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INSTITUTE OF ISLAMIC BANKING AND INSURANCE

Features

Regulars

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

Surat Al Baqara, Holy Quran

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Executive Editor's Note

On behalf of the Institute and the NewHorizon editorial team, I offer the warmest wishes for 2010 to all our readers, and students, members and supporters of the IIBI.

This issue of the magazine comes out against the backdrop of the ongoing financial crisis, currently fuelled by the financial unrest in the Middle East. We all hope that the New Year will finally bring the much talked about recovery, and the IIBI believes that Shari'ah-compliant finance will play an important role to bring about moral reform to address the inequalities and excesses in the global financial system.

I encourage NewHorizon readers to share their views on these and other developments in the world of finance on the IIBI's new website. It now has a fully-functional Discussion Forum, open for the members and students of the Institute as well as of organisations affiliated with it.

In this issue of NewHorizon, a prominent Islamic finance practitioner focuses on promises in Islamic finance – a subject of heated debate among industry participants. Also, NewHorizon raises a point on social business and explores the possibility of the use of the institution of waqf for such a purpose. Waqf is one of the important legacies of the early Islamic period, designed for poverty alleviation and humanitarianism. Also discussed is the concept of social business, promoted by Muhammad Yunus, founder of the world-renowned Grameen Bank and a Nobel Peace Prize winner. A social business model, which has been successfully applied by Grameen in Bangladesh, aims at solving social problems rather than making money for investors and at the same time being self-sufficient.

And of course, NewHorizon could not pass by the recent sukuk defaults and Dubai World's 'standstill' on debt payments. Among the vital questions these events raise is the issue of Shari'ah supervision and the role of Shari'ah advisers. Do they really act as 'moral filters' or do they by and large facilitate the desire of banks to make maximum profit?

Mohammad Ali Qayyum
Director General IIBI

Dubai World debt payment standstill

Dubai World, a government-owned investment company in Dubai, triggered concerns in global markets in late November when it asked for a 'standstill' on its debt payments. The company had run into trouble because of its exposure to falling property prices, and the announcement fuelled concerns about the solvency of Dubai itself.

The Dubai authorities have stressed that Dubai World's obligations are not guaranteed by the government, meaning that Nakheel's sukuk was to face a legal test if creditors have to fight for access to its assets. However, as NewHorizon was going to press, Abu Dhabi stepped in with a $10 billion bailout sum for its troubled neighbour, averting a default.

Nakheel made a statement on the Nasdaq Dubai website that 'it will honour all obligations related to the 2009 Nakheel Development Limited Sukuk'. Its $3.52 billion Islamic bond was to be repaid before the end of 2009, in the course of a two-week grace period (the sukuk was due to mature on 14th December).

Over the last year or two questions have hung over whether many sukuk are even halal, following comments from Shaikh Muhammad Taqi Usmani, head of Shari'ah committee of the Bahrain-based Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) in November 2007 *(NewHorizon, October–December 2008)*.

Saad Group sukuk defaults on repayments

A subsidiary of Saad Group, a Saudi Arabian conglomerate, has said it is unable to meet repayments on a sukuk (Islamic bonds) issue worth $650 million, which matures in 2012. Saad Trading Contracting and Financial Services informed the market that it is 'impossible for the issuer to perform its payment obligations under the sukuk'.

Saad Group has been troubled for some time. Saudi Arabian authorities froze its assets this summer, while a court in the Cayman Islands, where many of the group's subsidiaries are incorporated, froze an additional $9.2 billion of assets this year. The recent statement concerning the sukuk was, according to the group, precipitated when a court in Abu Dhabi placed its assets in the emirate under its protection, citing unpaid debts.

Meanwhile, in Pakistan, a major cement company, Maple Leaf, has announced its inability to repay $95 million worth sukuk bonds and has asked the creditors to restructure the financing. The repayment of sukuk is due from June 2010 in eight bi-annual instalments. The largest creditor of this sukuk is the Allied Bank of Pakistan, which has an exposure of around $37 million.

The problems at Saad Group and Maple Leaf are thought to have wider implications, as the rights of creditors are tested in practice.

IDB co-operates with UN for food aid

A UN Food Agency is co-operating with Islamic Development Bank (IDB) to help advance agriculture in poor countries. The UN Food and Agriculture Organisation (FAO) said it had reached an agreement worth $1 billion with IDB to develop the agricultural sectors of economies of countries which belong to both organisations. The FAO stated that 'this agreement comes at a critical moment, when the international community recognises it has neglected agriculture for many years. Today, sustained investment in agriculture – especially small-holder agriculture – is acknowledged as the key to food security.'

The announcement was made at the recent Hunger Summit, a meeting held to discuss solutions to world hunger. Around 60 heads of state and agriculture ministers attended the forum, whose generalised aim is to move developing countries away from a direct dependency on food aid and towards a situation where they can produce for themselves.

The move by IDB mirrors its efforts in 2008 when the global food crisis – which led to riots in a number of Islamic countries including Egypt, Pakistan and Yemen – spurred it to offer low cost loans totalling $1.5 billion tied to agricultural development. Saudi finance minister and chair of the IDB's governing committee, Shaikh Ahmed Bin Mohammad Al Khalifa, stated at the time that the five year programme was intended to 'help the least developed member states reach food security'.


Islamic Development Bank

Luxembourg's central bank to join IFSB

Banque Central du Luxembourg (BCL), the country's central bank, has applied to become a member of the Islamic Financial Services Board (IFSB), a global standard-setting body. The bank's governor, Yves Mersch *(below)*, has recently confirmed this. Acceptance of this invitation is expected to be announced next time the council of the Malaysia-based IFSB meets.

BCL's move reflects Mersch's increasing enthusiasm for Islamic banking, having recently called on European authorities to get to know Shari'ah-compliant finance, and also emphasised that the financial services needs of Europe's close to 40 million Muslims, and countless other millions who want more ethical service, have 'not yet been properly addressed by the conventional banking offering'. Mersch made the comments while addressing the 5th Economic Forum of the Belgium-Luxembourg-Arab Countries in Brussels. He added that it is important that regulators 'become more familiar with the principles and practices specific to Islamic finance in order to make appropriate supervisory and regulatory judgments'.

If accepted, Luxembourg will become the first European Union country to become an associate member of the IFSB, and the BCL plans to second staff to the IFSB where they can familiarise themselves with Islamic financial products and transactions, plus concepts such as liquidity and risk management.

Luxembourg has previously shown plenty of interest in Islamic finance. Three initiatives were announced in May 2009, including an investment fund working group to look into the opportunities of Islamic funds, an Islamic finance training programme at the Luxembourg Banking Training Institute, and also instruction by the government for the tax authorities to look into ensuring tax neutrality for Shari'ah-compliant finance.

Swift launches Islamic message standards

The Society for World Interbank Payments (Swift) launched a new pilot in December for Islamic finance. Although a relatively small beginning for the Society, it is seen as a potentially interesting area for diversification.

The initial focus is on treasury murabaha messages, with a London-centric pilot. This is a highly manual area at present, says Swift's managing director, UK, Ireland and Nordics, Arun Aggarwal *(right)*, so the aim is to replace the paper flows with ISO 15022 message standards. 'We have done the messaging, there were only very small tweaks needed, and it is really now about getting the community together.' There will quickly be a push to gain acceptance in major Islamic centres such as Dubai and Malaysia, he says. The fact that most of the Islamic banks will already have Swift connectivity should help the uptake. The instrument coverage will also be extended; he points out that the pilot is focused on one of the largest.

Aggarwal declines to name the banks involved until the pilot has gone live. However, it seems clear that they include users of Path Solutions' core banking system, iMAL, as this supplier and Swift have announced a partnership to support the new messaging standards. Path's customers in the UK are Bank of London and The Middle East, Europe Arab Bank, European Finance House and Gatehouse Bank. Partners will be important to facilitate the uptake, says Aggarwal. 'The first live trades should be in December,' he says. Patrik Neutjens, head of partner management, Swift, says: 'Swift is pleased to welcome Path Solutions into our Partner Programme. Together we can work towards standardising and automating processes such as the treasury murabaha, thereby helping to reduce cost and risk associated with manual processing'.

'We are delighted to collaborate with Swift on creating pioneering messages that will serve the special nature of the Islamic finance community', says Naji Moukadam, president of Path Solutions. Once the pilot phase is achieved and its progress monitored, Path will be among the first to implement the new Islamic messaging system standard.


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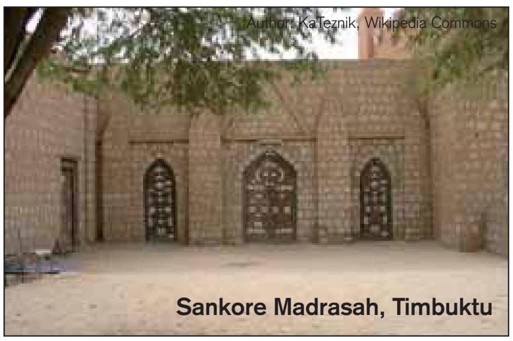
Bahamas
U.A.E.
Cayman Islands
Hong Kong
Qatar
Dutch Antilles
Kuwait
Italy
Panama
Bosnia
Saudi Arabia
Montenegro
Singapore
Serbia
Macedonia
Greece
Angola

Islamic legacy of Timbuktu

Scholars and scientists are analysing the manuscripts, discovered in Timbuktu in Mali, which was once the location of a distinguished Islamic university town. Because of its intellectual history Timbuktu is sometimes referred to as the African Oxford University town. Thousands of manuscripts have been unearthed in Timbuktu in recent years, on the subjects of astronomy, mathematics, medicine, music, poetry, commerce and Islamic law.

Most of the works stem from the late Middle Ages, when Timbuktu was an important crossroads for caravans and home to gold merchants and scholars.



Sankore Madrasah, Timbuktu

The manuscripts, which cover all main aspects of socio-economic issues of the times, are hoped to shed some light on how trade and commercial transactions based on Islamic principles were conducted by the Arab merchants. Written largely in Arabic, these manuscripts could make a valuable contribution to the development of Islamic finance. They would help academics and finance practitioners working in the Shari'ah-compliant finance industry to understand the progress and the achieved economic success in that region.

Malaysia committed to Islamic finance

The Malaysian government has recently made the announcement that it will introduce several key measures to support the speedy development of Islamic finance. The announcement has been welcomed by the Islamic financial industry. Malaysian Prime Minister Najib Abdul Razak confirmed in his 2010 budget speech that the government is to extend existing tax incentives for Islamic finance for another five years.

These incentives include a stamp duty exemption of 20 per cent on Islamic instruments, tax exemption on banking profits derived from foreign operations (including from takaful), and a double deduction on expenditure promoting Malaysia as an international hub for Shari'ah-compliant finance. These measures were due to expire in 2010, but will now be extended to 2015. Razak stated that that the government's commitment to forging an international Islamic financial hub is ongoing, through the Malaysia International Islamic Financial Center (MIFC) initiative, which was launched in 2006.

Similarly, other provisions designed to encourage an Islamic capital market will also be extended. These cover a deduction in expenditure incurred on the issuance of Islamic securities, a tax exemption on profits made from non-ringgit sukuk originating from Malaysia being widened in scope, and a deduction on expenditure incurred in the setting up of stock broking companies.

Malaysia can already claim to be a world leader in Islamic finance, with, for example, 62 per cent of sukuk outstanding at the end of 2008 coming from Malaysia. Malaysia's secondary sukuk market also averages $300 million a day.

New Islamic liquidity fund launched in the UK

Prime Rate Capital Management, a London-based independent provider of institutional liquidity and fixed income products, has launched an Islamic liquidity fund, which is the first Shari'ah-compliant liquidity instrument targeting a triple-A rating for the Islamic wholesale investment markets.

Prime Rate's chief executive officer, Chris Oulton *(left)*, described this initiative as 'an innovative cash product for the Islamic markets', which 'aims to enable capital stability and returns on short term cash, while at the same time remaining consistent with Islamic principles'.

The fund will be available in sterling, US dollars and euros and will offer customers a pooling mechanism that can be used for investment of overnight, call and short term cash surpluses. The investments will be made in commodity murabaha transactions.

Depositors' returns higher from Islamic institutions

A recent analysis of the returns to depositors of banks reveals that customers of Islamic banks tend to get a better deal than those of conventional financial institutions.

This conclusion is based on a comparison of the interest expense earned by conventional customers compared with the profit rate earned by Shari'ah-compliant banks' clients.

National Bank of Abu Dhabi's interest expenses for the first three quarters of 2008 constituted 53 per cent of the bank's total conventional interest income, but this figure dropped to 35 per cent for the same period in 2009. This compares with a number of Islamic banks which were more generous with their profits. Dubai Islamic Bank paid out around $350 million of total profits of approximately $850 million in 2008, but paid a similar amount in absolute terms in 2009 despite its total profits dropping by about $180 million. Emirates Islamic Bank showed a stronger tendency for generosity, raising the amount of profit it distributed by about $10 million, even as total profit fell by around a quarter.

Indeed, Tamweel, an Islamic real estate finance firm in the UAE, distributed so much to its customers that it posted a loss over the period. This has led some Shari'ah scholars to question whether distributing more profits than can be afforded is Shari'ah-compliant.

Dr Hussain Hamed Hassan, head of the Shari'ah board of Dubai Islamic Bank, commented that this should only be done in exceptional circumstances, and only if it is in the best interests of the institution.

Islamic outperforms conventional in UAE

Despite being more generous, a study has shown that Islamic banks in the UAE are outperforming their conventional rivals on a number of other important metrics. They have moved ahead in terms of liquidity, profitability and earnings per share, according to a recent report, compiled by Dr Mohammed Naeem Shaker, professor at the finance department of the College of Business Administration at Ajman University of Science and Technology, and Dr Abdalla Salih, assistant professor at the college's accounting department.

The report's conclusions were based on a comparison of three conventional banks (NBD, National Bank of Abu Dhabi and Abu Dhabi Commercial Bank) with three Islamic banks (Dubai Islamic Bank, Sharjah Islamic Bank and Abu Dhabi Islamic Bank) for the period of 2006 to 2009.

'The study has proved that the performance of the three Islamic banks was good and they were not basically affected by the fallout from the crisis,' said Dr Salih. 'They maintained their profitability level and their liquidity level went up. Also, there was an increase in the ratio of shareholders equity to total liabilities and equity. The ratio of liabilities to the value of assets remained steady or varied only slightly, and there was a clear rise in earnings per share.' This was in stark contrast to the conventional banks, whose liquidity and profitability fell sharply as a consequence of the global financial crisis.

Mohamed Albeltagi, head of the Shari'ah department at the Egyptian branch of Abu Dhabi Islamic Bank, backed this up in comments to the Forum for Accounting and Auditing Bureaus and Companies in GCC countries. He stated that Islamic banks in the UAE are among the best in the world in terms of performance and Islamic compliance. 'The number of Islamic banks is increasing greatly around the world and the rate of increase during the global financial crisis reached some 28 per cent,' he said. 'The assets of the 700 Islamic banks went up to $822 billion this year from $650 billion in 2008. And the assets are expected to rise to $1.3 trillion in 2010. The figure is based on an annual growth rate of 15 per cent to 20 per cent. Islamic banks have survived the global financial crisis since no Islamic bank has announced bankruptcy, unlike banks that pay interest in America and elsewhere in the West where the number of bankrupt banks has reached 100.'

ISRA and KFH Malaysia to translate Shari'ah rulings into English

International Shari'ah Research Academy for Islamic Finance (ISRA) and Kuwait Finance House (KFH) Malaysia have signed a memorandum of understanding (MoU) to translate the bank's Shari'ah resolutions from Arabic into English. The project covers translation of the resolutions from the KFH's Fatwa and Shari'ah Supervisory Board meetings over the three decades, starting from its inception in 1977.

The work is expected to last around one year and the results will be reviewed and endorsed by a dedicated committee, consisting of Shari'ah scholars and practitioners. It will then be distributed to the bank's customers, regulators, researchers and academics, and other relevant organisations. The Arabic version of the rulings is already available in Kuwait and the Middle East.

