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Best Practice

Instruments

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Viewpoint: *Shariah* Law—Bringing a New Ethical Dimension to Banking by Amjid Ali

INTRODUCTION

Amjid Ali, senior manager, HSBC Amanah Global, believes that *shariah* finance is broadening its appeal and reach—both among Muslims and non-Muslims—as a result of the banking and financial crisis. Recognized as one of the most influential Muslims in the United Kingdom by the Muslim Power 100 Awards, Ali has 22 years of branch banking experience with Midland Bank and HSBC in the United Kingdom. In September 2003 he joined HSBC Amanah UK as senior business development manager, with responsibility for raising the profile of Amanah Home Finance in the United Kingdom. He took over as UK head in January 2005, with responsibility for strategy, distribution, and sales, and was appointed senior manager, HSBC Amanah Global, in August 2008. In this role Ali is working as part of the HSBC Amanah central team headquartered in Dubai.

What are the underlying principles of *shariah* law from a financial perspective? In other words, what defines the kind of model to which a financial institution that seeks to offer *shariah*-compliant services to its Muslim customers will have to adhere?

Shariah is the body of Islamic faith and has two main sources. The first is the Qur'an, the sacred book that records the word of God as revealed to the Prophet Mohammed. To quote directly from the Qur'an: "God has permitted trade and forbidden interest," Qur'an, Chapter 2, Verse 275. The fundamental underlying principle is that interest is prohibited.

The second source is the *Hadith*, the body of documents that records the *Sunnah* (the practice, or "life example") of the Prophet Mohammed.

From these two sources there are five main prohibitions that must be observed in the creation of a *shariah*-compliant financial services model. They overlap somewhat and are mutually supportive.

1 *Riba*: the prohibition of interest.
2 *Gharar* (translated as "uncertainty" or opacity): there must be a full and fair disclosure (for example, certainty as to the price of a contract before it is concluded).
3 *Maysir*: the prohibition of speculation or gambling ("obtaining something easily or becoming rich without effort").
4 Profit: the Islamic financier should only generate benefit from the project in which they invest and must take some risk, since risk equates to effort and potential loss.
5 Unethical investment: Islam prohibits investing or dealing in certain products such as alcohol, armaments, and pork, and in activities such as gambling, entertainment, and hotels. (Exactly how this last prohibition is interpreted varies widely depending on where one is in the Muslim world.)

Is this list sufficient to define *shariah*-compliant financial services?

No, there are other factors to keep in mind when constructing product offerings. Very importantly, one has to keep in mind the Islamic view of money. In Islam money is not a commodity; it has no intrinsic use and it can only be exchanged for the same par value. Also, Islam allows the use of securities to support a transaction, which guards against the wilful wrongdoing or carelessness of partners.

HSBC, Lloyds, and other banks now offer *shariah*-compliant mortgages for house purchase. How can this be reconciled with the principles you have outlined?

If we are supporting a customer in the buying of a property, it is done under a contract known as diminishing *musharakah*. This translates as co-ownership. In this transaction, the bank and the customer buy the home jointly, in joint names. As time progresses the customer buys more and more of the property from the bank and the bank's share in the home diminishes, until the bank no longer has any stake in the home. It is proper for the bank to take a reward for bearing the initial risk, but this reward is not interest on a loan but a rental charge for the portion of the asset owned by the bank. This method follows the underlying principle that "you cannot make money on money," but it is permissible to "make money on the use or the exchange of an asset."

Can you provide a sense of the growing scale and importance of *shariah* finance around the world?

Islamic banking is already large and it is growing very substantially. The target market is the world's 1.6 billion Muslims, who represent 25% of the world's population and are largely concentrated in emerging economies. The industry's total funds under management are estimated to be worth around US$450 billion to US$500 billion, excluding Iran. The annual growth rate for Islamic finance is currently running at 30%, which suggests that the market will reach US$1 trillion in funds under management by 2010. These figures were provided in a recent issue of *The Banker*.

While the Muslim community in general views *shariah* banking as the only acceptable method of banking, we have to accept that, when viewed globally, *shariah* banking is an alternative to, rather than a replacement for, the conventional, traditional model of Western banking. The latter has been in existence for centuries and has developed into a very sophisticated global industry. By contrast, Islamic finance is still very much an emerging, developing form of banking, which continues to evolve almost on a daily basis. At this moment, no *shariah* bank has a complete set of products that would mirror the portfolio of products on offer in a traditional bank.

Following the financial crisis, there have been calls for a more ethical financial infrastructure in the West. Does *shariah* banking have anything to offer to non-Muslims on this front?

If you look at the ethical platform of *shariah* banking, it will undoubtedly appeal not only to the Muslim community, but to the wider community as well. The transparency of products and the sharing of risk, together with the emphasis on like-for-like benefits are very appealing universally. What is also very clear is that, with any *shariah* bank, the principle of treating customers fairly must be at the heart of the bank's practice or it cannot be *shariah*-compliant. There are lessons for all from the credit crisis and subsequent global recession. However, I personally do not believe that Islamic financing can be considered a replacement for traditional banking. However, as it stands today, it is a credible alternative for non-Muslims. And for Muslims, it is really the only way for a Muslim to do business and sleep peacefully at night.

The prohibition against interest is not just an incidental or minor detail. It is the only prohibition in the Qur'an for which it is actually specified that to be in breach of it is to "make war on God and on his messenger," the Prophet Mohammed. This is a fundamental dividing point between traditional banking practice and *shariah* banking and it is not something that a Muslim can "fudge" and be happy.

I should point out that both the Christian and the Jewish traditions have a long history of being against usury, or the payment and receipt of interest. So the three traditions are not very far apart on this point.

You have provided an example of mortgage finance *shariah*-style. What other products are available?

One that comes to mind is *ijarah*, a lease-backed contract, which "mirrors" asset-based finance in traditional banking. In *ijarah*, the bank buys the asset in its entirety and then leases it back to the client and charges a rental. With *ijarah*, the return going to the bank from the customer is rent not interest, and Islam is comfortable with the concept of rent. Here, the bank is making money on the use of an asset.

Another product area is pensions. The restrictions of *riba* mean that pensions cannot be invested in government securities, as these are pure interest-bearing investments. However, certain equities are perfectly acceptable because the investor is a partner in the company, so he or she shares its risks and losses. Therefore, our pension product is very heavily based on equities, although property is also allowed as an asset class if the transaction is structured correctly.

The whole pensions area is much undeveloped in the Muslim community. Because of *riba*, Muslims naturally look to rental income and property ownership as the most natural way of funding their retirement. There is a real culture clash in the area of pensions, and it is something that we have been in longstanding discussions with the HM Revenue & Customs about. In the United Kingdom, the law mandates that at the age of 75 you have no other option but to buy an annuity with your pension. And annuities, being interest-based, are not ideal for Muslims. We have made this point through the Islamic Finance Experts Group that the government has set up, in which I participate. But it is not an issue that can be resolved overnight.

Then there are wholesale products, such as support for major corporates that are Muslim-owned. Again, this is very much a developing area in Islamic banking.

It seems that Islamic banks and traditional banks do coexist in some areas, perhaps because they are serving different markets.

In others, Islamic financial institutions are predominant. And there are also areas where Western banks are developing Islamic finance arms, such as HSBC's Amanah proposition. Is this how you see things progressing?

Today there are over 500 institutions around the world offering *shariah*-compliant products in 47 countries across the globe. I expect this to continue to expand, particularly in the Middle East, Indonesia, and Malaysia. The market is big enough to accommodate both wholly Islamic financial institutions as well as those which have "window" operations that offer Islamic products through existing branch networks.

At HSBC we have adopted a three-pronged approach.

- Window Model—this offers Islamic products through existing branch networks, and is used in the UAE, Bahrain, the United Kingdom, and Indonesia.
- Partnership Model—a joint venture between HSBC and Saudi British Bank. This unique partnership has given us access to one of the biggest markets in the Muslim world.
- Islamic Subsidiary—HSBC's Malaysian subsidiary was the first international bank to be offered this license in Malaysia. This is a unique proposition available for HSBC, with the option of opening branches outside Malaysia (in Brunei and Bangladesh).

It is all about understanding the local market and deciding which model works best.

The window model, which offers *shariah*-compliant products through an existing branch network, works extremely well for us in markets where the idea of *shariah* banking remains unfamiliar. In the United Kingdom, for example, there is not a particularly well developed understanding of what makes a product *shariah*-compliant, even among British Muslims. There is also a lack of understanding of how a *shariah*-compliant financial product might benefit a Muslim customer. There are invariably many questions, and one needs the interaction with a customer and trained branch staff who can make clear how a *shariah* product differs from a conventional one.

Is it necessary for a bank that wishes to have a *shariah* banking service to have a body of Islamic scholars overseeing its *shariah* products and its operations?

It is absolutely fundamental. It is the key to gaining credibility and integrity in the eyes of the market. Right from the outset, in 1998, when HSBC first set up HSBC Amanah as the Islamic financial services division of the group, we established an independent board of leading Muslim scholars to be our *shariah* advisers. These are very eminent and respected scholars from across the Muslim world. Success in this market depends on a *shariah* bank's ability to deliver in a way that continually demonstrates a respect for and understanding of cultural differences and of the importance of Islam in the daily life of a Muslim.

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Islamic Modes of Finance and the Role of *Sukuk* by Abdel-Rahman Yousri Ahmad

EXECUTIVE SUMMARY

- Islamic finance modes are based on profit/loss sharing because of *riba* (interest) prohibition.
- *Murabahah* has been responsible since the 1970s for the employment of about 80–90% of Islamic banks' resources. The bank provides commodities on a "cost plus profit" price formula to customers who pay back their debt in installments.
- *Ijarah* ranks next in importance after *murabahah* and implies a promise by the bank (lessor) to gift or sell the leased asset at a nominal price to the lessee by the end of the leasing period.
- *Diminishing musharakah* is a new product whereby the bank provides capital to a customer/partner whose share in partnership is increased gradually by repaying the principal in installments, plus a share of the realized profits to the bank.
- *Salam* entitles instant cash to a bank customer against its commitment to deliver prescribed commodities at a future date. *Parallel salam*, on the other hand, is practiced by banks to hedge their *salam* operations.
- In *istisna'a* the bank finances the manufacturing of a commodity for a customer who pays its price in installments. It is practiced mostly in Gulf countries.
- Islamic financial institutions, in the form of the limited liability joint stock company, rely totally on "ordinary shares" for raising their capital.
- *Multiple-party mudarabah* has enabled Islamic banks to work as partner/investor on a profit/loss basis for large numbers of capital owners whose deposits take the form of investment accounts.
- Islamic financial institutions have recently extended their activities in capital markets, and *sukuk* (Islamic bonds) are playing an important role in mobilizing resources.
- Because of *riba* prohibition, securitization (for *sukuk* purposes) should neither include *murabahah*, *istisna'a*, and *salam* assets, which are debt arrangements, nor allow for guaranteed regular payment to *sukuk* holders. Yet, although *sukuk* experience has been successful in terms of resources mobilized, it shows deviation from these rules.
- If *sukuk* do not maintain strict *shariah* rules, they are bound to be confused with conventional bonds.

INTRODUCTION

Broadly speaking, Islamic modes of finance can be divided into two types: either they provide direct finance as capital funds through partnership (*musharakah* and *mudarabah*), or they provide indirect finance through leasing (*ijarah*) and sale contracts (*murabahah*, *bai ajil*, *salam*, and *istisna'a*). All modes are based on the principle of *riba* (interest) prohibition, and all seek to maintain Islamic business ethics (freedom and leniency of transactions, recognition of and regard for private property, and justice).

MODES OF FINANCE

Musharakah

Musharakah (partnership) is practiced by Islamic banks either on a "permanent" or on a "diminishing" basis. In both cases capital is provided by the bank in return for a share in the realized profit (or the loss, if a loss occurred). In *diminishing musharakah*, which is a new Islamic product, the bank is entitled to receive, in addition to its share in realized profits, an extra payment that is specifically assigned for the purpose of reducing its share in the company's capital until this is fully paid off by the partner. Diminishing *musharakah* has mostly been used to finance small and medium-size enterprises, but it has also been employed in the financing of several big projects in some Arab Gulf countries (Kuwait, Bahrain, and the Emirates).

Murabahah

Among all the modes of Islamic finance, *murabahah* has played the most important role. Banks' annual reports reveal that since the 1970s *murabahah* has been steadily responsible for the employment of about 80–90% of Islamic banks' resources. *Murabahah* in traditional *fiqh* (Islamic jurisprudence) is a spot sale contract where the price is based on a cost plus profit margin formula. The contract has been

modified to include *bai ajil* (deferred payment sale) and renamed as "*Murabahah* to the Order of the Purchaser." According to the new contract, the bank's customer orders the purchase of a prescribed commodity that is available in the domestic or the foreign market. If the customer's creditability is satisfactory, the bank buys the commodity, adding its markup to the market price. The bank accepts payment for the commodity in installments, which normally stretch over one year or more. When *murabahah* purchase is made by means of importation from foreign markets, letters of credit and foreign conventional banks are involved, and necessary *shariah* precautions are taken to avoid payment of "interest" at any step.

Murabahah, which has established a flexible mechanism for extending interest-free trade credit on short- and medium-term bases to households and firms, has also played a significant role in financing small and microenterprises (for example Faisal Bank's Um Dorman branch in Sudan). Banking risk involved in *murabahah* operations is significantly reduced by customers undertaking to fulfill the contract once the commodity is purchased and by collaterals in the form of mortgage rights given to the bank over the purchased commodity until its price is fully paid.

