and thus further exposure to Liquidity Risk due to changes in the cash-flow pattern. It is also exposed to Operational Risk due to external factors affecting the performance of the contract. *Istisna* is exposed to Market Risk through changes in the prices of the underlying commodity at the time of delivery.

Ijarah

Ijarah is used for lease financing, including operating lease and financing lease. It is used very commonly in corporate financing. The bank will acquire the asset for the client and lease it for a specific rent which is decided in advance. The ownership rests with the bank for the duration of the contract and is generally transferred at the end of the contract. However this can be made optional whereby the client may or may not purchase the asset. Where there is an agreement that the client will purchase the asset at an agreed price, it is called *Ijarah wa iqtina*; otherwise it is called *ijarah thumma al-bai*. It is evident that the two types of contract have different implications for the bank in terms of risk profiling. The bank in all cases is exposed to Market Risk and Operational Risk through the market price of the asset and ownership-related risks.

Summary and conclusions

Several factors have contributed to the growth of Islamic banking, but this phenomenal growth is not without concerns. Islamic banking fundamentally is based on few basic contracts which can be used to create products as desired. The risk profiles of these products reflect the risk profiles of these basic contracts, and are dynamic and complex. Islamic banking is fundamentally different from conventional banking and it is suggested that since Islamic banking does not have interest rates as a variable in the risk equation, it is less risky. This remains a fallacy, since the risks are more dynamic in Islamic banking and they are also generally higher for several reasons including, but not limited to:

- an unstructured Islamic banking market;
- limited availability of money market instruments;
- underdeveloped legislations;
- absence of globally accepted norms and standards; and
- infancy of Risk Management practices.

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[1] Akkizidis, Ioannis and Khandelwal, Sunil, *Financial Risk Management in Islamic Banking and Finance*, Palgrave McMillan, UK, 2007.

Part III

Products

Chapter 17

The potential of Islamic finance in the global market

Aly Khorshid
Elite Horizon

Introduction

Islamic finance and Islamic banking has expanded beyond the regional boundaries of the Middle East into the world of global capital markets to a tremendous value of a trillion dollars in the last three decades. Significant new players are now entering the market, while some well established institutions have expanded their geographical investment. Above all, the major international players, such as Citigroup, Deutsche Bank and HSBC, have further enhanced their Islamic finance capabilities. Other conventional regional banks like CIMB and Maybank in Asia, have opened Islamic subsidiaries and are immediately advantaged in the market place. In addition, financial institutions such as the National Commercial Bank (NCB), Kuwait Finance House (KFH) and Al Rajhi Bank have made significant acquisitions in Turkey and have also made their footprint in Malaysia. These factors have resulted in an increase in the diversity and quality of different product offerings and has encouraged innovation and sophistication. Furthermore, the basis of change in this unusual global growth has intensified the competitiveness of the Islamic finance market. While Islamic banking and finance continues to grow at a rapid pace, there is increasing pressure on institutions to increase cross-border penetration of mature *Shari'a*-compliant products trading markets in the West and to deliver on customer expectations.

According to McKinsey's 2007 *World Islamic Banking Competitiveness Report*, Islamic banking assets (excluding Iran) are on track to exceed US$1 trillion by 2010. Both their growth rate and profitability are better overall than their conventional peers in the Middle East region. The future high potential growth areas include *sukuk,* wealth management and infrastructure/project finance structured deals. The potential markets for expansion observed include the USA, Europe, Turkey, Egypt, Morocco, India and China.

Although the implications of the global credit contagion and liquidity crunch are still uncertain, the Middle East banks seem to be well positioned to weather the crisis and possibly benefit from strategic undervalued buy opportunities in the West. The aim is consistent with the existing players' increasing aspirations for cross-border expansion.

A number of countries including the UK, Singapore, Hong Kong and Indonesia are pushing to tap the rapid growth of Islamic banking. For example, the UK government has

set a clear objective to make the UK the global gateway for Islamic finance and the UK Treasury is expected to issue a sovereign government *sukuk* to become the first Western country to lead in issuing sovereign *sukuk*. In Hong Kong, the *Shari'a* Advisory Council was recently established and in Indonesia the Central Bank is encouraging Islamic banks to accelerate their efforts to reach US$10 billion in assets by 2008. A number of these international financial centres are focusing their efforts on the fast track growth of *sukuk* linked to mega infrastructure and real estate projects as well as the advent of wealth management services including asset management.

Currently, the growth of Islamic banking and finance also faces certain important challenges. These include raising customer awareness and education, increasing penetration of the non-Muslim customer segment and enhancing brand recognition. Consequently, key players in the industry are focusing on leveraging their capital base, expanding cross-border presence and improving risk management, particularly in credit and equity investment risks.

Firstly the evolution and constraints of the global Islamic capital market will be discussed; secondly, the undeveloped potential for retail banking in emerging markets will be explored; thirdly, the sudden demand for Islamic banking hubs in the Middle East, Europe and Asia and the challenges faced by the industry will be outlined.

The global Islamic capital market constraints

The general agreement points towards an industry that is now worth between $480 billion and $500 billion and is conservatively believed to be growing at an annual rate of 15%. At the start of 2008, more than 300 Islamic financial institutions were offering *Shari'a*-compliant banking services in over 75 countries, according to Zeti Akhtar Aziz,[1] Malaysia's Central Bank Governor. Islamic investment management continues to expand, as does the global *Shari'a*-compliant capital market, also the market for Islamic insurance (*takaful*) expanding rapidly. According to Moody's and ratings agency, there are now about 250 providers of *takaful* worldwide, which between them generated premium income of more than $2 billion in 2005.[2]

There is no indication that growth in the Islamic financial services is likely to slow down in the near future, its expected by the year 2010, assets held by the world's Islamic banking community will reach the $1 trillion mark, regarding the insurance sector published by Swiss Re reveal that by 2015 *takaful* premiums in the MENA (Middle East and North African) region will have risen to $3.3 billion (up from $650 million in 2005), with Malaysian premiums expanding over the same period from $395 million to $1.23 billion. Elsewhere, the Swiss Re projections see *takaful* premiums reaching $1.2 billion in Indonesia by 2015, $851 million in the US, $269 million in the UK, $173 million in Africa and $18 million in Turkey[3] according to a report published by McKinsey & Co at the end of 2007.[4]

Islamic retail banking: undeveloped potential

The evolution of Islamic banking in the global market for retail financial services has been much more fragmented. In part, this is due to retail banking itself remaining very underdeveloped in many parts of the Islamic world. Even in a relatively wealthy economy

such as Saudi Arabia, penetration of retail financial services remains low, with substantial room for expansion in areas such as personal loans, credit cards, insurance-related instruments and home loans. Also in Egypt, one of the world's most densely inhabited Muslim nations, only 10% of Egypt's population of 80 million have bank accounts, while household debt is estimated at around 8% of GDP, which is well below developed market levels.[5] Mortgage finance, which plays a vital role in conventional banking systems, continue to be undeveloped throughout the Islamic world. According to the World Bank housing finance as a percentage of GDP is about 3.5% in Oman, 8.3% in Saudi Arabia and 12.6% in Kuwait, compared with more than 50% in the US and the UK.[6] There is potential for increasing these modest shares, and the social benefits that would accrue as a result are considerable. Given that a market for Islamic mortgages is starting to flourish in a number of countries, *Shari'a*-compliant banks have the opportunity to expand into this largely dissatisfied demand for housing loans.

European potential in Islamic retail banking

In Europe, where the record in terms of the evolution of *Shari'a*-compliant retail financial services has been most irregular, even though the Muslim population of Europe has been estimated at 15 million, and is growing much faster than the average birth-rate across the European continent, by 2050 one in five Europeans will be Muslim. France alone is a home to a six million Muslims from north Africa, while in the southern port city of Marseilles Muslims now account for as much as 25% of the population.

Historically, France has proved not to be fertile territory for Islamic banks but this does now seem to be changing with the arrival of branches in Paris in 2009.

It is not that French banks have no interest in or understanding of Islamic banking. BNP Paribas was ranked by Euromoney as the world's eighth largest bank by shareholders' equity in 2006. It operates in more than 85 countries, employs over 160,000 people and has been rated by *Fortune* as the sixth most admired global banking brand in the world,[7] BNP Paribas describes itself as 'a pioneer in Islamic banking', and with good cause: as early as 1985 it introduced one of the world's first *murabahah* deposit schemes, providing Islamic banks with a short-term outlet for their liquidity, In the 1990s, the bank launched the Caravan Fund, which was one of the first Islamic Global Equity Funds. And in 2003 the French bank set up BNP Paribas Najmah in Bahrain 'as a global entity with the mission of providing Islamic solutions within its chart [sic] of excellence worldwide'. In 2005, BNP Paribas acted as mandated lead arranger and documentation bank in the landmark $1 billion *istisna'* and *ijara* facility for Dolphin. However, this commitment contrasts with the availability of retail Islamic banking services in France. At the time of writing BNP Paribas had 2,200 branches located throughout France, and enjoys a 15% share of the greater Paris market for retail banking services. But in common with other French banks, it has yet to offer *Shari'a*-compliant financial services to its retail customer base.

Germany is another European economy that also should be fertile ground for the development of Islamic retail banking services. Germany has a Muslim population of about 3.5 million, of which 2.6 million are of Turkish origin. Turkish residents in Germany save twice as much as Germans themselves, which means they constitute a market worth some €1.5

billion annually. Another survey has indicated that almost a quarter of German residents of Turkish origin are opposed to paying or receiving interest for religious reasons.[8] But as in France, while a number of German banks have played a very active role in supporting the development of the global institutional market for Islamic financial services, retail *Shari'a*-compliant products are still hard to find in Germany.

Elsewhere in Continental Europe, there have been similarly tepid attitudes towards the potential of retail banking services for Muslims. In June 2007, the website *Islam in Europe* reported that although there are 400,000 Muslims in Sweden, leading Swedish banks have shown virtually no interest in providing *Shari'a*-compliant banking services on their behalf. The website quoted a spokesperson for the Muslim Association of Sweden, which has some 700,000 members, as saying that his enquiries to three of the largest Swedish banks had fallen on deaf ears.[9]

It is difficult to grasp why a number of leading Continental European retail banks have been hesitant or reluctant to channel resources and marketing into Islamic banking services. The perception among banks appears to be that customers demanding *Shari'a*-compliant products are generally likely to be less profitable than those depending on conventional banking services, given that disposable income levels are generally lower among Muslim minorities in Europe than among other religious denominations. These relatively unattractive opportunities are not purely the preserve of the retail-banking sector in a market like France. By example, in November 2005 BBC News profiled the 55-year old French industrialist, Yazid Sabeg, who was described as 'a rarity among France's business elite'. Sabeg is Chief Executive of CS, a French communications group with an annual turnover of €400 million, the only person of North African origin to head a leading French company.[10] This would suggest that opportunities for high-volume, profitable corporate Islamic banking in France are likely to be muted. Another reason why retail financial Islamic services have yet to be made more extensively available in Europe is that politics has had an influence in shaping the evolution and even the nomenclature of financial services in a number of countries.

In the most extreme case, Christian south Sudan has banned Islamic banking altogether as one of a number of symbols re-affirming the social, economic and religious divide between the south and the Muslim north, where Islamic banking is mandatory. A less extreme case is Turkey, eager to maintain its secularity, which prefers to describe its *Shari'a*-compliant institutions as 'Special Finance Houses' or 'Participation Banks' rather than Islamic banks. In France, the lengthy shadow that the extreme right continues to cast over the political landscape may be one reason why the domestic financial services industry has hesitated to embrace the concept of *Shari'a*-compliant banking. The same may be true in Austria, where popular opposition to Turkey's proposed accession to the EU has been so vocal.

The UK's leading role in Islamic finance

A striking exception to the rule in Europe has been the UK, where the banking industry has demonstrated that the provision of Islamic financial services can be successfully

nurtured without jeopardizing profitability or enflaming a xenophobic or religiously bigoted social backlash.

In Britain, home to an estimated 1.8 million Muslims, chiefly of Pakistani and Bangladeshi origin, retail Islamic banking services have been growing very rapidly in recent years. This is chiefly thanks to a key legislative change enacted in April 2003, which underscored the UK's commitment to supporting the growth of *Shari'a*-compliant banking.

Prior to 2002, the only institution offering Islamic mortgages in the UK was the United Bank of Kuwait (UBK), with other potential lenders deterred by a tax regime that effectively levied double stamp duty on *Shari'a*-compliant home loans. The alteration of tax law abolishing double stamp duty immediately made Islamic mortgages affordable, encouraging HSBC to begin offering a range of these products in July 2003, when the Financial Services Authority (FSA) gave its formal authorization to the Islamic Bank of Britain (IBB).[11]

The establishment of IBB marked the first time that the UK's Muslims were offered access to retail banking services 'from a British bank which is established and managed on a wholly *Shari'a*-compliant basis'. IBB explained at the time that in keeping with Qur'anic doctrine, its Islamic mortgages would be based on partnership principles: 'under the new plan.' IBB tells prospective customers, 'homebuyers simply need to find a property and agree a purchase price with the vendor. The bank and the customer will then purchase the property together, with the bank leasing its share of the property to the customer for an agreed period of time. The customer makes a monthly rental payment to the bank, for the use of the bank's share of the property. In addition to the rental payments customers will usually make additional monthly repayments to buy out the bank's share in the property.'

Although IBB's latest annual report (for 2006) indicates that the bank is still making a loss, it has clearly come a long way in a short time in terms of rolling out its *Shari'a*-compliant franchise. By the end of 2006 the bank had opened eight branches across the UK, attracting almost 31,000 customers (compared with just over 14,000 at the end of 2005). At the end of 2006 more than 51,000 accounts had opened with deposits reaching £84 million, up from £48 million 12 months earlier, and total customer financing advancing to £10.4 million, versus just £4.5 million at the end of 2005. Among other mainstream UK banks, Lloyds TSB announced in June 2007 that it would be making *Shari'a*-compliant current accounts and mortgages available to all customers at each of its 2000-plus branches throughout the UK. The Lloyds TSB initiative was reportedly the result of research carried out by the bank that concluded that more than 75% of British Muslims wanted financial services that did not violate their faith.

Lloyds TSB and other providers of Islamic financial services have thus been eager to emphasize that their *Shari'a*-compliant range of products is open to followers of any (or no) religious faith. At the opening of the IBB, its managing director Michael Hanlon stressed that the bank's offering provided an opportunity 'not only for those who follow the Islamic faith, but also [for] anyone who is interested in an ethical yet modern and efficient banking service'. A clear indication that the potential for Islamic banking as an efficient alternative to conventional financial services had started to seep into the popular British psyche came at the start of 2008 when stock markets were in mini meltdown-mode in anticipation of a recession in the UK.

The response from listeners was generally positive, although their calls and e-mails exposed a number of misunderstandings about *Shari'a* finance. One caller from Leicester, for example, said that she was attracted by the concept of an Islamic mortgage but questioned whether or not – as a woman – she would be allowed to step into the branch of an Islamic bank to collect an application form. It is, therefore, clear that there are still numerous educational challenges to be addressed before the potential of *Shari'a*-compliant mortgages can be realized, even in a relatively well-developed market like Britain.

The UK financial services industry has demonstrated that there is no reason why *Shari'a*-compliant banking products need be confined to mortgages and other basic retail products. Buoyed by its success in the *Shari'a* mortgage market, in January 2008 Lloyds TSB built on its Islamic franchise with the introduction of the first *Shari'a*-compliant Nostro Account to be offered by a mainstream western bank.[12] This example represents an important step forward for Islamic financial services in Britain. In addition to supporting individuals who need to send money overseas in a secure way, it also allows the estimated 100,000 Muslim-owned companies in the UK to transmit and receive international payments. According to Lloyds TSB, 'the Nostro account adheres to the principles of Islamic law, because it does not pay interest on money that banks hold in the account; it does not provide an overdraft facility; and it does not allow any of the funds held to be invested in industries – such as alcohol and gambling – which are prohibited under the rules of the faith'. With Continental Europe unsure about the provision of Islamic financial services, there is no reason why UK-based lenders should not capitalize on their experience by expanding into other areas of the EU.

IBB, for example, advises that, 'under EEA (European Economic Area) regulations, we should, after at least two years of satisfactory operation in the UK, be able to extend our operations into other parts of the European Union. France and Germany are countries of specific interest due to the number of Muslims resident in those countries'. To date, however, IBB has been focusing exclusively on the development of its Islamic franchise in the UK.

Beyond Europe, a number of other countries with sizeable Muslim minorities have seen a growth in Islamic financial services. The Muslim Community Co-operative of Australia (MCCA), for example, was established in 1989 and by 2006 had almost 7000 members.[13] MCCA has opened up considerable opportunities for Australia's Muslims (who make up an estimated 1.7% of the population) to invest in the stock market via its *Shari'a*-compliant Crescent Ethical Fund and to finance home-ownership via Islamic mortgages.[14]

The need for Islamic banking in Muslim-populated Europe

Although they have made a significant contribution to making the Islamic finance option available to Muslims and non-Muslims alike, organizations such as IBB in the UK and MCCA in Australia inevitably remain very small, niche players within the global financial services industry. The growth pattern in Islamic banking has been contrary to that seen in western markets in recent years, Fitch observed in its report published in March 2007.[15] 'Whereas for the latter the focus has often been on consolidation, Islamic banks have burgeoned in response to increasing demand.' The consequence has been that few – if any – *Shari'a*-compliant banks domiciled in the Islamic world have built up anything like the

critical mass that would be required of banks able to compete effectively on a global stage with the heavyweights of the conventional banking universe. Indeed, it is telling – as *MEED* pointed out in February 2007[16] – that a London-based newcomer such as the European Islamic Investment Bank (EIIB) should have a larger capital base (of $200 million) than many of its Gulf-based competitors. Meanwhile, at a broader global level, according to data cited by Malaysia's Dr Zeti Akhtar Aziz, at the start of 2008, the total global Islamic financial assets was still equal to just 40% of those of the single largest conventional bank.[17]

Retail banking in South-East Asia

In South-East Asia, for example, the longest-standing regional player is Bank Islam Malaysia, which states that its vision is to 'be the global leader in Islamic Banking'. Established in 1983, 'with a network of 90 branches nationwide', Bank Islam affirms that 'the bank parades a comprehensive list of more than 50 innovative and sophisticated Islamic banking products and services, comparable to those offered by its conventional counterparts'.[18] This is accurate. However, until recently, with the signing of a co-operation agreement with the London-based EIIB in September 2007, Bank Islam's focus has been a very localized one.

In recent years, DIB has started to spread its wings, in terms of the products it has developed, the partnerships it has formed and the international acquisitions it has made. In the investment banking sphere, for example, DIB has teamed up with Barclays Capital to lead manage a number of the largest, most successful and widely distributed *sukuk* transactions ever launched. Meanwhile, overseas, the bank has started to explore opportunities outside in the Gulf. In 2005, it acquired 60% of Bank of Khartoum in Sudan, which has since announced that it is joining forces with Emirates and Sudan Bank (ESB), while the following year its fully owned subsidiary in Pakistan opened its first branch in Karachi. On a global basis, however, DIB remains a relative minnow. As of June 2007 it had total assets of just over $20 billion, which meant that it ranked as the fifth largest bank in the already over-crowded UAE market. Like DIB, a number of other Gulf-based Islamic specialists have been attempting to flex their muscles internationally, either by expanding their operations overseas or by announcing their intention to do so. Kuwait Finance House (KFH), for example, which dates back to 1977, making it the second oldest dedicated Islamic player, has established independent banks in Turkey, Bahrain and Malaysia.

Potential retail banking in the Middle East

In a recent signal of the potential for Islamic banking is Bahrain's Ahli United Bank (AUB), which is a relative newcomer to Islamic banking. At the start of 2008, AUB announced that it plans to increase the number of its Al Hilal Islamic branches from four (two in Bahrain and two in the UK) to 50 over the next two years, many of which will be located outside its home market. As Reuters reported in January 2008, the bank 'is in talks with the Egyptian Central Bank for an Islamic licence and will open another branch in Bahrain within a month and four more in Qatar this year'.[19]

It is clear that the source of power economies in the GCC are aware of the weaknesses inherent in highly fragmented banking sectors that do not have globally recognized brands able to compete on the global stage with the established multinational players of American or European parentage. In the UAE banking sector, a process of consolidation in the banking industry has begun with the merger of Emirates Bank and the National Bank of Dubai, which has created the largest financial institution in the UAE.

Furthermore, among specialist Islamic players capable of planting a larger footprint in the global market, a more recent new entrant to the Dubai banking market is Noor Islamic Bank (NIB), a full-service *Shari'a*-compliant bank with capital of $1.1 billion, which started operations at the start of January 2008. NIB is 50% owned by the government of Dubai and has an unequivocal objective of establishing itself as a global colossus in the Islamic banking industry. Commenting on the opening of the new bank, Sheikh Ahmed Bin Saeed Al Maktoum, who has a 25% holding in NIB, said that it represented 'the new dawn in the region'. He also confidently proclaimed that 'Noor will be the turning point in an industry that is rooted here but will grow globally to become the world's leading *Shari'a*-compliant financial services provider'. According to the press release accompanying its launch, NIB will initially focus on offering its services in the UAE, but 'intends to extend its footprint in the Middle East, Europe, the Far East and North Africa regions'.[20]

Constraints accelerating globalization in Islamic capital markets

In spite of the impressive growth rates posted in the international Islamic capital market in recent years, there are a number of constraints to its further development. The first of these is that, as a general rule, the administrative costs of issuing a *sukuk* or other Islamic instrument are higher than those that a borrower would incur for a conventional instrument of a comparable size and maturity. *Business Week* confirms in an article published in 2005 that 'while profit margins on *Shari'a*-compliant products are comparable with interest rates on non-Islamic investments, they often cost more to set up'. One reason for this is that all new instruments tailored to be *Shari'a*-compliant need to be approved by boards of highly qualified *Shari'a* scholars, whose time and expertise do not come cheap. Borrowers that have raised money in the *Sukuk* market – and the banks that have arranged their transactions – have by and large been prepared to shoulder these added costs, which they view as a reasonable *quid pro quo* for tapping into a new and very deep-pocketed investor base.

According to the AAOIFI, such a promise is in violation of the concept of risk and profit sharing, which underpins the principle of a *sukuk*. In addition to the controversy over experts' views on the compliance of Islamic instruments is the issue of availability of scholars with the necessary experience and qualifications to be capable of assessing the suitability of highly complex financial securities. In view of this, a *MEED* article published in February 2007[21] reveals that there are no more than approximately 150 scholars qualified to sit on financial institutions' *Shari'a* boards. However, only a minority of these experts have the 'international clout' demanded by global banks and financial institutions.

A further constraint on the longer term development of a broad and highly liquid Islamic capital market is the uncertainty over the extent to which derivative instruments can be tailored to be compliant with Qur'anic teachings. The salient point here is the Qur'anic pro-

scription of *gharar,* or uncertainty, which applies to most derivatives structures. Views differ on whether or not innovative banks and their *Shari'a* advisors will be able to agree on derivatives that are acceptable to the financial community and Islamic scholars alike. Nevertheless, it seems improbable that it will be possible to develop – for example – a liquid market in *Shari'a*-compliant credit default swaps (CDS) in the foreseeable future.

In spite of these constraints, the general consensus is that Islamic financing structures cannot help but play a pivotal role in the colossal investment that the Middle East in general – and the oil-rich members of the GCC in particular – plan to channel into infrastructure-related projects over the coming decade. Again, estimates of the region's total funding requirements vary widely, but some idea of their magnitude can be derived from figures published by the Dubai-based private equity house, Abraaj Capital, which has recently put the total for the next decade in the Middle East and South Asia at an outstanding $630 billion.[22]

Market potential

For the market in *Shari'a*-compliant debt-related products, a global Islamic market in equities is also taking more recognizable shape. Efficient screening procedures have fuelled a notable expansion in the market for equity funds acceptable to Muslim investors. According to a presentation delivered by the Bahrain-based Unicorn Investment Bank in 2006, the number of dedicated Islamic equity funds rose from just 9 in 1994 to 126 in 2006.[23] Meanwhile, assets under management at *Shari'a*-compliant equity funds expanded from $800 million in 1996 to $15.8 billion by 2005, according to the same source.

International co-operation between investment managers and other service providers has made a key contribution to the growth of this market. S&P reports that the global universe of *Shari'a*-compliant equities is worth more than $20 trillion. As a measure of how global this market has become, in January 2008[24] S&P added three new benchmarks to its family of *Shari'a* indices, covering large and small cap global companies as well as UK-based entities. Small Cap World *Shari'a* measure the performance of more than 4500 *Shari'a*-compliant equities with an adjusted market capitalization of just over $18 trillion from 26 'developed' markets, including the US, Australia, Hong Kong and South Korea as well as Europe. The S&P UK *Shari'a* Index includes 301 companies domiciled in the UK, with an adjusted market capitalization of just under $2 trillion.

In a report published by a ratings agency, Fitch Ratings[25] points out, 'Islamic finance is not a new phenomenon, having been practised since the Middle Ages, but has risen in prominence over the last 30 years'. Many Islamic scholars will inevitably attribute the recent growth in the industry to the definite benefits it appears to offer in comparison with conventional banking, and recent precedent would seem to support several of the arguments put forward by advocates of the *Shari'a*-compliant alternative.

For example, the Abu Dhabi Islamic Bank's website[26] gives a very concise comparison of the two systems, pointing out that in the interest-based system 'excessive use of credit and debt financing can lead to financial problems'. This is an irrefutable statement given the recent sub-prime crisis, which could not have unfolded in a *Shari'a*-compliant banking market. One explanation for this is that rather than repackaging the excessive risks

in the form of collateralised debt obligations (CDOs) and other dubiously engineered products, banks would have shared the risks and rewards according to a pre-arranged ratio.

There are a number of reasons for the recent explosive growth in Islamic finance other than the notion that there has been a sudden upsurge in religious consciousness. Fitch, for example, states in its analysis published in March 2007 that the rise in eminence of this financial industry is 'largely due to the growing financial resources of oil-producing countries where Islam is the main religion, increasing wealth and financial sophistication and increasing demand for financial services'.

Factors contributing to the growth of Islamic finance

A further factor commonly cited as contributing to the growth in the market is the atrocious events of September 2001 and its immediate aftermath, which saw the expatriation of substantial switch of investments held by Middle Eastern investors in the US to the Middle East. Many of those funds flowed back to the Middle East after 9/11, searching in the process for *Shari'a*-compliant homes. This observation seems to be shared by the authors of a report published at the beginning of 2008 by the Kuwait-based Global Investment House[27] which notes, somewhat obliquely, that 'as a result of the US policy towards certain financial organizations and charitable foundations, the Muslim world has reacted by increasing the demand for more Islamic banking'.

In addition to this, the Global report asserts that there have been further incentives for exploring *Shari'a*-compliant alternatives: 'Gulf investors found that more money can be made in Islamic banking than their conventional counterparts given [that] the regulatory regimes in the Islamic banking industry are still developing.'

Trends over the last two decades in terms of rising demand for financial services aligned with the Qur'anic message that 'God hath permitted trade and forbidden usury' (II, 275), have seen the progressive build-up of the institutional capacity needed to support the development of a relatively new, globally accepted financial market. For example, an important landmark was passed in 1991 with the creation of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), which is based in Bahrain and has been responsible for drawing up widely recognized guidelines on accounting, auditing and governance as well as codes of ethics and *Shari'a* standards. AAOIFI continues to introduce new standards, recently announcing that by 2009 it will have launched more than 90 such initiatives.[28]

An important contribution to the development of the sector has also been made by the International Islamic Financial Market (IIFM), which was set up in 2002 in order to strengthen co-operation between various supervisory bodies as well as between those entities and the Islamic Development Bank (IDB), with a view to harmonizing *Shari'a* interpretations of various Islamic financial products and practices. Since 2003, those of the Kuala Lumpur-based Islamic Financial Services Board (IFSB) have also complemented the activities of the AAOIFI and the IIFM. The IFSB serves as an 'international standard-setting body of regulatory and supervisory agencies that have vested interests in ensuring the soundness and stability of the Islamic financial services industry, which is defined broadly to include banking, capital markets and insurance'.[29]

Education offered for skilled personnel in the Islamic finance industry

The IFSB has been working in close co-operation with the Basel Committee on Banking Supervision, and its members include 37 regulatory and supervisory authorities as well as supranational bodies such as the IMF and the World Bank. These institutions have indeed been instrumental in formalising the industry. A recognized and accepted regulatory structure of the Islamic finance movement is an imperative consideration given that prior to the establishment of official formal institutions such as these there had been a number of scandals associated with entities marketing themselves as 'Islamic' units. The opening of these institutions has dovetailed with scores of initiatives around the world aimed at establishing training programmes for existing or would-be bankers eager to gain an understanding of the Islamic financial market.

Many of these have been industry-based, with banks and ratings agencies as well as media groups such as *Euromoney* offering a regular series of workshops, seminars and training courses in Islamic finance. Others have been developed under the auspices of academic institutions. In the UK, according to a report published early in 2008 by *The Independent,* there are 25 PhD students studying Islamic finance at UK Universities.[30]

Lancaster University Business School is offering an optional module in Islamic finance in co-operation with Cass Business School and the School of Oriental and African Studies (SOAS), Centre for Financial and Management Studies, with SOAS also offering an LBA degree in Conventional and Islamic law. Loughborough University is offering an MSc degree in international banking and Islamic finance. Oxford Academy UK, a London- based education institution, is offering an MBA degree in Islamic finance, capital market and conventional banking both as distance learning and under class tuition, in association with UK Universities and Al-Azhar University (Egypt). They also plan a number of short courses and workshops planned for 2008/2009. Bangor University business school is offering Islamic banking and a conventional banking Masters degree.

Growth potential in *Shari'a*-compliant products

The main impetus for the expansion and internationalization of the Islamic financial services industry has come from the banking community itself. While numerous new Islamic banks have sprung up in a wide range of Muslim-majority countries over the last two decades, the potential growth of the industry has not been lost on the multinational players. As early as July 1996, Citi Islamic Investment Bank which was incorporated in Bahrain as a 100%-owned subsidiary of Citicorp had been offering specialist *Shari'a*-compliant products through Islamic finance windows within the bank for at least a quarter of a century prior to the opening of its Bahrain operation. Since then, virtually all of the heavyweights in the international banking industry have followed suit by establishing Islamic banking units in one form or another.

Whilst establishing dedicated Islamic banking units, a number of international banks have participated in enhancing the visibility and understanding of *Shari'a*-compliant financing principles and techniques. As *BusinessWeek* noted at the start of an article published in August 2005 ('Islamic Banks: A Novelty no Longer'), 'when British banking giant HSBC

Group began offering mortgages carefully formulated to meet Islamic banking practices last year in Malaysia, it was astonished that more than half of its customers were non-Muslim'.

Progress towards a global Islamic capital market

While in the early stages of its recent renaissance, Islamic banking was predominantly a fragmented and highly localized industry. A prominent trend that has gathered momentum in recent years has been the move towards a global capital market in Islamic instruments on a number of levels. The most striking of these has been in the market for *Shari'a*-compliant bonds (*sukuk*), the international placement of which was spearheaded by sovereign Islamic borrowers such as Malaysia and Bahrain.

The success of these transactions, however, alerted the global borrowing community (Muslim and non-Muslim) to the depth of demand for *Shari'a*-compliant bonds and to the benefits that were to be derived from diversifying issuers' investor bases to tap into this substantial reservoir of demand. In 2004, the German state of Saxony-Anhalt responded to the existence of this demand when it became the first European government or quasi-government borrower to issue a *Shari'a*-compliant bond. At €100 million, the five-year Saxony-Anhalt bond was small by the standards of the international debt capital market, and has been very thinly traded. Its significance was therefore largely emblematic, because it very clearly demonstrated that you do not need to perform the *Hajj* or to observe Ramadan to raise wholesale *Shari'a*-compliant funding. Recent developments in the global Islamic capital market, meanwhile, have demonstrated with equal clarity that investors do not need to be practising Muslims to buy or trade Islamic debt instruments. These bonds – or *sukuk* – have been one of the fastest-growing asset classes in the international capital market in recent years, and this expansion has been underpinned as much by conventional investment banks (in their capacity as arrangers) and institutional investors as by dedicated Islamic players. The prime motor of recent *sukuk* activity has undoubtedly been the Gulf Co-operation Council (GCC), where corporate issuance expanded dramatically in 2007. According to data published by the ratings agency, Moody's,[31] corporate bond issuance from the Gulf reached $23.7 billion in 2007, compared with $14.6 billion in 2006; of that total, almost half ($11.7 billion) was accounted for by *sukuk,* up from $9 billion the previous year. Nevertheless, these totals need to be interpreted with caution, given the destructive ferocity of the credit crunch in the second half of 2007, which led to the wholesale postponement or cancellation of new issues in the primary market throughout the world. It is generally agreed that if market conditions had been more stable in 2007, issuance of *sukuk* would have been much higher. The weakness of conditions in the capital market in the second half of 2007 also led to a reverse in another trend within the *Sukuk* universe which is generally expected to be temporary. This is that transactions that had been placed with a progressively broader international audience were once again targeted principally at Middle East-based investors in the second half of 2007. The clearest indication of this trend appeared when Dubai's Jebel Ali Free Zone (JAFZ) replaced a planned dollar-denominated deal with a *sukuk* denominated in UAE dirham. However, as conditions in the global capital market stabilize, it is expected that issuers in the *sukuk* space will once again favour the broader international distribution and deeper secondary market liquidity that dollars provides.

Growing competition in Islamic financial centres

While there has been competition in recent years between Islamic banks, there has also been a dramatic increase in the number of financial cities that are competing to establish themselves as Islamic financial centres. Indeed, the competition between Noor and Al Hilal is symptomatic of the ferocious battle that is now being waged among a number of financial centres to establish their credentials as a clear centre of gravity for *Shari'a*-compliant services and products; this trend more conspicuously apparent than in the six-members of the GCC, where friendly but intense competition now appears to characterize virtually every pocket of society and the economy. In areas such as construction, hotels, airlines and sport, Dubai, Abu Dhabi, Bahrain and (more recently) Doha have been engaged in an energetic contest to see which city-state can build the biggest, the best and (some would argue) the showiest infrastructures. That competition has extended to financial services, conventional as well as Islamic, which throughout the 1970s and 1980s was a niche market centred largely in Bahrain.

Bahrain has indeed been fighting tooth and nail to retain its pre-eminence in Islamic banking, with initiatives such as the establishment of the Liquidity Management Centre, which facilitates the investment of Islamic banks' surplus funds into high-quality, short-term *Shari'a*-compliant instruments. It has already been suggested that other regional centres have started to eclipse Bahrain, where the Dubai International Financial Centre (DIFC) has flourished in the last three years into a highly successful regional competitor in the market for *Shari'a*-compliant products. In its review of issuance in the market for *sukuk* in 2007, Moody's commented that the DIFC has been emerging 'more and more as the primary hub with over $16 billion of *sukuk* listed at year-end'. At the opening of Noor Islamic Bank in early 2008, HH Sheikh Ahmed announced that 'Dubai is crowned now as a global financial hub for Islamic banking', with 'a' rather than 'the' presumably chosen in deference to the other financial centres in the Gulf. One of the most aggressive of those is the Qatar Financial Centre (QFC) in Doha, which was set up in May 2005 but by November 2007 had already awarded 66 licences to a virtual 'who's-who' of the global financial community. Not surprisingly, the QFC sees Islamic finance as one of the main pivots of its future expansion.

Islamic finance in Asia

Elsewhere in the Islamic world, such as Malaysia – where profitability and assets among Islamic banks burst through the RM1 billion and RM100 billion thresholds respectively in 2005 – has made no secret of its ambitions to establish itself as the obvious financial centre of choice for Islamic financial services in Asia, where there are an estimated 217 million Muslims in the South-East alone. Sixty percent of Malaysia's population is Muslim, and the country has consistently taken a lead in promoting the development of Islamic finance, issuing the first globally targeted *Shari'a*-compliant bond in 2002, for example.

Malaysia is guarding against complacency with regard to its standing as an Islamic financial centre. In its 2007 budget, the Malaysian government announced a number of measures designed to retain its position as a leading centre for Islamic finance. These included a 10-year tax exemption for Islamic banks licensed under the 1983 Islamic Banking

Act on income derived from *Shari'a*-compliant banking business conducted in international currencies. The Securities Commission also granted the same exemption. According to an analysis published by PricewaterhouseCoopers,[32] 'it is hoped that this tax incentive will attract fund managers to establish operations in Malaysia specifically for managing funds based on *Shari'a* principles. If reputable fund managers set up in Malaysia, more *Shari'a* funds and products will be created and marketed to foreign investors, making Malaysia the hub for attracting *Shari'a* monies for reinvestment around the region'.

Malaysia feels it must offer generous incentives in order to maintain its edge in the Asian Islamic banking sphere. Competition is intensifying within the Asian region, with Hong Kong's Chief Executive Donald Tsang declaring in his 2007 Policy Address that Hong Kong would need to offer more Islamic products in order to consolidate its position as a leading global financial centre. According to an article published by Arabian Business at the start of 2008,[33] Lord Edwin Hitti, a Lebanese businessman, has been at the forefront of setting up the building blocks of Islamic banking and finance in Hong Kong. For example, as Chairman of the Arab Chamber of Commerce and Industry, Lord Hitti in 2007 helped with the formation of Hong Kong's sole *Shari'a* compliance certification body and the Hong Kong Islamic Stock Index. Although it will be a while before Hong Kong comes anywhere close to challenging Malaysia as Asia's foremost centre for Islamic finance, it is indubitably moving in the right direction.

Asia's other premier financial services centre has historically been multi-cultural Singapore, where an estimated 15%/16% of the population of three million is Muslim. The number of conferences now being hosted there on the potential of Islamic banking is testament to the ambitions that the city-state has to develop its credentials in the market for *Shari'a*-compliant services. Within the financial services industry itself, the Malaysian bank OCBC took a lead among the local banks in the promotion of Islamic banking in Singapore with the launch in 1998 of the first local *Shari'a*-compliant deposit products in the form of the Al-Wadiah savings and current accounts for individual and corporate customers. OCBC chalked up another first in December 2005, when it became the first Singapore-based bank to appoint a permanent *Shari'a* council to advise on the development of its Islamic franchise.

In addition, commitment to the evolution of Singapore as a centre for Islamic financial services has also been expressed at a government level. At the International Islamic Enterprise Forum held in Singapore in September 2005, Heng Swee Keat, Managing Director of the Monetary Authority of Singapore (MAS) made no secret of the Lion City's ambitions.[34] Refreshingly, he also emphasized the need for global co-operation to support the evolution of the market. 'As a major financial centre, Singapore can play four useful roles to support and complement the efforts of other regulators of the industry,' said Keat.

- Firstly, we can add breadth and depth to the range of Islamic products, to complement those offered by other centres. 'Given [the] multi-ethnic and multi-religious make-up of our society, Singapore has the cultural software to facilitate and integrate different practices.'
- Secondly, added Keat, 'as a global financial centre, Islamic financial products will add to the suite of conventional financial products that Singapore already offers'.

- Thirdly, the depth and liquidity of the Singapore market is a source of strength. For example, the asset managers based here, with assets under management of close to S$600 billion, are a major group of investors. In the recent *sukuk* issues by Pakistan (US$600 million) and the Malaysian State of Sarawak (US$ 350 million), the issue managers held road shows in Singapore to reach out to these institutional investors. Singapore is a leading insurance centre in Asia, with a large number of international insurers, reinsurers and intermediaries.
- Fourthly, *takaful* insurers can use Singapore as a base to tap the regional *takaful* market. Keat used his address in September 2005 to announce a number of measures being introduced by Singapore to enhance the city-state's competitive credentials in the Islamic banking arena, which included relaxing restrictions on banks' *murabahah* transactions and easing the tax burden on Islamic institutions operating in Singapore.

Elsewhere in the region, the evolution of *Shari'a*-compliant banking may be held back by the relatively low levels of personal wealth within Muslim communities in Asia. As the *Financial Times* observed in an article published in December 2007,[35] although the number of High Net Worth Individuals (HNWIs) in India expanded by more than 20% in 2006, 'that rate of growth is an average for the population of the whole country and may not apply to the 150 million-strong Muslim community'. A similar story probably applies to Indonesia, where the number of HNWIs grew by 16% over the same period. As the FT commented, 'much of the country's wealth is concentrated in the Chinese minority who are not Muslims. Figures from the Central Bank estimate that, last year, *Shari'a* banks accounted for just 1.7 per cent of the country's total of $153 billion in banking assets'.

In May 2007 it was reported that two prominent international providers of *Shari'a*-compliant products, Kuwait Finance House (KFH) and Malaysia's CIMB Group, had sent teams to Australia to assess the longer term potential of Islamic banking 'down under'. Others also see potential in this market: in a news bulletin broadcast in December 2007, Australia's ABC News quoted a spokesman for KPMG as saying that Australia could become a notable regional Islamic banking centre within the next 10 to 20 years. The same broadcast reported that the National Australia Bank (NAB) had set up an Islamic banking scholarship. However, the fact that the bank was unwilling to discuss this on camera perhaps highlights the degree to which the promotion of Islamic banking in predominantly non-Muslim countries remains a sensitive issue.

Conclusion

Varying degrees of political sensitivity; a wide range of interpretations of what is and is not permissible under *Shari'a* law; competing interests among an ever-growing number of financial centres demonstrate that there are still many hurdles to be overcome if Islamic finance is to expand still further and establish itself as a viable alternative to conventional banking worldwide. But its potential is clear, as the Malaysian Central Bank Governor Dr Zeti Akhtar Aziz said in an address delivered in Hong Kong in January 2008: 'Islamic finance is now at the threshold of a new dimension in which it has the potential to strengthen international financial linkages between nations. And in so doing, it would contribute towards

a more optimum allocation of financial resources across borders.' Recently, two new financial institutions (Noor Islamic Bank and Al Hilal Bank) were established in the UAE with a view to providing a full universal bank offering in the Middle East region and in the UK. Countries like Egypt, Morocco and Turkey are also gearing up to attract Islamic institutional investors and financiers for real estate, infrastructure and other development projects. In addition, the British government is keen to promote London as the international wholesale Islamic finance hub and is currently evaluating the feasibility of launching a sovereign *sukuk*. The governments in Japan and South Korea are to become members of their organization and launch wholesale *Shari'a*-compliant instruments so have approached the Islamic Financial Services Board (IFSB) in Malaysia.

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Chapter 18

Growth outlook and economic considerations in Islamic capital markets

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Kuwait Finance House

Introduction

It should be recognized from the outset that the Islamic capital market in Malaysia is an essential element of the capital market. Within the broader market, Islamic finance has effectively functioned as an alternative market for capital seekers and providers, at the same time playing an important complementary role to the Islamic banking and the *takaful* industry. Rising demand for *Shari'a*-compliant financial products and services (from both Muslim and conventional investors) has contributed to the robust development of the Islamic finance industry in recent years. Heightened awareness of the option of investing in *Shari'a*-compliant assets has led to the rapid growth of Islamic financial products and services, namely Islamic banking products and services, *takaful* and *sukuk* over the years, particularly in the Gulf Cooperation Council (GCC) and emerging Asia. Given the abundant liquidity flows from the recycling of petrodollars, *Shari'a*-compliant assets worldwide grew to an estimated US$800bn as at the end of 2007 vs. US$150bn in the mid-1990s, signifying a growth rate of 23.5% per annum over the past five years.

Growth outlook

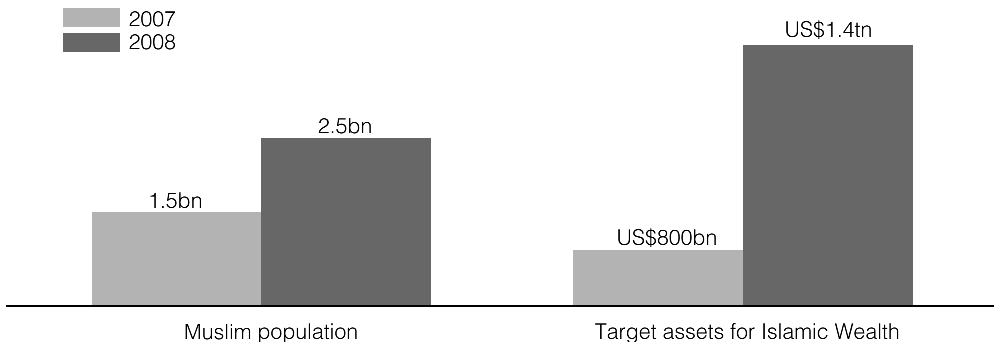
Research estimates show that of the total *Shari'a*-compliant assets, approximately US$640bn comprise Islamic banking assets, US$97.3bn outstanding *sukuk*, US$30.7bn Islamic equity funds, US$28.3bn other Islamic funds (fixed income, balanced, money market and leasing) and US$2.5bn *takaful* contributions. Moving forward, this author is optimistic on the prospects of global Islamic finance, given the following factors:

- Robust economic landscape in the GCC and Asia, coupled with rising wealth and strengthening demand for *Shari'a*-compliant investments, point to immense potential for further growth of the industry.
- Encouraging demographics and the proactive measures taken by jurisdictions worldwide to promote the development of Islamic finance.

- Government-linked and top tier companies in the Middle East and emerging Asia (financial, real estate, oil & gas and transport sectors) are looking for funds on the back of massive infrastructure and construction projects in the regions. Infrastructure spending in Asia and the Middle East is expected to reach US$1tn and US$500bn respectively from 2007–2012.
- By 2020, the worldwide Muslim population will be 2.5 billion from the current 1.5 billion (see Exhibit 18.1). Islamic banks are expected to manage 40–50% of total savings of the Muslim population in eight to ten years. Therefore, the potential for Islamic financial services is estimated at US$4tn by 2020.

Exhibit 18.1

Word Muslim Population Growth Trend



Source: UN, *CIA Factbook*, KFH.

On the *sukuk* market, the first *sukuk* debuted in Malaysia with the issuance of RM125m was Shell MDS Sdn Bhd. *Sukuk* instruments have since developed rapidly as investors tap into the increasing appetite for Islamic debt products. The international *sukuk* market began in 2002 with a US$600mn issuance by the government of Malaysia. The *sukuk* industry is now at the centre of the Islamic financial system. The demand for *sukuk* has been buoyed by high levels of surplus savings and reserves in Asia and the GCC. The savings rate in Asia is higher than in any other region in the world and is expected to remain between 30% and 40% of GDP for many years to come. Although Asia, in particular Malaysia, accounted for around 90% of corporate *sukuk* issued in 2004, issuance in the GCC has since then increased rapidly on the back of a construction boom in the oil-rich region, in particular after the equity market crisis in 2006 which resulted in corporates shifting their funding preference to *sukuk*.

