SUDAN: FORGOTTEN CENTRE OF ISLAMIC FINANCE

ZAKAT: FINANCE OR FAITH?

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FOOD FOR THOUGHT: INTEREST RATE RISK

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Deal not unjustly, and ye shall not be dealt with unjustly.

Surat Al Baqara, Holy Quran

With turmoil continuing to sweep across the global financial markets, the pressure is more than ever on Islamic finance to demonstrate its credentials as a viable, safe alternative to the conventional financial industry. Its underpinning principles of prohibiting speculation and interest whilst endorsing asset-based transactions are looked upon more and more favourably by practitioners across the globe. Even the Vatican has recently supported Islamic finance principles as a solution for the current worldwide economic crisis.

Could it be that, with interest rates in the conventional banking world approaching zero, the conventional sector will ape Islamic banking with profit sharing replacing interest? This issue is raised in the magazine’s new section, ‘Food for Thought’.

Islamic finance has many parallels with ethical and socially responsible finance, with zakat paid by Muslims being one of the core principles of the fair redistribution of wealth in the society. Many Muslim economists and jurists see the entire financial levy structure of an Islamic country built around zakat. The question is – does zakat represent finance or faith? Dr Azemuddin Subhani, who offered an original interpretation of riba on the pages of NewHorizon last year, ponders the subject of zakat and its relevance to modern times.

This issue of NewHorizon also features an in-depth analysis of Sudan, which claims to be the only country in the world with a wholly Islamic financial sector. Its neighbour, Ethiopia, is also moving towards Shari’ah-compliant finance, and further afield, the governments of two states in Central Asia, Kyrgyzstan and Kazakhstan, have amended their regulatory frameworks to accommodate Islamic financial institutions. Halfway across the world, US officials have also stated the country’s readiness to embrace the industry.

Closer to home, the Institute is working hard to promote the industry. It will hold a series of dedicated workshops and other events in London throughout 2009. Also, on 16th April, the IIBI will conduct a one-day workshop on sukuk; and on 7th August, it will begin a three-day residential workshop in the historic University of Cambridge, UK, to examine structuring innovative Islamic financial products.

Mohammad Ali Qayyum
Director General IIBI
France and Hong Kong encourage Islamic finance

The positive signals towards Islamic finance which emanated from the government of France in 2008 (NewHorizon, January–March 2009) have been translated into action in the form of specific changes to the tax code. The purpose of the changes is to ensure that Islamic modes of financing do not attract extra tax penalties in relation to conventional transactions. There would otherwise be a chance that an underlying asset changing hands – a necessary part of an Islamic transaction – would attract levies such as stamp duty. Because there is no requirement for an asset to change hands in a conventional transaction, such a tax would not enter consideration.

The change of the tax code has already encouraged some firms to move into France, including Islamic Finance Advisory and Assurance Services (IFAS), which decided to relocate in expectation of the change. IFAS is a UK-based Shari’ah-compliance advisory firm. Invest in France Agency (IFA), a group which encourages foreign direct investment into France, welcomed the move, reflecting the attractiveness of Islamic finance to markets in the West. There are between six and seven million Muslims in France, which is the largest concentration in Western Europe. A survey carried out in 2007 by the French Institute of Public Opinion (IFOP) suggested that half a million Muslims in the country would be interested in Islamic finance.

Senior officials in Hong Kong have echoed the moves taken by the French government. The secretary for the financial services and the treasury bureau of the Hong Kong government, Professor KC Chan, confirmed in a speech at the Asian Sukuk Summit, recently held in the country, that the government is finalising new tax laws. These would make sure that sukuk are treated in the same way as conventional bonds, relating to stamp duty, profits tax and property tax. Confirming Hong Kong’s interest in Islamic finance, Sam Kwok, treasurer at the Hong Kong Monetary Authority (HKMA), also suggested that Hong Kong plans to issue a sovereign sukuk when the market conditions are right.

Vatican backs Islamic finance

L’Osservatore Romano, a daily newspaper in the Vatican regarded as the mouthpiece of the Pope, has endorsed the values of Shari’ah-compliant finance as a solution to the problems in the world of conventional, interest-based finance. The paper suggested that the ethical foundations of Islamic finance should be adopted by conventional banks as a way of restoring the trust of their depositors and shareholders. It also stated the belief of the Vatican that the Islamic financial system could help the global financial system overcome the crisis.

‘The ethical principles on which Islamic finance is based may bring banks closer to their clients and to the true spirit which should mark every financial service,’ said L’Osservatore Romano. The article also quoted a fixed income specialist from Abaxbank Spa, the Italian investment bank of Credem Group, as saying: ‘Western banks could use tools such as the Islamic bonds, known as sukuk, as collateral’. Sukuk, the Shari’ah-compliant alternative to conventional bonds, could finance the ‘car industry or the next Olympic Games in London’. The Vatican has previously been critical of the destructive excesses of the interest-based conventional financial system during the ongoing crisis. The Pope, Benedict XVI, alluded late last year to the illusory nature of fiat money, and the Vatican has also recently been critical of the free market system.

Boost for Islamic banks in Kyrgyzstan

The country’s parliament has approved legislation enabling all commercial banks in Kyrgyzstan to operate according to Shari’ah principles. Until now, only one bank there, EcoBank, has had an Islamic window (NewHorizon, April–June 2007). It was initiated as a pilot project in the country’s banking sector and was issued an authorisation by the financial authorities to apply Islamic principles of finance (within the confines of the pilot project).

Now the regulators are hopeful that with the adoption of the new laws more financial institutions will move into Islamic finance. According to the Marat Alapaev, chairman of the National Bank of Kyrgyzstan (the country’s central bank and regulator), the introduction of Islamic banking in Kyrgyzstan alongside its conventional counterpart will enhance the range of products and services, facilitate competition in the banking sector and develop the country’s financial system as a whole. National Bank of Kyrgyzstan will be responsible for issuing licences to Shari’ah-compliant financial institutions, as well as supervising and regulating their activity.

A similar move has been recently made by Kyrgyzstan’s neighbour, Kazakhstan, with the president approving a range of amendments and additions to the existing legislation to accommodate Islamic finance.

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Two new insurance companies, Legal and General Gulf and Legal and General Gulf Takaful, have been licensed by the Central Bank of Bahrain. The two ventures have a total paid up capital of $26.5 million and were set up by a UK-based financial services provider, Legal & General Group Plc, and a local bank, Ahli United Bank BSC. The companies are to offer conventional and Islamic insurance products and services in Bahrain as well as other Middle East countries. Ahli United Bank’s existing branch network will be used to market the offerings.

‘The Middle East insurance sector continues to attract a lot of interest from international firms,’ said Ahmad Abdul Aziz Al Bassam, director of licensing and policy at the Central Bank of Bahrain. He noted that such factors as the country’s strong supervisory framework, well-developed infrastructure, strategic location and the availability of qualified human resources, have been attracting business to Bahrain.

Meanwhile, a local Islamic insurance provider, Solidarity Family Takaful, has teamed up with Nexus, financial advisory firm, to market a takaful offering in Bahrain. The product portfolio will include education and retirement protection plans, various saving and investment features, and life insurance. ‘We are seeing an increased demand for customised takaful products in Bahrain,’ says Gopi Rao, general manager of Solidarity Family.

Nexus will add the Islamic insurance line to its existing personal and corporate financial products. Nigel Watson, general manager of Nexus Bahrain, believes the new offering will become one of its most popular lines in the course of a year, with the help of Solidarity Family’s ‘strong localised service and marketing support’.

The International Zakat Organisation (IZO), a new charitable body of the Organisation of the Islamic Conference (OIC), has announced its selection of BMB Group, the Cayman Islands based global alternative asset management firm, to lead a new charitable initiative, the Global Zakat and Charity Fund. BMB Islamic (BMB Group’s subsidiary) is headed by Dr Humayon Dar, a leading figure in Islamic finance and close associate of the Institute of Islamic Banking and Insurance (IIBI).

The fund is expected to be $3 billion in size, and its purpose will be to fund charitable causes across the world, helping the needy and alleviating poverty. Zakat, one of the five pillars of Islam, is a religious obligation on Muslims to pay a prescribed percentage of their wealth to specified categories in their society, when their wealth exceeds a certain limit. The objective is to take away a part of the wealth of the well-to-do and to distribute it among the poor and the needy.

The Hon. Dato’ Seri Dr Ahmad Zahid Hamidi, minister in the Malaysian Prime Minister’s department and chairman of the board of directors of IZO, commented in his address at the signing ceremony that every Muslim ‘has the responsibility to solve the collective crises of poverty, corruption and inequality’.

As well as administering the fund, BMB will help encourage other OIC members onboard the project and its worthy goals.

Four general areas have been targeted for attention by the fund. These are: generation of income by private Shari’ah-compliant SME financing; assisting the establishment of the social infrastructure of deprived communities, including the building of hospitals, schools and housing; developing agriculture to ensure stable supplies of food; and disaster relief and emergency funding. The fund will enrol other institutions, such as governments, to assist in its work.

The fund will be co-managed by BMB Group and the IZO itself, and will be run on a professional asset management basis. ‘It is a long-awaited initiative,’ said Dr Dar, CEO of BMB Islamic. ‘Inevitably, there has been a huge emphasis on Shari’ah compliance in Islamic banking and finance, but the announcement of a Global Zakat and Charity Fund is the beginning of a new Islamic financial trend which favours social responsibility and community development. ’

Mohammad Hassan Esa, managing director and CEO of the IZO, who played an important role in its establishment, explained the importance of the new fund: ‘Zakat is a tool that can single-handedly eradicate poverty not only from the Muslim world but from the entire world. The only condition is that we collect and manage the funds efficiently. The Global Zakat and Charity Fund is a step towards achieving that efficiency.’
New Islamic investment product for Kazakhstan

Darahim Sukuk Basket has become the first Shari’ah-compliant product to be introduced to Kazakhstan’s financial market on a broad basis. The basket, with a value of $40 million, was introduced by Encore Fund Management Co Ltd, subsidiary of a Swiss management company, Encore Management SA, set up specifically to manage Islamic strategy portfolios. The company confirms that Darahim Sukuk Basket has already received commitments from investors for $23.5 million.

The product is a three-year note to be issued by BNP Paribas and is set to accumulate a portfolio of high grade rated sukuk issued in the GCC region, with the emphasis on Saudi Arabia.

According to John A. Sandwick from Encore Fund Management, the firm is ‘the first-ever investment company to offer high quality Shari’ah-compliant structured investments to Kazakhstani pension funds, corporate treasuries, commercial banks and national government agencies’.

Dhafer S. Alqahtani, CIO of Encore Fund Management, stated that this venture indicates the start of the remaking of the Silk Road, ‘by creating an important two-way flow of capital’. Kazakhstan and the Gulf region have many similar aspects, he added, such as abundant oil, gas and mineral resources, as well as up-and-coming markets ‘with a rich history and deep roots in Islam’.

Alqahtani is also setting up an investment company in Bahrain, Darahim Capital BSC (wholly owned by Encore Fund Management), which is currently awaiting regulatory approval of the country’s central bank. Once licensed, it will become the world’s first dedicated Islamic mutual funds company. Alqahtani noted that naming the sukuk basket ‘Darahim’ is strategic and in line with the plans to establish Darahim Capital.

Ethiopia latest in rush towards Islamic banking

The authorities in Ethiopia have approved the establishment of an Islamic bank. When set up, this will be the first in the country. The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) will conduct talks with the Ethiopian government, and a source stresses that it may take some time for the bank to become operational.

Ethiopia is the latest of a number of countries to embrace Islamic banking, other recent examples being Malta, Tanzania, Italy, Sweden and neighbouring Kenya (NewHorizon, January–March 2009). Ethiopia, situated in the Horn of Africa, is home to about 80 million people, and is thought to contain more than 25 million Muslims.

Australian Islamic co-operative awarded banking licence

The Muslim Community Co-operative (Australia) (MCCA) has recently received an Australian financial services licence from the Australian Securities and Investments Commission (ASIC). The licence will help the MCCA to attract partners and investors from abroad as well as from within the country, and should help the MCCA grow. It is also necessary for the MCCA to set up its Managed Investment Scheme, the ‘MCCA Islamic Finance Investment Fund’, by which the MCCA plans to launch its Shari’ah-compliant home finance products.

‘This is fantastic news as we have been working on this project for just over two years,’ said Chaaban Omran, the managing director of the MCCA. ‘This will represent a significant milestone in the history of the MCCA in that rather than be state-based, we can be federally regulated by ASIC.’ A new entity, MCCA Ltd, will be a public listed company. It will also be the first licensed Islamic financial institution in Australia.

The MCCA has until now been a mutually-owned co-operative. The plan for the next three years is to wind down the co-operative outfit and sell its assets to the new fund. And the intended launch date will either be 1st May or 1st July 2009. ‘A lot of work has been done recently to raise the awareness of the potential of the Australian market, and the role the MCCA can and will play in developing the opportunities for providing full retail Islamic banking operations in Australia,’ Omran said.
IFSBI issues new governance and capital adequacy guidelines

The International Financial Services Board (IFSB), the standard-setting body based in Malaysia, has recently adopted two new standards for Shari’ah-compliant finance. The two standards are, Guiding Principles on Governance for Islamic Collective Investment Schemes (IFSB-6), and Capital Adequacy Requirements for Sukuk Securitisations and Real Estate Investment (IFSB-7). They update and complement existing recommendations issued by IFSB in the past in their own particular areas. Specifically, they build on the standards of Guiding Principles on Corporate Governance for Institutions offering only Islamic Financial Services (IFSB-3), and Capital Adequacy Standard for Institutions offering only Islamic Financial Services (IFSB-2). These standards were formulated in 2006 and 2005 respectively.

IFSB-6 is designed to reinforce existing international best practices in the area of collective investment schemes, but also to address the specifics of the Islamic variants of this model of finance. It is split into four parts, which relate to general governance and the incorporation of best practices, transparency and disclosure issues, Shari’ah compliance, and the additional protection required by investors in Islamic collective investment schemes. IFSB-7 looks to cover those areas of capital adequacy which are not already covered by IFSB-2. This Standard applies to both issuing and originating Islamic financial institutions (including originating institutions that invest in Sukuk which they themselves originate). For real estate finance, IFSB-7 focuses principally on the capital requirements for a Shari’ah-compliant institution which invests its own funds in real estate investment activities. IFSB-7 also places importance on the necessity for those authorities which supervise Islamic banks to set appropriate threshold limits.

IFSBI, which is a global organisation, is comprised of regulatory and supervisory agencies, which all have a vested interest in ensuring the soundness and stability of the Islamic financial services industry. It covers a wide range of sectors, from banking and insurance to capital markets. Its membership has now reached the total of 178, including the International Monetary Fund (IMF), the World Bank, the Bank for International Settlements (BIS), Islamic Development Bank and Asian Development Bank.

Islamic hedge fund poised for launch

Amiri Capital, a Shari’ah-compliant global asset management firm, and Newedge, an international brokerage company, have teamed up to launch the first Islamic fund for the Middle East market. The fund, called Amiri Equity Alternative Strategies (AEAS), will be registered in the Cayman Islands, according to the Reuters news agency, and will include long and short hedge funds.

The original partnership for this venture consisted of Amiri Capital and Lehman Brothers, but the project had to be put on hold due to the latter’s collapse. Now the venture is back on track and according to Richard Ellis, Amiri’s co-founder, it won’t be long before AEAS commences its operations. ‘We are working with our seed investors to agree a time to invest in the market,’ he told Reuters. He added that the investors have already pledged assets to the fund, but investments will be made once the market starts picking up.

The fund will operate in compliance with Shari’ah principles, which means it will not undertake short-selling, as practised in the conventional markets. AEAS will apply a stock screening process to exclude companies that are involved in haram (prohibited) activities, such as gambling and alcohol, as well as companies that have debt to equity ratio, account receivables or interest payment exceeding certain limits. Certain types of derivatives will also be excluded. Hedge funds are a controversial subject, igniting a large amount of debate among Shari’ah scholars, with some considering hedge fund structures Shari’ah-compliant and acceptable, and others labelling them speculative and violating Shari’ah principles. NewHorizon has received a lot of feedback supporting each side of the argument after publishing an academic article, ‘Islamic hedge funds: work in progress’, last year (NewHorizon, July–September 2008).

