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OPALESQUE ISLAMIC FINANCE INTELLIGENCE

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Welcome to the twelfth edition of OIFI, where we dig deep to uncover the hidden gems of Islamic finance. Sometimes it seems we might not be able to see the forest for the trees, and our editorial section takes a different angle with respects to Shariah supervision and its overall role within the corporate walls. Our Featured Resource compiles a large selection of research papers from the International Shari'ah Research Academy for Islamic Finance (ISRA), which might not be widely disseminated but prove to be excellent reading.

Istijrar is a financial instrument that is seldom talked about in Islamic finance but which contains some intriguing characteristics, Nikan dissects it in the Featured Structure segment. For our Allocator Interview we hear from Chaaban Omran of Crescent Investments Australasia, as we discuss the investment rationale for Australia (which could be regraded as a frontier market for Islamic finance).

Furthermore, Abdulkhaliq Elshayyal takes on Lex Islamicus where he delves into how Islamic financial institutions manage the risk of non-compliance with Shariah, with some very interesting insights. The Industry Snapshot section sees Mobasher Zein tackle the topic of an Islamic currency, both revisiting the historical background as well as analyzing the various pieces of the puzzle that needs to be put together to support an Islamic economy. In addition, Mohammed Amin shares with us his review of the book "Islamic Banking and Finance: What It Is and What It Could Be" and we hope to bring more book reviews in the future.

As always, we are keen to hear your comments & suggestions and remember that you can visit our online archive (see reference link) for access to our ever-growing databank of Opalesque Islamic Finance Briefing as well as all of the back issues of Opalesque Islamic Finance Intelligence.

Best Regards,
Bernardo
Editor, Opalesque Islamic Finance Intelligence

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In This Issue

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The Shariah Compliance of Teldar Paper

By Bernardo Vizcaino, CAIA

It seems that the decay in the current financial system is pegged to the notion that bankers got greedy, way too greedy for their own good. ‘Greed is good’ is perhaps one of the most cited movie lines ever, and it was reflective of the individualism and pageantry of the 80’s. It has returned (alongside a movie sequel), this time to signify the collective excess of the financial industry, an excess that borders on the sinister. The character of Gordon Gekko, who utters the infamous phrase, has become one of the great villains of popular culture. It is said that he is based on a couple of individuals from that decade - among them a corporate raider, an arbitrageur, as well as a junk bond king. While we could point to a handful of Gekkos in the 80’s, it now seems that the current financial industry is saturated with many different versions of himself.

Feet on the ground, Head in the sky

Gekko made a strong case for greed - whether it is for life, love, money or knowledge. His argument though carried some caveats. First of all, our understanding of greed has to be differentiated from that which is aimed towards a basic need/necessity and the other geared towards a want or desire. Consider how greed can be qualified: short-term greed versus long-term greed; unrepentant greed versus greed with a conscience; individualistic greed versus greed on behalf of the community. You can talk about needs and wants, but they are all driven by some level of greed. Lets consider another human emotion - love. Love for country, love for war, love for cigarettes, let’s face it love can be bad. So can certain types of greed still be good? Can greed exhibit benevolence, good intentions, can greed grow a conscience?

Greed in its traditional definition is selfish, excessive, uncontrolled, but what if we could channel greed towards an unselfish, moderated and regulated purpose? Would the opposite make any sense - is all greed bad? If so, we must query the validity of our goals in the financial markets: capital appreciation, wealth accumulation, and even capital protection - they are all borne from differing levels of greed. Perhaps Gekko should have said ‘Greed is more or less ok, sometimes, well it depends’ although this would have been far less convincing to his audience.

The definition of greed has therefore been refined over time. The notion of efficient markets was always considered to be achievable when individuals sought the best outcome for themselves in an open market (i.e. they are motivated by their individual greed), whereas this has been revisited in modern financial circles with the concept of individuals seeking the best outcome for themselves and the group in less than efficient markets (i.e. they should be motivated by individual greed and a collective greed as well). Thus the former greed of Adam Smith’s efficient markets has been replaced with the latter greed suggested by the Nash Equilibrium. In other words greed has been qualified, but it is still greed.

Cover up the blank spots, Hit me on the Head

Another aspect of Gekko’s utterance is that it was not meant as a one-liner, it must be digested in the context of his entire speech. What was Gekko trying to achieve that day during the shareholder meeting of Teldar Paper (the fictional company that he is aiming to restructure)? He was positioning himself as the missing link between shareholders (apparently disenfranchised with how the company is being run) and management in the form of the board of directors (vilified as being focused on their own bonuses rather than the long term viability and financial health of Teldar Paper). It all boils down to governance and how corporations respond to their stakeholders - whether they are their shareholders, their creditors, or even society at large. Would we vilify Gekko if he had attempted the same speech at the shareholder meeting of Bear Stearns or Lehman Brothers? It seems greed is relative as well.

Curiously, Gekko was trying to play the role that regulators such as the SEC are eagerly trying to address today. He was presenting himself as a sentinel of the corporate entity, one that surveils and reviews everything that is being done inside Teldar Paper and calls into question any product, practice or action if it is not aligned with the interests of its shareholders. Regulators cannot fill that role as they must remain at arms-length with market participants, so who can fill this void? Is there any corporate instrument that can be put in place to pro-actively monitor the corporate entity, thus ensuring the company avoids practices that are non-compliant with its own charter, controlling and regularizing the ethos of the corporation? Who besides Gekko can do this? Who can be tasked with this duty of care towards not only shareholders but the community as a whole? The answer is closer than you can imagine.

Blue Horseshoe Still Loves Anacot Steel

The concept of a Shariah Supervisory Board (SSB) can blend of all of the above. All we need to do is rethink our understanding of an SSB: an ethical third-party committee. We can then position an SSB as an extension of a regulator in that it abides by specific rules and dictates. This can be the missing link between headless corporations and disenfranchised stakeholders (which would include investors, consumers and the community as a whole). The SSB is a device that can be at the forefront of the emerging school of Enterprise Risk Management. It is unfortunate that an SSB and an ERM methodology have yet to find each other, but this should not stop us from considering how the concept of an SSB would impact the incentive structure and the internal mechanics of a corporation.

Bear Stearns and Lehman Brothers might still be here today (probably to our dismay), their implosion perhaps avoided had they implemented an ethical supervisory board. In as much as some of their financial instruments and several of their corporate practices could have been vetoed by a panel of industry experts (trying to avoid the word scholars but academics, former industry bosses, professional consultants, etc). In theory they could have deemed many of their products as either toxic, too risky, or simply representing the wrong kind of greed (say, too much short term greed and not enough long term greed). This could equally apply to oil companies or car manufacturers, imagine having a third-party supervisory body that avoids certain practices (i.e. renting leaky oil rigs) or encourages others (designing more fuel-efficient vehicles).