Recent trends in the GCC that contributed towards rapid growth in *sukuk* include the following:

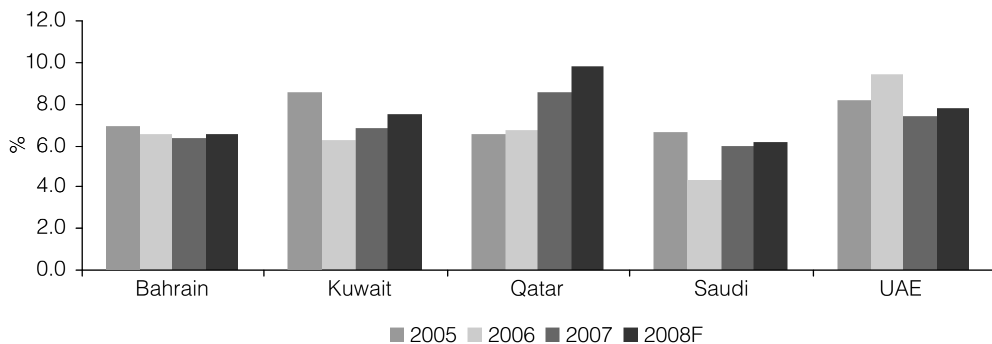
- Economic diversification away from oil and gas. In 2008, it is expected that GCC's GDP growth will come in strong at 7.5% vs 7.0% in 2007 on the back of sustained oil earnings, robust public infrastructure investments and positive growth in non-oil economic

sectors in line with continuous economic diversification and reforms. The GCC's non-oil sector is currently growing at almost double the rate of the oil sector. Continuous efforts on economic reforms and diversification have seen non-oil economic sectors contributing to the GCC's growth momentum. Services sub-sectors include financial/banking, tourism, information, ICT, ports/shipping, aviation, healthcare and education. Large surpluses have also been channelled into the real estate and property, construction and infrastructure/utilities sectors, leading to increased *sukuk* issuances (see Exhibit 18.2).

- Infrastructure development. Infrastructure spending in Asia and the Middle East is expected to reach US$1tn and US$500bn respectively over the next four years. During the period 2007–2011, over US$200bn of debts are expected to be raised across the GCC region to finance infrastructure, petrochemicals and other projects. Previously, syndicated loans dominated the funding of domestic investment projects in the GCC. However, as capital markets in the region gradually increase in importance, the banks' role as the major source of financing has been replaced. A large number of infrastructure development projects throughout the GCC has been financed by *sukuk*. This indicates the growing preference for *sukuk* as the source of cash flow and financing for companies in the region, combined with a drive to tap the deep pool of Islamic liquidity in the region (see Exhibit 18.3).
- Massive liquidity looking for *Shari'a*-compliant debt. Increased demand for *sukuk* is also driven by massive liquidity in the region searching high-yielding for *Shari'a*-compliant instruments. The Middle East is expected to generate approximately US$24.4bn *sukuk* or 61% of total *sukuk* issuances this year, buoyed by an increase in demand for such instruments.
- Increase in international investment. Foreign direct investment (FDI) inflows into the Middle East region increased by 85% year-on-year to US$35bn in 2005. The trend is expected to continue, driven by the region's strong economic growth on the back of high oil prices. For example, Saudi Arabia attracted US$4.6bn in FDI in 2005 and the figure is expected to double by 2010, underpinned by the opening up of key sectors such as telecommunications, power, petrochemicals and infrastructure to foreign investment.

Exhibit 18.2

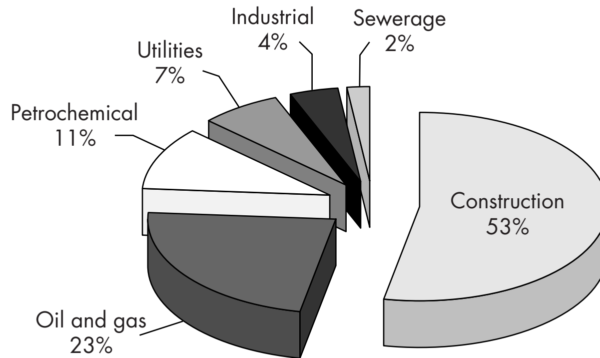
GCC GDP Growth Trend (2001–2008F)



Source: Central Banks, KFH.

Exhibit 18.3

GCC Planned and Under Construction Infrastructure Projects (2008)



Source: Zawya, Central Banks, KFH.

- **Corporate expansion, both organic and mergers and acquisitions (M&A) related**. Increasingly, the takeovers of foreign companies by GCC-based corporations are being financed by *sukuk*. For example, the takeover of P&O by Dubai Ports in 2006 was financed with the issuance of a US$3.5bn convertible *sukuk*. GCC companies' world-wide M&A, including transactions routed through third countries, reached US$59bn in 2007 vs. US$26.3bn in 2006. The booming economies and favourable business climate attracted large-scale greenfield investments and cross-border M&A deals in the region. These have resulted in global reach and expertise of regional companies, provided greater depth to the local markets and developed the local bond market.
- **Government policies**. The GCC governments allowed the private sector to participate in major infrastructure and real estate projects, introduced legislations to develop the capital market and encourage economic growth.
- **Perceived reduction in geopolitical risk for the GCC region**. Although geopolitical risk remains, it is expected that policymakers and economic leaders will exert their maximum influence to ensure the realization of the countries' economies and business growth.

New *sukuk* issuances rose from US$25bn in 2006 to US$47.1bn in 2007 as borrowers, led by GCC companies, sidestepped the credit market slump triggered by the US sub-prime mortgage loans crisis. Borrowers in GCC sold US$22.9bn of the securities, 67% more than that in 2006. Among notable varieties of new *sukuk* issues were:

- Saudi Electricity Co (Saudi's biggest power producer), SAR5bn (~US$1.3bn);
- Nakheel Development (UAE property/real estate developer), US$4.27bn;
- Jebel Ali Free Zone (business park operator), AED7.5bn (~US$1.995bn);
- Ras al-Khaimah Investment Authority (UAE investment authority), US$435m; and
- Nucleus Avenue (Malaysia's power producer), RM7.9bn (~US$2.4bn).

The *sukuk* market is projected to reach US$150bn by 2010. The bulk of *sukuk* are over-the-counter instruments. Listed *sukuk* account for only US$10–15bn or 20–25% of the outstanding *sukuk* issued worldwide. Most of the *sukuk* are listed in Dubai although the secondary market is not particularly active. Second is London, where the secondary market for *sukuk* totaled less than US$5bn at 21 March 2007.

The following are some of the main features of the *sukuk* market in 2007 and beyond:

- The Malaysian ringgit remains the most common currency for *sukuk* issuance, followed by the US dollar. Most *sukuk* issued in Malaysia are ringgit-denominated papers while the majority of *sukuk* issued in the GCC are in US dollars.
- An increase in the number of *sukuk* worth more than US$1bn, from four issues in 2006 to 14 issues in 2007, representing 56% of the total value of the market. Six of such *sukuk* papers were issued in Malaysia, while the UAE and Saudi Arabia issued five and three, respectively.
- A decline in the number of corporate *sukuk* issued from 167 issues in 2006 to 156 issues in 2007, but an increase in the value of *sukuk* issued from US$21bn to US$37bn over the same period. Malaysia recorded a decline in the number of corporate issues from 148 in 2006 to 112 in 2007. Elsewhere in the GCC, the number of corporate issues increased from 13 in 2006 to 21 issues in 2007.
- The largest proportion of *sukuk* was issued in the financial services sector, accounting for 31% of total volume, followed by real estate (25%) and power and utilities (12%).

Only three benchmark-sized *sukuk* papers were marketed publicly in the Gulf since the credit turmoil – state-owned UAE firms Dubai Electricity and Water Authority (DEWA), Ras Al Khaimah Investment Authority (RAKIA), and Jebel Ali Freezone (JAFZ), a Dubai-government owned business park. In October 2007, Dana Gas re-launched its issue and obtained a fixed profit rate of 7.5%, which was deemed reasonable under the market conditions. However, the structuring of the convertible *sukuk* helped to ensure its success. The conversion has been structured to take place in nine months, one of the shortest lead times in converting bonds into equity.

In November 2007, renewed weakness in the global credit market and increased speculation on a possible currency *depeg* in the region on concerns of a weaker dollar had also adversely affected the *sukuk* market. As a result, local investors preferred local currency bonds to dollar-denominated bonds. Effects included the following:

- DEWA faced some trouble attracting investors for its US dollar 3-year *sukuk* and hence postponed its plans to sell its first international bond. The issue was earlier priced at 100 basis points above Libor.
- JAFZ cancelled the US dollar tranche of its debt programme and doubled the dirham-denominated *sukuk*. The JAFZ's AED7.5bn (US$2.04bn) *sukuk* issue was priced at 130 basis points over the Emirates Interbank Offered Rate, which is similar to US dollar Libor.

Box 1

Impact of the sub-prime crisis on the *sukuk* market

The weaknesses in global credit markets stemming from the US sub-prime woes had a bearing on the *sukuk* market, where new *sukuk* may have to be either delayed or priced slightly higher to reflect rising debt market volatility as well as the slight drop in investors' demand for the *sukuk*. As a result, several companies were forced to delay or withdraw planned debt offerings, as witnessed by the following events:

- Dana Gas, the first victim of the sub-prime turmoil, postponed its US$1bn issue from July to Oct 2007.
- Pricing of Ithmaar Bank's US$300m *sukuk* was delayed.
- National Bank of Abu Dhabi delayed its US$1.7bn bond programme until conditions improve in global debt markets.
- In Dubai, Amlak Finance, an Islamic mortgage company, delayed its plan to issue US$260m mortgage-backed *sukuk* scheduled for end-2007.
- In August 2007, Malaysia's MISC deferred the sale of its planned US$750m, 10-year US dollar-denominated bonds issue.
- Saudi Basic Industries Corp was forced to lower the senior unsecured bond portion of its financing to buy GE Plastics from around US$2.76bn to US$1.5bn and raise the bank loan portion from US$5.4bn to around US$6.6bn.

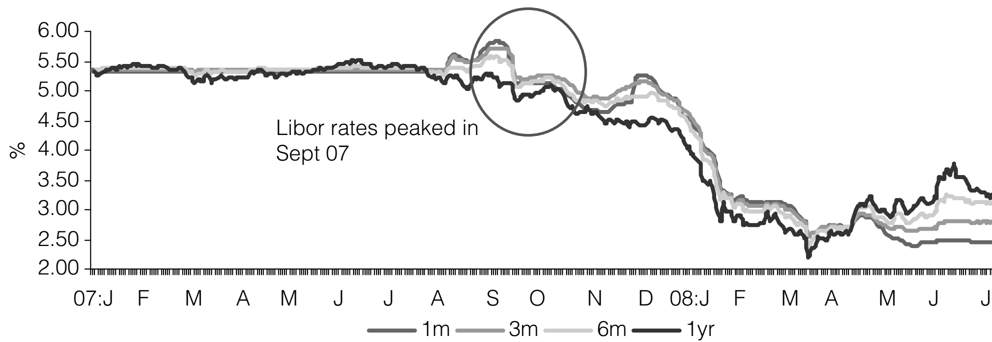
In 3Q07, the period when the subprime crisis was at its height, *sukuk* issuances in the GCC saw a threefold increase to US$10.56bn as compared with US$3.48bn during the same period last year. Since then, however, the turmoil in financial markets has widened the credit spreads and affected the issuance of new *sukuk*. The 3-month LIBOR peaked at 5.7283% on September 6 2007, an increase of 36 basis points within a month due to sub-prime concerns. The weighted average spread for more than US$15bn *sukuk* on the HSBC-DIFX Islamic bond index jumped from 65 basis points in June 2007 to 210.6 basis points over LIBOR in December 2007. Concurrently, the yield on dollar-denominated *sukuk* (for example, Dar Al Arkan) rose by 105 basis points between July 2007 and April 2008. To compare, yields on dollar-denominated conventional bonds of comparable maturity widened by 145 basis points over the same corresponding period (see Exhibit 18.4).

- RAKIA's US$325m 5-year *sukuk* issue fetched 150 basis points above Libor. The transaction was placed 70% in the GCC region, with the remainder in Europe, mainly in the UK and Switzerland. Proceeds from the issuance will be utilized for RAKIA's Al Marjan artificial island tourism project in the northern UAE.

However, sentiments improved in December 2007. Tamweel PJSC, the largest real estate finance provider in the UAE, announced on 16 December 2007 that its 10-year US$300m exchangeable *sukuk* issue had been successfully priced despite the difficult market conditions. The *sukuk*, whose order book was oversubscribed within hours of announcing the launch, was

Exhibit 18.4

LIBOR Trend, as at 11 July 2008



Source: Bloomberg, KFH.

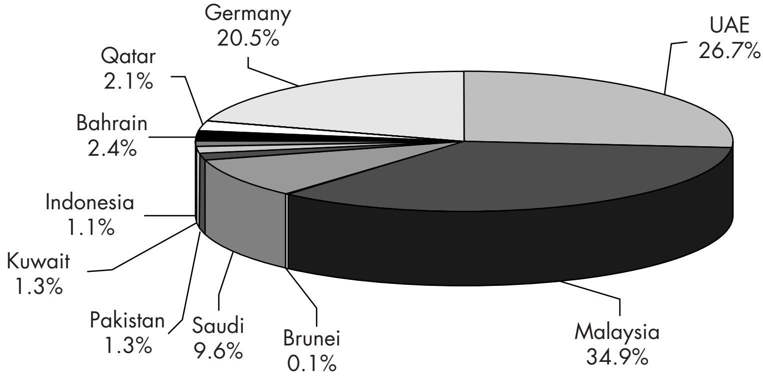
priced at an expected return of 4.31%, compared with price guidance of between 4.06% and 4.56%.

Although the cost of Islamic debt and financing have risen as a consequence of the turmoil, the Gulf region is likely to be less affected, as investors become more accustomed to wider spreads, evidenced by several large transactions being oversubscribed in the region during the sub-prime crisis. Under the present market conditions, companies may consider selling local currency *sukuk* as an easier proposition, given strong interest from national, regional and international investors for such *sukuk*. However, the issuer may be subject to exchange risk in the event of a currency revaluation, in particular in the GCC region where there is a pressure for most of the countries to decouple from the US dollar.

In 1H08, global *sukuk* issuances (both dollar and local currencies-denominated) amounted to US$14.6bn. Malaysia was the leader in the primary *sukuk* market, with market share of 34.9%, followed closely by the UAE at 26.7% and Germany at 20.5%. By economic sector, financial services dominated the primary market, contributing to 39.5% of total issuances, followed by real estate at 23.7% and oil and gas at 13.4%. Ijarah was the most popular structure, accounting for 68.6% of total *sukuk* issuances in 1H08, followed by *al istithmar* at 21%, *musharakah* at 7.7% and *mudarabah* at 2.8%. It is expected that momentum in the primary *sukuk* market will pick up in 2H08 given improved sentiment, with announced *sukuk* pipeline amounting to at least US$24.8bn for the remainder of this year (see Exhibits 18.5 and 18.6).

For full year 2008, it is expected that new *sukuk* issuances will sustain at US$40bn, dominated largely by huge infrastructure/utilities, property/real estate and oil, gas and petrochemicals financing in Malaysia and GCC countries. The total value of *sukuk* issuance in the GCC is projected at US$24.4bn, or 61% of total *sukuk* issuances in 2008, underpinned by vast liquidity and huge project developments as part of the region's continuing efforts to diversify the economy. Key potentials in the GCC include government-linked/top tier companies in the Middle East looking for funds on the back of massive infrastructure and construction

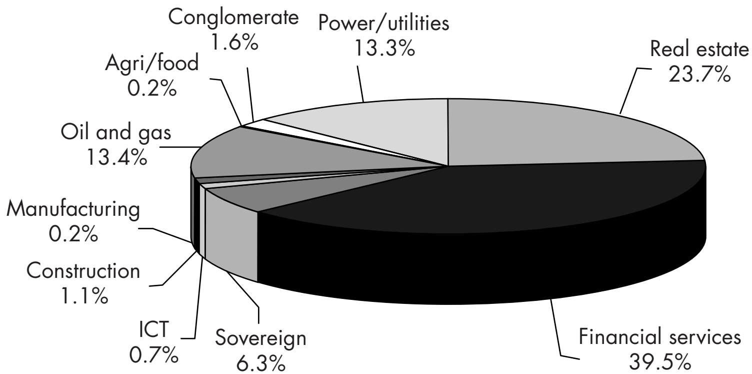
Exhibit 18.5
Sukuk Issued by Country (1H08)



Source: Zawya, KFH.

projects in the region. Some of the GCC governments are also expected to undertake benchmark issues this year, given that most of the GCC currencies will continue to be pegged to the US dollar. One interesting trend that we observe today is the increasing popularity of GCC local currencies-denominated *sukuk* issuances since 4Q07, the result of the liquidity crunch in the dollar funding market.

Exhibit 18.6
***Sukuk* Issued by Economic Sector (1H08)**



Source: Zawya, KFH.

Moving forward, the global financial system can expect to witness more issuances of sovereign *sukuk* in 2008, given a new precedence for *sukuk* out of Indonesia, Singapore, Hong Kong, Japan, Thailand, the UK, Kenya and Senegal (See Exhibit 18.7).

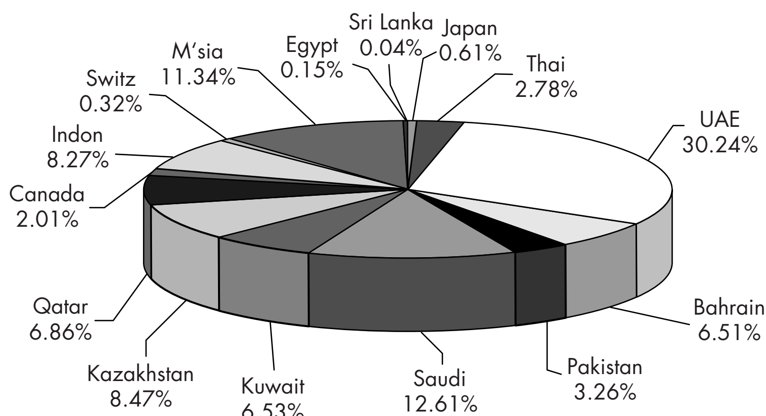
Further prospects also exist for Islamic products in the areas of Asset Origination and Asset Management. Following on from the theme of innovation, structures that can be explored include the gradual shift to *istisna*-, *ijarah*- and *salaam*-based products, short-term oil- and commodity-linked products, equity/debt hybrids and internationalizing distribution lines. Continuous R&D in the areas of product development can also enhance growth in Islamic equity funds, cultivate liquidity management of assets and create *syariah*-based equity benchmarks.

Summary

In summary, prospects for the Islamic finance industry remain bright, driven by an increasing demand for *Shari'a*-compliant investment products and initiatives taken by authorities to further develop respective Islamic capital markets. Growth potential for the *sukuk* market is huge, with the total global *sukuk* market projected at US$150bn by 2010 (vs. current US$97.3bn). The thrust of infrastructure investments in the GCC and Asia will continue

Exhibit 18.7

Projected *Sukuk* Issues by Country for 2H08

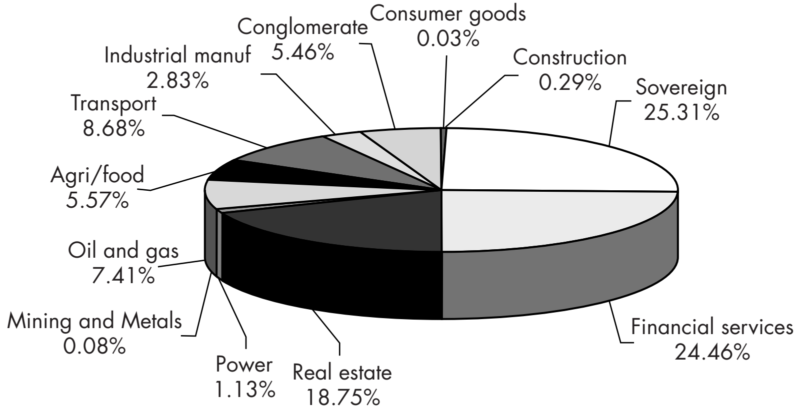


Source: Company Announcements, KFH.

Note: 2H08 will see more diverse issuers, with sovereign debuts expected from Hong Kong, Japan, Thailand, Indonesia, Singapore, Kenya and Senegal. GCC will continue to dominate the *sukuk* primary market, with 30.24% of total issuances projected to come from the UAE, 12.61% from Saudi Arabia, 6.86% from Qatar, 6.53% from Kuwait and 6.51% from Bahrain. Meanwhile for Asia, the top 3 *sukuk* issuers are expected to be Malaysia at 11.34%, Indonesia at 8.27% and Thailand at 2.78%.

Exhibit 18.8

Projected *Sukuk* Issuances by Economic Sector for 2H08



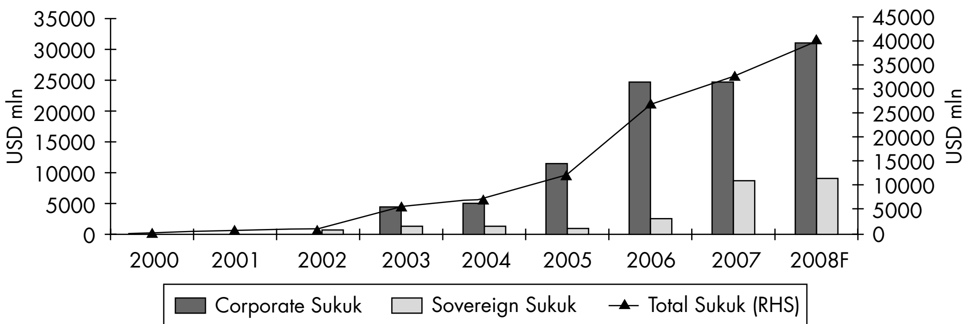
Source: Company Announcements, KFH.

Note: By economic sector, the financial services sector is anticipated to dominate the *sukuk* primary market in 2H08, accounting for 24.46% of total *sukuk* issuances, followed closely by sovereigns at 25.31% and real estate at 18.75%.

to drive demand for Islamic project finance structures specifically in the areas of infrastructure financing for water/power projects, education, healthcare, roads, among others (see Exhibit 18.9).

Exhibit 18.9

Global *Sukuk* Issuance Trend (2000–2008F)



Source: Central Banks, Zawya, IFIS, KFH.

Chapter 19

Understanding derivatives within Islamic finance

Aly Khorshid
Elite Horizon

Introduction

Derivatives are contracts created out of a need to minimize risk but also to maximize the value of the underlying asset. For example, a derivative of the shares of Company X (underlying) will derive its value from the share price (value) of Company X. Similarly, a derivative contract on soybeans depends on the price of soybeans.

Derivatives are specialized contracts that signify an agreement or an option to buy or sell the underlying asset of the derivative at an agreed price (the exercise price) up to a certain point in the future. The contract has a fixed expiry period, mostly in the range of three to twelve months. The value of the contract depends on the expiry period and the price of the underlying asset.

For example, a farmer fears that the price of soybean (underlying) will be lower than his cost of production by the time his crop is ready for delivery. Suppose the cost of production is $8000 per ton. In order to overcome this uncertainty in the selling price of his crop, he enters into a contract (derivative) with a merchant, who agrees to buy the crop at an agreed price (exercise price) when the crop is ready three months later (expiry period). Suppose the merchant agrees to buy the crop at $9000 per ton. The value of this derivative contract will increase as the price of soybean decreases, and vice versa.

If the selling price of soybean goes down to $7,000 per ton, the derivative contract will be more valuable for the farmer, and if the price of soybean goes down to $6,000, the contract becomes even more valuable.

This is because even though the market price is much less, the farmer can still sell the soybean he has produced at $9000 per ton. Thus, the value of the derivative is dependent on the value of the underlying asset.

Regardless of whether the underlying asset of the derivative contract is coffee, pepper, cotton, wheat, gold, silver, precious stones or, for that matter, even the weather, the derivative is known as a commodity derivative.

If the underlying is a financial asset such as debt instruments, currency, share price index, equity shares, the derivative is known as a financial derivative.

Derivative contracts can be standardized and traded on the stock exchange and are known as exchange-traded derivatives. Alternatively, derivative contracts can be customized in line with the needs of the user by negotiation with the other party involved.

Some of the most basic forms of derivatives are futures, forwards and options.

Futures and forwards: As the name suggests, futures are derivative contracts that give the holder the opportunity to buy or sell the underlying at a pre-specified price sometime in the future. They come in a standardized form with a fixed expiry time, contract size and price. Forwards are similar contracts but customizable in terms of contract size, expiry date and price, in accordance with the needs of the user.

Options: Option contracts give the holder the option to buy or sell the underlying at a pre-specified price sometime in the future. An option to buy the underlying is known as a Call Option. On the other hand, an option to sell the underlying at a specified price in the future is known as a Put Option. In the case of an option contract, the buyer of the contract is not obliged to exercise the option contract. Options can be traded on the open market.

Risk management tools: Derivatives are effective risk management tools. To illustrate this point, an investor holds the stocks of Company X, which are currently trading at $2,096. Company X has options traded on the National Stock Exchange, which gives the owner the right to buy (call) shares of Company X at an exercise price of $2,220 each, expiring on 30 June 2007. Now, if the share price of Company X remains no more than $2,200, the contract would become worthless for the owner, who would lose all that he paid to buy the option (that is, the premium).

However, because the premium is the maximum amount that the owner of the contract can lose, he has a limited loss. Should the share price of Company X go above $2,220, the owner of the call option can, by selling the share at the market price, exercise the contract; buy the share at $2,220; and still make a profit.

The gains are therefore potentially unlimited. If the share price of Company X rockets to $3,000 by June 2007, the owner of the call option can buy the shares at $2,220 (the exercise price of the option), and then sell them in the market for $3,000, making a $780 profit (minus the premium that has already been paid). If the premium to buy the call option is $10, the profit would end up as $770.

Brief history of derivatives

The history of derivatives is longer than many might imagine. Some texts even find the existence of derivative-characterized contracts in *Mahabharata* (Old Hinduism). Traces of derivative contracts have also been found in Roman times. However, the advent of modern day derivative contracts is attributed to the need for farmers to protect themselves from declines in the price of their crops due to a delayed monsoon or overproduction.

The first traceable futures contracts are thought to be from the Yodoya rice market in Osaka, Japan, in around 1650. These were evidently standardized contracts and in that way resemble modern-day futures.

Forward contracts on various commodities were standardized at the Chicago Board of Trade (CBOT), the largest derivative exchange in the world, in around 1865, less than

twenty years after the Board's founding. These well thought out contracts would look very familiar to anyone dealing with forward contracts today.

Derivatives also have a long history in India. The derivatives market has been functioning in India since the nineteenth century, with organized trading in cotton through the establishment of the Cotton Trade Association in 1875. Since then, contracts on numerous other commodities have been introduced. Exchange-traded financial derivatives were introduced in India in June 2000 at the two major stock exchanges, NSE and BSE, and today various contracts are traded on these exchanges. In December 2003, the National Commodity & Derivatives Exchange Limited (NCDEX) was set up to provide a platform for commodities trading.

Since the late 1980s, an ever-increasing list of applications and innovations surrounding the methodologies of derivative instruments has revolutionized the global financial industry. Derivative-based transactions have simultaneously benefited from document standardization and have now reached the point of uniform application in conventional markets and products. This has removed an immense amount of uncertainty and risk previously associated with these types of transaction. It can now safely be said that derivatives have become common in the international financial arena.

Concepts and transactions in derivatives

The inherent value of derivatives is driven from independently existing underlying assets or their prices, such as securities or commodities. For example, a miller and a grain farmer conclude an agreement today for the delivery of a specified quantity and quality of grain on an agreed future date, say six months ahead. The important element of this transaction is that the price to be paid for the grain is fixed on today's date. The primary reason for the immediate price determination is to remove the uncertainty for both parties of what the actual spot price for grain might be six months from now. Either party may stand to lose a great deal from this uncertainty if the price movement is against him, or gain if it is in his favour, so it is not ideal for financial planning. Since the parties face risk in opposite directions of price movement, it will make financial sense for them to meet and agree on a price which will suit both of them, to eliminate the risk caused by price movement of the commodity (called 'hedging the price'). The grain farmer then knows what input costs he can safely invest in his harvest to turn a profit; the miller, on the other hand, knows at what price he can sell flour into a competitive market six months into the future and can plan and market his product accordingly.

What has been explained above is a basic forward contract. The derivative element present in this simple set of facts is that, from the first day subsequent to this contract being concluded, the contract itself gains a value derived from the underlying price movements and future expectations of the spot price of grain on the agreed delivery date.

So, when the parties agreed on the price of grain six months into the future, it was more than a matter of mere guesswork. Both parties probably considered a plethora of contingencies for what they considered to be relevant elements in determining a fair price of grain six months into the future (such as market conditions, micro- and macro-economic

indicators, price volatility, weather patterns, and quality considerations). Every day thereafter, the input data on these elements and contingencies will vary constantly to the extent that had the parties known about the changed conditions at the time they contracted on the price of the grain, they would have come to a different conclusion. For example, if it does not rain in other farming areas during the early planting season, a bad harvest might be forecast, thus increasing demand and with it the expected future price of grain. The farmer who agreed on a price but experiences normal weather patterns might soon realize that he is selling his bumper crop cheaper than he otherwise would have, had he known about the coming drought in other areas.

This process of constantly monitoring the contingency variations pertaining to the forecasted spot price of grain, on the delivery date of the grain, in our example (called 'marking to market'), can give the contracting parties an indication whether the contract is in their favour ('in the money'), or not in their favour ('out of the money'). If, as in the example above, drought prevails, the grain farmer would most probably have found his contract's mark-to-market value to be out of the money. However, receiving a price lower than the expected market price was a risk he was willing to take at the outset, to hedge his position. Things might just as well have turned out the other way. It is this mark-to-market value (derived from translating present market conditions into an expected future price of the commodity at a later date) that represents the derivative value of the contract in question. It should be clear by now that this is a value independent of the underlying commodity; but at the same time it exists only because of changes in the variables determining the future price of the underlying commodity.

The forward contract is the most basic of derivative contracts. For a number of reasons it may be of particular use in purchasing foreign currency from authorized currency dealers; but in other areas it has certain obvious shortcomings. Firstly, it is not often that parties have an exact match in: (a) the opposite directions of price movement of the underlying instrument or commodity; and (b) the timing and the quantity of delivery (called the problem of 'double-coincidence'). Secondly, the risk of the counterpart defaulting on his obligations (the 'counterpart risk') is a higher than normal risk in these circumstances and can negate all good intentions when it comes to financial planning. If one refers back to the example of the grain farmer and the miller, it will soon be obvious why possible default is higher than normal between the parties. If the miller saw a substantial dip in the spot grain price (far below his forward contract price, thus rendering his contract out of the money) a few days before he was to take delivery of the grain, the attraction to default in terms of his forward contract with the farmer will be substantial. The same can be said of the farmer, if there was a big increase in the spot price of grain way above the forward contract price, a few days before delivery was due. Although the non-defaulting party will have recourse in law against the other, this can be a tedious and expensive exercise to bring to eventual fruition, which, once again, will undo all good intentions in respect of financial planning.

This brings us to the next tool in the evolution of derivatives: futures contracts. Designed to take care of both double-coincidence and counterpart risk, a futures contract is a standardized forward contract with respect to size, maturity and quality interposing a futures exchange between the original buying and selling parties, as the buyer to each seller, and

the seller to each buyer. Each party can then buy the number of contracts that will suit its individual needs. Because a large number of buyers and sellers deal via the exchange, the problem of double coincidence is easily overcome. Also, by doing daily marking to market and making margin calls from the party that is out of the money, the futures exchange substantially reduces counterpart risk.

The final basic concept to consider in this section is that of options. As was the case in our evolutionary tale before, the inadequacies of futures contracts gave rise to the development of options. Futures contracts have the underlying assumption of actual delivery of merchandise concerned, at the price initially agreed upon. The only way of avoiding definite performance under the contract is to enter into an equal and opposite sale or purchase of the underlying merchandise on the exchange at the prevailing mark-to-market price for the goods. It is clear that this does not cater for contingent scenarios (where actual obligations are not certain) that might arise in business on a daily basis. It also does not allow parties to take advantage of price movements in their favour. To properly understand this, let us revert once again to the example of the grain farmer and the miller. Firstly, the grain farmer is not exactly sure about the quantity or quality of the grain he will produce. Is it then sound financial planning to enter into a contract for the delivery of a specific amount and quality of grain in the early planting season? If he had taken out an option to sell the grain at a specific price to the miller (called a 'put option') and paid an up-front non-refundable minimal amount for such an option (called a 'premium'), he would have had the right (but not the obligation) to sell his goods at a specific price to the miller. If he could not deliver due to contingencies beyond his control, he merely would not exercise his option and would lose only the minimal amount of the premium paid for the put option. At least he would not be caught in a situation where he would be obliged to deliver, as would be the case under the futures contract.

Secondly, if the farmer was capable of getting a far better spot price for his grain at the time of delivery, he would be unlikely to exercise his put option but rather would sell his grain onto the open market. Thus, by having taken a put option instead of a futures contract, he will have: (a) covered the price risk on his goods; (b) catered for contingencies beyond his control regarding delivery of the goods; and (c) still had the opportunity to cash in on favourable movements in the spot price for grain, all in return for the premium. Conversely, the same reasoning applies for the miller. Instead of binding himself to one farmer, who may or may not be able to deliver, why not pay a premium for an option to purchase from more than one farmer (a 'call option')? This way he caters for contingencies on one farmer not being able to deliver, and if there is a favourable downturn in the spot price of grain, he need not take any of the farmers up on his call option.

Although the examples given above seem oversimplified, their basic elements are present in a great variety of business transactions worldwide on a daily basis. It should also be clear by now that there is an acute need for these instruments in businesses that require sound financial planning to give them the edge in the competitive modern world of global markets. It should also be clear that once these basic principles are clearly understood, it does not take much to make the quantum leap and realize that derivative values can be realized in almost anything tradable in the open market (equities, securities, currencies, interest rates, credit risk, any commodity imaginable, indexes thereof and/or baskets of

any combination of the above) and be utilized for a variety of purposes, notably those pertaining to hedging, arbitrage and speculation.

Forward contracts

A derivative instrument is simply a financial instrument or asset that derives its value from the value of some other underlying asset. The first derivative instrument was probably the forward contract. Not surprisingly, forwards were also the simplest types of derivative. In a forward contract, two parties undertake to complete a transaction at a future date, but at a predetermined price. The two parties could be a producer who promises to supply the product (underlying asset) and a consumer who needs the product. To see how a typical forward contract works, let us examine a simple example of a cocoa farmer (producer) and a confectioner who needs cocoa for his products (consumer).

To simplify matters, let us say the farmer has planted cocoa and expects to harvest 120 tons of cocoa in 6 months. The confectioner, on the other hand, has cocoa in his inventory to last him for the next six months, but will need to replenish his inventory in 6 months with 120 tons. Though simplified, this is a very common business situation. We have a producer who would have products available at future date and consumer who would need the product in the future.

Clearly, both parties here are faced with risk: essentially, price risk. While the farmer would be fearful of a fall in the spot price of cocoa between now and six months time, the confectioner would be susceptible to an increase in the spot price. Since they both face risk but in opposite directions, it would be logical for both parties to meet, negotiate and agree on a price at which the transaction can be carried out in six months' time.

Once the terms are formalized and documented, both parties have a forward contract. The benefit of such a forward contract accrues to both parties. First, both parties as a result of the forward contract have eliminated all price risk. The farmer now knows the price he will receive for his cocoa, regardless of what happens to cocoa prices over the following six months. The confectioner too has eliminated price risk since he will only have to pay the agreed price, regardless of spot prices in the following six months.

There is a second benefit to this. Since both parties have 'locked-in' their price and cost, they would be in a much better position to plan their business activities. For example, the confectioner can now confidently quote to his customers prices at which he can deliver the products in the future. This would not have been possible had he been uncertain about his input price. The benefits of a forward contract, therefore, are often much more than merely hedging price risk.

The need for futures contracts

The next steps in the evolution from forwards were futures contracts. Futures contracts were innovated to essentially manage risk. One would be tempted to ask why futures were needed if forwards were sufficient for risk management purposes. As pointed out earlier, a newly innovated product will not survive unless it has some added value over existing products. That futures contracts have become increasingly popular and have huge trading volumes is

testimony to their benefits over forward contracts. The need for futures contracts came about because of the problems associated with forwards. We will examine the three main problems here.

The first problem may be classified as that of double coincidence, whereby the party to a forward contract would have to find a counterpart who has opposite needs, with respect not only to the underlying asset, but also to the timing and quantity. The counterpart must require the product in the right quantity at the right time.

Thus, a number of factors will have to coincide before a forward price is arrived at through negotiation. Depending on the bargaining position, however, it may be possible that the forward price is forced upon one party by another. This may either be due to urgency on the part of one party (as with perishable goods), or more commonly due to informational asymmetry. A third, and probably the most important problem with the forward contract is counterpart risk. Counterpart risk refers to default risk of the counterpart in the contract; although a forward is a legally binding arrangement, legal recourse is slow, time-consuming and costly.

Default risk in forward contracts arises not so much from 'dishonest' counter-parties but from increased incentive to default as a result of subsequent price movement. When spot prices rise substantially above the forward price, the short position (seller) has the incentive to default. The long position would have the incentive to default if the opposite happens (that is, if spot price falls heavily).

As these shortcomings of the forward contract became apparent, a new instrument was needed that would provide the risk management benefit of forwards while simultaneously overcoming its problems. The resulting innovation was the futures contract. A futures contract is essentially a forward contract that is standardized with respect to contract size, maturity, product quality, place of delivery, and so on. With standardization, it was possible to trade on an exchange which in turn increases liquidity and therefore reduces transaction costs. In addition, since all buyers and sellers transact through the exchange, the problem of double coincidence of wants is easily overcome. One would transact in the futures contract with maturity closest to the required maturity and, in as many contracts as needed, to fit the underlying asset size.

With exchange trading, the second problem with forwards contracts, the possibility of being locked into an unfair price, would not exist. This is because each party is a price taker with the futures price being that which prevails in the market at the time of contract initiation. As exchange quoted prices are market-clearing prices, arrived at by the interaction of many buyers and sellers, they would, by definition, be 'fair' prices.

The problem of counterpart risk is overcome in futures contracts by means of the notation principal. The exchange, being the intermediary, 'guarantees' each trade by being the buyer to each seller and seller to each buyer. What this means in the case of futures contracts, is that each party transfers the counterpart risks onto the exchange. This transfer of risk to the exchange by parties to the futures contract has to be managed by the exchange, which then bears the risk. The exchange minimizes the potential default risk by means of the margining process and by daily marking to market. The basic idea behind the margining and marking to market process is that it reduces the incentive to default by requiring initial deposits (initial margins) and recognizing losses as they occur, and requires the party

whose position is weakening, to pay up as the losses accrue (margin calls). This margining and marking to market process has been refined and fine-tuned over the years by futures exchanges, to such an extent, that incidences of market cornering and systemic defaults have been reduced to negligible rates.

The need for options

Though futures contracts have been able to overcome the problems associated with forwards, they were still inadequate in some respects for latter-day business needs. In particular, there were two inadequacies that stimulated the search for innovation in futures products. The first is the fact that, while futures enabled easy hedging by locking in the price at which one could buy or sell, being locked in also meant that one could not benefit from subsequent favourable price movements.

A second and much more important inadequacy is the fact that futures (and forwards) were unsuited to the management of contingent liabilities or contingent claims. These are liabilities or claims on a business entity that could arise depending on an uncertain outcome. In other words, contingent claims or liabilities are business situations that involve at least two levels of uncertainty. In an increasingly turbulent world, such situations have become commonplace their management and much more important. By way of example, one of the easiest ways to see how a contingent claim/liability could arise would be in international business. Let us say a Malaysian company involved in the manufacturing of a certain electrical component has just submitted a bid in an international tender to a foreign government for supply of the components. Let us assume that that payment would be in a foreign currency, that today is the last day for submitting bids and that the foreign government will choose from among several international bidders and will make known its chosen bid and supplier in one month's time.

For clarity, let us assume further that once the government announces the winning bid, the chosen supplier will supply over the following five months, and will be paid in full at the end of the fifth month. The time line below shows the chronology of events.

From the viewpoint of the Malaysian company, they will know the outcome in one month and, if chosen, will supply and receive payment in foreign currency six months from today. Note that this is by no means a hypothetical situation (apart from the simplification for the purposes of this example); in fact, in international business, this is a highly common occurrence. Clearly, the Malaysian company faces risk. If chosen, they would be paid in a foreign currency. Since they would have to bid a fixed amount in foreign currency, they face the risk that the foreign currency could depreciate against the ringgit and as their costs would be in ringgits, this would result in them making losses. Note that this currency exposure begins the moment the bid is submitted, yet becomes reality only if their bid is chosen.

There are two simultaneous sets of uncertainty here. First is the uncertainty regarding the ringgit amount that will be received, given currency fluctuation and second, uncertainty as to whether the bid would be chosen at all. How could one manage such compounded risks? Suppose the company did nothing to hedge; they would face currency risk if chosen but would have no problem at all if they were not chosen. Clearly, there is a need to hedge

the currency risk, yet currency futures or forwards would be unsuitable. A forward would be unsuitable, since if the company were not chosen, a forward contract would be difficult to reverse.

With futures, the company has two choices: (a) take a short position in a six-month currency futures contract now and reverse out in a month if not selected; or (b) wait until the result is known in a month's time and then, if chosen, take a short position in five-month currency futures. While at first glance it may seem appropriate, neither of these alternatives would really be suited.

It is precisely for managing such complicated risks, that the option was innovated, whereby all exchange-traded options come in two types, call options and put options. A call option entitles the holder the right, but not the obligation, to buy the underlying asset at a predetermined exercise price at, or any time, before maturity. A put option, on the other hand, entitles the holder the right, but not the obligation, to sell the underlying asset at a predetermined exercise price at or before maturity. Since options provide the right but impose no obligation, the holder need only exercise it when favourable for him to do so. This non-obligation to exercise provides increased flexibility and is the key advantage of options over forwards or futures. The buyer of the options pays for this privilege by paying the seller a non-refundable premium. The maximum possible loss to a buyer of an option is therefore limited to the premium he pays. This loss occurs if he chooses not to exercise the option. In most other respects, such as trading methods and contract specification, the exchange trading of options is similar to that of futures. Though introduced in its exchange-traded form as recently as 1973, options have now taken centre stage in risk management.

So, how would options help in managing the compounded risks of the above example? The Malaysian company, at the time of its submitting the bid (today), would simply have to buy (long) six-month put options on the foreign currency.

The number of contracts needed would depend on the contract size. Buying the needed number of six-month put option contracts, to equate to the amount the foreign currency receivable, the company would fully hedge both the currency risk and the uncertainty about the outcome of the bid. In the event that the company's bid is not chosen, the put options could be left unexpired with losses limited to the cost of the premium. On the other hand, should it be chosen and the company receives a depreciated foreign currency, the put options purchased become profitable and would be exercised.

If properly designed to be fully hedged, the profit payoff from the long put position would equal the losses made on receiving the depreciated currency. Remember that in introducing the need for options, two inadequacies of futures contracts were pointed out, the first being that futures were inadequate with contingent claims/liabilities and the second being that the price lock-in feature of futures means that one could not take advantage of subsequent favourable price movements. We have seen above how options can be used where contingent claims or compounded risks are involved. Options also have the advantage that while the exercise price locks in the price to provide protection from unfavourable price movements, their non-obligatory nature also means that one could also take advantage of favourable price movements.

In short, options provide the best of both worlds. They provide downside protection by limiting losses to the premium paid while simultaneously allowing for gain.

To summarize, put options are useful where protection is needed from price falls but where price increases would be beneficial. Call options, on the other hand, would be useful where protection is needed from price increases but where price declines are beneficial.

Islamic financial instruments with features of derivatives

Doubts still remain among Islamic financial scholars about the permissibility of derivative instruments being used by Muslims. The instruments also remain an unknown to many Muslim scholars because of the unfamiliarity with their basic mechanics and the difficulty in communicating the basic principles. Although complex, explanation should not become a hurdle for those trying to get across an understanding and appreciation of the relevant matters.

A number of instruments and contracts exist in Islamic finance that could be considered a basis for derivative contracts within an Islamic framework. We examine two such contracts:

- The *bai salaam* contract
- The *istijrar* contract

While the *bai salaam* contract has provisions and precedence, the *istijrar* is a recent innovation practised in Pakistan.

Bai salaam

Salaam is essentially a transaction where two parties agree to carry out a sale/purchase of an underlying asset, at a predetermined future date, but at a price determined and fully paid for today. The seller agrees to deliver the asset in the agreed quantity and of the required quality to the buyer at the predetermined future date. This is similar to the conventional futures contract. However, the big difference is that in a *salaam* sale, the buyer pays the entire amount in full at the time the contract is initiated. The contract also stipulates that the payment must be in cash form.

The idea behind such a ‘prepayment’ requirement, has to do with the fact that the objective in a *bai salaam* contract is to help needy farmers and small businesses with working capital financing. The buyer in a contract is therefore often an Islamic financial institution. Since there is full prepayment, a *salaam* sale is clearly beneficial to the seller. As such, the predetermined price is normally lower than the prevailing spot price. This price behaviour is certainly different from that of conventional futures contracts where the futures prices are typically higher than the spot price by the amount of the carrying cost. The lower *salaam* price compared to spot is the ‘compensation’ by the seller to the buyer for the privilege given to him.

The *bai salaam* contract is subject to several conditions, the most important ones being that:

- full payment is made by the buyer at the time of effecting the sale;
- the underlying asset is standardizable, easily quantifiable and of determinate quality;
- the contract cannot be based on a uniquely identified underlying asset, meaning that the underlying commodity cannot be based on a commodity from a particular farm or field et cetera (since by definition such an underlying asset would not be standardizable);
- quantity, quality, maturity date and place of delivery must be clear in the *salaam* agreement; and
- the underlying asset or commodity must be available and traded in the markets through the period of contract.

Given our earlier description of futures contracts, it should be clear that current exchange traded futures would conform to all but one of these conditions (the exception being the first, which requires full advance payment by the buyer).

However, given the customized nature of *bai salaam*, it would more closely resemble forwards than futures. Thus, some of the problems of forwards, namely double-coincidence, negotiated price and counterpart risk, can exist in the *salaam* sale. Counterpart risk, however, would be one-sided in that since the buyer has fully paid, it is only he who faces the seller's default risk and not both parties as in forwards/futures. In order to overcome the potential for default on the part of the seller, *Shari'a* allows for the buyer to require security which may be in the form of a guarantee or mortgage.

The contract could also form the basis for the provision of working capital financing by Islamic financial institutions. Since financial institutions would not want possession of the underlying commodity, parallel contracts may be used.

Though not all jurists agree about its permissibility, the literature cites two avenues for parallel *salaam*. The first is a parallel *salaam* with the original seller while the other is an offsetting transaction by the financial institutions with a third party. In the first alternative, the financial institution, after entering into the original contract, gets into a parallel *salaam* to sell the underlying commodity to the original seller, after a time lapse, for the same maturity date. The resale price would be higher and considered justifiable since there has been a time lapse. The difference between the two prices would constitute the bank's profit. The shorter the time left to maturity, the higher the price. However, the requirement is that both transactions should be independent of each other. The original transaction should not have been priced with the intention of creating a subsequent parallel *salaam*. Under the second alternative, the bank, which had gone into an original contract, enters into a contract promising to sell the commodity to the third party on the maturity date of that contract. Since this second transaction is not a contract, the bank does not receive advance payment.

The *istijrar* contract

The *istijrar* contract is a recently introduced Islamic financing instrument. Introduced in Pakistan, the contract has embedded options that could be triggered if the underlying asset's price exceeds certain bounds. The contract is complex in that it constitutes a combination of options, average prices and *mudarabah* or cost plus financing. The *istijrar* involves

two parties: the buyer (which could be a company seeking financing to purchase the underlying asset) and a financial institution.