The practice of *murabahah* has been the subject of criticism. It is held against Islamic banks that they are frequently guided by prevailing interest rates in determining their profit margin (markup) when they should instead consider market conditions for deferred payment sale, as intended in *shariah*. Also, for instance in Pakistan, banks have sometimes not acted as purchasers and have merely financed customers in equivalent cash to the ordered commodity price plus markup. In this case the markup charged by the bank above the commodity price is no different from interest, which is prohibited.

Salam

Salam is the sale of a prescribed commodity for deferred delivery in exchange for immediate and full payment of its price. *Salam* is permissible in *shariah* to meet the instant cash needs of a seller who undertakes the future delivery of the commodity. *Salam* sale is absolutely forbidden in currencies, gold, silver, and all quasi-money assets, since gain in this exchange is *riba*. The objects of *salam* are commodities (or services) that are normally available in the market and can be specifically defined in terms of quantity, and quality. The exact date and place of delivery must be specified in the contract to avoid any problem. Thus, banking finance is extended to firms or individuals against their commitment to deliver commodities at future dates.

To hedge the *salam* operation, banks also practice *parallel salam*. This involves making counter deals with other parties whereby they obtain immediate cash payments against a commitment to deliver commodities of similar quantity and quality to those in the *salam* contracts at some future date. Islamic banks in Pakistan, Sudan, and in some Arab Gulf countries have practiced *salam* transactions.

Istisna'a

Istisna'a is a manufacturing contract, treated in traditional *fiqh* as a special sale contract. A household that wishes to build a house, or a firm that needs to construct a building, or to manufacture equipment with particular specifications, would approach the bank for this purpose. The bank has to estimate the economic viability of the operation and the creditability of the customer. If the response is favorable, an *istisna'a* contract will be signed between the two parties. The customer submits a down payment and undertakes to pay the remaining part of the manufacturing price, as mutually agreed with the bank, in installments over a given period of time. The Islamic bank would then sign a *parallel istisna'a* contract whereby it extends finance to a firm that agrees to manufacture the requested object according to specification and to deliver it at an agreed future date. Islamic banks in the Arab Gulf countries have used this type of contract successfully to finance big operations, particularly in the construction sector and infrequently in the industrial sector.

Ijarah Muntahia Bittamleek

Ijarah muntahia bittamleek (lease ending with ownership) ranks next in importance after *murabahah* as an employment mode. The Islamic bank purchases *real assets* for leasing as requested and specified by its customers. The bank (lessor) and the client (lessee) will mutually agree on the leasing period, rent, and terms of payment. Maintenance and insurance of the leased asset are the bank's responsibility, whereas the lessee has to bear the running costs as well as any repair costs in the case of misuse. As *shariah* does not allow for the combination of leasing and ownership in one single contract, *ijarah muntahia bittamleek* implies a promise on the part of one party—namely the bank—to gift or to sell the leased asset at a nominal price to the lessee by the end of the leasing term. *Ijarah muntahia bittamleek* has

opened the door for successful leasing activities by the Islamic banks, particularly in the housing sector. *Ijarah* of houses gives the bank the advantage of keeping the title to a property until the end of leasing period, and gives the lessee the benefit of subleasing rights.

THE DEVELOPMENT OF *SUKUK*

Of growing importance, particularly in the last decade, has been the development of *sukuk* (Islamic bonds). *Sukuk* arose as a natural response to the remarkable growth of Islamic financial services and allowed Islamic banks, companies, and sovereigns to raise *shariah*-compliant funds through the market. It is this development in fact which has led to the growth of an Islamic capital market, though trade in shares of Islamic banks, *takaful* companies (or companies whose activities comply with *shariah*) is always feasible.

According to the Accounting and Auditing Organization for Islamic Financial Institutions' (AAIOFI) definition of investment *sukuk* (*Shariah* Standard 17), there are 14 possible forms that these can take. However, *sukuk* development meant approval of securitization within Islamic finance. Within the *shariah* framework the scope of assets that can be pooled, designated, and packaged for securitization is comparatively limited. The *ijarah* contract has been widely accepted by *fuqaha* (Muslim jurists) for securitization, since *sukuk* will rightly be backed by physical assets and financial rights over usufruct. Contracts such as *murabahah*, *istisna'a*, or *salam* cannot be securitized because they are *debt arrangements*. According to *shariah*, debt-based contracts cannot be traded in secondary markets. If this is done it would typically mean trade in money and involvement in *riba*. Yet, the decision of the Organization of the Islamic Conference's Fiqh Academy (Number 5, Fourth Annual Plenary Session, Jeddah, 1988) opened the door for assets in the form of money or debt (for instance, *istisna'a* and *murabahah*) to be exceptionally securitized if mixed in "minor proportion" with physical assets (*ijarah*).

Under *shariah* principles of interest prohibition and profit/loss sharing, no guarantee can be given in respect of either regular payment to *sukuk* holders or redemption of the *sukuk*'s face value. This goes against conventional market practices. Payments to *sukuk* holders should be made from the *actual or realized* cash flow of the investment that is based on the assets in the underlying pool. However, guarantees of performance, collateralization attached to *sukuk*, and their rating by conventional standards (Fitch or Standard & Poor's) imply the existence of mechanisms that secure a regular known flow of income to *sukuk* and redemption of their full face value. For example, in the Islamic Development Bank (IDB) *sukuk* issue of US$400 million in 2003, returns were calculated on a fixed-rate basis of 3.635% per year until their full redemption in 2008. The same principle applies to all the *sukuk* issued by sovereigns, and Salman Syed Ali (2005) observes that "rents payable to *sukuk* holders are not necessarily generated from the use of *sukuk* assets but from general revenues and other earnings of the state enterprise."

All this throws doubt on the genuine submission of *sukuk* to the principle of profit/loss sharing. Besides, the exception made for possible securitization of *murabahah* and *istisna'a* assets in "minor proportion" with *ijarah* assets has been widely extended. As in the case of IDB's US$400 million *sukuk* of 2003, the "minor proportion" of *murabahah* and *istisna'a* assets reached 49% of total tangible assets. More serious in this case is that under exceptional circumstances the composition of *ijarah* assets can fall temporarily under 51%, but not to a minimum of 25%, of the total pool of assets!

In practice, therefore, the gap between Islamic *sukuk* and conventional bonds has narrowed considerably. In future issues, *sukuk* should stick strictly to *shariah* rules if they are not to be confused in the markets with conventional bonds.

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Introduction to Islamic Financial Risk Management Products by Qudeer Latif and Susi Crawford

EXECUTIVE SUMMARY
- The main features of Islamic finance and *shariah* scholars are introduced.
- Conventional financial risk management products are viewed as non-*shariah*-compliant, which means that such products are not available to Islamic investors.
- The popularity of Islamic finance has given rise to a demand for *shariah*-compliant financial risk management products for underlying Islamic investments.
- A number of structures of *shariah*-compliant financial risk management products are available in the marketplace, all based around a *murabahah* sale structure.
- The rising popularity of the *wa'ad* structure is discussed.
- The article concludes with a brief summary of the future of *shariah*-compliant financial risk management products.

INTRODUCTION: THE MAIN FEATURES OF ISLAMIC FINANCE

To consider the basics of Islamic financial risk management products it is helpful to summarize the Islamic principles and jurisprudence on which Islamic finance is based.

- **Speculation**: contracts which involve speculation (*maysir*) are not permissible (*haram*) and are considered void. Islamic law does not prohibit general commercial speculation, but it does prohibit speculation which is akin to gambling, i.e. gaining something by chance rather than productive effort.
- **Unjust enrichment**: contracts where one party gains unjustly at the expense of another are considered void.
- **Interest**: the payment and receipt of interest (*riba*) are prohibited, and any obligation to pay interest is considered void. Islamic principles require that any return on funds provided by the lender be earned by way of profit derived from a commercial risk taken by that lender.
- **Uncertainty**: contracts which contain uncertainty (*gharar*)—particularly when there is uncertainty as to the fundamental terms of the contract, such as the subject matter, price, and time for delivery—are considered void.

To ensure adherence to these underlying principles, most banks that sell Islamic products have a board of *shariah* scholars (or will appoint a *shariah* scholar on a product-by-product basis) to ensure the bank's (or product's) compliance with the Islamic precepts.

On the whole, *shariah* scholars in the financial field hold the view that financial risk management products (commonly referred to as hedging arrangements) in the conventional finance space fall into the category of speculation (*maysir*) and uncertainty (*gharar*), both of which are prohibited under the *shariah* and cannot therefore be marketed as *shariah*-compliant products or used in conjunction with Islamic financing.

With the rise in sophistication of Islamic finance in recent years, however, a school of thought has emerged among pre-eminent *shariah* scholars that Islamic investors should be able to enter into hedging arrangements, provided that the financial risk management product is itself structured in a *shariah*-compliant manner and that there is genuine underlying risk arising from an Islamic investment.

The conventional financial risk management products have become an intrinsic part of the mechanics of banking finance and are, to a large extent, documented by standard documentation and negotiated without recourse to lawyers. Any *shariah*-compliant financial risk products have to strike the balance of being faithful to the principles of *shariah* while maintaining the user-friendly structure of their conventional counterparts.

THE CONVENTIONAL PRODUCTS

Financial risk management products in the conventional world are, in their basic form, a derivative, and each product is based on the principles that a derivative is a financial instrument whose value derives from that of an underlying asset,

and the underlying asset must be capable of being ascribed a market value.

The number of "assets" that can be ascribed a market value and from which, therefore, a derivative can be derived has resulted in a variety of financial risk management products. The commonly known structures are those based on interest and currency rates: i.e. interest rate swaps, cross-currency swaps, and foreign exchange forwards. There are also commodity derivatives based on gold, steel, and other metals. More recently, products known as "exotics" based on the weather and carbon emissions have appeared in the market in response to the requirements of a changing environmental as well as financial climate.

HOW A *SHARIAH*-COMPLIANT PRODUCT IS STRUCTURED

The starting point in structuring an Islamic financial risk management product should be an understanding of the commercial purpose of its conventional counterpart. For example, when structuring a profit rate swap, one must examine the use and structure of the basic interest rate swap. The interest rate swap is a hedging arrangement that is used to limit exposure to possible losses of expected income due to interest rate movements, and there is a similar demand for *shariah*-compliant products to limit exposure in Islamic investments where the profit, rent, or commission is linked in part to interest rate movements.

One must also must consider the non-*shariah* aspects of a conventional financial risk management product and address the same in the Islamic structure. As noted in the introduction, a principle of Islamic finance is that any profit must be earned through trade and taking a risk in a transaction. A common reason why hedging arrangements are seen as non-compliant is that although a financial risk management product is linked to the value of an asset, it does not require ownership risk in the asset itself and any profit earned is earned independently of trade, ownership, or investment in such an asset.

Conventional risk management products are structured along the lines of a synthetic trade that occurs on each payment date. The elements of this synthetic trade are that:

- a party will be obliged to carry out an action (such as the delivery of an asset or the payment of a price) on a certain date; and
- the obligation to carry out such action will vary in accordance with the value of the underlying asset.

This structure has provided the framework for *shariah*-compliant financial risk management products by replacing the synthetic trade with an actual commodity (or any other asset) trade structured along the lines of a *murabahah*. This is a common Islamic structure under which assets can be sold for an express profit and the payment can be deferred.

By using commodity trades, the banks and the counterparty expose themselves to ownership, if only briefly, of an underlying asset. The traded commodity represents the principal amount of the underlying Islamic investment (the "cost price") and is sold at a profit, which is calculated by reference to an interest rate and, if applicable, a margin (the "profit"). As the bank has taken ownership in the underlying asset, it is permitted to on-sell this at the profit, which must be agreed upfront.

A number of structures of *shariah*-compliant products all based on the *murabahah* have appeared in the marketplace with varying degrees of success. A description of the main structures, using the example of a profit (interest) rate swap, are set out below, together with the advantages and disadvantages of each.

Profit Rate Swap Structure No. 1

As in a conventional trade the parties, namely the "bank" and the "counterparty," agree the commercial terms of the future transaction: i.e. the trade dates, the fixed rate, the floating rate, the assets to be traded, and the notional cost price. On each trade date, the bank and counterparty will enter into two *murabahah* agreements.

Under the first *murabahah* agreement (the "floating leg"):

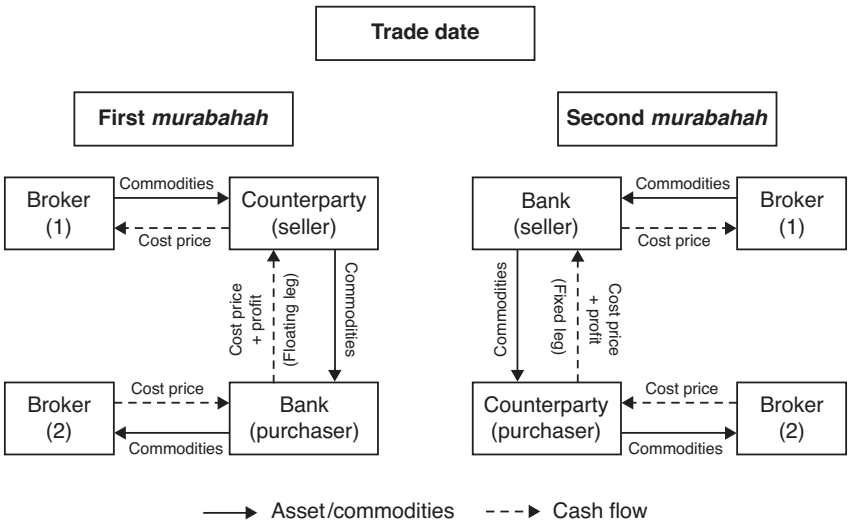
- the counterparty will sell to the bank an amount of commodities, the value of which will be the notional cost price;
- the sale price for these commodities will be cost price + profit;
- the profit element will represent the floating rate (calculated against the notional cost price).