AAOIFI to certify more vendors

Following Path Solutions’ iMAL core banking system receiving certification for Islamic compliance by the Accounting and Auditing Organisation of Islamic Financial Institutions (AAOIFI) (NewHorizon, January–March 2009), a source from the AAOIFI states that at least a couple of other vendors are in talks with the body.

It is likely that more banking system suppliers will receive certification soon. The AAOIFI has declined to name any of them, though the process with Path Solutions lasted seven and a half months, and covered both modules and contracts.
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Dubai Bank: taking the Shari’ah route

When the board of UAE-based Dubai Bank decided to convert from a conventional to a totally Shari’ah-compliant business model, the technology division had only six months to achieve this conversion. Don Brownlow, NewHorizon’s contributing editor, talks to two of the leaders of that conversion, which was the first step in a three-year IT strategy that culminates this year.

The bank was incorporated in 2002 as a conventional financial institution, but in mid-2006, the board of Dubai Bank decided to join the growing movement towards providing fully Shari’ah-compliant banking services and products. With the aim of launching Islamic operations on 1st January 2007, the bank had only six months to complete the conversion.

As can be imagined, ‘the conversion itself was the only initiative that the entire bank was focused on,’ says Faizal Eledath, chief information officer of Dubai Bank, who was brought in to oversee the systems aspects of the initiative. Although a three-year plan would soon be created, at the very beginning there was a freeze on any other IT initiative, so the bank’s focus was directed entirely on becoming Shari’ah-compliant. ‘We already had Islamic experts in the bank which helped us from the business definition and Shari’ah compliance standpoint,’ says Eledath. As is required in all Islamic banks, Dubai Bank formed a Shari’ah supervisory board (SSB) which was charged with advising and ensuring Shari’ah compliance. ‘The SSB also guided us with transformation,’ points out Eledath.

From a systems standpoint, the bank was using a conventional banking package as its core banking system. A decision was needed quickly as to what would be the future direction. The bank evaluated all options and made the decision to build its own Islamic banking solution. ‘We built a custom application to meet our Islamic banking needs,’ points out Ashraf Najim, project leader and the person responsible for the application portfolio at Dubai Bank. ‘It is a totally new Islamic module, named internally as Islamic Finance System (IFS), which handles our Shari’ah portfolio and allows for the Islamisation of our financial products,’ Najim continues.

The detailed functionality demanded from IFS was arrived at with the help of the bank’s Shari’ah experts. ‘Through them we got the Islamic knowledge of the products that we wanted to have in IFS,’ explains Najim (see Box 1 for an explanation of these products). All of the Islamic functionality was to be built into the new system. One advantage of this approach, in the bank’s view, is that the module can be independent of its core banking system but still share features such as customer information file (CIF) and general ledger.

‘IFS does all of the processing of the Islamic products, all of the payment schedules, all of the Islamic business functionality and transaction processing,’ explains Najim. At the end of the processing, only the general ledger accounting entries and information relating to the CIF are sent to the core banking system.

One of the most important differences between conventional and Islamic finance systems is the ‘profit’ calculations on customer accounts. So a key feature for the transformation process was the methods to be used to allocate profit amounts (see Box 2 for details). At Dubai Bank, the profit calculations for financing products are done within IFS, while the profit calculations for retail deposit accounts are done within the core banking system in a Shari’ah-compliant way.

The biggest challenge for the bank was the time that it had available. To mitigate the risk, ‘we had a very good governance process around the initiative, which meant we had people from the business including operations, the Shari’ah team, as well as the business units themselves’, claims Eledath. The implementation team was reporting to the bank’s executives and making decisions on a week-to-week basis. Because of the timeline constraint, the go-live had to be a big-bang, ‘as we did not have time for a phased approach’. So, to diminish that risk there were five test conversions (dress rehearsals) during the IFS application development. The bank went live, as scheduled, on 1st January 2007.

‘One of the hardest parts of the project was the migration of all the customers’ personal financings to the Islamic way of banking,’ recalls Najim. The approach that the bank took was to get each customer’s permission to move their account to the Islamic way. It did that by sending a letter to each customer saying that it is going to be Islamic and pointing out how all personal financing will operate. If the customer did not agree, they were invited to come to the bank and close their accounts prior to the conversion date. ‘Only a very few customers came back and said that they didn’t wish to continue,’ says Eledath, ‘most of them remained with us’.

For the actual conversion of the loan accounts, the bank took the outstanding prin-
The bank deciding to become Islamic was a business strategy that had evolved, so we had to align the IT strategy with that.

Faizal Eledath, Dubai Bank

Since the time of the conversion the bank has moved on. ‘When we started our IFS solution, it only covered retail products. Now we have also extended it to corporate ones,’ explains Najim. This has meant adding other Islamic products to the IFS repertoire (see Box 1) but has expanded the bank’s market through service offerings of cash management, treasury, trade finance, working capital, asset and project finance to SME and large corporates.

Eledath. ‘As we speak, there are initiatives underway to find out how our customers are reacting to our new banking services, but if you look at the transaction volumes of internet banking as an example, they are very high.’

Eledath is modest about what has been achieved, saying, ‘the critical thing is that it all boils down to having the right team, the right people and the right mandate’.
Some Shari’ah-compliant products and how Dubai Bank uses them

The Islamic products that were initially needed for IFS at Dubai Bank were oriented towards retail customers. The bank uses murabaha for auto financing, tawaruq for personal finance and ijara for mortgages. All of the transaction processing is done within IFS, including specialist processing, such as the commodity transactions necessary for tawaruq (as described below). The bank’s treasury department uses commodity murabaha for treasury operations. Later, with the launch of corporate banking, capabilities for sukuk and musharakah products were added to IFS.

Murabaha: This is the most commonly used instrument in the Shari’ah-compliant banking world. It has various forms, but the most basic is the ‘cost-plus’ form of financing. In the retail arm of Dubai Bank, this instrument is used for personal finance of specific items such as auto finance operating under the product name of ‘Markaba Auto Finance’.

In this form of transaction, the bank agrees to buy a specific item (in this case a car) and then sell it to the client for the cost price plus an agreed mark-up amount (profit). An essential part of the murabaha agreement is that the cost price and the mark-up are fully disclosed. The client can repay the bank in instalments over time (deferred payment). Once the mark-up amount has been agreed, that amount cannot change, even if the repayment time is extended.

The same instrument is also used for house purchase at Dubai Bank. In this case, the bank buys the property on behalf of the client and then sells it to the client on a deferred payment basis at an agreed marked-up price. The client repays the bank in instalments. At Dubai Bank this product is one of the options of its ‘Mulki Property Finance’.

Tawaruq: This is a variation of murabaha which is also known as commodity murabaha. In this case, the retail arm of Dubai Bank uses the instrument to provide personal financing to the client.

In its standard form, the process involves the sale and purchase of some easily tradable commodity (not gold or silver which have a special meaning in the Shari’ah). The bank is appointed as agent for the client and performs the commodity trades on their behalf. The process starts with the bank buying some commodity at market price (usually from a broker) and immediately selling it to the client on a deferred payment basis at an agreed marked-up amount to the original market cost. The client then sells the commodity, at a market price, to a third party for cash (this may be the original broker that sold the commodity to the bank in the first step of the transaction). The client then has a cash amount and an obligation to repay a higher amount to the bank. The marked-up amount represents the bank’s profit.

In some regions, a piece of land is bought and sold instead of a commodity.

At Dubai Bank, tawaruq forms the basis of its ‘Sanad Personal Finance’ product.

Ijara: This is a Shari’ah-compliant form of leasing. It is used in the retail arm of Dubai Bank as one of the options of financing home purchase through its ‘Mulki Property Finance’. The bank buys the property on behalf of the client who then leases the property back and makes regular agreed payment amounts. The lease payments contain the agreed lease amounts plus an element of capital repayment such that at the end of the lease period all of the bank’s original purchase price has been repaid and the ownership of the property is transferred to the leaseholder.

Musharakah: This is regarded by many as an Islamic banking product that follows the true spirit of the Shari’ah principles. It is a form of profit-and-loss sharing (PLS) financing arrangement in that the bank makes its money by sharing the profits and the risks of the business. In the standard form of this arrangement the bank, along with other investor(s), provides capital to the business in a partnership arrangement. The bank shares the profits of the business in a predefined ratio with the other investor(s). In the event of a loss, the bank shares that loss along with the other investor(s) in proportion to their original investments. Quite often, the bank will wish to reduce its investment over time, so the profit distribution from the business may include an element of repayment to the bank. This arrangement is known as a diminishing musharakah.
Musharakah is used at Dubai Bank to support its corporate banking activities.

Sukuk: Sukuk (plural of sakk) are often referred to as Islamic bonds. These do have similar financial characteristics to conventional interest-based bonds and are often used to finance large projects. A financial institution forms a special company (the sukuk company) to obtain funds from investors. In exchange for the funds, investors are given certificates (sukuk) that entitle them to share in regular profit amounts. The funds are used to finance a special project or fund some profit-making venture. Profits from that venture are collected by the sukuk company and distributed among the sukuk holders. From a financial institution’s standpoint it may be involved in the operation of the sukuk company or, more regularly, one of its clients may be a sukuk holder in which case the institution simply ensures that the regular profit payments are collected and the ‘face amount’ (often the amount of funds originally invested) is paid at the sukuk’s maturity date. This final repayment amount has caused some discussion in Islamic scholarly circles.

Treasury murabaha: This is essentially the tawaruq described above. The instrument can be used either by the bank to provide funds to other institutions (often other financial institutions through interbank treasury operations), or, when the flows are reversed, for the bank to receive funds from a depositor in the form of a fixed-term deposit. The treasury murabaha or tawaruq is characterised as often being for large amounts for fixed periods of time (often a year).

When the transaction is used by the bank to provide funds to another person or institution so that it receives back, at some future date, its original deposit amount plus a known marked up profit amount, it uses commodity trading as described under the tawaruq entry opposite.

When used as a deposit to the bank, the depositor buys some commodity to the equivalent value that they wish to deposit with the bank. The client then immediately sells that commodity to the bank on a deferred payment basis with the bank agreeing to pay the client, at a future date, the original sales price of the commodity plus an agreed marked-up amount that will represent profit to the client.

Profit calculations and how they work

In Islamic banking, any form of interest is prohibited but customers can benefit from profits made by the bank. As a simplistic example, the bank may use depositors’ funds to finance the building of an apartment block and then benefit from rental income which is distributed among the bank’s depositors. This would be how a mudarabah or musharakah account could work. Alternatively, it may use funds to provide a lease of capital equipment to a company and receive back lease payments that include profit.

In practice, the process is more complex. At Dubai Bank, as is most often the case at Islamic banks, an interim or ‘provisional’ rate is used to give some indication of the amount of bank outgoings to be given to savings/investment account customers in benefits. This rate is revised prior to actual payout and the calculation repeated using the ‘final’ or actual rate.

For a murabaha treasury deposit, the bank agrees upfront with the customer the amount of return that they will earn and will be due at the deposit’s maturity. This amount is amortised over the length of the deposit. This is the opposite of the calculation that is done in conventional interest bearing accounts where the amount of interest is accrued at a given rate during the term of the deposit.

For a murabaha financing, such as Dubai Bank’s Markaba Auto Finance, the amount of profit (or mark-up) is agreed with the customer at the time of the transaction. Under AAOIFI (Accounting and Auditing Organisation for Islamic Financial Institutions) standards, the bank records the total amount of profit as ‘unearned income from murabaha’ at the time the customer signs the agreement and amortises this amount into earnings over the term of the agreement.
The Islamic doctrine of zakat: finance or faith?

Dr Azeemuddin Subhani, who completed a PhD in Islamic Law and Finance at McGill in 2007, offered an original interpretation of riba on the pages of NewHorizon in 2008. He returns here to reassess the importance of zakat, the Islamic principle of charitable giving.

The above quoted command in The Quran – to establish salat (prayer) and give zakat (alms) – sets the tone for the central position of the concept of zakat in the belief system of Islam. The practice of zakat, being one of the five pillars of Islam, is an element of faith, although the historically evolved technical usage of the term colours it as a financial levy.

The resolution of this apparent lack of congruence between the scriptural and the technical usage lies in an examination of the term from a normative, historical and conceptual perspective.

The normative perspective

The zakat obligation, based on the Quranic, Prophetic/Companion Sunnaic and Ijmaic evidence, is enjoined by the repeated Quranic command to establish salat and give zakat, and is ranked as the third element of faith (thalit al-iman) by the Quran. The Sunnah of the Prophet treats zakat among the five pillars of faith. Ijmae justifies it because the entire Muslim community has agreed upon zakat being fard (compulsory).

The belief in zakat as an obligation of faith predates Islam to antiquity as, according to clear Quranic evidence, zakat (as well as salat) was prescribed in the earlier revealed Scriptures as well, through Prophets Abraham, Isaac and Jacob, Prophet Ismail, the Children of Israel, and finally, Prophet Jesus.

While warranting further research in the case of Judaism and Christianity, the practice of zakat in Islam has evolved and has come to be established as a well defined financial institution – from the concept of general charity and poverty alleviation to a fiscal levy – with specific definitions and evasion penalties.

The Islamic normative perspective of zakat is reflected in several Quranic stipulations which juxtapose zakat with salat, in at least 20 verses, describe zakat as purification, juxtapose charity (of property) with zakat and salat, contrast zakat with riba, associate denial of zakat with shirk (and consequent affliction), juxtapose sadaqah (charitable giving), zakat and salat, declare Divine exaction of sadaqah, reserve sadaqah for the eligible eight categories of recipients, and contrast sadaqah with riba.

The historical perspective

The early Quranic injunction stipulated the concept of obligatory help for the poor, the orphans and the deprived, as a rightful sharing between the rich and the poor, with the basic motive and enforcing power being the fear of God and the concept of individual responsibility before God in the Hereafter. The terms in vogue to describe this obligatory spending included infaq fi sabil Allah, sadaqah and zakat. However, the historical evolutionary process of these terms is complicated by the fact that the term infaq fi sabil Allah, spending in the way of Allah, which most closely describes this obligatory spending, got discarded and the term sadaqah, with its intrinsic meaning of truthfulness, acquired the status of general usage. The term zakat, with its intrinsic meaning of purification, acquired the status of technical/legal usage for this obligatory spending.

The textual support for the term sadaqah comes from the Quran and the Prophetic Hadith, both of which describe this obligatory spending as sadaqah and not as zakat. But the Prophetic Hadith also equates sadaqah with ‘impurities of the people’ (awsaq al-nas) unfit for consumption by the Prophet and his family. Finally, in the older Companions/Successor jurists’ period zakat as the technical term and its treatment as a state financial levy enforceable with punitive means were finalised and confirmed, except for a fundamental controversy as to whether the zakat obligation was discharged by payment to the state publicly, or by direct payment to the beneficiary privately?

The answer, with terminological and conceptual implications, is clearly dependent upon the
perception of zakat – either as a government- nel financial levy or as a faith obligation.

The conceptual perspective

The central conceptual question that this analysis will attempt to deal with – and perhaps answer – is ‘Why is zakat a fundamental pillar of religion if it is only a state financial levy and thus apparently not a faith issue?’ – or conversely – ‘Why is zakat a financial levy when it is a faith issue?’ and then, ‘What is the faith issue at stake?’ The conceptual model(s) to answer these questions rely on certain crucial relationships – Quranic and Sunnaic, above, and lexical and juridical, below:

Lexical relationship

The lexical meanings associated with zakat and sadaqah are the foundation of the conceptual lexical model (see p16).

The verb zaka means:

Verb form I: to be pure, just, righteous, good, fit, suitable; to thrive, grow, increase;
Verb form II: to increase, augment, make grow; purify, chasten; to justify, vindicate, vouch for, bear witness to integrity, honesty, uprightness; to attest to the truth, validity, credibility; to commend, praise; to recommend;
Verb form III: (not applicable to this verb);
Verb form IV: to cause to grow;
Verb form V: to be purified, be chastened.