A typical *istijrar* transaction could be implemented where, for example, a company approaches a bank seeking short-term working capital to finance the purchase of a commodity like a needed raw material. The bank purchases the commodity at the current price (P_0), and resells it to the company for payment to be made at a mutually agreed date in the future, say, in 90 days' time. The price at which settlement occurs on maturity is contingent on the underlying assets' price movement from t_0 to t_{90} (where t_0 is the day the contract was initiated and t_{90} is the 90th day: the maturity day). Unlike a *murabahah* contract (where the settlement price would simply be a predetermined price, P^*, where

$$P^* = P_0 \ (I + r),$$

with r being the bank's required return learning), the price at which the *istijrar* is settled on the maturity date could either be P^* or an average price (P) of the commodity during the period t_0 to t_{90}. Which of the two prices will be used for settlement will depend on how prices have behaved and which party chooses to 'fix' the settlement price.

The embedded option is the right to choose to fix the price at which settlement will occur at any time before contract maturity. At the initiation of the contract, t_0, both parties agree on the following two items: (i) the predetermined *murabahah* price P^* and (ii) an upper and lower bound around the P_0 (the bank's purchase price at t_0). For clarity, the different prices are shown below in a continuum from left to right, as prices increase.

Where P_0 = the price that the bank pays to purchase the underlying commodity,

P^* = *murabahah* price; $P^* = P_0 \ (l + r)$

P_{LB} = The lower-bound price

P_{UB} = The upper-bound price

The settlement price (Ps) at t_{90} would be:

(i) P_S = P, if the underlying asset price remained within the bounds,

or

(ii) $P_S = P^*$; if the underlying asset exceeds the bounds and one of the parties chooses to exercise its options and use P^* as the price at which to settle at maturity.

For either party to exercise its option and thereby the settlement price at P^*, the spot price during the term of the contract must have exceeded the bounds at any time. Which party would exercise its option would, of course, depend on the direction of the spot price movement.

For example, if the spot price at any time breaks through the upper bound, the buyer would get worried. But whether he will exercise his option or not would depend on his predictions of the spot price's performance over the remaining period of the contract. If he

believes that the price is likely to keep increasing, thereby causing P at which settlement will occur to be greater than P^*, it will be in his interest to exercise his option by fixing the settlement price now at P^*.

Essentially, he would notify the bank that he is exercising his option and that the settlement would be P^*. Should spot prices be falling such that it breaks the lower bound, the bank would have the option to fix the settlement price at P^*.

Analyzing the *istijrar* contract entirely from an options viewpoint is complicated since it has two different exercise styles rolled into one. Such an instrument would be highly unusual in conventional finance. Nevertheless, for our purpose here, the embedded options in the *istijrar* can simply be thought of as follows. The fact that the buyer can fix the buying price at P^* when the price goes higher implies that he has a call option at an exercise price of P^* while the bank has a put option at the same exercise price.

What the *istijrar* contract attempts to do is allow for the impact of price changes but to cap the benefits that accrue as a result. By definition, since changes are allowed only within a band, the advantage to one party and the disadvantage to the other are capped. The maximum potential gain or loss is limited. Such a contract fulfills the need to avoid a fixed return on risk less asset which would be considered *riba* and also avoids *gharar* in that both parties know P^* and the range of other possible prices in advance (by definition, between the upper and lower bounds).

Reviewing the arguments against derivatives

There are arguments and reservations raised by Islamic scholars from a conventional finance viewpoint. The contemporary derivative markets have been fine-tuned over many years of trial and error. There have indeed been many failures and markets have had painful lessons. They have responded by tightening regulation, redesigning instruments and trading methods and adding new control features. It would be absurd to brush aside all of this experiential learning.

Trading volume

The first issue that will be addressed here is the argument often put forward that the huge trading volume of derivative markets is indicative of extensive speculation, and so the market attracts and accentuates speculative behaviours. While it cannot be denied that there is plenty of speculative activity, there are logical reasons why the total trading volume is often much larger than the underlying asset volume. Often ten or fifteen times higher, this huge divergence between underlying assets and trading volume is due to risk dissipation. To see how this works and how it can lead to increased trading volume, let us use an example.

Let us say a hedger, Hedger *A*, wishes to hedge a foreign currency receivable of $100 million. He approaches his main banker, Bank *A*, with a request to make a forward contract. The Bank obliges as Hedger *A* is a regular customer. Once the forward contract is made, Hedger *A* is fully hedged but Bank *A* is exposed. To protect itself, Bank *A* would

either use the currency futures or options markets. Using futures, Bank *A* would short as many contracts as required to lay off the \$100 million. While Bank *A* shorts the foreign currency futures, there must be parties on the other side taking long positions. Since the amount is huge there may be several other counter-parties. Let us say four other parties become Bank *A*'s counterparts in currency futures, each taking \$25 million worth of contracts. These four are Bank *B*, Speculator *A*, Speculator *B* and Speculator *C*.

With this transaction, Bank *A* is fully hedged. Bank *B* may have come into the currency futures transaction to hedge its own needs. For example, Bank *B* may have a need to make a \$25 million foreign currency payment and so needs this contract to protect itself for appreciation of the foreign currency. The speculators *A*, *B* and *C*, however, are still exposed. Clearly, they must be willing to take the risk. However, as time passes and some time before maturity, some of the speculators might reverse their position. For example, Speculators *A* and *C* might now short the foreign currency to speculator *D* and Bank *X* respectively.

The reason why Speculators *A* and *C* reverse out could either be to take profit from favourable movement or to cut losses that may result from price falls. Bank *X*, the new bank that came into the picture, may have come in to hedge its own recently-arising exposure.

Note that the original single \$100 million transaction between Hedger *A* and Bank *A* led to a series of other futures market transactions. It can be seen that for a total of \$250 million of derivative transactions, \$150 million of transactions was created in futures even though the process is not complete because Speculator *B* and the new Speculator *D*, are still holding on to their positions. If we add the potential role of arbitrageurs to this, it becomes clear why trading volumes are more than underlying asset volumes. As mentioned earlier, the needs for all these sets of transactions arise because of risk dissipation (the need to share risk). As more players come in, the asset risk is more widely dissipated. It is this kind of speculative activity that Islamic jurists often try to remove.

However, this kind of drastic action can hinder rather than help. Without the speculators, hedgers would be disadvantaged. In our example, Bank *A* probably would not have entered into the forward contract with Hedger *A*, if it had been unsure of its ability to offset its resulting exposure. This process of trading and risk dissipation closely resembles insurance and the reinsurance process.

The issue of non-delivery

A second troublesome issue is the fact that many of those trading in the derivatives markets are not concerned with making or taking delivery of the underlying asset. These people must, say the jurists, be speculators because in essence there is no intention of delivery. There are many situations in which even genuine hedgers would not wish to take or make delivery. An easy example of such a situation follows.

A jeweller has just bought gold bars worth RM1 million for inventory purposes. They are to be used as raw materials for the next six months' jewellery he intends to produce. The jeweller clearly has exposure, as jewellery prices are dependent on the spot price of gold. If the spot price of gold subsequently falls, he would lose since the value of his remaining gold bars and his finished and incomplete jewellery would be worth less.

Can such a risk be hedged by the jeweller? One way would be to use gold futures contracts (that is, short (six-month) RM1 million gold contracts). By so doing, he neutralizes any subsequent declines in gold price because losses resulting from inventory value diminution are offset by the profit he makes on the short position in the futures contract. If gold prices rise, the opposite will happen. Even though the jeweller is technically a hedger rather than a speculator, he has no intention and will be in no position to deliver the gold. In six months' time, the gold in his inventory would be all but finished. He cannot deliver and had never intended to. All he ever needed was insurance against price falls for six months and he duly received that protection. The jeweller merely calls his futures brokers to reverse out his position just prior to maturity. The jeweller doesn't intend to sell the gold, he just needs to hedge gold price fluctuations. The position of the jeweller is normal, and would apply to any producer who relies on the price of an input product to set prices of finished products.

Cash settlement

Another contentious point is the issue of cash settlement. It has been alleged that cash settlement was created in order to enhance speculative activity. But cash settlement has many advantages, and it does not follow that it is solely intended to help speculators. Cash settlement is usually used with financial futures and options, for example, index options and stock index futures. Though a relatively new type of settlement procedure, exchanges prefer cash settlement for three reasons:

- Convenience to both parties. Without a cash settlement, the seller or short position would need to buy each underlying stock in the correct proportion in order to deliver. Not only would this be very trying, but it would also cause complications associated with having to buy in odd lot sizes. On delivery, the long position would need to get all the stocks registered or sell them, again a time-consuming and complicated process. With cash settlement, if the long position chooses to receive the stocks, it would be simplified, since underlying stocks are traded contemporaneously.
- Cost reduction. By avoiding the need for the short to buy and the long to sell the underlying stock and received stock, respectively, both parties save transaction costs. To take the Malaysian example, a brokerage commission of 1% of the value would have to be paid for either buying or selling. Cash settlement therefore saves 2% of the contract value, which could be several thousand ringgits. In this case, stockbrokers would be the only beneficiaries of requiring a physical settlement.
- An attempt at cornering the market will fail. It would not be possible to corner a market without the need for physical delivery. There is no reason why cash settlement would induce greater uncertainty (*gharar*) in contrast to physical delivery. Regardless of whether the contract is cash or physically settled, a hedger who had taken a position will have locked in a price.

The convergence principle means that much of the argument that cash settlement increases *gharar* is false. The futures price at maturity must, by this principle, converge to the spot

price, since at maturity, a futures contract is effectively a spot contract. Other than this, any disparity between futures and spot price at maturity will facilitate reckless arbitrage. The existence of such arbitrage is another reason why there can be no disparities to cause increased *gharar*.

Summary

This chapter has examined the evolution of derivatives; the unique benefits to businesses using them; and some Islamic viewpoints. Though most scholars have arrived at their evaluations from the basic contractual point of view, each appears to have taken a different approach and looked at contracts uniquely, before concluding on their validity. Aside from a differential approach on the *Shari'a* side, their conclusions also appear to be driven by their often-misguided perceptions of derivative instruments.

The question as to the validity of all derivatives currently traded is irrelevant. Clearly, instruments that have items with *haram* as their underlying assets, could be discounted straight away. But the case of derivatives on *halal* input commodities, equity instruments and currencies, deserves attention. Though Islamic scholars might prefer to fall back on conservatism, such a position can, in the long term, be costly for Islamic business. In today's competitive and sophisticated business environment, denying businesses the use of flexible and powerful instruments can, only disadvantage them, so social welfare should be considered in evaluating the permissibility of derivatives. Rather than having a limiting focus on the contractual framework, Islamic scholars should consider the potential for welfare loss when deciding on the permissibility of derivative instruments.

Chapter 20

Capital market transparency and fragmentation: lessons for Islamic markets

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Introduction

This chapter summarizes two related topics in market regulation: the long standing debate on the transparency of markets and the more recent one of how best to regulate multi-venue financial markets. The approach taken is to take a broad sweep through the issues and challenges rather than presenting an extensive literature review or large numbers of tables and charts.

Transparency

What is transparency?

In the context of financial markets, transparency is the question of 'who should be allowed to see what?' This is generally understood to be the question about whether 'normal' (by which is meant general traders, not simply large institutional traders or dealers) should be allowed to observe:

- Potential trades that have been communicated to the market but which have not yet been executed. This is *pre-trade* transparency and is usually no more than making visible any unexecuted orders on the electronic order book.
- Details of trades which have been executed. This is *post-trade* transparency and is usually taken as making available information on the asset traded, the size of the trade, the price of the trade and its time. (There is no serious suggestion that any information allowing the identities of the traders would be revealed.)

The debate on transparency has been long and, at times, acrimonious but at the heart of it are two questions:

1. Will increased transparency (that is, visibility) of trading improve the efficiency and fairness of the market? Or

2. Will increased transparency reduce the quality and liquidity in the market by deterring traders who do not want their actions revealed?

While these may appear esoteric (or obvious), the length of the debate suggests that participants regard it as affecting the core of their business. The degree of regulatory concern also shows that regulators regard transparency as critical to their future activities.

Why are regulators concerned about transparency?

Most financial regulators have a number of statutory responsibilities which usually include a general requirement to ensure 'the orderly conduct of business' on the exchanges they regulate, together with some more specific objectives, typically including:[1]

- Maintaining confidence in the financial system.
- Promoting public understanding of the financial system.
- Securing the appropriate degree of protection for consumers.
- Minimizing financial crime.

One part of this will be a wish to promote appropriate competition between markets and there should be concern either when obvious deviations from competition occur or when circumstances are likely to lead to a reduction in competition. Simple economics teaches us that imperfect competition results from some sort of barrier to entry into the industry and ownership of valuable information can form just such a barrier. Thus, any restriction in the free flow of information in financial markets has the potential to impair the functioning of the market concerned and to result in the undesirable effects of excessive profits, restricted output, higher prices and a lack of innovation.

In assessing the degree of competition and availability of information, a further key issue is whether market access should be limited to a pre-specified group of participants or designed to allow more or less open access. The former suggests the traditional model in which a relatively small group of dealers trade with each other and who will, almost by definition, be content with existing arrangements. The problem with this model is that those who are uneasy about the trading conditions will tend to withdraw from the market (or not enter it at all). If the second is accepted, then regulators must be aware of the needs of smaller and less well informed investors. Although open access may seem attractive, the difficulties in implementing it should not be underestimated and almost all markets have at least some restrictions on who may trade. Whatever the judgement on this, regulators need to be aware of the effect of market structures and rules on potential new entrants.

A clear and early summary of the reasons why transparency is beneficial was provided by the Securities and Investment Board (SIB):[2] 'In the SIB's view, the transparency of a market is a key factor in demonstrating its integrity because it:

- permits the demonstration of market fairness;
- is of fundamental importance to the price formation process;
- enhances competition between market intermediaries; and
- assists in the prevention and detection of a variety of abusive practices.'

Obviously, a regulatory view of this sort implies that transparency is understood to have had an important role to play in achieving the regulatory objectives listed at the start of this chapter.

Evidence of transparency

As part of the long-standing debate on transparency many studies, both academic and professional, on the benefits and costs of transparency have been produced. Many of these have been conducted for equity markets, for which large amounts of data are readily available. It is now largely agreed that increasing transparency in these markets has resulted in few negative effects and some positive ones:

- Transaction prices have generally improved (that is, bid-ask spreads have narrowed). It is arguable that this effect would have occurred anyway, but what matters here is that prices did not worsen with transparency.
- Market depth was undamaged (meaning that the volume of transactions did not decline and dealers appear to be no less willing to use their own capital).
- The flow of information to investors, particularly retail investors, has improved.

The 'anti' view of transparency is that increasing transparency will reduce the incentives for intermediaries to provide liquidity or that trading will be driven offshore. However:

- There is no empirical evidence of which we are aware demonstrating that liquidity has been harmed by increased transparency.
- There is no evidence that business has been driven away purely because of increased transparency requirements.
- Many exchanges now mandate high levels of transparency but have maintained their liquidity.

While these results are persuasive in regard to equity markets, it must be recognized that other markets are less naturally liquid and that these may, therefore, be adversely affected by incautious increases in transparency. The market for bonds is a good example of a market which is very large in aggregate but for which the level of trading in any individual bond is low. It is maintained that mandating transparency in such a market would induce the effects listed above, and the argument has been made sufficiently persuasively that few regulators require the same transparency for bond markets as they do for equity. It should be noted, however, that the US has mandated a rigorous transparency regime for its bond market and the results of many studies of this market are consistent with those for equity markets: narrower spreads, no reduction in depth and a general improvement in market quality.

Fragmentation and exchanges

The discussion over transparency was originally couched in terms of the need to promote retail investor confidence in what were seen as markets dominated by large institutions. It has

since been given further impetus by the realization that there is a process of fragmentation (and, to an extent, consolidation) in financial markets and that this raises a whole new set of regulatory problems. To some extent, some of these problems can be reduced if an equitable transparency regime can be implemented. This section therefore considers the effects of fragmentation and the influence of transparency on the regulation of such markets.

Exchange ownership and the fragmentation of trading

Financial exchanges have generally changed from being mutual organizations, which are owned by their members and which operate for the benefit of those members, to public companies which are listed on stock exchanges (often their own) and whose shares are traded in the same way as those of any other company. It is estimated that over 85% of equity exchanges worldwide (including all of the largest ones) are now publicly owned.

This change in ownership structure has had a number of effects. The most important of these is that exchanges are now subject to the same degree of scrutiny and analysis as are other investment vehicles. Exchanges which are seen as inefficient or undervalued are seen as appropriate for takeover, and those that are in desirable locations or whose business 'fits' are seen as presenting good opportunities for merger.

In addition, the sharp reductions in the cost of being an exchange have made it easier to open new exchanges, so that many countries now have two or more stock exchanges in addition to competing derivatives, energy and commodities markets. This means that any security can potentially be traded in a number of ways, including:

- on the principal, historic exchange;
- on a new exchange;
- offshore on an exchange in another country; or
- over the counter by direct contact (for example, via the internet) with the counterparty.

While this makes complete sense from the economic perspective, it causes regulatory problems arising from the difficulty of overseeing such fragmented markets. In addition, it becomes difficult for brokers to fulfil their fiduciary obligations to clients (for example, how to interpret their obligation to deliver best execution).

Trading structures and regulatory intervention

Worldwide, there is a pattern of convergence in trading systems, but there is continuing diversity in other parts of the trading process. Thus, although floor trading has generally been replaced by electronic order book system, exchanges retain significant differences in areas including transparency, market centrality, exchange scope, liquidity support, protection of order priority and retail protection. It can be argued that as the structure of markets is a major focus of competition between exchanges, then competing markets should be expected to open whenever an existing exchange fails to meet standards or market needs. If that is so, then the role of a regulator changes from forcing the incumbent market to operate in a particular way to simply facilitating competition between exchanges.

There have been several decades of research on the consequences of different market structures and disclosure regimes. A rather broad view of the conclusions of this work might be:

- There is no conclusive theoretical evidence either that one trading structure is absolutely better than others or that some trading structures are naturally more suitable for trading particular products or for particular traders than others.
- The move towards electronic trading will continue, and floor trading is likely to vanish in the near future. The reason for this is simply that the cost of executing an electronic trade is significantly lower than for floor-based trades.
- There is no substantive evidence to support the proposition that different types of asset require the application of a fundamentally different regulatory regime. This finding means that although particular aspects of any market, such as low liquidity, might justify different levels of transparency, the overall framework can and should be similar.
- The nature of the traders who use an exchange will change over time as investor tastes change, and new marketplaces develop. This implies that regulation needs to be broadly defined and avoid a reliance on particular market structures or set of client profiles.

Emergence of contestability

Competitive markets are those characterized by a large number of firms (exchanges) with easy entry and exit from the market. A market is said to be contestable when, even if only a few firms actually operate in the market, there is sufficient threat of new, competitive, entry that those existing firms keep prices low (and output high) to deter such entry. Thus, while contestable markets may appear to be concentrated, they display few of the adverse effects normally found in monopolies. The removal of the monopoly position of traditional exchanges and the changes in international regulation to allow competition between exchanges has arguably led to 'contestability' in trading services:

- Exchanges are extending their product range into new areas. Thus many stock exchanges now offer derivatives trading, and some new systems offer trading in equity, bonds and commodities.
- The increasing importance of trading systems which are not legally exchanges means that traditional exchanges now face direct competition in their core markets. In addition, brokers now match an increasing amount of business between their own clients. Both of these developments mean that trading is effectively being conducted away from traditional exchanges.
- The growth of the 'over the counter' markets, especially in derivatives or between the large financial institutions, represents a competitive threat for traditional exchanges.
- Much financial legislation has been rewritten both to remove references to 'the stock exchange' and to reflect a financial landscape in which multiple exchanges (or near-exchanges) operate.

Perhaps the best evidence of this trend is the actual emergence of so many new exchanges worldwide, and the issue is therefore how to modify the regulatory system to fit the new situation rather than to discuss the maintenance of the traditional single-exchange model.

This emerging competition in the supply of trading services means that:

- Trading system fragmentation is probably irreversible. Thus investors (and their advisors) need to adapt their practices to reflect the possibility that trading can be conducted on one of several markets and, for example, that brokers will need to survey all these markets when advising their clients.
- There is now extensive competition for trading services, leading to innovation and a greater focus on user needs. For example, the willingness of some traditional exchanges to make their data feeds available at zero cost (albeit with some delay) over the internet is one example of how competitive pressures have forced trading systems to respond to a user need.
- Change becomes part of the market landscape and markets will continue to change, maybe at an increasing rate. Competition will lead to consolidation in some parts of the market, but low entry costs should mean continuing innovation from new entrants, possibly aiming at niches or offering innovative systems in other parts.
- Competition should prevent exchanges from being able to perpetuate unsuitable regulations and systems, and this will allow regulators to move away from their traditional involvement in the micro-management of exchanges and their rules.

Principal challenges for regulators of fragmented markets

Security market fragmentation *per se* is not a problem. A problem only exists if fragmentation results in worse market conditions (for example, a widening of the bid–ask spread). Some of the difficulties raised by the fragmentation of markets are detailed below.

How to define an exchange

As trading fragments, it becomes increasingly difficult to distinguish between traditionally recognized exchanges and 'near-exchanges'. For example, technology enables organizations to present screens showing best prices, and to route orders to the trading system offering the best price, without themselves conducting trading. Such entities have many of the external (customer facing) features of an exchange but do not actually execute any trades. Ultimately, of course, investors themselves will decide on their preferred execution venue and the regulator's responsibility is to ensure that the investor can make an informed choice, not to force them to trade on one exchange rather than another.

Who has responsibility for market operation?

Investment firms which operate trading systems are, unlike exchanges, subject to regulation that focuses on customer relationships and not the quality of the market itself (for example, overall price formation). These firms may see no commercial benefit in voluntarily taking on

the regulatory responsibilities of being a recognized exchange. Equally, the commercial orientation of exchanges may encourage them to focus increasingly only on the business passing through their own trading systems, and they will become less interested in being a reporting mechanism for essentially off-exchange transactions, unless it offers a commercial return.

Investor protection and best execution

Arguably, the protection of small and retail investors is a major function of the regulator. One aspect of this protection is to ensure that a broker obtains best execution (by trading quickly and at a 'fair' price) for their client. Although best execution is relatively easy to define when there is a single trading system offering a single method of execution, it becomes very complex when there are multiple trading systems. Equally, obtaining absolute best execution becomes increasingly expensive for the broker (and this cost will also be passed on to the client). Thus, brokers will begin to define the quality of execution that they offer their clients and the clients will decide on the quality and extent of service they require. Monitoring this also becomes difficult and an appropriate transparency regime will be of material assistance (for example, by allowing the client to see that others were trading at similar prices).

Loss of efficiency (multiple trade prices)

In a fragmented market there is a possibility of loss of pricing efficiency because the price formation process may fragment, leading to multiple simultaneous trade prices. Early proposals for a Central Limit Order Book proved to be undesirable and unworkable. Correctly, it was felt that informal linkages (for example, traders with accounts on each market) will address this issue so that the user costs of split liquidity (for example, more executions and, maybe, arbitrage costs) are outweighed by the other benefits of a competitive market.

Order priority

Trading systems always include rules governing the sequence of execution of orders (almost always by price and then time) and priority rules are seen as crucial in attracting investors who can submit orders in the knowledge that they will not be traded through. The existence of multiple trading venues raises the possibility that price and time priorities will not be maintained between different exchanges trading the same security. The limited evidence available for the UK equity market has shown that offering a better price on a different RIE (RIE is an index for REIT by Dow Jones) does not necessarily guarantee execution priority. More generally, while a widely-drawn best execution rule will tend to safeguard price priority, it does nothing for time priority since the broker executing an order will want the best price, but will be indifferent to the time priority of the counterparty order.

Barriers to entry

If regulators are to rely increasingly on competitive forces to ensure the quality of different trading systems, they need to be assured that there will be competition and that incumbents

will not exclude new entrants by erecting barriers to entry. Dominant exchanges will, of necessity, be the main arenas for price formation, and so it is essential that new entrants have access to the information from the incumbent. The regulator's task is to identify what is a fair advantage from investment, and what is actually a barrier to entry.

Manipulation

It is harder to identify market abuse in a fragmented market, particularly at the level of an individual exchange. As a result, responsibility for preventing market abuse rests with the regulatory authority, which is likely to need access to trade and position monitoring information.

Lessons for Islamic markets

Fundamentally, there need be few differences between markets in Islamic products and those in conventional financial instruments, although there are significant differences in the products traded and, possibly, in the motivations of some participants. Thus, the issues noted above have implications for the design and regulatory management of any new and growing market.

The wish to trade matters

A common mistake when establishing financial markets is to focus on market infrastructure. However, while this is undoubtedly important for the ongoing success and development of the market, what matters most is the desire by investors to buy and sell. It is by no means guaranteed that any financial instrument will be heavily traded, just because it was bought in the first place – for example, many countries have corporate bonds, but these are seldom traded.

Do not assume that there will be a single market place

Even if Islamic markets initially develop around national exchanges, there is no guarantee that this will continue. This means that any regulatory framework needs to be non-specific as to trading venue. It also means that liquidity will tend to flow in certain directions and experience shows that it is hard to sustain well functioning markets when traders wish, for whatever reason, to trade elsewhere.

Trade may not be liquid

Long term contractual instruments tend not to be heavily traded. Most bonds trade quite heavily just after issue but thereafter remain untraded. This is in part because of the long term orientation of traders, but also because they may have other ways of managing their risk exposure and because the price paid will reflect the illiquidity of the instrument. While it is common to bemoan the lack of liquidity in these markets, it is instructive to realize that the

US corporate debt market is one of the few worldwide that exhibits significant liquidity (and this level of activity probably has historical roots).

Transparency matters

In establishing any market, what matters is a perception that the market is fair and offers more or less equal opportunities for all participants. The easiest, and cheapest, way to achieve this is through an appropriate transparency regime, so that investors are able to observe others' trade prices and quantities. While far from a panacea, such disclosure does discourage poor practices without interfering unduly in normal trade. Ultimately, transparency, appropriately designed, allows investors (both retail and professional) to monitor their own trade execution in a way that is more efficient than most alternative regulatory solutions.

Education matters

While this note has argued that transparency has the potential to allow investors to make informed decisions and to make appropriate judgements about the quality of service that they receive, this will only be possible when investors are able to process the information provided. This implies the need for widespread investor education to ensure that markets function well and to the greater benefit of both the economy and the investing community.

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[1] The specific list used here was drawn from the UK Financial Services Authority's statutory requirements.

[2] The SIB was the precursor of the Financial Services Authority. This quote was made during the SIB's discussion of proposals for increased transparency in the UK equity market.

Chapter 21

Sukuk and securitization

Aly Khorshid
Elite Horizon

Introduction

Throughout the Muslim world, the twentieth century witnessed the revival of Islamic finance as an alternative mode of financing that complies with *Shari'a*. The Islamic finance industry today offers a broad variety of products and services as well as corporate finance, project finance, equity funds, personal and wealth management, venture capital investment, real estate investment and private equity, all from its very ordinary beginnings when Islamic financiers were chiefly providing Islamic trade financing solutions. Structured in accordance with *Shari'a* principles are all these products and services, as interpreted in their respective jurisdictions. The range of products available is often priced according to the market needs, and provides Muslims with a practical option to manage their finance in an Islamic manner.

With the dawn of the twenty-first century, the Islamic finance industry is continuing to venture into new and exciting areas of finance. The development of Islamic debt securities (commonly known as *sukuk*) is one of the most important recent accomplishments. Many Islamic financiers have ended up with high levels of liquidity for various reasons such as increased oil prices, petrochemical manufacturing output, increase in trade activities, new product innovations and, above all, the increased output of goods from China and India, particularly over the last five years, which has created a large surplus instead of deficit in the world trade market. A huge amount of liquid cash has been generated within the GCC area and MENA region. The Islamic finance industry also lacks *Shari'a* compatible derivative products that could mitigate any asset-liability mismatch risks. The high levels of liquidity often led to inefficiency in the market and the industry leaders actively have to find solutions. The *sukuk*, which is a tradable liquid investment, was seen as a possible avenue for Islamic financiers to invest their surplus liquidity, but at a time of increased liquidity all over the world, that is not enough.

It is estimated that the overall size of the *sukuk* market worldwide is worth nearly US$70bn, the bulk of which are over-the-counter instruments. Listed *sukuk* account for only 20–25% of outstanding *sukuk* issued worldwide, that is US$10–15bn so far. There are more *sukuk* listed in Dubai than anywhere else, but the secondary market is virtually non-existent. Second is London, where the secondary market for *sukuk* totalled less than US$5bn in March 2007. Among listed *sukuk*, Standard & Poor's Ratings Services rates close to US$6bn, or roughly 50% of globally listed outstanding *sukuk*. According to conservative

forecasts, new *sukuk* issuance is expected to accelerate, and could reach US$20–25bn in the next five years. The largest *sukuk* to date were those issued by Dubai-based Nakheel Group for US$3.52bn early in the first quarter of 2007. These notes were listed in both London and Dubai.

Globally, the Islamic financial industry will benefit from the UK's development as an attractive marketplace for *Shari'a*-compliant financing and investment instruments on both the wholesale and retail side. Up to 300,000 retail customers in the UK are potential customers for *Shari'a*-compliant banking services. The establishment of these services in the UK would extend the reach of an Islamic financial model which is, so far, still concentrated in a few countries in the Middle East and Muslim parts of Asia. As for wholesale banking, London has the capacity to become a hub for *Shari'a*-compliant financial flows that seek recycling in Europe. For example, Islamic investment banks such as Bahrain's Arcapita Bank B.S.C. and Gulf Finance House both have offices in London where vast amounts of liquidity from the Gulf meet attractive *Shari'a*-compliant asset classes packaged in private equity, real estate and infrastructure funds domiciled in the more mature and stable European economies.

London has a wide approach to Islamic finance, encompassing a broad range of financial instruments and asset classes. The UK's Financial Services Authority (FSA) has recently licensed the European Islamic Investment Bank, a wholesale financial institution created expressly to recycle the massive amounts of institutional and private liquidity in the Gulf, into *Shari'a*-compliant asset classes originated in mature, stable, and transparent western markets. UK tax law, which is *sukuk*-friendly, could make London more attractive for issuing and trading *sukuk*, although Dubai has so far been the most active trading centre for *sukuk* notes. The UK intends to become a key player in market intermediation for *sukuk*.

Competition from Western financial centres is low, as limited appetite for Islamic finance is coming from New York (where facilitating the trading of *Shari'a*-compliant stocks, especially through the Dow Jones Islamic Index and through the family of Standard & Poor's *Shari'a* indices takes precedence).

Once issued, debt securities are traded in the secondary market. This process contributes to efficient pricing for upcoming issues. Unlike the stock markets, or futures and options markets, secondary trading in debt securities remains decentralized in most countries, although some securities regulators have sought to promote trading by requiring that the debt be listed on stock exchanges.

Liquidity of an issue is predicated on the breadth and depth of the buying base. It is measured with the help of the difference between bid and ask prices (generally called bid-ask spread) and is determined by the trading volume. For sovereigns or sub-sovereigns, high volumes lead to efficient pricing and lower bid-ask spread, while debts issued by lesser known borrowers suffer from lack of liquidity, which leads to a higher bid-ask spread. The size of the international bond market is estimated at $45tr and the size of the outstanding US$ bond market is estimated at $25.2tr.

Definition of *sukuk*

Sukuk (plural of *sak*) means certificates; *sukuk* refers to securities, certificates and papers with the features of liquidity, tradability and cash equivalence.

AAOIFI's definition of Investment *sukuk* – Standard 17(2) reads thus:

> Investment *sukuk* are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services (in the ownership of) the assets of particular projects or special investment activity; however, this is true after receipt of the value of the *sukuk*, the closing of subscription and the employment of funds received for the purpose for which the *sukuk* were issued.

Definition of securitization

Sukuk is the result of Islamic securitization of assets, and securitization is a form of asset regulated by money supply. Securitization refers to a process of converting assets into cash equivalent in the form of papers that are tradable in the secondary market, the process of packaging financial promises and transforming them into a form which allows them to be freely transferred among multiple investors. Through securitization, a liquid asset is transformed into a tradable security that gives the liquid asset the liquidity feature by the deployment or creation of some market mechanism that allows the borrower to have direct access to the capital market. Lenders or investors are able to liquidate their positions or opt for better investment opportunities, thus creating a secondary market that benefits both borrower and investor.

A history of Islamic debt securities

As far as the Islamic finance industry is concerned, *sukuk* are not new. Since the early days of Islamic civilization the concept of *sukuk* has been in use. In the first century, Hijri (corresponding to the seventh century AD) the Umayyad government would pay soldiers and public servants both in cash and in kind. The payment in kind was in the form of *sukuk al-badai*, which is commodity coupons or gain permits. The holders of the *sukuk* were entitled to present the *sukuk*, on its maturity date, at the treasury and receive a fixed amount of commodity, usually grain. Some of the holders used to sell their *sukuk* to others for cash before the maturity date and this is considered secondary trading of *sukuk*. In the classical period, Islamic *sukuk* was similar to the European root cheque inasmuch as it represented any document of a contract or conveyance of rights, obligations or monies done in conformity with the *Shari'a*. Empirical evidence shows that *sukuk* were a product extensively used during medieval Islam for the transferring of financial obligations originating from trade. From the modern Islamic perspective, the essence of *sukuk* lies in the concept of asset monetization that is achieved through the process of issuance of *sukuk*. Because *sukuk* may be issued on existing as well as specific assets that may become available at a future date, its great potential is in transforming an asset's future cash flow into present cash flow.

Sukuk re-emerged in Bahrain in 2001, almost fourteen centuries after they were first recorded, as an Islamic alternative to conventional debt securities. In the domestic market, the State of Bahrain offered *sukuk* with an *al-ijarah* issue. The issue amount was US$250m and had a tenor of five years. The *sukuk al-ijara* concept was derived from prevailing

practices of 'lease ending with purchase' (*ijara muntahia bi-tamlik*) known in conventional finance as 'financial lease'. The *sukuk* carried six monthly lease rentals that were fixed at the lease inception and paid in arrears during the lease term. The *sukuk* offering was highly successful. The Bahrain *sukuk* issue was a major milestone in Islamic finance as it marked the birth of an Islamic capital market where Islamic equity and debt-based instruments are issued and traded.

Another landmark was initiated by Malaysia in 2002 when it issued the first Islamic securities that complied with US Regulation S and Rule 144A formats that are used for conventional global bonds. Prior to that in December 2001, Kumpulan Guthrie Berhad, a Malaysian public listed company involved in the plantation and construction sectors, offered a *sukuk al-ijara* issue in the US Regulation S format. The company offered US$150m *sukuk* issues with a floating rate return and the tenor was divided into three years (US$50m) and five years (US$100m). The *sukuk* was listed on the Labuan International Financial Exchange. The first *sukuk* to be listed in the Luxembourg Stock Exchange was the Malaysian *sukuk al-ijara* and was rated by Standard & Poor's and Moody's. The US$600m *sukuk* was offered globally to Islamic and conventional investors including 'Qualified Institutional Buyers' in the US. The issue was highly successful and was oversubscribed twofold. The Malaysian *sukuk* was a significant development because it was able successfully to fuse the concept of *sukuk al-ijara* with conventional bond practices such as listing, ratings, centralized clearance and dematerialized scripts.

A number of successful *sukuk* issues have followed, including the Islamic Development Bank's offering of US$400m *sukuk* in 2003, the State of Qatar's US$700m *sukuk al-ijara* issue in 2003 and the Kingdom of Bahrain's US$250m *sukuk al-ijara* issue in 2004. In the Islamic finance markets, these successful issues have created much excitement and more issuers looking for a viable and attractive alternative source of funds are considering the *sukuk* option.

The characteristics of *sukuk*

A fundamental requirement of *Shari'a* is that the security must reflect or evidence the security holder's share in an underlying asset or enterprise, which must of course be *Shari'a*-compatible. On the basis that the security reflects the holder's ownership of the underlying assets of the company, contemporary *Shari'a* scholars have allowed investment in equity or share in a company. Through the ownership of the company, the shareholders are deemed to indirectly own the company's assets.

With regard to the link between the ownership of the company and the ownership in the company's assets, *Shari'a* scholars have allowed 'the buying and selling of these securities on the model not of partnership in the enterprise but of undivided co-ownership of the company's assets'. If the company, as a going concern, makes a profit by trading in goods, assets or services, the shareholders are entitled to receive a share in the profit, through dividends, from the company.

However, a conventional bond typically confers on the bondholder a contractual right to receive from the issuer of the bond certain interest payments during the life of the bond and the principal amount at the maturity of the bond. Creditors to the issuer of the bond

are the bondholders themselves and are ranked as senior unsecured and unsubordinated creditors of the issuer in priority to the shareholders. The juridical nature of a conventional bond is contrary to *Shari'a*. To structure a *Shari'a*-compatible instrument was the major challenge that embodies ownership characteristic of an equity instrument as well as the priority status and the fixed income characteristics of a bond instrument. The *Shari'a*-compatible instrument must also be transferable, rated by recognized rating agencies listed on major securities exchanges, cleared through major clearing houses, and documented in terms of legal documents and disclosures to maintain the conventional bond market's existing standards.

The principles of *sukuk*

While a conventional bond is a promise to repay a loan, a *sukuk* present partial ownership in:

- a debt (*sukuk murabaha*);
- an asset (*sukuk al ijarah*);
- a project (*sukuk al istisna*);
- a business (*sukuk al musharakah*); or
- an investment (*sukuk al istithmar*).

Sukuk structures most commonly replicate the cash flows of conventional bonds, being as they are listed on exchanges and made tradable through the conventional organizations like Euroclear or Clearstream. A key concept to achieve the capital protection without amounting to a loan, is a binding promise to repurchase certain assets, which in the case of *sukuk al ijarah* is made by the issuer. In the meantime a rent is being paid, which is often tied to an interest rate benchmark like LIBOR. *Sukuk al ijarah*, as debt certificates, can be only bought before the finance occurs and then held to maturity from an Islamic perspective, which is critical for debt trading at market value in terms of avoidance of *riba*.

The holders of the *sukuk* will be considered under *Shari'a* as co-owners of an asset, although held on trust. Each co-owner of an asset is entitled to sell his share in the asset without consent of the other co-owners at whatever price he can command in the market. When the trustee receives the variable rentals from the lessee, the *sukuk* holders will receive a proportionate share in the rental proceeds. At the maturity of the lease, which corresponds to the redemption date of the *sukuk*, the trustee will sell the trust asset to the lessee for a price equal to the original acquisition cost of the trust asset. On sale, the trustee will redeem the *sukuk* and the *sukuk* holders will receive their principal investment. The payment profile of the *sukuk* is thus comparable to a conventional bond or a floating rate note. As *Shari'a* considers money to be a measuring tool for value and not an asset in itself, it requires that one should not be able to receive income from money alone. This generation of money from money is *riba*, which is forbidden. This makes impermissible such things as selling of debts, receivables for anything other than par, conventional loans and credit cards.

In contractual terms, this principle is widely understood to mean uncertainty or the uncertainty in the existence of an underlying asset, and this causes problems for Islamic

scholars when considering the application of derivatives. *Shari'a* also incorporates the concept of *maslahah*, or public benefit, so if something is overwhelmingly in the public good, it may still be transacted, which is why hedging or mitigation of avoidable business risks might well fall into this category.

Types of *sukuk*

The following are commonly accepted as types of *sukuk*:

- *sukuk al ijarah* (rental);
- *sukuk al intifa* (operate and use);
- *sukuk al-musharaksh*, subdivided into participation *sukuk* (partnership company), *murabahah sukuk* (financing) and investment *sukuk*;
- *Salaam sukuk* (future delivery);
- *Istisna sukuk* (manufacturing);
- *sukuk al-mudarabah* (financing);
- *sukuk al-muzara'ha* (sharecropping);
- *sukuk al-musaqah* (irrigation);
- *sukuk al-mugharasah* (agriculture).

Bonds *vs sukuk*

A bond is evidence of debt issued by the issuer or borrower to an investor or lender, such as an IOU with a promise to pay the debt or the financial obligation at the end of a specified period. It is also a debt instrument with a fixed return (loan + interest), the obligation to pay the debt being evidenced by paper certificates called bonds or securities issued by the borrower or issuer; these certificates are tradable on the secondary market. Bonds are evidence of indebtedness only.

Sukuk provide evidence of financial obligation from the issuer to the *sukuk* certificate owner of the underlying asset. It is an asset instrument whereby the issuer pays the value being evidenced by a paper certificate called a *suk*, or securities issued by the issuer. This paper certificate is tradable on the secondary market. *Sukuk* are evidence of assets, not debit; therefore, *sukuk* are wider and have higher value than bonds.

Sukuk investors benefit from better risk profiles, tradable instruments in maturity and on the secondary market, and short- and long-term investment. They are priced competitively in line with conventional bond issues.

Sukuk al-ijarah

- *Sukuk al-ijarah* are subject to risks related to the ability and desirability of the lessee to pay the rental installments. Moreover, these are also subject to real market risks arising from potential changes in asset pricing and in maintenance and insurance costs.
- The expected net return on some forms of *sukuk al-ijarah* may not be completely fixed and determined in advance, as there might be some maintenance and insurance expenses that are not exactly determined in advance.

Exhibit 21.1

Conventional bonds *vs* Islamic *sukuk*

Conventional bonds	Islamic *sukuk*
• Primary level – loan contract to create indebtedness • Return to investors is the extra amount charged on the loan amount minus interest charges • The loan indebtedness is securitized with a zero coupon • Secondary level – trading of the bonds amounts to trading of debts, normally with discount • Binds represent pure debt obligations due from issuer • The core relationship is a loan of money, which implies a contract whose subject is purely earning money on money (*riba*) • Bonds can be issued to finance almost any purpose which is legal in its jurisdiction • Bond holders are not concerned with asset-related expenses • Bonds depends solely on the creditworthiness of the issuer; in case of issue failure unsecured bond holders join the pool of general creditors seeking the assets of a bankrupt company • Sale of bonds is basically the sale of a debt; if the debt is not receivable, there will be no value to the bonds	• Primary level – very rarely used loan contract, as there is no value added return from debt leveraging due to prohibition of *riba* in loan transaction • Primary level – use a variety of contracts to create financial obligations between issuer and investors, for example sale, lease, equity partnership, joint venture partnership • Return to investor comes from the in-built profit elements in the sale, lease or partnership contracts • The financial rights under the contracts are securitizable • Secondary level – tradability of the *sukuk* depends on the nature of the financial rights underlying the Islamic securities • *Sukuk* represent ownership stake in existing and/or well defined assets • The underlying contract for a *sukuk* issuance is a permissible contract such as a lease or any of the other 14 categories defined by AAOIFI • The underlying assets monetized in a *sukuk* issuance must be Islamically permissible in both nature and use, that is, a lorry would always be an eligible asset but not its lease to a distillery • Asset-related expenses may attach to *sukuk* holders • *Sukuk* holders are secured creditors as they own part of the underlying assets; even if a failure occurred, *sukuk* holders are paid before any secured or unsecured creditors. *Sukuk* prices depend on the market value of the underlying assets • Sale of a *sukuk* represents a sale of a share of an asset

Source: Authors own.

- *Sukuk al-ijarah* is completely negotiable and can be traded in the secondary markets.
- *Sukuk al-ijarah* will offer a high degree of flexibility from the point of view of their issuance management and marketability. The central government, municipalities, *awqaf*, or any other asset users, private or public can issue these *sukuk*. Additionally, they can be issued by financial intermediaries or directly by users of the leased assets.
- *Sukuk al-ijarah* holders, as owners, bear full responsibility for what happens to their property. They are also required to maintain it in such a manner that the lessee may derive as much usufruct from it as possible.

Steps involved in the structure

1. The obligator sells certain assets to the SPV at an agreed pre-determined purchase price.
2. a. The SPV raises financing by issuing *sukuk* certificates in an amount equal to the purchase price.
   b. This is passed on to the obligator (as seller).
3. A lease agreement is signed between the SPV and the obligator for a fixed period of time, where the obligator leases back the assets as lessee.
4. a. The SPV receives periodic rentals from the obligator.
   b. These are distributed among the investors: the *sukuk* holders.
5. At maturity, or on a dissolution event, the SPV sells the assets back to the seller at a predetermined value. That value should be equal to any amounts still owed under the terms of the *ijarah sukuk*.

Sukuk al-ijarah in practice

US$150m Serial Islamic Lease *Sukuk* by First Global *Sukuk* Inc.

The US$150m Islamic Lease *Sukuk* is part of a US$395m Serial Islamic *sukuk* issuance that Bank Islam (Labuan) Limited has been mandated to arrange by Kumpulan Guthrie Berhad (Guthrie). In December 2000, Guthrie was granted a RM1.5bn (US$400m) *al-ijarah al-muntahiyah bit-tamik* by a consortium of banks. The original facility was raised to re-finance Guthrie's acquisition of a palm oil plantation in the Republic of Indonesia. The consortium was then invited to participate as the *sukuk* transaction's underwriter/primary subscriber.

US$250m *Sukuk* Trust Certificate by BMA International *Sukuk* Company.

The Kingdom of Bahrain, acting through the Ministry of Finance and National Economy (in such capacity, the Head Lessor), will lease by way of head lease for a term of 100 years, a certain land parcel to the Issuer pursuant to the *Al-Ijarah* Head Lease Agreement. The Kingdom of Bahrain, acting through the Ministry of Finance and National Economy (in such capacity, the Sub-Lessee), will lease by way of sub-lease from the Issuer, the Land Parcel on the terms set out in the *Al-Ijarah* Sub-Lease Agreement for a period of five years, commencing on the Closing Date and terminating on the Periodic Distribution Date falling in June 2009.

US$350m *Sukuk* Trust Certificates by Sarawak Corporate *Sukuk* Inc. (SCSI).

Sarawak Economic Development Corporation (SEDC) raised financing amounting to US$350m through issuance of a series of *sukuk al-ijarah* trust certificates. For the proposed *sukuk*, SCSI was incorporated on 23 November 2004 as a special purpose company under the Offshore Companies Act (OCA) 1990 in Labuan. The certificates were issued with a maturity of five years and, under the proposed structure, the proceeds will be used by the issuer to purchase certain assets from 1st Silicon (Malaysia) Sdn Bhd. Thereafter, the issuer will lease assets procured from 1st Silicon to SEDC for an agreed rental price for an agreed lease period of five years. The rental payable by SEDC will be supported via a letter of support by the State Government of Sarawak.

Shari'a observations on *sukuk al ijarah*

Sukuk al ijarah do not represent debts, they represent undivided proportionate ownership of the leased asset. Thus, *sukuk al ijarah* can be bought and sold at whatever price the parties agree. In this sense, the *sukuk al ijarah* are not debt instruments, but participatory certificates similar to equities. Because the *sukuk al ijarah* are neither debts nor monetary, the Islamic legal difficulties surrounding the sale of monetary-debts with a discount do not arise. All these factors explain the near universal endorsement of *sukuk al ijarah* as *Shari'a*-compliant securities.

Sukuk al-mudarabah

Mudarabah means an agreement between two parties, according to which one of the two provides the capital (capital provider) for the other (*mudarib*) to work with on the condition that the profit is to be shared between them according to a pre-agreed ratio. A contract is made between two parties to finance a business venture. The parties are a *rabb al mal*, an investor who solely provides the capital and a *mudharib*, an entrepreneur who solely manages the project. If the venture is profitable, the profit will be distributed based on a pre-agreed ratio. The loss shall be borne solely by the provider of the capital in the event of a business loss.

Mudarabah sukuk give their owner the right to receive his capital at the time the *sukuk* are surrendered and an annual proportion of the realized profits as agreed. They play a vital role in the process of development financing, because it is related to the project's profitability.