'This joint project with KFH Malaysia provides us with the perfect tool to effectively share developments in Islamic finance over the years and enhance understanding of the Shari'ah among the Ummah,' said Dr Mohamad Akram Laldin, executive director at ISRA. 'This massive translation project creates a need for specialists and inspires us to increase our effort to identify and source for even more talent in Islamic finance.'

Dr Mohammad Abdul Razaq Al-Tabtabae, chairman of Shari'ah committee, KFH Malaysia, added that this work will contribute significantly to the limited pool of reference on Shari'ah-compliant financial cases, arising issues and rulings, which are currently available in the English language.

Al Hilal Bank tackles AML

Al Hilal Bank, a government-owned Islamic bank in the UAE, which was launched in 2008, has demonstrated its resolve to take seriously issues relating to compliance and financial crime by signing a deal with Norkom Technologies, an Ireland-based vendor. Al Hilal will implement Norkom's anti-money laundering (AML) and watch list management solutions across its operations in Abu Dhabi, Al Ain and Dubai.

Al Hilal's head of compliance says that the bank take issues of money laundering and terrorist financing very seriously. 'We are committed to improving our defences against these forms of financial crimes, as well as maintaining the highest standards of compliance with local and global regulations,' he says.

The software is designed to help its users monitor and analyse transactions and customer interaction across its entire customer base to identify and look into suspicious patterns and criminal behaviour. And Norkom's watchlist solution will immediately warn the bank if any party on lists attempts a transaction. This should help the bank avoid mistakenly doing business with suspected terrorists and criminals.

'To our surprise, the requirements or necessary changes to adapt to local or Shari'ah laws do not impact our systems. It's more the banking system itself where those changes are required,' explains Norkom's general manager for Europe, Alain Tayenne. Al Hilal is Norkom's second Islamic banking customer, the first being Dubai Islamic Bank, which signed in 2008.

Salaam Halal insurance fails to attract interest

Salaam Halal insurance, part of Principle Insurance Holdings and the first independent takaful provider in the UK, has stopped accepting new business, following a failed rights issue. It is now in a 'solvent run-off' situation, whereby its existing polices (there are about 10,000 policyholders) will operate until expiry, when they cannot be renewed.

Bradley Brandon Cross, CEO of Salaam Halal insurance, said that 'regretfully, a recent rights issue did not produce sufficient funds to support the company's continuation beyond the life of current customer policies'. Under Financial Services Authority guidelines, Salaam Halal was required to hold enough funds to cover the claims of its existing policy holders, but the failed rights issue left it with a gap. Salaam Halal managed to raise £60 million, but had been aiming at £80 million. The shortfall has been put down to the effects of the credit crunch and global recession.

Salaam Halal was profiled in New Horizon shortly after its launch in July 2008 *(NewHorizon, July–September 2008)*. Its initial products were for motor insurance but the company had been confident of moving into building and contents insurance, life insurance and commercial insurance.

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Promises, promises

Dr Humayon Dar, CEO of BMB Islamic UK Ltd and member of the IIBI editorial advisory panel, examines the use of promises in Islamic banking and finance.


Dr Humayon Dar, BMB Islamic UK Ltd

Promises have played an instrumental role in the development of the Islamic financial services industry. Criticised by many industry observers for bringing a number of (undesired) Western financial solutions to Islamic banking and finance, promises have, nevertheless, proven to be an effective tool for structuring innovative Islamic financial products.

A promise (or what is known as wa'ad in Islamic law) is a unilateral undertaking by a party (promisor) to do something (like buy or sell an asset) for someone (promisee) for a known consideration during (or at) a certain time (period). Promises are considered quasi-contracts in Islamic law, and are binding on just one party to an agreement, i.e. the promisor. This interesting characteristic of promises makes them an ideal underlying agreement for structuring Islamic options and other derivative contracts. Indeed, this was the very feature of promises, which was employed by a number of Western investment banks that offered a new range of Islamic structured products. This aspect of promises could also be used to structure Islamic futures contracts.

It is important to consider that only unilateral promises are useful for structuring above-mentioned products. Mutually given promises are binding on both parties and, therefore, amount to a contract, offering no options to either promisee or promisor. However, slight variations in the parameters of an agreement help construct unilateral promises that may be used in incentive-compatible structures for options, futures and derivative products. Bilateral promises, although admissible, are not considered as binding in most transactions involving either delay in payment of price or deferment in delivery of the object of sale.

For example, if person A unilaterally promises to buy a stock X from B at a future date T for a price P, and B unilaterally promises to sell a stock X to A at a future date t for a price P, then the two promises together are, in effect, a bilateral promise. From Shari'ah viewpoint, they should be binding on both parties, as they amount to a full contract. It must be noted that this bilateral promisory arrangement gives rise to a forward sale contract, which is forbidden in the Islamic law of contracts.

However, if A unilaterally promises to buy a stock X from B at a future date T_1 for a price P, and B unilaterally promises to sell a stock X to A at a future date T_2 for a price P, then the two promises together do not amount to a bilateral promise because they refer to different execution dates. Similarly, if all other parameters of the two promises are the same except that the promised prices are different, the two promises will be considered unilateral and, therefore, binding on the promising parties only. This discussion is summarised in *Table 1*.

Two unilateral and one-way binding promises can be put to use in structuring some sophisticated Islamic financial products. Some banks have developed Shari'ah-compliant swaps, options and similar products based on unilateral promises. In fact, promises can play an even wider role in developing some cutting edge financial products, like fund-linked derivatives.

This article focuses on a possible structure for Islamic options. There are a number of other interesting applications of promises in Islamic banking and finance. Those who are involved in structuring such products claim their Shari'ah authenticity and argue for even more sophisticated use of promises in Islamic finance. There is a group of industry observers who consider such developments unhealthy.

Promises have some interesting implications for structuring Shari'ah compliant financial options. However, there are some fundamental questions to be answered before one may suggest using promises in structuring Islamic options. These include:

- ❏ Do the promises have an economic value?
- ❏ Can a promise be sold for a price?
- ❏ What is the penalty for reneging on a contract?

Promises have an economic value only if they are binding, in which case the reneging party may be liable for a penalty equivalent to the actual monetary loss incurred to the promisee. However, 'unbundled' promises cannot be sold for a price, as is the case in conventional options wherein the buyer of an option (promisee) pays a premium for a right to buy/sell in future. Although some contemporary Shari'ah scholars opine that unbundled promises could be sold for a price, this is a view held by only a handful of Shari'ah scholars. Hence, this view must be employed with caution while structuring Islamic financial products. There are some Western banks that are pushing the case for the pricing of promises in Islamic finance, but resistance to the idea continues.

Keeping these restrictions in mind, promises may be used in conjunction with murabaha to structure Islamic options. Suppose party A wishes to protect itself against downward risk of holding a stock (similar to purchasing a protective put). Given the Shari'ah limitations, a conventional put option is not available; and, thus, the party enters into the following arrangement:

Table 1
Bindingness of Promises

Promisor	Promise	Object	Execution Date	Price	Condition	Comments
Case I A (to buy) B (to sell)	B A	X X	T T	Px Px	Unconditional Unconditional	Bilateral promise
Case II A (to buy) B (to sell)	B A	X X	T T	Px1 Px2	Unconditional Unconditional	Two unilateral promises
Case III A (to buy) B (to sell)	B A	X X	T_1 T_2	P P	Unconditional Unconditional	Two unilateral promises
Case IV A (to buy) B (to sell)	B A	X Y	T T	P P	Unconditional Unconditional	Two unilateral promises
Case V A (to buy)	B	X	$T_0 < T < T_1$	P	If A defaults on the lease contract during T_0 and T_1	
B (to buy)	A	X	$T \leq T_1$	P	If A fulfills all the obligations of the lease agreement between A and B	Two unilateral promises

Table 2
Payoffs when $P = P_{mur}$

Parties	When $P > P_m$	When $P < P_m$
A	0	$P_m - P > 0$
B	0 (gets its stock back)	P
Broker/Exchange	0	0

A buys the stock from B on a murabaha-basis whereby stock is delivered to A by B at T_0 for a price to be paid at T_1. The murabaha price, P_{mur}, is higher than the current market price of the stock and may include a 'premium'.

B then promises to buy the stock from a broker (or an exchange) for a specified price, P, on a future date, T_1 (European put). The agreed price, P, may be different from the murabaha price, P_{mur}. On receiving the Promise 1, the broker promises to buy the stock from A for the same specified price, P, on the future date T_1.

The arrangement described above (and depicted in *Figure 1*) should replicate a conventional put. An example should explain it.

Scenario 1:

Suppose the promised price, P, is actually equal to the murabaha price, P_{mur}, and at T_1, the market price of the stock, P_m, happens to be less than P. Given the

Figure 1
Promises in Islamic options

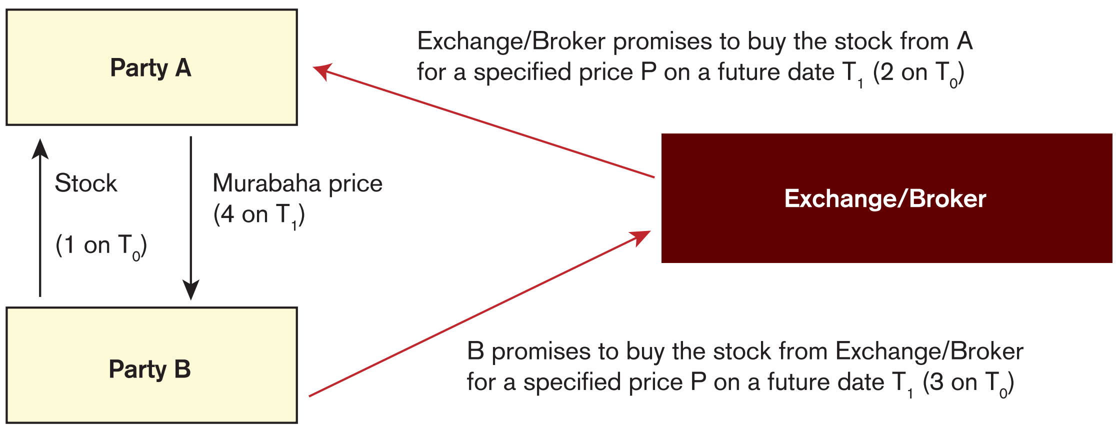


Table 3
Payoffs when $P \neq P_{mur}$

$P_m < P < P_{mur}$	$P_m > P > P_{mur}$	$P < P_m < P_{mur}$	$P < P_{mur} < P_m$	$P > P_m > P_{mur}$	$P > P_{mur} > P_m$
A will make the Broker honour its promise and buy the stock for P	A will not be interested in the promise given by the broker and would prefer selling the stock in the market	A will not be interested in the promise given by the broker and would prefer selling the stock in the market	A will not be interested in the promise given by the broker and would prefer selling the stock in the market	A will make the Broker honour its promise and buy the stock for P	A will make the broker honour its promise and buy the stock for P
A's payoff: $P - P_{mur} < 0$ (instead of losing $P_m - P_{mur}$)	A's payoff: $P_m - P_{mur} > 0$	A's payoff: $P_m - P_{mur} > 0$	A's payoff: $P_m - P_{mur} > 0$	A's payoff: $P_m - P_{mur} > 0$ (instead of earning only $P - P_m$)	A's payoff: $P_m - P_{mur} > 0$ (instead of earning $P - P_m$ it will be earning less)
B's payoff: $P_{mur} - P > 0$ + stock	B's payoff: $P_{mur} > 0$	B's payoff: $P_{mur} > 0$	B's payoff: $P_{mur} > 0$	B's payoff: $P_{mur} - P < 0$ + stock	B's payoff: $P_{mur} - P < 0$ + stock

Table 4
Conventional and Islamic put options compared

	Premium	Ownership of stock		Winner/loser	
		If option is exercised	If option is not exercised	If option is exercised	If option is not exercised
Islamic put	No separate premium but bundled in murabaha price; paid at the end	The stock goes back to the murabaha seller (seller of the Islamic put)	The stock ends up with the put-holder	The Put-holder gains the difference between the exercise (promised) price and murabaha price; the seller of the put loses the equivalent amount	The Put-holder gains the difference between market price and murabaha price; the seller of the put receives only the murabaha price
Conventional put	Unbundled premium; paid upfront	The stock ends up with the put-holer	The stock remains with the seller of the put, who also receives a premium upfront	The Put-holder gains the difference between market price and the exercise (strike) price minus the premium; the seller of the put loses the equivalent amount	The Put-holder loses the premium; the seller gains the equivalent amount

positive differential between P (the price A pays to B for the stock) and P_m (the price A may charge from the broker), $P - P_m > 0$, A would make the broker honour its promise and buy the stock from it. The broker would in turn make B honour its promise to buy the stock from it. This will shift the broker's loss on to B. If, however, $P_m > P$, A will not be interested in the promise given by the broker, as selling the stock to the broker will incur a loss to A. Similarly, the broker will not trigger Promise 2. The end result is given in *Table 2*, which clearly shows that this arrangement offers Party A with downward protection, which is a feature of a conventional protected put.

Scenario 2:

It may very well be the case that the promised price, P, is different from the Murabaha price, P_{mur}. *Table 3* shows different cases in which the promised price differs from the murabaha price, P_{mur}, and the future market price, P_m. The results indicate that although Islamic options may provide downward protection to the purchaser of a put, the extent of protection may actually decrease. Furthermore, combining murabaha with promises results into a structure that allows risk and profit sharing between the transacting parties. Unlike a conventional put option that offers downward protection to its purchaser, an Islamic option mitigates risk in such a way that the two parties end up sharing risk.

The above examples suggest that the working of an Islamic put is somewhat different from a conventional put. While in a conventional put, the buyer of the put calls the shot by putting to sell after having paid a 'premium', a buyer of an Islamic put calls the shot after actually having bought the stock from a seller (Party B in the above examples) on a murabaha basis. In a conventional put, the underlying stock ends up with the put-holder after they have exercised their option. In the Islamic put, however, the underlying stock goes back to the original seller (Party B) after the put-holder has exercised their option. Major differences between an Islamic and conventional put are summarised in *Table 4*.

It appears as if selling an Islamic put is not an attractive proposition. The seller of an Islamic put gets a premium, embedded in the murabaha price, when the put-holder does not exercise their option; and benefits from no premium when the Islamic put is exercised and, indeed, is left with a devalued stock. However, combining the sale of an Islamic put with the purchase of a conventional call has interesting implications for the payoff of the selling party. Combining such structures is a recipe for success and it is this area that is expected to benefit players in the Shari'ah-compliant finance industry in the near future.

Islamic perspective on social business

Mohamed El Mehdi Zidani, co-founder of Quantis, an Islamic finance consultancy firm, and MA student at EDHEC Business School, France, focuses on the relationship between the new social business concept and the old waqf system.

One thing a student immediately learns in a business school is that the ultimate goal of a company is profit.

This is what business is all about, at least in the capitalistic system we live in. But recently a new concept has arisen: social business. The concept does not refer to social enterprise or corporate responsibility, whereby a company is involved in social, environmental or educational programs. Lecturing at the Glasgow University in 2008, Muhammad Yunus described social business as 'a business whose purpose is to address and solve social problems, not to make money for investors. It is a non-loss non-dividend company.'

This definition, as well as the whole concept, was coined by Yunus, who is regarded as the father of microcredit. He founded Grameen Bank in Bangladesh – the bank that pioneered a microcredit model that subsequently spread all over the world. The bank and its founder received the Nobel Peace Prize 2006.

According to Yunus, most people retain from Adam Smith his most famous work, 'Wealth of Nations', where he pointed out the selfishness of the human being. But it is often forgotten that he also highlighted the other side of the human nature, namely its selflessness, in his 'Theory of Moral Sentiments'. Smith took the view that people are born with a moral sense – our conscience tells us what is right or wrong.

Yunus wants to bring this selflessness part into the business world, thus changing the way capitalism has been implemented so far. During the lecture, he stated that 'no one is calling for it [capitalism] to be abandoned in favour of some other system, such as socialism, because everybody is convinced that, with all its faults, capitalism is the best economic system known to humanity.'

According to him, capitalism is going through a very serious crisis and social business might prove an efficient tool for correcting it.