Under the second *murabahah* agreement (the "fixed leg"):

- the bank will sell to the counterparty an amount of commodities, the value of which will be the notional cost price;
- the sale price for these commodities will be cost price + profit;
- the profit element will represent the fixed rate (calculated against the notional cost price).

The structure is shown in Figure 1. The net result of these trades is that on each trade date: the amount of commodities sold under each *murabahah* will be the same and the cost price will be

Figure 1. *Murabahah* structure no. 1



the same, and these will effectively be netted off by way of on-sales to a third-party broker; only the profit element will differ; and, as in a conventional interest rate swap, the net beneficiary (of the difference between the fixed and floating rate) is dependent on whether the fixed or floating rate was higher.

The risks associated with this *murabahah* structure are as follows.

Commodity risk. This arises from the bank's and the counterparty's ownership of the commodity. To mitigate this risk, although the ownership lasts for a short period only, many banks require the counterparty to indemnify them against any losses incurred due to ownership of the commodity. Some Islamic institutions see this as undermining the principles of *shariah*, which require that full ownership risk is taken.

Execution risk. This arises due to the fact that, under Islamic principles, parties cannot agree to a future sale (where delivery of the asset and payment of the price are both deferred to a later date). Therefore, the delivery of a commodity must occur on the same day that the *murabahah* contract is concluded. The result of this "parallel *murabahah*" structure depends on both parties' willingness to enter into the *murabahah* agreements on each trade date (whether or not they are the net beneficiary).

Costs. These arise from the fact that two new *murabahah*s are entered into at the beginning of each "profit" period (with deferred payment provisions), or on the trade date itself (with immediate delivery and payment provisions), throughout the term of the profit rate swap. This exposes each party not only to ownership risk, but also to the brokerage costs associated with a commodity trade (normally the brokerage fees are the liability of the counterparty, who would then be liable for two sets of brokerage fees on each trade date).

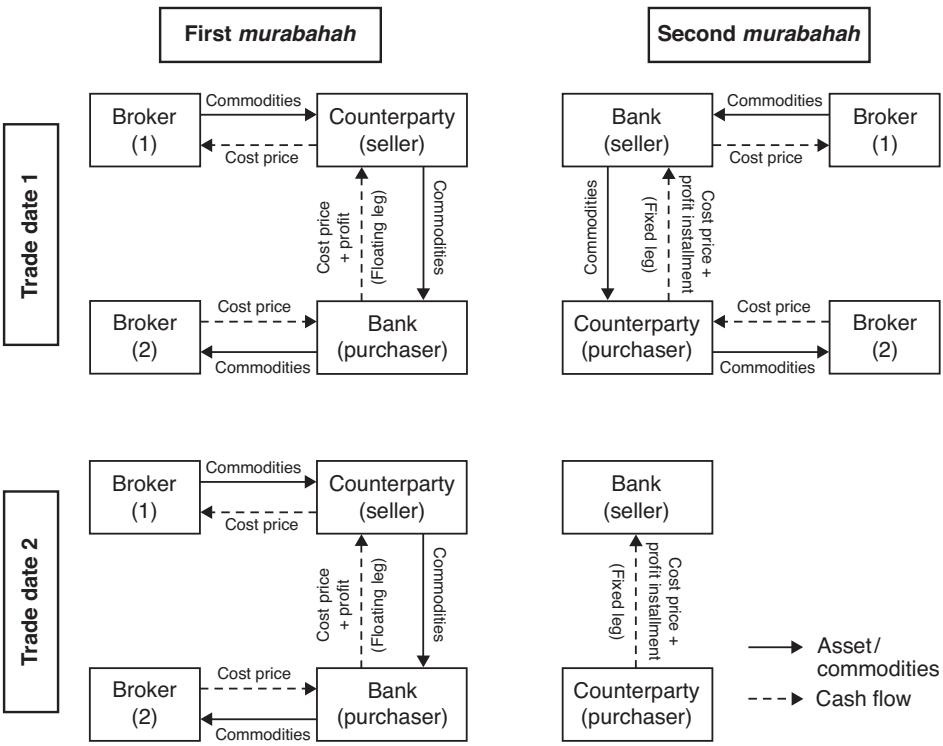
Profit Rate Swap Structure No. 2

In recognition of the risks set out above, the "parallel *murabahah*" structure has been developed in such a way as to limit the bank's and the counterparty's exposure to these risks, the key of which is that the fixed-leg *murabahah* is only entered into on day 1 and runs for the life of the profit rate swap, with "fixed" profit under the day-one *murabahah* being paid in installments over a number of deferred payment dates (with no need for further commodity trades to take place or *murabahah* agreements to be entered into).

The deferred payment dates under the fixed-leg *murabahah* will match the trade dates of each floating-leg *murabahah*. Because the floating-leg *murabahah* resets the profit rate a number of times, it has to be re-executed in relation to each trade date in order to give the parties certainty of the cost price + profit, which results in a commodity trade being carried out. The way structure 2 operates is illustrated in Figure 2.

This structure reduces the ownership risk (by reducing the number of commodity trades that are carried out) and the associated costs. It also reduces the execution risk as one half of the

Figure 2. *Murabahah* structure no. 2



trade is entered into on day 1. The parties are, however, still exposed to some execution risk—for example, a party not benefiting from a trade could walk away from the trade and the bank would remain liable to pay out under the fixed-leg *murabahah*.

Profit Rate Swap Structure No. 3

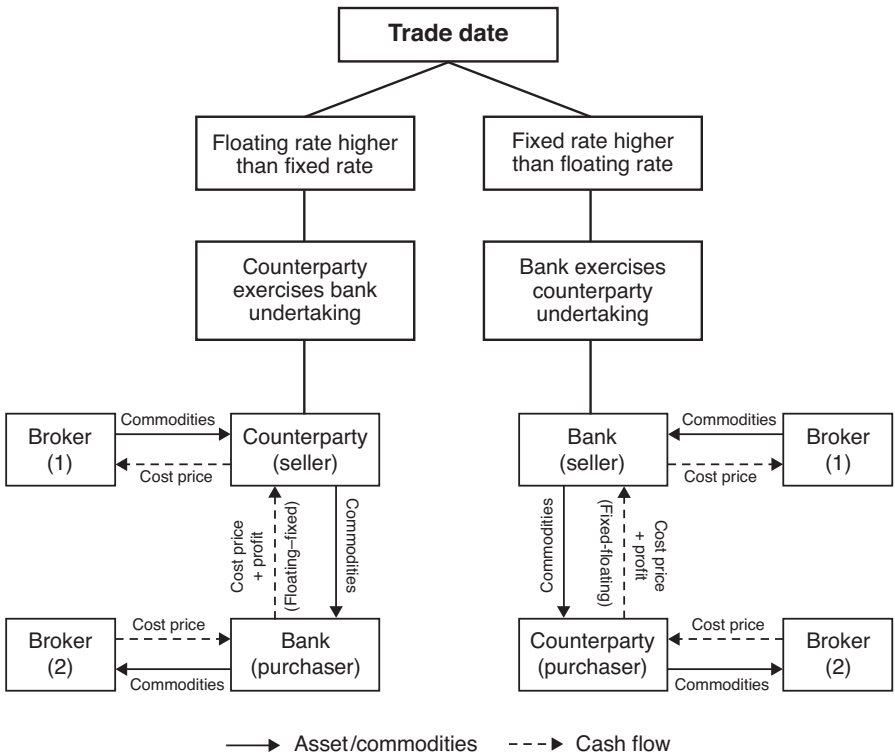
A structure that addresses the execution risk associated with structures 1 and 2 (and mitigates the ownership risk associated with structure 1) has recently appeared on the market and is known as the *wa'ad* structure (Figure 3).

Wa'ad is the Arabic word for promise. A promise, though commonly thought of as a moral obligation, is in most legal systems a legal one. The *wa'ad* structure is based on each party (as promisor) granting the other (as promisee) a unilateral and irrevocable promise to enter into a trade on certain dates for a certain price in the future (effectively a put option). The trade that takes place on a trade date is, like the *murabahah* structure, based on the purchase of commodities (or other assets), and the promise itself is documented by way of a purchase undertaking (or put option).

These two purchase undertakings cannot be linked in any way, but they can and do contain similar terms such as the trade dates and the commodities to be purchased. The only main difference is the price, which consists of cost price and profit (which will be calculated to reflect the difference between the fixed and floating rates).

The main aspect of the promise is the conditions attached to its exercise by the beneficiary, the promisee. The conditions attached to the exercise mirror those in the conventional hedge that determine which party benefits on a trade date. In an interest rate swap, this would be whether the fixed rate or the floating rate were higher. Depending on which is higher, only one party is able to exercise the purchase undertaking under which they are promisee and require the promisor to carry out a trade, purchase commodities, and pay the promisee the cost price + profit. The net result of the trade

Figure 3. The *wa'ad* structure



mirrors that of the *murabahah* structures in that the cash flows are gained through the purchase and on-sale of commodities, but also that of a conventional trade, where there is only one cash flow representing the difference in the profit.

As is the case with structure 2, the benefits are that there is only one trade on any trade date, which lowers the ownership risk and associated costs. The real advantage, however, is that it resolves the issue of execution risk as the party in the money is in "control" of the trade, and once the promise is exercised by the promisee, the contractual obligation to purchase the commodities and pay the cost price + profit arises without need for further execution.

The flexibility of the *wa'ad* structure makes it suitable for a number of products beyond profit rate swaps, as it can be adapted as a foreign exchange forward (with only one purchase undertaking) or cross-currency swap. It can also be drafted as a master agreement together with purchase undertakings, bringing it in line with its conventional counterparts.

CONCLUSION

The Islamic financial risk management products market has gathered such momentum in recent years that the favored structures are constantly under review and revision. Satisfied that the Islamic structure allows payments that mirror those of the conventional trades, bankers are now looking at the other International Swaps and Derivatives Association (ISDA) style provisions, such as right to terminate, termination events, tax events, and calculation of close-out amounts, and they are demanding the same level of sophistication in the Islamic financial risk management products.

MAKING IT HAPPEN

Before structuring or entering into an Islamic financial risk management product, consider the following points.

- What is the commercial objective of the transaction—i.e. what position should the parties be in on a trade date and at the end of the transaction? Does the Islamic structure reflect this?
- Which structure is more suitable considering the costs and the risks involved? This may be determined more by the *shariah* board of the financial institution involved than by commercial preference.
- How should the trade be documented? Who will be carrying out the day-to-day mechanics of the underlying trades, and will they understand the documentation? Conventional financial risk products are often based on ISDA documentation and are carried out by bankers without recourse to lawyers.
- What jurisdiction are you dealing in, and will the documentation be enforceable? What is the situation on insolvency? This will have to be considered when drafting the close-out or unwind mechanics.

MORE INFO

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International Islamic Financial Market: www.iifm.net
International Swaps and Derivatives Association (ISDA): www.isda.org

Islamic Insurance Markets and the Structure of *Takaful* by Suzanne White

EXECUTIVE SUMMARY

- Islamic scholars object to the concept of conventional insurance due to three key elements: *riba* (usury), *gharar* (uncertainty), and *maysir* (gambling).
- Islamic insurance or *takaful* operators have therefore redesigned their management and accounting practices to comply with *shariah* law.
- *Takaful* and conventional or traditional insurance policy wordings both operate in a similar way, with the protection that is provided to the client being exactly the same.
- The differences between Islamic and conventional insurance lie in the ownership and financing of the company, in the management and accounting systems, and in the entities in which the premiums are invested.
- Islamic insurance is a very close concept to that of "mutual insurers" in the West and, in particular, to those we call "ethical" insurers.

INTRODUCTION

Insurance plays a vital role in supporting both national and international economic development and growth. Islamic countries are no exception. The main issue for insurers in the Islamic world is that many Islamic scholars view conventional insurance as prohibited by Islam.

Muslim scholars are not against the concept of risk mitigation, risk sharing, or risk management, including risk financing, *per se*. In fact, they support the compensation of victims of misfortune. However, many scholars consider some aspects of conventional insurance contracts as being prohibited from a *shariah* (Islamic law) point of view. *Shariah* covers all aspects of a Muslim's life, not just worship.

PROHIBITED FACTORS OF INSURANCE

Several *fatawa* (the plural of *fatwa*, meaning an answer to a question related to an issue of *shariah*) have been issued by eminent Muslim scholars on the subject of insurance. The objections tend to relate to the insurance contract itself or to insurance market practice in general.