It is significant, as above, that the verb zakā does not include almsgiving and, as below, the noun zakat does not include growth/increase.

The noun zakat means:

Meanings common to the verb and the noun: purity; justness, integrity, honesty; justification, vindication;
Meaning of the verb but not of the noun: to grow, increase, augment;
Meaning of the noun but not of the verb: almsgiving, alms, charity; legally prescribed alms tax; obligatory donation of food before Eid al-fitr prayer.

The verb sadaqah means:

Verb form I: to be true, correct, right; fit exactly, apply, keep promise; advise sincerely;
Verb form II: to deem credible; to believe; to consent, approve, sanction, certify, confirm, substantiate, attend, ratify;
Verb form III: to befriend, consent, agree, approve, grant, sanction, certify, confirm, substantiate;
Verb form IV: to fix a bridal dower (for a woman);
Verb form V: to give alms, donate.

The noun sadaqah means:

The noun conforms to verbal Form V only, meaning charitable gift; almsgiving, charity, voluntary alms; legally prescribed alms tax; obligatory donation of food before Eid al-fitr prayer.

The noun sadaaq means: a bridal dower.

The noun sidq means: truth; sincerity; veracity, correctness; efficiency.

The noun sadaaqa means: friendship.

The noun sadaaq means:

The technical Hanafite juridical definition of the obligatory alms is:

The giving (tamlik: transfer of ownership of a property), as an act of piety, of a legally stated portion of one’s property to a poor Muslim who is not of the Hashim family or their clients (mawla), in such a way as to preclude for the giver any sort of benefit. This absence of ‘reciprocities’, above, is the foundation of the conceptual philosophical model (see p17).

Proposed conceptual models

Based on the above relationships, the author of this article has developed three models – lexical, monetary and philosophical – in an effort to reconcile and synthesise the various, often conflicting, relationships outlined above.
**Monetary model**  
*(based on a translation of Quranic/Sunnaic injunctions in financial terms)*

**Postulate 1**  
A simple but necessarily very lengthy mathematical model, constructed by this writer, shows that the run out period to reduce a balance of 100 to near zero at 2.5 per cent per annum on declining balance is a staggering 540-plus years. The balance is reduced to 50 per cent in about 28 years, to 25 per cent in about 55 years, to eight per cent in 100 years, and one per cent in 180 years.

**Postulate 2**  
In a riba-based loan transaction, the interest rate, say 2.5 per cent, remains the same at 2.5 per cent for both the lender and the borrower because it is expressed as a function of the loan amount and not of the net worth of either party.

**Postulate 3**  
In zakat, however, the 2.5 per cent rate is expressed as a percentage of the giver’s net worth (over nisab – the minimum threshold), which, when expressed as a percentage of the recipient’s net worth (under nisab), equates to more than 2.5 per cent:

<table>
<thead>
<tr>
<th>Giver</th>
<th>Recipient</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.5% of 100 N.W = 2.50</td>
<td>= 50% of 5 N.W (assumed nisab)</td>
</tr>
<tr>
<td>(N.W = net-worth = zakatable assets minus debts held for minimum one year)</td>
<td>= 100% of 2.50 N.W (below nisab)</td>
</tr>
<tr>
<td></td>
<td>= 200% of 1.25 N.W (below nisab etc.)</td>
</tr>
</tbody>
</table>

The Postulates 2 and 3 provide a financial explanation of the Quranic verse (30:39) that riba does not increase, but zakat increases manifold.
NEWHORIZON Rabi Al Thani–Jumada Al Thani 1430

POINT OF VIEW

Philosophical model

This model is structured around the mathematical concept of ‘reciprocity’ – a function of ‘inverse correspondence’ – which finds a religious use in the juridical definition of zakat, above, which reads in part ‘the giving (tamlik) in such a way as to preclude for the giver any sort of benefit’. Reciprocity finds religious expression also in the prohibition of riba and the permission of bai.

Exchange of similarity

<table>
<thead>
<tr>
<th>Action ‘Give’</th>
<th>Reciprocity ‘Take’</th>
<th>Interaction result</th>
<th>Implication</th>
</tr>
</thead>
<tbody>
<tr>
<td>Excess: 1.1/1</td>
<td>1x1.1/1 = 1.1</td>
<td>Growth (self-generating) (prohibited by Quran/Hadith)</td>
<td>= Riba</td>
</tr>
<tr>
<td>Equal: 1/1</td>
<td>1x1/1 = 1</td>
<td>Subsistence made meaningless = prohibited by Gold for Gold Hadith</td>
<td>= Baqa</td>
</tr>
<tr>
<td>Less: .9/1</td>
<td>1x.9/1 = .9  }</td>
<td>Annihilation (Zakat) (enjoined by Quran/Hadith)</td>
<td>= Fana</td>
</tr>
<tr>
<td>Nil: 0/1</td>
<td>1x0 = 0 }</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Exchange of dissimilarity

<table>
<thead>
<tr>
<th>Action ‘Give’</th>
<th>Reciprocity ‘Take’</th>
<th>Interaction result</th>
<th>Implication</th>
</tr>
</thead>
<tbody>
<tr>
<td>Excess: 1.1/1</td>
<td>1x1.1/1 = 1.1</td>
<td>Increase (co-generating) (permitted by: ❖ Quran 2:275 ❖ Gold for Gold Hadith)</td>
<td>= Bai</td>
</tr>
</tbody>
</table>

Conclusion

The lexical model demonstrates that zakat – the third pillar of faith of Islam – is a concept much broader and deeper than a mere financial levy which has come to be its popularly understood technical meaning. The Quranic zakat obligation, enjoined repeatedly with the salat obligation on all humanity, represents a whole process of legitimisation, truthfulness, and purification. In the area of legitimisation of transfer of resources, it regulates the process of growth – actual or potential productivity. Through the fiscal levy (2.5 per cent zakat), it legitimatises and regulates material growth. Through the social levy (bridal dower and inheritance), it legitimatises and regulates procreational growth. Through the religious levy (sadaqah al-fitr and the historical sadaqah al-najwa), it legitimatises and regulates bodily and spiritual growth, respectively. This process of resource transfer and the financial levy thereon is part of the concept of zakat, because it is a process of regulation of growth, which has deeper theological and metaphysical implications. In the area of purification, zakat covers the whole state of purity and chastity represented by ablution, sexual discipline, fasting and state of ihram in pilgrimage.

The monetary model demonstrates the growth characteristics of riba and zakat. It illustrates that riba is a process of static growth, while zakat is a more than a lifetime process of purification (for the giver) and of unlimited growth (for the recipient).

Furthermore, this principle of unlimited growth, through self-sacrificing zakat as against self-seeking riba applies to all resources – whether physical or non-physical, i.e. monetary, physical, intellectual, political, social, cultural or human. For example, what a teacher shares with his student may be a fraction of the teacher’s knowledge reservoir but it could represent a 100 per cent increase in the student’s knowledge. The transfer from higher resource base to a lower resource base always triggers this unlimited growth.

In the case of riba, the growth of the loan is intra-active because the growth measurement agent is ‘single’, i.e. the common loan amount, and the interest received by the lender is growth thereon – thus a growth of similarity. This intra-active growth of similarity is prohibited (haram), as being self-generating and hence an incursion in the Divine domain.

In the case of zakat, the growth is inter-active because the growth measurement agent is ‘dual’, i.e. the different net worth of the giver and the net worth of the recipient. For the giver, zakat is a reduction of similarity – the zakat on each property was originally payable for that property alone. For the recipient, the zakat received and his net worth do not necessarily represent the same property. Thus this growth is an inter-active growth – a growth of dissimilarity. This inter-active growth of dissimilarity is prohibited (haram), as being self-generating and hence an incursion in the Divine domain.

In the case of riba, the growth is inter-active because the growth measurement agent is ‘single’, i.e. the common loan amount, and the interest received by the lender is growth thereon – thus a growth of similarity. This intra-active growth of similarity is prohibited (haram), as being self-generating and hence an incursion in the Divine domain.
full consonance with the mode of human creation, i.e. inter-action in pairs.

While the full treatment of these metaphysical questions is beyond the scope of this paper, the profound nature of zakat, beyond a mere financial levy, is clearly established in the process.

The philosophical model, based on the mathematical concept of reciprocity, demonstrates that growth from exchange of similarity (riba) is prohibited. Even the permitted growth from exchange of dissimilarity (from bai and from other legal resource transfers – dowry, inheritance, gift, waqf) is then subjected to a process of decrease through enjoinder of absence of reciprocity on a fractional basis, i.e. through the imposition of 2.5 per cent zakat on actually or potentially productive properties. This entire process emanating from reciprocity is thus a process of regulation of growth. In a universe of finite resources, infinite growth is not sustainable. Circularity and not linearity is the law of our existence.

In sum total, zakat (self-annihilation) is antithesis of riba (self-generation) and both extend beyond the monetary/fiscal manifestations. The relevant Quranic verses are not focused merely on the external manifestations of positive and negative growth. They in fact provide a mode of behaviour for mankind, which is:

- Meaninglessness (= prohibition) of self-subsistence (baqa);
- Prohibition of self-generating growth (riba) and permission of co-generating growth (bai);
- Enjoinment of self-annihilation (fana – zakat), on fractional basis.

In this prescribed scale of actions, if fractional self-annihilation (zakat) is practised, as required, the self-subsistence and self-generating growth modes are further automatically precluded. The practice of zakat, signifying self-annihilation through giving and perhaps also through waging jihad leading to martyrdom, being the only positive command in this scale, is included in the fundamentals of faith of Islam. The other two commands, prohibition of baqa and riba, by virtue of being negative commands are not appropriate for inclusion in a listing of fundamentals, but are nevertheless inherently covered by the list.

In fact it appears that the five fundamentals of Islam can be captured by two foundations – salat and zakat. Salat regulates relations with God, while zakat regulates relations with man himself.

The relevant question, then, is not what is embodied in the title of this paper – whether zakat represents finance or faith – but why is it misrepresented?

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The Innovators

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On the move

AREIT Management Limited, the manager of Arabian Real Estate Investment Trust (AREIT), has added Chris Purdon (left) to its management, as chief investment officer. As CIO, Purdon will be overseeing investments across the Middle East, including a Shari’ah-compliant real estate fund in Saudi Arabia. Purdon moves to AREIT from Landmark Real Estate Investment Management, where he was CEO, and the manager of two real estate funds for the Middle East. He also co-managed a pan-Asian real estate investment fund at Jardine Fleming.

Salama-Islamic Arab Insurance, a takaful firm listed on the Dubai Financial Market, has reorganised part of its top level management. Rafiq Halani has become general manager for general and health takaful. And Noel D’Mello has been named general manager for family takaful. Salama claims to be the largest takaful and re-takaful firm in the world, and saw overall revenue growth of 42 per cent in 2008. The shake-up reflects efforts to focus more on attracting new customers in today’s volatile climate, and to improve the existing management structure.

Al Khaliji Commercial Bank, a Qatar-based bank which offers both conventional and Islamic financial products, has named His Excellency Sheikh Hamad Bin Faisal Al-Thani as chairman of Al Khaliji, succeeding to Tariq Al Malki. Al-Thani held a number of prominent positions before joining the bank, including the post of minister of economy and commerce of Qatar and vice chairman at Qatar National Bank.

Elaf Bank, an Islamic wholesale investment bank, has hired Nasser Haram as general manager for support services. Haram will perform oversight of areas including financial control, risk control, operations, administration, human resources, information technology and public relations. Haram brings over 27 years of experience in Islamic and conventional finance, having worked as senior vice president of the Saudi Economic and Development Company, where he controlled over $1.5 billion of public and private equity. Before this, Haram was chief financial officer of Isam Kabbani & Company in Saudi Arabia and financial controller of Solidere Inc in Lebanon.

The global law firm, DLA Piper, has announced that Shezhaad Sacranie has joined its Abu Dhabi office as project finance and Islamic finance partner. Sacranie moves from Allen & Overy, an international law firm. The appointment reflects DLA Piper’s aspirations for the region, the outfit having also recently opened an office in Oman.

Malaysia Building Society Berhad has announced that En. Ahmad Zaini has replaced En. Ahmad Farid Omar as chief executive officer. Zaini has 24 years of experience in the banking and corporate sector, and moves from AmiIslamic Bank, where he was also chief executive officer for three years. Other previous roles include senior general manager of corporate banking at Ambank, and senior general manager and director of corporate finance at Perwaja Steel. He also spent four years at Bumiputra Merchant Bankers and Intradagang Merchant Bankers.

In the Maldives, the state minister for Islamic affairs, Mohamed Shaheem Ali Saeed, has been appointed by the Islamic Development Bank (IDB) to the post of alternate governor of the country. He will focus on facilitating the introduction of Shari’ah-compliant banking to the island. The Islamic Corporation for the Development of the Private Sector (ICD) signed a memorandum of understanding (MOU) with the Republic of the Maldives with the aim of looking into the feasibility of setting up such a bank in 2007 (NewHorizon, April–June 2007). Saeed has suggested that, since the country is 100 per cent Muslim, the banking system should reflect this fact.

Gatehouse Bank, the Islamic wholesale bank based in London, has appointed Philip Churchill (right) to its origination team as head of real estate. Before joining Gatehouse, Churchill gained experience in Islamic finance and real estate through posts at HDG Mansur, where he was head of investment management, and HSBC Amanah Global Properties Income Fund, where he was fund manager. Churchill also previously spent nine years at Citigroup, where he was engaged in the launch of two Shari’ah-compliant real estate funds in Europe.

Rushdi Siddiqui has been appointed by Thomson Reuters, the information service business, as head of its Islamic finance business. His primary occupation will be to work with professionals from the Islamic banking industry including fund managers, treasury, financial hubs, regulators, stock exchanges, central banks, takaful entities, halal industry, intra-OIC (57 Muslim countries), trade and investment. Siddiqui joins from Dow Jones, where he spent ten years. His career there culminated in the post of global director for the Islamic market indices.

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Interest rate risk: a threat to the Islamic banking system?

At first glance, this topic may be dismissed as contradictory. How can interest rate risk impact a banking system that is independent of interest? In this new section of NewHorizon, dubbed ‘Food for Thought’, two experts from the IIBI voice different viewpoints on the issue that may present a real challenge to the industry.

Don Brownlow, NewHorizon’s contributing editor:

‘Islamic banking can’t go against the traffic’ – note many practitioners. From a commercial point of view, the effective returns on Islamic accounts, both deposit and financing, need to be of the same scale as the conventional ones.

In reality, the disparity in real returns may potentially represent a threat to the Islamic banking industry, at least in the short-term. As base rates in the conventional banking world have begun to approach zero, the interbank rates, although slow to respond, have now also begun to fall. Although the majority of Islamic banking is conducted through murabaha and ijara, the rates of return on mudarabah and musharakah are not immediately similarly impacted. The real returns on those products are reflected in the profits made by those enterprises that are financed in the Islamic profit-and-loss sharing (PLS) concept.

So, the dilemma Islamic banks that have financed through mudarabah or musharakah may face is that their returns may be significantly above the rates achieved by conventional banking. They may now face the commercial risk of being overwhelmed by an influx of funds for which there is no short-term liquid market; or alternatively, they may face the ethical dilemma of reducing the real return on their PLS investments to bring them in line with the low interest rates of the conventional world. Sukuk issuers, that have benchmarked their returns from ijara or mudarabah investment pools against LIBOR or other interbank investment rates, may have to deal with this problem soon, as their steady investment returns will be much higher than international rate benchmarks.

Mohammad Shafique, IIBI programme development co-ordinator:

Islamic Bank of Britain’s indicative rate of return on its direct savings account has now gone down to 0.40 per cent from four per cent in August last year. At present, over 75 per cent of Islamic financial transactions are based on murabaha and ijara, and others may be wakala, salam or istisna, with a maximum of five per cent for PLS-based structures.