In a social business, the goal is not to make profit, but to solve a social problem. The methodology is simple:

1. Identify a social problem;
2. Create a company to solve it.

Profits are not important because the goal is to solve the problem. If the company reaches break even, this is enough. If the company does make some profits, no money should be taken out. Profits can be used to:

- ❏ Expand the business outreach;
- ❏ Improve the product or service quality;
- ❏ Design methods to bring down the product or service cost.

Initial investors have the right to recoup their investment capitals, but no dividends will be taken. They will take back their initial investments in the future, at nominal value.

A second type of social business is a business owned by the poor, like Grameen (95 per cent is owned by the poor, receiving dividends on profits). A committed professional team runs the bank, but does not participate in the ownership.

Partnerships

Grameen has launched several social businesses to address problems faced by the poor, like providing renewable energy, technology or healthcare services at low cost.

It has also established partnerships with two French multinational corporations. One is with Danone to sell fortified yoghurts at very low prices to poor children (to fight malnutrition); and the second one is with Veolia to provide rural areas with clean water at low cost (to fight health issues). Neither Danone nor Veolia nor Grameen will get any profit from these joint ventures. All profits, as mentioned, are to be reinvested.

Grameen is also working with other multinationals as well, among which are BASF, Adidas and Volkswagen.

Yunus has also promoted social business funds (which will themselves be social businesses) to fund this kind of activity. A social business fund is to be created in Monaco. A partnership with the Islamic Development Bank (IDB) to create the IDB Grameen Social Business Initiative has already been agreed.

Delivering lectures in universities, Yunus encourages young students to launch social businesses. If they do business only to make money, that's fine, but they should ensure that their businesses make a positive impact on people's lives, or – at least – no negative impact. In his Glasgow lecture he added: 'Alternatively, you could use your talent to change the world by harnessing the power of creative social businesses to address human and social needs. Of course, you can do both types of businesses. Making money through responsible profit-maximising business could be the means, while using that money for social businesses could be the exciting end.'

Not-for-profit organisations

At a first glance, social business is very similar to not-for-profit organisations, which also aim at solving social problems rather than making profits. But the latter rely mainly on charities and external funds.

The social business, however, has as an objective to become financially self-sufficient. It usually takes several years, but ultimately a social business should not rely on external funds. Also, and it is related, a social business does not provide products or services for free.

The idea is to use business principles, but for a social goal. You keep the means, but change the objective.

An Islamic perspective

On a theoretical level, one may not agree with Yunus' statement that 'capitalism is the best economic system known to humanity'. According to Muslims, Islam is a complete code of life and provides guidance in all spheres of life including economic activities. It does not mean that we have each and every detail of economic policies, but Islam gives Muslims a necessary framework within which this creativity can be expressed. Putting ethics in business has been done for a long time by Muslim traders, but it is not really the idea of social business. When thinking about social business, the idea of waqf springs to mind. Waqf is an Islamic concept whereby an institution is self-sufficient and aims at solving a social problem. This is what waqf is all about (plus the reward in the Hereafter).

Waqf

Waqf is a good given for Allah's cause. It cannot be sold, or taken back. The waqif (the one who owned the good) is no more the owner.

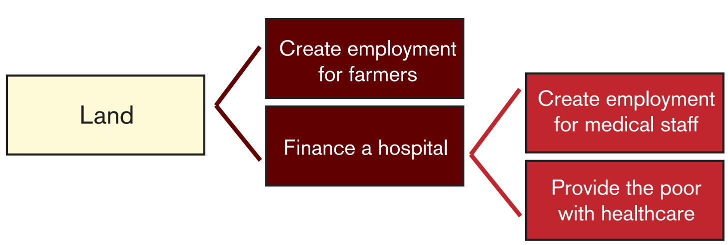
All profits are to be spent for a specific purpose set at the beginning by the waqif. Lands and buildings are examples of awqaf (plural of waqf).

The waqf will generate income indefinitely. Income will be then divided into three parts: one for management of the waqf (director, employees etc), one to be reinvested in goods (equipment, seeds etc) and the last one to be devoted to the targeted project (mosque, school etc).

Waqf has historically played a huge role in Muslim societies, financing the construction and maintenance of public entities, such as universities, libraries, hospitals and orphanages.

Let's take an example: you own a house. You give it as a waqf. It can be used as the building of a school, for instance, or it can be rented and the income generated will be used to pay teachers, electricity bills and so on. If used this way, it will be similar to a 'social business fund'.

Scheme 1. Waqf model (where the waqf is land)



Some differences though

Without getting into juridical (fiqh) issues that may point out differences between social business and waqf, it is worth noting that they are not exactly the same.

To be clear, we have to distinguish between the waqf itself and the project financed by the waqf.

The social business has as an objective to become self-sufficient. But in the case of a project funded by a waqf, it is not the case. A library funded by a waqf does not aim at being self-sufficient, since one characteristic of the waqf is that it generates money without end, so there will always be money to fund the library. Now, the waqf itself is indeed self-sufficient. Land will generate income by itself.

Also, there is a theoretical difference with the social business concept: the social purpose is not fulfiled by the business of the waqf, but by the project financed by the waqf.

In a social business, a business is started to solve a social problem. In the case of a waqf, a business is started to finance a project to solve a social problem.

That being said, the waqf can also solve the social problem by itself. In this case, the waqf is actually at a higher level than the social business concept.

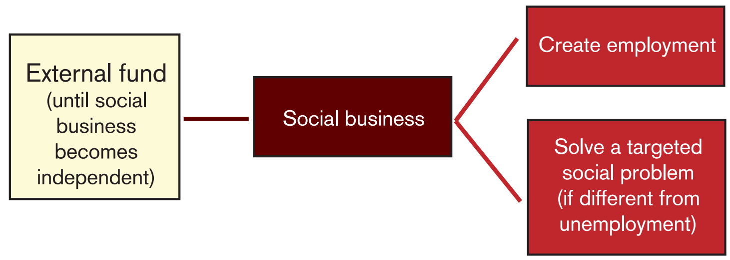
For instance: unemployment in rural areas is a social problem. To fight this problem, one might buy some land and give it as a waqf: not only will it create employment (solving the social problem), but the income generated can also be used to fund another project. The money can be used to establish, say, a clinic. This will provide more jobs (again fighting the initial unemployment issue) and solve another social problem – healthcare.

Another advantage of waqf is that it is self-sufficient by nature, from day one, while social businesses will often take years to reach their break even.

Schemes 1 *(p17)* and 2 *(right)* give examples of waqf and social business models. Benefits coming from the businesses themselves (e.g. developing agriculture with the land or benefits inherent of the business chosen as a social business) have not been taken into account here.

Therefore it goes faster with the waqf system – the business does not need time to become self-sufficient. The only wait is for the land to become profitable (and if it is a building there is no wait, since it starts generating income as soon as it is rented).

Scheme 2. Social business model



Combining the two?

In the waqf example, healthcare can be provided free of charge, if the income of the waqf is sufficient to cover the costs. In Grameen Bank philosophy, it is better to avoid giving charity to people since it does not encourage them to become independent. Therefore, except for rare exceptions, all services for the poor are charged, at very low costs. Even during natural disasters, support is provided on a loan basis.

It makes sense to only assist people who actually need to be assisted, like the elderly, disabled, orphans etc. You can help people in some fields without having to assist them in every aspect of their lives. If they can go to the hospital for free, it does not mean that they won't make any effort to be independent in their lives. There is a balance to be found here, and giving shelter on a loan basis to people who lost their houses seems a little extreme from an Islamic perspective. If the income generated by waqf is enough to finance all expenses of hospitals, should people pay? Even for people who have the means to pay, if their money is not really needed for the hospital to run, wouldn't it better to encourage them to invest their money in other projects? We can even develop the model and make people who have the means pay. Then, because this money is not needed, the hospital can use it to expand, or finance mobile clinics or a medical school.

One objection can be raised regarding the risk for an organisation (here the hospital) to rely exclusively on one source of funding. Let's say the land or the building burns out. No more funding. The hospital would have to close.

Shouldn't there be an attempt to make the project funded by waqf self-sufficient? In this case, waqf and social business would be combined.

The waqf funds a project (a social business), this project reaches self-sufficiency. Then the waqf can be used to develop another business, and another, and another… If these businesses are of the same kind (hospitals, for instance), then the waqf management could use its experience and the acquired expertise to establish each subsequent business more efficiently.

Now, how to become self-sufficient with a hospital serving the poor? This is what Grameen Health Care Services is doing. This social business has two hospitals. It took seven years to reach self-sufficiency. It has different brackets of fees, according to patients' means. It also provides free surgery for those who genuinely cannot afford it. To encourage people to pay, a higher quality of service is provided for them: they have, for instance, beds instead of mattresses. Is this really a good thing: beds for the rich vs. on the floor for the poor? Although this is, undoubtedly, a question to ponder, the point here is that it is possible to make a hospital self-sufficient.

But if this is possible with a hospital, it becomes harder for other projects, like an orphanage. How do you make an orphanage self-sufficient? And do we want to see orphanages becoming businesses? Yet another question to ponder.

Conclusion

Unfortunately, new concepts are not brought in (or are reluctantly brought in) by Islamic organisations. And when they have good ideas, they often remain ink on paper. Then the industry waits for other organisations to come up with new concepts, and copies them and tries to adapt what needs be to the Shari'ah, even though it had everything from the beginning to be the one introducing systems to solve current problems. The world is deeply in need of alternatives, particularly in the economic field.

What do you think? IIBI is calling for the readers' input and feedback on this subject, which can be discussed in more depth in the Institute's newly-launched discussion forum at www.islamic-banking.com
Alternatively, email us at: iibi@islamic-banking.com or editor@newhorizon-islamicbanking.com

Kuwait International Bank: from conventional to Islamic

Kuwait International Bank was formed out of a conventional entity, Kuwait Real Estate Bank. In mid-2007, it commenced operations as a fully-fledged Islamic bank. This change affected all areas of the bank, including technology. The core banking system conversion was a challenging task. NewHorizon finds out the details.

Kuwait International Bank (KIB) joins a handful of banks in the region that have made a similar transition from conventional to Islamic mode of business in recent years. Dubai Bank is one *(NewHorizon, January–March 2009)*. Sharjah Islamic Bank (formerly National Bank of Sharjah) became the first Islamic bank in the emirate a few years ago. Bank of Kuwait and Middle East (BKME), and Abu Dhabi Islamic Bank in Egypt, to name but two, have both taken this route as well. How easy is it to achieve this behind the scenes?

Kuwait Real Estate Bank, as the name suggests, had specialised in real estate finance. But about five years ago the bank decided to broaden its restrictive licence so it could compete better. Ziad Al Hasawi, IT development manager at KIB, explains that 'Islamic banking companies were really profitable, especially in this part of the world. So we thought, if we need to change our choice of business, why not just change the whole business altogether?' It changed its name to Kuwait International Bank, and gained permission from the Central Bank of Kuwait (CBK) to operate as an Islamic bank from 1st July 2007. So KIB has been a fully Islamic bank and its new systems have been live since that time.

As part of the conversion, Kuwait Real Estate Bank broadcast a request for proposal (RFP) for a banking system with Islamic functionality. Previously in place was Globus, a core system from a Swiss vendor Temenos, which 'was doing okay' for Kuwait Real Estate Bank's conventional banking needs. 'We met with many vendors,' Hasawi says. This list included Temenos, but at the time of the selection process it had not finalised its Islamic module. A couple of other vendors were also involved. 'We had gap sessions for almost a month with three different vendors,' Hasawi says. KPMG, as consultants, also advised the bank on its choice. And in September 2004, Kuwait Real Estate Bank chose Phoenix, from Kuwait-based International Turnkey Systems (ITS), as its new system. The main reasons for its choice were the position ITS enjoyed in the Kuwaiti market, and, consequently, this vendor's experience: 'ITS's solutions are in the majority of Islamic banks in Kuwait. So ITS has the know-how. And based on the recommendation of KPMG, and what we saw in the gap sessions, we decided to go with ITS.'

Changing the core system was, however, only one part of the transformation. And as Hasawi points out, it had never been done before in Kuwait. 'It was new to everyone in the bank, because none of us had this experience before,' Hasawi says. It meant 'a new banking system, new products and a new culture, with a change in the mentality of the staff'. In terms of systems, a number were chosen to be installed besides Phoenix. These included Tradewind, for trade finance, and Mosaic, Getronics' branch system which ITS also distributes. The part of the system which deals with Islamic aspects is the teller module.

Working on the project was staff from ITS, led by Hany Ramadan, banking implementation and support manager at the vendor, the bank's own resources and Ernst & Young, which acted as the project management office. ITS provided about seven workers for the implementation. And as well as the system knowledge, ITS can also claim to be well-versed in Islamic finance generally. 'We already knew a lot about the exact processes and workflows required, and Islamic compliance. So we

We are a lot smarter now, we know the system, we know Islamic banking and how it works. You can't really understand these if you are new, and you have to have that experience to understand what could go wrong because you can never plan for these things.

Ziad Al Hasawi, Kuwait International Bank

could share it with the bank,' says Ramadan. However, he adds that ITS had also learnt a great deal from the KIB project, which it can carry forward to comparable implementations – including the projects at Bank of Kuwait and Middle East (BKME) and Abu Dhabi Islamic Bank in Egypt: 'These processes which we built first time with KIB, now everybody is fully aware of.' In general terms also, Hasawi is positive about the experience as a whole. 'The whole conversion experience was really good,' he says. Ramadan mirrors this, saying 'I thought it was an excellent achievement'. However, the transformation did face difficulties, not least from the regulators.

The transformation was split into a number of different areas. 'We had all the projects we could think of for the conversion, and we were meeting on weekly basis to get the status of how each was going,' Hasawi explains. There were different projects not just by product, but also for other areas, such as conversion of the administration. 'Some would have so many staff because all of the bank's departments were involved in this particular area, so the team would be huge,' says Hasawi.

Ernst & Young had the role of keeping track of the different assignments. 'Its task here was co-ordinating with everybody, and it would be really difficult to keep up with all the different people, mentalities and departments,' Hasawi says. The overall process remained an IT-led one. 'IT was actively spearheading this project, because they're involved with all the systems, even though it's a business kind of thing.' Similarly, a web of committees oversaw all. 'If I tell you the number of committees we had, you'd be scared. But everybody had an input, at every step of the process. Everybody chipped in.'

'The bank needed to convert a lot of systems, processes, training and so on,' says Ramadan. 'But from the system point of view we achieved our target to go live within seven months,' he says, dating the implementation project as from October 2005 to May 2006. Hasawi agrees that KIB could have gone live in 2006, although not with the whole system. However, the extra time between then and July 2007 seems to have been spent well. 'We had about a year and a half to two years doing a parallel run with the conventional banking, and we had simulations each month of going Islamic,' Hasawi says. 'It was done thoroughly, and our efforts really paid off.'

Kuwait International Bank

This process was done one product at a time, because each was new to the staff of the bank. 'Because it was new to us, we didn't know exactly what's going on,' Hasawi adds. To mitigate this, 'we had some experienced people from different Islamic banks, teaching us what to expect and how to go about things'. These people were also hired to design new products, since KIB was keen to offer things which would differentiate it from Islamic competitors, though Hasawi admits that 'we just depended on those people. Maybe they were doing it wrongly, we don't know'.

And throughout this time, the bank was conversing with its customers, trying to convince them to convert their accounts into Shari'ah-compliant ones. This process was treated as if each customer was new to KIB, such that each would be sent the relevant documentation to sign. Some refused (or failed to consent), leaving KIB with a batch of 'non-consented' loans. KIB's Shari'ah committee instructed the bank to sell these loans, which the bank duly did. However, it still manages them for a fee on behalf of the firm which purchased the loans, because this particular outfit 'doesn't want the headache', Hasawi says. The Shari'ah committee also complicated the project in other ways. 'You don't have the liberty of conventional banking where you come out with a product, and no one will stop you. Every single project, and every little thing has to go through them.'

CBK also delayed the project by around a year. Some of the reasons for this delay were understandable, for example KIB lacked a general manager, who had resigned, and had one or two other senior vacancies for a period. Replacing the general manager took over a year, not least because the candidate would have to be approved by CBK. However, Hasawi stressed that regulating Islamic banking was new to CBK as well at the time. 'Even their procedures were new,' he explains. 'They did not really know what to look for.'