Gekko was partially right, although his arguments were incomplete. In his speech in front of the Teldar Paper board he defends himself as "not the destroyer of companies" but rather "a liberator of them". What the market needs is a new set of eyes so that these liberated/liberalized companies remain truthful to their corporate spirit and are reminded of their social responsibilities. The grand opportunity for the Islamic finance industry is that it is not sitting idle on this instrument of corporate governance, instead the SSB model is being revised, questioned, strengthened and revitalized. The current discussions surrounding Scholar independence, conflicts of interest, duties and responsibilities should be given a new boost, as this is a rough diamond that the industry can polish for implementation elsewhere. The SSB model is being primed for export beyond Islamic finance. Regardless of whether greed is good or bad, the development of the SSB as a corporate governance mechanism is most certainly a good thing.

Your feedback and comments are very important to us, please feel free to contact the author via email.

ISRA Research Papers

Blogger™ As Featured in the Islamic Finance Resources Blog

The International Shari'ah Research Academy for Islamic Finance (better known as ISRA) was established to promote applied research for the Islamic finance industry. Their initiatives range from translation projects to scholarship programs and their academic output have proven prolific, here we include a list of their research papers (all of which are available from the ISRA website):

Banking for the Poor: The Role of Islamic Banking in Microfinance Initiatives

Is the Ban on "Organised Tawarruq" The Tip of The Iceberg?

Insurable Interest in Takaful Pracitices: An Analysis

The Concept of Promise and Bilateral Promise in Financial Contracts: A Fiqhi Perspective

Challenges of Realizing Maqasid Al-Shari'ah (Objectives of Shari'ah) in the Islamic Capital Market: Special Focus on Equity-Based Sukuk Structures

The New Central Bank Act 2009 (Act 701): Enhancing the Integrity and Role of the Shari'ah Advisory Council (SAC) in Islamic Finance

Derivatives in Islamic Finance

Critical Appraisal of Shari'ah Issues on Ownership in Asset-based Sukuk as Implemented in The Islamic Debt Market

Islamic Banks and Wealth Creation

Can Bursa Malaysia's Suq al-Sila' (Commodity Murabahah House) Resolve the Controversy over Tawarruq?

Reshaping the Islamic Finance Industry Applying the Lessons Learnt from the Global Financial Crisis

The Issue of sequence and Pre-Signingin Contract Execution: A Comparison of Shari'ah Rules and Current Practice

Tools For Controlling Monetary Variables in the Islamic Banking System

The Concept and Operations of Swap as a Hedging Mechanism for Islamic Financial Institutions

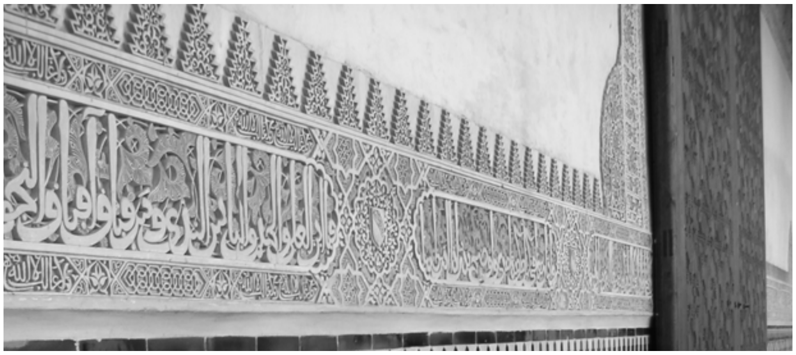
An Islamic Pricing Benchmark

An Analysis of the Role and Competency of the Shari'ah Committees (SCs) of Islamic Banks and Financial Service Providers

Istijrar - How does it really work?

By Nikan Firoozye, PhD

Nikan has over 14 years experience in leading Wall Street and City firms on the buy and sell-side including Lehman Brothers, Goldman-Sachs, Deutsche Bank, Sanford Bernstein Alliance, Citadel and Nomura where he is currently Head of European Rates Strategy. He has worked in a variety of primarily technical or quantitative fixed income roles from Rates & Hybrids Structuring to Rates Strategy and Quantitative Modelling to Asset Allocation and Risk Management to Prepayment Analysis and Securitization and Capital Markets. Education: PhD Mathematics (Courant Institute, NYU), Asst Prof University of Illinois.



The Background

Although technically Istijrar is just a repeat sale or 'supply' arrangement, (see reference link), it is both a very sophisticated contract and in the form most quoted can have elements resembling 'Asianing' in options (i.e., average price), and barrier options. Although note that it is not really an Asian option, but a series of barrier options. Further reference is given in 'Structuring Islamic Finance Transactions' (pp 71-2) by Thomas, Cox and Kraty (see reference link).

The modern use of the contract was begun by Mufti Taqi Usmani and this interesting payoff is described in some detail in papers by Obiyathulla I. Bacha's 'Istijrar: A Product of Islamic Financial Engineering' (see reference link) and Dr Mohammed Obaidullah (New Horizon, no 68, Oct 1997). While it is not possible to reproduce this latter article in electronic format as IIBI has not yet finished scanning their back issues.

It is also mentioned in some detail in Obaidullah's online textbook (see reference link, p 48), as well as in this lecture note by O.I. Bacha, 'Derivatives in Islamic Finance - An Overview' (see reference link, p 21) and his paper 'Derivative Instruments and Islamic Finance: Some Thoughts for a Reconsideration' (see reference link, p 23).

The Structure

The details of the arrangement are as follows (according supposedly to Dr. Muhammad Imran Ashraf Usmani), based on Meezan Bank's Guide to Islamic Finance (see reference link, section 19). Please note that although this is a sale, after the execution of the Master Murabaha, no offer or acceptance is issued and sale is concluded merely by posession (bay al-ta'ati or al-mu'atah).

A Master Murabaha facility or Istijrar facility agreement is signed between the bank and its client under which various Sub-Murabahas would be extended:

At Time T0:

The Master Murabaha agreement will describe the following formula for the price range an the Murabaha price P*:

1. The upper and lower range around the cost price P0 is determined. This price range may be linked to a benchmark such as LIBOR+margin'. Hence the price bound would change when the benchmark shifts.
2. The Murabaha price P* or the exercise price is set. This is the price which may be applied if the market price of the asset goes above or below the price range during time T0-T90.

The period during which the above two call options shall be valid is T0 -T90.

At T90:

1. When the Sub-Murabaha or 'Declaration' is signed at T90, the sale is executed.
2. The settlement price Ps is determined at this time.

Settlement price Ps may be one of the following two:

* Avg price of asset during T0-T90
* Exercise price fixed by either party afte the market price of asset during time T0-T90 has gone out of the rice range. This exercise price may be the murabaha price P* or some other price fixed by either bank or customer.

At Ts: On the settlement date, the settlement price Ps is paid as set at time T90.