Mudarabah sukuk neither earn interest nor entitle owners to make claims for any definite annual interest. This shows that *mudarabah sukuk* are like shares with regard to varying returns, which are accrued according to the profits made by the project. *Mudarabah sukuk* must represent a common ownership and entitle their holder to shares in a specific project for which the *sukuk* have been issued to fund. A *sukuk* holder is entitled to all rights which have been determined by *Shari'a* upon his ownership of the *mudarabah* bond in matters of sale, gift, mortgage, succession, and so on. On the expiry of the specified time period of the subscription, the *sukuk* holders are given the right to transfer the ownership by sale or trade in the securities market at his discretion.

Steps taken in the structure

- The *mudarib* enters into an agreement with the project owner for construction or commissioning of project.
- The *mudarib* collects regular profit payments and final capital proceeds from project activity for onward distribution to investors.

Sukuk al-mudarabah in practice

Shamil Bank of Bahrain BSC raised a 360m Saudi riyal investment through the Al Ehsa Special Realty *mudarabah*, representing an investment participation in a land development

transaction with a real estate development company in Saudi Arabia. The objective of the *mudarabah* was to provide investors with annual returns arising from participation in the funding of a land financing transaction. Profits due to investors are accrued on the basis of returns attained from investing the subscriptions.

Mudarabah and *muqaradah sukuk*

Mudarabah and *muqaradah sukuk* are equity-based and not debt instruments. In the *mudarabah sukuk* arrangement, investors will contribute their capital into a specific project to be managed by the issuer, who will act as the manager (*mudarib*). The issuer will issue certificates evidencing the capital contribution of the investors (*rabb al mal*) and the indicative rate of profit.

Profit, if any, will be shared between the investor and issuer at an agreed profit sharing ratio. Losses, if any, will be borne by investors alone (to attract market confidence, a third-party guarantee on capital preservation is allowed). The market value of the *sukuk* varies with the anticipated or expected profits. Unlike *murabaha/ijarah*, the financing mode is not set to a predetermined amount of profits that are functions of cost, but are on real-risk performances. The sale of *mudarabah sukuk* to investors in normal circumstances is not a form of sale of debt and discounting and is not an issue unless the *mudarabah* capital is in the form of cash or more than two thirds of it is cash. The need for discounting no longer exists, as the value of the *sukuk* will depend on the issuer's company's performance. When an investor wishes to dispose of *mudarabah sukuk* before maturity, the price depends on the project performance, which implies that *mudarabah sukuk* can be sold above or below face value.

Profits and losses in *mudarabah* and *muqaradah sukuk*

Profits realized from the investment in the *mudarabah sukuk* will be distributed between the *mudarib* and the investors according to the agreement. It is not permissible to guarantee a fixed profit. The *mudarib* is considered the manager and trustee of the common fund and the project is entrusted to him. The *mudarib* is not responsible for losses unless due to negligence, mismanagement or dishonesty leading to losses. The *mudarabah*'s risks are on the performances by the *mudarib*. This could be mitigated by investing in an assured cash flow stream investment such as back-to-back with an *ijarah* contract.

Sukuk al-musharakah

Musharakah means a relationship established under a contract by the mutual consent of the parties for sharing of profits and losses in the joint business. It is a partnership arrangement between two or more parties to finance a business venture whereby all parties contribute capital either in the form of cash or in kind for the purpose of financing the business venture. Any profit derived from the venture will be distributed based on a pre-agreed profit sharing ratio, but loss will be shared on the basis of equity participation. Both the issuer and investors contribute to the project being managed by either the issuer or a

third party. The *musharakah sukuk* can also be structured with all investors putting capital in a *musharakah* and appointing the issuer as their agent to manage the project. The issuer will issue certificates evidencing the capital contribution of the investors and the 'indicative rate of profit'. Profits, if any, will be shared between the *musharakah* participants at an agreed sharing ratio. Financial loss will be borne by all *musharakah* participants proportionate to their respective investment. All providers of capital are *entitled* to participate in management, but are not *necessarily required* to do so. The profit is distributed among the partners in pre-agreed ratios, while the loss is borne by every partner strictly in proportion to respective capital contributions.

Sukuk al musharakah are documents of equal value issued with the aim of using the mobilized funds for establishing a new project or developing an existing one or financing a business activity on the basis of one of the partnership contracts. The certificate holders become the owners of the project or the assets of the activity as per their respective shares. These *musharakah* certificates can be treated as negotiable instruments and can be bought and sold in the secondary market.

Steps involved in the structure

The Corporate and the Special Purpose Vehicle (SPV) enter into a *musharakah* arrangement for a fixed period and an agreed profit-sharing ratio. The Corporate undertakes to buy *musharakah* shares of the SPV on a periodic basis.

- The Corporate (as *musharik*) contributes land or other physical assets to the *musharakah*.
- A & B SPV (as *musharik*) contributes cash: the issue proceeds received from the investors to the *musharakah*.
- The *musharakah* appoints the Corporate as an agent to develop the land (or other physical assets) with the cash injected into the *musharakah* and sell/lease the developed assets on behalf of the *musharakah*.
- In return, the agent (the Corporate) will get a fixed agency fee plus a variable incentive fee payable.
- The profits are distributed to the *sukuk* holders.
- The Corporate irrevocably undertakes to buy at a pre-agreed price the *musharakah* shares of the SPV on, for example, a semi-annual basis and at the end of the fixed period, the SPV would no longer have any shares in the *musharakah*.

Sukuk al-musharakah in practice

US$550m *sukuk* transaction for Emirates, Dubai's national airline.

The seven-year deal was structured on a *musharakah* contract. The *musharakah* or joint venture was set up to develop a new engineering centre and new headquarters building on land situated near Dubai's airport which will ultimately be leased to Emirates. Profit, in the form of lease returns, generated from the *musharakah* or joint venture will be used to pay the periodic distribution on the trust certificates.

Sitara Chemical Industries Ltd, a public limited company.
This public limited company made a public issue of profit-and-loss sharing based term finance certificates (TFCs) worth Rs 360m which were subscribed on the 19th and 20th June 2002. The TFCs had a fixed life tenor of five years and profit and loss sharing was linked to the operating profit or loss of the Chemical Division of the company. The *musharakah* contract stipulated semi-annual profit distribution on account payment (provisional) on the basis of projections irrespective of profit and loss and the final profit payment were to be determined on the basis of annual audited accounts of the company and adjustments made accordingly.

Kuwait Finance House (KFH), Liquidity Management Center B.S.C. (LMC) and Al Muthanna Investment Company (MIC).
The mandated lead arrangers, launched the $125m Lagoon City *Musharakah sukuk* in support of the Lagoon City residential and commercial real estate development as part of the Kheiran Pearl City project. The two-year *musharakah sukuk* which is structured as a reducing *musharakah* and will offer a return of 200 basis points over 6 months, US$ LIBOR payable semi-annually, and has an average maturity of 1.25 years.

Sukuk al-salaam

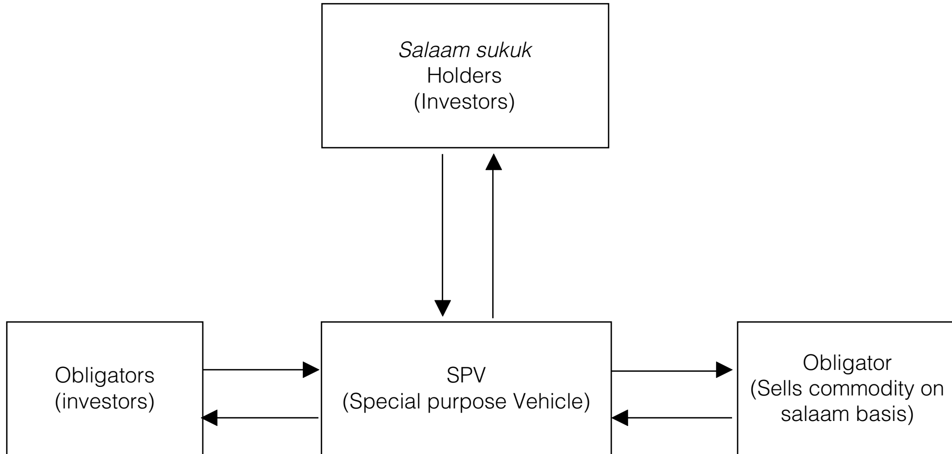
Salaam is the sale of a specific commodity, well defined in its quality and quantity, which will be delivered to the purchaser on a fixed date in the future, against an advanced full payment of price at spot.

Sukuk al-salaam are certificates of equal value issued for the purpose of mobilizing *salaam* capital so that the goods to be delivered on the basis of *salaam* come to the ownership of the certificate holders.

The issuer of the certificates is a seller of the goods of *salaam*; the subscribers are the buyers of the goods; while the funds realized from subscription are the purchase price (*salaam* capital) of the goods. The holders of *salaam* certificates are the owners of the *salaam* goods and are entitled to the sale price of the certificates or the sale price of the *salaam* goods sold through a parallel *salaam*, if any. *Salaam*-based securities may be created and sold by an SPV under which the funds mobilized from investors are paid as an advance to the company SPV in return for a promise to deliver a commodity at a future date. SPV can also appoint an agent to market the promised quantity at the time of delivery, perhaps at a higher price. The difference between the purchase price and the sale price is the profit to the SPV and hence to the holders of the *sukuk*.

All standard *Shari'a* requirements that apply to *salaam* also apply to *sukuk al-salaam*, such as full payment by the buyer at the time of affecting the sale, the standardized nature of underlying asset, clear enumeration of quantity, quality, date and place of delivery of the asset et cetera. One of the *Shari'a* conditions relating to *salaam*, as well as for creation of *sukuk al-salaam,* is the requirement that the purchased goods are not re-sold before actual possession at maturity. Such transactions amount to selling of debt. This constraint renders the *salaam* instrument illiquid and hence somewhat less attractive to investors. Thus, an investor will buy a *salaam* certificate if he expects prices of the underlying commodity to be higher on the maturity date (see Exhibit 21.2).

Exhibit 21.2
Structure of the *salaam sukuk*



Source: Author's own.

Steps involved in the transaction

1. The SPV signs an undertaking with an obligator to source both commodities and buyers. The obligator contracts to buy the commodity, on behalf of the end-*sukuk* holders, and then to sell it for the profit of the *sukuk* holders.
2. a. *Salaam* certificates are issued to investors and the SPV receives *sukuk* proceeds.
   b. The *salaam* proceeds are passed onto the obligator who sells a commodity on a forward basis.
3. The SPV receives the commodities from the obligator.
4. a. The obligator, on behalf of *sukuk* holders, sells the commodities for a profit.
   b. *Sukuk* holders receive the commodity sale proceeds.

Sukuk al-salaam in practice

Aluminum was designated as the underlying asset of the Bahrain Government *Al-Salaam* contract, whereby it promised to sell aluminum to the buyer at a specified future date, in return for a full price payment in advance. The Bahrain Islamic Bank (BIB) was nominated to represent the other banks wishing to participate in the *Al-Salaam* contract, being delegated to sign the contracts and all other necessary documents on behalf of the other banks in the syndicate. At the same time, the buyer appointed the Government of Bahrain as an agent to market the appropriate quantity, at the time of delivery, through its channels of distribution. The Government of Bahrain provides an additional undertaking to the BIB representative to market the aluminum at a price, which will provide a return to *Al-Salaam*

security holders, equivalent to those available through other conventional short-term money market instruments.

Salaam al-murabah

Murabah is the sale of goods at a price comprising the purchase price plus a margin of profit agreed upon by both parties concerned. *Sukuk al-mudarabah* are certificates of equal value issued for the purpose of financing the purchase of goods through *murabah* so that the certificate holders become owners of the *murabah* commodity.

The issuer of the certificate is the seller of the *murabah* commodity; the subscribers are the buyers of that commodity; and the realized funds are the purchasing cost of the commodity. The certificate holders own the *murabah* commodity and are entitled to its final sale price upon the re-sale of the commodity.

The possibility of having legally acceptable *murabah*-based *sukuk* is only feasible in the primary market. The negotiability of these *sukuk,* or their trading on the secondary market, is not permitted by *Shari'a*, as the certificates represent a debt from the subsequent buyer of the commodity to the certificate-holders, and this amounts to trading in debt on a deferred basis, which would be *riba*.

Despite being debt instruments, the *murabah sukuk* could be negotiable if they were the smaller part of a package or portfolio; the larger part of which were made up of negotiable instruments such as *mudarabah*, *musharakah*, or *ijarah sukuk*.

Murabah sukuk has, however, become popular in the Malaysian market due to a more liberal interpretation of *fiqh* by Malaysian jurists permitting sale of debt (*bai-al-dayn*) at a negotiated price.

Sukuk al-murabah in practice

Arcapita Bank, a Bahrain-based investment firm, has mandated Bayerische Hypo- und Vereinsbank AG, Standard Bank Plc and West LB AG, London Branch (together the 'Mandated Lead Arrangers') to arrange a five-year multicurrency (US$, € and £) *murabah*-backed *sukuk*. The *sukuk* will have a five-year bullet maturity and proposed pricing three month LIBOR + 175bps.

Sukuk istisna'

Istisna' is a contractual agreement for manufacturing goods and commodities, allowing cash payment in advance and future delivery or a future payment and future delivery. A manufacturer or builder agrees to produce or build a well-described product or building at a given price on a given date in the future. Price can be paid in installments, step-by-step as agreed between the parties. *Istisna*' can be used for providing the facility of financing the manufacture or construction of houses, plant projects and building of bridges, roads and highways.

Sukuk al-istisna are certificates that carry equal value and are issued with the aim of mobilizing the funds required for producing products owned by the certificate holders.

The issuer of these certificates is the manufacturer (supplier/seller) and the subscribers are the buyers of the intended product. The funds realized from subscription are the cost of the product. The certificate holders own the product and are entitled to the sale price of the certificates or the sale price of the product sold on the basis of a parallel *istisna*', if any.

The suitability of *istisna*' for financial intermediation is based on the permissibility for the contractor in *istisna* to enter into a parallel *istisna*' contract with a subcontractor. Thus, a financial institution may undertake the construction of a facility for a deferred price and subcontract the actual construction to a specialized firm.

Shari'a prohibition of *riba* precludes the sale of these debt certificates to a third party at any price other than their face value. Clearly such certificates, which may be cashed only on maturity, cannot have a secondary market.

Sukuk al-istisna' in practice

Tabreed's five-year global corporate *sukuk* (on behalf of the National Central Cooling Company, UAE) provided a fixed coupon of 5.50%. It is a combination of *ijara istisna*' and *ijarah mawsufah fi al-dhimmah* (forward leasing contracts). The issue was launched to raise funds to retire some existing debt, which totals around US$136m, as well as to finance expansion.

The Durrat *sukuk* will finance the reclamation and infrastructure for the initial stage of a broader US$1bn world-class residential and leisure destination known as 'Durrat Al Bahrain', one of Bahrain's largest residential development projects. The return on the *sukuk* is 125 basis points over 3 months LIBOR payable quarterly, with the *sukuk* having an overall tenor of 5 years and an option for early redemption. The cash proceeds of the issue will be used, by the issuer, to finance the reclamation of the land and the development of base infrastructure through multiple project finance (*istisna*') agreements. As the works carried out under each *istisna*' are completed by the contractor and delivered to the issuer, the issuer will give notice to the project company under the master *ijarah* agreement and will lease such base infrastructure on the basis of a lease-to-own transaction. If the *sukuk* is listed during the *istisna*' period, the *istisna*' receivable (amounts held as cash) shall be traded only at par value.

Hybrid *sukuk*

Considering the fact that *sukuk* issuance and trading are an important means of investment, and taking into account the various demands of investors, a more diversified *sukuk* – hybrid or mixed asset *sukuk* – emerged in the market. In a hybrid *sukuk*, the underlying pool of assets can comprise of *istisna*', *murabah* receivables and *ijarah*. Having a portfolio of assets comprising different classes allows for a greater mobilization of funds. However, because *murabah* and *istisna*' contracts cannot be traded on secondary markets as securitized instruments, at least 51% of the pool in a hybrid *sukuk* must comprise *sukuk* tradable in the market such as an *ijarah sukuk*. Because the *murabah* and *istisna* receivables are part of the pool, the return on these certificates can only be a predetermined fixed rate of return.

Hybrid *sukuk* have yet to make much headway in the market, but the structure represents the potential of new structures and benefits to investors. The Islamic Development Bank issued the first hybrid *sukuk* of assets comprising 65.8% *sukuk al-ijarah*, 30.73% of *murabah* receivables and 3.4% *sukuk al-istisna*'. This issuance required the IDB's guarantee in order to secure a rating and international marketability. The $400m Islamic *sukuk* was issued by Solidarity Trust Services Limited (STSL), a special-purpose company incorporated in the Channel Islands. The Islamic Corporation for the Development of Private Sector (ICD) played an intermediary role by purchasing the asset from IDB and selling it to The Solidarity Trust Services Limited (STSL) at the consolidated net asset value.

Structuring Islamic asset-backed securities

The securitization transaction means that an arrangement which involves the transfer of assets or risks to a third party where such transfer is funded by the issuance of debt securities or Islamic securities to investors. Payments to investors in respect of such debt securities or Islamic securities are principally derived, directly or indirectly, from the cash flows of the assets. The securities derive their value from the asset pool and income streams while the investor relies solely on those assets for payment. The assets must be legally isolated so that the securities will not be impaired by the financial behaviour of the related originator. Islamic private debt security is still relatively new and limited in terms of numbers of issuance.

Special Purpose Vehicle (SPV)

- An SPV must have independent and professional directors or trustees.
- An SPV must be sufficiently 'bankruptcy remote'.
- The SPV is ultimately responsible for ensuring that its assets are managed with due care and in the best interests of the ABS holders.
- The SPV and the securities issued must not carry the same name as the originator or be similarly identified with the originator.
- The SPV must maintain proper accounts and records to enable complete and accurate views to be formed of its assets, liabilities, income and expenditure, and to comply with all other regulatory reporting required in respect of the issuance.

Criteria of securitized assets

- The assets must generate cash flow.
- The originator has valid and enforceable interest in the assets and in the cash flows of the assets prior to any securitization transaction.
- There are no impediments to prevent the effective transfer of the assets or the rights in relation to such assets from an originator to the SPV.
- The assets are transferred at a fair value.
- No trust or third party's interest appears to exist in competition with an originator's interest over the assets.

- Where the interest of an originator in the assets is as a charge, the charge must have been created for a period of more than six months before the transfer.

Sales criteria

Any transfer of assets by an originator to an SPV must comply with the true sale criteria.

- The underlying assets must have been isolated from an originator (even in receivership or bankruptcy).
- The originator must effectively transfer all rights and obligations in the underlying assets to the SPV.
- The originator must not hold any equity stake, directly or indirectly, in an SPV.
- An SPV must have no recourse to an originator for losses arising from those assets save for any credit enhancement provided by the originator at the outset of the securitization transaction.

Difference between *sukuk* and asset-backed securities

Exhibit 21.3
sukuk vs. asset-backed securities

Sukuk	Asset-backed securities
• More than 90% of all global *sukuk* issues in the market are on balance sheet issues which are 'asset-based' • Normal *sukuk* – revenue/income from *sukuk* assets does not necessarily form the source of payment, instead, the source of payment usually comes from issuer/obligor's cash flow • Off balance sheet	• *Asset backed* securities usually refers to securities/*sukuk* backed by assets sold/transferred by an originator to a buyer/issuer (usually an SPV) – 'asset backed' • Main source of payment – revenue from underlying *sukuk* assets • Can either be ON or OFF balance sheet

Source: Author's own.

Benefits of asset-backed securitization

For the originator:

- Additional source of funding that is cheaper – due to additional structural protections (credit enhancement) and better rating.
- Reduce asset/liability mismatch – monetize illiquid assets.
- Lock in profits.
- Transfer risk.
- Off balance sheet.

For investors:

- Portfolio diversification.
- High quality asset not to be exposed to bankruptcy risk of the originators.
- Potentially higher rate of return than other fixed-return investments.

Profit and loss in *sukuk*

All profit must be shared between the *sukuk* holders in proportion to their capital invested, and the expected profit rate of each segment. Subject to waiver arrangement, the *sukuk* holders will agree among themselves that they shall waive any profit in excess of the expected profit rate for each segment. Profit will be calculated, based on the actual number of days elapsed, and the actual number of days in the year. Any loss has to be shared between the *sukuk* holders in proportion to their capital invested in the project. The proportions of the loss should be computed as the ratio of capital invested by each *sukuk* holder and the total capital invested by all *sukuk* holders and stakeholders.

Bay' al-'ina

Bay' al-'ina (known also in *Fiqh* as *bay 'bi-thaman 'ajil*) is a transaction involving two sales where the seller sells an asset to the buyer on a spot payment basis, and the buyer then immediately sells it back to the seller at a higher price, on a deferred payment basis. Both parties end up executing two contemporaneous contracts, one for spot payment and another for deferred payment, without taking any delivery or possession of the underlying asset.

Bay' al-dayn

Bay' al-dayn is still being debated by contemporary *Shari'a* scholars. In the Middle East, most scholars have prohibited *bay' al-dayn* on the basis of a consensus among the scholars although there is no evidence in support. These scholars also rely on a *Hadith* where it is reported that the Prophet has prohibited *bay' al-kali' bi-al-kali'*. Others argue that if the exchange of $100 today for $110 payable in cash one month later is considered as *riba*, it is inconceivable that *Shari'a* would allow an exchange of $100 today for $110 worth of receivables that will accrue one month later. The prohibition of *bay' al-dayn* is a logical consequence of the prohibition of *riba*.

Scholars in Malaysia have adopted the minority view that the concept of *bay'al-'ina* and *bay' al-dayn* were permissible and issued *bay' bi-thaman 'ajil* bonds. Scholars in the Middle East have prohibited both these contracts.

Conclusion

The Islamic finance industry today offers a broad variety of products and services as well as corporate finance, project finance, equity funds, personal and wealth management, venture

capital investment, real estate investment and private equity, all from its inauspicious beginnings, when Islamic financiers were providing Islamic trade financing solutions. *Sukuk* have proven to be the most common, replicating the cash flows of conventional bonds and being listed on exchanges and made tradeable through conventional organizations. There are several types of *sukuk*: *sukuk al ijarah* (rental), *sukuk al* intifa (operate and use), *sukuk al-musharaksh* (participation *sukuk* (partnership company)) *murabaha sukuk* (financing), and investment *sukuk*, *salaam sukuk* (future delivery), *istisna sukuk* (manufacturing), *sukuk al-mudarabah* (financing), *sukuk al-muzara'ha* (sharecropping), *sukuk al-musaqah* (irrigation) and *sukuk al-mugharasah* (agriculture).

Currently, the Islamic debt market consists of *sukuk* which are structured in a number of ways to reflect the various modes of Islamic finance. Some examples are *ijarah sukuk* and *al-salaam sukuk*. A key concept to achieve capital protection without being a loan is a binding promise to repurchase certain assets as in the case of *sukuk al ijarah*. A rent is generated and paid on a regular basis to the *sukuk* owners, which is frequently benchmarked to an interest rate benchmark like LIBOR. From an Islamic perspective, *sukuk al ijarah* as debt certificates can only be bought before the finance occurs and then held to maturity, which is critical on debt trading at market value as far as *riba* (interest on money) is concerned.

Islamic institutions conduct the major part of their business in the Muslim world. Securitization is common, primarily in countries with a developed regulatory framework, such as the OECD countries and some emerging economies like Singapore and Malaysia. The regulatory environment in the countries where the demand for Islamic finance is the strongest needs to be supportive of Islamic financial products.

Due to lack of demand, Islamic banks have not used securitization. This lack of demand arises because of the underleveraged status of the balance sheet of most Islamic banks. Banks having high levels of disposable risk assets compared with capital typically demand securitization. Securitization also removes a class of assets from the balance sheet to reduce strain on the capital.

Sukuk in short

- The market for *sukuk* is now maturing and there is increasing momentum in the wake of interest from issuers and investors. *Sukuk* have confirmed their viability as an alternative means to mobilize medium- to long-term savings and investments from a huge investor base.
- Investors are able to focus on the underlying asset and viability of a project and not just on the credit of the issuer.
- Different *sukuk* structures have been emerging over the years but most of the *sukuk* issuances to date have been *sukuk al-ijarah*. Since they are based on the undivided pro-rata ownership of the underlying leased asset, it is freely tradable at par, premium or discount. Tradability of the *sukuk* in the secondary market makes them more attractive.
- Although less common than *sukuk al-ijarah*, other types of *sukuk* are also playing significant roles in emerging markets to help issuers and investors alike to participate in major projects, including airports, bridges and power plants.

- The sovereign *sukuk* issues, following Malaysia's lead, are enjoying widespread and positive acclaim among Islamic investors and global institutional investors alike.
- In general, corporate *sukuk* tend to have a lower credit rating than sovereign *sukuk* and are also smaller in size.
- As investors become more diverse, so too will their appetites, and this will lead to issuances beyond the currently prevalent *ijarah* and *salaam* contracts into more profit-and-loss sharing contracts.

Appendix

Accounting and Auditing Organization for Islamic Financial Institutions
(AAOIFI)

In the name of Allah, the Merciful and Mercy-Giving

Introduction

Praise to Allah, and peace and blessings on His Noble Prophet! And on his family and Companions!

As to what follows:

In view of the expanding application of *sukuk* worldwide, the public interest in them, and the observations and questions raised about them, the *Shari'a* Committee of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) studied the subject of *sukuk* issuance in three sessions; firstly, at Madinah on 12 Jumada al-Akhirah 1428 AH (27 June, 2007), secondly, at Mecca on 26 Shaban 1428 AH (8 September, 2007), and thirdly in the Kingdom of Bahrain on 7 and 8 Safar 1429AH (13 and 14 February, 2008). Following the meeting of the working group it appointed on 6 Muharram 1429AH (15 January, 2007) at Bahrain which was attended by a significant number of representatives from various Islamic banks and financial institutions; the working group presented its report to the *Shari'a* Committee.

Following its consideration of what took place at these meetings, and of the papers and studies presented there, the *Shari'a* Committee, while emphasizing all that has been stated concerning *sukuk* in the *Shari'a* Standards, advises Islamic financial institutions and *Shari'a* supervisory boards to adhere to what follows when issuing *sukuk*.

First: Tradable *sukuk* must represent ownership for *sukuk* holders, with all of the rights and obligations that accompany ownership, in real assets, whether tangible or usufructs or services, that may be possessed and disposed of legally and in accordance with the *Shari'a*. All of this Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) should be in accordance with *Shari'a* Standard (17) on the subject of Investment *sukuk*, articles (2) and (2/1/5). The manager of a *sukuk* issuance must establish the transfer of ownership of such assets in its books, and must not retain them as its own assets.

Second: It is not permissible for tradable *sukuk* to represent either revenue streams or debt, except in the case of a trading or financial entity that is selling all of its assets, or a portfolio which includes a standing financial obligation such that debt was incurred indirectly, incidental to a physical asset or a usufruct in accordance with the guidelines mentioned in *Shari'a* Standard (21) on the subject of Financial Paper.

Third: It is not permissible for the manager of *sukuk*, regardless of whether the manager acts as a *mudarib* (investment manager), or a *sharik* (partner), or a *wakil* (an investment

agent), to undertake to offer loans to *sukuk* holders when actual earnings fall short of expected earnings. It is permissible, however, to establish a reserve for the purpose of covering such shortfalls to the extent possible, on condition that the same be mentioned in the prospectus. There is no impediment to the distribution of expected earnings on account, in accordance with *Shari'a* Standard (13) on the subject of *mudarabah*, article (8/8), or to obtaining project financing on the account of the *sukuk* holders.

Fourth: It is not permissible for the *mudarib* (investment manager), *sharik* (partner), or *wakil* (investment agent) to agree to purchase assets from *sukuk* holders, or from whoever represents them, for a nominal value of those assets at the time the *sukuk* are extinguished at the end of their tenors. It is permissible, however, 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, in accordance with *Shari'a* Standard (12) on the subject of Partnership and modern partnerships, Article (2/6/1/3) and with *Shari'a* Standard (5) on the subject of Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) Guarantees, Articles (1/2/2) and (2/2/2). It should be understood that the *sukuk* manager acts as guarantor of [investor] capital at its nominal value in cases of negligence or *mala fides* or non-compliance with stated conditions, regardless of whether the manager is a *sharik* (partner), *wakil* (agent), or *mudarib* (investment manager). If, however, the assets of a *sukuk al-musharakah*, or *mudarabah*, or *wakalah*, are of lesser value than assets leased by means of a lease ending in possession (*ijarah muntahiya bi't-tamlik*), then it will be permissible for the *sukuk* manager to agree to purchase those assets at the time the *sukuk* are extinguished, for the remaining lease payments on the assets, by considering these payments to be the net value of those assets.

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, as long as the lessee is not also an investment partner, *mudarib*, or agent.

Sixth: *Shari'a* 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 actual transaction, and then oversee the ways that these are implemented in order to be certain that the operation complies, at every stage, with *Shari'a* guidelines and requirements as specified in the *Shari'a* Standards, and that the investment of *sukuk* proceeds, and what those proceeds are converted to, takes place in accordance with one [or another] of the approved *Shari'a* methods of investment as stated in *Shari'a* Standard (17) on the subject of Investment *sukuk*, Article (5/1/8/5).

In addition to all this, the *Shari'a* Committee advises Islamic Financial Institutions to decrease their exposure to debt-related operations and to Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) increase their operations based on true partnerships and the sharing of risk and reward and thereby achieve the higher purposes of the *Shari'a*.

Chapter 22

Development of a secondary *sukuk* market

Aly Khorshid
Elite Horizon

Introduction

The Islamic banking and finance market is estimated to be worth US$500–800 billion, with a growth rate of 15–20 per cent annually, and Muslim investors are looking for some serious investment options that comply with Islamic *Shari'a*.

One of the rating agencies, Standard & Poor's, estimates that 20 per cent of those investors, with billions to invest, would now spontaneously choose an Islamic financial product over a conventional one with a similar risk-return profile. That has led to the increased use of *sukuk*, especially in the Gulf countries and Malaysia. (*Note*: the word *sukuk* is plural.)

The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) defines *sukuk* as 'certificates of equal value representing after closing subscription, receipt of the value of the certificates and putting it to use as planned, common title to shares and rights in tangible assets, usufructs and services, or equity of a given project or equity of a special investment activity'.

Sukuk in varied structures and sizes worth $50 billion came to the market in 2006 and are expected to exceed $70 billion in 2007, as companies seek to diversify their sources of financing. The size of the profit margin is helping to create secondary market in *sukuk*.

Although companies in Kuwait, Bahrain, Saudi Arabia and Qatar have all been actively using *sukuk* financing for many years, Malaysia led the *sukuk* issue market in 2006 with a share of about 60 per cent. That year also saw the first *sukuk* originating in the US. The trends in 2007 suggest that at the time of writing, the United Arab Emirates, especially Dubai, have most likely taken the lead.

Sukuk structures are being developed rapidly in response to the demands of issuers and investors; *sukuk* issues have ranged from the simple sale and leaseback (*ijarah*) structures, such as the $1 billion Dubai Department of Civil Aviation *sukuk* issued in November 2004, to the $2.53 billion trust finance *sukuk* structure issued by Aldar Properties in March 2007, demonstrating the flexibility of Islamic finance principles.

Criteria of *sukuk* in secondary market trading

Sukuk securities tend to be buy and hold and as such, only a small amount of the securities enter the secondary market (allowing them to be traded). Furthermore, only public *sukuk* are able to enter this market as they are listed on stock exchanges.

The secondary market, whilst developing, remains a niche segment with most of the trading done at institutional level. The size of the secondary market remains unknown, though LMC Bahrain state that they traded $55.5 million of *sukuk* in 2007. The European Islamic Investment Bank (EIIB), in an interview published on *sukuk*.net, stated that 'Secondary market trading volume has contracted significantly in the first half of 2008 when compared to 2007, where *sukuk* with a nominal value of approximately $0.5bn was traded'.

The financial obligations and rights created at the primary level are securitized into *sukuk*. Secondary Level – trading of the *sukuk* at the secondary market – depends very much on the underlying financial rights as follows:

- If backed by real assets – tradable in the secondary market.
- If backed by usufructs – tradable in the secondary market.
- If backed by services – tradable in the secondary market.
- If backed by real assets and receivables – tradable in the secondary market with conditions.
- If backed by receivables – for example *salaam* goods – non-tradable.
- If backed by receivables – for example *murabahah/istisna*' prices – generally non-tradable (except for Malaysia).

The path to a liquid secondary market

Liquidity in the secondary market is a function of supply and demand of Islamic financial instruments and value changes that offer profit opportunities. These factors are market-driven (arising due to inefficiencies in the market), and are caused by the limited choice of instruments available to Islamic Investors, the regulatory environment and a lack of insight into the risk characteristics of *Shari'a*-compliant instruments.

To remove inefficiencies in the market, the following measures are available:

- Development of a consensus Islamic benchmark rate beyond LIBOR.
- A larger number of market participants offering various novel Islamic instruments to appeal to a wider selection of investors.
- Refinement of price validation mechanisms based on prices set in the market which will inspire further issuance of future issues.
- Development of ratings-based pricing to ensure correct capital allocation.
- Use of derivatives and structured products such as swaps and forwards designed to hedge the risk of fluctuations in market value from movement in rates.
- Availability of *Shari'a*-compliant debt instruments to grow with the level of acceptability and understanding.

The regulatory environment is evolving and it has to be able to support the financial engineering innovations, the cornerstone of efficiency in the debt market. The stages of progress that developed countries have witnessed in the evolution of the conventional debt market suggest there is no ‘quick fix’. The process is gradual and the regulatory environment must first provide a level playing field for all the existing players in the market and it has to keep pace with developments of new products.

Role of a credit rating agency

The role of a credit rating agency is to assist the flow of information from the issuer to the investors, and to convey the importance of that information in the form of an independent, reliable, clear and informed opinion regarding the issuers. The role of an Islamic finance-focused credit rating agency should be to educate investors at individual and institutional levels about the quality of instruments covering such aspects as:

- Probable future net free cash flow, core earnings and sustainability in the earning power of the issuers.
- The structure of instruments based on Islamic principles.
- *Shari’a* products and their level of compliance with *Shari’a* guidelines.
- Regulatory support for Islamic modes of financing, the implications to Islamic banking in the economy, and the presence of sets of exclusive rules governing Islamic Financial Institutions.
- The extent of knowledge and awareness of *Shari’a* and commitment to adhere to *Shari’a* laws in letter and spirit by the top management of the issuer.
- The capital adequacy focused on core capital and core funding with an assessment of the ability of existing resources to support the risk profile of the organization.
- The differentiating characteristics between Islamic financial institutions and conventional institutions.

Are complex instruments more difficult to trade?

As financial markets reach maturity, their participants begin to appreciate the need to manage various inherent risks. The market responds with innovative products, and this leads to the development of structured financial products. Initially, simple products such as interest rate swaps and forward rate agreements were introduced. To meet the needs of various other participants, options in the securities were introduced, resulting in structuring of various mortgage-backed and asset-backed securities. Financial instruments thus become ever more complex as time passes.

The final stage saw complex structured products such as instruments with floors, caps, and ‘swaptions’ (where more than one derivative or a number of options are combined in a single product).

This complexity originates from the evolution in the market and the level of maturity the market has reached. One instrument has never been more difficult to trade than another. It is always a question of what the needs of the market participants are. At a primary level, where

the basic instruments are yet to achieve acceptability for all participants, the most important issue is to provide a level playing field for further market developments. The complex instruments will create their own demand once the participants are comfortable with what they are being offered.

Examples of *sukuk* issuances and their structures

Some recent examples of *sukuk* issues emphasise that *sukuk* have matured and diversified, and become an acceptable instrument to raise corporate finance in several countries. This is true for acquisitions or working capital purposes, for use in the transportation sector (especially in the shipping and aircraft sectors), as well as real estate, construction and petrochemical projects.

- German *sukuk* (Saxony-Anhalt *sukuk*). In 2004, a €100 million *sukuk*, structured as a *sukuk al ijarah*, was issued in the federal state of Saxony-Anhalt in Germany. The Federal Republic of Germany guarantees the debts of Saxony-Anhalt. The underlying transactions are a certain number of specified buildings owned by the Ministry of Finance. The master lease was sold for 100 years to an SPV, incorporated in the Netherlands for tax reasons, which in turn rented it back for five years to the Ministry of Finance. The certificate holders receive a variable rent benchmarked to the EURIBOR over the rented period. The *sukuk* is listed on the Luxembourg Stock Exchange. As of July 2007, the Saxony-Anhalt *sukuk* remains the only sovereign *sukuk* from a non-Islamic country to have tapped the market.
- *Sukuk* by the Governments of Bahrain, Qatar and Malaysia. The Government of Bahrain, via its Central Bank, regularly issues *sukuk al ijarah* and *sukuk al salam* to finance its infrastructure projects. Malaysia's Global *sukuk*, launched in June 2002, was similarly backed by an *ijarah* lease on a single piece of government property. The money raised by the Government of Qatar through the $700 million Qatar Global *sukuk* is being used partly to finance the construction of the Hamad Medical City.
- Emirates Airlines *sukuk*. The first *sukuk* issued by Dubai's national airlines, Emirates, closed in July 2005. At $550 million, it was at that time the single largest corporate *sukuk* issuance. The *musharakah*-structured *sukuk* has a seven-year term and the proceeds of the issue, which is listed on the Luxembourg Stock Exchange, will be used to finance the new Emirates Engineering Centre and their headquarters building in Dubai.
- MT *Venus Glory sukuk*/Al Safeena *sukuk.* In 2005, ABC International Bank, in collaboration with Abu Dhabi Commercial Bank arranged, structured and underwrote a pioneering Islamic ship finance transaction through the issuance of a $26 million Al-Safeena *ijara sukuk*. At that time, the Al-Safeena *sukuk* was the first issue that combined Islamic equity with conventional debt for the same asset, which in this case was VLCC (called *Venus Glory*), owned by Pacific Star (Pac Star) International Holding Corporation, which in turn is owned by Saudi Aramco, the world's largest oil exporting company.
- Dubai Civil Aviation Authority *sukuk.* The Dubai Civil Aviation Authority, a quasi-sovereign entity, broke the mould in 2004 by issuing a $1 billion *sukuk* instead of using

conventional finance, creating the world's largest single *sukuk* issuance in terms of size at that time. The proceeds were used to finance the building of a new international terminal and for the expansion of existing infrastructure. The *musharakah* was set up to develop a new engineering centre and a new headquarters building on land near Dubai's airport that will ultimately be leased to Emirates. Profit generated from the *musharakah* (in the form of lease returns) will be used to pay the periodic distribution on the trust certificates.

- Bahrain Financial Harbour (Al Marfa'a Al Mali *sukuk*). The *istisna'a-ijara sukuk*, known as the Al Marfa'a Al Mali *sukuk*, was structured by the Liquidity Management Centre. The *sukuk* has a five-year term maturing in 2010 offering a quarterly profit distribution with the proceeds used to finance the development and construction of the Financial Centre, the first phase of the Bahrain Financial Harbour project comprising the Dual Towers, the Financial Mall and the Harbour House.
- Dar Al Arkan Real Estate Development Company ('Daar'). A well capitalized real estate investment and development company based in the Saudi Arabia, launched their debut $600m Daar International *sukuk* at LIBOR+200bp. The *sukuk* traded strongly in the secondary market with the spread narrowing to LIBOR+150bp and investors seeming reluctant to take any profits on their positions.
- Dubai Islamic Bank and Dubai World *sukuk*. In 2006, the Nakheel Group, a Dubai-based property developer, sold the world's largest Islamic bond after increasing its size by more than 40 per cent to $3.52 billion to meet demand. Nakheel uses cash from its *sukuk* to fund projects in Dubai, which is leading a surge in Gulf Arab investment in construction and real-estate developments. The *sukuk* has been listed on the Dubai International Financial Exchange.
- Aldar. Driven by convertible specialists and hedge funds trading around market volatility, Aldar has been among the most actively traded *sukuk*. In the days leading up to investor allocation in the primary market, Aldar was trading above par in response to a sharp share price increase.
- Emaar. With a market capitalization of circa $20 billion and holding the title of the world's largest listed property developer, Emaar has projects under its management including the Burj Dubai, holder of the world's tallest building when completed in 2008, and the Dubai Mall – the world's largest entertainment and shopping complex. The Emaar issued *sukuk* in 2004 at Libor+70bp and it has since been bought by investors comfortable with the financial strength of the underlying obligor, attractive credit spread and two-year maturity profile. In 2006, Emaar closed a $1 billion, five-year syndicated *Murabaha* facility at Libor+60bp.
- Tabreed. The Tabreed 2009 and 2011 issues continue to attract investor interest despite supply deficiencies hampering secondary market trading.
- DP World *sukuk*. In 2007, global marine terminal operator DP World priced a $1.75 billion conventional bond and a $1.5 billion *sukuk*. It was the first issuer to list both conventional and Islamic debt securities on the Dubai International Financial Exchange. The 10-year *sukuk* attracted demand from as far afield as the US, significant because it was the first time US investors had been able to subscribe to a UAE corporate rated *sukuk*. DP World's *sukuk* is innovative because it is partly convertible to shares

should the group list through an initial public offering, making it the Islamic finance market's first convertible instrument. The issue included the financing of the purchase of P&O.

- East Cameron Gas *sukuk.* Tapping the market in 2006, the East Cameron Gas *sukuk* was the first *sukuk* to have originated from the US, the first ever *Shari'a*-compliant gas-backed securitization and the first Islamic securitization rated by Standard & Poor's. The $165.7 million *sukuk* originated from Houston-based East Cameron Partners, whose reserves are located just offshore of Louisiana. It was structured as a *musharakah* in terms of the management of the assets and a funding agreement between the issuer and the purchaser.

The initiatives taken by the governments of the UAE, Bahrain, Malaysia and the UK, among others, have sped up the evolution and growth of the *sukuk* market and the development of Islamic finance as a whole. The regulatory bodies within these countries and others have been actively introducing rules and regulations pertaining to the issuing and offering of *sukuk*s, which in time will help provide standardization and a resultant maturation of the field.

From financing structures focused mainly on plain commodity trading *murabaha* transactions to the complex *sukuk* structures, the latter have emerged as major financial instruments. With international banks, financial institutions, law firms and financial service providers eager to capitalize on the Middle East growth, Islamic banking and finance has grown into a specialized practice area of its own. With billions of dollars' worth of successful issues reflecting the huge appetite for *sukuk*, long-term success and growth of the structure looks promising.

Emirates Airlines' US$550 million *sukuk*

The largest corporate *sukuk* to date is the Emirates Airlines *sukuk*. The seven-year, $550m deal was a structured as a *musharakah* and was the second *musharakah sukuk* to be listed on the Luxembourg Stock Exchange. The joint venture was set up to develop a new engineering centre and a headquarters on land situated near Dubai's airport which will ultimately be leased to Emirates. Profit, in the form of lease returns, generated from the *musharakah* will be used to pay the periodic distribution on the trust certificates. Dubai Islamic Bank, HSBC, Standard Chartered Bank, Gulf International Bank BSC and National Bank of Abu Dhabi were all involved in the transaction.

Trade ideas in *sukuk*

Dubai Global *sukuk*, whose underlying obligor is the Department of Civil Aviation (DCA) matures in November 2009. Long-term holders of the Dubai Global *sukuk* can switch out of the *sukuk* and into the DCA facility for a 13bps pick-up should investment liquidity not be paramount.

The challenges

Notwithstanding current growth rates, the development of a liquid *sukuk* market could be impeded by certain commercial and legal challenges. Sukuk are listed on exchanges in the Middle East, South East Asia and Europe but they remain relatively illiquid due to the absence of a diverse investor pool or a customized regulatory framework, leading to a lack of investor confidence. Although non-Muslim investors have begun to express an interest in the product, the majority of current *sukuk* investors occupy Muslim majority countries. However, there are strong signs of commitment by market participants intent on promoting continued market growth and secondary market trading.

The DIFX

Another significant event in the market was the establishment of the DIFX, the Gulf region's first international financial exchange. The regulatory framework of the DIFX follows international standards and the exchange aims to be the leading trading venue for both conventional and Islamic financial products. Established financial centres in New York, London and Hong Kong provide *sukuk* issuers with access to a diverse investor pool, their respective regulatory frameworks do not take into account the unique features of Islamic financial products, so they cannot adequately monitor and promote *sukuk* trades. It is thought that following implementation of the EU Prospectus Directive across the European Economic Area, the European exchanges will treat *sukuk* as a debt instrument for admission to trading on a regulated market. Yet *sukuk* cannot create or acknowledge indebtedness, a principal component of the definition of 'debt' under the EU Prospectus Directive. The DIFX's reputation as a viable alternative to these well-established exchanges was enhanced further by Dubai Ports' choice of the exchange for the $3.5 billion (£1.89 billion) *sukuk* issue, the first convertible instrument in the Islamic financial markets. If the DIFX is able to capitalize on the momentum and diversify its investor pool, there should be nothing to stop Dubai emerging as a leading global financial centre with obvious positive implications for the *sukuk* market.

If the *sukuk* market is to sustain its strong growth rate and develop an active secondary market, it will require a reliable trading forum, innovative product structures and a broader investor pool. As regulators, market participants and investors certainly recognize the potential in the market, as well as the primary obstacles to its continued growth, it would seem that half the battle has been won.

The DJCSI

Dow Jones & Company and Citigroup jointly launched the DJCSI, with the aims of serving as a benchmark for investors seeking *sukuk* investments and facilitating secondary and cross-market trading. The DJCSI's US dollar-denominated *sukuk* is certified by a recognized *Shari'a* supervisory board and conforms to the standards set by the AAOIFI. Underlying assets are screened for *Shari'a* compliance through business guidelines established by Dow Jones. DJCSI *sukuk* must also have a maturity of at least one year, an issue size of at least $250 million (£135 million) and a recognized credit rating of at least BBB-/Baa3 or equivalent.

At the time of writing, the DJCSI tracks seven sovereign and corporate fixed- and floating-rate *sukuk* issues with a market value totalling $4 billion (£2.16 billion). The DJCSI and the Dow Jones Islamic Market Indexes (DJIMI) both provide investors with comprehensive tools for evaluating *sukuk*, thus providing issuers with an incentive to meet international market standards, helping new investors to enter the *sukuk* market.

Characteristics of the conventional secondary debt market

The secondary debt market conventionally consists of:

- High liquidity, as shown by a large number of buyers and sellers and high trading volumes.
- Market depth, allowing money market traders to execute large orders without compromising substantially on the price.
- Efficiency – pricing reflects issuer credit strength, investment value and diversity of both issuers and traders.
- A defined yield curve. Traditionally, yield curves slope upwards with 200–300 bps difference between maturities of long and short tenures.
- Other useful curves, mirroring expectations for forward and swap rates helping instrument pricing.
- Valuation of issues continually validates the pricing of outstanding issues set by actual trades.
- Credit risk premium is determined by the issuer's credit strength. Credit rating agencies provide credit opinions which form the basis of risk-based pricing.
- Interest rate risk resulting from changes in market interest rates affecting cash flows for variable rate securities; market value for fixed rate securities is controllable with the help of derivatives.
- Despite their high liquidity and numerous issuers, debt markets do not move as quickly as equity markets, and debt instrument trading in the secondary market is carried out through direct interaction of buyers and sellers via dealers.

Secondary market development

While global issuance of *sukuk* has grown rapidly, a secondary market has yet to emerge, with most of the *sukuk* being taken by investors who want to hold on to them. As Islamic bonds become more popular, banks are creating a viable secondary market and there are efforts to kick-start secondary market trading. Until recently, trading of *sukuk* has been slow because holders have waited until after maturity before selling bonds. With the market's maturation, more issues are becoming available and a new dynamic is taking hold.