Objections relating to the insurance contract itself are those of *riba* (usury), *gharar* (uncertainty), and *maysir* (gambling). The other objections relating to market practice are usually concerned with two issues: the first is that insurance companies' investment policies are generally interest-bearing (which is not acceptable in Islam); and the second issue is the fact that life assurance is considered to breach Islamic inheritance rules by distributing the sum assured among beneficiaries. These objections relating to market practice can be easily overcome by the insurer making changes to their company policy, as they do not affect the insurance contract itself.

The objections related to the contract itself, however, require the restructuring of insurance contracts to be in line with *shariah*.

Riba (Usury)

Under a conventional insurance contract, the insured pays the insurance company a premium (either as a lump sum in general insurance or as installments in life insurance), in exchange for financial compensation at the time of a claim, subject to the happening of an insured occurrence or event. Claims are generally larger amounts than the premium paid. Islamic law objects to this payment on the grounds that a small amount of money (premium) is being exchanged for a larger amount of money (claim). Scholars consider this an unjustified increase of money, and therefore *riba*. Islamic insurers therefore have to structure their operations and investments to avoid *riba*.

Gharar (Uncertainty)

Gharar can be defined as uncertainty or ambiguity. Islamic law seeks to avoid ambiguity in contracts in order to prevent disputes and conflict between parties. This is a general Islamic principle that must be applied to all contracts, including insurance.

In the case of conventional insurance, neither the insurer nor the insured knows the outcome of the contract (i.e. whether a loss will occur or not). The insurer is entitled to get the premium in all cases, whereas the insured may not receive a claim because the payment of claims depends

on the probability of loss occurrence (which is a random variable). Other uncertain elements are as to when the claim may be paid and how much the insured may receive.

In life assurance contracts, *gharar* can be seen to exist even in the premium, as the insured party does not know how much he will pay to the insurance company each year, or for how many years. The insured may know the monthly or yearly premium, but he does not know how much he will pay to the insurer before he dies. In general insurance (nonlife insurance), the premium is pre-agreed, but there is *gharar* in the claim amount. Therefore *gharar* exists in all insurance contracts, either in premiums or in claims. In Islamic insurance, scholars agree that engaging in *takaful* transactions, with a donation element as part of their contribution, offsets *gharar*.

Maysir (Gambling)

Some arguments against conventional insurance are based on the grounds that insurance contracts are basically gambling contracts. Islam rejects any contract where financial gain comes from chance or speculation. Insurance, however, needs to comply with the principle of insurable interest. This principle requires a financial and legal relationship between the insured and the subject matter of insurance. The insured is only entitled to get a claim if he proves his insurable interest, and this feature therefore nullifies the notion that insurance is a gamble.

The other difference between gambling and insurance is that the first is a speculative risk (which is uninsurable), while the latter consists of pure risk only (i.e. the insured should not make a gain but should be put back into the same financial position as before the loss occurred).

THE CONCEPT OF ISLAMIC INSURANCE

The first Islamic insurance company was set up in Sudan in 1979. Today there are many Islamic insurance operators in Muslim as well as non-Muslim countries. The main concept of Islamic insurance is that it is an alternative to conventional insurance, with characteristics and features that comply with *shariah* requirements. This is done by eliminating the objections against conventional insurance. "The term *takaful* is an infinitive noun which is derived from the Arabic root verb *kafal'* or *kafala,* meaning to guarantee or bear responsibility for." (Kassar *et al.* 2008, p. 26).

The main features of Islamic insurance are:

- cooperative risk sharing by using charitable donations to eliminate *gharar* and *riba*;
- clear financial segregation between the participant (insured) and the operator (insurance company); and
- *shariah*-compliant underwriting policies and investment strategies.

Cooperative Risk-Sharing

The characteristics of a cooperative include self-responsibility, democracy, equality, equity, solidarity, honesty, openness, social responsibility, and caring for others. While mutuality or cooperative risk-sharing is at the core of Islamic insurance, it cannot alone create an Islamic insurance operation. Islamic insurance is based on more than one contractual relationship: the first relationship is a mutual insurance contract between policyholders (contributors) and each other. This is similar to a pure mutual insurance relationship, taking into consideration the concept of donation *(tabarru)* instead of premiums and an ethical framework of Islamic transactions. The main features behind cooperative insurance are as follows.

- Policyholders pay premiums to a cooperative fund with the intention of it being a donation to those who will suffer losses (*tabarru*).
- Policyholders are entitled to receive any surplus resulting from the operation of the cooperative insurance fund.
- Policyholders are liable to make up for any deficits that result from the operation of the cooperative insurance fund.
- The amount of contribution (premium) differs from one participant to another, based on the degree of risk in general insurances and actuarial principles in life assurance.
- There is no unified system to operate the treatment of surplus and deficit. There is therefore more than one model accepted by *shariah* scholars being used in practice.

Clear Segregation Between Participant and Operator

In conventional insurance, the insurance company is a profit-making organization that aims to maximize profit by accepting the financial burden of others' losses. The insurance company is owned by shareholders who are entitled to receive any profit and are responsible for financing any deficit. Under Islamic insurance, the system is that the insurance company's role is restricted to managing the portfolio and investing the insurance contributions for and on behalf of the participants. The relationship between the participants and the insurance company (as an operator, not as an insurer) is different. There are four different models in operation: the

CASE STUDY

American Insurance Group

The potential for *takaful* business is evidenced by the fact that almost all new insurance license applications in the Middle East region are for *takaful* companies. Even many Western insurers, such as American Insurance Group (AIG), have realized the potential of *takaful* and have set up their own *takaful* operations. AIG Takaful, known as Enaya, which means "care," was established in 2006 in Bahrain with a US$15 million paid-up capital and licensed by the Central Bank of Bahrain. Enaya's plan was to start business in the Gulf region and then expand into the Far East and Europe.

mudarabah model, the *wakalah* model, the hybrid *mudarabah–wakalah* model, and the pure cooperative model (nonprofit). "The overarching goal of Takaful is brotherhood, solidarity, protection and mutual cooperation between members" (Kassar *et al.* 2008, p. 66).

Shariah-Compliant Policies and Strategies

Ethical insurers invest money in a responsible way in industries that are ethically sound and do not harm the environment or people. Islamic insurance is similar, except that the ethical considerations are extended to those which do not contravene the religion of Islam and are monitored by a *shariah* board, which is part of the company structure. In particular, the investment and underwriting policies need to be free of any involvement with the prohibited activities of gambling, alcohol, pork, armaments, tobacco, and interest-bearing activities, loans, and securities.

CONCLUSION

Islamic insurance has grown out of the need of many stakeholders in the Islamic world to have protection for assets and liabilities. This protection was required in a similar fashion to that provided by conventional insurance, which, for a variety of reasons, was often viewed as prohibited in Islam. *Takaful* or Islamic insurers have been structured in such a way that Islamic scholars are satisfied that the main objections to insurance, which are *riba, gharar,* and *maysir*, have been addressed.

MAKING IT HAPPEN

Islamic insurance is the fastest-growing area of insurance throughout the world, including in Western countries. In order to call a company Islamic, there are features that need to be built into the structure:

- cooperative risk-sharing, by using charitable donations to eliminate *gharar* and *riba*;
- clear financial segregation between the participant (insured) and the operator (insurance company);
- *shariah*-compliant underwriting policies and investment strategies.

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Identifying the Main Regulatory Challenges for Islamic Finance by Bilal Rasul

EXECUTIVE SUMMARY

- Harmonization and standardization within the Islamic financial industry, as well as with the conventional banking and finance industry, are the biggest regulatory challenges.
- *Shariah* rulings in *Fiqh* should be harmonized by central Islamic authorities such as the Islamic Fiqh Academy.
- Pursuit is toward uniform regulatory frameworks which restrict *shariah* arbitrage.
- *Shariah* advisers and advisory boards are indispensable in the regulation of Islamic financial institutions, but there is a dearth of expertise and there are not enough advisers to match growing demand.
- *Shariah*-compliant securities are relatively few and not liquid.
- The Islamic Financial Services Board's Ten-Year Master Plan for Islamic financial services is a good starting point to tackle the regulatory challenges.

INTRODUCTION

Globally, Islamic finance has exhibited its potential through the ever-increasing number of Islamic financial institutions (IFIs). Unofficial estimates figure Islamic financial assets of the IFIs at nearly US$1 trillion. The Islamic financial industry is still growing and is finding its niche in many Muslim as well as non-Muslim countries. The growth is swift, but it is accompanied by regulatory issues and challenges that will need to be addressed in order to facilitate and coordinate the innovation and diversity that it brings.

ISLAMIC FINANCE: THE FUNDAMENTAL DIFFERENCE

In order to understand Islamic finance it must be known that the underlying theme of Islamic finance is the *niyah* or "good intention"—the element that drives the Islamic socioeconomic system for ensuring the enhancement of the welfare of society. The *niyah* may represent the Islamic philosophy of conducting life and business, but it is not restricted to Muslims. The tenet pertains to justice and fairness which can be practiced by all, Muslim and non-Muslim alike. The Islamic financial system, therefore, hinges on the *niyah* as an essential ingredient for every contractual transaction that is executed.[1]

For the layman, the fundamental difference between Islamic finance and conventional finance is the feature in the latter to put a cost on money in financial transactions, i.e. interest, or *riba* as it is known in the Islamic financial world. Basically, whatever is borrowed has to be returned, but with an increment.

In Islamic finance one of the questions most often visited is: "Money has time value; how can it not have a cost?" The simplest answer is that in Islamic finance there is no concept of money as a commodity: there is always an underlying contract in the form of a partnership or venture that is entered into between the lender and the borrower, with the profits or losses and the risks all being shared. Therefore, a fixed return *per se* cannot be assured. This perspective of Islamic finance confers a "soul" on business activity. The motives are: the welfare of the people; an egalitarian society; and the opportunity for all to benefit without being exploited. Islamic finance covers the social aspect of being in enterprise. Above all, it is trust-based.

ISSUES

Harmonization and Standardization

The contracts prescribed in Islamic law provide a significant part of the principles and procedures explicitly laid down in the *fiqh* (Islamic jurisprudence) which must be observed for *shariah* compliance. For instance, the Qur'an is replete with passages that denounce *riba* as exploitative and against the norms of fairness. The problem arises where the principles and procedures for specifics are not so easily found and therefore have to be derived from the *fatwa*s, or interpretations of the *shariah* scholars. The *fatwa*s awarded on financial transactions differ amongst scholars and across jurisdictions, which produces the problem of pluralism in *shariah* interpretations.[2] There are mainly five schools of thought in Islamic jurisprudence, for example, *Hanafi, Shafi'i, Hanbali, Maliki,* and

Ibadi, among others. Each school of thought has its own set of *mufti*s (scholars) on Islamic financial issues which, more often than not, creates conflict and ambiguity in decisions on the veracity of a transaction in terms of its compliance with the *shariah*. In this context the Qur'an states: "As for those who divide their religion and break up into sects, thou hast no part in them in the least: their affair is with Allah: He will in the end tell them the truth of all that they did." Qur'an, *sura* 6 (Al-Anaam) *ayat* 159.

and applying the Basel II principles.[3] Effective risk management measures applied to the conventional financial system need to be applied to Islamic finance, but with certain modifications and adaptations. The Islamic financial industry has to be adept with techniques and competitive products to improvise and emulate the conventional banking and finance industry. Only then can IFIs compete with the conventional giants and access the international markets while maintaining their Islamic identity.

CASE STUDY

The Case of *Sukuk*

Sukuk (the plural of *sakk*, meaning Islamic bond) are a case that particularly highlights the divergence in views of Islamic scholars. One of the most popular Islamic financial instruments, the *sukuk* have questions looming over them. The renowned *shariah* scholar Sheikh Muhammad Taqi Usmani believes that the guarantee to pay back the invested capital in *sukuk* undermines the tenets of the *shariah* by compromising on the risk and profit/loss sharing philosophy. Sheikh Usmani contends that the investment must be consequential to the investor where profits and losses both have to be anticipated. The views of Sheikh Usmani are difficult to oppose, but in giving impetus to the Islamic financial industry certain exemptions are in order, for which AAOIFI may well have the solution.[4]

So, the biggest challenge faced by the regulators of Islamic finance is harmonizing and standardizing these interpretations into a consistent and efficient regulatory framework that will ensure unimpeded Islamic financial intermediation among the participants.

The process of harmonization and standardization of transactions across and within borders is undoubtedly a daunting one and has to be comprehensive. In some jurisdictions certain transactions are considered *shariah*-compliant, while in others they may not be accepted as so. It is extremely difficult to adjudge as to which is the closest to *shariah*. Consensus in the *fatwa*s may be overcome by the centralization of the *shariah* rulings in a central Islamic authority such as the Islamic Fiqh Academy of the Organisation of the Islamic Conference, which is recognized by a large majority of scholars. In the event of disagreement the Academy can give its verdict.

The pursuit should be toward uniform regulatory frameworks based on principles and standards designed by universally accepted organizations such as the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). The adoption of the guidelines drafted by these institutions is the panacea for the *shariah* arbitrage that exists otherwise.

Not secondary to this issue is the problem of emulating the conventional financial system

Shariah Expertise

The lack of *shariah* expertise is one of the challenges that face the regulators of the Islamic financial industry. Due to the infancy of the system, very few institutions have produced the desired skill set for the Islamic financial and banking industry. While there are plenty of Islamic jurisprudence experts, there is a dearth of Islamic financial experts with a knowledge of the dynamics of conventional finance and its transformation to an Islamic/*shariah*-compliant system. Due to the regulatory obligation of instating *shariah* supervision, IFIs employ less-experienced *shariah* scholars, as only a limited number of professionals are available and they are usually attached to more than one IFI concurrently.