The Islamic finance industry, as it stands today, relies on debt-based structures instead of equity-based ones. Thus, it cannot offer a visible difference to depositors as well as borrowers. The industry’s size is still very small, compared to conventional finance, and hence, it is not in a position to influence the market. Therefore, there is no choice except to ‘follow the traffic’.

Conventional banks’ lending rates will stay positive even if the base rate goes down to zero and the same will apply to Islamic banks; the impact will be felt by depositors (savers), irrespective whether they are banking with Islamic or conventional institutions.

If Islamic banks use equity-based structures, like mudarabah and musharakah, on asset and liability sides ‘in substance’, their operations will be riskier. While this may provide some comfort in the present economic scenario, in the long term the real rate of return to depositors at Islamic banks will be low, due to compliance with regulatory and taxation rules. Capital adequacy requirements for equity-based products are higher than debt-based ones. Also, taxation treatment of debt makes it more attractive than equity.

In a nutshell, due to the above-mentioned issues, Islamic banking products are not very different from conventional ones. Is it not time to re-think and change the strategy for moving to equity-based structures at least in the markets that are more supportive of Islamic finance, such as Malaysia and Bahrain? Surely, once there is a success story in one market, it will become easier to emulate it in other places.

What do you think? The Institute is calling for the readers’ input and feedback on this subject, which will be discussed in more depth in the following issues of NewHorizon.

Please email us at: iibi@islamic-banking.com or editor@newhorizon-islamicbanking.com
Sukuk, their Applications and Challenges

George Green Building,
115 East India Dock,
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Sukuk (understood as Islamic bonds) are an increasingly important asset class and enable organisations to raise capital in a Shari’ah-compliant manner. Sukuk can be structured in a number of ways, some of them increasingly complex.

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- Issues arising in structuring Sukuk transactions, with the help of case studies
- How Sukuk may be used for project financing
- Process of Shari’ah compliance certification from the Shari’ah boards
- Controversy on Sukuk deals raised in 2008 and way forward
- Taxation issues for UK-based Sukuk issuers and investors

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Fax: +44(0)20 7245 9769
Sudan: forgotten centre of Islamic finance

When discussing Islamic economics, specialists usually cite Malaysia, Bahrain, the UAE, Iran and, of late, the UK, as evident examples. But such a country as Sudan is either not brought up at all or mentioned in passing. Meanwhile, Sudan is the only country in the world that has a wholly Islamic financial sector, argues Renat Bekkin, PhD in Law, senior researcher at the Institute for African Studies at the Russian Academy of Sciences.

In late 1970s/early 1980s, three countries – Iran, Pakistan and Sudan – embarked on the process of converting their financial systems to Islamic ones. This implied that starting from a predetermined date, all banks and financial institutions in these countries were to use only Shari’ah-compliant methods of financing in their work. In addition, Pakistan and Sudan introduced a new obligatory state tax – zakat (an religious obligation on Muslims to pay a prescribed percentage of their wealth to specified categories in their society, when their wealth exceeds a certain limit). However, the takaful (Islamic insurance) sector was left virtually untouched by the reforms in all three countries.

By the start of the new millennium it became apparent that Sudan was the only country that managed to successfully complete the project of Islamising its entire financial sector. In Iran, despite the official prohibition of interest (riba), interest-based transactions are quite common within the banking sector and the black market. For example, mudarabah (profit-and-loss sharing) comprises an ample portion of financing instruments in Iran, but in a form that does not really comply with Shari’ah – the profit of the bank is specified in advance and does not depend on the outcome of a project. Meanwhile, in Pakistan, after several attempts to eradicate interest-based banking, it was decided to adopt a dual model, thus giving equal ground to conventional and Islamic financial institutions.

In Sudan, following a failed attempt to Islamise the financial sector in the mid-1980s during the rule of president Jaafar Nimeiry, in the early 1990s Sudan’s current president, Omar al-Bashir, initiated another series of efforts to make Sudan’s financial industry Shari’ah-compliant. These economic reforms were less sporadic and more consistent, yet they were not introduced as rapidly as those during Nimeiry’s rule. From the early 1990s, the monistic model of the finance sector introduced by al-Bashir’s government has left no alternative to Shari’ah-compliant financing tools.

In 1992, the state established the High Shari’ah Supervisory Board, a supervisory council to oversee the progress of the reforms and their compliance with Shari’ah. The body was comprised of scholars, jurists and economists. Prior to this, some of the functions of the council had been carried out by the department of technical control at the central bank, Bank of Sudan. However, it never dealt with the issues of Shari’ah.

In 1998, a new clause was added to the country’s legislation, stating that the state directs the growth of the national economy guided by planning on the basis of work, production and free market to prevent monopoly, usury, fraud, and to ensure national self-sufficiency, abundance, blessings and the aims of justice among states and regions (Article 8).

The status of the High Shari’ah Supervisory Board is subject to the terms of the law regulating the banking activity (ordained in 2003). The council consists of eleven people, the majority of whom are Shari’ah scholars, although it also has economists and bankers (including the central bank’s governor) amongst its members. All members are Sudanese citizens and are appointed by the president of the country upon recommendation of the Bank of Sudan’s governor and the minister of finance. There is no time restriction on the mandate, so theoretically it can be a life-long post. The members are allowed to combine their membership at the council with the membership of the Shari’ah boards of commercial banks.

The decisions of the council are based on the majority of votes if agreement cannot be reached otherwise, but practice shows that in most cases consensus is achieved without voting.

The High Shari’ah Supervisory Board also acts as an appeal authority for disputes between various Islamic banks, Islamic banks and the Bank of Sudan, and an Islamic bank and its customers. Therefore, the council’s functions are not limited to the direct supervision over the country’s banking sector.

A bank can also turn to the High Shari’ah Supervisory Board as the ultimate authority if it doesn’t agree with a decision of its internal Shari’ah board. The distinguishing trait of Shari’ah boards of some Sudanese banks (e.g. at Tadamon Islamic Bank of Sudan) is that they act as in-house law departments and deal with various legal issues on a daily basis, carrying out the supervisory role at the same time. In the majority of Islamic banks across the world a Shari’ah board is
just a supervisory body, similar to the board of directors.

Fatwas (rulings) of the High Shari’ah Supervisory Board are not based on views of one particular school of law (for example, the Maliki school, which is dominant in Sudan).

In the period of 1999–2002 the country underwent financial reforms that introduced Basel requirements to the banking sector and aligned them with Shari’ah principles. Sudan learnt from the mistakes of similar reforms in other countries, including Pakistan, where the central bank simply executed orders of the ideological organisations, such as the Council of Islamic Ideology. The High Shari’ah Supervisory Board does not interfere in the issues outside its competence.

Today, all banks in Sudan use only the contracts that are halal (permitted by Shari’ah). Bank of Sudan does not differentiate between Islamic banks and those financial institutions that have conventional roots. The latter must use only the Islamic financial mechanisms approved by the central bank.

There are currently 30 banks in Sudan. A considerable portion of their business is focused on the foreign trade sector. The agricultural and livestock sectors are serviced by specialised banks, such as Farmers’ Commercial Bank, Agricultural Bank of Sudan and Animal Resources Bank. The latter has the Ministry of Finance among its shareholders. The bank’s share capital is $35 million and since its establishment in 1993, it has accrued a regional network of 18 branches. Its main activity is financing the export of cattle to Saudi Arabia, based on the murabaha mechanism (the exporter purchases the cattle) and the musharakah mechanism (the actual process of export—mainly services for the cattle drive from the breeding regions in the West Kurdufan province to Port Sudan on the Red Sea shore). Livestock financing comprises up to 80 per cent of the bank’s operations. Other banking services for this sector are offered through the subsidiaries and affiliated companies of Animal Resources Bank, namely Livestock Routes Company (provision of water for the cattle) and Animal Resources Services Company (import of the veterinary medicines). The finance models used are murabaha, musharakah and mudarabah. At present, the bank is financing a large-scale project of building of a slaughter-house in Omdurman, worth around $9 million.

Animal Resources Bank also offers standard services such as deposits (current, savings and investment accounts), money transfers and correspondent operations to the public and enterprises.

In the recent years, Sudan has experienced growth of Islamic microfinance. Islamic mi-
crofinance organisations face the same problems as the Sudanese banks: for example, an overwhelming majority of projects (up to 95 per cent) are financed using murabaha and only a tiny portion of ventures is based on musharakah.

Sudan-based financial institutions at present concentrate on the local market and their expansion abroad is unlikely. Moreover, the domestic growth of Islamic banking is being tapered. Thus, in 2007, following the civil war, all banks operating in Southern Sudan were told either to convert to the conventional way of conducting business or to cease their operations there. 15 banks that had branches in the south chose the latter option. By late February 2009, Faisal Islamic Bank, Omdurman National Bank and the Agricultural Bank of Sudan announced the closure of their branches in the region, resulting in the capital outflow of over $45 million. Conventional banks are taking the place of their Islamic counterparts, with around ten institutions now operating in Southern Sudan, including Kenya Commercial Bank, Nile Commercial Bank and Ivory Bank. The Bank of Southern Sudan regulates the activities of the financial sector in the region.

The issue of banning takaful companies in the south of the country was not as pressing as the prohibition of the Islamic banking activity, mainly due to the lack of takaful operators in that region. The majority of the population there is not covered by Islamic insurance. However, it is clear that the ban on Shari’ah-compliant finance in Southern Sudan will affect any takaful operators there, if no other reason than without Islamic banks, the activity of Islamic insurance companies will be virtually impossible.

Everywhere else in Sudan, the insurance sector must comply with Shari’ah, and it is stipulated in state legislation. The world’s first takaful company was set up in Sudan.

The main reason for the emergence of Islamic insurance in Sudan was the banks’ need to insure their operations according to Islamic principles. The issue was particularly acute in the sphere of marine insurance. Life insurance appeared later, but did not manage to gain popularity (alongside other savings-oriented products), due to the country’s rate of inflation of 50 per cent at the time.

Traditionally, in the conventional commercial insurance company the shareholders are the company’s owners. Therefore, all proceeds and profits belong to them. In the case of Islamic Insurance Company of Sudan, the shareholders retained the right to receive profits earned by the company. At the same time, the surplus was to be distributed only among the policy-holders in proportion to their contributions. The policy-holders also obtained the right to a portion of the profit gained as a result of the surplus investment. Furthermore, the insured party could also participate in the decision-making process of the company. The general meeting of the policy-holders takes place once a year, to discuss financial results and to elect a representative to a directors board (practically all boards of directors of takaful companies have a number of representatives of the policy-holders community, usually up to five people). The general meeting of the policy-holders can also provide recommendations to the shareholders of the company.

Islamic Insurance Company of Sudan was given a range of incentives, including tax exemption on all of its assets and profits. Also, the firm’s assets could not be confiscated or
nationalised. The regulatory framework for conventional insurance companies did not apply to the Islamic Insurance Company of Sudan. At the time, Sudanese lawmakers saw Islamic insurance as an alternative to conventional, and therefore takaful companies were not to be regulated by the conventional legislation, still present at that time in Sudan.

It took a while for the legislation dealing specifically with the takaful sector to be devised and implemented. The first reference to Islamic insurance in the country’s regulatory documents appeared in the civil code of 1983. By 1985, Sudan had four takaful operators.

In 1992, the state passed a decree on the control and supervision of the insurance sector, which stated that all insurance operators in Sudan must comply with Shari’ah principles. In 2001, more detailed legislation was adopted, and in 2003 the government expanded it further and passed the Law of Insurance and Takaful. Thus, Sudan is the only country today that has a completely Islamised insurance sector de jure.

Despite some deviation from the course along the way, Sudan became the only country that introduced reforms in the set direction more or less consecutively. The development strategy encompassed the transformation of the banking and insurance markets, as well as government bonds (the first Islamic bond was issued in 1999). However, none of the legislation covers Southern Sudan, where, as mentioned above, Shari’ah-compliant finance is banned.

Of course, creating an Islamic economy in Sudan would be much more difficult if it hadn’t received foreign assistance. The International Monetary Fund (IMF) played a significant role in supporting Sudan’s endeavours. Amongst other things, the IMF specialists helped to devise government bonds, based on the mechanism of musharakah.

In 1994, Khartoum Stock Exchange (KSE) was set up. Today, the exchange trades shares of 54 Sudanese companies, nine investment funds and twelve issues of government sukuk (Islamic bonds). KSE requires full information disclosure, which ensures a high level of transparency. The stock exchange has its own Shari’ah board, which screens and approves the products prior to their trading. Such a conservative approach prevents speculation. It is also worth noting that the banks in Sudan do not lend money for any speculative operations and finance only certain projects. Shari’ah prohibits short-selling, as one cannot sell what one does not own.

In 2003, KSE launched the Khartoum Index, developed with the assistance of the IMF. In five years it grew from 1000 to 2500 points. Today, KSE is one of the top five African exchanges – it ranks fifth, with the volume of trading around $5 billion (not including sukuk trading). Due to the prohibition of speculation, the price of the listed stock usually equals its nominal book value. For that reason, the problems of the world stock markets hardly affected KSE.

The listing rules of the exchange are stipulated in the Law of Khartoum Stock Exchange of 1994. The trading process is still manual, but a move towards automation is scheduled for the first half of 2009.

Like in many other countries, sukuk have been one of the most popular financial instruments in recent years in Sudan. Sukuk trading accounts for a major segment of KSE’s activity, with the choice of musharakah, ijara and government investment certificates.

Government musharakah certificates (GMCs) are medium-term securities, based on various contracts financed by the Ministry of Finance of Sudan via the isticna, murabaha and ijara tools. Issuance of these sukuk is similar to the conventional securitisation, where the Ministry of Finance acts as the originator. GMCs are based on a limited mudarabah, which means that the raised money is invested solely in the projects stipulated in the original contract.

Ijara certificates of the Bank of Sudan (CICs) are backed by the buildings owned by the central bank. According to the law, Sudanese banks must invest up to 30 per cent of deposits in CICs. These bonds use ijara as the method of financing. At the end of each term, an independent surveyor evaluates the buildings.

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All of the afore-mentioned sukuk can be invested in only by banks, and only banks are permitted to resell them.

In October 2003, the Ministry of Finance set up a special committee to deal with sukuk, with the main task to research the ways of effective use of the attracted funds. The advantage of issuing government sukuk is that they are based on actual, tangible assets. Such instruments help to contain the inflation level (additional banknotes are not printed, and therefore, the money supply is not increased). In five years, Sudan’s Ministry of Finance raised around $3.5 billion via sukuk (about $600 million annually).

Although sukuk is still issued as a hard copy in Sudan, a depository has recently been set up and there are plans to automate the clearing process in the near future.

The reforms have also addressed the country’s fiscal policy. However, the government has not achieved the same results as in the banking sector. In 1984, it passed a law on zakat and taxation. Unlike the preceding legislation of 1980, where zakat was a voluntary act, the new regulation made it obligatory for all Muslim citizens of Sudan residing in the country and outside it.

A decree in 1984 made void 19 laws that regulated various taxes and levies, including the excise duty on alcohol, which made a substantial regular contribution to the budget. Instead, the government introduced three new taxes: stamp duty, social solidarity tax for local non-Muslims and foreigners residing in Sudan, and development tax.

The latter does not quite fit in the strategy of creating an Islamic financial system, as Shari’ah, whilst not having anything against capital investment, strongly opposes hoarding. Unfortunately, these reforms were ill-timed – in 1984 Sudan experienced one of the worst droughts in history. It transpired very quickly that the results of the undertaken reforms did not meet the expectations of the government. By the end of the first fiscal year since the introduction of zakat, the budget received a considerably lower sum than the anticipated $51.7 million. A few weeks after the budget announcement, the government was forced to introduce a value added tax (VAT) and social fairness tax.

The new government that came to power a year later, restored the previous tax policy, but zakat retained the status of a state financial levy. Today, the zakat system exists independently from the rest of the fiscal system in Sudan. Zakat is paid prior to paying taxes and from a fiscal point of view it is calculated as costs, i.e. the taxed sum is reduced by the amount of zakat payment.