* If a number of Sub-Murabahas have been executed under the Master Murabaha Agreement, then each will be settled according t is own settlement price on the settlement date.
* In order to decrease the price volatility between Declaration Date an the Settlement Date, the duration may be reduced.

Terms Used:
T0 - Time when Master Murabaha agreement or Istijrar agreement is signed.
T90 - Time when declaration is signed
Ts - Settlement Date P0- Cost price
P*- Murabaha Price
Ps-Settlement price
Declaration -- Offer and Acceptance between Custeomer and Bank to sell the asset back to customer.

Key Points:

* Murabaha Price P* is to be determined at the time of extending the Sub-Murabaha.
* The Murabaha Price P* cannot be fixed as the settlement price Ps by the Bank or the Customer during the tenor of the sub-Murabaha T0-T90
* Ps-settlement price may be the prevailing market price of an average of the price during the Istijrar period.
* The price on the settlement date cannot be changed by either party even if the market price has gone out of the pri range during the tenor of the sub Murabaha.

Process Flow:

1. Master Murabaha Agrement/Istijrar agreement is signed at T0
2. Agency agrement is signed (if required) at T0.

Featured Structure

3. When the bank purchases the commodity the Declaration (Sub Murabaha) is signed at T90.
4. Ps-the Settlement Price (Contract Price) is paid on the Settlement Date.

Short Discussion

While the features of this derivative contract/arrangement are described in some detail in these papers, the technicalities and legalities and Shariah aspects are less easily found. But the amazing thing is that this arrangement is merely a set of sales.

Islamic Law of sale is such that Istijrar is not considered a set of strange options, no wa'ad is necessary, no khiyar is needed (although they can apparently also be used). In sale contracts there is flexibility according to the payment and settlement of price. Bay' bi Sirr al-Suqq or payment at market-determined price (see reference link) is the subject of relatively rich discussion, this is one area of fiqh which touches upon Istijrar. The fact that Istijrar is a repeat sale makes many scholars feel that this flexibility (delay of payment and price set according to market average) should be afforded to this arangement. Moreover, the embedded derivative elements help to reduce the risk, reducing the gharar of the arrangement to something considered to be 'acceptable'.

Please note as well that Istijrar is extremely flexible and can be used for many other types of contracts (e.g., ijara, and mudaraba, supposedly) and can probably allow for a great many other payoff profiles. This usage of Islamic Law of Sale is something that has not been explored to its fullest in Islamic Finance, and we should probably expect much more future innovation in Islamic Finance using Istijrar.

A future topic of discussion remains the notion of sale at market-determined price (see reference link) as well as the more conventional delay in payments and conclusion of sale without offer/acceptance. Undoubtedly, Istijrar is one of the hidden gems of Islamic Finance.

Your feedback and comments are very important to us, please feel free to contact the fund manage via email.

Crescent Investments Australasia

Interview with Chaaban Omran, CEO

Chaaban Omran is the former Managing Director of Muslim Community Co-operative Australia (MCCA). Chaaban was instrumental in demutualising the co-operative and in attaining Australia's first Financial Services License for a Shariah Compliant Retail Investment Fund. Also during his time at MCCA, Chaaban lectured and presented to the banking and services industry, both domestically and internationally, on Australia as an emerging market for Islamic Banking. Prior to MCCA where has been serving and is a director for nearly 4 years, Chaaban was Head of Business Systems for topASX200 company Australian Wealth Management (now known as IOOF Ltd). Chaaban has been in senior roles for 10 years also with Perpetual Investments, MLC and AMP. As a community volunteer, Chaaban was the former National President of the Federation of Australian Muslim Students & Youth (FAMSY). Chaaban has Bachelor of Commerce (Economics and Finance), Diploma in Business and a Certificate in Superannuation Management. Chaaban is a Fellow of the National Institute of Accountants and a Fellow of the Australian Institute of Management.

Q1. What are the main reasons to consider allocating into the Australian market? Is this rationale any different when being considered by conventional or Islamic investors?

Australia is an attractive investment destination due to its strong economic fundamentals especially given its exposure to Asia (and in many respects China), has a well regulated and sophisticated financial markets and is surprisingly tax friendly for offshore investors.

Australia has a developed and well Regulated Financial Market

* Australian share market is developed and well regulated – Australian Securities and Investments Commission, Australian Prudential Regulatory Authority, Australian Stock Exchange
* 4th largest retirement savings market in the world estimated at over $AUD1 trillion
* All major custodians have operations here
* Banking sector escaped the contagion from the US property market

Australia has a Strong Domestic Economy

* Shallow downturn due to government stimulus and flow on from China
* Banking system resilient and well capitalised
* Abundant natural resources in Iron Ore, Coal and gas which China needs
* Investment in resource projects in LNG, Iron Ore, Coal and potentially Coal Seam gas to underpin strong domestic recovery.
* Government net debt negligible

Leveraged to China

* Australia's largest trading partner
* Exporter of resources to China, beneficiary of Chinese investment

* Listed equities biased towards resources
* Approximately 27% of the Top 100 index is resource companies
* Approximately 37% of the Small Ordinaries index is pure resource companies

Outlook

* Strong pickup in growth in CY10 driven by rising investment and domestic demand
* Improving Terms of Trade to drive income growth
* Unemployment has peaked and is declining
* AUD beneficiary of improving commodity demand and global growth

Australia remains a strong destination for conventional investors due to the abovementioned reasons. At the conventional level, financial services and banking stocks especially have faired extremely in comparison to the world during the Global Financial Crisis due to our strong regulatory framework – nonetheless the risk of investing in Riba-based stocks were still felt in our economy during that period. However for Islamic investors value can also be found in undervalued stocks and new upcoming innovative companies that meet the Shariah screening process. Australia is also a new market for Islamic investors that will allow them to exploit this new opportunity and add further diversification to their portfolio. There are vast opportunities and our appointed investment sub-advisor Sigma Funds Management believes there is significant upside in the next 12 months in our share markets.

Q2. The Australian economy has at times behaved independently of the global markets (most notably during 2005), does this enhance diversification benefits for Islamic portfolios? Has this quality been persistent/sustained over the years?

In Australia, Islamic portfolios are highly skewed towards resource stocks and in particular smaller companies with great upside opportunities. In general, The Australian market has reported record profits for many companies and for this reason our market has remained strong and resilient in comparison to global markets. Given we are en emerging market for Islamic portfolios we don't have any track-record going back to 2005. However, if we look at the performance of the Australian share market (ASX300) over the past 5, 10 and 15 years, Australia has consistently outperformed the Japan, FTSE and S&P500 indices. In over the 10 years to June 2010, the ASX300 produced a return of 30% whereas the other markets produced -46%, -22% and -29% respectively (source: Sigma Funds Management).