Despite these delays, it seems to have been the data conversion that caused the most problems. 'The conversion was very smooth, but we were still suffering from it for a long time,' Hasawi admits. He gives the example of a loan, which would normally be paid in regular installments, having a higher amount paid off in one chunk. The 'interest' on the remainder would be less than otherwise; but Hasawi notes that the bank's systems had trouble picking this up. Re-amortised loans also created difficulties. However, the bank and the vendor have been working hard to resolve these issues.

Looking back on the project, Hasawi says that 'we learnt the hard way', but he is adamant that 'I wouldn't change a thing'. 'We are a lot smarter now, we know the system, we know Islamic banking and how it works. You can't really understand these if you are new, and you have to have that experience to understand what could go wrong because you can never plan for these things,' he says. The following phase was a project to consolidate all the various systems in use at KIB, to make it easier for the end users. The aim was that 'the user will only see one system but actually through a web service would be talking to all the different systems'.

BKME and Abu Dhabi Islamic Bank in Egypt stand to learn from KIB's experience. BKME, for example, is set to keep its conventional core system (TCS Financial Solutions' Bancs), so 'it won't have the problem of converting individual products', Hasawi says. Ramadan's advice is that 'you need a very mature system in terms of Islamic industry, so you don't reinvent the wheel. Try to choose an off-the-shelf product, and try to apply and adopt the current processes of this ready-made system'. Ramadan also flags the experience of the implementation team as important. Both Hasawi and Ramadan agrees that converting gradually is a viable option, as is simply opening an Islamic window. 'This can be a very good move, as you don't need to convert your operations, and can keep the current business as it is,' says Ramadan. However, this path would also depend on regulatory approval.

Whichever implementation strategy is chosen, Ramadan is sure that the continued appeal of Islamic finance suggests a growing number of banks will bite the bullet and choose to convert, despite the pitfalls of a full migration. As Hasawi says, 'it's rewarding, the business has been boosted and the customer base has grown'. ITS, which has completed one such project and is involved in a further two (BKME was at the testing stage by mid-2009), appears to be picking up valuable experience as well.

Sukuk default: questions about Shari'ah supervision

Mian A. Saleem, retired banker:

In the present gloomy economic condition of the world, we are now faced with yet another economic meltdown, the 'collapse of Dubai boom'. The reasons for the extraordinary collapse of the Dubai property market are much too reminiscent of what world leaders are now referring to as unbridled greed of lending institutions that led to the sub-prime mortgage crisis. Lord Myners, the Minister for the City of London, talked recently about moral failures and, in calling for moral reform, he said that the financial crisis had exposed a fundamental imbalance between the power and accountability of banks, and that the sector should follow the values and ethics of wider society.

The real issue for me on the default of Islamically structured Dubai bonds is whether there are failures on the part of the independent Shari'ah advisers in respect of the moral function that they are required to observe. I was told by Islamic bankers that transactions structured on profoundly moral and ethical principles are the strength of Islamic finance. While all markets have their upturns and downturns, Shari'ah advisers appear to be increasingly driven by commerce's rising demands for them to show more flexibility when they rule on the validity of large financial transactions. This downplays the seriousness of the Shari'ah objective in the midst of worries about the credit crisis. Some Shari'ah advisers would say that it is not always easy to balance religion and business, and many of them are now being trained to understand modern funding structures that sometimes challenge Islam's basic beliefs. As a result, the Shari'ah prohibitions on excessive speculation and gambling, and dubious conventional practices such as short-selling and derivatives are slowly finding a regular place in Islamic finance.

Indeed, Islamic banks are beginning to look more like conventional banks. When Islamic banks need to establish a distinct identity that separates them from conventional banking practices, this would require coming out of the clutches of managers with a conventional mindset. Due to their conventional banking experience it seems that they are unable to see beyond the simple exercise of making profit by whatever means. They appear to be the forces driving the Shari'ah advisers when it should be the other way round. It does not surprise me that it was reported sometime ago that one Western banker who had moved to the Middle East region to set up a Shari'ah-compliant team shared tips about various ways to create 'structured investment products' that for all practical purposes looked like conventional products, but were never called that.

A central difficulty for me is to understand the wider purpose of Shari'ah supervision and precisely the Shari'ah advisers' role in addressing the moral questions that go beyond looking at the financial transaction itself. Are they simply working with the intention of earning a fee for certifying that transactions are structured in a Shari'ah-compliant manner? Do they also analyse the moral facts to ensure that the financial transactions are capable of accomplishing the key Shari'ah objectives, in particular justice and equity in society as a whole?

Shari'ah advisers should only be allowed to offer their supervisory services to banks if they can be held responsible for putting adequate moral reforms in place. It will not be good enough if they are not subject to a regular audit in respect of the moral balance sheet of the banks that employ them. Certifying projects that are luxury and extravagant is sheer wastage and contrary to Islamic values, as these do not contribute to the community at large and are unproductive. It is shocking to read reports on how millions of dollars were spent on one-night opening ceremonies of projects in the Middle East while the salaries of the poor labour work force employed for these projects are known to be greatly disproportionate to the levels of the amounts earned by the overseas consultants and investors.

While Shari'ah advisers must play a supervisory role in approving investments in Shari'ah-compliant assets, in this role they must also be held responsible for the fulfilment of the Shari'ah objectives. Shari'ah compliance should not be seen by Shari'ah advisers and Islamic banks as an end in itself; instead it should be understood as a supervisory process which also provides a moral compass for Islamic banks to increase their benefit to society.

A senior contemporary Islamic economist, Dr Umer Chapra, commented on the failure by advisers of the Shari'ah boards of Islamic banks to act as a moral filter and prevent the degeneration of the banks into what he described as 'jungle capitalism'. Morality, strictly speaking, is used to refer to what we would call moral conduct or standards.

The current state of Islamic banking has a long way to go to realise the higher objective of the Shari'ah. If we look at the Muslim majority countries around the world, there is evidence of great disparity between the rich and the poor than in the Western countries which as far as I can see have embraced many of the Shari'ah objectives within their society. Everyone would know that there is still a continuing perception held among a large population of Muslims that the religion of Islam is being exploited for the purpose of making money and Islamic products and services are just a conventional approach with an Islamic wrapper to appease people's consciences. This may not be entirely correct but Shari'ah advisers must provide the highest degree of transparency of their supervisory role if they are to remove this mistrust in the community.

What do you think? IIBI is calling for the readers' input and feedback on this subject, which can be discussed in more depth in the Institute's newly-launched discussion forum at www.islamic-banking.com

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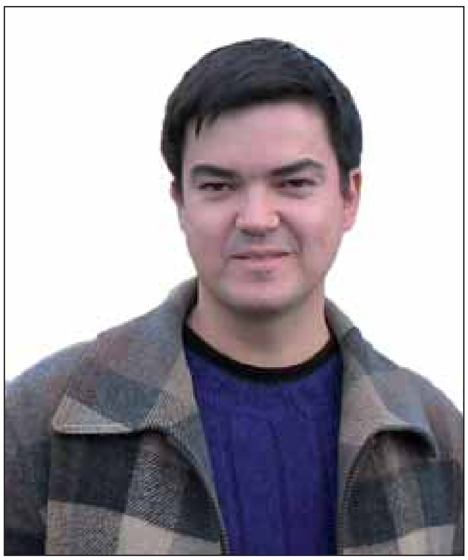
INSTITUTE OF ISLAMIC BANKING AND INSURANCE

Zakat as sadaqah or sadaqah as zakat?

In the second of a two-part analysis, Dr Renat Bekkin, senior research fellow at Mardjani Foundation, Moscow, continues the discussion on poverty alleviation, in the case of Russia.



Dr Renat Bekkin, Mardjani Foundation

It is not accidental that the Muslim Religious Boards in Russia promote federal legislative amendments regarding waqf and almost ignore the issue of zakat while the latter could be a part of a federal religious tax, like, for example, 'church tax' in Germany.

The lack of interest in zakat of Muslim clergymen is logical. As distinct from waqf, zakat is not a universal instrument designed to cover the expenses of religious organisations. Most theologians, for example, are convinced that the money received as a purifying tax should not be used to build mosques in places where there are enough of them. They believe that the state (obviously, the Muslim state) should shoulder these expenses. In a non-Muslim state, likewise, it is undesirable to spend the larger part of zakat on the same things. Zakat can be used, however, to fund education, publishing, and other activities designed to promote religious knowledge among Muslims.

As for the culture of zakat in Russia, it was lost during Soviet rule, just like the culture of waqf. However, during the first years of Soviet power in Russia zakat was collected in places with predominantly Muslim populations (the Volga area, the North Caucasus, Central Asia) and was used to buy tools for collective farms. Yet, during the following years zakat was not collected in the areas of compact settlement of Muslims. It was replaced by irregular sadaqah paid by devout Muslims on the days of religious holidays.

Sooner or later the Russian Muslims would inevitably come across the issue of zakat since – unlike waqf – it is one of the five pillars of Islam. Since February 2005, two domestic banks, Ak Bars Bank and Tatfondbank, have been receiving zakat payments from the Muslims of the Republic of Tatarstan (a federal subject of Russia); it seems that they work as intermediaries between the payers of zakat and the recipients. It should be said that the money received is unlikely to be used as effectively as in some of the Muslim states.

In some regions of Russia, the Islamic clergymen are trying to use other religious taxes, although their original meaning is not always certain in the Shari'ah. In some districts of Tatarstan, imams ask collective farm chairmen to donate potatoes for the students of Muslim religious establishments. This should be described as the collection of sadaqah, a charitable donation paid once in a while, not ushr in Tatarstan, which is a tithe.

It's another matter if zakat paid by Muslim businessmen will be paid in the form of an interest-free loan given to those collective farms or individual farmers under the condition that they should provide the needy with food instead of paying back the principal of the loan – in other words, to provide those who belong to at least one of eight categories of zakat recipients.

The zakat culture has been very slow to strike root in Russia because the local Muslims know next to nothing about it. The above example shows that most of the faithful do not distinguish between zakat and other Islamic charities. So far, the clergy has failed to deal with this ignorance. Several years ago, a Russian anthropologist, Ahmed Yarlykapov, did some research in the North Caucasus. He described this situation: the imam of a mosque in Maykop (capital of the

Republic of Adygeya, Russia) set up two boxes – one for zakat, the other for sadaqah – only to remove them after a while because the believers could not distinguish between them.

However, confusion of zakat and sadaqah is half the trouble. In Moscow regular payments of Muslims that cover administrative expenses of local communities are often called zakat. It is obvious that the leaders of those communities deliberately seek to sacralise the membership dues collected for the community's needs and attach a 'special' status to them. From the author's point of view, such tricks are rather improper. The believers see that the money paid as 'zakat' does not go to those categories that were indicated in the Quran, and consequently they lose trust in zakat as an institution that contributes to effective redistribution of wealth in society for the benefit of its needy members.

Abuses are inevitable while redistributing the part of the purifying tax that is supposed to go to the collectors of zakat. Often their share goes up to 30 per cent of the redistributed zakat.

In recent years in Russia paying such Muslim tax as zakat al-fitr has been observed. Some Muslim peoples of Russia, for example, Adygs and Kabardin, distribute zakat al-fitr even before the end of fasting. At the same time paying zakat al-fitr is regulated not only by Shari'ah, but by local customs as well. Yarlykapov described a case, when one of the women in aul (village) Hatukai in Adygeya while calculating zakat al-fitr included not just her children among those for whom she should pay the tax, but her cows as well, saying that they are also living creatures and she should pay alms for them to. In another aul in the region, Koshehabl, zakat al-fitr was distributed mostly among relatives and close friends of the payer.

Unfortunately, it is the local superstitions and prejudices rather than conscious necessity to follow one of the five pillars of Islam that form the basis of paying irregular alms by many Muslims in Russia. For example, in the North Caucasus they pay sadaqah for deceased relatives if the payer saw them in dreams.

Given that there is no centralised zakat system in Russia, some regional Muslim religious administration assumed the function of collection and distribution of the purifying tax. At the same time, in most mosques the clergy and believers continue to confuse 'sadaqah' and 'zakat'.

The Republic of Karelia probably has the most positive record of collection and distribution of zakat in today's Russia with direct participation of the local Muslim religious authorities. There, the collection and distribution of zakat is the responsibility of the regional Muslim religious board, which has communities in major cities of Karelia.

The success of the Karelian community in collecting and distributing zakat is to a large extent explained by its small population. The community members know each other as well as those who can pay zakat and those who are in need. Consequently, the Muslim Religious Board of Karelia fulfills a rather technical task of collecting and distributing the purifying tax. It is also important that the mufti of Karelia, Wisam Ali Bardwil, places emphasis on the necessity to pay zakat in his sermons, publications and public speeches.

One can't underestimate the personal authority of Bardwil (born Palestinian Arab, now a citizen of Russia) in development of the system of zakat in the region. His honesty seems to be the best guarantee for zakat-payers. They can be confident that their money would be used properly and according to Shari'ah rules. Unfortunately, there aren't enough persons among Muslim spiritual leaders who enjoy the same confidence in the material issues among Russian Muslims as Bardwil. As to official Muslim organisations on a federal level, the majority of Muslims believe that their capacity to collect and distribute zakat is much lesser than of Muslim boards on a regional level. The lack of knowledge of zakat among Russian imams also does not strengthen the

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Dr Renat Bekkin, Mardjani Foundation

confidence of Muslims to this purificatory alms.

Today, it is too early to talk about establishment of a centralised all-Russia zakat collection and distribution system under the aegis of the Russian Mufti Council or some other Muslim co-ordination structures given the absence of a Muslim religious board that would be common for all Muslims. The first step on this path should be improvement of the database of those who receive the purifying tax. Moreover, it is necessary to spread the use of modern technologies. For example, in 2005, a local website, Takafol.ru (the first Russian internet resource on Islamic economics and finance), launched the country's only zakat-calculator in the Russian language.

Given the imperfect system of zakat collection and distribution under the aegis of the Muslim religious boards in Russia, it is often misinterpreted by both the zakat officials collecting it and zakat payers. For example, instead of paying zakat to a dedicated fund or zakat officials, some payers tend to give money (including in the form of non-interest loans) to small and medium-size enterprises (SMEs), usually to those that are owned or run by businessmen originating from the same ethnic community.

To collect and distribute zakat in Russia it is not necessary to amend the legislation. Yet it is necessary to provide tax remissions for regular payers of zakat. Otherwise zakat is bound to be irregular charity payments – in other words, it will merge with sadaqah. However, there is nothing wrong in the development of an Islamic charity based on sadaqah. The main condition here is the same as in the case with zakat: the payers should be provided with a transparent system of collecting and distributing of their money. Sadaqah has several advantages over zakat in Russia; one being that it does not need mediators in the form of bodies responsible for the collection and distribution of collected funds. The only thing needed is technical support to ensure that those who lack the funds and those who can grant them, find each other. A good example is the Islamic charitable project named Sadaka.ru. The purpose of the project, according to its website, is to unite Muslims to help brothers and sisters in faith who are in difficult life situations. There is a special form on the website, which anyone in need of financial assistance can fill out. Those who want to help can directly contact the needy through the information displayed on the site. The website organisers themselves do not accept any funds to their accounts.

The disadvantages of such projects should include the fact that not all those in need have access to the internet, and that in such a situation the deception by the applicant in the section 'need help' is quite possible. So far, these projects have been effective in large cities with high levels of internet users and with large numbers of wealthy Muslims.

Despite this, there is hope that the future of Islamic charity is for projects such as Sadaka.ru, which enables benefactors and those in need to find each other directly, without any difficulties. It is possible that such innovation will be popular among

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payers of zakat, who do not trust the existing structures responsible for the collection and distribution of zakat: fortunately, there is a technical opportunity to calculate tax purification using online zakat-calculators.

As to compact Muslim communities in small towns and rural areas, the most effective form of Islamic charity still remains traditional sadaqah – and sometimes zakat. The effectiveness of collection and distribution of the latter will be directly dependent on the competence of the local spiritual leaders of the Muslim community in the issue of zakat, as well as his honesty in such matters.

However, an independent entity in the form of a zakat-foundation is not the answer. Such independent foundations, not under the wing of the official Muslim structures, will attract increasing attention from security services.