Sudan tried to avoid the serious mistakes that were made during tax reforms in Pakistan and attempted to couple the zakat collection with the ease of the tax burden rather than its increase. But the financial system, thus depriving it of the opportunity to function as the core. Furthermore, the zakat collection and distribution scheme is far from transparent, making it easy to abuse the system. At present, the government is working on a new model of zakat allocation, according to which the funds will be issued directly to the needy.

As for another important Islamic charity institution, waqf, it has not yet found any application in the Islamic economic infrastructure of Sudan. The majority of waqf endowments are circulated in the religion-related sector. Waqf is well established in the form of shops that sell gold items and other articles on the territory of the mosques.

Overall, Sudan’s Islamic economic system has proved to be effective. It has been developing continuously since the establishment of the country’s first Shari’ah-compliant bank in 1977. However, whilst acknowledging Sudan’s progress in creating an Islamic financial sector, many specialists point out that the undertaken reforms brought the country political, rather than economic dividends. Its Islamic financial institutions in reality do not fulfill the role they should in a poor agricultural country. The overwhelming majority of Islamic banks tend to invest in short-term commercial projects using murabaha, rather than in the industrial or agricultural sectors. 90 per cent of investments of Sudanese banks are made in the export and import operations, whilst the agricultural sector gets no more than four per cent.

Without doubt, the consistent approach of Muslim scholars and practitioners in Sudan has helped the market to avoid a number of problems related to applying some questionable mechanisms, like reverse murabaha or tawaruq (a sale of a commodity to the customer by a bank on deferred payment at cost-plus profit). On the other hand, Sudanese banks drastically lack creativity, which would enable them to expand the product range. In addition, the deficiency of competition from conventional counterparts adversely affects the process of introducing innovations to the marketplace.
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Craig J Dent, Director, Revenue Resources Pty Ltd., Australia. (Participant 2008)

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Promoting Islamic finance

January: The way forward for Islamic structured products

Ahmad Chaudry explained the current status of the Islamic structured products industry and suggested that the way forward for these instruments would be in offering unique, bespoke solutions matching investors’ requirements with consideration not only to Shari’ah-compliant contracts, but also underlying assets, strategy and wrappers.

Chaudry is a dynamic strategies structurer with the equities division at RBS Global Banking & Markets. His primary responsibility involves the development of conventional and Shari’ah-compliant trading algorithms for retail, private and institutional clients. An aerospace engineer by academic background, Ahmad has also worked at HSBC Global Markets and HSBC Amanah.

The lecture was chaired by Iqbal Asaria from Afkar Consulting Ltd.

Structured finance has no particular definition. Generally, it involves the combination of various legal structures to achieve a certain solution or products matching investors’ requirements. Normally, the starting point is to analyse the commercial objectives of the investors. Once those are known and clearly set out, then it becomes a question of looking at the possible Shari’ah-compliant financing techniques and undertaking any necessary due diligence, which may extend to matters such as legal research, tax analysis and a review of underlying assets that are to be employed in Islamic financing or investments structures.

After describing the structured products, Chaudry mentioned that for centuries, Muslims all over the world have conducted commodity-based trades, financed ambitious projects and managed their physical/cash wealth in methods consistent with Islamic law. As a result, they have gained a highly sophisticated understanding of transactions, based on a prescribed set of Shariah-compliant contracts.

Islamic financial institutions employ a board of Shari’ah scholars with the primary aim of reconciling the Shari’ah requirements and the law of the land in the business transactions. He pointed out that enormous development has been made in innovation of various Shari’ah-compliant contracts used in Islamic structured products in the last 25–30 years, for which credit goes to Shari’ah scholars, lawyers and practitioners. However, to achieve the true potential of Islamic structured products, there is a need to focus on the underlying assets and strategy for investment which received little or no consideration so far. In 1999, the Dow Jones Islamic Index was launched which employs various sectorial and financial criteria for the screening of stocks for Shari’ah-compliant investments. While it was a good start to facilitate Shari’ah-compliant investment transactions, for Islamic product structurers it really did not meet the objectives of their clients, especially those who wanted to invest in particular sectors or wanted to take a specific (either bullish or bearish) view on the stock. The problem is that after business and financial screening, the available universe of stocks becomes very limited and difficult to invest in due to liquidity (and sometimes foreign ownership issues) and it does not meet the requirements for big investments. On top of this, hedging the investment becomes a real problem due to lack of active secondary market and wide bid-offer spreads on such stocks.

Chaudry then proposed that the true potential of Islamic structured products can only be realised if there is a shift from Shari’ah-compliant to Shari’ah-based structuring. He pointed out that such strategies meet very well the investors’ investment objectives and are gaining more popularity. These strategies change the allocation (and weighting) of investment in various stocks over time. Then, he went on to explain the concept of dynamic weighting and risk allocation in such structured products with the help of an example of three stocks. If an Islamic investor has $1 million for investment and based on his requirements there are three Shari’ah-compliant stocks available to invest in, the weighting of investment in each stock will be monitored and adjusted continuously, either on a weekly or monthly basis, after looking at the pattern (upside as well as down side) in the respective stock movements. If in the portfolio of three stocks, A, B and C, a weighting of 50 per cent was assigned to stock A, and 25 per cent to stock B and C respectively, and the value of stock C appreciates in a week’s time, then weighting of stock C and A will be adjusted after one week to match the investor’s requirements. He emphasised that it is the shift in selection of underlying assets, strategy of investments and wrapper used for such products that will bring credibility to Islamic structured products and make them different from conventional ones.

After the presentation, participations raised various questions about the costs of employing dynamic strategies, why bid-offer spreads are so wide in Shari’ah-compliant stocks and the risk management techniques which may be used in dynamic structuring strategies.
February: The appeal of Islamic finance to investors seeking ethical alternatives

Naveen Raza, head of Islamic finance at Africa Invest Fund Management (AIFM), explored the appeal of Islamic finance to ethical investors and used a case study to illustrate an example of an Islamic investment with ethical and socially responsible appeal.

Ms Raza specialised in Islamic finance by becoming the very first graduate on the HSBC Amanah Graduate Programme. At HSBC, she worked in various departments including wealth management, global onshore banking and HSBC Amanah private banking. She is currently head of Islamic finance for AIFM, part of Cru Investment Management, a UK-based firm. In her latest role, Ms Raza is working on the first Shari’ah-compliant African agriculture fund, which aims to help alleviate poverty in sub-Saharan Africa while also offering attractive returns to investors.

The lecture was chaired by Mohammed Amin, partner, PricewaterhouseCoopers LLP and a member of the IIBI editorial advisory panel for NewHorizon.

Following the credit crunch, investors are now looking for alternatives to conventional banking methods which led to the financial crisis in the first place. Many have argued that global economies are ‘broken’ and new more ethical practices must be sought. Islamic bankers have taken this opportunity to highlight the benefits of Islamic finance which has been shielded to some extent from the troubles that conventional banks have faced.

Ms Raza started off by examining the Islamic equity markets, using the Dow Jones Islamic Indexes for October 2008 and comparing them to their conventional counterparts. The table above shows that there was not a vast amount of difference between the two: She then went on to look at other asset classes in the Islamic world, such as the property and sukuk markets, which have suffered in the credit crunch in similar ways to their conventional counterparts. From this, Ms Raza concluded that although the Islamic sector has been shielded to some extent from the problems of the global economy, there is no doubt that Islamic investors have still suffered heavily.

She then went to ask: the global economy is in meltdown... what’s next? The answer lies in more ethical banking practises. Ms Raza went on to make a comparison between Islamic finance and ethical investing. She discussed the overlaps – such as screening out companies whose activities are seen as harmful to society – and the differences, such as the ban in Islamic finance on short-selling and investing in conventional finance/banks. Furthermore, Ms Raza discussed what each type of investment practice can learn from the other.

Ms Raza then talked about AIFM and its origins. The concept was the brainchild of Cru and Africa Invest chairman, Jon Maguire, who was moved to do something about the plight of orphan children in some of the world’s poorest countries. She went on to discuss the company’s investment philosophy which believes in investing in human endeavour and human capital rather than capital markets.

AIFM currently has one fund which invests into commercial agriculture in sub-Saharan Africa, working on large commercial farms and with smallholder farmers. It is now due to launch a second fund in May 2009, to replicate the model in another seven sub-Saharan countries. The fund has multiple aims including increased food security, poverty and hunger alleviation, achieving the UN’s Millennium Development Goals as well as offering attractive returns to investors.

Ms Raza used this case study to demonstrate how a Shari’ah-based product can achieve multiple bottom lines for the investor but also contribute positively to society. The fund aims to return 15–25 per cent per annum, showing that investment returns need not be compromised in order to achieve social returns. AIFM has strict...
policies in place to ensure that the African farmers are being treated fairly. According to Ms Raza, the motivation behind launching the fund was to assist the rural poor of sub-Saharan Africa to help themselves out of poverty as well as become contributors to global food security.

She concluded her presentation by stating that there are always risks associated in starting new venture, especially when investing in developing countries. However, Islamic investing is about sharing risk – not shying away from it. ‘Intelligent risk mitigation strategies are needed in order to effect such investments,’ she stated. ‘This requires thought, innovation and to some extent a leap of faith – but that is what Islamic finance is all about.’

After the lecture, participants raised questions about the competition in this area of investment especially when countries like China and the UAE were making investment in some African countries to ensure their food security; how AIFM will use returns in some African countries to ensure their food security; how AIFM will use returns in some African countries to ensure their food security and how Islamic investing is about sharing risk – not shying away from it. ‘Intelligent risk mitigation strategies are needed in order to effect such investments,’ she stated. ‘This requires thought, innovation and to some extent a leap of faith – but that is what Islamic finance is all about.’

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Derivatives are financial instruments that derive their value from underlying assets. There are many derivatives products available in the conventional financial markets; most common are futures, swaps, forwards and options. Negative connotations of excessive risk taking or gambling are attached to derivatives, especially after the huge losses incurred by AIG, brought on by its extensive use of credit default swaps, but these products were originally developed to provide low-cost protection, or hedging, against unwanted market trends.

Ms Abd Rahim pointed out that Shari’ah-compliant funds are seeing strong demand and leading to an increased number of Islamic fund managers. Islamic fund managers are restricted from carrying out conventional derivatives trading as it contravenes Shari’ah. She argued that in the prevalent market conditions, there is a case for allowing Islamic fund managers, sovereigns and Islamic financial institutions to access to Shari’ah-compliant hedging techniques. A challenge for the Islamic finance industry is to further probe Shari’ah-compliant derivatives for risk-mitigating strategies.

Although Shari’ah-compliant versions of these instruments do exist in some cases, the liquidity associated with these markets is considerably reduced compared with the conventional alternative. Traditionally, scholars saw these instruments as speculative and a form of gambling. They are now increasingly being accepted as a hedging tool. She mentioned that the most common Shari’ah-compliant derivative structures are the wa’ad followed by the arboun (resembling a forward sale) and the salam (resembling a forward sale).

She then discussed the elements of conventional derivatives that contravene the principles of Shari’ah. A basic principle of Shari’ah is that there must not be any gharar, or excessive uncertainty, in relation to any trade. After examining the conventional future trading sequence, she questioned whether current futures trading carries excessive risk or uncertainty any more than other forms of financial trade. Another fundamental Shari’ah rule is that trade should happen at spot with both counter-values being exchanged at spot. If the seller does not own the asset at the time of effecting the trade and subject to certain exceptions, this breaches the fundamental Shari’ah rule that one must not sell what one does not own. Another issue related to the lack of possession is where there is a resale. In practice, futures trading works on the principle of margin accounts, effectively allowing traders access to interest-based leverage which would breach Shari’ah principles.

At the close of her presentation, Ms Abd Rahim raised points about the regulation of Islamic futures trading; could Shari’ah-compliant futures trading be tailor-made to be less uncertain than its conventional counterpart? To remove access to leverage and involvement of riba (interest) she considered whether it would be possible for a futures trade to require a 100 per cent deposit, and whether this would address the issue of speculation.
Mohammad Ali Qayyum, director general of the Institute of Islamic Banking and Insurance (IIBI), has recently visited India at the invitation of Mehroof Manalody, managing director of G-TEC Computer Education, for the launch of Islamic finance courses at the company’s headquarters in Calicut, India.

The courses have been developed by the IIBI and the Association of Business Executives (ABE) and offered by the Association of Business Practitioners (ABP). G-TEC is the training division of the Glosoft Technologies (P) Limited based in India. It is one of the largest computer education networks with 238 training centres in both local and international markets, including Saudi Arabia, Kuwait, Dubai and Iran.

The launch ceremony was attended by national and international delegates including organisations such as the ABE, British Computer Society, International Association of Book-keepers and De Montfort University from the UK. V. P. Abdul Kareem, chairman of G-TEC, hosted the event which was attended by over 300 representatives from G-TEC centres. The launch of Islamic finance courses in India will give G-TEC students an opportunity to build their knowledge and skills for a career in the growing field of Islamic finance worldwide. The courses include the Concepts and Principles of Islamic Economics and Islamic Finance.

On successful completion of both programmes, candidates will be eligible for exemption from the first two modules of the IIBI's Post Graduate Diploma (PGD) course on their enrolment, subject to fulfilling other entry criteria. Upon completion of the PGD, students can enter the Masters Programme at the University of Durham, a highly ranked UK-based university.

G-TEC is now accredited by the Institute to deliver the Islamic finance courses and a long-term association with G-TEC is an opportunity for the IIBI to raise the awareness of the industry for the large Muslim population in India, as well as specifically those who wish to study in the UK or consider a career abroad. One of the key challenges facing Islamic finance today is the availability of qualified human capital. G-TEC's offering will certainly help in bringing a pool of talented people to the Islamic finance industry through its well-established networks and state of the art IT facilities. It will enable potential students to achieve an international qualification in Islamic finance and facilitate their career building in this sector.

Andy Eames, ABP’s representative, requested Qayyum to present the plaque from the ABP to Manalody confirming the accreditation given to G-TEC. This was followed up by an award ceremony. Qayyum was requested to present nine laptops and twelve camcorders to students whose names were drawn from a list of entries.

Hennie van Greuning, senior advisor in the World Bank Treasury, visited the IIBI in early March 2009. He was received by Mohammad Ali Qayyum, director general of the Institute, along with Mohammad Shafique, programme development co-ordinator. Qayyum briefed him on the IIBI’s efforts to expand its courses in Islamic banking and also introduce new courses on takaful. Van Greuning is associated with Islamic finance efforts at the World Bank and has co-authored a number of publications.

He expressed his interest in assisting the IIBI with the development of courses in Islamic banking, in particular the lessons dealing with Islamic accounting, risk and governance. Van Greuning is a CFA charterholder and a chartered accountant. He worked in an international accounting firm and a central bank before moving on to the World Bank. Together with his colleague, Zamir Iqbal, van Greuning has recently co-authored ‘Risk Analysis for Islamic Banks’, which was well-received by the industry’s practitioners.
GK Partners, advisers to socially responsible business, and the IIBI are to organise one-day workshops on ‘Access to Islamic Finance’ at The British Library. The last two workshops, held in December 2008 and February 2009, were very successful.

The next workshop will be held on 27th April 2009, followed by one every two months until end of 2009. The programme explores Shari’ah-compliant financing options available to small and medium size enterprises (SMEs) in the UK. This sector of the economy is badly affected by the current financial crisis, due to the decrease or non-availability of business credit from conventional banks.

The workshops start with an introduction to Islamic financial principles compared and contrasted with conventional finance. The main prohibitions in Islamic finance such as riba (interest), gharar (excessive risk or uncertainty) and maysir (gambling) along with other prohibited activities are discussed.

The workshops draw attention to the strong parallels between ethical or socially responsible investments and Islamic investments. In both cases, business, financial and social screening criteria are used to exclude companies which contravene the underlying ethical and Shari’ah principles. The main types of equity investments, such as musharakah and mudarabah, and debt-based financial structures such as murabaha, ijara, salam and istisna are introduced. To reinforce understanding of Islamic contractual structures and the state of the sector in the UK, participants are given role-play exercises for them to analyse and explain the structural nature of the different types of Islamic commercial and personal finance products available in the UK.