The transition to Islamic finance is highly technical and complex. A balance has to be maintained in order to provide an adequate return and, at the same time, to remain within the boundaries of the Qur'an and *Sunnah*, which cannot be done without quality *shariah* supervision. In order to achieve this, regulators of the capital and money markets will have to encourage the development of educational institutions that offer programs and syllabi for Islamic financial technical skills. The International Centre for Education in Islamic Finance (INCEIF) in Malaysia is an example that has designed an outstanding course—namely, CIFA (Chartered

Islamic Financial Analyst), which prepares the student for a specialized course in Islamic finance.

Shariah-Compliant Securities

The limited number of *shariah*-compliant securities emanates from the lack of both harmony and Islamic financial prowess, and poses yet another problem in the development of the industry. Due to the paucity of available instruments in the market, investors are constrained to take their funds elsewhere. The limited choices also affect the liquidity of the securities as there is a limited market for them. The buying and selling of such securities is not as lively as in the conventional securities market, possibly due to their non-speculative nature. Nevertheless, investors are eager to place their funds in *shariah*-compliant securities, even for a comparatively lower return, provided that a reasonable degree of assurance can be given with regard to their nearness to *shariah*. The market for *shariah*-compliant securities, in terms of buyers and sellers, quite certainly exists, but it awaits the introduction and innovation of new Islamic instruments. Much of the apprehension that exists in the market with regard to *shariah*-compliant securities, or Islamic banking and finance for that matter, is owed to the slow pace of development of products and awareness-creating endeavors. In this context, the Liquidity Management Centre and the International Islamic Financial Market have a huge mandate and are vigorously involved in bridging the gaps in terms of investment of surplus funds of IFIs and creating Islamic financial markets.

"The combination of services offered by operating IFI and the prevailing practices compound the difficulties of designing a regulatory framework to govern them."[5]

CONCLUSION

A purely Islamic financial system would be ideal: one in which the *niyah* and trust are predominant so that a self-perpetuating regulatory system prevails. There would be minimal regulatory interference—only for transparency and disclosure. In such a system, issues of compliance diminish directly with the prevalence of a coherent and trustful financial environment in which profits and risks are authentically disclosed and equitably distributed.

While a conventional financial system cannot evolve into an Islamic one overnight, praiseworthy efforts are being made in terms of bringing the diverging interpretations to a common platform and attempting to accord them congruence. In this context, the contributions of AAOIFI and the IFSB, as conduits for bringing solutions to the problems of standardization and harmonization, and as cornerstones of change and adaptation, must not be undermined in any way. The IFSB's Ten-Year Master Plan for Islamic Financial Services is an excellent precursor to the type of regulatory environment that should prevail in jurisdictions offering Islamic finance.

MAKING IT HAPPEN

The solution to the harmonization problem is to design regulatory frameworks that are standard. Thus, all criteria relating to the formation of Islamic financial institutions, the induction of *shariah* experts, the risk management measures, and the various codes should conform to a standard document, such as an enabling Islamic financial services law, which prescribes common Islamic financial accounting standards, corporate governance practices, and prudential regulations for risk management for the industry, and which interfaces with the IFSB's Ten-Year Master Plan for Islamic Financial Services.

To bolster the Islamic securities market, companies listed on the stock exchanges (financial or manufacturing) should be encouraged to pursue *shariah* compliance. To achieve these objectives the role of the regulator(s) is emphasized.

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1 Mirakhor (1989).

2 Venardos (2006).

3 Basel Committee on Banking Supervision (BCBS). "Consultative document: Overview of the new Basel Capital Accord." Bank for International Settlements, April (2003). Online at: www.bis.org/bcbs/bcbscp3.htm

4 Thomas and Becic (2008).

5 El-Hawary *et al.* (2004), p. 36.

Islamic Microfinance: Fulfilling Social and Developmental Expectations by Mehmet Asutay

EXECUTIVE SUMMARY

- Islamic banking and finance (IBF) is a value-oriented ethical proposition; the principles of IBF can be located in the principles and norms of Islamic moral economy (IME), which aims at human-centered economic development as opposed to the financialization of the economy.
- Social responsibility is an essential part of IBF; however, IBF institutions have been criticized for their social failure.
- Microfinance is a novel method for human-oriented economic development and a capacity-building tool, which easily fits into the IBF paradigm through social responsibility.
- The financial instruments of IBF and IME institutions can provide an important base for the development and progress of Islamic microfinance (IMF), which fulfills the aspirations of developing communities in an Islamic way.
- A number of IBF institutions have demonstrated success in IMF, particularly by overcoming the burden of interest on the poor and expanding the asset base.

RATIONALIZING ISLAMIC MICROFINANCE THROUGH ESSENTIALIZING THE ISLAMIC MORAL ECONOMY

Islamic banking and finance (IBF) has become a mainstream financing method utilized by Islamic, as well as conventional, banking and financial institutions all over the world. Recently, however, IBF has been criticized for its social failure, in the sense that its operations are not different from the existing conventional tools minus the interest. An essential nature of this criticism is related to the foundational axioms and principles of IME which, as a worldview, is based on the authentic principles of Islam. Thus, IME is an authentic response to the failure of economic developmentalism in the Muslim world in constructing a human-centered development. In this attempt, IBF was considered as the financing and operational tool of the new paradigm, and consequently it is expected to fulfill the expectations and aspirational paradigm of IME.

The foundational principles and axioms of IME aimed at revealing the principles behind IBF through an ethical worldview are:

- vertical ethicality in terms of individuals as the creature of God being equal (*tawhid*);
- social justice and beneficence (*adalah* and *ihsan*) in terms of horizontal ethicality;
- growth in harmony (*tazkiyah*);
- allowing the social (individual and society) and natural environment to reach to and sustain its perfection (*rububiyah*);
- voluntary action but also compulsory action (*fard*) in serving the social interest;
- individuals, being the vicegerent of God on Earth (*khalifah*), are expected to fulfill and act according to these principles in their economic and financial behavior.

These foundational principles are justified by a particular methodological understanding; the *maqasid al-Shari'ah* (objectives of *shariah*) are interpreted as human well-being, which, in this context, is achieved through a socially operating moral economy in an Islamic framework that is expected to produce a socially and economic-financially optimum solution in overcoming the socioeconomic problems of a society.

ETHICAL OBJECTIVE FUNCTIONS OF ISLAMIC FINANCE

As part of this ethical economic paradigm, IBF is expected to operate within such an objective function and framework to establish the optimality between financial operations and social objectives (as a morally identified objective function). To operationalize the ethical objective in IBF, further principles are developed through the ontological sources of Islam. These principles, which aim to promote an ethical and socially oriented way of "doing finance," are as follows.

- Prohibition of interest (or *riba*) with the objective of providing a stable and socially efficient economic environment.
- Prohibition of fixed return on nominal transactions, with the objective of creating productive economic activity or asset-based financing over the debt-based system.
- In this moral economy, money does not have any inherent value in itself and therefore it cannot be created through the credit system.

- The principle of profit and loss sharing, and hence risk sharing, is the essential axis around which economic and business activity takes place. This prevents the capital owner from shifting the entire risk on to the borrower, and hence it aims to establish a just balance between effort and return, and between effort and capital. This axiom identifies the essential nature of Islamic microfinance.
- An important consequence of the profit/loss sharing principle is the participatory nature of economic and business activity, as IBF instruments, capital, and labor merge to establish partnerships through their individual contributions which, as a principle, constitutes the fundamental nature of microfinance.
- By essentializing productive economic and business activity, uncertainty, speculation, and gambling are also prohibited, with the same rationale of emphasizing asset-based productive economic activity.

As can be seen, each of these principles, together with the above-mentioned axioms, provide rationale as to why microfinancing is an essential part of IME and, hence, IBF. The following description of IBF in terms of institutional and operational features provides further rationale as to why microfinance is inherently Islamic in its nature (Khan, 2007).

- It is a form of community banking aiming at serving communities, not markets;
- It offers responsible finance, as it runs systematic checks on finance providers and restrains consumer indebtedness; it also offers ethical investments and corporate social responsibility (CSR) initiatives;
- It represents an alternative paradigm in terms of stability by linking financial services to the productive, real economy; it provides a moral compass for capitalism;
- It fulfills aspirations in the sense that it widens the ownership base of society and offers success with authenticity.

As these principles indicate, IBF should serve social interests (for example, through microfinance) in establishing its financial optimality such that it offers ethical and social solutions to development in Muslim and developing countries.

While IBF has been criticized for not fulfilling these principles in its current practice due to its adoption of a commercial banking structure, it can be seen that it has the potential to respond to the social objective, which is an inherent function of Islamic finance.

In helping IBF to demonstrate its original ethical and social nature, new methods of financing can be developed to appeal to their commercial nature as well. Since, by definition, IBF institutions are nevertheless expected to contribute to social development, they have to move to the third institutionalization stage (the first stage was social banking in the 1960s, followed by commercial banking as the second institutional phase from the mid-1970s until now), in which society and capacity building-oriented institutions, such as microfinancing and social banking, should run alongside the commercial banks. This fulfills the social and ethical expectations as identified by IME, but also responds to the development needs of the societies in which they are operating.

ISLAMIC MICROFINANCE

Microfinance has become a critical tool in tackling poverty and aiding development through building the capacity for the poor to enjoy greater self-sufficiency and sustainability, granting them access to financial services and conceptualizing the poor individual as someone with innate entrepreneurial abilities who can generate jobs, income, and wealth if given access to credit. Through microfinance, the poor are given the opportunity to become stakeholders in the economy; therefore, enabled and functioning individuals will be the outcome. Due to this objective function of microfinance, as a development tool it has enjoyed some success. Consequently, a number of conventional financial institutions and banks now offer microfinance in supporting business ideas from small projects to housing projects.

Despite its success, microfinance has been criticized from an Islamic perspective for getting people into debt due to its fixed interest charges. If a project does not yield the expected returns in conventional financing, difficulties can ensue for the borrower. IBF, thus, offers a more viable solution as a value-oriented financial proposition as part of the IME. Thus, typical IBF instruments, such as *musharakah* and *mudarabah* (based on profit/loss sharing), or institutions such as IBF, but also *waqf*s (pious foundations), are rather appropriate as providers of microfinance. IMF fits into the asset-based economic paradigm and equity objective of IME as well as fulfilling all other expectations. Thus, there is compatibility and complementarity between the objectives and operational mechanism of microfinance and of IBF.

Despite having similar objectives, IBFs have not fully appreciated microfinance, which is also

a commercially viable undertaking. However, in recent years there has been movement in this direction, as the successful implementation of IMF has shown in countries such as Bangladesh, Indonesia, Yemen, and Syria. In Bangladesh, however, the direct involvement and success of the Bangladeshi Islamic Bank as a banking institution is an important experiment.

IBF instruments can provide an additional opportunity for microfinance to flourish by giving the entrepreneurial poor access to finance in an alternative and dynamic manner. The contractual nature of such products is consistent with the financing nature of microfinance. Table 1 provides further details of IBF instruments and their degree of compatibility with microfinancing.

Table 1. Instruments of financing in Islamic microfinance. (*Source*: Obaidullah and Khan, 2008: 21)

Instrument	*Suitable for*	*Cost of capital*	*Risk to borrower*	*Risk to institution*	*Remarks*
Mudarabah/ Musharakah	Fixed assets, working capital (declining form suitable for housing and equipment finance)	Very high	Low	Very high	Costs of loan administration and monitoring are high, given the complexity of the repayment schedule and lack of proper accounting. Perceived to be ideal, but not popular in practice.
Ijarah	Fixed assets	Moderate	High	Moderate	Costs of loan administration and monitoring are low, given the simple repayment schedule that allows flexibility and customization based on client preferences. Popular among IMFs and has potential for easy adaptation in conventional microfinance.
Murabahah	Fixed assets, working capital	Moderate	High	Moderate	Costs of loan administration and monitoring are low, given the simple repayment schedule; the multiplicity of transactions in working capital financing can push up costs. Highly popular in practice, notwithstanding popular perception of it being a close substitute of *riba*-based lending.
Qard	All purposes	Very low	Very low	Moderate	Charity-based, usually combined with voluntarism. Low overheads. Popular because it is perceived to be the purest form of financing.
Salam	Working capital	High	High	High	Back-to-back nature creates risk of lack of double coincidence. Untried.
Istisna'a	Fixed assets	High	High	High	Back-to-back nature creates risk of lack of double coincidence. Untried.
Istijrar	Working capital	Moderate	Moderate	Moderate	Ideal for micro-repetitive transactions. Its complexity is not easily understood by parties, hence it is not a popular mechanism.

Other financing methods have also been proposed, such as the *wakalah* model and special purpose vehicle (SPV). It is suggested that SPV can be used by banks for the financing of microfinance projects, which can be a subsidiary of the sponsoring firm or may be an independent SPV. Dusuki (2008: 61) highlights the features and the procedures of using SPV for Islamic microfinance as follows: "(i) the Islamic bank mobilizes various sources of funds with specific microfinance objectives; (ii) the Islamic bank creates a bankruptcy-remote SPV; (iii) the bank allocates a certain amount of funds and passes it to the SPV; (iv) the funds are then channeled to various clients depending on needs and demand. For example, *zakah* funds may only be allocated to poor clients for consumption purposes and capacity-building initiatives, while other types of funds can be used to finance their productive economic activities." The selective nature of expenditures and investments, for instance from *zakah* funds, under such an arrangement, can overcome the fundamental problems of microfinance, as this would render financial accessibility for the poor for their consumption but also help them to engage in capacity-building projects with the objective of productive economic activity and job creation.