Australian Equities-Cumulative Returns in Local Currency Till Jun-10

Source: Sigma Funds Management

Q3. This economic resilience has been partly driven by the resources sector (which accounts for well over 20% of the Australian share market), does this overshadow other sectors and/or investment opportunities?

The resource sector has been the engine of growth in Australia for the last 5 years but these benefits flow into other sectors as well. Increased investment has flowed into full employment which should be positive for consumption and housing. The higher terms of trade should lead to higher national income and hence consumption and government expenditure.

A strong domestic economy leads to investment opportunities in other sectors, hence the benefits of a strong resources sector become more widely spread.

Q4. With $1.65 trillion, the ASX represents the second largest stock market in Asia-Pacific after Japan, nevertheless there are very few Shariah-compliant products offering exposure to this market. What are some of the reasons for such a lack of product?

Up until now, Australia has not seen Shariah-compliant products as an alternative innovative investment class. The recent traction for the financial services industry to take not of these products has come about due to the strong performance of such products in the US and the UK-both from an Islamic Finance and from an Islamic Investments Funds point of view. Further the ethical investments concept in market over the past 15 years seems to be waning and it's most likely that if marketed correctly and strongly to wider Australians that Shariah-compliant products will be a more attractive investment class than ethical investments.

The lack of product in this market is an opportunity. Australia does not have a large number of muslims as in some other South East Asian markets which may be one of the key reasons it gets overlooked. Unfortunately the domestic funds management industry is not focused on developing product for this market in Australia as it is seen as a niche.

The other constraint is the lack of local Islamic scholars who are well versed in financial matters who can help develop the industry locally. Also the lack of Islamic financial practitioners also acts as a handbrake.
Nevertheless it can be a profitable niche for a first mover given the latent demand of Australia's 400k odd muslims via superannuation or as a retail product offering.

Q5. Data from the Australian Bureau of Statistics shows that 40% of listed equities are owned by overseas investors, what are some of the factors that have facilitated access to the Australian marketplace?

Australia is an economy that is open to offshore capital flows which helps facilitate foreign investment. A well regulated share market also gives foreign investors confidence to invest in Australia. Finally the attractive economic outlook and investment opportunities that are available has also been a driver of foreign investment into Australia.

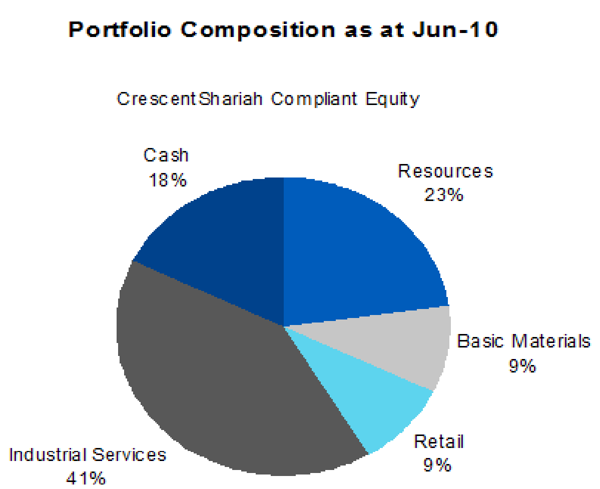
Q6. What are the implications for overseas investors considering recent legislation surrounding Managed Investment Trusts (MITs)?

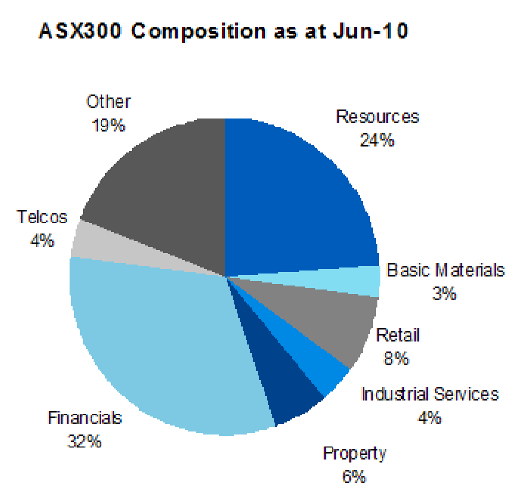
Recent proposed changes relating to Managed Investments Schemes centre around the need to ensure that clients are getting the right financial advice and simplifying fees and offer documents. For example the proposed regulations prescribe that a Product Disclosure Statement (PDS) must be no longer than six A4 pages — a significant shift from the current regime, which does not prescribe any PDS length. In addition to prescribing PDS length, the Regulations mandate the content to be included in the PDS.

Nonetheless leaving these positive changes aside, the taxation benefits for Managed Investment Schemes are surprisingly attractive for overseas investors. Overseas investors have the perception that Australia levies far too much tax on them – this is not the case. Taxation in a managed investment scheme is minimal.

Q7. Does the screening preclude your ability to have exposure to any specific market sector (i.e. retail, mining, etc) or segment (i.e. large caps)?
The screening precludes Crescent from investing in Financials which make up 33% of the market cap of the ASX300. The screen is also biased towards resource stocks and small caps in particular. This also makes it difficult for mainstream fund managers to offer a shariah based product given the mix of skills required to manage the fund.

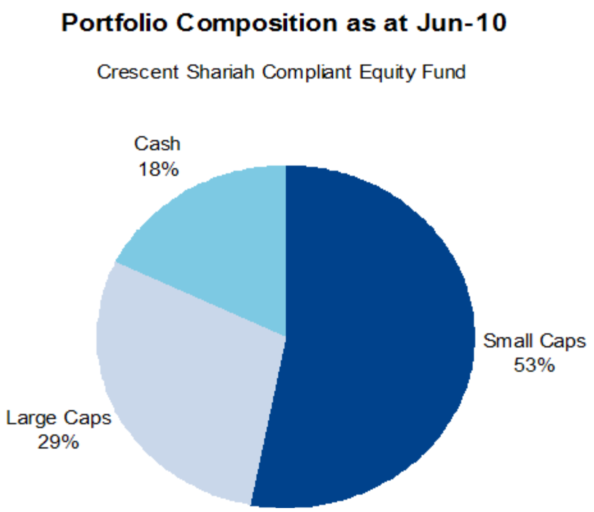
Below is a graph that shows the sector make up for the Crescent Shariah Compliant Australian Equity Fund which shows that we do not invest in the Financial and Property sectors due to their Riba and gearing exposure. The ASX300 Index is the conventional index.