The final session of the workshop broadly outlines the key principles for preparing business plans suitable for raising finance from Islamic financial institutions. Each workshop has a maximum of 20 participants.

ISRA head of research visits IIBI

Dr Asyraf Wajdi Dato’ Dusuki, head of research affairs at International Shari’ah Research Academy for Islamic Finance (ISRA), has recently called on the IIBI and met with Mohammad Shafique, IIBI programme development co-ordinator.

Dr Dusuki was accompanied by Dr Humayon Dar, CEO of BMB Islamic. Shafique shared with Dr Dusuki the Institute’s history and current activities.

In turn, Dr Dusuki explained the reasons for establishing ISRA which was set up last year with the support of Bank Negara Malaysia (the central bank of Malaysia) and aims to be the premier Shari’ah research centre in Islamic finance promoting applied research. It will also act as a repository of knowledge for Shari’ah views or fatwas, and undertake studies on contemporary issues in the Islamic finance industry.

The discussions covered the avenues of co-operation between ISRA and IIBI and the possibility of working together in undertaking research related programmes in Shari’ah-compliant finance in the future.

AAOIFI director calls on IIBI

Khairul Nizam, director at the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), has recently visited the IIBI and Mohammad Shafique, the Institute’s programme development co-ordinator.

They discussed areas of mutual interest. Nizam briefed Shafique about the AAOIFI’s continuing efforts in developing accounting and Shari’ah standards. Shafique updated Nizam on the Institute’s efforts to expand its activities, in particular introducing new courses and increasing the number of training workshops from previous years.

The IIBI and AAOIFI have a memorandum of understanding (MOU) in place to support each other and the Institute conducts AAOIFI's Certified Islamic Professional Accountant examination for the UK and European candidates.
IIBI awards post graduate diplomas

IIBI’s Post Graduate Diploma (PGD) course in Islamic banking and insurance, offered since 1994, is highly regarded worldwide. UK-based Durham University has accorded this course recognition as an entry qualification for the University’s Research MA as well as its modules on Islamic economics and Shari’ah-compliant finance.

To date, students from 77 countries have enrolled in the PGD course. In the period of December 2008 to March 2009, the following students successfully completed their studies:

- Abid Mahmood, teacher, S. K. B. Zayd Arab Pakistan School, UAE
- Amine Imghi, director, project office, BNP Paribas, US
- Bilal Rasul, registrar (mudarabah), Securities & Exchange Commission, Pakistan
- Don Brownlow, banking systems consultant, UK
- Imran Mahmood, senior financial analyst, GMAC LLC, US
- Mansoor Ahmed Qazi, Pakistan
- Mohamed-Umer Esmail, UK
- Mohd Nazir Bin Abu Hassan, UK
- Meera Mohideen Sahib Quvylidh, head of operations, Amana Investments Limited, Sri Lanka
- Muhammad Ismail, financial controller, Sony Marketing Europe, UK
- Muhammad Owais, senior accountant, International Turnkey Systems (ITS), UAE
- Rahul Sharan, India

- Rehab Lootah, senior vice president, Mawarid Finance, UAE
- S. M. Fazly Marikar, Sri Lanka
- Salah Aldin Alkhair Abdulmageed, senior legal advisor, Arab National Bank, Saudi Arabia
- Syed Farhan Shah, UK
- Usman Tariq Khan, centralised operations controller, United Bank Limited, Pakistan
- Zoeb Adamali, senior consultant, business process transformation, Oracle Financial Services Consulting, India.

I have done research on Islamic banking for my MBA dissertation before starting this course, but I found the material of this course very detailed and comprehensive, particularly Module VI on takaful. As there has been very little literature available on takaful products compared to other Islamic financial products, I was pleased that the module material is very comprehensive and understandable.

After studying this course, I’ve become very informed about Islamic banking and its products. The IIBI’s administration has been very helpful and supportive on all queries and issues. I have already recommended this course to my university fellows. I wish the Institute the best of luck.

Syed Farhan Shah, UK
On the 29th January 2009, around 30 delegates gathered at the British Bankers' Association offices in the heart of the City of London to attend a one-day workshop organised by the IIBI.

The number of attendees indicates the growing importance that Islamic financing is taking in the world of project finance. Delegates travelled in from as far a field as the UAE, Poland and the Maldives. Practicing lawyers made up around 30 per cent of the attendees, with bankers making up 35 per cent, so it was always going to be an intensive hands-on workshop.

The speakers were also all active participants in the field of project finance and their experience showed in the depth of the presentations. These were not academic aspirations as to what may be offered and what could happen in the future, but, instead, showed the real-life practical contributions that were being made to major infrastructure projects through the use of Islamic finance. The topics discussed at the workshop ranged from introductory concepts as to what constitutes Islamic project finance, what instruments and structures are used and why, through to specific case studies of how several real-life projects had been put together, the problems encountered and overcome, as well as discussions on how these arrangements can be syndicated.

Naturally, the istisna and ijara contracts received much attention but murabaha, musharakah and mudarabah, along with sukuk structures, were also discussed in detail with the practical implications of real-life decisions being demonstrated.

Mufti Muhammad Nurullah Shikder, head of Shari’ah advisory and compliance at UK-based Gatehouse Bank, discussed the wider issues of what constituted Islamic project finance but pointed out other useful practical aspects. Richard T de Belder, a well-known friend of the IIBI, and a partner at Denton Wilde Sapte, shared his thoughts on various Shari’ah-compliant financing structures. Those thoughts were based on his experience of setting up some of the structures used in significant deals, such as the convertible mudaraba sukuk for Aldar Properties (a real estate developer in Abu Dhabi) to build tower blocks.

Other sukuk issues were examined by Farmida Bi, partner at Norton Rose, who looked at the types of sukuk that are used for project finance and showed the structures behind some of the recent deals. The techniques and detailed structures for the $134 million Bahrain Financial Harbour sukuk were examined, and some of the key issues and hurdles encountered in the deal were discussed. This included an assessment of the concept and compliance of advance rentals, a topic that had also been discussed by de Belder. The details of the first musharakah sukuk, the 2005 Dubai Metals Corporation that used the musharakah to build two towers, were also discussed, as was the $1.1 billion Sorouh Real Estate sukuk in Abu Dhabi that closed in August of 2008. The size of some of these projects and the need to share the risks has brought about the need for syndication.

Allen Merhej, a colleague of Ms Bi at Norton Rose, talked about the similarities and differences of mudarabah and wakala when enabling syndication, and the issues involved in mixing conventional debt with Islamic financing. Complexities of choosing the governing law when entering into international agreements and syndications and the problems associated with that choice were discussed, culminating in a review of the Shamil versus Beximco court of appeal rulings.

Many of the day’s concepts were pulled together when Merhej looked at the detail of the Queen Alia International Airport project, a 25 year concession for the rehabilitation, expansion and operation of the airport in Amman, Jordan. This was a public-private partnership that used dual tranche conventional and Islamic financing in Jordan’s biggest project finance deal and private sector investment. The Islamic portion was based on an istisna manufacturing agreement and an ijara mawsufa fi al-dhimah (Islamic forward lease) that raised $100 million.

The next IIBI workshop will be held on 16th April 2009 and will look at sukuk, their applications and challenges.
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Islamic banks in the United States: breaking through the barriers

Abdi Shayesteh, senior associate with the King & Spalding law firm in New York and a member of the Middle East and Islamic finance practice group, takes a look at what the US Islamic finance market has to offer.

The question of whether US regulators will be accommodating towards the growth of Islamic banking is now moot. Today, the United States is home to at least nineteen providers of Islamic banking products and services, including retail banks, investment banks, mortgage companies, investment advisors and community-based finance providers (see the chart on pp.38–39). With the estimated number of Muslims living in the country ranging from three to eight million (based on various private surveys) it now appears that real market demand and viability for offering Islamic banking products and services in the US either exists or is being developed and penetrated by these early-to-market providers.

Given these positive factors and the push by Gulf-based Islamic institutions to establish a strong presence in the United Kingdom, their absence from the US is puzzling. One explanation is that Gulf-based Islamic institutions are most likely suffering from a mirage of barriers and a set of misunderstandings when it comes to entering the US market.

One significant mirage relates to a misconception that US regulators are not interested in the growth of Islamic banking. Unfortunately, many believe that they are resistant towards the growth of the industry in the US, just because the country’s officials are not as vocal or direct about expressing their interest as their counterparts are in the UK. Many Gulf bankers have noted that they would like to hear the same type of ‘cheerleading’ speeches like the ones made by Gordon Brown (UK’s prime minister) or Kitty Ussher (formerly a Treasury minister and now parliamentary under secretary at the Department of Work and Pensions) in recent years – where London has been declared to be ‘the next global hub for Islamic banking’. The important thing to note, however, is that just because US officials don’t offer the same type of direct declarations, it does not mean that they are not interested in accommodating the growth of the industry. The reality is that US regulators have significant constitutional, policy and economic reasons to accommodate the growth of Islamic banking in the country.

From a constitutional perspective, US regulators are (and will continue to be) involved, in part, because it is their duty as public servants under the US Constitution to make sure they accommodate the free exercise of religion, even as it relates to banking practices. There is a limit to this accommodation, however, in that the constitution also prohibits the promotion of a particular religion over another by a public official or agency. This limit may explain why we don’t see the same type of direct encouragement from US officials like the ones witnessed in the UK.

From a policy perspective, US regulators may have an interest in accommodating the growth of Islamic banking as a means of providing banking services to the unbanked population. For example, many Muslims in the country currently do not bank at a conventional bank because doing so violates Shari’ah restrictions on the receipt and payment of interest. US regulatory involvement with Islamic-centric banks or banks that seek to offer Islamic products and services would be seen as a means to enhance community development activities in such unbanked segments.

Finally, from a macro-economic perspective, the United States, like other western countries, has every interest in attracting Gulf-based capital that has built up over the last five years due to the bullish oil market. Accommodating Islamic finance may be one way to entice this capital to come back to the country after some left post-9/11.

One significant misunderstanding that is deterring some Gulf-based Islamic institutions
from entering the US market relates to the complexity of the US regulatory regime. So far, the investors launching Islamic finance operations in the UK predominantly had to deal with one regulator, the Financial Services Authority (FSA), which is the country’s primary regulator of banks, insurance companies, securities dealers and other financial institutions. Unfortunately, many Gulf bankers mistakenly think that they only need to deal with one regulator when it comes to managing their entire chartering process in the United States as well. But this is not the case. Depending on the types of products and services a prospective bank would offer, an applicant would likely have to deal with a variety of US regulators, including the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, state banking authorities, the Internal Revenue Service and the Securities Exchange Commission. This misunderstanding has often led to confusion and frustration as well as a lot of wasted time and resources for many prospective applicants, sometimes leading to unnecessary suspicion and a mistaken perception that the US authorities are being deliberately unaccommodating and not interested in facilitating any Islamic banking-related applications. In the light of this, it would be prudent for the applicants to first engage with the right advisors that have deep experience in understanding both Shari’ah law and US laws and bank regulations. Equally important, applicants should develop a thorough business plan early on in the process that identifies the range of products and services they want to offer, as this will ultimately dictate the relevant authorities to work with.

Another area of misunderstanding relates to the actual time and investment involved in launching a Shari’ah-compliant financial institution in the United States. A conventional bank application there may typically take up to a year and a half to be approved due to the various regulatory approvals that may be needed. Launching a bank that has Shari’ah components may take up to two years or more depending on the types of products and services the institution plans to offer. Many Middle East investors have a difficult time understanding this and are often discouraged when they learn about the potential lengthy timeframes. Of course, no application is the same and there are no exact timescales to go by, but many are often surprised that any application could take longer than six months. If it took the Islamic Bank of Britain in the UK almost two years to get all of the right approvals in place, why should it take less time in the US?

Fortunately, we are finally beginning to see more potential investors from the Gulf region getting a deeper understanding of the situation and gaining the necessary knowledge to overcome the mirage of barriers and take advantage of the upcoming opportunistic US market. Over the last few months, US legal and consulting firms have witnessed a surge in interest from Gulf-based institutions and individual investors wanting to venture into the United States to make Shari’ah-compliant investments or to offer Shari’ah-compliant banking products and services — both at a retail and wholesale level. There is an increasing realisation that the perceptions about the US regulatory environment regarding Islamic banking were simply incorrect. This, of course, is attributable to the fact that the country’s Islamic finance market is now more populated with players and offerings than it used to be. More and more investors are also recognising the opportunities that will exist for them in the American market by mid to end of 2009. Many are seeing this downturn as an opportunity to utilise the down time to build the appropriate infrastructure, obtain the necessary (and time consuming) regulatory approvals, and establish the important relationships with the right advisors, service providers and managers, so that all the right pieces are in place by the time the US economy picks up.

Given the positive financial position that many Islamic financial institutions (including Gulf-based ones) are reporting to have in this current global financial crisis (as compared to their conventional counterparts around the world), the timing could not be more perfect for them to take the industry to the next level in the United States. While initially the analyst reports were mixed concerning how Islamic financial institutions will weather the current financial crisis, it is now clear that they, while not immune from the crisis, are being less impacted than conventional institutions. This is because Islamic financial institutions, by their nature, have not invested in toxic assets or derivative structured instruments that many conventional institutions invested in. While some Islamic banks in the Middle East have recently taken a hit due to their over-investment in the Gulf real estate market, on the whole, many were not as impacted because they either took a more diversified approach or they have enough cash to absorb the temporary losses. Let’s not forget that many Gulf-based Islamic financial institutions also benefited from a five-year windfall due to the bullish run in the oil markets.

On the demand side of the equation, the picture looks quite encouraging, as economically distressed western countries have not been shy at all recently about using the unique healthy position of Gulf-based Islamic institutions to their advantage. For example, in November last year, the US Treasury department hosted a seminar in Washington DC, called ‘Islamic Finance 101’. A large number of Islamic scholars and banking professionals from around the world were invited to this event to engage in discussions focused on the provisioning of Islamic finance products in the US. Just a few weeks prior to this seminar, the US Treasury department deputy secretary, Robert Kimmit, travelled to the Middle East and publicly expressed the US’s positive and accommodating attitude towards the development and growth of the industry in the country.