In addition to mainly commercial microfinance instruments, Wilson (2007) proposes that nonbanking institutions conduct microfinancing by using the *wakalah* model through the collection of *zakah* (compulsory alms-giving for those whose wealth is beyond the established threshold) and *waqf* (religious charitable foundation) funds. The *wakalah* agency model combines certain features of a credit union through financial management with the capital provided by a donor agency; in this case it can be a *zakah* fund or a *waqf*. The use of a *zakah* fund or *waqf* under such an arrangement would work in the same manner as described above.

It should be noted that *waqf*, as private nonbanking institutions, were used extensively throughout Muslim history to provide welfare services to the poor. Therefore, there is clear justification for their revitalization in modern times to fund microfinance projects aimed at self-sufficiency and a sustainable economic life for the poor. Furthermore, *zakah* have great potential in creating funds for development purposes. However, due to the absence of clear and transparent management structures in most Muslim societies, *zakah* funds are disbursed to individual causes with no questioning of their wider sustainability and social objectives. Thus, IMF can be an excellent solution for the collection and management of *zakah* funds for the alleviation of poverty. Other forms of private charitable giving such as *sadaqah* (voluntary alms), *hiba* (donations), and *tabarru* (financial contributions), can form additional funding opportunities for IMF through nonbanking microfinance institutions.

In addition to these instruments for raising funds for IMF, deposit-type banking instruments such as *wadiah*, *qard al-hasan,* and *mudarabah*, in the form of savings, current, and time deposits, respectively, can be used to raise funds for Islamic microfinance institutions. In deciding on the appropriate instrument to deploy, IMF programs have to consider the relevant costs, benefits, trade-offs, and nature of the instruments, as set out in Table 1.

In addition to the implicit administration costs of IMF projects, potential risk areas have to be taken into account by both the program and the borrower(s). The instrument selection process is dependent on the nature of the client and the project proposed. For instance, if the client is already in business and has a progressive attitude and good business record, then the *musharakah*, *mudarabah*, and *murabahah* models of financial instruments, which involve various degrees of profit/loss sharing, would be appropriate. In addition, new clients who do not have any credit or track record could be financed by the *qard al-hasan* type of soft loans, which do not have any financing or risk implications.

In the banking-oriented IMF, management of risk by the institution also becomes an important aspect of the process—based on the guarantee (or *kafalah*) and collateral (*daman*). The former is used as an alternative risk management tool for default and delinquency in the case of financing individual microfinance arrangements, while mutual *kafalah* is commonly used by IMF institutions in the case of group financing. It should be noted that *daman* in terms of physical assets as collateral is not extensively used in managing risk by IMF institutions.

Another aspect of risk management is the protection of borrowers against potential risks, for which micro-*takaful* (in the form of mutual guarantee) is proposed as a solution, though this has yet to be developed as a fully fledged instrument. In reality, however, largely informal methods are used for the protection of borrowers or members. These often take the form of short-term emergency funds in the case of hardship and difficulties. In some cases IMF institutions have managed to raise insurance funds from contributions to cover clients against any form of adversity they may face.

As regards Islamic microfinance providers, in addition to formal IMF institutions large numbers of informal microfinance institutions, member-based organizations, and nongovernmental organizations are active in delivering IMF-related services in different parts of the developing world.

CONCLUSION

A financial system should be able to provide financing to different segments of a given society such that, in addition to financial and economic objectives, social objectives may be served. Since social objectives are an essential part of the IME, it is imperative for IBF to fulfill such objectives alongside their business interests. As a social and moral method of financing, IBF, therefore, should contribute directly to economic and social development. This can become possible through social banking and microfinance, though it should be recalled that the initial experience of IBF in the early 1960s in Egypt was a social bank that was microfinancing-oriented.

Due to the complementarity between IBF and microfinance, there is a need to see further and proactive involvement of IBF and nonbanking Islamic institutions to provide IMF.

By using the essential methods and instruments outlined here, authentic models of IMF can be developed that will ensure the proactive development and efficient running of microfinancing, so that self-sustaining and human-centered development, aimed at helping poor individuals and entrepreneurs who are excluded from economic and financial life, can be achieved as expected by IME by also creating social capital.

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Risk Management of Islamic Finance Instruments by Andreas Jobst

EXECUTIVE SUMMARY

- Derivatives are few and far between in Islamic countries. This is due to the fact that the compatibility of capital market transactions with Islamic law requires the development of *shariah*-compliant structures that guarantee certainty of payment obligations from contingent claims on assets with immutable object characteristics. Notwithstanding these religious constraints, Islamic finance can synthesize close equivalents to conventional derivatives.
- Based on the current use of accepted risk transfer mechanisms, this article explores the validity of risk management in accordance with fundamental legal principles of *shariah*, and summarizes the key objections of *shariah* scholars that challenge the permissibility of derivatives under Islamic law.
- In conclusion, the article offers suggestions for the *shariah* compliance of derivatives.

TYPES OF ISLAMIC FINANCE

Since only interest-free forms of finance are considered permissible in Islamic finance, financial relationships between financiers and borrowers are not governed by capital-based investment gains but by shared business risk (and returns) in lawful activities (*halal*). Any financial transaction under Islamic law implies *direct participation in performance of the asset*, which constitutes entrepreneurial investment that conveys clearly identifiable rights and obligations for which investors are entitled to receive a commensurate return in the form of state-contingent payments relative to asset performance. *Shariah* does not object to payment for the use of an asset as long as both lender and borrower share the investment risk, and provided that profits are not guaranteed *ex ante* but accrue only if the investment itself yields income—subject to the intent to create an equitable system of distributive justice and promote permitted activities in the public interest (*maslahah*).

The permissibility of risky capital investment without explicit earning of interest has spawned three basic forms of Islamic financing for both investment and trade: (1) synthetic loans (*debt-based*) through a sale–repurchase agreement or back-to-back sale of borrower- or third-party-held assets; (2) lease contracts (*asset-based*) through a sale–leaseback agreement (operating lease) or the lease of third-party-acquired assets with purchase obligation components (financing lease); and (3) profit-sharing contracts (*equity-based*) of future assets. As opposed to equity-based contracts, both debt- and asset-based contracts are initiated by a temporary (permanent) transfer of existing (future) assets from the borrower to the lender or the acquisition of third-party assets by the lender on behalf of the borrower.

"IMPLICIT DERIVATIVES" IN ISLAMIC FINANCE

From an economic point of view, the "creditor-in-possession"-based lending arrangements of Islamic finance replicate the interest income of conventional lending transactions in a religiously acceptable manner. The concept of *put–call parity*[1] illustrates that the three main types of Islamic finance outlined above represent different ways of recharacterizing conventional interest through the attribution of economic benefits from the ownership of an existing or future (contractible) asset by means of an "implicit derivatives" arrangement.

In *asset-based* Islamic finance, the borrower leases from the lender one or more assets, A, valued at S, which have previously been acquired from either the borrower or a third party. The lender allows the borrower to (re-)gain ownership of A at time T by writing a call option $-C(E)$ with time-invariant strike price E subject to the promise of full repayment of E (via a put option $+P(E)$), plus an agreed premium in the form of rental payments over the investment period. This arrangement amounts to a *secured* loan with *fully collateralized* principal (i.e. full recourse). The present value of the lender's *ex ante* position at maturity is $L = S - C(E) + P(E) = PV(E)$,[2] which equals the present value of the principal amount and interest of a conventional loan. In a more realistic depiction, this put–call combination represents a series of cash-neutral, maturity-matched, risk-free (and periodically

extendible), *synthetic* forward contracts

$$\sum_{t=1}^{T} [P_t(E) - C_t(E)]$$

over a sequence of rental payment dates t. By holding equal and opposite option positions on the same strike price at inception, there are no objectionable zero-sum gains or uncertainty of object characteristics and/or delivery results.

Overall, the put–call arrangement of *asset-based Islamic lending implies a sequence of cash-neutral, risk-free (forward) hedges of credit exposure*. Since poor transparency of S in long-dated contracts could make the time value of $+P(E)$ appear greater than its intrinsic value, long-term Islamic lending with limited information disclosure would require a high repayment frequency to ensure efficient investor recourse. In *debt-based* Islamic finance, borrower indebtedness from a sale–repurchase agreement ("cost-plus sale") of an asset with current value $PV(E)$ implies a premium payment to the lender for the use of funds over the investment period T and the same investor payoff L.[3] In Islamic profit-sharing (*equity-based*) agreements, the lender receives a payout in accordance with a pre-agreed disbursement ratio only if the investment project generates enough profits to repay the initial investment amount and the premium payment at maturity T. Since the lender bears all losses, this equity-based arrangement precludes any recourse in the amount $+P(E)$ in the absence of enforceable collateral.

"EXPLICIT DERIVATIVES" AND *SHARIAH*-COMPLIANT RISK MANAGEMENT

Amid weak reliance on capital market financing in many Islamic countries, risk transfer mechanisms are subject to several critical legal hindrances that impact on the way derivatives redress perceived market imperfections and financing constraints. Although "implicit derivatives" in the form of synthetic forward contracts (see above) are essential to profit generation from temporary asset transfer or profit-sharing in Islamic finance without creating the potential of unilateral gains, and thus are not deemed objectionable on religious grounds, the *explicit* use of derivatives remains highly controversial (Jobst, 2008b).

While "explicit derivatives" remain few and far between in Islamic finance, the implicit forward element of Islamic lending contracts, like forwards in conventional finance, involves problems of double coincidence and counterparty risk due to privately negotiated customization. Parties to forward agreements need to have exactly opposite hedging interests, which *inter alia* coincide in the timing of protection sought against adverse price movements and the quantity of asset delivery. Moreover, forward contracts elevate the risk of one counterparty defaulting when the spot price of the underlying asset falls below the forward price prior to maturity, rendering the contract "out-of-the-money" and making deliberate default more attractive.

Although the premise of eliminating these risks is desirable *per se* under Islamic law, the assurance of definite performance through either cash settlement (in futures) or mutual deferment (in options)—as in conventional derivatives contracts—is clearly not, as it supplants the concept of direct asset recourse and implies a zero-sum proposition (Usmani, 1999). Instead, in Islamic finance, the bilateral nature and asset-backing *ensure definite performance* on the delivery of the underlying asset (unlike a conventional forward contract). By virtue of holding equal and opposite option positions on the same strike price, both creditor and debtor are obliged to honor the terms of the contract irrespective of changes in asset value. Unlike in conventional options, there are no unilateral gains from favorable price movements (for example, "in-the-money" appreciation of option premia) in the range between the current and the contractually agreed repayment amount. Any deviation of the underlying asset value from the final repayment amount constitutes shared business risk (in an existing or future asset).

Shariah scholars take issue with the fact that futures and options are valued mostly by reference to the sale of a nonexistent asset or an asset not in the possession (*qabd*) of the seller, which negates the *hadith* "sell not what is not with you." *Shariah* principles, however, require creditors (or protection sellers) to actually own the reference asset at the inception of a transaction. Futures and options also continue to be rejected by a majority of Islamic scholars on the grounds that "...in most futures transactions, delivery of the commodities or their possession is not intended" (Usmani, 1996). Derivatives almost never involve delivery by *both* parties to the contract. Often parties reverse the transaction and cash-settle the price difference only, which transforms a derivative contract into a paper transaction without the element of a genuine sale. Given the Islamic principle of permissibility (*ibahah*), which renders all commercial transactions *shariah*-compliant in the absence of a clear and specific prohibition, current objections to futures and options constitute the

most discouraging form of religious censure (*taqlid*).

Besides the lack of asset ownership at the time of sale, other areas of concern shared by Islamic scholars about *shariah* compliance of derivatives have centered on: the selection of reference assets that are nonexistent at the time of contract; the requirement of *qabd* (i.e. taking possession of the item prior to resale); mutual deferment of both sides of the bargain, which reduces contingency risk but turns a derivative contract into a profitable sale of debt; and excessive uncertainty or speculation that verges on gambling, resulting in zero-sum payoffs of both sides of the bargain (Mohamad and Tabatabaei, 2008; Kamali, 2007; Khan, 1991).

Although Khan (1995) concedes that "some of the underlying basic concepts as well as some of the conditions for [contemporary futures] trading are exactly the same as [those] laid down by the Prophet for forward trading," he also acknowledges the risk of exploitation and speculation, which belie fundamental precepts of *shariah*. For the same reasons, several scholars also consider options in violation of Islamic law. Nonetheless, Kamali (2001) finds that "there is nothing inherently objectionable in granting an option, exercising it over a period of time or charging a fee for it, and that options trading like other varieties of trade is permissible *mubah*, and as such, it is simply an extension of the basic liberty that the Qur'an has granted."

However, so far only a few explicit derivative products have been developed by various banks for managing currency and interest rate risk. While recent innovation in this area has focused mostly on highly customized option contracts as well as commodity hedges, cross-currency swaps and so-called "profit-rate swaps" constitute the most widely accepted forms of newly established *shariah*-compliant derivatives (see next section). Given the prohibition of interest income and the exchange of the same assets for profit (which includes the cost-plus sale of debt), for Islamic investors to execute a swap both parties instead agree to sell assets, usually commodities, to each other for deferred payment. In the case of cross-currency swaps, the contractual parties exchange commodities in the form of a cost-plus sale and settle their mutual payment obligations in different currencies according to a predefined installment schedule.