Rising liquidity in the Gulf region is helping to force the growth of Islamic financing and massive new projects and growing economies are increasing the demand for funds. Syndicated *sukuk* will be used extensively to finance the estimated $1 trillion worth of government and private projects leading up to the start of the 2020s.

While issuance has been growing steadily, a relatively small number of investment banks and investors have been able to gain exposure to the *sukuk* market. That is due partly to the small size of issuance, but also to strong demand from *Sharia'a*-conscious Islamic investors.

Demand is so great that Dubai Ports World's release of a $2.8 billion *sukuk* oversubscribed fourfold. Because most investors have had a 'buy-and-hold' mentality, calls for greater secondary market trading have largely been ignored.

Developing a robust repo market will give *sukuk* holders free capital on their balance sheets for agreed amounts of time, be it to invest elsewhere or to gain regulatory capital relief. Simultaneously, smaller investors will be able to gain exposure to the *sukuk*. The Middle East has not yet caught up with Malaysia, with its $30 billion of *sukuk* issuances, 40-plus names and an average of 100 trades a week of up to $50 million each. Malaysia has a single regulatory body and documentation framework for all new *sukuk*; the tax regime allows corporations to claim back expenses linked to *sukuk* issuance. In the Gulf region, there are varying interpretations of *Shari'a*, part of the reason why 14 different *sukuk* structures have emerged.

The secondary market is not as liquid as the standard upfront market, partly because *sukuk* differ very much in structure. Some are asset-based; some are based on a profit-sharing agreements; others are based on something different.

Middle Eastern banks hold the vast majority of *sukuk*, and rising oil prices mean the region's financial institutions have record amounts of cash. According to Moody's, assets of banks in the United Arab Emirates (UAE) are more than 144% of GDP at $150 billion, while in Bahrain, it is 908% of GDP at $109 billion.

A trading mentality could emerge as more international banks and investors enter the market. Most participants agree that the key to a secondary market taking off is increased issuance, and some issuers are actively trying to make tradability a key part of the structure. As more *sukuk* is issued, secondary market liquidity will inevitably follow.

Malaysia's achievements in developing *sukuk* market

The Malaysian Islamic bond market has made significant progress since the first *sukuk* issue in 1990 by a multinational corporation operating in Malaysia. The development of the market involved facilitating an efficient issuance process, the price discovery process, the broadening of the investor base, the establishment of a benchmark yield, liquidity in the secondary market and regulatory strengthening, all reinforced by the legal and *Shari'a* framework and the supporting financial infrastructure.

With the development of an active domestic market, initiatives have been taken to improve the international dimension of the Islamic financial system. This has included liberalization measures such as bringing in new foreign Islamic finance players into the system through the issue of new licenses and allowing for greater levels of foreign interest in the country's domestic financial institutions.

In 2002, the Malaysian government issued the first global sovereign *sukuk*, raising $600 million, which became an international benchmark for the issuance of global *sukuk*. The *sukuk* issue was listed on the Luxembourg Stock Exchange, Labuan International Financial

Stock Exchange and the Bahrain Stock Exchange. There has since been a further sovereign issue in the global capital market.

In 2006, Malaysia saw the launch of a *sukuk* using concepts such as *mudarabah*, *musharakah* and *ijarah*. The issuers included Malaysia's government-linked companies. A key example is the $750 million exchangeable *sukuk* musharakah by Khazanah, the government's investment corporation, to sell a stake in Telekom Malaysia. It was the first issue of its kind anywhere in the world, and incorporated full convertibility features normal in conventional equity-linked transactions.

Following these developments, the Malaysian *sukuk* market attracted diverse lead arrangers, and rising demand, the growing number of issuers and the broadening investor base has sophisticated the market. By January 2007, Malaysia accounted for about $47 billion, 67 per cent of the outstanding global *sukuk* .

This growth also reflects the commitment of the Malaysian government and regulators. There can be no doubt about the vision and policies to drive the local Islamic capital market, all of which is reinforced by strong legal, regulatory and tax frameworks.

Bank Negara Malaysia and the Securities Commission have worked closely on several major blueprints: the 10-year Financial Sector Master Plan, the 10-year Capital Market Master Plan and the Islamic Securities Guidelines. Other key components are the Islamic financial system, money market, banking and *takaful* sectors, which have proved able to meet the different requirements of the economy such as the differentiated tenure for which the funds are required.

With Malaysia moving towards a more liberalized and globalized Islamic capital market, the role of the industry in the continued success of the Islamic financial system grows in importance. The role of the industry has been vital in product innovation, profiling, branding, promotion and marketing of the Islamic capital market's products and services, contributing to the development of a more diverse, liquid, efficient, transparent and effective *sukuk* market.

Challenges

For financial institutions and portfolio managers to manage their funds effectively, greater diversity must be developed in the types and maturity of *sukuk* in the market. The Malaysian government's actions could point the way forward; in order to create a benchmark yield curve, it regularly issues *sukuk* with different maturities. Since 2000, the government has developed an auction calendar for both conventional and *sukuk* government issues. In 2005, it commenced issuing shorter-term Islamic treasury bills and longer-dated (10-year) *sukuk* to add diversity to the range of instruments available to investors. Islamic private debt securities now account for half the total private debt securities market.

A vital factor in the development of capital markets is the creation of a secondary trading platform for the capital market instruments, providing investors with flexibility to manage their liquidity requirements. In this respect, more needs to be done to create a continuous supply of Islamic papers and instruments that promote secondary trading of instruments.

Shari'a sukuk experts are vital in ensuring proper governance and their decisions should be transparent and open to allow the public to appreciate the reasoning, which in turn should lead to more general acceptance of *Shari'a* decisions that could be just as applicable in a range of nations. Furthermore, *Shari'a* principles and interpretation must converge to ensure market confidence among investors from different parts of the world.

To achieve this, there needs to be engagement among *Shari'a* scholars; indeed, the engagement that is already taking place among the scholars is creating convergence.

The harmonization of standards and practices is required for the global acceptance of Islamic finance. International standard-setting organizations such as the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) need to be supported in their efforts to formulate standards. The IFSB has undertaken initiatives to strengthen the framework and practices in the Islamic money market, and work to formulate strategies for strengthening the liquidity management framework is being done, and measures are being identified to develop benchmark Islamic securities that will help to determine global benchmark rates.

A global effort

While many challenges remain, the overall direction and potential of Islamic financial markets have not gone unnoticed. Greater engagement between the industry, scholars and the authorities can only help improve understanding and appreciation of the issues and how to overcome them, until the full potential of Islamic finance can be realized. This global effort will succeed through the work of scholars, the industry and the authorities throughout the world.

Chapter 23

The global reach of Islamic banking and *takaful*

Sohail Jaffer
FWU Group

Introduction

According to a report by Global Investment House,[1] 'banks in the UAE have benefited from the rapid economic expansion currently happening in the UAE. The total bank assets and profits increased by 43% and 24% respectively in 2007'. Furthermore, 'Islamic banks have increased their share of total bank assets, from 8.8% at the end of 2002 to 13.4% at end of 1Q2008' (according to recent newspaper reports). A range of *Shari'a*-compliant products was introduced in the market and Islamic products like *ijarah* and *murabahah* have become common in property transactions. The region has witnessed Islamic *sukuks* attracting large investor volumes with subscriptions exceeding planned issuance, even in large-sized mandates.

Industry expansion . . .

The significance of Islamic banking was further underlined as a few of the major banks started an Islamic banking wing or in some cases converted themselves into Islamic banks. For instance, EBI formed Emirates Islamic Bank by converting its subsidiary, Middle East Bank, into an Islamic one. New issuance of licenses includes Abu Dhabi-based Al-Hilal bank in 2007 and Ajman bank in 2008. It is expected that the assets of ADIB, DIB and SIB will rise at a 2007–2011 CAGR of 21% and that Net Commission Income and the bottom line of Islamic banks will grow at a 2007–2011 CAGR of 26% and 21% respectively. Recently, ABN AMRO bank announced[2] its plan to launch retail Islamic banking services in the Middle East region by the second quarter of 2009. ABN AMRO will accelerate the introduction of Islamic products introducing between five and 10 new products every month, and plans to launch at least 30 new Islamic products during the second half of 2008.

UAE-based Islamic lender Al Hilal Bank will open 10 branches in its first year of operations in 2008 and expects to post first profits next year. The bank, which has a paid-up capital of 1bn dirham ($272.3m), is looking to tap into growth in the Islamic finance

sector whose assets are said to be increasing by at least 60% per year. 'The economy of the UAE is big. It continues to grow as is the Islamic finance sector. It is a big pie and we want a share of it,' said Mohamed Berro, Chief Executive. The Abu Dhabi Government took a 7.5% stake in the premier Carlyle Private Equity Group in September 2007.

The recent expansion of the Islamic banking sector is highlighted by press announcements in all geographical areas:

- Abu Dhabi Islamic Bank applied for a banking license in Algeria.
- The broker Nexus, resulting from the MBO of Zurich International Life opens a second branch in Bahrain.
- Bank Negara Indonesia and a unit of Saudi Arabia's Islamic Development Bank will set up an independent *Shari'a* bank in Indonesia by the end of 2008 or early 2009.
- UK-based Gatehouse Bank gets *Shari'a* licence to become the fifth Islamic Bank.
- Kuwait Finance House (KFH) plans to open 175 new branches worldwide by the end of this year. The expansion plan is expected to cover the Kuwaiti, Malaysian, Bahraini and Turkish markets.
- Qatar Islamic Bank (QIB) is looking to diversify its base in Turkey and has plans to either set up an Islamic bank or buy a stake in a *Shari'a*-compliant bank in the country, said CEO Salah Jaidah. QIB has also expressed interest to invest in real estate industry in Turkey.

The flows of acquisitions as well as the new Islamic banks created are accelerating the pace of the exponential growth. According to an *AT Kearney Report*, the number of Islamic Banks doubled in the last 12 months. Abu Dhabi Islamic Bank recently acquired the National Bank of Development in Egypt. There are three new Islamic Banks in Kuwait: BKME, Kuwait Real Estate Bank and Boubyan Bank. In Indonesia, Bank Rakyat Indonesia (BRI) is to set up a standalone *Shari'a*-compliant bank in July 2008.

Sukuk

In Asia, where the Hong Kong Securities and Futures Commission recently approved the first Islamic fund for retail investors, the market for Islamic finance (*sukuk*) expanded by 27% in the second half of 2007 alone. This was driven mainly by issuance from Malaysia, which has been a powerhouse of Islamic finance for many years now, accounting for three quarters of outstanding *sukuk*. Japan's International Bank for Cooperation (JIBC) indicated plans to introduce *sukuk* in 2008. Thailand and Singapore are also contemplating *sukuk* issues in the near future.

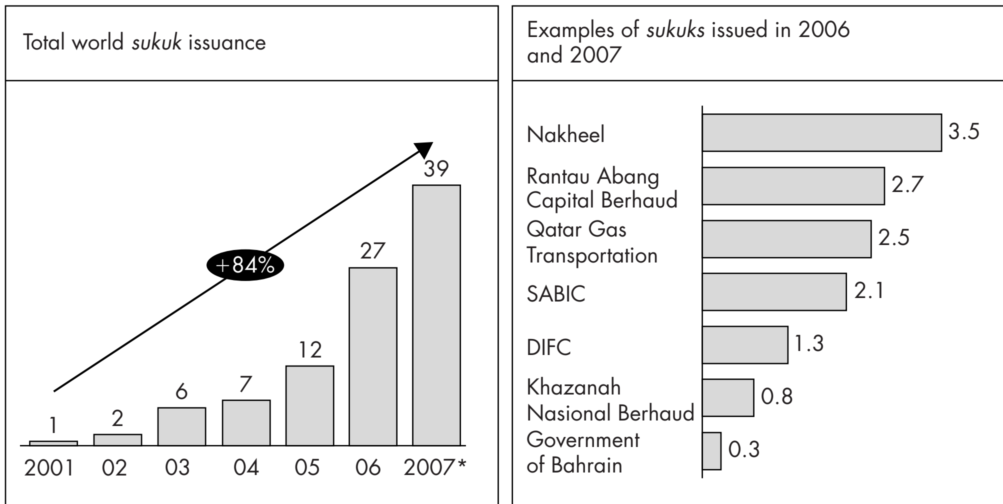
According to the IFN,[3] the Jeddah-based Islamic Development Bank (IDB) will launch its First Ringgit Denominated *sukuk* in August in Malaysia, amounting to RM500m (US$152.7m).

The UK government wishes to develop its tax law to make the issue of *sukuk* by UK companies or by reference to UK assets feasible.

According to Anouar Hassoune,[4] ‘French law does in fact appear to be sufficiently flexible and open, give or take a few adjustments, to accommodate Islamic financial principles and products without any major upheaval’. In particular, a law approved on the 11th February 2007 introduced the concepts of trusts and trust management, which could well make Islamic investment in and finance of real estate easier for legal entities, opening the way to the issue of ‘French-style’ *sukuk*. Recently, the French Economic Minister confirmed his target to facilitate the *Sukuk* emission in France.

Exhibit 23.1

McKinsey & Co, 4th *Annual World Islamic Banking Competitiveness Report* 2007/08, July 2007



* October

Source: DMO and Islamic Finance Information Service (IFIS); press search; interviews; McKinsey analysis.

. . . spurred the development of asset management . . .

Shari'a-compliant investing

Shari'a is the body of Islamic law, which governs *inter alia* banking, finance and business law. Institutional investors are attracted to *Shari'a*-compliant investments because of corporate governance and low correlation with conventional portfolios and the economic reward characteristics. *Shari'a*-compliant investments are now available across a select range of asset classes primarily comprising equities, real estate, commodities, trade finance and leasing. In addition, product innovation has spurred the emergence of *Shari'a*-compliant private equity, long/short equity hedge funds, Exchange Traded Funds (ETFs), a few *sukuk* mutual funds and structured products.

A *Shari'a* Supervisory Board, comprising eminent scholars who have significant expertise in both Islamic jurisprudence and international banking and finance, actively monitor adherence to the *Shari'a* principles for each investment. Under *Shari'a* laws, investments in businesses related to alcohol, tobacco, pork products, defence, weaponry, leisure and entertainment are banned, due to religious beliefs of the Islamic faith. Furthermore, any securities with revenues from financial interest, known as '*riba*', are excluded. Also, the products are completely *halal*; therefore no one will have to compromise on their faith in order to take advantage of the best of what is available for financial protection.

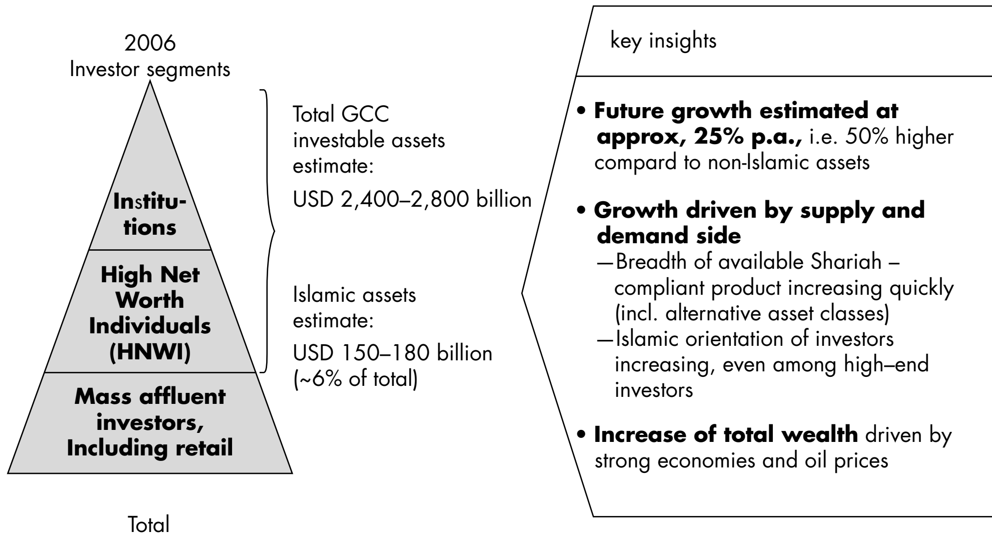
The *Shari'a* Advisory Council (SAC) of the Malaysian SEC is performing a screening that is made available twice per year for compliant stocks.

The Dow Jones Islamic index proposes both a status on the *Shari'a*-compliant activities and acceptable finance ratios, excluding companies for which the level of debt is not satisfactory.

The FWU Group has its own *Shari'a* board with renowned advisers who monitor the integrity of products and principles for each investment. FWU are also an observer member of the Islamic Financial Services Board (IFSB).

Exhibit 23.2

McKinsey & Co, 4th *Annual World Islamic Banking Competitiveness Report* 2007/08, July 2007



Source: World Wealth Report; McKinsey.

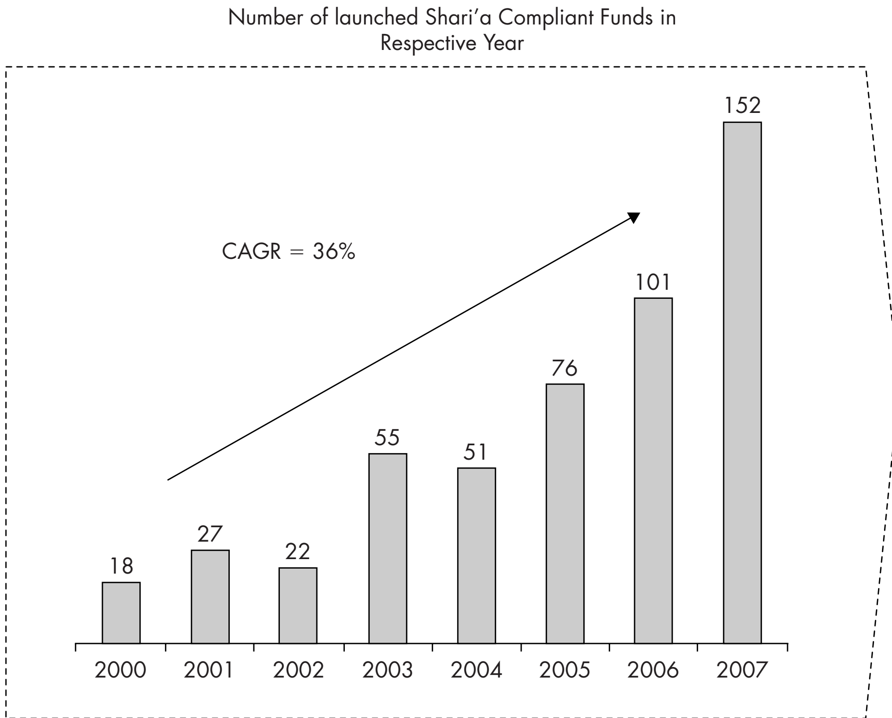
Opportunities in the asset management landscape

Buoyant economies throughout the Islamic world, directly or indirectly underpinned in many instances by soaring oil prices, have led to a dramatic increase in disposable personal income levels. McKinsey's *4th Annual World Islamic Banking Competitiveness Report 2007/08* stated that 'The Islamic asset management market presents an important opportunity and is centered on the Gulf Cooperation Council'.[5] It is easy enough to see why. Buttressed by high oil prices and a surge in real estate markets throughout the region, disposable income levels in the GCC are at an all-time high. Nor are there any indications that the rise is likely to decelerate in the foreseeable future.

According to the Ernst & Young Report 2008 ('Outlining Opportunities in the Asset Management Landscape'), the Islamic fund universe continues to expand and is beginning to provide improved coverage across asset classes and geographical mandates:[6] at the end of Q1 2008 there were over 500 *Shari'a*-compliant funds in the world and it is forecasted to reach 1,000 funds by 2010 (see Exhibit 23.3).

Exhibit 23.3

Ernst &Young's *World takaful Report* 2008



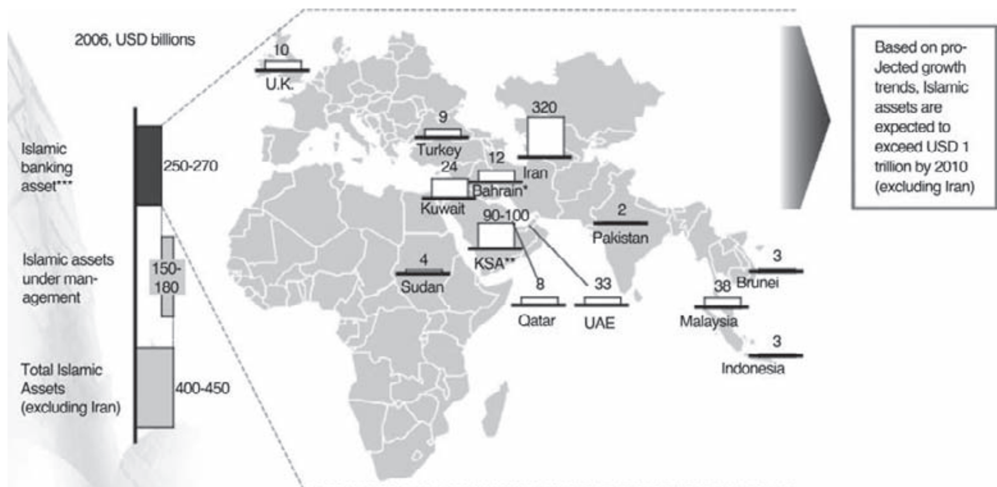
Source: Ernst & Young's *World Takaful Report* 2008.

Standard & Poor's estimates the Islamic market to have a potential of US$4tr with current utilization standing at 10%. In its core regions of Asia Pacific, Africa and the Middle East, *takaful* is growing at a rapid rate. *Takaful* is also making inroads into those territories in which it has not enjoyed traditional strength, such as Indonesia and Pakistan. In Singapore a number of banks are setting up dedicated Islamic subsidiaries.

In recent years there has been considerable growth in demand for *Shari'a*-compliant financial products. There are estimated to be around 300 Islamic financial institutions in existence operating in 75 countries, with an estimated average annual growth of around 15–20%. Furthermore, there is huge potential for expansion, with US$200bn of investments located in Islamic windows or divisions of conventional banks. McKinsey & Company, in its *Worldwide Islamic Banking Competitiveness Report* 2007, said that by 2010 the assets of the industry, worldwide (excluding Iran), will top the US$1tr mark (see Exhibit 23.4).

Exhibit 23.4

McKinsey & Co, 4th *Annual World Islamic Banking Competitiveness Report* 2007/08, July 2007



*Including offshore assets **Estimate of Islamic share of Saudi Market based on Islamic loans' share out of total loans ***excluding Iran

Source: *Bankscope*; *The Banker*; Annual reports.

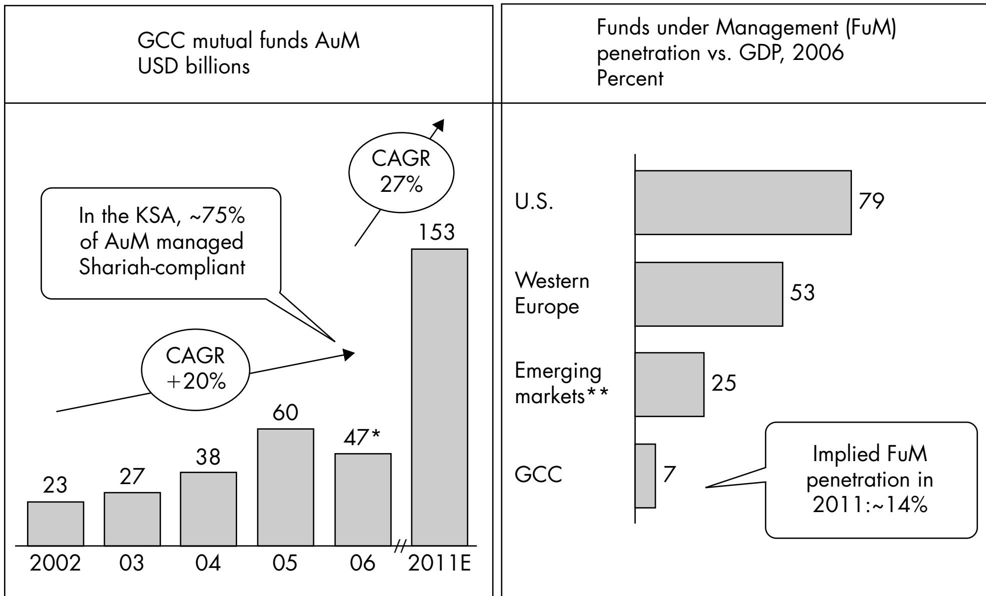
Mutual funds within the Gulf Cooperation Council (GCC) countries are showing rapid and sustained growth. Standard & Poor's 2007 report on the prognosis of *takaful* in the Gulf was bullish in its findings; it stated that the market in the Gulf alone is growing by about 40 per cent each year. When taken in context with the available potential in more mature OECD markets, this represents an extremely interesting opportunity. This upward trend can be attributed to a combination of factors: high oil prices, excess liquidity, partly driven by 'white knights' coming to the rescue of stricken banks, and limited opportunity

for local investment. There is too much money chasing too few opportunities, which has pushed the market into an inevitable upward curve. Companies that come to markets are often 20 to 30 times over-subscribed. The majority of these issues are from relatively small family-owned firms floating a portion of the company on the stock market.

As a result, returns have not been badly impacted by the bear market, other than through the effect of the weakened dollar. There has recently been some talk of de-pegging the six GCC currencies from the dollar in favour of the euro and a basket of currencies. Indeed, Kuwait has already taken this step, opting for a basket of currencies which includes the euro and the yen. If cynics still question the maturation of the *takaful* market, they need only look at the rush of major brand names looking to participate in this sector. AIG *takaful* (a subsidiary of American Insurance Group) was recently awarded a licence by the Central Bank of Bahrain; Axa is active in Saudi Arabia; and Prudential recently signed a memorandum of understanding with Aljazira, to develop the bank's successful *ta'awuni* business. These brands are entering a relatively under-developed market which has huge potential for growth. With disposable income on the rise, Muslims are becoming more financially sophisticated (see Exhibit 23.5).

Exhibit 23.5

McKinsey & Co, 4th *Annual World Islamic Banking Competitiveness Report* 2007/08, July 2007



*Dip due to stock market correction, but still NNA-positive
**Brazil, Spain, Portugal, Greece, and Mexico

Source: Central banks; stock exchange; Start Consult; SHUAA Capital; McKinsey.

Attractive wealth market

The most recent BCG report finds that the average assets under management of wealthy households in the GCC were close to US$1m in 2006, compared with the global average of less than US$400,000. It is no surprise, therefore, that BCG describes the GCC as an 'attractive wealth market',[7] or that its report should observe that 'nearly all international players are currently working to establish representative offices or a more substantial presence in the GCC region'. That has engendered heightened financial literacy among Muslims throughout the world, which in turn has led to burgeoning demand for a broader range of savings products.

As Morgan Stanley observes in its analysis, in Western economies, 'increasing wealth and asset accumulation drive the desire to protect possessions' in Islamic societies. As a consequence, for wealth management firms that are concentrating so much of their marketing on the *Shari'a*-compliant market, *takaful*-based savings products should be an anchor product.

Islamic finance is targeting not only faith-based Muslims but also customers interested in ethical and socially responsible investments such as Malaysia, where non-Muslims represent half of the customer base.[8] After the implementation of the *takaful* act in 1984 and the contemporary creation of the first *takaful* company, the number of *takaful* operators in Malaysia grew to eight in 2007. Together with a modern regulation, young demographic growth as well as the growth of the Islamic finance industry (*sukuk*, Islamic banking, and the like), the *takaful* operators bounded strategic alliances with local banks and boosted *bancatakaful* and the *takaful* industry, becoming a blueprint for the Global Market.

The most recent edition of the Cap Gemini/Merrill Lynch *World Wealth Report*,[9] for example, forecasts that the assets of Middle East-based high net worth individuals (HNWIs) will grow faster than those in any other part of the world over the coming few years. The 2007 report predicts an annual growth rate of HNWIs in the Middle East of 9.5% between 2006 and 2011, which would see the value of their assets expand from US$1.4tr to US$2.2tr. By contrast, the projected annual global growth rate is a more modest 6.8%, and even in the economically vibrant Asia Pacific, it is 8.5% (see Exhibit 23.6).

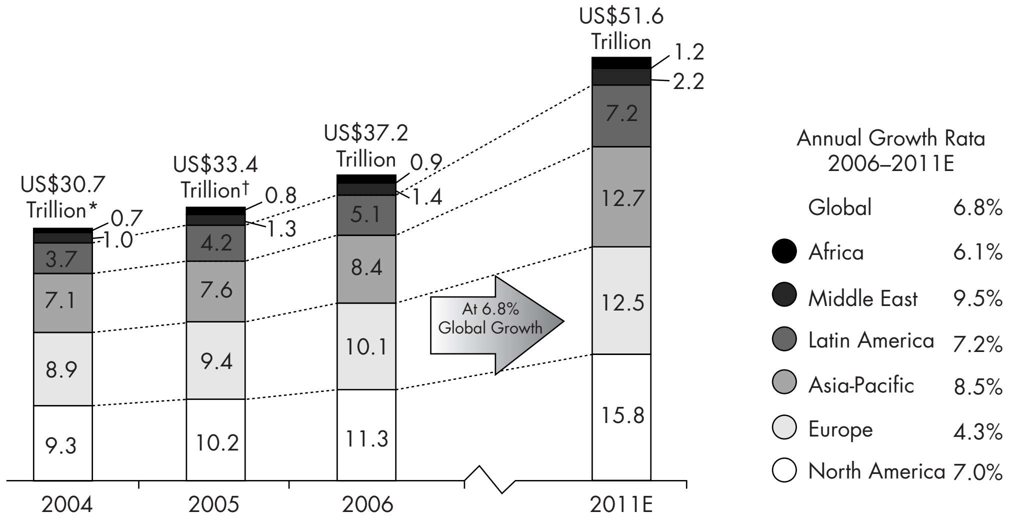
. . . and paved the way for long-term life cycle financial planning

Insurance supply and demand perspective in the GCC

According to a Booz Allen report,[10] 'Insurance in the MENA region has traditionally lagged in growth and development relative to other elements'. Exhibit 23.7 compares the size of the insurance markets of major regions of the world. A measure of the development is the Gross Premium Income (GPI) defined as a percentage of gross domestic product (GDP). When comparing the MENA region with other regions of the world, this measure reveals the extent to which the MENA market is underdeveloped. In 2005, the level of penetration

Exhibit 23.6

CapGemini/Merril Lynch World Wealth Report 2007, Financial Wealth Forecast, 2004–2011E (By Region)



Notes
* In 2004, HNWI wealth figures were restarted as a result of undated data becoming available.
† Bahrain and Qatar were added to the model for year 2005 onwards.

Source: CapGemini/Merril Lynch World Health Report 2007.

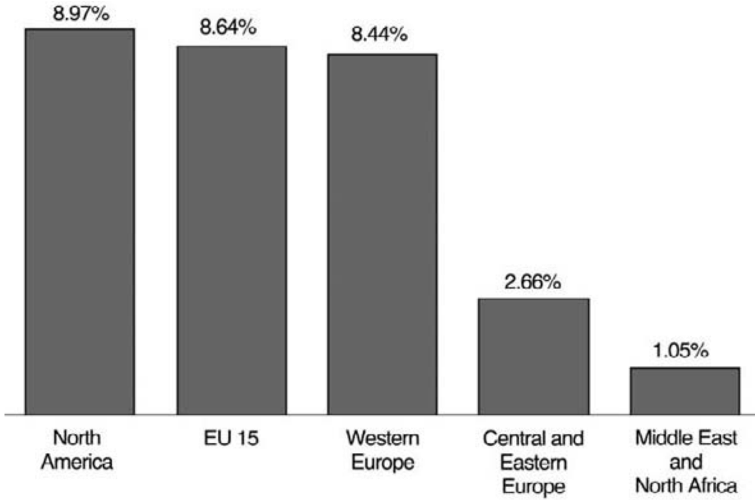
in the MENA region was approximately 1%, compared with an average of 6–9% in industrialized countries and 2.5% in emerging markets. Exhibit 23.8 compares GPI as a percentage of GDP for major regions in the world.

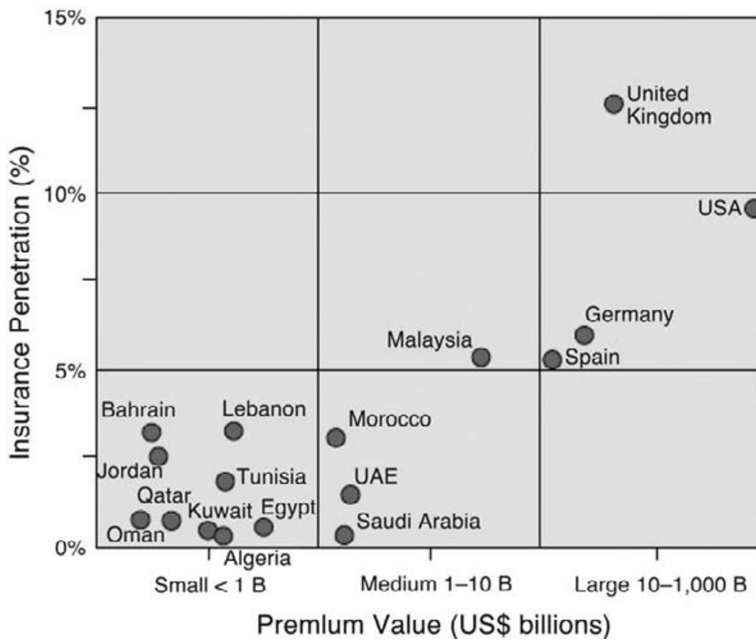
The factors contributing to the market potential future growth are:

- Macro-economic Growth in energy rich countries and large infrastructure investments.
- Emergence of compulsory insurance (such as automobile and health).
- Restructuring and privatisation of government pensions and programs (education, pensions).
- Growth of the financial sector and Islamic banking.
- Demographics of the region (as the population matures, the insurance demand will increase).
- Emergence of *takaful* as an alternative to conventional products.
- Fragmented supply base with a large number of small competitors and a lack of presence of foreign banks.
- Nascent Intermediary distribution channels.

Exhibits 23.7 and 23.8

Booz Allen Hamilton – May 2007 – *Promoting the Growth and Competitiveness of the Insurance Sector in the Arab World*





Source: Booz Allen Hamilton – May 2007 – *Promoting the Growth and Competitiveness of the Insurance Sector in the Arab World.*

Takaful industry overview

Malaysia's innovation and initiatives . . .

In 2008, Malaysia continues to be a trailblazer in the *takaful* market. It has also demonstrated leadership qualities by developing products that are helping to globalize the market for Islamic financial services.

In March, for example, the Kuala Lumpur-based Hong Leong Tokio Marine *takaful* (HLTM *takaful*) became the first operator in the sector to launch a fully *Shari'a*-compliant *takaful* plan linked to investment opportunities in the Middle East. Structured by Citibank, this capital protection investment-linked product is known as the HLTMT Gulf Opportunities Plan (GOP) and uses the concepts of *wa'ad* and commodity *murabahah* as a means of delivering *Shari'a* compliant returns to policyholders. In the event of death, the plan pays 125% of the initial investment amount, with initial investments starting as low as RM10,000 (US$3,064), although bonus units are allocated to investors subscribing for at least RM50,000 (US$15,329).

The product is, therefore, a good example of an innovative scheme that combines the protection offered by conventional insurance with the investment returns that leading wealth managers offer their clients. According to a Citibank briefing, GOP is a three-year *takaful* product providing investment returns benchmarked against the performance of Middle Eastern equities, commodities and currencies 'where the projected annualized return at maturity could be up to 10%'. It adds that 'understanding the volatility of today's market, the GOP's investment is based on the 'best-of-profile' structure that allows investors to enjoy the highest return allocation from the underlying investment profiles'.

Another initiative to have emerged recently from the Malaysian *takaful* sector, and which again blends elements of conventional insurance with those of wealth management, is an education savings product from CIMB Wealth Advisors. The 3 in 1 Education Plan, developed in collaboration with CIMB Aviva, CIMB Trustee and CIMB-Principal Asset Management, is marketed as a product that 'combines unit trust investment, insurance and *takaful* coverage and trust nomination services in a complete solution to enable parents to plan for their children's education'.

Innovative growth of *takaful* solutions has not, however, been confined to Muslim-majority countries in recent years. In the UK, for example, an important building block was laid down at the start of May when its first independent Islamic insurance company, Principle Insurance, was granted authorization by the Financial Services Authority. Principle will be offering *takaful*-based motor and home coverage to Britain's estimated two million Muslims who had previously been unable to purchase insurance policies that are compatible with their religious beliefs.

Clearly, the penetration and global acceptance of *takaful* is going to be an evolutionary rather than a revolutionary process. But as understanding of its mechanics grows throughout the Muslim world, *Shari'a*-compliant insurance should become a pivotal product for companies offering wealth management services to a customer base that is increasingly wealthy and aspirant.

. . . paved the way for the global *takaful* Renaissance

Years of growth

This is spurring greater interest in a wider range of financial structures – not just bank accounts, but also insurance, mutual funds and home loans. Acting through these local distribution partners, major product providers are bringing similar services to those that they offer in the West. Despite current penetration of insurance standing at only one or two per cent, the 'gold rush' of major brands into this sector suggests a genuine confidence that this market could experience rapid growth in the near future. Legislative changes, such as the introduction of compulsory health insurance for expatriates in UAE and mandatory third-party motor insurance in Saudi Arabia, are likely to further fuel demand for insurance products. To combat its housing shortage, the Kingdom of Saudi Arabia is on the verge of passing a new mortgage law. Only 22% of Saudis own their own home and estimates suggest that 4.4 billion new housing units will be needed over the next five years. This law will facilitate the provision of long term loans, much of which will be structured on a *Shari'a*-compliant basis. As an offshoot of the growth of the mortgage market, demand for housing insurance will inevitably surge.

Global renaissance

To view *takaful* purely in a regional context, however, is to underestimate the real potential of the market. In 2006 Moody's released a special comment, entitled *Takaful: A Market with Great Potential*, in which it stated that *takaful* premiums could rise from their current level of US$4bn to as much as US$20bn, with around half of that demand coming from developed OECD countries. Rather than viewing opportunities for *takaful* in the context of the size of Muslim populations, investors should look at the level of interest in insurance, and the capacity to buy. The developed nations of Europe and North America are home to millions of Muslims who want to use conventional financial institutions but are under-served by the options available. Consultants Oliver Wyman, in their report on the *takaful* market, put it this way: 'Western Europe, home to only 15 million Muslims (1% of the total population), makes up to 40% of potential demand.'

As it becomes a more recognised part of the landscape, and as religious consciousness among Muslims grows, this group will increasingly turn towards *Takaful*. Although the *Qur'an* does allow the use of conventional financial structures when no alternative is available, the appearance of viable *Shari'a*-compliant alternatives could make it socially unacceptable to use anything other than *Shari'a*-compliant solutions, sparking a huge surge in demand for *takaful*.

The most promising European market for *takaful* is the UK, which has both the demand and a favourable regulatory environment. There are approximately 1.8 million Muslims in the UK with combined spending estimated at £20bn, currently generating insurance premiums roughly equal to the whole of the Gulf region. Furthermore, the government has been receptive to the prospect of *takaful*. Gordon Brown has spoken of his desire to transform Britain into a global 'hub' of Islamic finance. We have even seen the creation of a dedicated

UK Islamic bank: the Islamic Bank of Britain. *Shari'a*-compliant bank accounts have been available in the UK since 2006, but recent developments look set to move *takaful* on a stage further.

In February 2008, UK outsourcing group Capita confirmed it was ready to start marketing *takaful* to British Muslims in partnership with British Islamic Insurance Holdings (BIIH) now rebranded to Principle Insurance. Initially BIIH will focus on motor and home insurance policies, later expanding into life insurance, investments, savings and ethical finance products. This expansion into 'must have' products is highly significant, for while there is no requirement to have a bank account, this is not the case with these products. Motor insurance is mandatory to all UK drivers and life insurance is generally an obligatory requirement for home loans in the UK.

A survey by BIIH suggests there is genuine interest among British Muslims in these structures as long as they can prove competitive with their cover; 50% of UK Muslims said they were likely or very likely to use motor *takaful*, and 26% said they were quite likely to. For household insurance those figures were 46% and 28% respectively. In February 2008 we saw a landmark deal for the world of *takaful*. Kuwait's Adeem investment company, an investment arm of Efad Holdings, acquired Aston Martin from Ford for £522m. The closure represented the first time a fully *Shari'a*-compliant leveraged loan mechanism had been used in the acquisition of a European company.

Britain has the potential to act as a gateway to the global financial markets for *takaful*. If *takaful* starts to achieve its desired growth in Britain, then other favourable European markets such as Germany and France are likely to follow suit. It is difficult to overstate the importance of these markets. According to Moody's, up to 50% of future uptake could come from these territories. However, it is not enough that *Shari'a*-compliant finance appeals to Muslims on religious and ethical grounds. In order to spread into a wider, non-Islamic market, these products must prove themselves at least as competitive against conventional funds and there is a significant body of evidence to suggest that this might be the case. According to Failaka Advisors, the assets of *Shari'a*-compliant funds have increased three-fold. The Dow Jones Islamic Market World Index has risen by 8.4% in the year to the end of February 2008. The transparency and stability of these products makes them attractive regardless of religion. The *Qur'an*'s proscription of *gharar* ('uncertainty' or 'speculation') means dedicated Islamic funds would not have been exposed to the problems of the sub-prime market. The ability of *Shari'a*-compliant models to steer clear of those companies with inadequate business practices is one reason why Islamic finance has demonstrated impressive performance, even in the bear market of recent times. Some analysts are now recommending *Shari'a*-compliant portfolio management beyond the Islamic world and according to some estimates, non-Muslims could account for up to 20% of demand for *takaful*.

Socially responsible investment in secular states

Innovative growth of *takaful* solutions has not, however, been confined to Muslim-majority countries in recent years. In the UK, for example, an important building block was laid down at the start of May when its first independent Islamic insurance company, Principle

Insurance, was granted authorization by the Financial Services Authority. Principle will be offering *takaful* based motor and home coverage to Britain's estimated two million Muslims who had previously been unable to purchase insurance policies that are compatible with their religious beliefs.

Islamic Finance is increasingly appealing to non-Muslim countries and non-Islamic institutions across the globe, which is veering more towards ethical ways of investing and financing. Secular challenges are ahead of markets that are religiously neutral or prohibiting religious branding. The essence of the products is the same even if the religious terminology is not used, for example 'alternative products' in Morocco (*musharakah*; *ijara*; *murabahah*).

Kuwait Finance House (KFH) plans to open 175 new branches worldwide by the end of 2008, said its CEO, Mohammed Sulaiman Al-Omar. The expansion plan is expected to cover the Kuwaiti, Malaysian, Bahraini and Turkish markets. It is part of the bank's efforts to diversify its investments in different sectors and regions. KFH, the first *Shari'a*-compliant bank in Kuwait, has seen rapid expansion in the Middle East and Asian regions. It is also targeting new markets in Europe, Central Asia and the GCC.

In an attempt not to violate any of the principles of Islam or avoid any sensitive religious issues being publicly disputed, secular markets may inadvertently align themselves more closely to the underlying principles of *Shari'a* than would other jurisdictions where Islamic finance is widely practised. Secular states such as Turkey and France and other like-minded states such as Morocco and Egypt will not amend their legislation to adapt them to specific Islamic requirements but welcome alternative structures and wish to facilitate best practices.

In February 2008, UK outsourcing group Capita confirmed it was ready to start marketing *takaful* to British Muslims in partnership with British Islamic Insurance Holdings (BIIH), rebranded as Principle Insurance. Initially, Principle will focus on auto and home insurance policies, later expanding into life insurance, investments, savings and ethical finance products. This expansion into 'must have' products is highly significant, for while there is no requirement to have a bank account, this is not the case with these products. Motor insurance is mandatory to all UK residents and life insurance is generally an obligatory requirement for home loans in the UK.

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According to a recent Moody's report and article,[11]

> France's Muslims constitute the biggest Islamic community in the Western world but the French financial and banking system does not as yet offer access to a range of alternative products and services in line with that community's religious principles – something that would, by extension, offer a dynamic and ethical response to the financial and investment needs of all French citizens.

> The underlying idea is to maintain the attractiveness of the UK by remaining open to forms of finance currently regarded as alternative or even exotic but which may in the long term be capable of absorbing considerable flows of liquidity and hence creating wealth, jobs and know-how.
>
> The reduction of legal, fiscal and regulatory barriers is no more than a means to a more ambitious end, and it is particularly ironic that the political willingness of more than a decade with all its symbolic, opportunistic and farsighted characteristics has coincided with a time when the UK has attracted the condemnation of the Arab world for its involvement in the Iraq war.
>
> Although France suffers no such hindrance, paradoxically it has not yet been able to benefit from the comparative advantage of cultural, political and military neutrality, and to calmly and dispassionately develop an "industrial" version of Islamic finance. Even while seeking to attract surplus oil wealth, France is running the risk of erecting barriers to establishing its own market for Islamic finance.

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The ability of *Shari'a*-compliant models to steer clear of those companies with inadequate business practices is one reason why Islamic finance has demonstrated impressive performance, even in the bear market of recent times. Some analysts are now recommending *Shari'a*-compliant portfolio management beyond the Islamic world and according to some estimates, non-Muslims could account for up to 20% of demand for *takaful*.

The growing international prominence of SRI, which shows no sign of weakening, has important implications for the Islamic investment management industry – which itself is becoming increasingly closely integrated with conventional financial services – on a number of levels.

The first of these is in the fundamental discipline of screening funds in order to ensure that all unsuitable or undesirable elements are excluded from an investor's portfolio. While the so-called 'ethical' offshoot of the conventional investment management industry in markets such as the UK is generally agreed to date back to the early to mid-1980s, which is when products such as the Friends Provident Stewardship Fund were launched, the first Islamic equity funds can be traced back to the late 1960s. Since then, the market for *Shari'a*-compliant funds has expanded impressively, developing a track record for highly sophisticated screening of companies to safeguard against any violation of Qur'anic teachings. While the lion's share of these funds has been equity-based, the recent growth in the broader Islamic capital market in general – and the expansion in the market for *sukuk* (Islamic bonds) in particular – has widened the product range available to *Shari'a*-compliant funds.

A second way in which there is a clear overlap between dedicated Islamic investment management and the sustainable investment model that is gaining popularity in the

conventional market is that so-called ethical funds outlaw a range of sectors that have always been proscribed under *Shari'a* law. Buyers of Islamic funds, which are readily available to conventional as well as to Muslim investors, can be absolutely certain that they will be taking no exposure of any kind to companies involved in the production or sale of alcohol, or in those generating any turnover from areas such as gambling or pornography. Investors in so-called 'ethical funds' in conventional markets do not always enjoy the same certainty. *Shari'a*-compliant funds may be increasingly appealing to investors in the Islamic world or elsewhere who are uneasy about the activities of companies in sectors such as retailing or hotels, which may generate considerable earnings from products considered to be '*haraam*' by Muslims.

By extension, funds structured to ensure they do not violate Qur'anic teachings may become increasingly attractive to conventional investors concerned about some of the more short term-oriented, speculative activities about mainstream companies not normally associated with being off limits for 'ethical' funds. As an obvious and topical example, witness the recent misdemeanors that have damaged the reputation of the conventional financial services sector. Islamic funds unable to invest in companies generating income through *riba* (interest) or *gharrar* (uncertainty, which includes trading in speculative instruments such as derivatives) would have safeguarded investors against exposure to the sub-prime fiasco as well as to the more recent debacle at Société Générale. Generally, the screening process that *Shari'a*-compliant funds undergo is considerably stricter than those used in the construction of socially responsible funds sold in conventional markets.