Given this continued spirit of accommodation in the current US economic environment, Gulf-based Islamic financial institutions, if they are as healthy as they say, are perhaps at the most optimal position they have ever been concerning the prospects for growing their industry in the US. It is encouraging to see that more investors are waking up and taking advantage of this opportunity today.
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<td>• Headquarters: Detroit, Michigan&lt;br&gt;• Shari’ah-compliant products offered in: California, Connecticut, Idaho, Illinois, Maryland, Michigan, New Jersey, New York, Ohio, Pennsylvania, Virginia</td>
<td>• State chartered bank&lt;br&gt;• Financing products are offered through its wholly owned subsidiary, University Islamic Financial</td>
<td>• Residential real estate financing&lt;br&gt;• Deposit product&lt;br&gt;• Money market product&lt;br&gt;• Mutual funds</td>
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<td>Devon Bank</td>
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<td>• State chartered bank&lt;br&gt;• Financing products are offered through its wholly owned subsidiary</td>
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<td>Broadway Bank of Chicago</td>
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<td>Zayan Finance</td>
<td>• Headquarters: Chicago, Illinois&lt;br&gt;• Shari’ah-compliant products offered nationwide</td>
<td>• Non-bank mortgage company&lt;br&gt;• Funding provided by foreign investors</td>
<td>Commercial real estate financing</td>
<td>Diminishing musharakah and ijara</td>
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<tr>
<td>Guidance Residential</td>
<td>• Headquarters: West Falls Church, Virginia&lt;br&gt;• Shari’ah-compliant products offered in: California, Connecticut, Washington DC, Florida, Georgia, Illinois, Indiana, Massachusetts, Maryland, Michigan, Minnesota, Missouri, North Carolina, New Jersey, New York, Ohio, Oregon, Pennsylvania, South Carolina, Tennessee, Texas, Washington</td>
<td>• Non-bank mortgage company&lt;br&gt;• Funding provided by Freddie Mac and/or foreign investors</td>
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<td>Lariba – American Finance House/Bank of Whittier</td>
<td>• Headquarters: Pasadena, California&lt;br&gt;• Shari’ah-compliant products offered nationwide</td>
<td>• Non-bank mortgage company&lt;br&gt;• Brokers/offers its financing products in some states through its affiliate, Bank of Whittier&lt;br&gt;• Funding provided by Freddie Mac, Fannie Mae and/or Bank of Whittier</td>
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<td>Samad Group</td>
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| City of Minneapolis – Alternative Financing Programme      | Headquarters: Minneapolis, Minnesota                     | • Government sponsored programme for small business owners  
• Co-financing arrangements with other community providers (i.e. African Development Center, or other banks) | • Real estate construction financing  
• Microfinancing                                                                 | Murabaha          |
| Minnesota Housing Finance Agency, State of Minnesota       | Headquarters: Minneapolis, Minnesota                     | • Government sponsored programme for low income participants  
• Funding provided by State of Minnesota | • Low-income residential real estate financing; wholesale provider to Devon Bank’s residential real estate financing products | Murabaha          |
| African Development Center                                | Headquarters: Minneapolis, Minnesota                     | Non-profit community development corporation                                                 | • Microfinancing  
• Residential real estate financing  
• Residential mortgage broker for Devon-Minnesota Housing Finance Agency Project | Murabaha          |
| Neighborhood Development Center – Riba Free Programme     | Headquarters: Minneapolis/St. Paul, Minnesota            | Non-profit community development corporation                                                 | Microfinancing                                                                 | Murabaha and musharakah |
| World Relief                                               | Headquarters: Nashville, Tennessee                       | • Non-profit community development corporation                                                 | Microfinancing                                                                 | Murabaha          |
| Ameen Housing Co-operative                                 | Headquarters: Palo Alto, California                      | • Funding provided by co-op and investors                                                   | Co-op residential financing programme                                                                 | Co-operative financing structure with income distributed as dividends |

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<td>Saturna Capital</td>
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<td>Azzad Asset Management</td>
<td>Headquarters: Falls Church, Virginia</td>
<td>Investment advisor, asset manager</td>
<td>Public investment funds (Azzad Mutual Funds)</td>
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<tr>
<td>North American Islamic Trust/Allied Asset Advisors</td>
<td>Headquarters: Burr Ridge, Illinois</td>
<td>Investment advisor, asset manager</td>
<td>Public investment funds (The Iman Fund)</td>
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| INVESTMENT BANKS                                           |                                                                                                           |                                                                                               |                                                                                |                  |
|-----------------------------------------------------------|----------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------|                  |
| Arcapita                                                   | Headquarters: Atlanta, Georgia                                                                           | Subsidiary of Arcapita Bank (Bahrain)                                                         | • Private equity  
• Real estate focused investments  
• Venture capital                                                                 |                  |
| Innovest Capital                                           | Headquarters: Cleveland, Ohio                                                                            | Subsidiary of Gulf Investment House (Kuwait)                                                  | Real estate focused investments                                                                 |                  |
| TransOcean Group                                           | Headquarters: Boston, Massachusetts                                                                     | Subsidiary of Gulf Investment House (Kuwait)                                                  | Private equity                                                                 |                  |
| UIB Capital – Chicago                                      | Headquarters: Chicago, Illinois                                                                          | Subsidiary of Unicorn Investment Bank (Bahrain)                                               | Private equity                                                                 |                  |
| Overland Capital Group                                     | Headquarters: Boston, Massachusetts                                                                     | Investors include Gulf-based financial institutions and investors                              | • Real estate focused investments  
• Equipment leasing  
• Asset management                                                                 |                  |
Resilience and stability of Islamic finance

Abbas Mirakhor, former executive director at the International Monetary Fund (IMF), and Noureddine Krichene, economist at the IMF and former advisor at the Islamic Development Bank in Jeddah, examine the issue.

In contrast to conventional finance which has periodically experienced crises, Islamic finance is considered as a stable financial system capable of promoting sustained growth of income and employment. Prohibiting interest, speculation, and debt trading, Islamic finance establishes one-to-one mapping of financial and real sectors of the economy. That is, it is based on real trade and production activities. The financial sector cannot expand beyond the real economy, and is immune to unbacked credit expansion and speculation that are characteristics of conventional finance and that have destabilised even the most sophisticated and complex financial systems.

Conventional finance is inherently unstable

The financial crisis that broke out in August 2007 is considered to be the worst in the post-war period. Representing the collapse of trillions of dollars of fictitious credit derivatives and the meltdown of uncontrolled credit growth, the scope of the crisis could reach unmanageable size. The crisis has shown that advanced financial systems are very vulnerable. Massive bankruptcies were avoided only at the cost of gigantic government bailouts. Capital markets are frozen. Consequent de-leveraging led in turn to an unexpected crash in stock markets, wiping out trillions of dollars in share values and in retirement investment accounts.

Economic uncertainty has never been as high. Has the crisis been correctly tackled or has it only been made worse? Could affected industrial countries grow with unsustainable public debt? In view of the incredibly high liquidity injection by major central banks, is money supply growth out of control? What will be the crisis' impact on growth and employment? What will be its fiscal and inflationary cost? While precise answers are not possible, the present crisis has already slowed down economic growth in industrial countries, triggered food riots and energy protests in many vulnerable countries, increased unemployment and imposed extraordinary fiscal costs. Notwithstanding its devastating consequences, the crisis has made the quest for financial stability a pressing and fundamental issue in economics and finance. Such was the purpose of the G20 Summits in November 2008 and April 2009.

Financial instability has been a recurring phenomenon in contemporary economic history, affecting countries with varying intensity. The most enduring crisis was the Great Depression of 1929–33. Eminent economists who lived through the Great Depression fought very hard to establish a banking system capable of achieving and preserving financial stability. Their proposals became known as the Chicago Reform Plan, as they were elaborated by some members of the economic faculty of the University of Chicago. Although unaware of Islamic finance, their proposals were a natural restatement of some basic pillars of Islamic finance. The Chicago Plan basically divided the banking system into two components: a depository component with 100 per cent reserve requirement and an investment component with no money contracts and no interest payments, where deposits were considered as equity shares and were remunerated with dividends, and where assets' and liabilities' maturities were fully matched. Independently of this plan, Muslim economists reached the conclusion that if Islamic finance were to achieve stability, the banking system had to be organised along a similar ‘two-tier’ structure.

In view of its devastating effects, considerable effort has been devoted to explaining the causes of financial instability and to prescribe remedies that would reduce risk of deep contraction in output, large-scale unemployment, bankruptcies, dramatic fall in real incomes and social hardship. The classical economists attributed financial instability to money and credit expansion. They considered excessive credit expansion and contraction to be caused by deviation of the money interest rate from a non-observeable natural interest rate which equilibrates real savings and investment in the economy. The natural rate of interest was defined in many ways; mainly, it was seen as a rate of profit, productivity of capital in roundabout production, or marginal efficiency of capital.

Irving Fisher, a prominent American economist of the Great Depression era, strongly argued that two dominant factors were responsible for each boom and depression: over-indebtedness in relation to equity, gold, or income which starts a boom, and deflation consisting of a fall in asset prices or a fall in the price level which starts a depression. He noted that over-investment...
and over-speculation were often important, but they would have far less serious results if they were not conducted with borrowed money. That is, over-indebtedness may reinforce over-investment and over-speculation.

Another American economist, Hyman Minsky, considered that conventional finance dominated by interest-based debt contracts is inherently unstable. This assertion is based on a construct known as Financial Instability Hypothesis (FIH), which posits that stability is inherently unsustainable. A fundamental characteristic of a conventional financial system, according to Minsky, is that it swings between robustness and fragility and these swings are an integral part of the process that generates business cycles. In the early 1990s, Minsky addressed financial innovations, which he considered to be evolving at a fast pace and to be driven by fierce competition among financial institutions for profits. In his view, the proliferation of innovations in deregulated capital markets would lead to a huge inverted credit pyramid based on a thin real basis, i.e. over-leverage. Any small fall in expected cash flows would send this pyramid crumbling.

Central banks’ cheap money policy is a key factor in a major financial crisis. Notably, the present crisis was caused by major central banks deliberately setting interest rates at record lows irrespective of risk. As a consequence, total credit expanded at an unsafe high rate of twelve per cent per year in the United States during 2001–08. This phenomenal credit growth was at the cost of creditworthiness and erosion of underwriting standards. George Soros wrote, ‘when money is free, the rational lender will keep on lending until there is no one else to lend to’. Rapidly expanding money and credit combined with an ideologically-based fierce de-regulation movement which began in the early 1980s in industrial economies and continued throughout the next two decades. It put at high risk the financial stability of these countries and, as the result of rapid financial globalisation, the rest of the world as well.

**Islamic finance is inherently stable**

The sources of financial instability in the conventional system, i.e. interest, unbacked credit, abundance of liquidity and highly leveraged financial transactions, as well as opportunities for speculation are by and large absent in an Islamic financial system. Basically because of absence of interest-based debt contracts and the 100 per cent reserve requirement that protects the nations’ payment system, thus ensuring the inherent stability of this system.

In the Quran and Sunnah, Islamic finance has always been conceived as existing within an institutional framework composed of rules of behaviour such as sanctity of contracts, strict rules of conduct for all market participants, including rules regarding distribution and redistribution of income, and wealth resulting from production and sale of goods and services which guarantee equitable and just distribution in the society as well as rules regarding governance, transparency, cooperation and social solidarity. In such a system, finance will be guided toward employment creating investment and wealth creation.

In Islamic finance there are no risk-free assets and all financial arrangements are based on risk and profit-and-loss sharing (PLS). Hence, all financial assets are contingent claims and there are no debt instruments with fixed or floating interest rates. Investment accounts could be conceived as non-speculative equity shares. The rate of return on financial assets is primarily determined by the return to the real sector, and therefore in a growing economy, Islamic banks will always experience net positive returns.

Financial intermediation in Islam is different from that in a conventional system. Banks do not contract interest bearing loans and do not create and destroy money. They participate directly in production and trade operations on a PLS basis. Banks do not act as simple lenders; they have to be directly involved in trade and investment operations, and assume direct ownership of real assets.

There is no credit creation out of thin air in Islamic finance. Under conventional fractional reserve banking, deposits at one bank can be instantaneously loaned out or used to purchase a financial asset and become reserves and a basis for a new loan at a second bank. The credit multiplier is determined by the reserve requirement and could be high. In case of securitisation and over-leverage, the credit multiplier is theoretically infinite, leading to violent asset and product price fluctuations. Such a phenomenon does not exist in Islamic banking because of the 100 per cent reserve requirement. Deposits intended by their owner for investment purposes find their way directly as investment in trade and production activities to create new jobs as well as lead to additional flows of goods and services. New money flows arise from the proceeds of sales of goods and services. Money expansion is determined by the savings ratio in the economy and the money multiplier is very small, ensuring price stability. Investment is equal to savings, and aggregate supply of goods and services is always equal to aggregate demand. The liabilities of the financial institutions are covered by tangible real assets that are owned directly by the institution. They are not covered by financial assets. Risks for Islamic financial institutions are mitigated as they relate essentially to returns from investment operations and not to the capital of these institutions.

Architecturally, an Islamic banking system is composed of two tiers: amanah or safekeeping plus payments, transactions services, and transfer activities. In this tier, banks are required to keep 100 per cent reserves against deposits which remain highly liquid.

The second tier is composed of investment activities whereby deposits are longer-term savings and placed for the sole purpose of investment in trade, leasing, and productive activities in agriculture, industry, and services. The most important characteristic of this activity is that it is immune to unbacked expansion of credit. Returns to invested funds arise ex-post from the profits or losses of the operation, and are distributed to depositors as shareholders of equity capital.
The expansion of finance is fully determined by real growth in the economy and not by unstable speculative finance or money creation by financial institutions. Accordingly, an Islamic system would not be expected to experience deep boom and bust cycles. Moderate and brief booms and recession may be generated by good crops, productivity, technical change, or by adverse shocks. They cannot be generated by the financial system itself. Equilibrium in an Islamic economy thus structured will be stable and the rate of return to the financial sector will be fully aligned with the profit rate in the real sector of the economy.

Risks in Islamic finance consist of credit risk, market risk, displaced commercial risk, operational risk, and governance risk. While the individual financial institutions engaged in investment activities face these risks, in and of themselves these are not systemic and do not impact the overall stability of the financial system, as this system is immune to speculative mania, liquidity expansion, and instability of returns. The latter is due to the fact that there is no value or maturity mismatching between assets and liabilities of the institutions. If asset prices decline, so will the liabilities, unlike what happens in a system dominated by interest-based debt contracts.

Many types of financial transactions and instruments are excluded from Islamic finance, particularly interest rate-based bonds, securities, finance based on securitisation of fictitious assets, speculative finance, hedge funds, and consumer finance that is not backed by real assets. In all of this type of finance, either the acquired assets are financial papers, or loans that are not backed by real assets and do not contribute to generate real activity and income.

In Islamic finance, the central bank has the sole monopoly for creating money. An interest rate cannot be used as a policy instrument. The central bank does not refinance banks as in conventional banking. The central bank has to apply a quantitative ceiling on money aggregates. Such policy when and where implemented has been effective in maintaining financial stability and precluding speculative booms and inflation. Money injection occurs through the central bank buying foreign exchange, gold, or non-interest bearing government debt, possibly indexed to gold, a commodities basket, or a portfolio of real assets created by the government.

Conclusion

History is replete with episodes of instability of the conventional financial system. Prominent economists have argued that such a system is inherently unstable and prone to severe financial crisis. They have considered the interest rate to be a cause of large fluctuations in asset and commodity prices, a source of financial instability and cumulative inflation, and detrimental to long-term economic growth. They have called for a separation of deposit and investment banking.

Islamic finance prohibits interest and speculation and engages directly in trade and investment operations. Unbacked expansion of credit is preempted, and banks cannot initiate and accentuate a speculative process. Credit is based on real savings. Hoarding for the sake of earning interest does not take place. Savings can only earn a return if directly invested in employment creating activities. Not only does hoarding earn no monetary reward, there is also a direct disincentive for doing so since whatever is hoarded is subject to zakat which will continuously erode its base. In such a system, no excess purchasing power can be created by a stroke of the pen. Money flows arise from sales of goods and services and transit through the banking system for payments or investment purposes. Islamic banks do not compete to issue loans to borrowers for liability management purposes arising from mismatched maturities between assets and liabilities; they compete only for real investment opportunities; their resources are reinvested in real activities. Given the stability of its financial system and resilience to monetary shocks, an Islamic economic system would experience sustained economic growth and avoid detrimental impacts on social justice since inflation cannot be used to tax creditors and wage earners in favour of debtors and speculators. Although reforms of the conventional system along the lines comparable to Islamic finance system were strongly advocated by some leading economists in the 1930s in the aftermath of the Great Depression, these reforms were not fully implemented. The intensity of recent financial instability has renewed calls for such reforms which many consider as the only path in the quest for stability. The chart below contrasts distinctive features of conventional and Islamic finance.