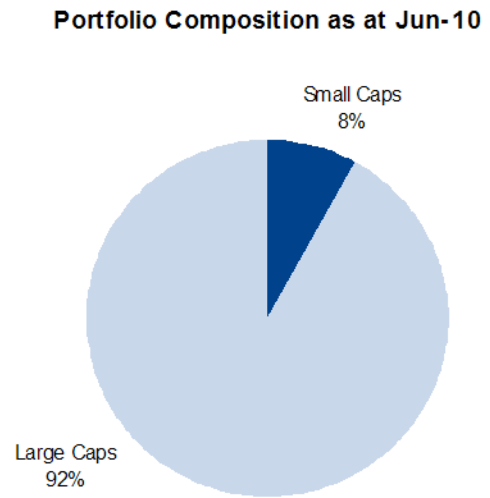




Allocator Interview

In terms of the segment, we find that our Shariah Compliant Australian Equity Fund is highly skewed towards smaller companies as can be seen by these illustrations:

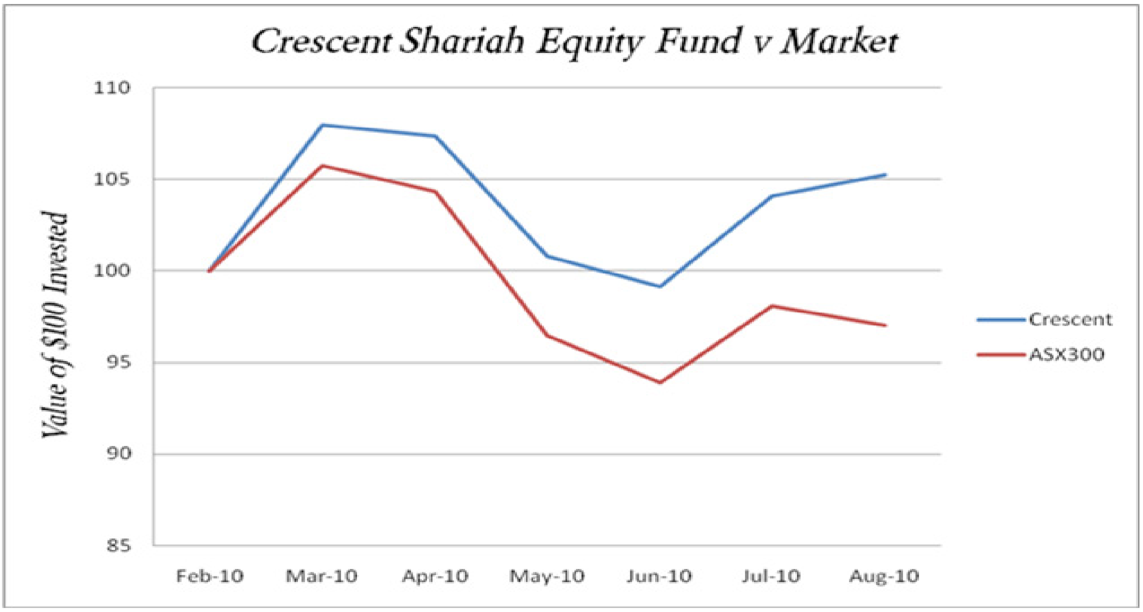




Q8. While there are more than 2,000 companies listed in the ASX, what is the impact on this universe after applying a Shariah screening methodology?

Depending upon the method used to screen the ASX the shariah screen reduces the number of stocks to invest in from 2000 to approximately 230-300. Crescent uses the AAOIFI method as we believe this is the method that blends a strict application of financial screens and wide market recognition.

As a matter of fact, when you take the differences between the Shariah compliant portfolio and the conventional index you will see that our fund has outperformed the conventional index in the past seven months as shown below:



Q9. Taking into account the absence of a readily available Islamic index, what are the most appropriate benchmarking options available?

That is a difficult issue to address, and Crescent is advocating the creation of such an index by the mainstream index providers. In Australia that is S&P which owns the rights to the S&P/ASX indices. We are also investigating the provision of a custom index by other reputable providers for eg Dow Jones.

For the moment and for comparison purposes we use the S&P/ASX300 (see above sector allocations) as a guide to how the fund is performing. Our aim is to achieve comparable returns to the market despite the obvious index composition issues. This we believe can be delivered by stock selection and risk management within portfolio construction.

We also benchmark on an absolute return basis given that investors want to achieve positive absolute returns and are less concerned with relative returns.

Q10. The Australian dollar remains one of the strongest (and most traded) currencies today, how would this impact an allocation decision? Considering the link to commodities, is this appealing for institutions with significant exposure to oil revenues?

Obviously the Australian dollar is highly correlated to commodity prices given that the exports of such commodities are a significant part of the Australian economy. A strong domestic outlook for Australia and the bias towards rising interest rates suggests that the fundamentals point towards further appreciation of the currency. This adds to performance when measured in USD, and given oil is traded in USD this would be particularly attractive to institutions in oil producing countries. Both from an investment return enhancer as well as for diversification purposes.

Q11. Considering its dynamic investment fund community and vast superannuation industry, what are the necessary steps to position Australia as an Islamic asset management hub?

Australia has a competitive advantage in terms of the sophistication, maturity and regulation of its investment fund industry given how long we have had superannuation. So the skills exist to manage and service the Islamic asset management industry. We need to lift the awareness of shariah compliant investing and the issues that this raises in terms of investing. We also need more Islamic scholars being available to help with the constitution of shariah advisory boards. Local Fund managers also need to invest the time and money in developing products that can meet the needs of the domestic market before it would be taken seriously by offshore Islamic investors. The fact that the domestic market is underserviced is the real opportunity, 400k muslims with superannuation assets are seeking such alternatives but to date other than the efforts of Crescent Investments little has been accomplished. Getting the government to support the development of the industry by seeding some of these funds would lift the profile and awareness of such products as well as highlight the supportive intentions of the government towards shariah compliant investing. This is something that we can learn from the Malaysian government in terms of nurturing the expertise and development of the industry.

Your feedback and comments are very important to us, please feel free to contact the author via email.

A Brief Look at Ikhtilaf - Diversity of Ijtihad in Islamic Finance

By Abdulkhaliq Elshayyal

Abdulkhaliq joined BLME in 2008 where he holds the position of legal adviser and shariah compliance officer. He advises on legal matters as well as structuring and developing Islamic banking products and services and has been involved in award winning transactions as BLME has grown to become the largest Islamic financial institution in Europe. He also manages the bank's relationship with its shariah supervisory board. Having graduated in law and subsequently obtaining a masters degree in law (specialising in Islamic law) from the University of London he worked in the UAE in the Islamic finance team of a major international law firm before returning to the UK to join BLME in its first year. Abdulkhaliq has also studied classical and contemporary Islamic jurisprudence with a focus on economics and financial transactions.

With the increased attention on the regulation of the financial sector under the last two years, there have been concerns that the Islamic finance industry remains subject to lower standards of regulation. One of the areas often cited in this regard is shariah risk. A term, which was coined to primarily refer to instances where a product or transaction originally deemed shariah compliant, becomes no longer regarded as such. The perceived lack of governance or regulation of this risk has become an issue of popular discussion following recent events which will be considered below.