Conclusion

❑ At the moment, unco-ordinated Muslim religious boards in Russia, while imperfect, are still the only working structures able to collect and distribute zakat and sadaqah.

❑ In the majority of Muslim regions of Russia notions of zakat and sadaqah are often confused.

❑ Innovation technologies need to be developed in order to facilitate payment and distribution of zakat.

❑ The future of the Muslim charity in the big cities will be largely determined by independent internet portals, in which benefactors will not need intermediaries to find each other.

❑ There is no need to amend legislation in order to form a system of collecting and distributing zakat. However, to stimulate payment of purifying tax on a mass and regular basis, it is necessary to provide tax benefits for regular payers of zakat, at least on the level of regional legislation.

It's the niyya that counts

Warren Edwardes, CEO of Delphi Risk Management and a member of IIBI Banking advisory group:

I have just realised that I have been involved with Islamic banking for nearly a quarter of a century. Back in 1985, when I was head of treasury product development at a UK bank, everything non-standard landed on my desk. And that included a proposal from a Switzerland-based Islamic bank. Well, they wanted to do something strange – it seemed strange to me at least.

The Swiss Islamic bank wanted to invest in British pounds at zero per cent. That sounded pretty good at that time of high UK interest rates but there was a catch. Its source of funds was in US dollars and it wanted to be hedged back into US dollars. It sounded an interesting project… but here was the real catch: the bank wanted a special tailor-made forward rate on the foreign exchange swap at a special adjusted rate. It wanted its overall rate of return through the package to be the same as the normal market US dollar interest rate of eight per cent.

No problem. I just had to clear the deal with The Bank of England (BoE) which prohibited foreign exchange transactions at off-market rates so that banks didn't help their customers defer losses or indeed profits from one year to the next. The BoE had no objections because overall the deal was at market rates so the transaction went ahead smoothly.

Riba

The transaction was quite clever, I thought. The Islamic institution could not receive interest but it was allowed to trade.

The Quran states:

3:130 O you who have believed, do not consume usury, doubled and multiplied, but fear Allah that you may be successful.

2:275 Allah has permitted trade and has forbidden interest.

Prophet Mohammad said in his farewell sermon: 'God has forbidden you to take riba, therefore all riba obligation shall henceforth be waived. Your capital, however, is yours to keep. You will neither inflict nor suffer inequity. God has judged that there shall be no riba and that all the riba due to 'Abbas ibn 'Abd al Muttalib shall henceforth be waived.'

The foreign exchange transactions that I organised for my Swiss Islamic client could be regarded as trade, but such transactions in currencies are no longer deemed to be halal (permissible).

But instead of 'trading' in currencies, 'trading' is permitted in commodities. And commodity murabaha with a similar or perhaps a tripartite, four-part or circular package of 'independent' transactions is the dominant Islamic financial structure product.

Niyya

Now let's roll forward 25 years. A few months ago I realised that as a non-Muslim it is somewhat odd working in Islamic finance and writing articles and delivering speeches on the subject without at least having a basic understanding of Islam. So I attended an intensive 'Understanding Islam' course in London.

Very early on the first day the concept of 'niyya' was introduced. And in all my years in Islamic finance I had never ever heard the term niyya in connection with Islamic finance. And now when I speak with Muslims they tell me that 'niyya is everything' and 'niyya is fundamental'. So it is all the more surprising that I had not heard of niyya in connection with Islamic finance.

According to 'Understanding Islam' by C.T.R. Hewer, there is a Hadith of the Prophet Mohammed that 'all actions are but by intention'.

Hadith #1 in al-Nawawi's Forty Hadith states that 'actions are according to intent' or 'actions are what they are by virtue of intent'.

Niyya is intention. An inner act of the heart consisting in formulating one's intention to perform an outer act as the fulfilment of a particular duty rather than as just a series of motions without religious value.

Conclusion

Before entering into a financial transaction ask yourself: 'What is the niyya? What is the objective of this transaction?' Yes, clearly it's the niyya that counts. And the niyya comes from the heart and is not sung out loud or on paper.

So if you simply create a packaged series of transactions that individually appear halal but where your niyya is to replicate riba then that appears to be haram. That seems pretty clear-cut to me.

If the intention is to trade and not receive or pay riba then are you sure of the niyya behind the package? What do you really know about trading sugar or iron ore? What factors affect the demand and supply of sugar or iron ore and where do you think the market is going and why? Or have you no idea about these markets and have entered into a synthetic riba transaction that does not depend on the performance of these markets and with the niyya or intention so to do?

That's for you to decide. You are the Muslim investor who seeks a halal return on investment.

What do you think? IIBI is calling for the readers' input and feedback on this subject, which can be discussed in more depth in the Institute's newly-launched discussion forum at www.islamic-banking.com

Alternatively, email us at: iibi@islamic-banking.com or editor@newhorizon-islamicbanking.com

INSTITUTE OF ISLAMIC BANKING AND INSURANCE

IIBI launches Discussion Forum

The IIBI has launched Discussion Forum for its members and students which is part of its new website. The aim is to create a fraternity of Islamic finance professionals and interested individuals with a view to fostering closer co-operation among them.

The IIBI Discussion Forum is a unique platform for students and members of the Institute to exchange views on important issues and developments in the Islamic financial services industry. The forum also provides a study support network aimed at helping students and members, and facilitates their progression along their chosen pathway in Islamic finance. Members and students of other organisations who have affiliation with the IIBI may also use the forum and can take this opportunity to contribute their thoughts and express their views on key issues and developments in the world of Islamic finance.

To be able to use the forum, it is necessary to register to obtain a user name and password. All users of the forum are respected members working in the Islamic financial sector, including banking and insurance professionals, accountants, consultants, and, of course, students of the Institute.

For further information please visit the IIBI's website: **www.islamic-banking.com**

Hong Kong Financial Services and the Treasury Bureau calls on IIBI

Cheng Yan Chee, deputy secretary for financial services and the treasury, of Financial Services and the Treasury Bureau of Government of the Hong Kong Special Administrative Region, called on the IIBI. He was accompanied by Andy Lam, deputy director general, and Clara K. C. Chan, assistant secretary for financial services and the treasury.

The delegation was received by Mohammad Ali Qayyum, IIBI director general, and Mohammed Shafique, programme development co-ordinator. Qayyum briefed the visitors about the Institute's activities and areas of mutual interest were discussed.

Hong Kong is aspiring to become a leading centre of Islamic finance and is making efforts to achieve this goal. The Hong Kong delegation appreciated the role and efforts of the IIBI in raising awareness and promoting the education of Islamic finance.

IIBI awards post graduate diplomas

The 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 its postgraduate degrees in Islamic finance, including the MA and MSc in Islamic finance and the Research MA. Applicants will also have to fulfil the specific entry qualifications for each specialist degree programme.

To date, students from nearly 80 countries have enrolled in the PGD course. In the period of October 2009 to December 2009, the following students successfully completed their studies:

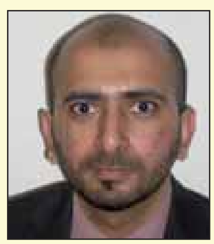
- Muhammad Kashif Khurshid, Shari'ah compliance manager, Absa Islamic Banking (Absa Ltd), South Africa;
- Muhammad Tahir Chouhan, finance manager, Al-Khayarin Group Trading & Contracting, Qatar;
- Leman ul Haq Malik, credit and marketing manager, Al-Zamin Leasing Modaraba, Pakistan;
- Fidrus Sukor, strategic planning officer, Islamic Development Bank Group, Saudi Arabia;
- Fatima Azahra Hamid, financial analyst, Financial Institution Consulting Corporation, US;
- Osman Ibrahim Belal, accountant, Efg-Hermes, Egypt;
- Anthony Watson, senior associate, Denton Wilde Sapte, Kuwait;
- Muhammad Tariq Soomro, accounts assistant, Supercover Insurance Plc, UK;
- James A King, UK;
- Zia Ahmed Khan, corporate finance manager, Al Razzi Holding Company, Kuwait;
- Muhammad Tariq Gondal, head of operational risk management division, risk management group, MCB Bank Ltd, Pakistan;
- Bibi Husna Banon Dowlut, bank's officer; Bramer Banking Corporation Ltd, Mauritius;
- Abbes Mehdi, section head, Central Bank of Tunisia, Tunisia;
- Sarfraz Aaron, IT development manager, Direct Energy, Canada;
- Azmat Ali Khan, Pakistan.

As a beginner in this field, I found the course an interesting and enriching experience. This course is excellent for both beginners and professionals. It is highly recommendable to bankers, accountants, insurers and lawyers. It has been an enjoyable experience for which I am grateful and thankful to my tutor and the management of the IIBI.

Bibi Husna Banon Dowlut, Bramer Banking Corporation Ltd, Mauritius

Overall this was a good experience for me. With the help of this course, I have increased and refined my knowledge about the practical experience of Islamic banking during my work at Al-Zamin Leasing Modaraba.

Leman ul Haq Malik, Al-Zamin Leasing Modaraba, Pakistan



It has been a very helpful course. It will be very helpful for me in product structuring and Shari'ah compliance, which are part of my job profile.

Muhammad Kashif Khurshid, Absa Islamic Banking (Absa Ltd), South Africa

Excellent course – every time I read one chapter, I am eager to read the next one. It is full of knowledge. This course is well designed and very detailed. It clearly shows us the difference between the conventional and Islamic banking and insurance, and also how we can transform the conventional system into an Islamic one.

Fatima Azahra Hamid, Financial Institution Consulting Corporation, US

INSTITUTE OF ISLAMIC BANKING AND INSURANCE

IIBI TRAINING

Deal not unjustly, and ye shall not be dealt with unjustly — The Holy Qu'ran 2:279

Sukuk, their applicatons & challenges

3rd Annual One-Day Workshop

Tuesday 27 April 2010

National Skills Academy Financial Services
George Green Building
155 East India Dock Road, London, E14 6DA, UK

Sukuk (understood as Islamic bonds) are an increasingly important asset class that 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.

The workshop presented by industry experts will acquaint the particpants with:

- Most popular Shari'ah-compliant contracts used in Sukuk structuring
- Issues arising in structuring Sukuk transactions with help of case studies
- How Sukuk may be used for project financing
- Process of Shari'ah compliance cetification from the Shari'ah boards
- Key points of AAOIFI's standards on Sukuk
- Taxation issues for UK-based Sukuk issuers and investors

For more information or to book a place, please contact:

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Promoting Islamic finance

October: Considering the dichotomy between the ideals and realities of Islamic finance

Dr Mehmet Asutay discussed the dichotomy between theory and practice of Islamic finance and sources of this divergence, and looked at ways and means to overcome it in future. Dr Asutay is a lecturer in Islamic and Middle East political economy at the School of Government and International Affairs, Durham University. He teaches and supervises research on various aspects of Islamic economics, banking and finance, economies of the Middle East and the Muslim countries, and political economy and economic development related subjects. He is also co-director of the Durham Islamic Finance Programme, director of the Durham Islamic Finance Summer School, and the programme director of the newly established MA/MSc in Islamic finance.

The lecture was chaired by Warren Edwardes, CEO of Delphi Risk Management and member of IIBI's banking advisory group.

Dr Asutay started the lecture by stating that during the initial days of the recent financial crisis, a number of commentators including politicians talked about the 'reckless nature of financing', 'greed' and the 'irresponsible attitude' of the financial sector as being an important source of the problem. Later, an archbishop of the Church of England came out with strong statements to criticise the current financial practices by suggesting that 'ethical' and 'moral' practices are necessary to establish a responsible economy. For this, the Vatican praised Islamic banking and finance (IBF) *(NewHorizon, January–March 2009)*.

He pointed out that in providing academic insight to the current financial crisis Reinhart and Rogoff (2008) stated that 'crises frequently emanate from the financial centres with transmission through interest rate shocks and commodity price collapses'. This also refers to the wisdom in Islam, which prohibits interest. IBF-related developments, hence, are particularly important in the current financial climate.

He mentioned that the criticisms of the financial system opened up a new discussion on the importance of morality in economic and financial life. Islamic moral economy (IME) provides a constructivist response to this through integrating morals into IBF in a systematic and spiritual manner. However, a critical examination of the developments and trends in IBF since its globalisation in the 1990s indicates that the convergence has been from IBF to conventional finance in terms of operations and functioning; and that IBF, through its commercial banking and finance nature, does not necessarily uphold the spirit of IME.

Dr Asutay emphasised that what distinguishes IBF from conventional finance in essence is not the nature of contracts or being interest-free, but the philosophy that lies behind. This aims at establishing a moral economy with social justice and socially acceptable growth in harmony with economy, business, society, natural environment and values through a human-centred economic development strategy. It is based on financial and economic efficiency and effectiveness but also social optimality in which the 'due' and the 'share' of the society must be returned through various social institutions. He pointed out that this 'moral economy' nature is the strength of IBF, having a foundation in the form of IME, which further aims at productive economic activity or real economy; and profit-and-loss sharing (PLS) and hence risk-sharing; thus partnership against the dominance of the strong, namely the capital; serving humanity


Dr Mehmet Asutay

and society for the sake of spiritual attainment and to perceive resources as trust from God, and hence directing all the resources to their perfection; spiritual accountability; and working for social good and justice not as a voluntary exercise but also in some cases as compulsory acts. These are the values that go beyond the mechanistic and limited nature of Shari'ah compliancy, as the current practice of IBF aims at adhering.

Dr Asutay described that when it comes to the working of Islamic financial institutions (IFIs), we witness that they have opted for a mechanistic understanding of Shari'ah compliance, namely interest prohibition, and have failed to endogenise these values in the sense of IME. Thus, the difference has been reduced to legal technicality, and the value system is no longer mentioned beyond describing the prohibition of riba. This has led to a new discussion on Shari'ah-compliant finance vs. Islam-based finance, the latter indicating the moral economy norms. He showed the marketing brochure for Zamzam towers where the image of Holy mosque appeared very small in the background from one of the rooms in the building with world class facilities. He emphasised that financing the infamous Zamzam towers in Mecca through Shari'ah-compliant instruments is possible with the former. However, Islam-based financing or the moral economy cannot accept the construction of such a building in such a holy place, as it undermines the environment and historicity of the place, equality in worshipping and the spirituality of the place.

He explained that the existence and prevalence of developmental issues negates the entire discourse of IFIs in relation to social justice or maslahah. The financial crisis should, therefore, encourage the IFIs to overcome this apparent divergence and the growing dichotomy between the ideals of IME and the realities of IBF. He stressed that these fiqh-based novel financing methods away from values, assumptions and norms of IME might bring us closer to financial and economic disaster that is being experienced with the current financial system. Consequently, the practice of IFIs is not beyond failures and challenges. Due to the IFIs' lending criteria, terms and costs of loans, financial exclusion, unfulfilled aspirations, not having the capacity affecting stability and micro- and macroeconomic variables, and developmental failures in terms of touching the lives of individuals in the streets of the developing world, we are yet again in the beginning of the vicious circle, despite the existence and promise of IBF.

Dr Asutay noted that the important question is now, how social justice and good is to be served? What social-financial institutions can IBF offer to solve economic development issues in the developing Muslim world and developing countries?

He mentioned that notwithstanding its limitations, IFIs have proved to offer a valuable service for both consumer and producer needs. The social justice and developmental need, including PLS and long-term financing in line with the moral economy, can be structured in a more specialised Islamic institutional set up. In other words, correcting the failure of Islamic finance should be in the form of introducing further but robust social justice oriented principles into IBF by endogenising social justice into its operational nature. Therefore, there is a need to go beyond the legal interpretations and rational reading of the text. A value and objective oriented approach would help to overcome the growing tension between the performance of IBF and the utopia of IME.

In concluding remarks, he stated that the moral economy with social justice and growth with spiritual purification remains an important discourse of Islam and the prophetic tradition, the search for which should continue as part of trying to understand divine wisdom.

November: The challenge for the global sukuk market

Farmida Bi discussed the developments in the sukuk market to date, the impact of the financial crisis and the likely nature of the market going forward.