<table>
<thead>
<tr>
<th>Contrast of two financial systems</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Conventional finance</strong></td>
</tr>
<tr>
<td>- Interest and interest-based transactions.</td>
</tr>
<tr>
<td>- Deposits and loans.</td>
</tr>
<tr>
<td>- Banks create and destroy money.</td>
</tr>
<tr>
<td>- Asset-liability mismatch, illiquid.</td>
</tr>
<tr>
<td>- Money multiplier depends on reserve ratio, very high; infinite with securitisation.</td>
</tr>
<tr>
<td>- Speculation, a casino, debt trading.</td>
</tr>
<tr>
<td>- Interest rate not related to real economy, high price distortion.</td>
</tr>
<tr>
<td>- Social inequity: inflation tax, redistributive issues, food riots.</td>
</tr>
<tr>
<td>- Highly cyclical: booms and busts, uncertainties, unpredictable growth.</td>
</tr>
<tr>
<td>- Massive bankruptcies, contagion, bailouts.</td>
</tr>
<tr>
<td>- Interest rate policy, highly destabilising.</td>
</tr>
<tr>
<td><strong>Islamic finance</strong></td>
</tr>
<tr>
<td>- No interest and interest-based transactions.</td>
</tr>
<tr>
<td>- Equity shares and ownership of real assets in investment projects.</td>
</tr>
<tr>
<td>- Banks do not create or destroy money.</td>
</tr>
<tr>
<td>- No asset-liability mismatch, liquid.</td>
</tr>
<tr>
<td>- Money multiplier depends on the savings ratio, very low.</td>
</tr>
<tr>
<td>- No speculation, no debt trading.</td>
</tr>
<tr>
<td>- Profit rate determined by real economy, no price distortion.</td>
</tr>
<tr>
<td>- Social equity: no inflation tax, no redistribution.</td>
</tr>
<tr>
<td>- Stable economic growth, predictable.</td>
</tr>
<tr>
<td>- No systemic bankruptcies, no bailouts.</td>
</tr>
<tr>
<td>- No interest policy, money aggregates are used, highly stable.</td>
</tr>
</tbody>
</table>
NEWHORIZON Rabi Al Thani–Jumada Al Thani 1430

Book Review:

Islamic Capital Markets: Products, Regulation & Development
Edited by Syed Salman Ali
Publisher: Islamic Research and Training Institute (IRTI) of Islamic Development Bank (2008)

The global financial markets are in a crisis and could take a lesson from the products and strategies of an evolving Islamic capital market. The Islamic financial system's ability to remain largely unscathed by the difficulties affecting the conventional international financial system may see greater interest in Islamic finance playing a more prominent role in the global financial sector. This publication is a collection of articles covering developments in the important and growing segments of Islamic finance and has 21 chapters divided into three parts. The book combines the developments in Islamic capital markets and analyses the opportunities and challenges posed, in particular relating to product development and strategies, regulatory framework and policies, as well as comparative development in various countries. This publication edited by Salman Syed Ali (who is also working at IRTI) has 451 pages including tables and glossary, and is an important contribution to the debate on issues of policy and a good read for all those interested in Shari‘ah-compliant finance.

Risk Analysis for Islamic Banks
Authors: Hennie van Greuning and Zamir Iqbal
Publisher: The World Bank (2008)

Islamic finance today is a global phenomenon reaching beyond traditional markets. The book has fifteen chapters and aims to fill a knowledge gap for risk management in Islamic finance and discuss the issues that have not been adequately addressed by others in this field. The authors deal extensively with a wide range of issues in one publication, which assists in understanding the complexities of Islamic banks. It considers the theory and practice of Islamic financial intermediation and matters of corporate governance that can affect the welfare of more than 20 per cent of the current world population. The chapter on risk management provides a comprehensive explanation of the framework for risk analysis, the balance sheet and income statement structures as well as looking at the operational risk that include credit risk, liquidity and market risk and risks specific to Islamic banking, in particular reputational risk. A chapter is devoted to governance and regulation dealing with issues in Shari‘ah governance, transparency and data quality, capital adequacy and Basel II. The last chapter deals with future challenges covering areas for improvement and some recommendations. The book is recommended reading for all practitioners as well as regulators in the Islamic financial sector. Hennie van Greuning is a senior advisor in the World Bank Treasury. Zamir Iqbal is also serving at the World Bank in Washington and has published several articles in reputed Islamic finance magazines and presented papers at international forums. The book has 309 pages including appendices, references and index.

Financial Risk Management for Islamic Banking and Finance
Authors: Ioannis Akkizidis and Sunil Kumar Khandelwal
Publisher: Palgrave Macmillan (2008)

Risk management in banking and finance is one of the greatest challenges that the world faces today, and this applies equally to the market growth in Islamic financial products. Islamic banks face similar but not entirely identical risks to the conventional banks. This book analyses in detail the risk management issues for Islamic banks in seven chapters. Both authors appear to have done extensive research to write this book, which presents a common framework of how to efficiently manage the risks faced and minimise the overall degree of financial risks pertinent to the Islamic financial services industry. This book would be a good addition to the library of those working in the Islamic financial sector. Ioannis Akkizidis works as a risk management consultant at FRSGlobal, and Sunil Kumar Khandelwal was head of risk management, Middle East, for IRIS integrated risk management AG (now part of FRSGlobal). The book has 220 pages including bibliography and index.
Dow Jones Islamic Market World Index

Below is a chart of the performance of Dow Jones Islamic Market World Index, provided by Dow Jones Indexes, the first index provider to launch Shari’ah-compliant indices in 1999. Over the course of 2008, the Dow Jones Islamic Market World Index was down -38.87%, compared to its standard counterpart, the Dow Jones World Index which was down -42.85% over the same time period. Also listed is the performance of the respective industry indices for both indices in 2008. More information can be found on www.djindexes.com

### Industry performance in 2008:

<table>
<thead>
<tr>
<th>Industry Index</th>
<th>Dow Jones Islamic Market World Index</th>
<th>Dow Jones World Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basic Materials</td>
<td>-51.90%</td>
<td>-52.90%</td>
</tr>
<tr>
<td>Consumer Goods</td>
<td>-38.13%</td>
<td>-36.28%</td>
</tr>
<tr>
<td>Consumer Services</td>
<td>-28.62%</td>
<td>-35.25%</td>
</tr>
<tr>
<td>Financials</td>
<td>-36.01%</td>
<td>-54.18%</td>
</tr>
<tr>
<td>Health Care</td>
<td>-21.44%</td>
<td>-23.03%</td>
</tr>
<tr>
<td>Industrials</td>
<td>-44.77%</td>
<td>-45.18%</td>
</tr>
<tr>
<td>Oil &amp; Gas</td>
<td>-39.79%</td>
<td>-41.29%</td>
</tr>
<tr>
<td>Technology</td>
<td>-43.96%</td>
<td>-45.26%</td>
</tr>
<tr>
<td>Telecommunications</td>
<td>-34.71%</td>
<td>-36.25%</td>
</tr>
<tr>
<td>Utilities</td>
<td>-42.04%</td>
<td>-31.87%</td>
</tr>
</tbody>
</table>

### Top 5 components and their weights, as of December 31st 2008:

<table>
<thead>
<tr>
<th>Rank</th>
<th>Company</th>
<th>Dow Jones Islamic Market World Index</th>
<th>Dow Jones World Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Exxon Mobil Corp.</td>
<td>4.09%</td>
<td>Exxon Mobil Corp.</td>
</tr>
<tr>
<td>2</td>
<td>Procter &amp; Gamble Co.</td>
<td>1.84%</td>
<td>Procter &amp; Gamble Co.</td>
</tr>
<tr>
<td>3</td>
<td>AT&amp;T Inc.</td>
<td>1.70%</td>
<td>AT&amp;T Inc.</td>
</tr>
<tr>
<td>4</td>
<td>Johnson &amp; Johnson</td>
<td>1.68%</td>
<td>Johnson &amp; Johnson</td>
</tr>
<tr>
<td>5</td>
<td>Microsoft Corp.</td>
<td>1.55%</td>
<td>General Electric Co.</td>
</tr>
</tbody>
</table>

Source: Dow Jones Indexes
Diary of events endorsed by the IIBI

April

14–15: 4th Annual World Takaful Conference (WTC 2009), Dubai
Conference to chart the future direction of the market, showcase innovations and address the key enablers to boost growth in the international takaful market.
Contact: Naomi Njoroge
Tel: +971 4 343 1200
Email: naomi@megaevents.net
www.megaevents.net

May

20–21: 2nd International Islamic Venture Capital & Private Equity Conference, Kuala Lumpur
Conference to discuss Islamic alternative investments and strategic funds, as well as the role of Shari’ah-compliant finance in social and economic development of Islamic countries.
Contact: Khairul Sabudin
Tel: +603 2031 1010 ext 532
Email: Khairul.sabudin@ibfim.com
www.islamicvc.com

25–26: 5th Annual World Islamic Funds & Capital Markets Conference (WIFCMC 2009), Bahrain
Supported by the Central Bank of Bahrain, conference to review which markets and asset classes offer the most upside in a challenging global landscape.
Contact: Naomi Njoroge
Tel: +971 4 343 1200
Email: naomi@megaevents.net
www.megaevents.net

August

7–9: Structuring Innovative Islamic Financial Products, Cambridge, UK
Three-day residential workshop to focus on different types of innovative structures, their underlying techniques and legal issues, as well as new developments in this field.
Contact: Mohammad Shafique
Tel: +44 (0) 20 7245 0404
Email: m.shafique@islamic-banking.com
www.islamic-banking.com

November

3: 4th World Islamic Infrastructure Finance Conference (WIIFC 2009), Doha
Conference to explore the latest developments and opportunities for the next generation of Islamic finance structures on a global scale.
Contact: Naomi Njoroge
Tel: +971 4 343 1200
Email: naomi@megaevents.net
www.megaevents.net

December

6–8: 16th World Islamic Banking Conference (WIBC 2009), Bahrain
Conference to discuss the key issues, developments and challenges of Islamic finance worldwide, with special focus on Italy, China, Japan, Singapore, France and the UK.
Contact: Naomi Njoroge
Tel: +971 4 343 1200
Email: naomi@megaevents.net
www.megaevents.net

16: Sukuk, Their Applications and Challenges, London
One-day workshop to focus on this increasingly important asset class, its developments, structures, applications and challenges.
Contact: Mohammad Shafique
Tel: +44 (0) 20 7245 0404
Email: m.shafique@islamic-banking.com
www.islamic-banking.com

February 2010

8–9: 6th Annual Middle East Insurance Forum (MEIF 2010), Bahrain
Forum to focus on unlocking new growth opportunities in the Islamic and conventional markets of the Middle East, and assess key regional industry trends.
Contact: Naomi Njoroge
Tel: +971 4 343 1200
Email: naomi@megaevents.net
www.megaevents.net

Throughout 2009, IIBI will organise a number of training workshops to build the skill base and share ideas among practitioners within the Islamic finance industry. The objective of the Institute’s training is to fill the human resource gap and to enhance the professional skills of personnel who are either interested in building their careers or already involved in the Islamic finance sector. Training programmes are delivered by experienced professionals; the number of participants is kept small to ensure the interactive environment and provide a practical learning experience for the participants with the help of suitable case studies.

For more information about upcoming programmes, please visit: www.islamic-banking.com
GLOSSARY

arboun
A non-refundable down payment for attaining the right to buy goods at a certain time and certain price in future; if the right is exercised, it becomes part of the purchase price.

bai
Sale.

fatwa
A ruling made by a competent Shari’ah scholar on a particular issue, where fiqih (Islamic jurisprudence) is unclear. It is an opinion, and is not legally binding.

gharar
Lit: uncertainty, hazard, chance or risk. Technically, sale of a thing which is not present at hand; or 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.

Hadith
A record of the sayings, deeds or tacit approval of the Prophet Muhammad (PBUH).

Hajj
An annual pilgrimage to Mecca and other holy places. The fifth pillar of Islam, Muslims have the duty to perform Hajj at least once in their lifetime.

halal
Activities which are permissible according to Shari’ah.

Hanafi School of law
Islamic school of law founded by Imam Abu Hanifa. Followers of this school are known as Hanafis.

haram
Activities which are prohibited according to Shari’ah.

ijara
A leasing contract under which a bank purchases and leases out a building or equipment or any other facility required by its client for a rental fee. The duration of the lease and rental fees are agreed in advance. Ownership of the equipment remains in the hands of the bank.

ijara mawsufa fi al-dhimah
Shari’ah-compliant forward lease.

ilm
Consensus of Shari’ah scholars on certain matters.

istisna
A contract of acquisition of goods by specification or order, where the price is fixed in advance, but the goods are manufactured and delivered at a later date. Normally, the price is paid progressively, in accordance with the progress of the job.

kifah
Islamic school of law founded by Imam Abu Hanifa. Followers of this school are known as Hanafis.

murabaha
A contract of sale between the bank and its client for the sale of goods at a price plus an agreed profit margin for the bank. The contract involves the purchase of goods by the bank which then sells them to the client at an agreed mark-up. Repayment is usually in instalments.

musharakah
An agreement under which the Islamic bank provides funds which are mingled with the funds of the business enterprise and others. All providers of capital are entitled to participate in the management but not necessarily required to do so. The profit is distributed among the partners in predetermined ratios, while the loss is borne by each partner in proportion to his contribution.

musharakah, diminishing
An agreement which allows equity participation and sharing of profit on a pro rata basis, but also provides a method through which the bank keeps on reducing its equity in the project and ultimately transfers the ownership of the asset to the participants.

nisab
Exemption limit for the payment of zakat. It is different for different types of wealth.

riba
Lit: increase or addition. Technically it denotes any increase or addition to capital obtained by the lender as a condition of the loan. Any risk-free or ‘guaranteed’ rate of return on a loan or investment is riba. Riba, in all forms, is prohibited in Islam. Usually, riba and interest are used interchangeably.

sadaqah
Charitable giving.

salam
Salam means a contract in which advance payment is made for goods delivered later on.

saalat
The five daily prayers, practised by Muslims in supplication to Allah s.w.t.

Shari’ah
Refers to laws contained in or derived from the Quran and the Sunnah (practice and traditions of the Prophet Muhammad).

Shari’ah board
An authority appointed by an Islamic financial institution, which supervises and ensures the Shari’ah compliance of new product development as well as existing operations.

Sunnah
It refers to the sayings and actions attributed to Prophet Muhammad (PBUH).

sukuk
Similar characteristics to that of a conventional bond with the key difference being that they are asset backed; a sukuk represents proportionate beneficial ownership in the underlying asset. The asset will be leased to the client to yield the return on the sukuk.

tamlik
Transfer of ownership of a property.

takaful
A form of Islamic insurance based on the Quranic principle of mutual assistance (ta’awuni). It provides mutual protection of assets and property and offers joint risk sharing in the event of a loss by one of its members.

tawaruq
A sale of a commodity to the customer by a bank on deferred payment at cost plus profit. The customer then sells the commodities to a third party on a spot basis and gets instant cash.

wa’ad
A promise to buy or sell certain goods in a certain quantity at a certain time in future at a certain price. It is not a legally binding agreement.

wakala
A contract or agency in which one person appoints someone else to perform a certain task on his behalf, usually against a certain fee. The agent (wakil) is allowed to generate an income for himself in excess of the minimum agreed upon returns as agreed with rab-al-maal (investor of the capital).

waqf
An appropriation or tying-up of a property in perpetuity so that no propriety rights can be exercised over the usufruct. The waqf property can neither be sold nor inherited nor donated to anyone.

zakat
A religious obligation on Muslims to pay a prescribed percentage of their wealth to specified categories in their society, when their wealth exceeds a certain limit. Zakat purifies wealth. The objective is to take away a part of the wealth of the well-to-do and to distribute it among the poor and the needy.
FUNCTIONALITY OF IMAL

IMAL is a new generation of comprehensive E-WAY Banking and Investment System, encompassing the in-depth business requirements and the functionalities of IMAL as a single, fully integrated front-end, middle and back-office system, promoting an effective Straight Through Processing (STP) environment.

IMAL delivers a comprehensive solution, addressing all the operational requirements.

IMAL provides an integrated solution that manages the entire business cycle from front to back, ensuring efficient and seamless processing.

IMAL’s design optimizes operational efficiencies, allowing for streamlined workflows and reduced errors.

IMAL’s robust solution covers a wide range of functionalities, from account opening to portfolio management, ensuring a comprehensive solution.

IMAL’s implementation strategy is tailored to meet the unique requirements of each institution, ensuring a successful roll-out.

ELIMINATING PRINCIPLES AND BEHAVIOUR

ACCOUNTS, BUSINESS PROCESSES, CONTRACTS

AAOIFI CERTIFICATE

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Retail Banking
Commercial Banking
Investment Banking
Islamic Products
Fund Management & Administration
E-banking / E-brokerage

TARGET SUCCESS