As the Islamic finance industry continues to grow at a remarkable pace, the need to recognize and appreciate the shariah as the core of the industry is more important than ever. Thus, not only is it essential for products to be structured and documented on a shariah compliant basis but the objectives, spirit and ethos of the shariah must be maintained throughout the industry and implemented correctly by industry practitioners to ensure that the services being provided are indeed shariah compliant.

Recently, three landmark events in the industry have renewed the discussion on shariah risk. The comments by Sheikh Taqi Usmani on the structures of certain types of sukuk products, the IFA opinion on the use of tawarruq in certain ways by Islamic financial institutions and The Investment Dar case in the English courts. Incidentally, the first two are examples of efforts to ensure that the principles of shariah are upheld and to create greater transparency and regulate the industry from a shariah perspective. However, these efforts were overshadowed by issues, including the timing of the events and misinterpretation of them to great extents led to a call by many of the shariah risk they created. Subsequently, shariah risk became a popular topic in industry forums and at conferences, headlines were made looking at how these risks came about while mostly ignoring the unique nature of the shariah and failing to acknowledge how these events were not in fact the risks many were purporting them to be.

Notwithstanding the substantial misconception of the first two events, it is difficult to successfully argue that they in themselves created any significant risks to the industry as opposed to the risks created by the industry's reaction to them. It is this reaction which should be considered in order that future events are not addressed in a similar fashion partly through a deeper understanding and appreciation of how the shariah provides for ijtihad (scholarly reasoning by interpretation of primary shariah sources) and talfiq (the derivation of rules from material of various schools of Islamic jurisprudence). While following the development of the debate on tawarruq, two matters came to mind. The first was the practice of the ninth century Hanafi judge, Ibrahim ibn Al Jarrah of noting the different opinions of Imam Abu Hanifa, Imam Malik and others before issuing his decrees and judgments and the second being the shariah maxim on the finality of judgments, (الاجتهاد لا ينقض الاجتهاد) "By attempting to form a correct opinion [through ijtihad], an existing or previous such attempt is not invalidated."

As Islamic finance and Islamic economics in the wider sense are religion based systems, it follows that their primary governance and regulation should stem from the code they are subject to – the shariah. Add to this the jurisdictional and local regulatory requirements that are necessary for Islamic financial institutions to operate under and we are presented with a young, unique system being tested for the first time in a sophisticated environment during a historic period for the financial sector. Therefore, aside from the national regulatory measures which Islamic financial institutions remain subject to, there are the additional layers of governance which must also be met. At the centre of ensuring good governance of these institutions is the role that the shariah supervisory board plays. The growth of the industry saw certain institutions develop more innovative products to meet the demand of what was becoming a growing market. In order to deliver such products, the industry sought shariah scholars with a specific skill set to meet the demands of the contemporary Islamic finance market.

However, as certain capabilities became more desired by financial institutions and were marketed from Malaysia to Bahrain rather than just locally, the industry came to realise that such products were not always acceptable to all scholars and that certain practices which were becoming common market practice were at the same time deemed non shariah compliant by certain scholars, albeit having been approved by others. Far from this being a risk or a setback of this shariah based industry as many practitioners tend to argue, such instances of difference in opinion are examples of the flexibility and wealth of diversity of the shariah. At this stage it is important to consider the science of ijtihad. As classical Muslim jurists applied their ijtihad to matters of their day, similarly today, the industry is witnessing contemporary issues being the subject of scholarly ijtihad. Here, it is necessary to make the distinction between disagreement and rejection of views on unfounded bases (khilaf) and difference of opinion based on ijtihad derived from sources and supported by evidence from the shariah (ikhtilaf). It is in fact this diversity of acceptable opinions which provides the opportunity to fulfill maqasid ash-shariah on a wider scale and maslaha on a more macro level as Islamic finance is practiced in numerous diverse communities. The great Maliki judge, philosopher and scientist, Ibn Rushd (Averroes) explained the reasons for ikhtilaf as six reasons concluding that these reasons indicate that the difference of opinion on a particular matter is indeed a natural event which should not be denied nor should it be seen as opposed to the shariah.

Having said this, and as opposed as this may appear to the efforts being made to standardise elements of shariah governance, the reality is that both diversity and standardization work hand in hand. The wealth of diversity between the four main schools of Islamic jurisprudence provides ample substance on which to continue to develop modern products which the industry requires. At times, such juristic reasoning and historic application of decisions is only found in a single school of thought. Thus, the pragmatic nature of the shariah should be embraced as a system which facilitates the development of ijtihad to further apply shariah tenets towards achieving the objectives of the shariah. Consequently, the existence of certain practices should not be seen as a hindrance to harmonisation or regulation of industry practices. This can be witnessed in the Malaysian approach to the subject as adopted by Bank Negara Malaysia and the Securities Commission. The progress made in Malaysia in this regard is widely viewed as a model towards practicing harmonization and standardization by a regulatory body in a fast moving industry. Other attempts have been made to achieve the same objectives, for example by the Central Bank of Bahrain and by standard setting agencies like the AAOIFI and IFSB.

Ikhtilaf when applied correctly in matters of fiqh al muamalat should therefore not be considered as a risk but as a means to achieve a more ultimate objective for the industry. It is for this same purpose of striving to maintain shariah compliance that a realistic approach to standardisation should be adopted without compromising shariah principles.

Your feedback and comments are very important to us, please feel free to contact the author via email.

Islamic Dinar Reloaded

By Mobasher Zein Kazmi

The writer is an Islamic finance researcher who completed his MBA (Investment Management) from Concordia University and is a CFA Level 3 candidate. He was recently awarded the Islamic Finance Qualification (IFQ) designation.

An Islamic Reserve Currency

The rise of modern Islamic banking and finance in the 21st century has been one of the greatest success stories in recent economic history. The industry remains poised in a high-growth stage as banking practices are evolving into a core group of standardized financial products compliant with the letter and spirit of Sharia law. The initial challenge of reorienting conventional banking structures towards interest-free financial systems has endured as Islamic banks are hard-pressed in pricing financial products using benchmark interest rates to remain competitive. Critics of Islamic banking charge that the Islamic financial system has not reached the pristine level of best practices as ordained by Sharia through the negation of uncertainty in financial contracts; current financial practices remain tainted with the brush of riba am naseeyah (usury). It is in this context that the introduction of an Islamic reserve currency becomes paramount in removing the element of doubt in Islamic financial contracts while providing a strong moral foundation for Islamic financial systems to thrive across the global economic landscape.