Bi is a partner at international legal practice Norton Rose in London and specialises in Islamic finance and capital markets. She has acted on many of the ground breaking Islamic finance transactions which have originated from the Middle East where many of her clients are based, including the $3.5 billion Dubai Port Sukuk and the Tamweel Shari'ah-compliant securitisation. A recognised expert in the Islamic capital markets field, Bi is the only female named as a 'leading individual' for Islamic finance in the legal industry guide, Chambers UK 2009, which ranks solicitors and barristers in over 60 specialist areas of law.

The lecture was chaired by Gibril Faal, director, GK Partners – advisors to socially responsible business.

Sukuk (commonly referred to as Islamic bonds) are Islamic investment instruments which represent their holders' undivided ownership interest in the underlying assets and their entitlement to the revenue from those assets. Sukuk differ from traditional fixed income securities (bonds) in that, technically, they do not pay interest – something that's prohibited in Islamic finance. Instead, investors are compensated through a cash stream typically generated from assets placed in special purpose vehicle. Also, conventional bonds, unlike sukuk, do not represent ownership of the bond holders in the assets/projects for which bonds are issued in commercial or industrial enterprises; these only represent contractual debt obligations and document interest-bearing debt owed to the holders of the bonds. In addition, conventional bonds guarantee return of principal when redeemed at maturity, regardless of whether the enterprise was profitable; the interest amount paid to bond holders is a percentage of the capital and not a percentage of actual profits of projects. Sukuk are unique financial instruments which


November lecture

provide new and attractive investment opportunities, help the development of secondary market instruments in Islamic finance and facilitate liquidity management to Islamic financial institutions, thus affecting the ability of Islamic banks to serve the communities in which they operate, despite the inherently just and ethical nature of Islamic finance.

Bi began by discussing the Accounting and Auditing Organisation for Islamic Financial Institutions' (AAOIFI) definition of sukuk which states that sukuk are 'certificates of equal value representing undivided shares in the ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activity'. However, AAOIFI does not differentiate between project finance sukuk, asset finance sukuk or other types of sukuk and classifies sukuk with regard to the underlying contract which governs the use of the funds received from the sukuk holders (istisna sukuk, mura-baha sukuk, sukuk of ownership of usufructs of existing assets, etc). Sukuk are considered as debt securities – subject to compliance with certain conditions, in the UK market their treatment as Collective Investment Schemes would have profound implications on taxation of sukuk deals.

Then she went on to discuss asset-backed sukuk where returns of sukuk holders are dependent upon the results and performance of the underlying project. This is not the case for asset-based sukuk. Most of the sukuk issued so far are asset-based. She pointed out that growth in sukuk has been the biggest change in capital markets in the last four years and at present over $100 billion worth of sukuk are outstanding. Rating of sukuk reflects the creditworthiness of the provider of the purchase undertaking in asset-based sukuk. In case of insolvency/default, recourse is usually to the purchase undertaking (unsecured claim) provider and not the assets in such sukuk.

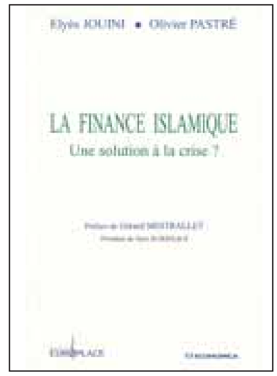
She mentioned that sukuk issuance grew enormously between 2004 and 2007, increasing by 49 per cent in 2005, 153 per cent in 2006 and 79 per cent in 2007, worth $46.65 billion in 2007. The primary reasons for this increased activity were easy access to credit, high oil prices and sentiment in favour of Islamic financing. Because Islamic banks had not invested in toxic assets and instead held actual assets representing their investments (often real estate and equity) and were not over-leveraged, this shielded Islamic banks from losses at the start of financial crisis in 2007. However, due to the fall in asset values, drying up of credit in the conventional markets and general economic conditions, 2008 was a worse year for sukuk than 2006 and 2007 and global sukuk issuance in Q4 2008 was the lowest since 2002. It is expected that normal activity will resume in Q1 2010 in the sukuk market, albeit the global sukuk market continues to grow at a slower pace. New issuance topped $9.3 billion in the first seven months of 2009, which is a very positive outcome as compared to total of $11.1 billion sukuk issuance in the whole of 2008. Asia is taking the lead with Malaysia representing 45 per cent of global sukuk issuance, followed by Saudi Arabia which stands at 22 per cent.


November lecture

Bi highlighted that the market has witnessed some sukuk defaults in the last 18 months, such as Investment Dar of Kuwait, Saad Group of Saudi Arabia and East Cameron Gas Sukuk in the US. How these defaults are dealt with will impact on investors' confidence and market sentiment for investments and demand for sukuk in future. She mentioned that sovereign deals are dominating the sukuk market at present and there is increased interest in the sector from conventional industries as well as Muslim minority countries such as France and Singapore. There is also continuing interest in real estate from Islamic financial institutions as there are likely buying opportunities. Increased activity in energy renewables as well as pharmaceuticals, food-stuffs and IT has been observed. These indicators suggest that there is still enormous potential for the use of sukuk to meet the needs of the wide range of investors and corporates who are looking to raise finance using such instruments. While due to the financial crisis some major projects have been delayed, regional infrastructure projects will continue and equity will remain a preferred option indicating the potential of sukuk issuance for financing such projects.

She concluded the session by stating that as economic recovery is likely in 2010, sukuk deals are expected to pick-up again next year after the bumpy ride of the previous two years.

'La Finance Islamique: Une solution a la crise?' by Elyes Jouini and Olivier Pastré



Professor Joseph E Connolly, visiting professor of global finance and management at the Ecole Nationale des Ponts et Chausees, Paris, reviews this book, published in 2009 by Economica, Paris (ISBN 978-2-7178-5679-8). The book is 128 pages long including index and bibliography.

Elyes Jouini and Olivier Pastré are professors at the University of Paris. This new, little book called 'Islamic Finance: A Solution to the Crisis?' is written in straightforward French. It contains three chapters and neatly and succinctly defines a coherent plan for establishing Paris as a key capital market in Islamic finance. It deftly identifies and assesses the opportunities, risks and hurdles in attempting such a plan. In addition to proposing a framework for implementation of their ideas, which appear to complement current finance minister, Christine Lagarde's, economic policies, the authors suggest too that solutions and mitigants to the current crisis may well lie within the architecture of a Shari'ah-compliant ancillary market. This they plausibly propose for Paris.

Their measured and sober argument has much merit, and is thoughtful, incisive and compelling. It constitutes, in fact, part of a financial blueprint presently evolving in Paris which ought not to be summarily dismissed by competing marketeers in London, Kuala Lumpur, Dubai, Bahrain, Kuwait, New York or Singapore. There is much foresight demonstrated in their argument. Intellectual rigour synthesises neatly with practical and realistic arguments throughout this book.

The book starts with an overview of the universe of global Islamic finance, which does indeed serve valiantly as a solid introductory text. It provides a thorough overview and description of products, issues, participants and channels and moves quickly and straightforwardly to a candid discussion of the hurdles French proponents of such implementation face today. An overview of various Islamic financial instruments and structures such as sukuk, mudarabah, murabaha, ijara and takaful, is included.

Both professors tackle potential problems like the legal code, tax regime and infrastructure requirements head-on, but brush over the negative implications of the tradition of insularity in the French banking world. They quietly acknowledge Britain's current pre-eminent position in Islamic finance among EU countries, but point out that France has a Muslim population three times that of the UK. They address the issue of language but are, like many of their compatriots, perhaps a bit optimistic in their detection of fluency in professional English in Paris, though the trend toward embracing one global business language is certainly heartening.

They exude a great and contagious optimism, a stance their evidence supports well. History aside, there is today among key players a fledgling commitment to organise Islamic finance; regulation, supervision and examination of marketplace participants is really already in place, which the authors find healthy. Education of key constituencies is next, and marketing the concept abroad will ensure this. Paris ought not to miss the boat on this occasion. That is the argument and that is the reason for this book's existence.

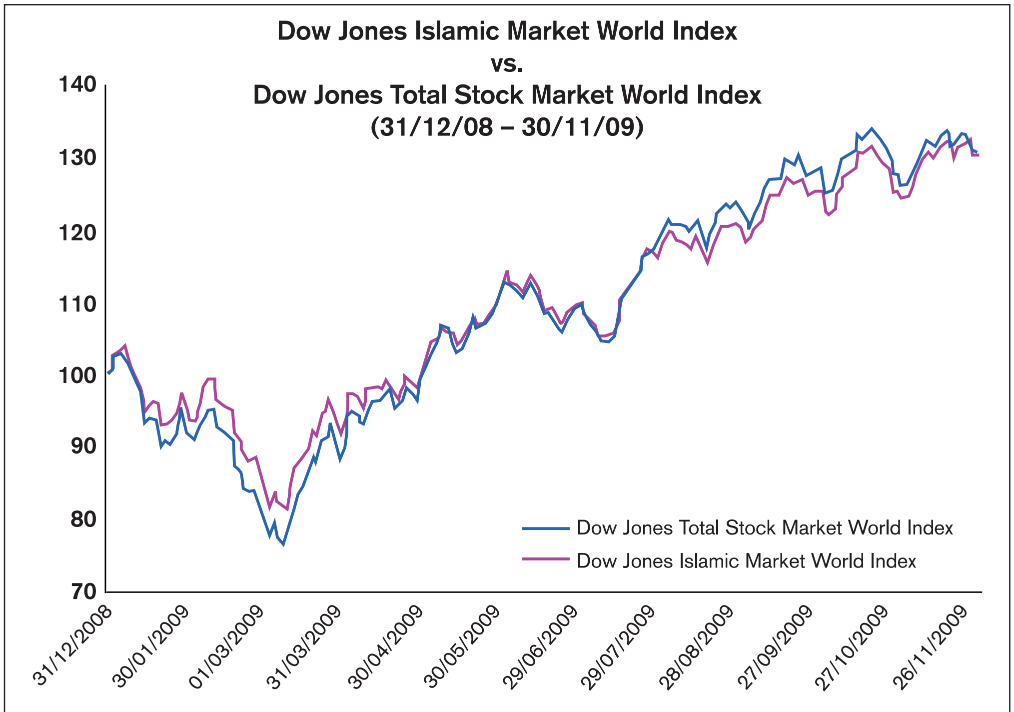
The two professors argue that because of the importance of the euro as a currency, Paris should enjoy supremacy over London and that substantial market participants will find Paris attractive as a way of diversifying their risk profile in terms of geography and human resources. They suggest leveraging knowledge assets like the DJIM (Dow Jones Islamic Market) at NYSE Euronext.

In their examination of the ability, capacity and desire of NYSE Euronext (the product of a merger between the old Paris Bourse and New York Stock Exchange) to exploit these opportunities, they also suggest the possibility of collaboration with the US. That seems a very exciting proposition. Americans have yet to embrace Shari'ah-compliant finance in a truly substantial way. They could, and badly need to do so.

The book is priced at €18 (around $26) and at present is available only in French. It provides interesting insights about the growth potential as well as the positive attitude of regulators towards Islamic finance. So, too, one should be quite satisfied that the historic overview and general current aggregate data are concise and clearly presented, holding few surprises. This would be a good read for those involved in policy-making, as well as students and academics interested in the Islamic finance sector.

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 2009, the Dow Jones Islamic Market World Index was up 30.26%, slightly outperformed by its standard counterpart, the Dow Jones Total Stock Market World Index, which was up 30.56% over the same time period. Also listed is the performance of the respective industry indices for both indices in 2009. More information can be found on www.djindexes.com



Top 5 components, as of November 30th 2009:

Rank	Dow Jones Islamic Market World Index	ICB
1	Exxon Mobil Corp	0537
2	Microsoft Corp	9537
3	Procter & Gamble Co	3724
4	BP PLC	0537
5	Johnson & Johnson	4577

Rank	Dow Jones Total Stock Market World Index	ICB
1	Exxon Mobil Corp	0537
2	Microsoft Corp	9537
3	HSBC Holdings PLC (UK Reg)	8355
4	Procter & Gamble Co	3724
5	Apple Inc	9572

Industry performance in 2009:

Industry Index	Dow Jones Islamic Market World Index	Dow Jones Total Stock Market Index
Oil & Gas	26.58%	30.77%
Basic Materials	66.38%	68.54%
Industrials	36.00%	30.32%
Consumer Goods	28.17%	28.98%
Health Care	14.00%	16.00%
Consumer Services	25.84%	26.93%
Telecommunications	5.19%	9.56%
Utilities	3.83%	4.35%
Financials	21.14%	32.12%
Technology	46.47%	51.38%

All rates are reviewed on a regular basis
Source: Dow Jones Indexes

Shari'ah-compliant finance: UK regulation

The UK is globally recognised as the leading Western country for Islamic finance. However, from time to time, proponents of the industry ask why the UK does not allow Islamic banks to offer 'true' profit-and-loss sharing investment accounts. In this article Mohammed Amin, tax partner at PricewaterhouseCoopers and member of the IIBI editorial advisory panel, gives a long answer to that short question.

Mohammed Amin, PricewaterhouseCoopers

The UK government set out its strategic approach in the December 2008 document, 'The development of Islamic finance in the UK: the Government's perspective' (available to download from HM Treasury's website). It states that 'the UK authorities' support for Islamic finance is characterised by an approach of equal treatment for conventional and Islamic finance'. Despite devoting a whole of page to regulation, the document adds little more to that. The author of this article has set out to 'reverse engineer' the regulatory principles that the UK has been following by looking at what it has done. The following key points emerged.

Neutrality regarding religion

Strictly speaking, the UK does not have any special tax law for Islamic finance. Instead, it defines certain types of transactions or instruments such as 'alternative finance investment bonds' (AFIBs) and specifies a tax treatment for them. The definition of an AFIB is such that most sukuk having the economic characteristics of debt should qualify as AFIBs. However, the tax definition is self-contained and does not depend in any way on the Shari'ah status of the instrument.

The same approach of religious neutrality is followed when regulating companies offering Shari'ah-compliant financial services. In the UK, Islamic banks are licensed as banks, and takaful operators are licensed as insurance companies. There is no special regulatory regime for Islamic banks or for takaful companies. This contrasts, for example, with Malaysia where takaful operators are licensed under the Takaful Act 1984 while other legislation governs Malaysian insurance companies.

A number of consequences appear to flow from this approach:

❏ The UK government and its agencies have no interest in whether an Islamic bank conducts its affairs in accordance with Shari'ah. However, this is qualified by the point that where a bank has held itself out as being Shari'ah-compliant, the contracts held by its customers may entitle them to redress for failure to adhere to Shari'ah, or the bank may acquire legal exposures if its marketing were held to be untruthful.

❏ Unlike Malaysia, there would appear to be no realistic prospect of a UK government-sponsored Shari'ah board which lays down mandatory Shari'ah standards. It would be entirely inconsistent with an approach whose foundation is that the government is not a religious regulator.

All depositors should be entitled to full repayment

The decisions taken regarding regulation imply a government view that all customers depositing money with UK licensed banks should be entitled to be repaid in full unless the bank becomes insolvent. This can be deduced from the fact that Islamic banks are not allowed to offer profit-and-loss sharing (PLS) investment accounts. The nearest approximation they can offer is an account where the customer's money is invested into a pool from which investment returns are paid. However, if losses arise in the pool, the bank is obligated (unless it is insolvent) to provide funds from its own resources to ensure that customers are repaid in full. Customers are given the right to elect, at that time, to take less than full repayment, and are also advised that if they elect to receive full repayment they will not be acting in accordance with Shari'ah.

This approach maintains equality of customer protection between Islamic banks and conventional banks, while allowing customers of Islamic banks to comply with Shari'ah principles if they so wish. In particular, it avoids the mis-selling risk that would otherwise arise if customers, when opening an account, were allowed to irrevocably expose themselves to the risk of not being repaid in full. The mis-selling risk arises from the fact that in reality many customers would fail to appreciate the full economic impact to them of receiving less than full repayment, or may fail to properly evaluate how likely that risk might be to materialise. That is why under the UK's approach, the customer is only called upon to decide whether to accept less than full repayment when the circumstances have actually arisen, and is not asked to make a prospective election when the account is opened.

Equal risks should receive equal regulatory treatment

Islamic banks sometimes complain that Shari'ah-compliant mortgages require a larger amount of capital to support them compared with conventional mortgages. However, where that arises, the reason will be a difference in the risks faced by the bank.