A report published at the start of 2008 by the investment management company Holden & Partners found that the top 10 holdings of many of the early leading ethical funds in the UK are 'surprisingly mainstream',[12] with names such as Vodafone and the Royal Bank of Scotland (RBS) appearing 'again and again'. Increasingly, evidence is emerging to suggest that individual investors are becoming dissatisfied with investment strategies that appear to pay lip service to areas such as environmental responsibility.

A striking example of this trend came in February 2008 when Standard Life of the UK, which manages almost £600m in its range of ethical funds, announced that these funds would no longer be investing in the shares of airlines. This move was a direct response to feedback from Standard Life's clients, 30% of whom indicated that they would prefer to see airlines excluded entirely from ethical funds. The need for ever more careful screening of funds marketed to increasingly demanding and discriminating investors suggests that there may be important and exciting partnership opportunities ahead for conventional fund management companies tailoring developing socially responsible products and specialists in *Shari'a*-compliant funds. This is because in the future an ever-expanding share of the global customer base – Muslim and non-Muslim alike – will demand highly-focused investment opportunities, capable of outperforming conventional benchmarks on the one hand and meeting exacting ethical standards on the other.

For all classes of investor, be they institutions, high net worth individuals, mainstream retail investors and family offices, the message is clear. As the financial columnist Tom Stevenson put it in a recent piece in the *Daily Telegraph*, 'green investing is no longer a niche, but probably the biggest single investment theme of the decade'.[13] The same is becoming true of the broader SRI theme. Witness the findings of a survey released in 2007 by

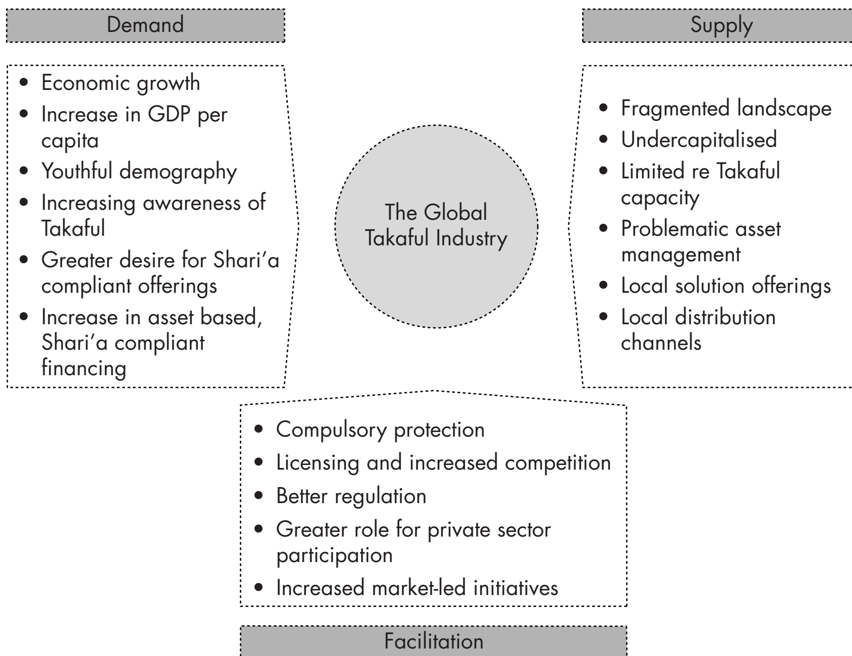
the Social Investment Forum in the US analysing the asset allocation strategy of defined contribution (DC) retirement plans. This survey, undertaken by Mercer[14] Investment Consulting, found that 19% of DC plans already include an SRI option, but that a further 41% of all plan sponsors are not currently offering SRI options to investors but expect to do so within three years. As Mercer points out, 'this would translate to 60% market penetration for SRI options in DC retirement plans by 2010'.

Overview of the drivers of the *takaful* industry

According to Ernst and Young's *takaful Report* 2008, the *takaful* industry is poised for significant growth as demand increases and industry enablers are further aligned (see Exhibit 23.9).

Exhibit 23.9

Ernst & Young *World Takaful Report* 2008



Source: Ernst & Young *World Takaful Report* 2008.

Industry challenges to be overcome

Though the outlook is bright, there are still a number of obstacles standing in the way. Some have already been addressed, such as the traditionally fragmented nature of the

regulatory environment. The Islamic Financial Services Board (IFSB) and the International Association of Insurance Supervisors have drawn up an international set of regulations which will enhance the transparency and marketability of *takaful* products.

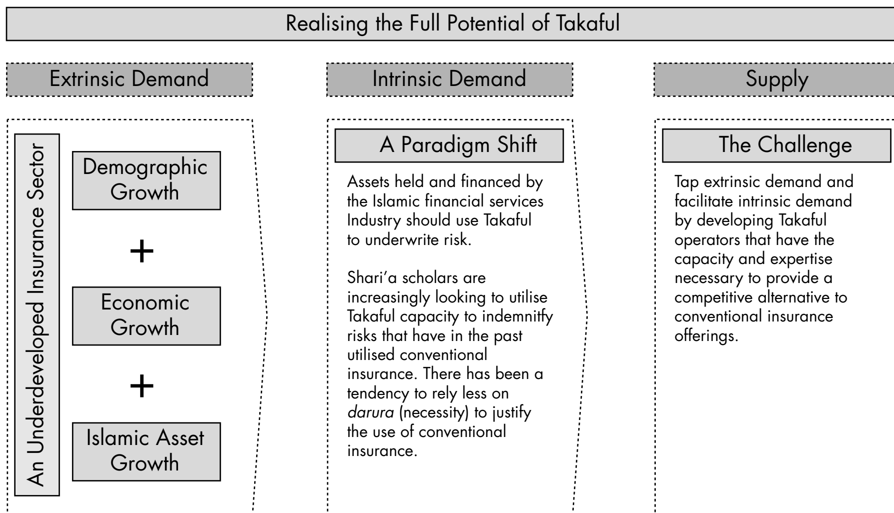
A particular area of development is in establishing a re-*takaful* market. In 2005 the Dubai-based *takaful* Re was launched, which is BBB rated by S&P, and reported a net profit of US$1.263m in its first year of operations. Tokio Marine, Swiss Re, Converium, Munich Re and Hannover Re are all among those to have entered the Re-*takaful* market in recent years. Dubai Banking Group (DBG), Khazanah Nasional and Asian Capital Reinsurance (ACR) created what is at the time of writing the world's largest re-*takaful* company with a total capital of $300m (Dh1.1bn). The group is operating as a global *Shari'a*-compliant investment company, focusing on investing in *Shari'a*-compliant assets in the Islamic sector.

The establishment of a successful re-*takaful* market would lead to greater capacity, which will in turn help build the re-*takaful* industry. More solutions would make a positive contribution to the further evolution of a re-*takaful* market (see Exhibits 23.10a and b).

Exhibit 23.10a

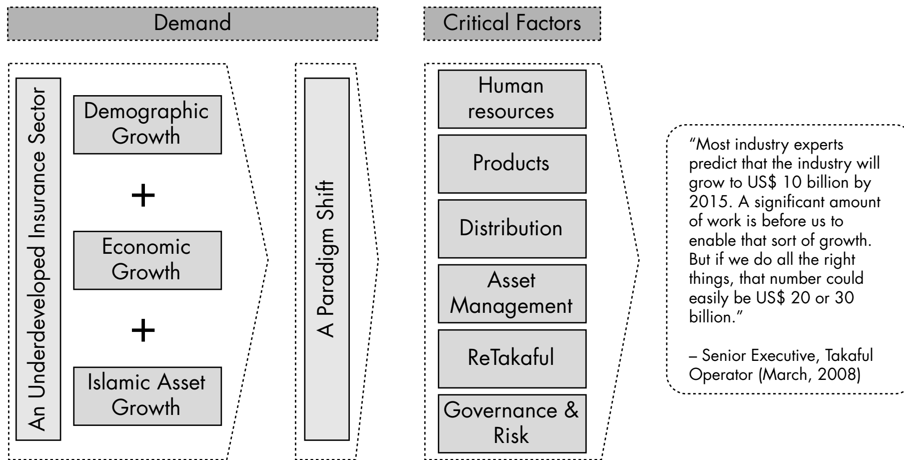
Ernst & Young *World Takaful Report* 2008

Extrinsic demand drivers suggest upside potential for the Takaful industry, with emerging intrinsic demand further augmenting growth...



Source: Ernst & Young *World Takaful Report* 2008.

Exhibit 23.10b
Ernst & Young *World Takaful Report* 2008



Source: Ernst & Young *World Takaful Report* 2008.

From an outward perspective there is some confusion regarding exactly how the *Shari'a* boards reach their rulings. Non-Muslim investors may be forgiven some uncertainty about the consistency of rulings from different boards. For example, some believe that life insurance is unacceptable under Islamic law.

There has been some progress in making non-life insurance-related products and we are gradually seeing the emergence of products tailored in a way that is acceptable to *Shari'a* experts. However, *takaful* products will still have to combat a level of suspicion from non-Islamic investors. They will have to be convinced that these lifecycle products will not be susceptible to a religious crisis with no financial basis. It is a matter of education; *takaful* providers must engage in a clear dialogue making customers aware of the nature and benefits of Islamic finance. They will have to instill in the popular consciousness the ability to regard the constraints imposed by *Shari'a* law as opportunities rather than limits.

Every step of the way *takaful* will be strictly compared against conventional structures and at every step they will have to match or even surpass their performance. Key to success will be creative product design, superior customer services and transparency of product terms and efficient distribution and pricing. The *takaful* industry has enjoyed some success distributing products through its agency sales force, e-commerce and, to a degree, through retail banks. Online administration and web-based point-of-sale systems can optimize customer relationships and after-sales service.

Conclusion

Many challenges are faced by the global *takaful* industry:

- Strong competition from conventional insurers, which may be able to earn greater investment return due to the absence of restrictions in unethical investments, as well as from other *takaful* businesses.
- There is a lack of clear, standardized regulatory and accounting framework for *takaful* providers.
- Competition between *wakalah* and *mudharabah* models may confuse consumers.
- A modest level of capitalization among many *takaful* businesses, especially within the *takaful* fund. Increasing this capital base within the *takaful* fund is a particular challenge as the surplus is provided by the fund's participants and would usually only grow gradually over time.
- The scarcity of suitable (Islamic-compliant) investments and reinsurers. These shortages can lead to concentration risks or lower quality assets.

The market is fluid and in a state of change. *Takaful* operators must be willing to innovate and to understand the evolving needs of the customer and the direction of the market. Those that find themselves stuck with an outdated vision of the *takaful* market will be swiftly overtaken by others. *Takaful* has come much further than many imagine; it is no longer a niche market, good for small-time investment, but has reached a level of maturity that makes it a real part of the mainstream financial climate. It may still have its doubters, but the future promises great things.

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[1] Global Investment House, UAE Banking Sector, *All in Good Faith*, May 2008.

[2] *Emirates Business online newspaper*, June 25 2008.

[3] *Islamic Finance News*, Jul 4 2008, Vol. 5, Issue 26.

[4] Anouar Hassoune, Moody's Investors Service, *Islamic Finance in France: Terra Incognita?*, IFN, Volume 5.26.

[5] McKinsey & Co, *4th Annual World Islamic Banking Competitiveness Report* 2007/08, July 2007.

[6] Ernst & Young *Report*, 2008 'Outlining Opportunities in the Asset Management Landscape'.

[7] Boston Consulting Group, *World Wealth Report*, 2007.

[8] Islamic Finance News, *Country Report Malaysia*, April 11 2008.

[9] CapGemini/Merril Lynch *World Wealth Report*, 2007.

[10] Booz Allen Hamilton – Promoting the growth and Competitiveness of the insurance sector in the Arab world, May 2007.

[11] Anouar Hassoune, Moody's Investors Service, 'Islamic Finance in France: Terra Incognita?', *IFN*, Vol. 5.26.

[12] Holden & Partners 'Guide to Climate Change Investment', February 2008.

[13] Quoted in the Holden & Partners Guide, February 2008.

[14] See Mercer press release (www.mercer.com), June 5 2007.

Part IV

Special issues and special considerations

Chapter 24

The role of women in Islamic finance

Aly Khorshid
Elite Horizon

Introduction

An opinion that is often expressed from outside the world of Islam is that Muslim women are treated as second-class citizens, with few options or opportunities in life. Like most prejudices, this opinion is not based on a solid foundation. Whilst the equality gap certainly could, and should, be narrower, it would be wrong to assume that the problem is significantly worse than in Western society.

This chapter explores the historical, *Quranic* and contemporary roles of women, particularly in Islamic finance, and points to some notable women who have made contributions that simply would not have been possible, had the imagined restrictions been based on truth. The resulting picture is of an encouraging level of involvement of women that points to women having a bright future in Islamic finance, at all levels of management and ownership of business.

Early historical background

To evaluate the effect of Islam on the status of women, we must discuss the status of women in pre-Islamic Arabia.

Some evidence shows that women before Islam were more liberated, particularly on marriage and worship, although women's status was in general poor because they had been deprived of their inheritances by men. Pre-Islam women were more or less the property of men, like in many other world religions, especially Hinduism, Christianity and Judaism.

Islam changed the structure of Arab society, and to a large degree united the people, reforming and standardizing gender roles throughout the region. Islam improved the status of women by instituting rights of property ownership, inheritance, education and divorce.

During the early reforms under Islam in the seventh century, reforms in women's rights affected marriage, divorce and inheritance. Women were not given such legal status in other cultures, including the West, until centuries later. Under Islamic law, marriage was no longer viewed as a 'status' but rather as a 'contract', in which the woman's consent was imperative. Women were given inheritance rights in a patriarchal society that had previously restricted inheritance to male relatives; they were supposed to be the property of the man, and if the man died everything went to his sons. Muhammad, however, by instituting rights of property ownership, inheritance, education and divorce, gave women certain basic

safeguards. Prophet Muhammad granted women rights and privileges in the sphere of family life, marriage, education and economic endeavours; rights that help improve women's status in society.

In terms of women's rights, women generally had fewer legal restrictions under Islamic law than they did under certain Western legal systems until the 20th century. For example, a restriction on the legal capacity of married women under French law was not removed until 1965.

Cairo Declaration of Human Rights in Islam (CDHRI)

On 5 August 1990, there was a declaration of the member states of the Organization of the Islamic Conference (OIC), which provides an overview on the Islamic perspective on human rights, and affirms Islamic *Shari'a* as its sole source. CDHRI declares its purpose to be 'general guidance for Member States (of the OIC) in the field of human rights'. This declaration is an Islamic counterpart of, and a response to, the post-World War II United Nations' Universal Declaration of Human Rights (UDHR) of 1948.

Early women's rights reforms under Islam in the 7th century affected marriage, divorce and inheritance. Women were not accorded with such legal status in other cultures, including the West, until centuries later. Under Islamic law, marriage was no longer viewed as a 'status' but rather as a 'contract', in which the woman's consent was imperative. Women were given inheritance rights in a patriarchal society that had previously restricted inheritance to male relatives, were supposed to be the property of the man, and if the man died everything went to his sons. Muhammad, however, by instituting rights of property ownership, inheritance, education and divorce, gave women certain basic safeguards. Prophet Muhammad granted women rights and privileges in the sphere of family life, marriage, education and economic endeavours, rights that help improve women's status in society.

Female figures in the *Qur'an*

Important *Qur'anic* women abound, in a list that includes Eve (God created Adam and Eve and had them live in Paradise), who along with Adam committed the first human sin by eating fruit forbidden by God; the wives of Noah and Lot; Sara, wife of Abraham; the mother and sister of Moses; the wife of Moses; Asiyah, wife of the Pharaoh; the wife of the Pharaoh, known in some traditions as Asiyah; the Queen of Sheba (Bilqis); the wife of Imran (father of Mary); Isa's grandmother is not named in the *Qur'an* but is referred to in narratives (in the Judeo-Christian tradition, she is identified as Hannah). According to the *Qur'an*, Imran and his wife were old and childless, and she invoked God for a child, Mary (a key female character in the *Qur'an* and the mother of Jesus). The name of Miriam frequently appears in the *Qur'an* alongside that of Isa (Jesus) in the format 'ISA Ibn Miriam' (meaning Jesus, the son of Mary), and the woman who complained to Muhammad.

The history of women in Islamic trade and finance

The history of women in Islamic trade and finance is not adequately written. At first sight, Muslim women's stories (and the general interest in them) seem to focus on family

matters like marriage, divorce and children. Stories about the Prophet's wives focus, in most cases, on the Prophet and their relationship with him rather than their own activities, personalities and interests. Five examples will be dealt with below: Khadija, Hind, Zaynab, Shifa' and Ijliyah.

Khadîja bint Khuwailid

Khadîja is often proudly pointed out as the first Muslim and one of the Prophet's greatest spiritual, emotional and material supporters. She is known as a businesswoman who employed young Muhammad and then married him. After that, details are scarce, except for the children she had, her reaction to the prophetic revelation and a number of beautiful stories about angels greeting her. Questions beyond that might not be compatible with habitual thought patterns:

- How did she become the rich businesswoman she was at a time when newborn girls were sometimes buried alive?
- What were her arrangements with Muhammad (a) regarding the work he did for her and (b) how she continued business after their marriage?

Some of the answers can be found by drawing conclusions from various traditions. She inherited the import-export business from two previous husbands; as women in those days did not normally inherit, she probably kept charge on behalf of her children. Why did she not travel to Syria herself? Were business trips impossible or unacceptable for a woman, or were the children too young for her to get away? We do not know how many employees she had beforehand.

The agreement with Muhammad was apparently based on profit sharing, with her investing capital and administration and him investing the work. We hear how impressed she was with his reliability, but would that be enough for marriage, even considering that, in principle, the idea of a marriage contract is not too far away from a business contract? Perhaps this was a key point. But there was also another similarity. Both of them were committed to the cause of the poor: she had contributed to projects like sponsoring and running a hospital during the plague epidemics, and he had been involved in the *Hilf al-Fudul* movement to stand up for the rights of the underprivileged. Except that the business continued to be successful, we have no information about their respective agreements, but considering both their personalities and later Islamic property rules, they cannot have been far away from a similar partnership that lasted though the years of persecution and boycott after Muhammad started teaching in public until Khadîja died.

In later societies, where segregation of the sexes often limited women's access to the public sphere, especially among the ruling class, we repeatedly come across women who made profitable use of the rights guaranteed in Islamic law by managing and investing their property, either directly or through their agents. For example, going back to a class of slave soldiers with a high mortality rate among men, the Mamluks in Egypt used to leave the management of their property to their wives. Whatever the popular image, the harem system such as was practised in the Ottoman Empire, was not necessarily an obstacle:

comprising wives, daughters, indoor and outdoor servants and slaves as well as unmarried sisters and elderly relatives, it provided access to education and management skills. That is how many women became famous for sponsoring and managing *awqâf*, endowments for needy relatives or philanthropic endowments like hospitals, colleges, *sufi* convents, libraries, mosques or orphanage projects as well as roads, bazaars and rest-houses that paid for the former.

Hind bint 'Uqba

Hind is mainly remembered for the disgusting scene at Badr, mutilating the body of Hamza killed in battle, as well as her pointed remarks when, after the Opening of Makkah, she became a Muslim. The connection is not often made with a report about her consulting the Prophet about helping herself from her husband Abu Sufyan's purse because he was too mean to give her enough for herself and the child, and the Prophet's permission to do so within reasonable limits. This is taken as an illustration of a self-evident point: a woman has a legal right to support from her husband. The experience must have been humbling for her but did not break her spirit.

According to a later casual note, she was granted a substantial loan from the Baitul-Mâl (known to most Muslims as the contemporary treasury and social office) to start a business; interest-free, of course. If there had been anything extraordinary or controversial about this, the resulting debate would have left its traces in the records.

Zaynab bint Abi Mu'awiya

According to a hadîth (tradition), Zaynab 'used to provide for (her husband) Abdullah (b. Mas'ûd) and the orphans who were in her care'. She (and at least one other woman in a similar situation) asked the Prophet if it is permissible for a woman to give *zakat* to her husband and other family members and was encouraged to do so. This is because women are not legally obliged to support their families.

We come across a number of women who were involved in agriculture, home industry and crafts, or simply in 'buying and selling goods'. We hear about midwives, nurses, perfume makers and a number of other professions. Unlike domestic servants, they were self-employed. Otherwise, the advice they asked the Prophet for would have been different. We find their counterparts in all Muslim societies in later centuries.

Shifâ'

We know about how Shifâ' taught the Prophet's wife Hafsa to read and write, and that the Caliph 'Umar employed her as a market inspector, that is she had to enforce the rules concerning measures, weights and business transactions. 'Umar was not exactly known as a feminist, but he does have a reputation for choosing the most competent candidates for government posts. Whether Shifâ' had to do the actual inspecting by herself or had a team to help her, the implications might sound alarming to Muslims who are convinced that women should not have positions where they can give orders to men. Perhaps that is why the case is not very well known.

However, this conviction, widespread as it may be, is hardly compatible with key concepts of the *Qur'an* that consider men and women 'each other's protecting friends who enjoin what is good and prohibit what is evil . . .' (9:71). It not only points to women in resistance against oppressive political authority, like Pharaoh's wife and Moses' mother and sister, but also the example of the Queen of Sheba, traditionally called Bilqis, who, after listening to her advisors, makes a much more constructive decision for the benefit of her people. There were certainly controversial debates about women in leading positions, but the outcome was mainly determined by the socio-cultural circumstances. According to Tabari, women can be judges in all cases. Abu Hanifa actually demanded that there should be women judges in every city in order that women's rights can be guaranteed. Even where women as rulers or judges were under debate, women were accepted as *muftis*, going back to the example of the Prophet's wife Aisha who made a considerable impact on the development of law and theology.

Ijlîya bint al-Ijlî al-Asturlâbi

Ijlîya was an astrolabe builder who had learned her father's trade and took over his business. An astrolabe, like its successor the sextant, is used for various calculations in astronomy and navigation. Obviously successful, she was employed at the court of Saif ad-Dawla in Northern Syria (944–967 C.E.).

Women are never said to have tried to find the 'Philosophers' Stone', but they were active in the sciences, medicine and religious scholarship. In the pre-industrial age, children usually learned their profession from their parents or relatives, normally boys from their fathers and girls from their mothers. However, in scientific studies it was more a matter of interest. It was not uncommon for well-trained women to be employed as house teachers for the children of well-to-do families. In medicine, we hear of cooperation between a male and a female doctor: a young man studying to be a doctor got married with a young women from a similar family, then they shared their work. The female doctor treated the female patients while her husband treated the male ones, either self-employed or in a hospital. But social norms of segregation did not always apply in study situations.

Among the numerous examples of men studying with women teachers is ash-Shâfi'i who studied with Nafisa (born *c.*762 C.E.), or the traveller Ibn Battuta who studied with several scholarly women teaching at the colleges of the contemporary Muslim world. If travelling proved difficult for women, they often overcame this obstacle by accompanying male family members or during the pilgrimage to Mecca that had a large number of males and females together, which developed in later dates to a University-type education, or by meeting scholars from all over the world in male family presence; that has not been a problem since women have been acting professionally.

These examples from history show women making use, within the framework, of their respective contemporary local understanding of Islamic law and social conventions. These possibilities were open to all women and were simply a matter of free choice. For our modern times, and the need for women's input into economic and family matters that meet the purpose of Islamic principles and modern demands, both in traditionally Muslim countries and for Muslims in the West, women are empowered to use their spiritual, intellectual and economic potential.

Women in 21st century Islam

The average spectator from Western countries might consider women in the Muslim world as introverted and restricted to their homes by their male partners. In fact, real life is different, particularly over the last few decades. Women in Islamic countries are now in charge of large corporations, are ministers and prime ministers and have reached top jobs and are imposing success on their own terms. As HE Queen Rania Al Abdullah of Jordan said on the subject, 'The landscape is starting to change'.

Women are now business owners in Jordan, Bahrain, Lebanon, Tunisia and the UAE. They are finding their own place in the business and the community and creating opportunities for themselves, and their participation in business is on an upward trend. Making a significant contribution in the booming economies, women's business networks have grown rapidly across the region. And not just business, the advancement of Arab women in all occupations, particularly in this millennium, is certainly impressive.

As HE Sheikha Lubna Al Qasimi, the UAE's Minister of Foreign Trade, says: 'The participation of women in business and investment has become a key economic booster for the region and has empowered many women.'

Salma Hareb, CEO, Jebel Ali Free Zone and Economic Zones World, said:

> Women in the UAE are as much part of the corporate world as anywhere else on the globe. This signals a significant change in a society where women's roles used to be marked differently by our earlier social customs. Being an entrepreneur is about more than just starting a business or two – it is about having the attitude and the drive to succeed in business. Businesswomen in the Middle East are doing just that. We observe women as corporate heads occupying various decision-making positions in the public as well as the private sectors.

Arab first ladies are leading by example. These include, among others, women such as Princess Haya Bint Hussain, wife of His Highness Sheikh Mohammad Bin Rashid Al Maktoum, HE Queen Rania of Jordan, Mrs Suzan Mubarak, first lady of Egypt, HRH Princess Moza, wife of Sheikh Hamad bin Khalifa Al-thani, Qatar Ruler.

Recent statistics show that women in the Gulf region represent 35% of the total Arab workforce. The UAE alone is home to more than 11,000 women entrepreneurs managing investments worth more than $4bn. Women are becoming increasingly very proactive investors; women investors in the UAE now manage investment worth more than Dhs140bn [$38bn]; and these numbers are growing at an extraordinary rate. Women have been involved in medicine, education, engineering, research, academics, sports, business, law or media. They are now judges and are involved with Muslim jurisprudence. Women's rights in the region have been progressively enhanced.

Over 40% of the workforce of the UAE, Bahrain, Kuwait, Egypt, Jordan, Morocco, Tunisia and Algeria is composed of women. Women hold 30 per cent of management positions in finance, 32% of the transactions of the financial and banking sector is done by women, and 20% of management jobs in financial institutions are held by women. The number of women heading businesses in the Middle East has grown significantly; there are

a growing number of highly skilled Arab women in the Middle East region who are putting to good use their education, intelligence and creativity.

Arab countries have invested significantly in human resource development and in providing equal opportunities for both men and women to have access to education and other opportunities. That has helped in providing women with a proper education and skills. With more open-minded leaders of Muslim countries, there are increasing opportunities for women to do extremely well in the workplace, if they have the qualifications and drive.

According to a report by the Hawkamah Institute for Corporate Governance based at the Dubai International Financial Centre (DIFC), women's businesses in the MENA region are among the most sizeable entities. A larger share of women are principal owners in family-owned businesses. They own close to 40% of the individual firms in the region, and there is a direct correlation between corporate performance and women's participation on boards. Based on a survey conducted last year, among the Fortune 500 companies, those having more women board directors have shown stronger financial performance (in terms of return on equity, return on sales and return on invested capital) than those having the fewest women as board directors. Women business owners surveyed in the MENA region are well ahead of their counterparts in Western Europe and North America with respect to the size of their firms and many report substantial levels of revenue. It also says that the majority of the women surveyed in Bahrain and Tunisia are sole owners of their firms, at 59% and 55%, respectively. This compares with 48% sole owners in Jordan and the UAE, and 41% in Lebanon. Most survey participants own established businesses and many have extensive years of experience.

On average, women in Lebanon have owned their businesses for 10.6 years, in Bahrain for 10.2, Tunisia for 8.6, Jordan for 6.1 and in the UAE for 5.9. Female-owned firms in the MENA region are as large, successful and tech-savvy as male-owned firms. Apart from being successful businesswomen, a number of Arab women have also excelled in the public sector. Even on a much smaller scale, micro-finance initiatives have helped scores of women across the region to gain access to financial services and enabled them to start up business ventures.

According to the report based on a survey of more than 5,100 male- and female-owned firms in eight MENA countries, of the formal-sector female-owned firms surveyed, only 8 per cent are micro firms and more than 30 per cent are very large firms employing more than 250 workers. Furthermore, the average age of female-owned firms is slightly higher than that of male-owned firms, 21 years across the region, compared with 18 years for male-owned firms.

The World Bank report adds that more women in the Middle East are individual owners than expected. It says:

> The share of women in the MENA region owning their firms individually instead of as part of a family is higher than expected. In Syria and Yemen, most women own their firms individually, at rates comparable with male individual ownership. In Egypt, Lebanon, and Saudi Arabia, however, the proportion of female-owned firms owned individually is significantly lower than that of male-owned firms.

Although women still do not have equal access to economic opportunity, they are in control of their own wealth, according to Islamic principles. As a businesswoman or an entrepreneur, women in the Middle East have an amazing opportunity to step into their destiny and live out their full potential. However, in order to become more diversified and globally competitive, more needs to be done to empower women and address issues that inhibit female entrepreneurship.

A significant contribution by women to Islamic finance and to financial institutions has been noticeable in Malaysia, as well as in global finance. Women in Islamic financing are much more able to follow the principals of *Shari'a* than are men because their main concerns are to details and efficiency; they are less likely to engage in speculative or risk-taking behaviour and the sale of financial assets. Women have become a powerful force in the economy, and this success should be recognized. Although there are still obstacles to overcome, there are a number of women who have reached the highest positions in financial institutions, as shown in this survey:

- American women constitute the largest economic force in the world, spending $4.9tr a year.
- The estimated growth rate in the number of women-owned firms was twice that of all firms. Women own an estimated 10.6 million firms that generate $2.5tr in sales.
- Women are expected to acquire 94% of the growth in US private wealth by 2010.

Women in the 2005–2006 school year will earn 59% of the Bachelor's degrees and 60% of the Master's degrees. The purpose of this chapter is to consider what might be the major obstacle for women over the years, to playing a part in global financial institutions, particularly from an Islamic financing perspective. Women today face unique financial challenges, but with careful planning, these challenges can turn into opportunities. Financial advisors are dedicated to empowering women through education, support and knowledgeable advice.

Women are researching, educating themselves and taking more control of their finances. When it comes to investing, women make fewer mistakes, are more risk averse and more consistent during volatile market times. These positive investment tendencies are necessary when it is considered that women face unique challenges and pressures that make it essential for them to be proactive with their investments.

Some factors that are unique for women include the following:

- Women live on average seven years longer than men;
- Women earn 23% less than men, creating a risk of outliving their retirement savings;
- Women currently influence 80 per cent of financial decisions in the household;
- On average, women take about 12 years off work to care for children or elderly parents compared with less than two years for men; and
- American women constitute the largest economic force in the world.

Women have different styles of doing business

It will help us to understand the differences between women and men in doing business, and their approach and style of business. By style, we mean the way people choose to do

business. What are their priorities? How do they choose to communicate them? One of the biggest style differences is the relative importance individuals put on relationships and connection, as opposed to tasks. We have to ask a few questions:

- Are there real differences in how the brains of men and women work?
- Do they have different styles of doing business, for example, in their priorities or the way they communicate?

A survey conducted by Prudential Financial in February 2006 found that women are capable of taking financial decisions wisely, for example:

- only one in five women feel very well prepared to make wise financial decisions; the others admitted they needed assistance;
- 43% of women's top priority is getting out of their debt;
- 53% of women are saving or investing their money; and
- the majority of women place a priority on health.

There are now a host of women-focused products. Examples include:

- Conventional products that already exist to cater for women investors, for example:
  - Women-only insurance (Sheila's Wheels, Diamond).
  - Hotels catering for women travellers (Grange Hotels in London; Radisson SAS in Leeds, UK).
  - Wealth consultation services specifically for women (Bramdiva, Coutts).
- Products that cater for women's different investment needs, for example:
  - Women are more ethical investors.
  - Women have an appetite for lower-risk, capital-protected products.
  - Women have social restrictions in accessing of ordinary products.
- Women-focused financial services, for example:
  - Products targeted at women as investors such as health, education and shopping benefits.
  - Use of technology, including remote trading.
  - Promoting participation of women in finance.
- Different techniques of accessing women as an investor base taking into account cultural sensitivities, for example:
  - Companies run by women targeted at women investors.
  - Greater empowerment of women through education.
  - Building a local company, particularly in the Middle East in partnership with local investors.

Leading women in the Muslim world

Women influential in the development of industry:

- Dr Zeti Akhtar Aziz, Governor of Bank Negara, Malaysia.
- Dr Rabiah Adawiah, Islamic finance *Shari'a* adviser with the Securities Commission of Malaysia.
- Dr Shamshad Akhtar: Governor of the Bank of Pakistan.
- Her Excellency Sheikha Lubna Al Qasimi, Minister of Foreign Trade, UAE.
- HRH Princess Mashaeil bint Fisal, President of the board of the business women forum in Saudi Arabia.
- HE Suhair Al Ali, Minister for planning and International corporation, Kingdom of Jordan.

High profile business women in the region include:

- Mona Al-Shinnawy, UAE: founding member of Durra.
- Lama Al-Sulaiman, Saudi Arabia: on board of the conglomerate Rolaco, elected to Jeddah Chamber of Commerce.
- Thaira Karajeh, Palestine: operates the only shopping centre in the West Bank.
- Hanan Saab, Lebanon: founder of Pharmamed, the pharmaceutical and medical supply company.

Other emerging markets

We end with some interesting statistics about women in business:

- In Bahrain, 30% of finance sector employees are female.
- In the Masrafy Bank, Kuwait, 40% of employees working in finance and property are female.
- Malaysian women have set the pace in Islamic finance:
  - Women head the authorities that regulate Islamic finance.
  - Malaysia created the first registered female Islamic finance *Shari'a* advisor.
  - Jamelah Jamaluddin became the CEO of the RHB Islamic Bank in August 2007.
- In Nigeria, Lotus Capital, a provider of *Shari'a*-compliant investment products in West Africa, has Hajara Adeola as its Founder and Managing Director.
- In Iran and Pakistan:
  - there is an Islamization of the banking system as opposed to parallel system as in Malaysia;
  - interest-based banking is allowed as an exception to accommodate correspondent banking relations;
  - Women participate in the banking sector in Iran.

The world's women billionaires

Out of 497 billionaires in the world, 35 (or 7%) are women. In the US, there has been equal opportunity for women only in the past 20 years. It was not until relatively recently

that women could be found as chief executives of blue-chip companies. Twenty years may not be enough time to build the kind of fortune that lands a person on Forbes' World's Richest People list. There are self-made billionaires such as Oprah Winfrey, Nina Wang, Abigail Johnson, Miuccia Prada, Maria Aramburuzabala, Marilyn Carlson Nelson and others.

Summary

It could be said that women in Islamic financing are much more able to follow the principles of *Shari'a* than men because of their tunnel vision on details and efficiency. They are less likely to engage in speculative or risk-taking and the sale of financial assets; they have certain limitations but overall performance is encouraging, particularly in Malaysia. One of the main difficulties is that the men do not give them enough opportunity for training, education, top jobs and responsibilities. I believe that women are capable of playing a larger part in Islamic finance, but they are either frightened of making mistakes or they are leaving the men to make the mistakes and they learn from them before taking the responsibilities.

I expect to see more women than before in top Islamic finance jobs, particularly in the fast growing businesses.

Chapter 25

Offshore structuring

Tahir Jawed
Maples

Introduction

As Islamic finance has grown over recent years and new structures developed, offshore structuring has become a useful and efficient tool in modern Islamic finance transactions. Companies incorporated in the traditional offshore jurisdictions such as the Cayman Islands, Jersey and the British Virgin Islands have become commonplace in Islamic finance. This chapter examines offshore jurisdictions, their benefits and how they are proving useful in Islamic finance.

Offshore jurisdictions

The term 'offshore financial centre' or 'offshore jurisdiction' originally referred to a number of island jurisdictions offering low taxes and light regulatory environments for companies and other business-related activities. Offshore jurisdictions and, in particular the Cayman Islands, came to prominence during the 1980s as the preferred domicile for securitization vehicles during the first mortgage securitizations. Today, their uses are much wider and encompass a number of areas, including repackaging securities, aircraft and shipping finance and insurance.

The modern definition of an offshore jurisdiction is the focus of much debate. The notion that offshore jurisdictions are all islands is long gone. The International Monetary Fund's (IMF) list of offshore jurisdictions now includes London, Switzerland, Luxembourg, Bahrain, the US and Japan. The IMF suggests that an offshore jurisdiction is a centre where the bulk of the financial sector activity is offshore on both sides of the balance sheet (that is the counterparties of the majority of financial institutions' liabilities and assets are non-residents), where the transactions are initiated elsewhere, and where the majority of the institutions involved are controlled by non-residents. Thus, offshore financial centres are usually referred to as:

- jurisdictions that have relatively large numbers of financial institutions engaged primarily in business with non-residents;
- financial systems with external assets and liabilities out of proportion to domestic financial intermediation designed to finance domestic economies; and
- more popularly, centres which provide some or all of the following services: low or zero taxation; moderate or light financial regulation; banking secrecy and anonymity.

In addition to the previously mentioned factors, a major feature of offshore jurisdictions today is that a large proportion of the business which takes place in the jurisdiction originates elsewhere, with the jurisdiction being chosen for the legal and financial benefits it offers. Among the most prominent offshore jurisdictions today are the British Virgin Islands (which domiciles the largest number of offshore companies), the Cayman Islands (particularly for investment funds and securitizations), Jersey (for European securitizations and real estate investment trusts) and Luxembourg (for the Eurobond market).

Use of offshore companies

Offshore jurisdictions have a number of uses. The primary use is simply to provide a holding company for property and other assets or a special purpose vehicle for individual transactions. Incorporating a company in an offshore jurisdiction is usually quick and cost-effective, and allows owners to live wherever they like, and hold assets all over the world. Offshore companies thus assist with asset protection, limiting liability and succession planning in many cases.

Offshore jurisdictions are also prominent as a domicile for collective investment vehicles, in particular, hedge funds and private equity funds. The Cayman Islands is the market-leader in this area. The major advantage in setting up a fund in an offshore jurisdiction is that regulatory and tax considerations are simplified. While investors still need to consider their tax and legal positions in their home jurisdictions, and the fund is usually subject to some regulation, offshore jurisdictions tend to impose few restrictions on investment strategies. Moreover, there is usually no tax at the fund level avoiding double taxation of the same income (at the fund level and the investor level).

Two further uses of offshore jurisdictions are as a domicile for captive insurance companies, particularly Bermuda, and asset registration for ships and aircraft. The reinsurance of risk, by way of an offshore special purpose vehicle, helps insurance companies to manage capital requirements. Holding an aircraft or ship through an offshore company can be an effective way to ring-fence debt, isolate the asset from insolvency risk, and manage political considerations.

Finally, offshore jurisdictions are the usual domicile for special purpose vehicles (SPVs) in securitizations and repackagings. Offshore vehicles have traditionally been employed as the issuer of mortgage or asset-backed securities, with the Cayman Islands again being the dominant jurisdiction in this respect.

Benefits of offshore structures

The low taxes in most offshore jurisdictions make them a natural choice for doing business outside the region and with foreign investors. Additional advantages include the legal framework and levels of regulation.

Legally, many offshore jurisdictions have inherited the English common law regime as a result of being former British colonies or remaining dependencies of the British Crown. Final appeals are often still to the Privy Council, and interpretation of statutes is guided by English and local case law. This framework means that people and businesses using offshore jurisdictions can be certain of what their legal rights are and how they might be enforced.

Offshore jurisdictions also take a 'light but effective' approach to regulation of SPVs, collective investment vehicles and capital markets issuance vehicles. Offshore vehicles are thus attractive to businesses which operate across several jurisdictions, eliminating red tape at the level of the company, partnership or trust. The flexibility afforded by being able to have directors and shareholders all over the world is also an advantage. It is important to note that most offshore jurisdictions now comply with the Foreign Action Task Force's guidelines on money-laundering checks. Regulated institutions in many offshore jurisdictions are required to satisfy know-your-client checks and determine the sources of funds before receipt. This adds a level of protection, and offers additional confidence in an environment which already offers advantages to business.

Offshore and the Middle East

Although Islamic finance is now practised internationally, much of the focus remains in the Middle East and Asia where the majority of the world's Islamic population resides. Even prior to the growth of Islamic finance, most Middle East and Asian jurisdictions already had strong links with particular offshore centres, for example, Malaysia favoured Labuan while the GCC favoured Bahrain and the Cayman Islands. Historically, the offshore centres were used by Middle East investors to organize investments and structure personal wealth, thus avoiding concerns about local inheritance laws and political instability. When practitioners, particularly lawyers, were presented with the challenges of structuring *Shari'a*-compliant transactions, most were already familiar with the uses of the offshore jurisdictions and utilized the efficiency of the offshore centres to structure the new wave of Islamic finance products.

In return, the offshore centres have kept a keen eye on the Islamic finance market and have been quick to market their value in structuring complex financial structures, taking away many of the concerns with tax, regulation and cost when compared to using onshore structures. The Cayman Islands, for example, has recently introduced legislation to allow companies to be registered with names in Arabic and to clarify the regulatory status of *sukuk* instruments.

Sukuk transactions

In recent years, *sukuk* issuances have grown and become a mainstream product for raising funds in the Islamic world, by both Islamic institutions and non-Islamic institutions. *Sukuk* transactions are discussed in other chapters, but here we will examine the use of offshore companies in *sukuk* transactions.

The offshore entity most commonly used in *sukuk* transactions is the 'orphan' company or 'off-balance sheet special purpose vehicle', often abbreviated to 'SPV'. This type of company is unique to the offshore world and provides an independent entity, managed and operated independently from the other parties to the transaction, which can transact with the other parties on an 'arm's length' basis. Such orphan companies are useful in transactions to hold assets, grant security or make payments. As they are independent from the other parties in the transaction, they can be relied on to fulfill their contractual obligations without bias. Historically, such companies were used to hold assets for securitizations or title to aircraft or

vessels being financed, giving reassurance to the lenders that they could, if needed, secure and take possession of the asset if there was a default on repayments. However, orphan companies have now become a useful tool in a variety of transactions such as derivatives, repackaging of securities and now *sukuk* issuances.

To summarize, *sukuk* are typically structured as trust instruments under English law. An orphan company or SPV will issue *sukuk*, or trust certificates, and invest the proceeds in assets. The orphan company which issues the *sukuk*, also referred to as the 'issuer', will then hold the assets on trust for the benefit of the *sukuk* holders, using the income from the assets to make payments to the *sukuk* holders. At the end of the financing term, the issuer will sell the asset and repay the principal to the *sukuk* holders. The overall structure is very similar to that of a securitization although the documentation and detail varies.

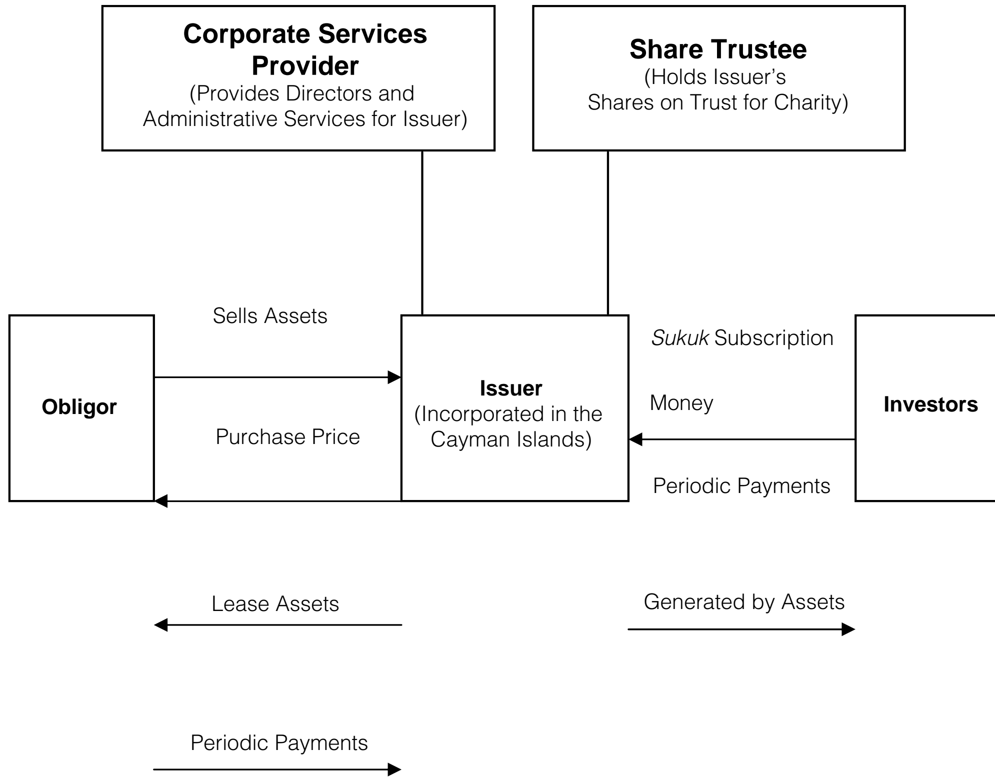
The wider *sukuk* structure can be more complex, having a few more players involved. Typically, the entity looking to raise funds, often referred to as the 'obligor', will arrange for the issuer to be established. The obligor will then, for example, either sell or lease its assets to the issuer. The issuer will purchase the assets or lease them with the proceeds from the issue of the *sukuk*. The issuer will then make periodic payments back to the *sukuk* holders from proceeds generated by the assets, often by leasing them back to the obligor. At the end of the transaction, the issuer will sell the assets back to the obligor and use the proceeds to redeem the *sukuk*. There are several variations to this structure, with the issuer leasing, buying or entering into a joint venture to buy and manage the assets from the obligor but the cashflows generally follow the same pattern.

To those from the offshore industry looking at this structure, it will look very similar to a securitization structure. All of the benefits which have attracted the securitization industry to establish bond issuers in offshore jurisdictions would also apply to the *sukuk* issuer. The Cayman Islands in particular was quick to market its services for *sukuk* structures as a domicile for the issuer with considerable success. Initially, the opportunity was simply for the Cayman Islands' law firms to establish a Cayman Islands company to act as issuer. The Issuer would typically be a subsidiary of the obligor and managed by the obligor. However, recently, this was seen as too synthetic; effectively the obligor was selling assets to itself (or at least a wholly owned subsidiary) and most *Shari'a* scholars now require some distance between the obligor and the issuer. This again created a great opportunity for the offshore service providers to establish and manage the *sukuk* issuers for the duration of a *sukuk* transaction.

The typical structure of an offshore *sukuk* issuer is a limited liability company, with its shares held by a trust company on trust for charitable purposes. This is an offshore invention to avoid any troublesome beneficiaries; the trust will not specify which charity is to benefit until the end of the transaction to avoid any interference from the charities. A corporate services provider (usually the same trust company) will then provide the company with a registered office and directors to maintain the company, obviously for a fee. The services from the corporate services provider may also extend to preparing accounts, arranging audits or provision of a secretary. The result is a legal entity completely independent of the obligor able to deal with the obligor at arm's length.

The overwhelming majority of *sukuk* issuances now utilize an orphan company to issue *sukuk* instruments. At present, this is generally seen as the accepted format for *sukuk* deals and some of the offshore jurisdictions have taken steps to formalize the status of *sukuk* under

Exhibit 25.1
Typical structure of an offshore *sukuk*



Source: Author's own.

their laws to ensure the structure remains the market standard. More recently, jurisdictions in the Middle East, such as the Dubai International Finance Centre in the UAE, have issued legislation permitting the establishment of orphan companies or SPVs in an attempt to attract more aspects of the lucrative Islamic finance market to the region. Although not strictly 'offshore', they offer many of the same tax advantages as the offshore centres and are more accessible for local obligors and arrangers of *sukuk* transactions.