The introduction of an Islamic reserve currency will bring some measure of stability to the existing disorder in international financial markets whose origins can be traced to the actions of a coterie of Wall Street bankers and their reckless use of financial instruments in pursuit of bottom-line profitability. Federal Reserve notes are undeniably in a permanent state of decline as the economy of the United States is saddled with record budget and trade deficits; external financial inflows will prove inadequate in sustaining future US government spending programs particularly the badly needed stimulus required to jumpstart its moribund economy. In this uncertain environment the need for a genuine alternative reserve currency becomes ever more critical if only as a vehicle of wealth preservation for sovereign nations.

The Islamic Development Bank is the ideal financial institution which can assume the responsibility of providing such a reserve currency to member and non-member states alike authenticating its halal credentials while working towards cementing the ascendancy of Islamic financial systems. The trade off in utilizing fiat currency as a principal medium of exchange remains a costly option as its store of value consistently erodes after each business cycle. Instead, the new reserve currency will improve upon the old Bretton Woods System of fixed parities and will be backed by a free-float gold peg ensuring the reserve currency retains intrinsic value. The current global financial crisis has clear implications for the Muslim world and a desire for macro-economic stability mandates a monetary policy that will protect regional economies in the medium to long-term from the inevitable currency crisis.

Islamic Origins

The introduction of an Islamic currency can be traced to the reign of the second Caliph Omar bin Khattab (644-655 AD) who established the following currency standard which was upheld by succeeding Islamic governments namely:

* The Islamic Dinar whose weight of gold was fixed at 4.3 grams
* Islamic Dirham whose weight of silver was fixed at 3 grams.[i]

Commodity backed Islamic currencies were in use up until the collapse of the Ottoman Empire and onset of World War 1 in 1914 when the Ottoman Empire chose to abandon the gold standard.[ii] Clearly, a very strong tradition of metal based currency exists in the Islamic world and can gain rapid acceptance provided the sponsor is an established and recognized institution willing to act as a force stabilizer of the Islamic financial system. The Kelantan state of Malaysia is only a recent example of attempts by local authorities to bring greater confidence in the monetary system and is understandable given the savage speculative attacks the Malaysian Ringgit has suffered in the recent past. Former Malaysian Prime Minister Mahathir Mohammed himself has been a champion of Islamic monetary reform and is at the forefront in calling for a new reserve system used to facilitate international trade. [iii]

Historical Perspective

Looked at through the ages, gold has played a pivotal role in the execution of economic transactions as the principal medium of exchange; be it in the era of Pax Romana or the medieval Ming Dynasty of China. However, the late 19th and early 20th century witnessed an extensive use of gold reserves within the prevailing international monetary system especially for the use of settling international trade accounts. This fell into complete disfavor by 1933 when the gold standard was abandoned by the United States under the aegis of President Roosevelt.[iv] Its critics argued that gold was no longer seen as desirable, citing its perceived inability to cope with the demands of global trade and investment. In this backdrop the Bretton Woods system was born where fixed exchange rates would be managed by the newly created International Monetary Fund placing the US Dollar as the world's reserve currency; it remained fully convertible to gold until 1971 underscoring the value of utilizing gold in stabilizing exchange rates.

Aside: Bretton Woods Reloaded

In order to discuss the Islamic Dinar (and the broader topic of an Islamic economy) we are required to take equal attention to the fiat currency system of today as well as previous monetary systems. This calls for an analysis of not just the Bretton Woods but what came before as well as what came after (and the reasons surrounding these choices). Effectively the current debate surrounding monetary policy is rather similar to the one that has surrounded Islamic finance instruments, namely we have a distinction between asset-backed and asset-based products. The gold standard (i.e. pre-Bretton Woods) represented the notion of an asset-backed currency, whereas the exchange rate systems that followed (the fixed system of Bretton Woods and the and floating rate system of today) represent an asset-based regime (the fiat or faith-based regime banks on the credit worthiness of the issuer country).

Specifically, the gold standard as practiced in the 19th and 20th century was based on the concept of having currencies being backed by a unit of fixed weight in gold. In fact there have been different versions of this system (namely the gold specie standard, the gold exchange standard, and the gold bullion standard). The latter would have a relatively short lifespan, in-between the end of WWI and the outset of the Great Depression. Nonetheless, the gold standard reflected a need to manage exchange rate risks and it was seen as an automatic regulator of trade imbalances, although the effectiveness of this system increasingly came into question. In particular with regards to short term shocks and its inability of monetary policy to alleviate these pressures in a timely fashion.

Overall, the gold standard proponents cite various benefits including: long term price stability (i.e. inflation and specifically hyperinflation are hampered); limiting governments from engaging in excessive seignorage (supressing their ability to inflate prices through extensive issuance of their paper currency); and the subsequent control of a government's deficit (as countries can't inflate away the value of their foreign debt). On the other hand, disadvantages to the gold standard are equally numerous, mainly relating to the linkage between a gold standard and deflation; the total amount of gold available (suggested to be insufficient to back all current money in circulation); removing a key tool of monetary policy to be used to alleviate a recession; eventual dependence on gold production (i.e. inflationary pressures could ensue when gold production increases or decreases) and in that sense short-term price fluctuations due to the volatility of gold price in the open markets.

The introduction of Bretton Woods aimed to replace the gold standard in favour of a specified fixed exchange rate, US dollars to Gold ($35 per ounce of gold), therefore each signatory country would be obligated to maintain the exchange rate of its currency within a fixed value. Nevertheless, there were stark differences as to how this system could be implemented. Most notably, John Maynard Keynes proposed the creation of a global currency - the Bancor - which would be backed by barter and its value denominated in weight of gold. In other words this system called for replacing the direct barter of "goods for goods" (i.e. currency for currency) with a "goods for bancor for goods". Keynes argued that this would lead to an equilibrium in international trade flows, in other words he viewed imbalances as being caused when goods are not exchanged for other goods but for money instead (i.e. any promissory note - form cash to bills of exchange). The Bancor would have addressed these issues, although as we know the US dollar was eventually chosen as the reserve currency. This was due in part to geopolitical pressures emanating from the cold war (and the fact that the USSR had access to significant gold deposits) as well as the economic prominence that the US had built in the post-war era (and the perceived strength of the US dollar).

The current monetary system is primed for an overhaul and the advent of a so-called Bretton Woods II regime. All in all, many factors are coming into play: the concept of Gold as a store of value has been extended to other commodities (not just hard commodities); the prominence of a single economic power is much less apparent (as well as a clear shift from US current account surpluses to significant deficits); there is less political polarization (i.e. the end of the Cold War) and instead a global segmentation into economic blocs (with the emergence of the BRIC, Asian and MiddleEastern economies, as well as the relatively-recent creation of the European currency); and ultimately the economic liberalization/globalization of the world economy. While many lessons have been learned from both fixed-rate and floating-rate monetary regimes, we can expect that the effectiveness of the current system will continue to be challenged - in much the same way as Bretton-Woods challenged the gold standard.