The customer documentation of one Shari'ah-compliant mortgage plan contains a table of key differences from a conventional mortgage:

Shari'ah-compliant finance	Interest-based mortgage
Both the bank and the customer have responsibilities towards maintaining the property.	All maintenance responsibilities rest with the customer.
The bank as a partner in the property will be subject to the risks associated with ownership of a property.	The bank as a lender will not have exposure to any ownership risks.

If the leaflet is accurately describing the differences in risks, then in the case of the Shari'ah-compliant mortgage the bank faces additional risks which a conventional lender does not face. If that is the case, a higher capital charge would appear to be warranted for its Islamic mortgages compared with conventional mortgages.

Legislative changes are sometimes necessary

As explained above, Islamic banks are licensed as banks and takaful operators (Islamic insurers) are licensed as insurance companies. Nevertheless sometimes existing legislation cannot adequately cope with Islamic financial instruments. A specific example is sukuk. For some time there has been doubt regarding whether sukuk might fall within the legal definition of a collective investment scheme. If they did, then the regulatory responsibilities of sukuk issuers would be significantly more onerous than the corresponding responsibilities of issuers of conventional debt.

To resolve this, secondary legislation is being introduced to define (for regulatory purposes) an investment called an AFIB. At the risk of causing confusion, the regulatory definition of an AFIB is similar to, but not identical with, the tax legislation definition of an AFIB. If an investment qualifies as an AFIB for regulatory purposes, then it will be classified for regulatory purposes as equivalent to debt and excluded from the definition of a collective investment scheme. This is explained in a document on the HM Treasury's website, 'Legislative framework for the regulation of alternative finance investment bonds (sukuk): summary of responses'.

Consistent with the religion-neutral approach outlined above, the regulatory definition of an AFIB does not depend in any way on whether it is, or is not, Shari'ah-compliant.

Conclusion

The UK's approach to the regulation of Islamic finance works, in the sense that Islamic financial institutions are able to operate within it. It does have the drawback that certain products offered overseas cannot be offered in the UK, such as profit and loss sharing investment accounts. However, this limitation is a small price to pay compared with the advantages of having a uniform regulatory regime that applies across the whole of the financial services sector, both conventional and Shari'ah-compliant.

Unlike Malaysia, there would appear to be no realistic prospect of a UK government-sponsored Shari'ah board which lays down mandatory Shari'ah standards.

The article was first published on Mohammed Amin's Islamic finance blog, http://pwc.blogs.com/islamicfinance

Waqf and Jersey foundation: common grounds

Kate Anderson, an associate of the commercial team at law firm, Voisin, discusses the similarities between the Jersey foundation and waqf and the benefits these structures offer.

The Foundations (Jersey) Law 2009 was registered by the Royal Court of Jersey on 19 June 2009 and came into force on 17th July 2009.

In the past, a substantial amount has been written about the use of Jersey-based Shari'ah-compliant trusts as a financial planning tool for Muslims, and the similarities between the Jersey trust and waqf. The introduction of the Foundations Law in Jersey has added another tool that can be utilised when designing Shari'ah-compliant structures. As with the trust, many similarities can be drawn between the Jersey foundation and waqf, and each has its own benefits.

What is a Jersey foundation?

A Jersey foundation is designed to blend the highly attractive features of both Jersey corporations and Jersey trusts. It provides Jersey with an alternative financial planning vehicle to companies and trusts for wealth management and charitable purposes.

A Jersey foundation is an entirely new type of Jersey legal entity and is not an exact equivalent or copy of any foundation established in any other jurisdiction, as it has been modelled on the best features present in the laws of other jurisdictions, while also including unique Jersey features.

The remainder of this article will focus on the features of the Jersey foundations and some similarities and differences between Jersey foundations and awqaf (plural of waqf).

Legal personality

The nature of a foundation is that it has a separate legal personality, it is able to contract with third parties, sue and be sued in its own name, and holds its own assets which can be traded.

Similarly, Shari'ah law provides that a waqf is an independent legal entity (thimmah) that may engage in trading with third parties, but a waqf may be restricted from trading in the original settled assets (see below).

Creation

As the incorporation of a Jersey foundation is regulated under the Financial Services (Jersey) Law 1998, only a person who is appropriately licensed under that law will be able to apply for the incorporation of a foundation (a 'qualified person'). The founder will be the person who instructs the qualified person to incorporate the Jersey foundation.

In order to create a Jersey foundation a founder, qualified person, charter (which will contain the objects of the foundation) and regulations are required. There does not need to be an initial endowment (settlement) or beneficiaries (although a purpose must be identified) for the establishment of the foundation to be valid.

The creation of a valid waqf on the other hand is more similar to that of a trust in that it requires a settlor (waquef), a declaration (al-hugah), the property given as waqf (al-mawqufah) and a beneficiary (al-mawquf alayh). There has been debate amongst scholars as to the requirement for pious intent (niyya al-qurba) on the part of the settlor but most agree that the purpose of a waqf itself must simply not be sinful.

Objects

The objects of a foundation may be to benefit a person or a class of persons or to carry out a specified charitable or non-charitable purpose (or may indeed be a mixture of these things). The foundation will hold assets in its own name. It will use these assets in accordance with its constitutional documents (the charter and the regulations), either to benefit specified persons or for a specified purpose.

Waqf is commonly established for the provision of religious, charitable or social services or to support the family of the settlor. There are two basic types of waqf:

❏ waqf khairee, where the income of waqf property is dedicated in perpetuity for charitable or religious purposes;

❏ waqf ahlee where income of the waqf is dedicated in perpetuity to members of the settlor's family. It is possible to have waqf that combines both religious and charitable purposes with the maintenance of the settlor's family.

It is therefore possible to structure a Jersey foundation in such a way as to have the same objects as waqf would have.

Assets

A Jersey foundation will hold assets in its own name. It will use these assets in accordance with its constitutional documents (the charter and the regulations), either to benefit specified persons or for a specified purpose. The foundation shall invest these assets and either distribute them to beneficiaries or use them for the stated purposes.

In comparison, views differ as to the ownership of property which has been declared as waqf. Different Shari'ah schools have different views upon this. The Maliki school, for example, takes the view that the settlor remains the owner of waqf property but is prevented from using it; however, Hanafi and Shafi'i schools believe it is effectively ownerless. Shia scholars generally agree that the property ceases to be the settlor's, but there is a division within Shia school as to whether it becomes ownerless or belongs to the beneficiaries, subject to whether the property is held within a public or private waqf.

The main difference between the Jersey foundation and waqf with regards to assets is therefore in the application of capital assets. It is possible to structure a foundation in such a way as to apply income only to a purpose however some direction must be given as to the application of the capital upon the winding up of the foundation.

Constitutional documents and organisation

The constitutional documents of a Jersey foundation consist of the charter (a public document, which will be filed with the Jersey Registrar of Companies and available for public inspection at the Registry) and the regulations (which are private and thus may be viewed by only those defined as 'persons appointed under the regulations of the foundation'). The regulations are required to establish a council to administer the foundation's assets and to carry out its objects. The regulations must also provide for the appointment of a guardian to ensure the accountability of the council.

The council exercises the power of the foundation. Council members only have duties towards the foundation itself; they have no fiduciary duty to individuals who may benefit from the foundation.

Waqf is established with a declaration, using words which clearly prove the settlor's intention. It is not settled between Shari'ah schools as to whether waqf can be settled by actions. There is usually only one nazir

or mutawalli however there is nothing in principal to prevent the waquef or the mutawalli appointing a council.

For both waqf and a Jersey foundation it is important that the objects of the entity are established clearly at the outset and this is the main purpose of any charter and regulations or declaration.

Guardian

The principal role of the guardian is to ensure that the council carries out its functions in order to achieve the objects of the foundation. The requirement for a guardian ensures the proper administration of foundations and the protection of the beneficiaries of the foundation. The guardian may retain various executive powers, such as a veto over certain decisions of the council.

This is an area where, although not directly in line with the usual structure of waqf, the Jersey foundation provides an interesting edge in terms of Islamic finance. Because the guardian can retain powers it may make sense to appoint either the founder or (possibly a more interesting concept) a Shari'ah scholar to oversee the foundation and council. Something that we often see in Jersey when setting up Shari'ah-compliant structures is an unease on the part of the settlor in handing their assets to a trustee. With a Jersey foundation, not only can the founder (settlor) legitimately be a council member but they can also appoint family members to the council and either become guardian themselves or appoint an appropriate person. Whilst the trust concept is flexible, the foundation clearly offers an attractive proposition to clients who wish to retain a high level of continuing control over the assets settled into a structure.

Use of foundations

Foundations provide Jersey with an alternative financial planning vehicle to companies and trusts for wealth management and charitable giving. Many civil law jurisdictions do not recognise the concept of a trust, but are happy with the foundation. It is expected that Jersey foundations will be used by those who require transparency, wish to control assets (rather than transferring the assets outright to the trustee of a trust), or who prefer a structure with which they are familiar. In terms of Islamic finance, each of the trust and the foundation provide a facility to clients to structure their affairs in compliance with Shari'ah law under regimes that can be said to have clear and identifiable similarities and differences to waqf.

Keeping clean

Hany Abou-El-Fotouh, board secretary and director of policy and corporate affairs at CI Capital Holding, the investment banking arm of Egypt-based Commercial International Bank, discusses the issue of fighting money laundering in Islamic banking.

Hany Abou-El-Fotouh, CI Capital Holding

Money laundering is not a new trend. It is a process that takes illegal or 'dirty' money generated from illegal activities and puts it through a cycle of transactions, so that it comes out at the end as apparently legal or 'clean' money. The process is driven by criminal activities and conceals the true source, ownership or use of funds.

No one can deny that money launderers may use Islamic banks as a place to clean their dirty money through the use of various financial instruments. It is important to ensure that Islamic banks are well-protected from being unwittingly used by money launderers and the public at large is able to maintain confidence in the credibility of the Islamic financial system.

The beginning of money laundering

In medieval times, when the Catholic Church banned usury as not only a crime but also a mortal sin, merchants and money lenders intent on collecting interest on loans engaged in a wide variety of hiding, moving and washing criminal money. The main objective was to make interest charges disappear or disguise their nature, and this could be done in many ways. When merchants negotiated payments over long distances, they would artificially increase the exchange rates sufficiently to cover interest payments as well. They would claim that interest payments were a special premium to compensate for risk. They would make interest appear to be a penalty for late payment, with lender and borrower agreeing in advance that such a delay would take place. They would pretend that interest payments were really profits by using something similar to today's so-called 'shell companies' (companies that have no real operational role). Capital would be lent to the company and then taken back again, allegedly in the form of profits rather than interest on the loan, even though no profits had really been made. All of these tricks to deceive the Church authorities have their rough equivalents today in the techniques used to launder criminal money.

The size of the problem

Today, money laundering represents an estimated two to five per cent of the world's gross domestic product (GDP). The International Monetary Fund (IMF) describes it as one of the most serious issues facing the international financial community. Estimates of money laundering worldwide range from \$800 billion to \$1.6 trillion; 47 per cent of the launderers use banks to clean dirty money.

Three stages of money laundering

The money laundering process is comprised of three main stages.

'Placement' is the first stage in money laundering where physical currency is made to enter into the financial system. The illegal profits may derive from drug trafficking, prostitution rings, smuggling, illegal arms sales, kidnapping for ransom, bribery, computer-fraud schemes and smuggling of human beings and organs. It is here that the illegal proceeds are most vulnerable to detection.

The second stage is 'layering', the separation of the money from its illegal source by conducting a complex series of transactions.

At each layer, the money looks more and more like legitimate funds. Launderers try to make any tracing back to the dirty source impossible. Examples include bank-to-bank transfers, wire transfers between different accounts in different names in different countries, often using shell companies and the purchase of high-value items (boats, houses, cars, diamonds and securities) to change the form of the money.

The last stage is 'integration', integrating the illegal proceeds back into the economy as legitimate funds through legitimate transactions such as business ventures, luxury assets, lending, financing and investing. This stage provides a money launderer with an apparently legitimate explanation for his/her wealth.

Is terrorist financing similar to money laundering?

Terrorist financing is the process of reverse laundering, but tends to use smaller amounts than is the case with money laundering. This process uses funds raised from legitimate sources, such as personal donations and profits from businesses and charitable organisations, as well as from criminal sources.

Terrorists may use the same money laundering techniques to evade authorities' attention and to protect the identity of their sponsors and the ultimate beneficiaries of the funds. They may use conventional and Islamic banks, informal value-transfer systems, hawala and physical transportation of cash, gold and other valuables through smuggling routes.

Money laundering from an Islamic perspective

Islam forbids involvement in economic activities which are not in line with the teaching of Islam, such as money laundering. Money laundering involves proceeds of unlawful activities and Islam does not allow any property derived from such sources.

Islam obliges Muslims to do good things and forbids criminal activities. This duty rests with individuals and corporate entities. Islamic banks are responsible for preventing or combating money laundering activities which are clearly not in line with the teachings of Islam.

Are Islamic banks more vulnerable to money laundering?

Conventional and Islamic banks and other financial institutions are vulnerable to money laundering. Money launderers may target them because of the fast, safe services offered with the possibility of transferring enormous amounts of money electronically around the globe.

Sadly, Shari'ah-compliant banks and financial institutions are often seen as the weak link in the West. There is a false perception about inadequate anti-money laundering (AML) and internal controls.

The reality is that AML standards are the same in Islamic financial institutions as in their conventional counterparts. However, Islamic finance is a new industry, and with all new industries, there is always room for improvement.

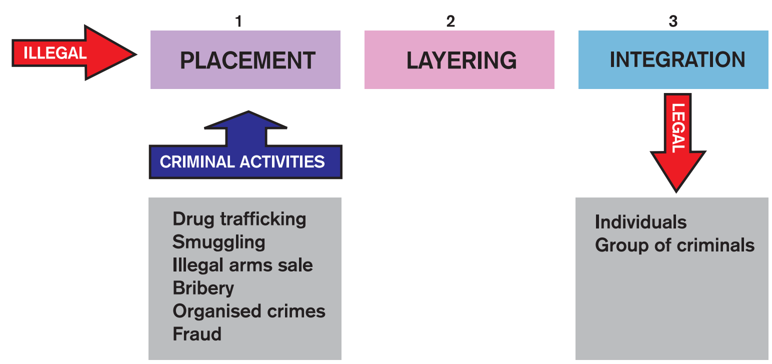
Five common myths about Islamic banks

Myth 1: Many Muslims send their zakat (alms giving) through Islamic banks. There is no assurance that they have funded a legitimate charity rather than a terrorist group.

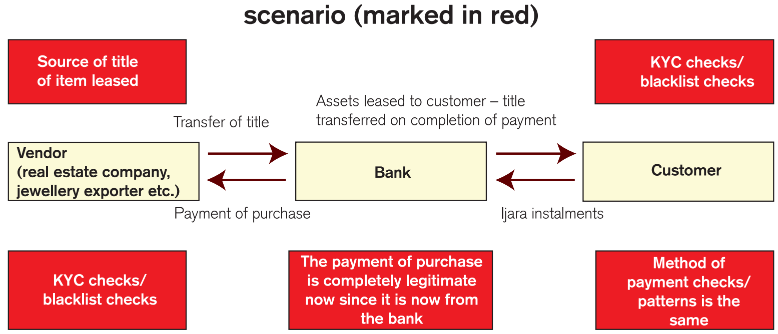
Reality: Islamic banks oversee payment of zakat to worthy charities and apply adequate due diligence so that no payments are made to doubtful charities.

Myth 2: The Islamic banking system operates under loose regulatory oversight. There are no proper accounting and auditing standards.

Stages of money laundering



Money laundering vulnerabilities and its similarities to conventional banking scenario (marked in red)



Reality: Islamic banks are well-regulated and follow defined standards of institutions such as state regulators, the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) and the International Financial Services Board (IFSB).

Myth 3: Terrorist groups are more likely to find willing collaborators within the Islamic banking system.

Reality: Shari'ah principles do not conflict with international AML and counter-terrorist financing standards. Islamic banks are subject to the same laws and regulations as their conventional counterparts.

Myth 4: Assets and commodities are used as degrees of separation in purely financial dealings, resembling the 'layering' methods of criminal financiers.