Funds

The other growth area for offshore jurisdictions, resulting from the increase in Islamic finance, has been the *Shari'a*-compliant fund. The offshore centres, again particularly the Cayman Islands, have long been the favoured domicile for investments funds. It is estimated that some 70 per cent of the world's hedge funds are domiciled in the Cayman Islands. Again, it is the certainty and efficiency which these jurisdictions provide which attracts funds to be domiciled there. The same benefits apply to *Shari'a*-compliant funds.

Funds have developed into a major industry for the offshore jurisdictions, from lawyers forming the funds to fund administrators to administer the funds; from custodians to hold assets to accountants to prepare accounts and audit funds. Although not all of these services have to be provided offshore, the 'one-stop-shop' offered by many law firms and service providers, is often favoured by asset managers who are keen to get their fund up and running as quickly as possible.

Shari'a-compliant funds have presented some challenges for traditional fund structures but these have now generally been resolved. *Shari'a*-compliant private equity funds are typically structured as partnerships giving investor flexibility with investments and a *Shari'a* board often acts as an advisor to approve investments as *Shari'a*-compliant. These structures are easily accommodated within the existing fund structures available in offshore jurisdictions which have provided a fast and efficient home for *Shari'a*-compliant funds.

Although the *Shari'a*-compliant fund structure is comfortably accommodated within existing offshore structures, the challenge for *Shari'a*-compliant funds remains identifying *Shari'a*-compliant investments and arranging appropriate financing to leverage the funds.

Conclusion

The offshore industry was quick to recognize the opportunities presented by Islamic finance and has also been quick to capitalize on them. The Cayman Islands, in particular, are established as the jurisdiction of choice for *sukuk* issuers and private equity funds; in 2007 the government introduced legislation allowing companies to register with Arabic names as an indication of its acceptance of Islamic finance and transactions from the Middle East. Jurisdictions in the Middle East such as Bahrain and the Dubai International Financial Centre have also sought to offer offshore-style products to attract the Islamic finance industry. Offshore law firms and service providers have also opened offices in the Middle East, for the first time, as an indication of their commitment to the region and Islamic finance. The potential for Islamic finance is well documented, but it would seem that the potential for the offshore centres is just as good.

Chapter 26

Ethical investment *versus* Islamic investment

Aly Khorshid
Elite Horizon

Introduction

The most commonly recognized form of investment for ethical or socially responsible investment is *avoiding* companies which are known to have a negative social or environmental effect. Most ethical funds will not invest in the following:

- the arms trade;
- nuclear power;
- oppressive regimes;
- animal testing (cosmetic or medical);
- the fur trade;
- factory farming;
- alcohol promotion;
- tobacco promotion;
- environmentally damaging practices;
- poor employment practices;
- genetic engineering;
- gambling;
- pornography;
- third world debt/exploitation.

Positive screening, on the other hand, is where investors will actively seek to invest in companies with a commitment to responsible business practices which promote any or all of the following:

- Environmental protection.
- Pollution control.
- Energy conservation.
- Use of wind, wave or geothermal energy.
- Recycling.

- Waste management.
- Environmentally friendly manufacture energy conservation products or recycling equipment.
- Education and training.
- Fair trade.
- Strong community involvement.
- Ethical employment practices.
- Health and safety.
- Family-friendly employment practices.
- Openness about activities.
- Equal opportunities policy.
- The sale or manufacture of 'basic necessities'.
- Providing drugs to developing countries at a substantial discount.
- Products/services that directly benefit developing countries, such as water purifiers, education, AIDs research.

Most socially responsible funds exclude government loan stocks or 'gilts'. Gilts are integral to guaranteed financial products such as 'with-profits' policies, annuities and guaranteed growth/income bonds.

There are now more than 80 UK ethical funds, which may be Unit Trusts, OEICs (open-ended investment companies), ISAs or investment trusts. All of the products below can be linked to a socially responsible fund:

- Regular savings.
- Lump sum investments.
- PEP and ISA transfers.
- Individual Savings Accounts.
- Investment Bonds.
- Charity investments.
- Child/Grandchild plans.
- Stakeholder & Personal Pension Plans.
- Additional Voluntary Contribution plans.
- Company pension schemes.
- Pension transfers.
- Mortgage related plans.
- Life assurance.
- Critical Illness Plans.
- Discretionary Fund Management.
- General Insurance.

It is becoming increasingly accepted that socially responsible companies will prove to be an even better financial investment in the future. The rigorous screening processes involved in ethical investment can help to identify companies that, in the long term, have great potential to do well. The proportion of smaller companies included in such a portfolio is an

advantage, as the high performance of smaller companies over the long term is well documented. It must be remembered, however, that past performance is not necessarily a guide to future performance, and that the price of units can fall as well as rise.

Many SRI funds are outperforming their conventional peers. It is becoming increasingly accepted that this is no coincidence, and that socially responsible funds will prove to be even better investments in the future. The reasons for this are manifold, with both negative and positive criteria contributing:

1 The high proportion of smaller companies included in ethical funds can be considered an advantage, as the high performance of smaller companies over the long term is well documented. However, past performance is not necessarily a guide to future performance and the price of units can fall as well as rise.
2 Screening out companies involved in armaments, tobacco, nuclear power et cetera creates a much more manageable grouping of shares for the fund manager.
3 The extra research and the rigorous screening processes carried out by the more proactive ethical fund managers leads to more informed investment decisions. It means they get to know the companies very well and can spot laggards and potential top performers much more easily.
4 Positive criteria provide excellent yardsticks for identifying well-managed and forward-looking businesses, since only they will have the spare energy and time to take on such commitments.
5 In the past, it was often argued that businesses that followed social and environmental good practice were less competitive, but this is no longer the orthodoxy. Growing numbers of economists, politicians and business people now accept that responsible corporate behaviour with a commitment to society and the environment are key elements of competitiveness. It is increasingly being recognized that treating employees properly can improve productivity. Companies that behave poorly are suffering bad publicity, a loss of market share and a lower share price. Industries that harm society or the environment are being hampered by tightening legislation and litigation.

Ethical funds tend to focus on market sectors which are growing rapidly as the world tries to adapt to the increasing social and environmental concerns of the twenty first century. In a climate of growing public awareness of environmental issues and increasing environmental regulation, old SRI favourites are proving lucrative investments. In the UK, for instance, increased awareness of global warming and the climate change levy have led to a huge increase in demand for renewable energy, and an explosion in the profits of those companies involved in providing it.

Ethical Indices

The performance of a unit trust or investment trust is usually measured against an index, so investors can easily compare their chosen funds with the direction of a particular area of the market. A conventional fund and an ethical fund can both be compared to the same index, for

example, the FTSE All Share Index. A conventional fund has many companies to choose from that satisfy its investment objectives, whereas an ethical fund may be restricted in its range of companies to choose from, particularly by negative screening. As a result, some ethical funds may underperform the benchmark they have been measured against.

Some SRI supporters have argued for a need for a suitable ethical index, while others believe ethical funds should continue to be compared with mainstream indices to dispel ideas of underperformance.

For example, in the UK the FTSE4Good indices, a series set up by FTSE and EIRIS, have attracted equal amounts of praise and criticism since their launch in February 2001. The criteria for stock selection include the environment, universal human rights, social issues and stakeholder relations. It is the first ethical benchmark to be set up by an independent body in the UK. While in the US, the Domini 400 Social Index is meant to be a socially screened version of the Standard & Poor's 500-stock index. The Domini index excludes companies associated with alcohol, tobacco, gambling and weapons, and seeks companies with good labour and environmental records.

Economic teachings of the *Qur'an*

In my opinion, the concept of the limited liability company – the modern corporation – has its roots in the economic teachings of the *Qur'an*. The basis for this assertion is that *Qur'an*ic teachings support production, partnerships and enterprise creation and maintenance, while eschewing personal debt and usury. Thus, commercial industries with their job creation are supported through joint investment and limited liability, while personal borrowing is strongly discouraged.

Do we really see evidence of commercial law in the *Qur'an*? No, but it is strongly hinted at in the *Qur'an*'s insistence on treating commercial agreements with due diligence and seriousness; to get witnesses and contracts covering all tangible agreements and to stay away from interest-bearing personal debts, while at the same time, to promote trade. There are even special rules about trading during the Hajj and at other times, and with allies or those with whom a state of war exists, all as a separate discussion from other laws and ordinances regarding personal status and actions.

The number of *Qur'an*ic teachings focusing on the proper conduct of business is, I believe, unprecedented in historic religious dispensations. It makes plain and establishes for the first time, the importance of commercial enterprises, suggests that commerce is sanctioned by *Allah*, and that wealth earned from work and trade is acceptable in His sight, all else being equal. And with its references to trade between states at war or at peace, it also lays a foundation for establishing international trading practices.

It has been shown that with the Crusades, which lasted over two centuries, numerous Islamic teachings, habits and customs, both casual and formalized in law and jurisprudence, were transferred in whole or in part to Europe. It can also be argued that these borrowings influenced the European Renaissance. That the modern corporation traces its roots back to Europe and the US is not surprising, nor does it weaken the strength of its ties to the *Qur'an* and the commercial teachings of Islam.

The pillars of Islamic finance

Islamic finance is an outcome of the need to extend the tenets of religious faith to economic activity in such a way that benefits are evenly shared among all stakeholders and the economy as a whole (see Box 1: Basic Pillars of Islamic Finance). Some of the other underlying features of Islamic finance include:

- *Time due of money*. Under Islamic finance, time due of money is not recognized, that is, once the sale price is fixed for financing, even if the asset were to become 'non-performing' the institution cannot claim more than the pre-fixed sale price. The dues to the institution, once fixed, remain fixed.
- *Asset backed*. Typically all Islamic structures have an underlying asset backing the deal. As such, financing under Islamic structures has a propensity to control inflation.
- *Means and end*. Though profitability can be stated as a common 'end' for both Islamic and conventional financial institutions, the Islamic institutions carefully structure and adhere to procedures and process steps (means) to ensure that the profits earned are in line with the *Shari'a* prescriptions.
- *Process orientation*. Each of the financing structures is composed of processes and tasks. Even if a transaction was to be fulfilled by missing 'one task', the transaction will be rendered invalid in the eyes of *Shari'a*. For example, in a *murabahah* transaction, the institution is permitted to earn profit only as a reward for risk undertaken, as evidenced by the institution taking prior possession of the asset. If the institution did not have the prior possession (and hence the risk of destruction) the transaction would be invalid.

The journey so far

Flexibility

Institutions have demonstrated flexibility and innovation in structuring financing under multiple structures. For example, property finance (ready-built) can be extended under *murabahah*, *ijarah* or even diminishing *musharakah*. Typically, this flexibility offers customers choice to opt for financing under any of the available structures. Also, since the institution cannot be expected to manage the 'asset layer' on its own, the concept of agency (*wakalah*) is deployed both at procurement and post-sale level (for example, maintenance in an *ijarah* contract) where the customer itself is appointed as the agent.

The balance between customer and institution

Islamic finance principles ensure that a mutually beneficial balance is maintained between the customer and the institution. The customer, for example, is protected in an *ijarah* transaction if the asset were to be totally destroyed owing to factors beyond the customer's control. The customer also benefits from upfront clarity since typically the deal and the underlying documentation are structured in an unambiguous manner to rule out '*gharar*' (uncertainty). Also 'mutual consent' is required for any modifications or alterations to any of

the partnership-based structures. These underlying principles ensure that the customer is duly represented in the deal right through the term. The structures also ensure that the institution is not placed in a position of disadvantage. Islamic institutions face greater risks since they go beyond the financing layer to the underlying 'asset layer'. As such, built-in structures in terms of security deposit (*hamish jiddiyah*), documentation (for example, unilateral promise/undertaking), trust deeds et cetera ensure that the institution's interests are duly protected.

Innovation

Institutions have been introducing products based on innovative structures, such as:

- Credit cards based on annual fee (*ujr*) without any other profit element added.
- Utilization of concept of *tawaroq* (tripartite sale) for addressing the liquidity needs of the customers.
- Leverage of services *ijarah* towards financing education, medical treatment and so on, thereby eliminating the need to extend monetary financing to customers.

Collaborative network

Financing based on structures like *istisna'a* and *salam* require an institution to enter into independent parallel contracts. Such contracts are entered into with manufacturers and buyers of the underlying asset respectively. Thus, the institution acts as an interlinking factor by managing a collaborative network of demand and supply.

Collaboration with conventional banks

Increasingly, conventional banks are collaborating in syndicated financing deals with the institutions. Large deals based on *ijarah* and *musharakah* structures are being financed in this manner.

The basic pillars of Islamic finance

- *Basis of* Shari'a*: Shari'a* (Islamic law) forms the basis of the framework of Islamic finance. The *Shari'a* is derived from five sources – The Holy *Qur'an*, the *Sunnah* of the Holy Prophet (PBUH), '*ijmaa*' – consensus among the jurists, '*qiyyas*' – analogy and '*ijtihad*' – reasoning.
- *Schools of thought:* Over time, various schools of thought have shaped and led the development of Islamic finance. The popular schools are Hanafi, Maliki, Shafie and Hanbali.
- *Prohibitions:* The following are specifically prohibited: '*riba*' – interest; '*gharar*' – uncertainty, '*maysir*' – gambling, hoarding and dealing in unlawful goods or services. Islamic institutions structure their products and processes to ensure total compliance.
- *Basic Islamic Finance Structures:* The popular Islamic financing structures are:

- *Mudarabah* – A partnership structure that represents a 'joint enterprise' in which all partners share the profit and loss of the joint venture. Various products such as financing imports, exports, working capital, project finance and so on can be structured using this concept.
- *Mudarabah* – A partnership structure where contribution is from one partner and management is by the other. Various deposit products are structured using this concept.
- *Murabahah* – A sale structure where a specific commodity is sold on a cost-plus basis. Various products like auto/vehicle loans, goods loans, property loans and equipment loans are structured under *murabahah*. This is the most popular mode of financing.
- *Ijarah* – A sale structure based on rentals for usage of underlying asset/services. Comparable to 'leasing' product from the conventional world, it is a very popular mode of financing.
- *Istisna'a* – A sale structure where the underlying asset is to be built. Various products like project financing and construction financing are structured under *istisna'a*.
- *Salam* – A sale structure that provides for future dated sales against advance payment.

Evolution of the modern corporation

The corporation, a non-person legal entity that could borrow money, be sued and held accountable for its actions, is responsible for much economic improvement in the world. Evidence of this can be seen in the early successes of groups in England who would pool resources to offer limited insurance against loss of cargo on the open sea and from other dangers. The European guilds also utilized a similar system for insurance and capital loans for the mutual support of their member-dedicates. But all these examples are of a modified co-operative structure. What was needed was a true corporation having limited liability for its officers and principals, thus legally separating the actions of the investor, individuals and employees from the actions of the corporation itself.

Limited liability means that the company exists independently of its stockholders and officers in the sense that the individuals of the company may not be held personally responsible for the debts and mistakes of the company, including its contracted debts. The benefit of this structure is in its ability to enable the economy to recover from a downturn and begin rebuilding the employment and trading base. With simple interest-bearing loans to pay off, the economy is saddled with bad debts resulting from the previous downturn from which it cannot be extricated, thus slowing down recoveries and reducing their possible scope. Therefore, limited liability was needed. Take, for instance, the situation within the US after it suffers an economic downturn, where corporations are allowed to declare bankruptcy or reorganize and reschedule their debts. This allows the economy to quickly write off these debts and begin growing again. Compare this to developing countries today that, because they still owe huge amounts of money to lenders from the developed world, cannot generate the cash to finance needed growth and job-creating enterprises. Of course, financial discipline is essential for the long-term success of any enterprise, but when developing countries are offered the same opportunity to cancel their debts, gains have followed losses and growth has followed downturns, all else being equal.

Can Islamic banking appeal to non-Muslims?

Some commentators consider judgments on the potential of Islamic banking to be premature as it is an industry in its infancy, while others consider Islamic financial practice to be the answer to problems created by the conventional debt-based money system.

Which group is right? Could they both be right? And how realistic are Islamic bankers' dreams of penetrating non-Muslim markets as a global alternative to conventional finance?

At the risk of oversimplifying, the essence of Islamic finance is that all parties engage in trade without any use of *riba* (interest). The *Shari'a* rules governing the prohibition of *riba* are well known to most, and the values underpinning the rules are righteousness, benevolence and fair profit. Muslims and non-Muslims alike share these values, with most people wanting to govern their personal and business affairs in accordance with these basic, yet extremely important, ethics.

While the majority of conventional bankers will, of course, conduct their business in a principled manner, the nature of the interest-based money system is nonetheless at odds with *Shari'a*. Conventional finance models treat money as a commodity. In contrast, *Shari'a* prohibits the trading of money as a commodity for a number of different reasons:

- Money is considered not to have any intrinsic value.
- Whereas commodities can be of different qualities, the same cannot be said of money.
- Units of money of the same denomination cannot be identified in any given transaction: so, the $100 bill shown at the time of negotiating a sale need not necessarily be the same $100 bill that is exchanged to consummate the transaction.

In simple terms, *Shari'a* distinguishes between money and commodities because the intended use of money is to act as a measure of value rather than to be the subject matter of a trade.

Imam Al Ghazzali, when discussing the nature of money, commented that:

> All these commodities need a mediator to judge their exact value ... Allah Almighty has, therefore, created dirhams [money] as judges and mediators between all commodities ... and their [dirhams] being the measure of the value of all commodities is based on the fact that they are not an objective in themselves.

Debt begets debt

Goldsmiths of medieval Europe first employed the concept of creating money out of money. Through their simple system of lending gold, the goldsmiths realized that they had the ability to lend more than they actually had. Their lending was therefore increased in the form of gold deposit receipts. It is this basic principle that has been followed over the years, and as we see now, has evolved itself into the modern debt-based money system.

Analysis of various economic data shows that the volume of coins and notes issued by some governments as debt-free money is much lower than the money actually in circulation, the balance being 'virtual' money that has been created in the form of loans advanced by institutions.

In short, the debt-based money system creates money in parallel to an equivalent quantity of debt with interest.

The problem is that the impact of a debt-based money system has been devastating. The World Bank's Global Finance Development Report shows that total debt continues to rise. Despite ever increasing payments, some countries' debt obligations far outstrip their total income, meaning that citizens of all religions and ethnicities suffer economically under their national debt burden. The list of shocking statistics in respect of debt and interest payments is long and well-documented, yet relatively few alternative solutions have been offered, and often the best creditors can come up with is to restructure repayments or to waive portions of state debt in times of crisis.

The S*hari'a* principles governing financial transactions, on the other hand, promote an equity-based and asset-backed financial system by abolishing the concept of money production and by prohibiting *riba* on the advancement of money.

Islamic finance is built on the principles of exchange, rather than creditworthiness and the ability to repay loans. This means that a system based on Islamic principles will neither punish people who need access to capital for not having it already, nor allow them to take on the burden of debt.

Non-Muslim support for asset-backed practice

John Tomlinson, an Oxford-based economist, presents strong arguments for the conversion of the current system to an equity-based system that is similar to the principles present in the rationale employed for prohibiting *riba*, not least the value of focusing on real as opposed to theoretical assets.

Kahf Ahmad, another economist, concludes that Islamic banking has a wider role to play than merely meeting the needs of the Islamic investor, and that this form of banking can and should be extended to the wider community by its practitioners.

Is that what ethical investment is all about?

Where to start

Of course, while Islamic banking could make excellent sense as the foundation of a new money system, the conventional debt-based system is deeply entrenched in every sphere of life, and an overhaul would take many years and would require substantive reviews of legal, accounting and regulatory structures.

If Islamic banks and institutions continue their aggressive growth and development of innovative and competitive products, then it will be difficult for the wider non-Muslim audience to ignore the benefits of such a system.

It may be too late to entirely replace the debt system, but on the face of it there is no reason why the Islamic system cannot be offered in parallel and promoted as the preferred system. Non-Muslims who are fed up with penalizing interest payments, and who are attracted to a system that imposes ethical practices on business leaders, might well be the first to sign up for such services.

Shari'a principles employed by Islamic banks have recently achieved double-digit growth figures. The argument for non-Muslims to invest in *Shari'a* investment and in Islamic banking is now a convincing one.

Challenges and opportunities: how to progress

The players for the Islamic finance market can be viewed in three categories:

- Conventional Islamic banks.
- Commercial banks with an Islamic finance window/subsidiary.
- Commercial banks evaluating an entry into Islamic finance.

The challenges and opportunities facing each of these categories of institutions will be different given different points of departure (where they are) and points of arrival (where they want to be). Some of the possible areas that need greater focus from a 'conventional Islamic bank' perspective are discussed below at two levels: external and internal.

External to the institution

Growth markets and scope of services

Institutions are subject to 'dual compliance' *viz* both *Shari'a* and regulation of the land (where the institution is domiciled). Viewed as a 2 × 2 matrix, with the X axis as 'regulation of the land' with 'permissible' and 'non-permissible' options and the Y axis as *Shari'a* regulation with 'permissible' and 'non-permissible' options, the scope of operations of Islamic institutions is limited to a 'single quadrant' that has permissibility under both the laws. In traditional home markets, where there is greater alignment between both the laws, the scope of services is relatively higher. With conventional banks providing *Shari'a*-compliant products in home markets under the 'Islamic window/subsidiary' route, pursuit of growth outside the home markets will be an imperative. Institutions that attempt to enter newer markets will have to measure the alignment and levels of 'co-existence' between both sets of regulations and determine the scope of services.

Standardization: a fine balance

The permissibility of a structure for an institution is in the hands of the *Shari'a* board of that particular institution. Based on extensive discussions with reasoning (*ijtihad*), analogy (*qiyyas*) and the resultant consensus (*ijmaa*), a structure is approved or declined by the *Shari'a* board. On the other hand, leading institutions like the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) are working hard to align principles on a collective basis. A fine balance is required between the collective initiatives (collaborative space) and institution-specific initiatives (competitive space) to ensure that standardization is achieved while keeping the flame of innovation alive.

Fee services/transaction banking

Institutions are comfortably placed in providing transaction services like payments, collections, account services, utility payments and so on to their customers. These services do not have an element of financing and are rendered for a fee. This could be an area that institutions can attempt to grow. This could also be one of the first services to be offered when institutions are looking at entering new markets. Latest advances in transaction banking such as XML-based messaging (ISO 20022) and trade services utility (TSU) can be fully leveraged.

Benchmarking

Selective benchmarking against conventional banking is a powerful tool that can provide useful insights into new product development. Conventional banks have always been up against restrictions and have been successful at arriving at acceptable business practices to ensure smoother operations. For example, intercompany lending (liquidity solutions) in China is accomplished in using an 'entrust framework' where banks act as intermediaries. On similar lines, can liquidity solutions between related companies be arrived at using the *musharakah* or any other structure? It is to be noted that such benchmarking will only be a source of ideas and as such 'only' those ideas that stand the test of *Shari'a* compliance will see the light of day.

Internal to the institution

Product configuration and process orchestration

It is a challenge to create and maintain the IT systems in such a manner that they continuously support current products and also the implementation of new product innovations on an end-to-end basis. Also, some of the deals may be supported by the systems only to the extent of booking with little or no support in 'origination' and 'servicing', leaving such activities to be fulfilled manually. Deployment of process orchestration systems will assist in stepwise fulfillment and visibility of processes. They also aid in wiping out possibilities of process non-compliance, which in some cases could render the transaction invalid in the eyes of *Shari'a*.

Greater operational risk

Owing to participation in the 'asset layer' there are additional sets of risks to which an institution is exposed. These risks also vary depending upon the nature of the underlying asset and the financing structure. For example, in a normal lease, the contract is terminated in the case of a complete destruction of the asset, whereas in a forward lease the contract is not terminated. Also, non-option of documents that essentially protect the interest of the institution like promise to purchase, trust deed, et cetera could affect the enforceability and result in financial loss. Along with traditional risks (known in conventional banking) all such risks arising

out of the structures of financing have to be identified, measured, monitored and managed at the institutional level.

Cost management

It is sometimes opined that Islamic financial services tend to be on the more expensive side than the comparable services of conventional counterparts. While fees can be charged for services rendered (*ujr*) and all permissible expenses incurred by the institution under structures like *mudarabah* are deductible, the institution will only be better off in utilizing offshore leverage and/or similar measures, that could effectively contribute to lowering the differential in cost of services and also contribute to a better profit pool available for sharing with customers under investment schemes (*mudarabah*) and/or partnerships (*musharakah*).

KYC norms

Know your customer (KYC) is equally important in Islamic finance. If the business/purpose for which the finance is being extended is prohibited in *Shari'a*, the whole transaction would be void. Also, such information can be a significant contributor to choose the structure under which finance is extended. For example, if working capital finance is extended under the *musharakah* structure, there is every possibility that the customer can project lower profits at the expiry of term, leading to a lower share of profits for the institution than are otherwise due. Hence, it is very important to factor in the latest customer information prior to extending finance through a relevant structure.

E-documentation

Islamic finance tends to be document-intensive. This is because typically each transaction has multiple phases – contract, procurement, sale, financing and servicing. Various documents are required to be completed during the various stages of the deal. Completing all the documentation at once may render the transaction void. Also 'elapse of time' between the stages is sometimes primary to the acceptance of the structure itself (for example, *tawarruq*). Adoption of e-documentation can obviate the need for multiple physical meetings, evidence the elapse of time, and also alleviate the need to maintain paper and related storage and retrieval costs.

Credit risk scoring and modelling

Products may be offered not only on the basis of assessment of a customer's creditworthiness, but also by linking the customer assessment to the risks of the structure of financing. For example, products for low risk customer segments can be structured on a *musharakah* basis (sharing) whereas for relatively riskier customer finance may be extended on a *murabaha* (cost-plus sale) basis. Also, it is to be noted that some of the leading scholars believe that

musharakah and *mudarabah* are the ideal structures and, where possible, such structures are to be preferred over structures such as *murabahah*. Risk scoring and modeling tools could assist in moving customers with a good track record from sale-based structures to partnership (*musharakah* and *mudarabah*) structures, thereby increasing the representation of partnership structure-based advances in the overall portfolio.

Part V

Tax and regulatory issues

Chapter 27

The tax treatment of Islamic finance in western countries and Muslim majority countries

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Introduction

The tax treatment of a transaction is a fundamental part of any evaluation of its economics. Tax law, however, differs from country to country. Accordingly, this chapter considers two specific Islamic finance structures to assess how they might be treated for tax purposes in different countries. After a brief review of the tax position, it then considers what general conclusions can be drawn.

Illustrative transactions

For simplicity, this chapter considers:
- commodity *murabahah*, also known as *tawarruq*, and
- diminishing *musharakah.*

Commodity *murabahah* or *tawarruq*

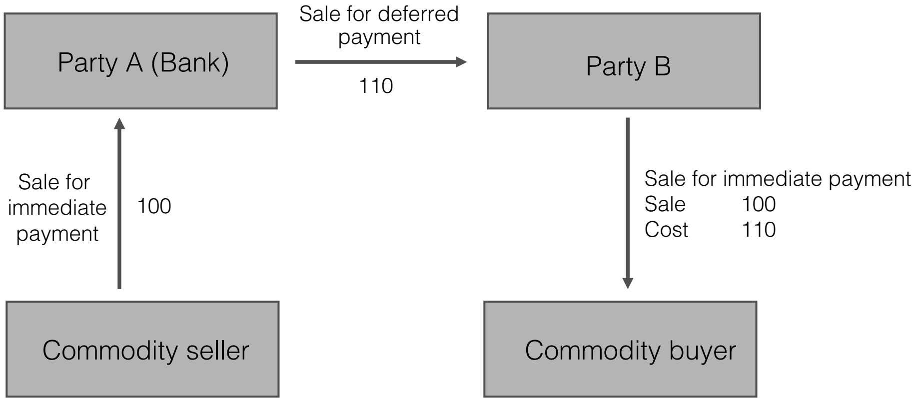
This transaction is used when Party A wishes to advance money to Party B, as is illustrated by Exhibit 27.1.

Party A (usually a bank) will buy something that can be sold very easily afterwards and with little difference between the bid/offer (buy/sell) prices. A typical example would be a quantity of copper bought in a commodity market. Party A buys the copper, immediately paying £100 for it, and transfers ownership to Party B at a price of £110 payable in, say, two years' time.

Party B can then immediately sell the copper for a price of about £100. This gives Party B cash equal to what Party A has laid out, £100, and an obligation to pay Party A £110 in two years' time. The extra £10 is the cost of the finance, and corresponds to a simple interest rate of 5% p.a.

Exhibit 27.1

Commodity *murabahah* or *tawarruq*



Source: Author's own.

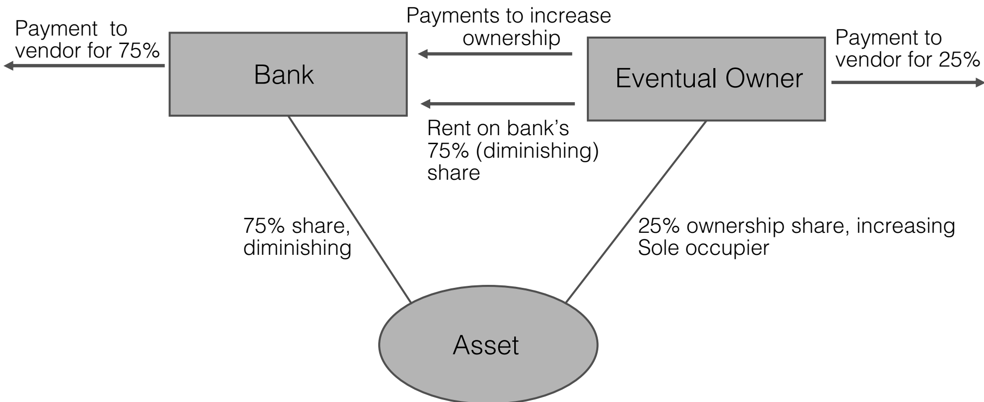
Diminishing *musharakah*

This is often used by people buying houses for owner occupation instead of a conventional mortgage, but can also be used for the purchase of investment property. It is illustrated in Exhibit 27.2.

Diminishing *musharakah* is used when one party, here called the 'eventual owner', wants to buy an asset but cannot afford to pay for all of it. In Exhibit 27.2, on day one the bank buys 75% of the asset, for example a building, while the eventual owner buys

Exhibit 27.2

Diminishing *musharakah*



Source: Author's own.

25%. Under the contract, the eventual owner has immediate rights to sole occupation of the entire building.

The eventual owner pays rent to the bank on the 75% of the property that he does not own. Then, over the life of the arrangement, as well as paying the rent, the eventual owner will make additional payments to the bank to purchase additional slices of the asset. These purchases may be at the option of the eventual owner, although usually the bank will also have a 'put' option to require the property to be purchased at some stage.

Tax treatment of commodity *murabahah* or *tawarruq*

The key question in the tax treatment of the *tawarruq* transaction is whether the finance cost which is implicit in Party B's deferred purchase price of £110 and immediate sale price of £100 is recognized as such for tax purposes.

Many Muslim majority countries where Islamic finance is practised do not have a corporate income tax, as it is not needed due to the level of government revenues from natural resources. However, others that do, such as Egypt, treat the £10 difference as a finance cost without considering specific legislation to be needed. As the legal systems of Muslim majority countries have been heavily influenced by, or are expressly based on, *Shari'a*, one would expect a *Shari'a*-compliant financial transaction to have its implicit finance cost recognized as such for tax purposes.

Malaysia, however, has put the matter beyond doubt. Section 2(7) of the Malaysian Income Tax Act 1967 provides that 'any reference in this Act to interest shall apply, *mutatis mutandis*, to gains or profits received and expenses incurred, in lieu of interest, in transactions conducted in accordance with the principles of *Shari'a*'. This means that the Malaysian income tax legislation treats 'profits' as similar to interest, making the taxability or deductibility of 'profits' similar to the treatment of interest in a conventional financing agreement. All of the other requirements of Malaysian tax law, governing when interest is taxable or deductible, are then applicable.

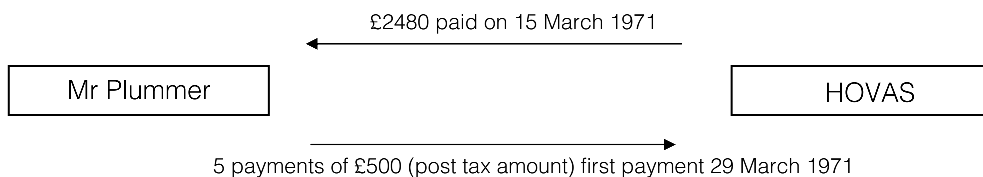
In the case of Western countries where *Shari'a*-compliant transactions are still relatively new, there is no reason to assume that any particular tax treatment will apply.

One of the factors that distinguish tax systems from one another is the relative emphasis they each place on 'form' and 'substance'. In this context, 'form' is used to describe putting significant emphasis upon the legal form of a transaction, in other words how is the transaction implemented from a legal perspective? In contrast, 'substance' is used to denote an approach of basing the tax treatment primarily upon the economic reality of a transaction. Tax systems based entirely on 'form' or entirely on 'substance' do not exist. Instead, there is a spectrum, with countries combining the two elements in varying degrees. Furthermore, different parts of a country's tax system may have distinct positions on the spectrum.

To illustrate the distinction between form and substance, it is helpful to review a UK tax case, *Commissioners of Inland Revenue (CIR) v. Plummer*, citation 54 Tax Cases 1. While the case was heard several decades ago, and its specific facts have been superseded by subsequent changes in UK tax law, it illustrates the form and substance distinction very clearly.

Exhibit 27.3

CIR v Plummer



Source: Author's own.

The facts of the case are relatively simple. On 15 March 1971, a charity called HOVAS paid £2,480 to Mr Plummer. In exchange, he undertook to make five annual payments to HOVAS under a deed of covenant, with the first payment due on 29 March 1971. The amount of each annual payment was whatever sum, after deduction of all taxes, amounted to £500.

The substance of the transaction was that Mr Plummer was borrowing £2,480 from HOVAS and repaying this in five annual instalments of £500; effectively he was borrowing at a relatively small rate of interest.

Under the legal form adopted, each of the £500 payments was treated as a larger gross payment from which Mr Plummer was entitled to withhold and retain income tax at the standard rate. For example, at the tax rate then prevailing, the first payment was legally a gross payment of £851.06. As a charity, HOVAS was entitled to a refund from the Inland Revenue of the tax withheld of £351.06, making the transaction very attractive to HOVAS; an internal rate of return of 27% was mentioned during the litigation.

Under the tax law then prevailing, Mr Plummer was entitled to offset the gross payment of £851.06 when computing his liability to higher rate tax, but not standard rate tax. (The standard rate tax relief was already achieved by him deducting and retaining the £351.06.) Accordingly, the transaction was also extremely attractive to Mr Plummer as a way of reducing his higher rate tax liability.

The tax authorities litigated and the case went through every level of the UK court system. Mr Plummer was successful before the Special Commissioners, before the High Court in 1977, before the Court of Appeal in 1978 (where the judges decided 3-0 in his favour) and before the House of Lords in 1979 (where the judges decided 3-2 in his favour).

The case is instructive to read as the legal arguments were directed almost entirely to the legal form of the transactions and whether the detailed stipulations of UK tax law had been complied with. The Inland Revenue did not attempt to argue that the transaction should simply be taxed on its economic substance as such an argument would find no support in UK tax law. (The courts might well take a different approach today, given the way case law has subsequently evolved in the UK.)

Against this background, tax systems which seek to identify the 'substance' (the underlying economics) of the transaction have no difficulty deciding that Party B has suffered a £10 finance cost. Quite clearly, the only reason Party B is paying £110 for copper that it

can only resell for an immediate payment of £100 is that Party B is granted a two-year deferral before it needs to pay the £110. This treatment applies in the Netherlands and in the US, both of which have tax systems that look very much to the substance of a transaction.

Conversely, the UK approach is that the tax treatment is heavily influenced by the legal form of the transaction. The legal form is that Party B has actually purchased an amount of copper at a price of £110 and then sold that copper, for immediate payment, at a price of £100. Accordingly, its loss has arisen on the purchase and resale of copper.

Such a loss on the purchase and resale of a commodity may not be tax deductible. In the UK, for example, unless Party B can show that it is trading (as understood by tax law) in copper, it will not be entitled to deduct the £10 loss against its other income.

Furthermore, even if Party B regularly trades in copper, this transaction does not look like a legitimate trading transaction since Party B knew that it would suffer a £10 loss when it commenced the transaction. (Trading is normally done with a view to profit.) Accordingly, under UK tax law (before the recent changes to facilitate Islamic finance discussed below), Party B would not be expected to obtain tax relief for its £10 cost.

UK tax law changes to facilitate Islamic finance

The UK is a pioneer amongst Western countries in adapting its tax system to facilitate Islamic finance. Accordingly, the strategic considerations that underlie the UK approach merit analysis, as the UK's example may be followed by other Western countries that seek to encourage Islamic finance.

Strategic design considerations

The tax law changes governing the computation of taxable income were introduced by the Finance Act (FA) 2005, with subsequent expansion of the range of transactions covered in the FA 2006 and FA 2007. A review of the legislation enables one to 'reverse engineer' the design considerations that underlie it. Four key principles emerge:

- Tax law must apply equally to all taxpayers.
- Tax law changes should not impact upon transactions not intended to be covered.
- Legislation should not be longer than is necessary.
- Specific obstacles to Islamic finance must be addressed.

Tax law should apply equally to all taxpayers

Strictly speaking, the UK has not enacted any Islamic finance legislation. A search of FA 2005 will fail to find words such as Islamic, *Shari'a*, *tawarruq* or any other term used specifically in Islamic finance. The reason is that the tax treatment of a transaction cannot be allowed to depend upon whether it is *Shari'a*-compliant. As well as introducing significant uncertainty into the UK tax system, introducing *Shari'a* considerations would create a situation where all taxpayers were not receiving identical tax treatment.

Instead, the UK identified certain types of transaction widely used in Islamic finance, and ensured that those types of transaction received appropriate tax treatment. This is illustrated by FA 2005 section 47 'Alternative finance arrangements', reproduced here in full as originally legislated:

(1) Subject to subsection (3) and section 52, arrangements fall within this section if they are arrangements entered into between two persons under which —
  (a) a person ('X') purchases an asset and sells it, either immediately or in circumstances in which the conditions in subsection (2) are met, to the other person ('Y'),
  (b) the amount payable by Y in respect of the sale ('the sale price') is greater than the amount paid by X in respect of the purchase ('the purchase price'),
  (c) all or part of the sale price is not required to be paid until a date later than that of the sale, and
  (d) the difference between the sale price and the purchase price equates, in substance, to the return on an investment of money at interest.
(2) The conditions referred to in subsection (1)(a) are —
  (a) that X is a financial institution, and
  (b) that the asset referred to in that provision was purchased by X for the purpose of entering into arrangements falling within this section.
(3) Arrangements do not fall within this section unless at least one of the parties is a financial institution.
(4) For the purposes of this section 'the effective return' is so much of the sale price as exceeds the purchase price.
(5) In this Chapter, references to 'alternative finance return' are to be read in accordance with subsections (6) and (7).
(6) If under arrangements falling within this section, the whole of the sale price is paid on one day, that sale price is to be taken to include alternative finance return equal to the effective return.
(7) If under arrangements falling within this section the sale price is paid by instalments, each instalment is to be taken to include alternative finance return equal to the appropriate amount.
(8) The appropriate amount, in relation to any instalment, is an amount equal to the interest that would have been included in the instalment if —
  (a) the effective return were the total interest payable on a loan by X to Y of an amount equal to the purchase price,
  (b) the instalment were a part repayment of the principal with interest, and
  (c) the loan were made on arm's length terms and accounted for under generally accepted accounting practice.

Reading section 47, it is clear that it was designed to facilitate *murabahah* and *tawarruq* transactions. However, nowhere does it use those terms and nothing in section 47 limits its application to Islamic finance. If a transaction falls within section 47, the tax treatment follows automatically, regardless of whether the transaction is (or was intended to be) *Shari'a*-compliant.

Tax law changes should not impact upon transactions not intended to be covered

Commercial sales of goods often involve a credit period for the customer. It would unduly complicate UK tax law if every sale of goods with deferred payment required identification of the price that would have prevailed if no credit were given, and then giving separate tax treatment for the implied cost of the credit. Consider, for example, a food manufacturer selling hundreds of thousands of tins of food to retailers with 30 days' credit allowed for the payment of each sales invoice.

Section 47 limits its impact by requiring the involvement of a financial institution in subsection (3). This ensures that only transactions where finance is provided by or to a financial institution fall within the new rules. Accordingly, the food manufacturer and its customers should not be impacted by these new rules. (One drawback of this approach is that it is currently impossible for two non-financial companies to transact Islamic finance with each other and receive the tax treatment given by the new legislation.)

Financial institution is defined in section 46(2) as:

(2) In this Chapter 'financial institution' means—
  (a) a bank as defined by section 840A of ICTA [1988],
  (b) a building society within the meaning of the Building Societies Act 1986 (c. 53),
  (c) a wholly-owned subsidiary of a bank within paragraph (a) or a building society within paragraph (b),
  (d) a person authorised by a licence under Part 3 of the Consumer Credit Act 1974 (c. 39) to carry on a consumer credit business or consumer hire business within the meaning of that Act, or
  (e) a person authorised in a jurisdiction outside the UK to receive deposits or other repayable funds from the public and to grant credits for its own account.

Tracing through the definitions establishes that they cover all banks licensed in the European Economic Area and also persons licensed to take deposits in other countries, which is the key practical definition of a bank. However, many other bodies engaged in financial activities, such as hedge funds, fall outside these definitions.

Legislation should not be longer than is necessary

Section 47 reproduced above demonstrates how complex it can be to legislate for an apparently straightforward transaction. Drafting the new legislation would have been very arduous if it was then necessary to legislate specifically for all the tax consequences flowing from *murabahah* or *tawarruq* transactions.

The legislation avoids this burden by assimilating the tax consequences of Islamic finance transactions into the existing tax legislation. For example, where a company undertakes a *murabahah* or *tawarruq* transaction, the tax consequences are governed by FA 2005 section 50(1):

(1) Where a company is a party to arrangements falling within section 47, Chapter 2 of Part 4 of FA 1996 (loan relationships) has effect in relation to the arrangements as if —
   (a) the arrangements were a loan relationship to which the company is a party,
   (b) any amount which is the purchase price for the purposes of section 47(1)(b) were the amount of a loan made (as the case requires) to the company by, or by the company to, the other party to the arrangements, and
   (c) alternative finance return payable to or by the company under the arrangements were interest payable under that loan relationship.

FA 1996, which governs loan relationships, contains a very extensive and complex set of provisions which apply to companies engaging in the lending or borrowing of money and paying interest or other finance costs. Section 50(1) is not saying that section 47 involves the making of a loan; instead it taxes the company as if a loan had been made and as if the alternative finance return (the profit or loss under the *murabahah* or *tawarruq* transaction) were interest.

The UK's approach here is similar to that in Malaysia, where the tax treatment of 'profit' on Islamic financing transactions is assimilated to the tax treatment of 'interest'.

Addressing specific obstacles to Islamic finance

Tax legislation in the UK has grown steadily since income tax became a permanent feature of the tax system in 1842, and was of course developed long before Islamic finance was contemplated in the UK. Not surprisingly, it happened to contain specific provisions which would impact upon Islamic transactions, even though the equivalent conventional transaction was not affected. These were addressed by specific legislation.

For example, the UK has long had a provision to counter companies disguising equity finance in the form of debt, in order to obtain tax relief for payments that are economically equivalent to dividends to risk bearing shareholders. This can be found in ICTA 1988 s.209 (2) (e) (iii):

(2) In the Corporation Tax Acts "distribution", in relation to any company, means . . . (e) any interest or other distribution out of assets of the company in respect of securities of the company (except so much, if any, of any such distribution as represents the principal thereby secured and except so much of any distribution as falls within paragraph (d) above), where the securities are . . . (iii) securities under which the consideration given by the company for the use of the principal secured is to any extent dependent on the results of the company's business or any part of it.

This provision would preclude Islamic banks offering investment accounts to their customers, since the profit share paid to the customer would be treated as a distribution. This means that the payment would not be tax deductible for the bank.

This problem is addressed specifically by FA 2005 s.54 which effectively disapplies ICTA 1988 section 209 (2) (e) (iii):

> *Profit share return* [defined in FA 2005 section 49 in a form that corresponds to profit share return on investment account deposits of Islamic banks] *is not to be treated by virtue of section 209(2)(e)(iii) of ICTA as being a distribution for the purposes of the Corporation Tax Acts.*

Tax treatment of a diminishing *musharakah* transaction

The diminishing *musharakah* transaction outlined previously presents relatively few difficulties from the perspective of corporate or personal income tax. The Eventual Owner is paying rent to the bank, and the deductibility or otherwise of this rent in most countries will depend on whether the property is occupied for business purposes or for personal use.

The UK has, however, legislated specifically for such transactions, by setting out precise requirements in FA 2005 section 47A for a transaction called 'diminishing shared ownership'. If a transaction falls within these rules, the rent being paid is treated for tax purposes as if it were interest, both for the payer and for the receiving financial institution. This is particularly important if the financial institution is not UK resident, since the UK always charges withholding tax on rent paid to foreign persons, whereas interest paid to foreign persons often has a reduced or zero withholding rate due to the operation of double taxation treaties.

The legislation in FA section 47A is very precise. The financial institution can share in any losses on the asset. If the bank could not share in any losses on the asset, then this contract would probably fail to be *Shari'a*-compliant and nobody would ever use it. However, FA section 47A states that the bank cannot participate in increases in the value of the asset. This could become a problem. While many diminishing *musharakah* contracts are based upon the original purchase price, there is also a move by some organizations to have a contract which allows the financial institution to participate in the growth of the asset. This may be regarded by them as being slightly better from a *Shari'a* perspective. Unfortunately, such a contract does not satisfy the UK tax rules as they currently stand.

The most important question with diminishing *musharakah* however is the taxation if the property ownership changes, as many countries have some form of real estate transfer tax. In the case of a conventional bank mortgage, there is normally only a single taxable real estate transfer, from the vendor to the purchaser buying with the aid of a mortgage. However, in diminishing *musharakah*, the vendor sells to the bank, and the bank then sells to the eventual purchaser. Are there two incidences of real estate transfer tax?

The distinction between substance and form discussed above is not relevant, and a double real estate transfer tax charge will apply, in the absence of specific relief, even if the country adopts a substance-based approach to taxation. That is the case in the Netherlands, for example. In most countries, the double real estate transfer tax charge can only be eliminated if there is specific legislation to that effect.

Malaysia has enacted specific legislation. Section 2(8) seeks to ignore the underlying transaction so that tax neutrality can be achieved in Islamic funding transactions, by providing that:

> . . . any reference in this Act to the disposal of an asset or a lease shall exclude any disposal of an asset or lease by or to a person pursuant to a scheme of financing approved by the Central Bank or the Securities Commission or LOFSA [Labuan Offshore Financial Services Authority], as a scheme which is in accordance with the principles of Syariah where such disposal is strictly required for the purpose of complying with those principles but which will not be required in any other schemes of financing.

The requirement for advance approval negates any uncertainty in the application of the provision.

Similarly, the UK legislated relief from multiple charges to its real estate transfer tax called Stamp Duty Land Tax (SDLT) in FA 2003 section 71A. This relief from SDLT was originally only available where the person renting or buying the property was an individual. In the Finance Act 2006, the relief was widened because it was recognized that Muslims wanted to use this approach not only for the acquisition of personal residential property, but also to acquire property for their businesses in a *Shari'a*-compliant way, and such a business might well be conducted by a company.