The Islamic Dinar

The Islamic Dinar is presently the Islamic Development Bank's unit of account and forms the basis for its authorized capital stock of 30 billion and subscribed capital stock of 16 billion.[v] One Islamic Dinar is equivalent to one special drawing right (SDR) of the International Monetary Fund.[vi] This special drawing right based on IMF guidelines is further weighted in the following manner to derive its value:

				YTD 2010	YTD 2010
Symbol	Currency	Share	Value	Exchange Rate	USD Equivalent
$	US Dollar	44%	$ 0.63	1.00	0.63
€	Euro	34%	€ 0.41	1.32	0.45
¥	Japanese Yen	11%	¥ 18.40	0.01	0.20
£	British Pound	11%	£ 0.09	1.53	0.14
				SDR1=USD	1.42

Note: Exchange rates based on average yearly rates.

If instead the Islamic Dinar was pegged and fully convertible to gold based on the established Islamic precept of 4.3 grams per dinar then its hypothetical make-up would be quite different:

	Price of 1 SDR in USD	Price of 1 Islamic Dinar
2006	1.47	83.49
2007	1.53	96.14
2008	1.58	120.50
2009	1.54	134.50
YTD 2010	1.42	161.13

Note: Exchange rates based on average yearly rates.

Gold prices have clearly shown an upward trend and remain grossly undervalued when inflation is factored in and prices are evaluated in real terms. The long-term preservation of value particularly of a reserve currency such as the Islamic Dinar can only be maintained if a gold standard is adopted. The fact that the Bretton Woods system collapsed can be traced towards the US government's spending programs (Lyndon Johnson's "Great Society") and the Vietnam War. In fact one can draw a reasonable correlation between the abandonment of sound monetary policy and the rise of wars where governments recklessly print fiat currencies to pay for bloated defence budgets with costs being passed on to the citizenry in the form of higher taxes and price inflation. Frankly, this is destructive and quite toxic for growth to the most productive sectors of the economy.

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Your feedback and comments are very important to us, please feel free to contact the author via email.

Islamic Banking and Finance: What It Is and What It Could Be

By Mohammed Amin

Mohammed Amin is an Islamic finance specialist, with a particular interest in how Islamic finance is treated in Western tax and regulatory systems. He is a member of the HM Treasury Islamic Finance Experts Group, established by the Economic Secretary to the Treasury to advise the Government on Islamic Finance strategy, and is the only practicing accountant on that group. Until he retired at the end of 2009 Amin led PricewaterhouseCoopers' Islamic Finance practice in the UK as well as being a member of PwC's four-person Global Islamic Finance Leadership Team. He shares his thoughts on Muslim community issues and Islamic finance topics on his website (see reference link).

"Islamic Banking and Finance: What It Is and What It Could Be" was published in March of this year by 1st Ethical Charitable Trust, and is an impressively well presented book, hardbound, printed on high quality paper and 500 pages long including the appendices and index. Including the editor, Tarek El Diwany, there are 12 contributors including experts in Shariah, lawyers and academics. However, only one of the authors, Shaharuddin Zainuddin, is a practicing banker.

Unlike many multi-author publications, with two exceptions (pieces expressly appearing over the names of the editor and of Nejatullah Siddiqui), specific parts of the text are not attributed to named authors, a process that clearly attaches the author's reputation to the text that he writes. However, page xxiv sets out in broad terms who was the main contributor of each section.
The back cover sets out the book's objectives and structure:

> *"This text has been designed for use by professionals new to the field of Islamic banking and finance and by students at undergraduate level or above. While many reference works focus on a narrow set of content, "Islamic Banking and Finance; What It Is and What It Could Be" expands its coverage to include the historical, theological, commercial, legal, institutional and macro-economic factors affecting the modern world of Islamic banking and finance. It is organised into four main sections: Islam and the Shariah, Traditional Contract Forms, Contemporary Practices, and A Response to Capitalism.*
>
> *In a rare approach to the topic, the content encompasses views both for and against the current direction of the Islamic banking and finance industry and suggests a number of basic reforms at the institutional and contractual levels. Traditional and contemporary interpretations of Islam are contrasted, along with differences of opinion among the various schools of thought, so that the reader can better understand current discourse among scholars of Shariah. And in a section devoted entirely to the modern application of Islamic contract law, fourteen case studies provide a detailed analysis of the extent to which modern Islamic financial products adhere to the legal principles outlined elsewhere in the book."*

This is a very ambitious set of objectives.

Despite the length, and the apparent dryness of the subject, I found the book very easy to read and enjoyed reading it. It is well laid out, with excellent typography and a high quality of proofreading. It is also very well referenced with an extensive bibliography and many footnotes. The book is highly structured, with an outline that goes five levels deep.

Unfortunately the use of multiple writers has resulted in some of the treatment becoming very "bitty." For example the use of secular or Shariah law is covered in several different places, instead of being brought together in one. This significantly detracts from the quality of the book.

Overall, despite all of the effort that has been put into it, I believe that the book failed to achieve its objectives. In my opinion the main reasons are:

1. The objectives were too ambitious for a book that is only 500 pages long.
2. The writers have not remained focused on the needs of the target readers.
3. The fragmented coverage of key issues indicates that the editor has not maintained sufficient editorial control over his 11 co-authors.
4. The book, despite its claim in the above quote, is not properly balanced. There are many arguments against current Islamic banking practices, but few in favour of them. The editor is well known for his criticisms of current Islamic banking and I believe this is the reason for the absence of balance.

> *"However, in the backdrop to all of this, there lurks an intractable political problem. The Islamic banking and finance industry has so far embraced age-old Islamic contract types as the basis of its client relationships. While it is increasingly clear that such a strategy cannot succeed within an institutional framework that contradicts Shariah, the replacement of that framework necessitates a challenge to an interest-based industry whose annual revenues extend into trillions of dollars. Is the Islamic banking and finance industry facing this challenge? Does it even seek to?*
>
> *The fact that interest-based banks are so heavily involved in promoting the Islamic financial system should give us pause for thought in this regard. It is an alliance whose consequences are particularly evident in the intellectual domain. Those who disapprove of the Islamic methodologies being employed by large financial organisations are unlikely to be appointed as Shariah advisers by those same organisations. Students who come to the subject afresh are presented with case studies that discussed the 'what is' of Islamic banking and finance rather than the 'what should be'. By such means, narrow contemporary understandings of Islamic banking and finance are reinforcing themselves. There is of course nothing new in this. When the main commercial banks of the United Kingdom sponsored the establishment of the LondonBusinessSchool, they did so in order to develop the executive mindset that is required of bankers, not revolutionaries."*

The editor is of course entitled to hold views as revolutionary as he wishes. Unfortunately, these have gotten in the way of providing students with an objective textbook on what Islamic finance is and how it operates, which I regard as a necessary precondition before going on to promote the manner in which the editor would like it to change.

Your feedback and comments are very important to us, please feel free to contact the author via email.

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