Reality: Criminal activities are not in line with Shari'ah. Islamic banks cannot undertake activities which are harmful to society, such as gambling, casinos and the liquor trade. As Islamic financial institutions cannot lend money on interest, but finance trade, leasing and businesses on a partnership basis, they purchase/sell assets and commodities as required by their clients. However, these will not be tools to disguise illegal proceeds.

Myth 5: Islamic banks operate in countries known to have weak banking regulations.

Reality: A lot of conventional international banks have Islamic windows, including Citigroup, HSBC, UBS and Standard Chartered Bank. National financial regulators are strongly involved. For example, the Financial Services Authority (FSA) in the UK with its 'no obstacles, no special favours' approach is successfully regulating five fully-fledged Islamic banks.

Fighting money laundering

Almost all countries in which Islamic banks operate have made serious efforts to combat money laundering by introducing AML laws and guidelines, such as know your customer (KYC). Islamic banks are obliged to report suspicious transactions to financial intelligence units. Furthermore, they should have AML policy approved by the board, a competent compliance officer, transaction monitoring and watchlist screening systems in place, as well as rules on record keeping and KYC guidelines. Indeed, Islamic banks have further duty to combat money laundering activities as mandated by religion of Islam.

Diary of events endorsed by the IIBI

January

18–21: 18th Islamic Finance Forum, London
Forum to engage the key issues shaping the future of the European and global Islamic finance industry in today's difficult economic environment and to focus on new ideas, new directions, and new leadership.
Tel: +971 4 335 2437
Email: info@iirme.com
www.iirme.com

February

1–3: World Cards & Payments Summit, Dubai
Summit to focus on creating a profitable cards business and payments environment for 2010, both for conventional and Islamic financial industries.
Tel: +971 4 60 91 581
Email: anthony.permal@fleminggulf.com
www.worldcardsummit.com

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7–8: 6th Annual Middle East Insurance Forum (MEIF), 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

11: Islamic Finance Seminar, London
Organised by the British Bankers' Association (BBA), seminar to assess the current activity in the UK, opportunities for growth and how the credit will affect Islamic finance.
Email: conferences@bba.org.uk
www.bba.org.uk

April

12–13: 5th Annual Middle East Retail Banking Forum, Dubai
Forum to discuss effective retail banking strategies for Islamic and conventional financial institutions in the Middle East.
Tel: + 971 4 609 1576
Email: mehwish.hilal@fleminggulf.com
www.fleminggulf.com

INSTITUTE OF ISLAMIC BANKING AND INSURANCE
DISCOVER NEW PERSPECTIVES

Islamic Money & Banking: Integrating Money in Capital Theory

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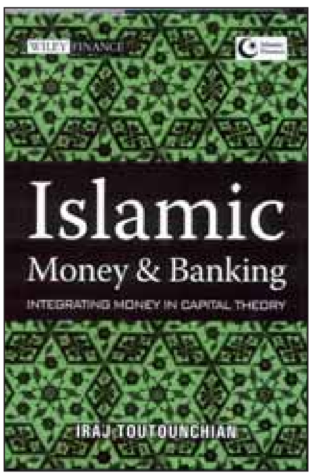

The book examines how money, in the absence of interest (riba) and money markets, can become a dependent variable of an economic system. It further tries to integrate money in capital theory and to make the monetary sector part of the real sector aiming at removing the problems that arise from separation of the two.

In the preface the author says that the performance of the stock market, evidenced by crashes and lopsided distribution of income and wealth, has become the most suitable barometer of the merits of capitalism. Such are the catastrophic and all-embracing consequences of the current crisis that many exponents of the system are now beginning to doubt whether it can, or should, survive. Such doubts are only logical if humanitarian considerations are to enter into the equation. In the zero-sum game of capitalism, someone's gain is someone else's loss. The author seeks an answer by taking a different look at the present problem, and one which involves a much deeper understanding of the fundamentals of capitalism, such as those that go back to the assumption of non-satiation, which in turn give rise to unchecked greed and self-interest.

The author goes on to argue that the complexities of human nature require guidelines and restrictions set down by the Creator of the universe. But lessons to be learned from the Divine Laws go far beyond human nature. It is a matter of order and regularity; as it has been observed for centuries in the universe and the human body, so too should it be with socio-economic affairs. Ignoring these rules and regulations has caused nations serious problems that could have been avoided. A truly Islamic economic system is one that accommodates all positives. Its sustainability is guaranteed because it is compatible with human instincts; positives praised and negatives denounced. Greed can be restricted either through legal measures and/or obedience to the Divine teachings. Co-operation can moderate greed as well as further guarantee the universality of the Islamic economic principles. A comparison with capitalism only serves to highlight capitalism's many pitfalls and tendency to emphasise the negatives in human behaviour. A viable economic system has to take care of all human characteristics because, ultimately, this is what Nature demands. Muslims – and indeed many non-Muslims – have learned that love, empathy, altruism, co-operation, sacrifice, mutual concern, forgiveness, gratitude, virtue, benevolence and honesty are as much a part of human heritage as hatred, self-interest, apathy, revenge, vice, dishonesty or fraud.

Throughout history, there has always been conflict between 'good' and 'bad' behaviour, and the people who embody these characteristics are either admired or denounced. At this point, the crucial question we should be examining is the role capitalism has played in this regard.

The book is divided into seven chapters, the first chapter discusses an evolution of money from a new perspective; the second chapter deals with a brief history of interest, interest on money and its scope; the third chapter takes a legal perspective on Islamic finance; the fourth chapter goes on to discuss interest and the place of man in the economic system; chapters five and six deal with conventional banking versus Islamic banking, looking at the structure and functions of banking, the philosophical foundations of the place and ultimate goal of man and Islamic Modes of finance along with Islamic bank structure and contracts; the final chapter discusses the role of central banks in Islamic banking and learning from experience.

The book is 409 pages long (including bibliography and index) and is priced at $85.00.

About the author

Dr Iraj Toutounchian is a professor of economics at Al-Zahra University, Tehran, Iran. Currently, he is also chief of academic affairs, Bank of Industry and Mine, Iran, responsible for implementing Islamic banking. He was formerly the deputy minister of economics and international affairs at the country's Ministry of Economic Affairs and Finance, and also he has served as a member of the Money and Credit Council at Central Bank of Iran.

Keynes: The Return of the Master

When unbridled capitalism falters, is there an alternative? The current global financial crisis has brought to a head wider issues concerning the explanation of human behaviour and the role of moral judgements in economics. These touch on attitudes to economic growth, globalisation, justice, the environment and so on. Keynes has important things to say about these matters. To take just one: if growth is a means to an end, what is the end, how much growth is 'enough', and what other valuable human purposes may be pre-empted by a single-minded concentration on economic growth?

The book is unquestionably the most important contribution to economic debate since Lehman Brothers folded, and it should be read by policy makers, bankers, regulators, and the wider public. All will appreciate its embrace of history and ordinary language – Keynesian traits that subtly but powerfully reduce economics to its rightful place, not as a branch of applied maths but 'as a moral, not natural, science'. Keynes was a moralist. There was always, at the back of his mind, the question: What is economics for? How does economic activity relate to the 'good life'? How much prosperity do we need to live 'wisely, agreeably and well'?

Keynes' reflection on ethics and economics can be considered under four headings: the relationship between wealth and goodness; the psychology of wealth creation, the role of justice in economics; and the place of religion in economic life. The author makes the broader point that Keynes only saw wealth creation in terms of the 'good life'; 'and a good life was not what made people better off: it was what made them good. To make the world ethically better was the only justifiable purpose of economic striving.' Of course, the author continues, except for religious groups very few people would even recognise this definition of the good life.

The definition of good life in Islamic teachings promotes human brotherhood, socio-economic justice and the well-being of all through an integrated role of moral values, the market mechanism, families, society, and good governance; Islamic economics does not seek to abolish private property, as was done by communism, nor does it prevent individuals from serving their self-interest. It recognises the role of the market in the efficient allocation of resources, but does not find competition to be sufficient to safeguard social interest. While conventional economics generally considers the behaviour and tastes and preferences of individuals as given, Islamic economics does not do so. It places great emphasis on individual and social reform through moral uplift.

The book is divided into three parts. The first looks at what went wrong and the present state of economics. The second looks at the success or failure of Keynesian economics, and the third at Keynes and the ethics of capitalism.

The book is 232 pages long (including bibliography and index) and is priced at £20.00 (around $33).

By Robert Skidelsky
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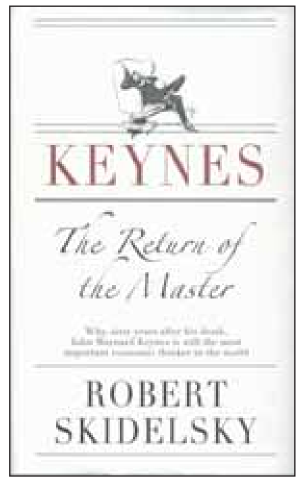

About the author

Robert Skidelsky is Emeritus Professor of Political Economy at the University of Warwick. His three-volume biography of the economist John Maynard Keynes (1983, 1992, 2000) received numerous prizes, including the Lionel Gelber Prize for International Relations (founded in 1989 by Canadian diplomat Lionel Gelber, the prize honours 'the excellence of those who think and write about the local and global forces of change in international issues') and the Council on Foreign Relations Prize for International Relations. He was elected Fellow of the British Academy in 1994.

IIBI regularly researches the market for books and publications on various aspects of Shari'ah-compliant banking and insurance that may help the IIBI community to advance their knowledge of Islamic finance. In this series of book reviews, the Institute's specialists bring you concise and up-to-date analysis of specialist literature. If you have any questions regarding the reviewed books or would like to suggest a book, please email **iibi@islamic-banking.com** or **editor@newhorizon-islamicbanking.com**

On the move

HE Dr Sabir Mohamed Hassan, governor of the Central Bank of Sudan, has been appointed by the Islamic Financial Services Board (IFSB) as its chairman of the council for the year 2010. His deputy chairman, who was appointed at the same time, is to be the governor of the Central Bank of Jordan, HE Dr Umayya Toukan. Dr Muhammad Sulaiman Al-Jasser, governor of the Monetary Authority of Saudi Arabia, has stepped down following his year's tenure. The chairmanship of the IFSB rotates on an annual basis between the members of the council.

Daud Vicary Abdullah has been announced as Deloitte's global leader of the Islamic finance industry group. He will be responsible for the overall strategy and development of Deloitte's global Islamic finance division, and provide guidance to group members on governments, corporations and financial institutions. Abdullah has over 35 years of experience in finance and consulting, having worked in Europe, Asia, Latin America and the Middle East.

Jordan Dubai Islamic Bank has announced a new hire. This is Dr Hussain Hamed Hassan *(left)*, who is now chairman of the bank's Shari'ah and Legitimacy Control Council. Two others, Dr Ali Al Swa and Dr Ahmed Melham, have also been appointed to the council as members. Hassan has plenty of experience to prepare him for this role. He is already on the Shari'ah committees of a number of Islamic financial institutions in the UK, Pakistan, Algeria, Sudan, Bahrain, Saudi Arabia and the UAE.

Abu Dhabi Islamic Bank has appointed Amir Riad as global head of corporate finance and investment banking. Riad moves from Standard Chartered Bank in the UAE, where he held the post of regional head of corporate finance and advisory for the MENA region. He also spent over twelve years at Citigroup, during which time he held managerial positions in the areas of corporate finance and private equity. Before that he was VP with Citigroup/Salomon Smith Barney's investment team in London.

Bilal Ahmed has been promoted to senior manager of Ernst & Young to lead its Islamic finance team in the Channel Islands, as part of a number of appointments at the professional services firm. Ahmed joined Ernst & Young in 1998. Before his current appointment he worked for the firm in Karachi, Dubai, Johannesburg and London. He has worked in Jersey since 2006.

Saudi Hollandi Bank has appointed Dr Bernd van Linder as managing director by the bank's board of directors. Van Linder has fulfiled this role in an acting capacity since May 2009. He joined the bank in 2006 as GM in the treasury department. Before this, he worked at ABN Amro.

The International Capital Market Association (ICMA), which has recently been actively engaged with the International Islamic Financial Market (IIFM) to develop market practice and documentation for the sukuk market, has announced the appointment of Robert H Mohamed as chairman of ICMA Middle East, Far East and Africa. Mohamed is co-head of investment banking in the corporate and investment banking division of National Bank of Abu Dhabi, and has previously worked for Arab Banking Corporation, Deutsche Bank and Merrill Lynch.

Shaikh Dr Mohamed El Gari, Shaikh Dr Nizam Yaqoubi and Shaikh Lahem AlNasir have been named as the three Shari'ah scholars who will sit on the board of Khalijia Invest, a newly launched Shari'ah-compliant investment company in Bahrain. The company is to specialise in corporate finance and asset management. The CEO of the firm is Muneer Al Shehri, and he will be joined by Dhafer Salih Alqahtani *(above)* as deputy CEO. Khalijia Invest plans to launch four Shari'ah-compliant investment funds in the first half of 2010.

Sudanese Egyptian Bank has chosen Amr Bahaa as its new MD. Bahaa is a former assistant managing director and executive board member of Piraeus Bank Egypt. Bahaa also restructured the dealing room, and developed a number of innovative products for private banking clients, while he was general manager for treasury and product development at Piraeus Bank Egypt. Before joining that bank he held various managerial posts with Arab International Bank, Crédit Lyonnais and Arab Banking Corporation.

Khaled M. Khaleif has been appointed finance manager of Takaful Re, a Dubai-based Islamic insurance provider. A Libyan national, he moves from Arab Insurance Group, where he has picked up twelve years of experience.

Sameh Al Awadhallah is the new head of branches at Abu Dhabi Islamic Bank. He has previously held industry posts such as head of branches, priority banking and SME banking in various financial institutions. He has 15 years of industry experience.

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EIIB was incorporated in January 2005 and received authorisation by the FSA in March 2006. In April 2006, EIIB opened for business, and in May 2006 completed its IPO and was admitted to London's AIM market. In November 2006, EIIB opened a representative office in Bahrain. EIIB's mission is to achieve excellence in the provision of Shari'ah-compliant investment banking products and services. Headquartered in London, EIIB's range of products and services include the following Shari'ah compliant investment banking activities:

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al-hugah
Declaration for waqf.

al-mawqufah
Property given as waqf.

al-wadia
Resale of goods with a discount on the original stated cost.

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 fiqh (Islamic jurisprudence) is unclear. It is an opinion, and is not legally binding.

fiqh
Islamic jurisprudence. The science of the Shari'ah. It is an important source of Islamic economics.

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.

halal
Activities which are permissible according to Shari'ah.

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 wa iqtina
The same as ijara except the business owner is committed to buying the building or equipment or facility at the end of the lease period. Fees previously paid constitute part of the purchase price. It is commonly used for home and commercial equipment financing.

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.

maal
Wealth, money, property; any valuable thing which can be possessed.

maysir
Gambling – a prohibited activity, as it is a zero-sum game just transferring the wealth not creating new wealth.

mudarabah
A form of business contract in which one party brings capital and the other personal effort. The proportionate share in profit is determined by mutual agreement at the start. But the loss, if any, is borne only by the owner of the capital, in which case the entrepreneur gets nothing for his labour.

mudarib
In a mudarabah contract, the person or party who acts as the entrepreneur.

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 clientat 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.

nazir
Caretaker/manager.

niyya
Intention.

qimar
Lit: gambling. Technically, an agreement in which possession of a property is contingent upon the occurrence of an uncertain event. By implication it applies to those agreements in which there is a definite loss for one party and definite gain for the other without specifying which party will gain and which party will lose.

rab-al-maal
In a mudarabah contract, the person who invests the capital.

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
A contract in which advance payment is made for goods delivered later on.

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

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.

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.

taskeek
The process of issuing sukuk.

ta'widh
Compensation.

thimmah
Independent legal entity.

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.

wafq ahlee
Where income from waqf is dedicated in perpetuity to members of settlor's family.

waqf khairee
Where income of waqf property is dedicated in perpetuity for charitable or religious purposes.

waquef
Settlor for waqf.

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.


A joint approach
to develop innovative
financial solutions.