Conclusions

The treatment of Islamic finance transactions in computing business income may or may not need specific legislation. Muslim majority countries may not need legislation, as illustrated by Egypt, or may choose to legislate to put the tax treatment beyond doubt, as in the case of Malaysia. In the case of Western countries, if the tax system looks primarily to the substance of a transaction as with the Netherlands or the US, specific legislation may not be needed. Conversely, if the tax system looks primarily to the legal form as with the UK, then specific tax legislation will be needed to ensure that Islamic finance transactions receive the expected tax treatment.

With regard to transaction taxes such as real estate transfer taxes, Islamic finance transactions risk incurring multiple charges to such taxes, compared to conventional transactions which bear only a single charge, unless the country concerned enacts specific legislation to prevent such multiple charges.

Chapter 28

The regulation of *Shari'a*-compliant financial services and products: approaches and challenges

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Introduction

With the growth in the market for *Shari'a*-compliant financial services and products, comes the risk of detriment for the users of those services and products. With the increased risk of investor detriment comes the scrutiny and intervention by those governmental bodies charged with overseeing those providing *Shari'a*-compliant services and products.

The regulation of *Shari'a*-compliant products and services creates a special challenge for regulators and gives rise to specific issues. These include:

- the role and powers that regulators assume, or should assume, when regulating *Shari'a*-compliant products and services;
- the classification of *Shari'a*-compliant products and services within a conventional or non-*Shari'a* legal and regulatory framework to ensure that they are properly regulated;
- the imposition or superimposition of *Shari'a* governance requirements on Islamic financial institutions and the role of disclosing these requirements; and
- the challenge of developing appropriate capital adequacy standards.

These issues are examined below.

Choices of regime: general or special

The regulators of *Shari'a*-compliant products and services have chosen different approaches to their regulation. Some do not require providers to submit to a special regime but regulate them as part of their general regulatory regimes. Others have dedicated regimes where institutions offering *Shari'a*-compliant financial services are required to do so using a special licence. Meanwhile, others only impose requirements on the part of providers' businesses that offer *Shari'a*-compliant products and services via the concept of the 'Islamic window'.

Regulation under a general regime

As will be discussed further below, some jurisdictions have adopted special regimes for governing Islamic finance service providers. The majority, however, regulate those firms offering Islamic financial services in the same manner as those offering conventional (non-Islamic) financial services. When it comes to the manner in which Islamic securities are offered, the process and rules for such offerings, even in those jurisdictions with special licensing regimes, are, in effect, the same. (For example, the rules governing the listing of Islamic bonds issued by the Securities and Commodities Authority of the United Arab Emirates are almost identical to the rules governing the listing of conventional bonds save for the use of word ‘profit’ instead of ‘interest’.)

Therefore, a firm looking to carry on a business in *Shari'a*-compliant securities and investments in a given country, will, as a matter of law, require a licence or authorization from that country's securities and investments regulator. Generally, the scope or type of the firm's business, with respect to both the particular activities it wishes to carry out (for example, broking and dealing or asset management) and the particular securities or investments it wishes to carry out the activities (for example, equities, mutual funds or commodity derivatives), will determine the type of licence or authorization for which the firm needs to apply. For example, in Saudi Arabia the Capital Market Authority (CMA) specifies five categories of activity for which it may grant a licence: dealing, arranging, managing, advising and custody. It identifies the following securities and investments: shares (which include *sukuk*), debt instruments, certificates, warrants, units in investment funds, options, futures, contracts for difference and rights in any of these. A firm wanting to manage *Shari'a*-compliant investment funds would, therefore, need to apply to carry out all of the activities but, subject to the investment strategy and composition of the fund, it would not need to apply to carry on the activities with respect to all the securities and investments identified by the CMA.

In principle, the type of license or authorization held by a firm will determine the scope and extent of the rules or regulations with which it has to comply and the levels of regulatory capital that the firm will need to hold. In general, regulators or other governmental authorities will impose rules and regulations governing subjects, such as the manner in which a regulated firm must organize and manage its business, market and sell its products and treat its clients and their investments.

Regulation under a special regime

Some of newly created or recently reformed jurisdictions, such as Bahrain, the Dubai International Financial Centre (DIFC) and the Qatar Financial Centre (QFC), have adopted special regulatory regimes, with similar provisions, to govern or supplement the general regulatory regime.

To take Bahrain as an example, in Bahrain the regulation of banking and financial services is governed by the Central Bank of Bahrain and Financial Institutions Law 2006. The law expressly recognizes financial institutions governed by *Shari'a* principles as a specific subset of financial institution with respect to which a banking licence is required.

It is perhaps not surprising, therefore, that the Central Bank of Bahrain (CBB) has established a separate regulatory regime for Islamic banks alongside conventional banks, insurance institutions and investment business institutions. The law prohibits any entity from undertaking regulated Islamic banking services or from holding themselves out to be licensed to undertake such services without the relevant CBB licence. The CBB rules require any entity wishing to apply for a licence to carry out the activities of an Islamic bank to satisfy the conditions relating to legal status, mind and management, controllers, board and employees, financial resources, systems and controls and other requirements, including those related to books and records, provision of information and general conduct.

Once licensed, the CBB rules require Islamic banks to comply with detailed provisions covering, *inter alia*, the financial promotion of products, rules for foreign exchange dealing, client confidentiality, customer account services and charges, margin trading and, as set out above, rules for *Mudaraba* contracts. These rules rest on specific 'principles of business' for Islamic banks similar to the principles of business for other entities and the principles under the regimes in the DIFC, QFC and UK, both of which apply to Islamic institutions in those jurisdictions. The 'principles of business' for Islamic banks cover issues such as integrity, conflicts of interest, due skill and care, confidentiality, market conduct and management, systems and controls.

Regulation of the 'Islamic window'

The DIFC Law Regulating Islamic Financial Business permits an authorized firm or authorized exchange, other than an institution that carries on its entire business in accordance with the *Shari'a*, to operate an Islamic window where it conducts a part of its business in accordance with the *Shari'a* as part of its overall business operations.

The Governance Standards recommended by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) contain special provisions governing Islamic windows. The primary obligation for those institutions offering services through an Islamic window is to ensure that the *Shari'a*-compliant and non-*Shari'a*-compliant parts of their business are kept separate, with the *Shari'a* parts subject to financial reporting standards recommended by AAOIFI and oversight by a *Shari'a* supervisory board.

The Islamic window provides a compromise for those institutions that wish to participate in both the Islamic and conventional financial industries while ensuring that its Muslim clients are appropriately protected.

Approaches to regulation: formal or substantive?

When examining the regulation of *Shari'a*-compliant financial services and products, a proper understanding of the underlying purpose of financial services and products regulation is vital. Generally, the interests that regulators have in protecting the users of financial services and products, including investors and the markets in which the providers of those services and products participate (which in turn include the exchanges on which financial instruments are traded) underpin and inform the use of regulatory authority and power. In the context of the regulation of *Shari'a*-compliant financial services and

products, a further issue arises: should regulators leave it to the providers to determine *Shari'a* compliance by regulating the manner for and disclosure of such determinations – a formal approach? Or should regulators themselves seek to determine *Shari'a* compliance within the matrix of investor protection and market integrity – a substantive approach?

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

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

Where a regulator is charged primarily with the protection of investors' financial welfare rather than their spiritual welfare, the formal model would seem the more appropriate. Against this is the argument that the standardization of particular Islamic finance requirements, which the substantive model helps achieve, enhances liquidity by reducing the costs which the originators of investments have to incur on a case-by-case basis to ensure that the investments are *Shari'a*-compliant. Enhancing liquidity is hardly at odds with a financial regulator's objectives.

The categorization challenge

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

The issue of categorization highlights one of the challenges for regulators and product services and providers alike: how to ensure that, despite their special characteristics which distinguish *Shari'a*-compliant products and services from their conventional counterparts, regulators properly protect the users of *Shari'a*-compliant services and appropriately regulate the markets in which their providers operate. This is a particular issue in countries without a dedicated Islamic finance regulatory regime.

For example, in the UK, where there is no special regime for the regulation of Islamic finance, the Financial Services Authority (FSA) requires an entity seeking to be licensed as a bank to apply for an authorization to carry on the regulated activity of 'accepting deposits'. A deposit is categorized as 'a sum of money paid on terms under which it will be repaid either on demand or in circumstances agreed by the parties'. An Islamic Bank which offers a *mudarahaba*, or profit-sharing investment account, as a way for investors to maintain their savings would struggle to satisfy this requirement. However, in licensing the Islamic Bank of Britain, the FSA reached an agreement with the bank whereby legally its customers would be entitled to full repayment, thereby satisfying the FSA's requirements. However, the customers would have the right to turn down deposit protection after the event on religious grounds and choose to be paid out under a *Shari'a*-compliant risk and loss-bearing formula. (See the FSA Paper *Islamic Finance Regulation in the UK: Regulation and Challenges*, November 2007.)

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

The issue of categorization has also arisen in the context of *sukuk*. In addition to the regulation of those who offer and sell *sukuk*, the financial regulators in the countries referred to above also regulate those who manage collective investments such as mutual funds. The definitions of collective investment vehicles are not uniform. However, for the purposes of explaining the characteristics of a collective investment vehicle, the following features are common in the UK, the DIFC and the QFC:

- any arrangement, the purpose or the effect of which is to enable persons taking part to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income;
- the arrangements must be such that the participants do not have day-to-day control over the management of the property; and
- the contributions of the participants and the profits or income out of which payments are to be made to them are pooled or the property is managed as a whole by or on behalf of the operator of the scheme or fund.

On the face of it, most *sukuk* vehicles will have the characteristics set out above: for example, the holders of the *sukuk* certificates will participate in or receive profits or income arising from the assets, in respect of which the *sukuk* are issued; they will not have

day-to-day control of the assets: their contributions will be pooled in order to make the investment in the assets and the assets will be managed by the operator of the vehicle which has purchased the assets or delegated. Therefore, the presumption is that, in the UK, DIFC and QFC at least, a *sukuk* manager will need to be licensed to operate a collective investment scheme or fund.

Fortunately for *sukuk* managers, there may be relief in the form of an exemption from the requirement to operate a scheme or fund, where the rights or interests of the participants are represented by debentures issued by a single body corporate, which is not an open ended investment company. For these purposes, debentures include instruments creating or acknowledging indebtedness, including (but not limited to) bonds. In the DIFC, the DFSA has interpreted these provisions to exclude the requirement for a manager to be licensed. In so doing, the DFSA appears to have adopted the following reasoning: *sukuk* are similar to conventional bonds in that they are security instruments that provide a predictable level of return. They are structured to have the same risk characteristics as conventional bonds and, therefore, they should be treated in the same manner as conventional bonds for the purpose of exempting managers from the requirement to be licensed or authorized. The approach of the DFSA, although commercially sensible and fair from a risk perspective, required it to interpret its rules in the absence of a crystal clear answer. In order to create legal certainty, the DFSA amended its rules to exclude *sukuk*, where the *sukuk* holders may rely on the creditworthiness of the issuer or obligor to enforce their rights under the *sukuk* from the definition of units in a collective investment fund. In the UK, the Treasury and FSA are consulting on similar changes to the relevant UK regulations.

The focus on governance and disclosure

Where regulators choose to regulate Islamic financial institutions, the one regulatory characteristic that primarily sets the regulation of those institutions apart from the regulation of conventional institutions is the focus on governance systems and controls for ensuring *Shari'a* compliance. The issue of internal *Shari'a* governance may arguably be more acute where a formal approach to the regulation of Islamic finance is adopted, with regulators placing the issue of determining *Shari'a* standards firmly with the institutions themselves, as opposed to leaving them to centrally identified *Shari'a* supervisory boards.

In the DIFC, the DIFC law regulating Islamic financial business sets out a single substantive requirement for the conduct of Islamic Financial Business: an authorized firm which has an endorsed licence authorizing it to conduct Islamic Financial Business must appoint a *Shari'a* supervisory board.

In its rules, the DFSA amplifies these requirements by reference to the AAOIFI Governance Standards – an approach that the CBB follows in Bahrain, although even more so by merely referring to the relevant AAOIFI Governance Standards as opposed to seeking to incorporate the substance of those standards into its rulebook.

The DFA sets out rules:

- governing the appointment of the *Shari'a* Supervisory Board, including the requirement to have at least three members who are competent and independent of the firm's management;

- for demonstrating the process for appointing and retaining members of the *Shari'a* supervisory board, including the process for considering the suitability of the board;
- governing the effectiveness of the *Shari'a* supervisory board, including the requirement to ensure that the board is independent of, and not subject to, any conflict of interest with respect to the firm; and
- governing the manner in which the *Shari'a* supervisory board operates, including the requirement for reviews in accordance with relevant AAOIFI Governance Standards.

With respect to rules governing the effectiveness of the *Shari'a* supervisory board, the following requirements placed on a DFSA-authorized firm's employees are noteworthy:

- to provide such assistance as the board reasonably require to discharge its duties;
- to give the board right of access at all reasonable times to relevant records and information;
- not to interfere with the board's ability to discharge its duties; and
- not to provide false or misleading information to the board.

The central role of *Shari'a* governance and focus of regulators that choose to regulate Islamic finance, as the distinguishing practical feature that marks out any system of regulating Islamic finance, is evident from the fact that the *Shari'a* supervisory board issue arises in many contexts. These include:

- the governance of banks and other financial institutions, which would encompass the approval of the structure of particular products;
- the management of *Shari'a*-compliant investment funds – the DFSA and QFCRA rules referring expressly to the requirement for fund managers holding funds out as *Shari'a*-compliant to appoint *Shari'a* supervisory boards to oversee the investment decisions of those funds;
- the governance of *Shari'a*-compliant markets and exchanges – the DFSA rules requiring markets and exchanges to appoint *Shari'a* supervisory boards to oversee the activities of the relevant market or exchange; and
- listing of *Shari'a*-compliant products – the rules of exchanges, such as the Dubai International Financial Exchange, requiring the issuer of *Shari'a*-compliant securities, such as *sukuk*, to disclose the details of the *Shari'a* supervisory board which approved the securities to be listed as *Shari'a*-compliant.

Such is the importance of the *Shari'a* supervisory board in the regulation of Islamic finance that, in plain terms, the question of what constitutes a *Shari'a*-compliant bank or financial institution may be answered simply by the statement: a bank or institution that has its own *Shari'a* supervisory board.

This, in turn, highlights the central role of disclosure in the context of the regulation of Islamic finance, particularly where regulators employ a formal model where investors will rely on the *fatwa* of a product provider's *Shari'a* supervisory board instead of any *fatwa* issued by a central *Shari'a* supervisory board.

This would appear to underpin the single requirement set out by the DFSA with respect to the marketing and promotion of *Shari'a*-compliant products or services. The DFSA requires that before a firm communicates any marketing material to a person, it must ensure that, in addition to the information generally required by the DFSA for inclusion in any marketing material, the marketing material states which *Shari'a* supervisory board has reviewed the products or services to which the material relates. In addition, in Saudi Arabia, the Capital Authority requires the manager of a *Shari'a-compliant* investment fund to disclose not only the identity of the *Shari'a* supervisory board that approved investments made by the fund but also the criteria for determination.

The development of capital adequacy standards

Appropriate capital adequacy standards need to complement appropriate governance standards to ensure proper risk management. The Islamic Financial Services Board (IFSB) has developed capital adequacy standards for Islamic finance institutions based on the Basel II standards but adapted to cater for the special characteristics of *Shari'a*-compliant services and products. The standards address the Basel II Pillar One requirements dealing with credit risk, operational risk and market risk. It does not address the Basel II Pillar Two (Supervisory Review Process) and Pillar Three (Market Discipline) requirements.

In Bahrain, the CBB has adopted the IFSB standards in its capital adequacy rules for Islamic banks published in early 2008. The rules set out, amongst other things, capital adequacy requirements for *Shari'a*-compliant products, such as *ijara* and *ijara muntahia bittamleek*; *musharakah* and diminishing *musharakah*; and *mudarabah*.

The CBB's regulation of *Shari'a*-compliant products is underpinned by the principle that the CBB requires CBB-regulated Islamic banks to maintain adequate capital against their risks as capital provides banks with a cushion to absorb losses without endangering customer accounts. Each section of the rules dealing with the products sets out the minimum capital adequacy requirements relevant to each product.

For example, the rules dealing with the capital adequacy requirements for *ijarah* and *ijarah muntahia bittamleek* set out the minimum capital requirement to cover:

- counterparty risk and residual value risk of leased assets, arising from a CBB regulated Islamic bank entering into contracts or transactions that are based on the *Shari'a* rules and principles of *ijara* and *ijara muntahia bittamleek*; and
- the market or price risk of assets acquired for *ijara* and *ijara muntahia bittamleek*.

For example, in the case of a binding promise to enter into an *ijara*, where the bank takes credit risk on the leasor, the capital requirement is measured by determining the bank's credit exposure to the leasor, which is the amount of the asset's total acquisition cost to the bank, less the market value of the asset as collateral, and less the amount of due from the lessee. This exposure is given a risk weighting which is calculated by reference to the standing of the obligor that is rated by a rating agency and, in the case that the obligor is unrated, a risk weighting of 100%. In applying this treatment, the CBB rules require the bank to ensure that the binding promise to lease is properly documented and is legally

enforceable. In the absence of proper documentation and legal enforceability, the asset is treated similarly to one in a non-binding promise to lease, which is determined according to market or price risk.

Other national regulators have yet to follow the CBB's lead in adopting the IFSB standards. However, with concerns about the convergence of international capital adequacy that have arisen in the context of the so-called credit crunch of 2007 and 2008, the adoption and development of capital adequacy and prudential standards for Islamic institutions may become a key area for Islamic financial regulatory development particularly in light of the events of 2008 and 2009.

Conclusion

The challenges for regulators seeking to protect the interests of users of *Shari'a*-compliant products and services, and ensure the integrity of Islamic markets in an industry that is experiencing dramatic growth, cannot be underestimated. However, with the development of standards by international bodies such as AAOIFI and the IFSB and the increasing interest taken by national regulators this challenge should, God willing, be met. Even if the solutions are never perfect, and regulatory solutions seldom are, regulators' recognition of the issues that they, and participants in the Islamic finance industry, need to address can only be viewed positively.

Glossary of Islamic finance*

Most common instruments

These are the most common Islamic finance instruments. They are dealt with in more detail in the 'General terms' section of the glossary, which covers subjects in more depth from within Islamic – and also non-Islamic – finance.

ijara: A leasing agreement whereby the bank buys an item for a customer and then leases it back over a specific period.

ijara-wa-iqtina: Similar to *ijara*, except that the customer is able to buy the item at the end of the contract.

mudarabah: Offers specialist investment by a financial expert in which the bank and the customer share any profits.

murabahah: A form of credit which enables customers to make a purchase without having to take out an interest-bearing loan. The bank buys an item and then sells it on to the customer on a deferred basis.

musharakah: An investment partnership in which profit-sharing terms are agreed in advance, and losses are pegged to the amount invested – basically private equity.

General terms

al ajr: Refers to commission, fees or wages charged for services.

al fard al kifa'i: Socially obligatory duties. *Literally*, a collective duty of Muslims, the discharge of which, by some of them, absolves the rest of its performance, such as funeral prayers. *Technically* it covers such functions which the community fails to, or cannot, perform and hence are taken over by the state, such as the provision of utilities, building of roads, bridges and canals et cetera.

amana (alt. sp. ***amanah***): *Literally*, reliability, trustworthiness, loyalty, honesty. *Technically*, an important value of Islamic society in mutual dealings. It also refers to deposits in trust. A person may hold property in trust for another, sometimes by implication of a contract.

al wadia: Resale of goods with a discount on the original stated cost.

al wakala: Absolute power of attorney.

al rahn al: An arrangement whereby a valuable asset is placed as collateral for a debt. The collateral may be disposed of in the event of a default.

al wadiah: Safekeeping.

arbitrage: An attempt to profit from momentary price differences that can develop when a commodity or security is traded on two different exchanges.

ask: The asking price; the price at which someone who owns a security offers to sell it.

awkaf/awqaf: A religious foundation set up for the benefit of the poor.

back office: The 'behind the scenes' support operations of a brokerage, insurance company, and so on.

bai muajjal: A deferred payment contract; a contract involving the sale of goods on a deferred payment basis. The bank, or provider of capital, buys the goods (assets) on behalf of the business owner. The bank then sells the goods to the client at an agreed price, which will include a markup since the bank needs to make a profit. The business owner can pay the total balance at an agreed future date, or make instalments over a pre-agreed period. This is similar to a *Murabaha* contract since it is also a credit sale. There is a financial institution in Malaysia that offers an Islamic Visa card based on this type of contract.

bai al-arboon: A sale agreement in which a security deposit is given in advance as a partial payment towards the price of the commodity purchased. This deposit is forfeited if the buyer fails to meet his obligation.

bai al-dayn: Debt financing; the provision of financial resources required for production, commerce and services by way of sale/purchase of trade documents and papers. *Bai al-Dayn* is a short-term facility with a maturity of not more than a year. Only documents evidencing debts arising from *bona fide* commercial transactions can be traded.

bai inah: Sale and buy-back; the sale and buy-back of an asset for a higher price than that for which the seller originally sold it. A seller immediately buys back the asset he has sold on a deferred payment basis at a price higher than the original price. This can be seen as a loan in the form of a sale.

bai istijrar: Supply sale; when a supplier agrees to deliver to a client on a regular basis at an agreed price and mode of payment.

bai muajjal: *see bai bithaman ajil.*

bai muzayadah: Open bidding trading; the principle governing open auctions, where the asset is awarded to the highest bidder.

bai wafa: Sale and buy-back; the sale and buy-back of an asset within a set time, when the original buyer agrees to the original seller's repurchase.

Basel II: Abbreviated version of *The International Convergence of Capital Measurement and Capital Standards – A Revised Framework*. A round of deliberations by central bankers from around the world, under the auspices of the Basel Committee on Banking Supervision

(BCBS) in Basel, Switzerland, aimed at producing uniformity in the way banks and banking regulators approach risk management across national borders. Also known as *The New Accord*.

batil: Null and void.

bai al salam: Advance payment for goods which are to be delivered later. Normally, no sale can be effected unless the goods are in existence at the time of the bargain. But this type of sale forms an exception to the general rule provided the goods are defined and the date of delivery is fixed. The objects of this type of sale are mainly tangible but exclude gold or silver as these are regarded as monetary values. Barring these, *bai al salam* covers almost all things which are capable of being definitely described as to quantity, quality and workmanship.

One of the conditions of this type of contract is advance payment; the parties cannot reserve their option of rescinding it but the option of revoking it on account of a defect in the subject matter is allowed. It is also applied to a mode of financing adopted by Islamic banks. It is usually applied in the agricultural sector where the bank advances money for various inputs to receive a share in the crop, which the bank sells in the market.

bai bithaman ajil: A contract where goods are sold on a deferred payment basis. Equipment or goods requested by the client are bought by the bank which subsequently sells the goods to the client at an agreed price which includes the bank's mark-up (profit). The client may be allowed to settle payment by instalments within a pre-agreed period, or in a lump sum. Similar to a *murabahah* contract, but with payment on a deferred basis.

baitul mal: Treasury.

bear: A person who thinks a market will soon be in decline, as opposed to a 'bull'.

bid: The price a buyer is willing to, or must buy at, as opposed to 'offer' or 'asked', the price the seller will take. The difference, or the spread, is the broker's share of the transaction.

book value: The net asset value of a company. The book value is arrived at by subtracting liabilities from assets. Dividing the result by the number of common stock shares arrives at a book per share value that can be used to gauge the real value of the stock.

bourse: Used generally for all stock exchanges, particularly European exchanges.

broker: Professionals who buy and sell shares on behalf of their clients, as private individuals and institutions are not usually allowed to deal in shares directly. In the Gulf region, financial advisers are often called brokers because they sell financial product on behalf of their providers.

bull: Someone who thinks the market is going to go up.

call: The right to buy a security at a given price within a given time. Used by investors who expect the price of a stock to rise.

close: The final transaction price for an issue on the stock exchange at the end of the trading day.

CMA: The Capital Markets Authority, the regulator of the Sultanate of Oman.

commodity: A physical substance which is interchangeable with another product of the same type, and whose rights and responsibilities are shared between the investors, buy or sell, usually through futures contracts. The price of the commodity is subject to supply and demand.

darura: Necessity; in an emergency, Muslims may disregard aspects of *Shari'a* laws in order to save their lives, or to preserve the Islamic community.

derivative: A financial instrument whose value depends on changes in the value of some other security.

DFM: Dubai Financial Market, where listed Dubai securities can be bought.

DFSA: Dubai Financial Services Authority; an independent, integrated regulatory authority that has responsibility for the regulation of all financial and ancillary services conducted in or from the Dubai International Financial Centre. It is based on authorities used in London and New York.

DGCX: Dubai Gold and Commodities Exchange. A fully automated, online commodities exchange, DGCX is the first international commodities derivatives marketplace in the time zone between Europe and the Far East.

DIFC: Dubai International Financial Centre, an onshore hub for global finance. It has proved useful for minimizing the time differential between Hong Kong and London and is intended to turn Dubai into a major hub for institutional finance.

dirham: Name of a unit of currency, usually a silver coin, used in the past in several Muslim countries and still used in some Muslim countries, such as Morocco and United Arab Emirates.

DMCC: Dubai Multi Commodities Centre, founded in 2002 to create a regulated commodity marketplace in Dubai. It deals widely in the gold, diamonds, energy and commodities markets.

DME: Dubai Mercantile Exchange, the first energy futures exchange in the region, with a joint venture between the New York Mercantile Exchange and a subsidiary of Dubai Holding.

DSM: Abu Dhabi Securities Market, the bourse of the UAE capital.

equities: Freely traded stocks and shares in publicly owned companies that entitle their holders to a share in the fortunes of the company and receive annual dividend payments.

ex-dividend: The period between the declaration of a dividend by a company or a mutual fund and the actual payment of a dividend.

face value: The redemption value of a bond appearing on the certificate.

fard al kifa'i (*alt. sp.* ***fard kifaya***): Socially obligatory duties; a collective duty of Muslims. The performance of these duties (for example funeral prayers) by some Muslims absolves the rest from discharging them.

This term covers functions which the community fails to or cannot perform and hence are taken over by the state, such as the provision of utilities, or the building of roads, bridges and canals.

fasid: Unsound or unviable; a forbidden term in a contract, which consequently renders the contract invalid.

fatwah: A religious decree.

fiqh: Islamic jurisprudence. The science of the *Shari'a*. It is an important source of Islamic economics.

faqih (*pl.* ***fuqaha***): *Shari'a* jurist.

futures contract: A stock exchange contract committing one to buy or sell a specific commodity (share or index) on a specified future date.

gharar: *Literally*, uncertainty, hazard, chance or risk. *Technically*, the word has several meanings.

1 Sale of a thing which is not present at hand, the sale of a thing whose consequence or outcome is not known or a sale involving risk or hazard in which one does not know whether it will come to be or not, such as fish in water or a bird in the air.
2 Deception through ignorance by one or more parties to a contract. Gambling is a form of *gharar* because the gambler is ignorant of the result of the gamble. There are several types of *gharar*, all of which are *haram*. The following are examples:

   - Selling goods that the seller is unable to deliver.
   - Selling known or unknown goods against an unknown price, such as selling the contents of a sealed box.
   - Selling goods without proper description, such as a shop owner selling clothes with unspecified sizes.
   - Selling goods without specifying the price, such as selling at the 'going price'.
   - Making a contract conditional on an unknown event, such as 'when my friend arrives' if the time is not specified.
   - Selling goods on the basis of false description.
   - Selling goods without allowing the buyer the properly examine the goods.

   The root '*gharar*' denotes deception. *Bay' al-gharar* is an exchange in which there is an element of deception either through ignorance of the goods, the price, or through faulty description of the goods. *Bay' al-gharar* is an exchange in which one or both parties stand to be deceived through ignorance of an essential element of exchange. Gambling is a form of *gharar* because the gambler is ignorant of the result of his gamble.

3 Uncertainty. One of three fundamental prohibitions in Islamic finance (the other two being *riba* and *maysir*). *Gharar* is a sophisticated concept that covers certain types of uncertainty or contingency in a contract. The prohibition on *gharar* is often used as the grounds for criticism of conventional financial practices such as short-selling, speculation and derivatives.

going public: Offering shares to the public for the first time (initial public offering, IPO).

Hadith: Prophet's commentary on the *Qur'an*.

Hajj: Pilgrimage to Mecca and other holy places. *Hajj*, the fifth pillar of Islam, is a duty on every Muslim who is financially and physically able to carry it out at least once in his lifetime. There is a specific period for *Hajj*, namely one week from the 8th day of the Islamic month of *Dhul Hijjah* to the 13th day of that month in the Islamic lunar calendar.

hak tamalluk: Ownership right; a tradable asset in the form of ownership rights.

halal: Lawful and permissible. The concept of *halal* has spiritual overtones. In Islam there are activities, professions, contracts and transactions which are explicitly prohibited (*haram*) by the *Qur'an* or the *Sunnah*. Barring them, all other activities, professions, contracts, and transactions and so on are *halal*. This is one of the distinctive features of Islamic economics *vis-a-vis* Western economics where no such concept exists. In Westem economics, all activities are judged on the touchstone of economic utility. In Islamic economics, other factors, mostly spiritual and moral are also involved.

An activity may be economically sound but may not be allowed in Islamic society if it is not permitted by the *Shari'a*.

Hanbali: An Islamic school of law founded by Imam Ahmad Ibn Hanbal. Followers of this school are known as *Hanbalis*.

Hanifite: An Islamic school of law. One of the major Islamic schools of law, founded by Imam Abu Hanifa. Followers of this school are known as *Hanafis*.

haram: Unlawful, forbidden. Activities, professions, contracts and transactions that are explicitly prohibited by the *Quran* or the *Sunnah*. *Cf halal*.

hawala: *Literally*, a bill of exchange, promissory note, cheque or draft. *Technically*, a debtor passes on the responsibility of payment of his debt to a third party who owes the former a debt. Thus, the responsibility of payment is ultimately shifted to a third party. *Hawala* is a mechanism for settling international accounts by book transfers. This obviates, to a large extent, the necessity of physical transfer of cash. The term was also used historically in public finance during the *Abbaside* period, to refer to cases where the state treasury could not meet the claims presented to it, and it directed the claimants to occupy a certain region for a specified period of time and procure their claims themselves by taxing the people. This method was also known as '*tasabbub*'. The taxes collected and transmitted to the central treasury were known as '*mahmul*'.

hedge: Any combination positions taken in securities options or commodities in order to balance out and reduce risk.

hibah: A gift voluntarily donated in return for a loan provided or a benefit obtained.

hila: A forbidden structure; a transaction which appears permissible, but is in fact structured in an non-Islamic way.

ibra: A rebate; when a person withdraws the right to collect payment from a borrower.

ijara: Leasing; a contract where the bank or financier buys and leases equipment or other assets to the business owner for a fee. The duration of the lease, as well as the fee, are set in advance. The bank remains the owner of the assets. This type of contract is a classical Islamic financial product. It is used to acquire equipment, buildings or other facilities with a view to renting them against agreed rental payments. Leasing is also a lawful method of earning income, according to Islamic law. In this method, real assets such as machines, cars, ships and houses can be leased by one person (lessor) to the other (lessee) for a specific period against a specific price. The benefit and cost of each party are to be clearly spelled out in the contract so as any ambiguity (*gharar*) may be avoided.

Leasing is emerging as a popular technique of financing among Islamic banks. Some of the Islamic banks that use this technique include the Islamic Development Bank, Bank Islam Malaysia and many commercial banks in Pakistan.

Under this scheme of financing, an Islamic bank purchases an asset as per specification provided by the client. The period of lease may be determined by mutual agreement according to nature of the asset. During the period of the lease, the asset remains in the ownership of the lessor (the bank) but its right to use is transferred to the lessee. After the expiry of the lease agreement, this right reverts back again to the lessor.

Leasing as a technique of Islamic finance holds a lot of promise and potential to develop into a viable and power tool of financing. At present, many Islamic banks are experimenting with various forms of leasing, one of which is the lease purchase agreement. In this scheme, the lessee can purchase the equipment at the end of the lease period at a price that is agreed in advance. In most cases, the payment may constitute two components; rent and a portion of the price to be paid in the instalments. In another variant of the lease purchase agreement, the rent may itself constitute the part payment of the price.

ijarah thumma bai: Leasing to purchase; the principle governing an *ijarah* contract at the end of the lease period, when the lessee buys the asset for an agreed price through a purchase contract.

ijarah wa iqtina: Lease to purchase; this term refers to a mode of financing adopted by Islamic banks. It is a contract under which the Islamic bank finances equipment, a building or other facility for the client against an agreed rental together with an undertaking from the client to purchase the equipment or the facility. The rental, as well as the purchase price, is fixed in such a manner that the bank gets back its principal sum along with some profit which is usually determined in advance.

ijtehad: *Literally*, effort, exertion, industry, diligence. *Technically*, endeavour of a jurist to derive or formulate a rule of law on the basis of evidence found in the sources.

index: A composite measure of the movement of a whole market or specific sector that consists of a number of stocks.

initial public offering: Issuance or selling of stock to the public for the first time (sometimes called ‘going public’).

iman *or* **fa inan**: Financial partnership.

istijrar: Recurring sale; different quantities are bought from a single seller over a period of time. Sometimes, it also refers to transactions whereby the seller delivers different

quantities in different instalments to complete the full purchase. There is some difference of opinion among scholars in terms of the timing of fixation and pricing.

istisna: Progressive financing; a contract of acquisition of goods by specification or order where the price is paid progressively, in accordance with the progress of a job. An example would be for the purchase of a house to be constructed, payments are made to the developer or builder according to the stage of work completed. This type of financing along with *bai al salam* are used as purchasing mechanisms, and *murabaha* and *bai muajjal* are for financing sales.

ittifaq dhimni: Pre-agreed contract; the sale and repurchase of an underlying asset. Prices are agreed in advance, prior to the contract, to allow the bidding process to take place.

ju'alal: *Literally*, the stipulated price for performing any service. *Technically* applied by some to the model of Islamic banking. Bank charges and commission have been interpreted to be *ju'ala* by the jurists and thus considered lawful.

jahl: Ignorance (of morality or divinity).

kafalah: Guarantee; *Shari'a* principle governing guarantees. It applies to a debt transaction in the event of a debtor failing to pay.

leverage: Trading an amount of a security using a fraction of its true value, the remainder of which is borrowed from the brokerage firm.

loans (with service charge): Some Islamic banks give loans with a service charge. The Council of the Islamic *Fiqh* Academy established by the Organisation of Islamic Conference in its third session held in Amman, Jordan from 8 to 13 Safar 1407 H (11–16 October 1986), in response to a query from the Islamic Development Bank, has resolved that it is permitted to charge a fee for a loan related service offered by an Islamic Bank. However, this fee should be within actual expenditures and any fee in excess of actual service related expenses is forbidden because it is considered usurious.

The service charge may be calculated accurately only after a certain period when all administrative expenditure has already been incurred, for example at the end of the year. Hence, it is permissible to levy an approximate charge on the client then reimburse or claim the difference at the end of the accounting period when actual expenses on administration become precisely known.

long position: Ownership of a security, with the right to transfer ownership and to benefit (or suffer) from the changes in its market value.

mark-to-market: An investment or a liability being revalued to the current market price.

market capitalization: Price per share of a stock multiplied by the total number of shares outstanding; the market's total valuation of a public company.

market order: An order to buy or sell a stock at the market's optimum price, without the customer specifying a price.

maysir: Gambling; one of three fundamental prohibitions in Islamic finance (the other two being *riba* and *gharar*). The prohibition on *maysir* is often used as the grounds for criticism

of conventional financial practices such as speculation, conventional insurance and derivatives.

muamalat (*alt. sp.* ***mu'amalah***, ***mu'amalat***, ***muamalah***): Economic transaction.

mudarabah (*alt. sp.* ***modaraba***): Trust financing; a form of business contract in which one party brings personal effort and the other capital. *Mudarabah* can be individual or joint. The proportions of profit shares are determined by mutual agreement. Any loss is borne only by the owner of the capital, in which case the entrepreneur gets nothing for his labour. The financier is known as '*rab-al-maal*' and the entrepreneur as '*mudarib*'. When adopted by Islamic banks as a financing technique, it is a contract in which all the capital is provided by the bank while the business is managed by the other party.

The profit is shared in pre-agreed ratios loss and (unless caused by negligence or violation of terms of the contract by the *mudarib*) is borne by the bank. The bank passes on this loss to the depositors. There is no loss sharing in a *mudarabah* contract.

The owner of the capital cannot interfere with the management of the business enterprise. This is the sole responsibility of the entrepreneur. However, he may advise on specific conditions to ensure better management of his money. That is why the *mudarabah* is sometimes referred to as a sleeping partnership. The profits may be shared between the parties in any pre-agreed proportion, but loss is to be borne completely by the capital owner; the agent loses any potential reward.

Islamic banks practise *mudarabah* in both its forms. In case of individual *mudaraba* an Islamic bank provides finance to a commercial venture run by a person or a company on the basis of profit sharing. The joint *mudarabah* may be between the investors and the bank on a continuing basis. The investors keep their funds in a special fund and share the profits without the liquidation of those financing operations that have not reached the final settlement stage. Many Islamic investment funds operate as a joint *mudarabah*.

mudarib: The person or party acting as the entrepreneur or agent in a *mudaraba* contract.

mu'amalah: *Literally*, an economic transaction. *Technically*, lease of land or of fruit trees for cash payment or a share of the crop.

mufawadah: An equal, unlimited partnership.

murabahah (*alt. sp.* ***morabaha***): Cost-plus financing. *Literally*, sale on profit. *Technically*, a contract of sale in which the seller declares his cost and profit. This has been adopted as a mode of financing by a number of Islamic banks. As a financing technique, the client must ask the bank to purchase a certain item on his behalf. The bank does that for a definite profit over the cost which is settled in advance. Some people have questioned the legality of this financing technique because of its similarity to *riba* (interest).

Murabahah has, in its modern form, become Islamic banks' most popular method of financing. It is estimated to account for 80–90% of the financial operations of some Islamic banks. A conventional interest-based bank would lend money on interest to a customer and the customer would go and buy the required commodity from the market. This option is not available to the Islamic bank, as it does not operate on the basis of interest; but nor can it lend money with zero interest rate, as it has to make some money to stay in the

business. Whilst a portion of total finance may be offered as an interest free loan, the banks still need to make profit in order to stay in business. The *murabahah* model is one solution. The bank purchases the commodity and *sells* it to the customer for a profit. The customer then buys the commodity on a deferred payment basis, so he gets the commodity and the bank makes a profit.

To meet standards of Islamic legality, the *murabahah* transaction is completed in two stages. In the first stage, the client asks the bank to initiate a *murabahah* transaction and makes a promise to buy the commodity specified, if the bank acquires the same commodity. This promise is not legally binding and the client may renege on his promise and risk the bank's investment. In the second stage, the client purchases the good acquired by the bank on a deferred payments basis and agrees to a payment schedule. An important requirement of the *murabahah* sale is that the two sale contracts should be separate and real transactions.

The *murabahah* form of financing is used widely by Islamic banks to satisfy diverse financing requirements such as consumer finance for purchase of cars and household appliances, in property finance and in the manufacturing sector to finance the purchase of machinery and raw materials. However, probably the most popular application of *murabaha* is in financing short-term trade.

musaqah: An agricultural contract where the owner of agricultural land shares its produce with another person in return for his services in looking after the crop.

musharakah: A form of venture capital, roughly translated as a partnership. In this method, two or more financiers provide finance for a project. All partners are entitled to a share in any profits at a pre-agreed ratio. However, the losses, if any, are to be shared exactly in the proportion of capital proportion. All partners have a right to participate in the management of the project, but partners also have a right to waive the right of participation in favour of any specific party.

There are two main forms of *musharakah*: permanent and diminishing.

In a permanent *musharakah*, an Islamic bank participates in the equity of a project and receives a pro rata share of profit. As the period of contract is not specified, the bank can continue for as long as the parties concerned wish it to. This technique is suitable for financing lengthy projects.

With a diminishing *musharakah*, equity participation and sharing of profit on a pro rata basis are allowed, but a method through which the bank continuously reduces its equity in the project, and ultimately transfers ownership of the asset to the participants, is also allowed. The contract provides for a payment, above the bank share in the profit, for the equity of the project held by the bank. In other words, the bank gets a dividend on its equity. At the same time, the entrepreneur purchases some of its equity. Thus, the equity held by the bank is progressively reduced. Eventually, the equity held by the bank will reach zero and it will no longer be a partner. This form of financing is increasingly being used by the Islamic banks to finance domestic trade and imports and to issue letters of credit, but there is no reason why it could not also be applied to agriculture and industry.

muzara'a: A contract whereby one person agrees to tend the land of another in return for a share of the produce of the land.

nisab: Exemption limit for the payment of *zakah*. Different types of wealth have different applications.

offer price: Ask; asking price.

option: A contract where the option writer grants the buyer the right to demand that the writer perform a specific act.

over-the-counter (OTC) market: A decentralized market in which international dealers negotiate trade for customers over the telephone or, increasingly, via an electronic trading system.

qard hasan: Interest-free loans; most Islamic banks provide interest-free loans to their customers. While this practice is not practicable on a large scale for commercial reasons, exceptions are made for the needy. According to Islamic teachings, loans should be offered free of charge. A person should seek a loan only if he needs it and there is a moral duty of the lender to help without taking advantage of the needy person. *Qard hasan* can indeed be translated as 'benevolent loan'.

Some Islamic banks provide interest-free loans exclusively to their investment account holders; others allow them on a case-by-case basis, for example, to students, small businesses, farmers and entrepreneurs who would otherwise be unqualified. In such cases, they can be seen as investments in people's futures.

qimer: *Literally*, gambling. *Technically*, an agreement in which possession of something depends upon the occurrence of an event which is inherently uncertain.

rab-al-maal: In a *mudarabah* contract, this is the person who invests the capital.

riba: *Literally*, an increase or addition. *Technically*, any increase or advantage obtained by the lender because of the loan, usually called interest. Any guaranteed rate of return on a loan or investment is *riba*. *Riba* is prohibited in Islam.

riba al buyu: A transaction in which a commodity is exchanged for an unequal amount of the same commodity and delivery of at least one commodity is postponed. As a form of *riba*, it must be avoided in Islam. The exchange of commodities should therefore be equal and instant.

riba al fadl: Usury of trade; an alternative form of *riba al buyu*.

riba al diyun: Usury of debt.

riba al nasia: Increment on the principal of a loan payable by the borrower, or the practice of lending money for any length of time on the understanding that at the end of this period, the borrower will return to the lender the amount originally lent, together with an increment in consideration of the lender having granted him time to pay. The mechanism was common in Arabia in the days of the Prophet Muhammad.

ruq'a: A banking instrument from the early Muslim period resembling a payment order to draw money from a bank.

sadaqah: Charitable giving.

salaam (*alt. sp.* ***al salam***, ***bai al salam***, ***bai salam***): Advance purchase for goods to be delivered at a specified future date. Normally, a sale cannot be set in motion unless the goods physically exist at the time of the deal. *Salaam* introduces an exception, as long as the goods are defined, and there is a fixed date of delivery and quality and workmanship. This mode of financing is often applied in agricultural contracts, where the bank's money is used to develop the crop in return for a share in its fruits, which the bank will then sell.

scrip: Document proving the share of a stock distributed by a company through stock, split or spin-off. The owner has the right to buy the remaining fraction to complete the share.

securities: Shares of stock bonds or any tradeable financial asset.

security: A transferable instrument evidencing ownership or creditorship.

settlement date: Delivery date; the day on which transaction certificates are due at the purchaser's office.

Shari'a (*alt. sp.* ***Sharia***, ***Shari'ah***, ***Shariah***): Islamic canon law derived from the *Qur'an*, the *Hadith* and the *Sunnah*.

***Shari'a*-compliant**: Meeting the requirements of Islamic law.

***Shari'a* board**: A committee of Islamic scholars from whom an Islamic financial institution seeks guidance and supervision when creating or modifying *Shariah*-compliant products.

shirkah: A contract between two or more persons who launch a profit-making enterprise.

shirka: Alternative name for *musharakah*.

short selling: Capitalizing from an expected decline in the price of a stock or other security by reversing the usual order of buying and selling.

stop loss order: A safety net for the customer by setting the sell price of a stock below the market price, thus locking in profits and preventing further losses.

suftaja*h** (*alt. sp.* ***suftaja, ***suftajal***): A bill of exchange between three parties – the payer, the payee and the transmitter – which was used for delegating credit particularly during the Abbasides period. It was used to collect taxes, facilitate governmental expenditure and transfer funds by merchants, especially travelling ones. *Suftajahs* had to be payable on a fixed date. Although similar to a modern bill of exchange, monies transferred by *suftajah* had to maintain their identity and currency. Finally, a *suftajah* could be endorsed, a process that had been present since the days of the Prophet Muhammad.

sukuk: Islamic bond; an asset-backed *Shari'a*-compliant bond. A *sukuk* offers proportionate ownership in the underlying asset, which will be leased to the client to yield a return.

Sunnah: Practice and traditions of the Prophet Muhammad.

tabarru': A *takaful* donation, whereby a participant agrees to donate a pre-determined percentage of his contribution to the fund to provide assistance to fellow participants, thus filling his obligation of joint guarantee and mutual help should another participant suffer a loss.

takaful: Mutual support based on the concept of insurance or solidarity among Muslims. Conventional insurance is prohibited in Islam because it contains elements such as *gharar* and *riba*, so *takaful* provides mutual protection of assets and property, and allows joint risk sharing. It is therefore similar to mutual insurance as members are both the insurers and the insured.

take a position: To hold stocks or bonds or to purchase securities as a long-term investment.

tawarruq: The opposite of a *murabahah*; a client buys an item on credit from a bank on a deferred payment basis and then immediately resells it to a third party for cash. This allows the client to obtain cash without taking out an interest-based loan.

ticker symbol: An abbreviated version of a company's name, used by stock-quote reporting services and brokerages.

trend: Movement in a security's market price or in the market itself for a minimum period of six months.

ujrah: A fee; the charge for using services.

volatility: The relative amount by which a stock's price rises and falls during a period of time.

volume: Number of bonds or shares traded during a specific period.

wadiah (*alt. sp.* ***wadia***, ***al wadia***, ***al wadiah***): The 'safekeeping' of goods by an Islamic bank with a discount on the original stated cost. The bank acts as the keeper and trustee of depositors' money and guarantees to return the entire deposit, or any part of it, should the depositor so demand.

wakalah (*alt. sp.* ***wakala***, ***al wakala***, ***al wakalah***): Agency; absolute power of attorney. An arrangement where a representative is chosen to undertake transactions on another person's behalf. In *takaful* transactions, *wakalah* refers to a chargeable agency contract.

waqf (*pl.* ***awkaf***, ***awqaf***): A charitable trust or endowment set up for Islamic purposes (for example, education, mosques or to assist the poor). It involves making a commitment on a property in perpetuity that it cannot be sold, inherited or donated.

write: Selling an option.

zakat (*alt. sp.* ***zakah***): Islamic tax; an obligatory contribution to the Islamic state or to the poor which every wealthy Muslim is required to pay. As the third pillar of Islam, *zakat* purifies wealth and the soul. *Zakat* is levied on cash, cattle, agricultural produce, minerals, capital invested in industry and business.

zakat al fitr: *Zakat* payable at the end of Ramadan by every Muslim able to pay. It is sometimes called *zakat al nafs* (poll tax).

zakat al maal: An annual levy on the wealth of a Muslim above a certain level. The rate paid differs in line with the type of property owned.

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* Compiled by Dr Aly Khorshid.