Nonetheless, governance issues—especially *shariah*-compliance of products and activities—constitute a major challenge for the Islamic finance industry in general and risk management in particular. Although *shariah* rulings (*fatwa*s) and their underlying reasoning are disclosed, there are currently no unified principles (and no precedents) on the basis of which *shariah* scholars decide on the religious compliance of new products. *Fatwa*s are not consolidated, which inhibits the dissemination, adoption, and cross-fertilization of jurisprudence across different countries and schools of thought. Therefore, the fragmented opinions of *shariah* boards, which act as quasi-regulatory bodies, remain a source of continued divergence of legal opinion. In particular, there is considerable heterogeneity of scholastic opinion about the *shariah*-compliance of derivatives, which testifies to the general controversy about risk management in Islamic finance. In particular, it underscores the difficulties of reconciling financial innovation and greater flexibility in the principled interpretation of different modes of secondary sources supporting religious doctrine—i.e. analogous deduction (*qiyas*), independent analytical reasoning (*ijtihad*), and scholarly consensus (*ijma*).

Recent efforts of regulatory consolidation and standard-setting have addressed the economic constraints and legal uncertainty imposed by both Islamic jurisprudence and the poorly developed uniformity of market practices. Private sector initiatives, such as an Islamic primary market project led by the Bahrain-based International Islamic Financial Market (IIFM) in cooperation with the International Capital Markets Association (ICMA), have resulted in the adoption of a memorandum of understanding on documentation standards and master agreement protocols for Islamic derivatives. Also, national solutions are gaining traction. In November 2006, Malaysia's only fully fledged Islamic banks, Bank Islam Berhad and Bank Muamalat Malaysia Berhad, agreed to execute a master agreement for the documentation of Islamic derivative transactions (Jobst, 2007, 2008a). Therefore, market inefficiencies and concerns about contract enforceability caused by heterogeneous prudential norms and diverse interpretations of *shariah*-compliance are expected to dissipate in the near future.

ISLAMIC SWAP TRANSACTIONS: CROSS-CURRENCY AND PROFIT-RATE SWAPS

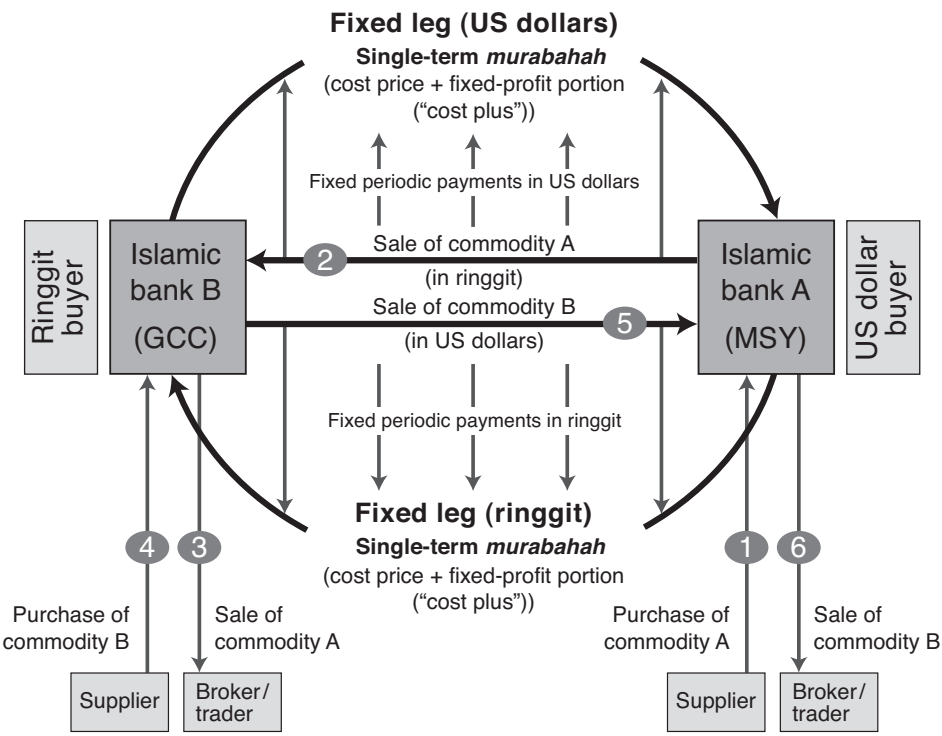
Shariah-compliant swap transactions are traded bilaterally and combine opposite, maturity-matched *murabahah* contracts with instantaneous (or periodic) transfer of similar assets and delayed payment of the sales price (inclusive of a premium payment for the use of the asset until the maturity date).[4]

Islamic Cross-Currency Swap

Islamic cross-currency swaps (CCS) debuted only recently when Standard Chartered executed the first ever swap transaction of this kind for Bank Muamalat Malaysia in July 2006. The basic structure of a CCS matches two commodity *murabahah* sale contracts that generate offsetting cash flows in opposite currencies with maturities desired by the contracting parties.

The following example illustrates the functioning of a CCS (see Figure 1). Consider the case of a Malaysia-based Islamic bank that raises revenue in Malaysian ringgit but faces payments in US dollars over a certain period of time. To eliminate this forseeable currency mismatch, the bank could substitute its future outflows in US dollars for outflows in Malaysian ringgit by entering into a CCS with a US dollar-paying counterparty. Under this contract, the Malaysia-based Islamic bank purchases an amount of commodity A on a *murabahah* basis (i.e. against future installments) denominated in Malaysian ringgit. Simultaneously, an Islamic bank based in a Gulf Cooperation Council (GCC) country buys an amount of commodity B, also under a *murabahah* agreement but denominated in US dollars. By combining the two *murabahah* contracts, each denominated in a different currency, each party will be able to receive cash flows in the desired currency. Finally, both banks sell their respective commodities in order to recoup their initial expense, where the fair value of each commodity (A and B) should wash out at the prevailing exchange rate.

Figure 1. *Murabahah*-based cross-currency swap. (Numbers indicate sequence in which transactions are executed. GCC indicates country in Gulf Cooperation Council)



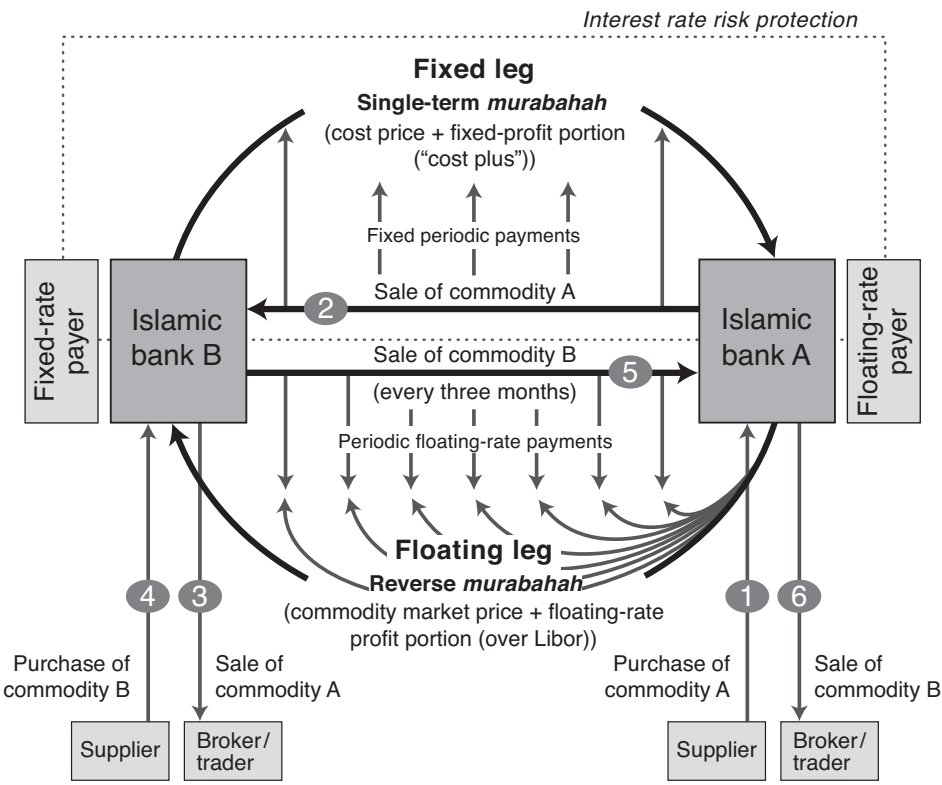
If the parties wanted to hedge term risk (i.e. the risk of the fair market values of the exchanged assets diverging over the life of the transaction), either in addition to the cross-currency swap or as a separate transaction, they would enter into a profit-rate swap. In this Islamic version of an interest-rate swap, the two sides exchange periodic fixed-rate for floating-rate payments. After selling a designated commodity to the protection seller, the protection buyer receives periodic fixed-rate payments in return for floating-rate installments.

Islamic Profit-Rate Swap

This instrument, pioneered by Commerce International Merchant Bank of Malaysia in 2005, allows financial institutions to manage their exposures to fixed and floating rates of return. That is, through the profit-rate swap (PRS) institutions can restructure the nature (fixed vs floating) of their existing rates of return. As in the CCS, profit-rate swaps are based on the combination of two commodity *murabahah* contracts (see Figure 2). The floating-rate leg involves the periodic *murabahah* sale of a commodity by the protection seller in exchange for future installments at the fair value (market) price plus a *floating-rate profit portion* ("cost-plus") that varies according to changes in some pre-agreed benchmark (for example, some interbank funding rate such as the London or Kuala Lumpur Interbank Offered Rate). The fixed-rate leg stipulates the one-off sale of a commodity by the protection buyer in exchange for a stream of future predetermined payments. As in the cross-currency swap, both parties may sell their commodities in order to recoup their initial disbursement. Note that the floating-rate payer (or interest rate protection buyer) purchases commodity B in periodic increments—unlike the fixed-rate payer (or interest rate protection seller), who receives commodity A in full at inception.

Attempts to design other *shariah*-compliant derivatives, such as total return swaps, have been mired in controversy. One particularly contested structure is based on a dual *wa'ad* (or promise) contract, which swaps the returns of a *shariah*-compliant asset portfolio with those of a designated index or reference investment portfolio, which can contain conventional assets. This Islamic total return swap would allow investors to access returns from assets that are prohibited under *shariah* principles. DeLorenzo (2007) has argued that, in practice, this swap structure does not conform to *shariah* norms, because the returns from the alternative portfolio are not derived from religiously acceptable activities.

Figure 2. *Murabahah*-based profit-rate swap[5]



MAKING IT HAPPEN

Possibilities for Establishing *Shariah*-Compliance of Derivatives and Risk Management

The heterogeneity of scholastic opinion about the *shariah*-compliance of derivatives is largely a reflection of individual interpretations of *shariah* and different knowledge of the mechanics of derivative structures and risk management strategies. Many policymakers, market participants, and regulators are unfamiliar with the intricate mechanics and highly technical language of many derivative transactions, which hinder a more comprehensive understanding and objective appreciation of the role of derivatives in the financial system and their prevalence in a great variety of business and financial transactions. Risk diversification through derivatives contributes to the continuous discovery of the fair market price of risk, improves stability at all levels of the financial system, and enhances general welfare.

In principle, futures and options may be compatible with Islamic law if they: (1) are employed to address a genuine hedging demand on asset performance associated with a direct ownership interest; (2) disavow mutual deferment without actual asset transfer; and (3) eschew avertable uncertainty (*gharar*) as prohibited sinful activity (*haram*) in a bid to create an equitable system of distributive justice in consideration of the public interest (*maslahah*). *Shariah*-compliant derivatives would also maintain risk sharing that favors win–win situations from changes in asset value. For instance, the issuance of stock options to employees would be an ideal candidate for a *shariah*-compliant derivative. By setting incentives for higher productivity, firm owners reap larger corporate profits that offset the marginal cost of greater employee participation in stock price performance. However, the *de facto* application of many derivative contracts is still objectionable due to the potential for speculation (or deficient hedging need) to violate the tenets of distributive justice and equal risk sharing subject to religious restrictions on lending and profit-taking without real economic activity and asset transfer.

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NOTES

1 The relation between the put and call values of a European option on a nondividend-paying stock of a traded firm can be expressed as $PV(E) + C = S + P$. $PV(E)$ denotes the present value of a risky debt with a face value equal to exercise price E, which is continuously discounted by $\exp(-rT)$ at a risk-free interest rate r over T years. In our case of a lending transaction, the share price S represents the asset value of the funded investment available for the repayment of terminal value E.

2 The lease payments received from the borrower wash out in this representation.

3 However, some debt-based financing with deferred payment of future claims on existing assets (*salam*), predelivery finance for future assets (*istisna'a*), or the deferred cost-plus sale of a third party-held asset imply counterparty and market risks from lost recovery value, which could translate to a lower strike price F on the call or put option respectively.

4 The degree of collateralization of each leg of the swap depends on the original ownership of the transferred asset (or, in this case, the exchanged commodities), defining the level of creditor indebtedness. In the standard *murabahah* sales contract, the creditor has either full recourse to the underlying asset and periodic payments (in a sale–repurchase agreement at an initially discounted sales price (cost-plus sale)), or limited recourse to periodic payments only (in a back-to-back cost-plus sale of an asset which the seller acquired previously from a third party). In a *murabahah*-based swap transaction the restrictions on recourse apply, even though both contract parties hold mutually offsetting payment obligations against each other, preventing speculative interest and mitigating the contingency risk of periodic payments.

5 This includes full payment and physical settlement in each period. This structure was pioneered by the Commerce International Merchant Bank of Malaysia in 2005.

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Sukuk Issuance and Issues in Purchase Undertakings by Barry Cosgrave

EXECUTIVE SUMMARY

- *Sukuk* issuance utilizes a number of different *shariah* structures, but all make use of the purchase undertaking.
- The purchase undertaking is the key credit document in *sukuk* issuance. It provides for the return on an investment at maturity and under any early redemption right, whether arising as the result of a default event or otherwise.
- Purchase undertakings have come under great scrutiny from *shariah* scholars, who feel that they have been developing into an instrument guaranteeing a return on certain types of *sukuk* that should be subject to the investment risk associated with an equity investment.
- AAOIFI has sought to move sukuk away from classification as a pure debt instrument toward reclassification as an equity instrument, in order to better reflect the position of *sukuk* in the Islamic finance sphere.
- An evolution in market perception will need to occur to move transaction risk disclosure, and therefore investor focus, away from focusing solely on the obligor under the purchase undertaking toward greater focus on the creditworthiness of the *sukuk* assets as well.

INTRODUCTION

As is the case with most Islamic finance instruments, the typical approach to *sukuk* is to take the equivalent instrument in conventional finance and to attempt to replicate it in a way that is *shariah*-compliant. In the case of *sukuk*, consideration is given to the important commercial features (such as rate of periodic return, return at maturity, and financial covenants), together with key legal considerations (such as transaction risk disclosure, events of default, and representations and warranties). The market has tended to place *sukuk* in the same asset class as a conventional bond and has thus identified *sukuk* as debt capital market instruments.

However, this view is at odds with Islamic jurisprudence, which, though differing on certain issues of interpretation in relation to detail, has almost universally agreed that *sukuk* should be viewed as equity investments, thereby exposing the investor to ownership risk in relation to the assets they have purchased through their investment in *sukuk*. This issue came to a head in February 2008, with the announcement by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)[1] that in its view the majority of *sukuk* in the market at that time were not in compliance with the precepts of *shariah*. The concerns of the scholars centered around the use and application of the purchase undertaking in *sukuk* transactions, and particularly the methodology used to determine the exercise price (or purchase price) for the *sukuk* assets upon an exercise by the issuer/trustee of its right to require the obligor to purchase those *sukuk* assets pursuant to the terms of the purchase undertaking.

WHAT STRUCTURES ARE USED IN *SUKUK* ISSUANCES?

In any issuance of a *sakk* (the singular form of *sukuk*) there are three main parties:

- the *sukuk*-holders (or investors);
- the issuer/trustee (normally a special purpose vehicle (SPV));
- the obligor (the company that ultimately wishes to benefit from the proceeds of the *sakk*).

In a *sakk*, irrespective of the structure, the *sukuk*-holders will purchase the *sukuk* (or trust certificates) from the issuer/trustee at the issue price—for example, US$100 million. The issuer/trustee will then use the proceeds of the issue to purchase certain assets from the obligor. These assets will need to be *shariah*-compliant income-generating assets. In an *ijarah sakk*, the issue proceeds will be used to purchase certain "hard" assets (for example, machinery, automobiles, or aircraft). Those assets will then be leased to the obligor against payment of rental on a periodic basis to the issuer/trustee (acting in the capacity of lessor) under the terms of an *ijarah* (lease) agreement. The proceeds from that *ijarah* agreement will be used by the issuer/trustee to make payment of the profit amount due from it to the *sukuk*-holders under the terms of the *sakk*.

A slight variation on this structure is the *istisna'a/ijarah* structure, pursuant to which the issuer/trustee will use the issue proceeds in two ways: (i) a portion will be used to fund the purchase price payable in respect of certain hard or already existing assets; and (ii) a portion will be used to fund the construction of certain other assets. According to *shariah* principles, the assets purchased under (i) must be equal to at least 33% of the principal amount of the *sakk* and must not be allowed to drop below this ratio at any time during the life of the *sakk*. As each asset under (ii) is constructed, it will be delivered to the issuer/trustee and will become subject to the *ijarah* agreement. Further, *shariah* requires that by the maturity date of the *sakk*, the value of the hard assets subject to the *ijarah* agreement is equal to the outstanding face value of the *sakk*, i.e., that no assets remain to be constructed under the *istisna'a* agreement.

Musharakah, *mudarabah*, and *wakalah* structures differ from the structures described above in that they are *sukuk* that involve investment in certain assets. A *musharakah* is an equity participation arrangement between the issuer/trustee and the obligor under which each party contributes capital to a project and shares in its risks and rewards. While profits may be apportioned according to any previously agreed ratio, losses must be borne according to the ratio of capital contributed. A *mudarabah* involves the issuer/trustee (as investor) appointing the *mudarib* (investment manager) to invest its funds in certain *shariah*-compliant assets. Profits from those investments are shared according to a previously agreed formula, but losses in respect of the assets are borne wholly by the investor (the *mudarib* bears the loss of its time and effort). A *wakalah* structure involves the issuer/trustee as *muwakkil* (investor) appointing the obligor as *wakeel* (agent) to invest in certain pre-identified assets. Similar to a *mudarabah*, the *muwakkil* bears the loss in relation to the assets, while the *wakeel* bears the risk of loss of its time and effort.

WHAT ROLE DOES THE PURCHASE UNDERTAKING PLAY IN A *SAKK* ISSUANCE?

A purchase undertaking is a unilateral undertaking or promise given by the obligor to the issuer/trustee that it will purchase the *sakk* assets at a future date or on the occurrence of certain events. The purchase price for those assets is determined in accordance with a pre-agreed valuation mechanic. This usually takes the form of a formula, but it can also be a price set by an independent third party (usually an industry expert), at a time on, or prior to, the date of purchase.

The purchase undertaking is the key credit document in any *sakk* transaction as it is the means by which investors receive the return on their investment at maturity and is also the means by which *sukuk* investments may be terminated early should an event of default or certain other pre-agreed trigger events occur. As such, when an investor comes to look at the documentation used in a *sakk* transaction, the documents to which they will turn first are the terms and conditions of the *sakk* and the purchase undertaking.

IN WHAT CIRCUMSTANCES WILL A PURCHASE UNDERTAKING BECOME OPERATIVE?

As mentioned above, the purchase undertaking is the key credit document in a *sakk* as it deals with the means by which investors will receive the repayment of principal at maturity or upon the occurrence of an event of default.

The purchase undertaking may also become operative upon the occurrence of nondefault-based events, such as the exercise of an early redemption right (in conventional terms, a put right) by the *sukuk*-holders. However, the most common nondefault-based exercise of rights under a purchase undertaking is the exercise upon maturity of the *sakk*.

A purchase undertaking will set out all the circumstances in which the rights under it may be exercised. Typically, a purchase undertaking also sets out in detail the events of default and the terms of any nondefault-based early redemption rights. Such rights will mirror any *sakk*-holder put right or other early redemption provisions as may be applicable under the terms and conditions of the *sakk*.

HOW IS A PURCHASE UNDERTAKING EXERCISED?

Shariah requires that any sale and purchase of assets takes place on a spot basis. This is why a purchase undertaking, rather than a forward sale and purchase agreement, is used in *sukuk* transactions. *Shariah* prohibits a sale agreement being entered into if there is uncertainty as to the date on which such sale and purchase will actually take place. This is particularly applicable to early redemption rights (whether arising as a result of an event of default or otherwise). To address this requirement, an undertaking is used. However, *shariah* also requires that contracts arising out of the purchase undertaking be

entered into correctly, through offer and acceptance leading to the conclusion of a formal sale agreement. In order to achieve this, and to ensure that negotiation is not required at the time at which the sale is entered into, the necessary documentation required for the issuer/trustee to exercise the rights under the purchase undertaking will be scheduled to that document. The schedules will usually include a form of exercise notice and a form of sale and purchase agreement.

In order to exercise its rights under the purchase undertaking, the issuer/trustee is required to deliver an exercise notice to the obligor (declaring its intention to require the obligor to purchase the *sakk* assets from it) together with the sale and purchase agreement signed by it. The obligor indicates its acceptance by returning a copy of the sale and purchase agreement duly countersigned by it. Having promised under the purchase undertaking that it would do so, any failure by the obligor to return the original sale agreement within a stated period of time will constitute an event of default. Payment of the exercise price to the issuer/trustee and the transfer to the obligor of the *sakk* assets will occur shortly thereafter.

HOW ARE THE RIGHTS OF THE ISSUER/TRUSTEE EXERCISED IN A DEFAULT OR EARLY REDEMPTION SCENARIO?

While the exercise of rights on the maturity date of a *sakk* is a straightforward matter, the exercise of the rights of the trustee (on behalf of *sukuk*-holders) under a purchase undertaking in an early redemption scenario (whether fault-based or not) presents more complications.

The purchase undertaking acts as a mirror of the rights of the *sukuk*-holders under the terms and conditions. As with any finance special purpose vehicle (SPV), the issuer/trustee will appoint an administrator to perform its day-to-day functions—for example, issuing notices through the clearing systems (if any), liaising with *sukuk*-holders, and acting on the instructions of the *sukuk*-holders under the terms and conditions of the *sakk*. Neither the issuer/trustee nor the transactions administrator will wish to prejudice the rights of the *sukuk*-holders as to whether to not to exercise the early redemption right, and as such will only act on the instructions of the *sukuk*-holders. The means for providing such instructions will be set out in the terms and conditions and the trust deed and will broadly follow the terms relating to such instructions found in conventional documentation.

WHAT ALTERNATIVE FORMS OF CONSIDERATION MAY BE USED TO SATISFY THE EXERCISE PRICE PAYABLE UNDER A PURCHASE UNDERTAKING?

Although a purchase undertaking will typically use cash to settle the exercise price payable in respect of the *sakk* assets, other forms of consideration can be used. The most obvious example of this is in the convertible or exchangeable *sukuk* market. In order to achieve conversion or exchange, the clauses dealing with payment of the exercise price will be amended to state that the obligation to pay the exercise price will be satisfied through the delivery of a certain number of shares in the obligor (for a convertible) or in another entity (for an exchangeable). The number of shares to be delivered will be calculated in the same manner as under a conventional convertible or exchangeable investment.

SHARIAH ISSUES WITH THE CALCULATION OF THE EXERCISE PRICE UNDER PURCHASE UNDERTAKINGS

Purchase undertakings are typically drafted such that the exercise price (and thus the value) of the *sakk* assets is calculated by reference to a formula resulting in an amount equal to the principal amount of the *sakk* plus any accrued but unpaid profit amounts. This formula may easily be adopted in relation to physical assets in an *ijarah* or *istisna'a/ijarah* structure, owing to the fact that there is no partnership or investment management relationship between the parties with an agreement to share in the losses associated with the *sakk* assets. The assets in an *ijarah*-based *sakk* are hard assets. As such they are not subject to *shariah* concerns about investment risk and, provided that they have not been destroyed, can be purchased at a price agreed between the parties.[2]

The *shariah* view is that this formula may not be used in relation to the valuation of the *sukuk* assets in *musharakah*, *mudarabah*, and *wakalah* structures because such structures are used in relation to intangible investment-type assets. In a number of cases the assets to be invested in are broadly identified according to certain criteria. Such assets are inherently more unstable than, for example, movable equipment, and as such are subject to fluctuations in market price. As a result of this, *shariah* scholars are uncomfortable with the idea that an asset such as a *shariah*-compliant equity instrument could be ascribed a value five years in advance of its purchase date, thereby providing an implicit

guarantee of the value of those assets. This formulation of the exercise price would run counter to the *shariah* principle that the investor should share appropriately in (for example, in a *musharakah*) or should absorb wholly (as in a *mudarabah* or *wakalah*) the losses associated with the *sakk* assets. These concerns were formally voiced in February 2008 when the AAOIFI handed down its guidance to Islamic finance institutions on the issuance of *sukuk*.[3]

The February 2008 announcement by the AAOIFI and its effect on the determination of the exercise price under a purchase undertaking appeared to end the market in *musharakah*, *mudarabah*, and *wakalah sukuk*. While this may have been the initial reaction of the market, it is also clear that financial institutions and other corporations in the market that do not possess a large inventory of hard assets will still require funding in a *shariah*-compliant manner in the future. How then can *sukuk* be used to fund such operations? The simple, albeit somewhat unsatisfactory, answer is that a more sophisticated valuation methodology needs to be applied in the *sukuk* market in order to accurately price the underlying assets in a purchase undertaking, for the purposes of returning principal to investors in a manner that meets the requirements of both potential investors and *shariah* scholars.

A SHIFT FROM DEBT TO EQUITY?

It would appear from the above that the general spirit of the February 2008 AAOIFI guidelines is to shift the focus of the *sukuk* market away from a purely debt-based model toward an equity-based one. Given the global economic events of the past two years, it has become clear to investors that the ultimate credit in a *sakk* transaction is not, in fact, the obligor, but rather the assets that form the *sakk* assets. It is the ownership interest that *sukuk*-holders have in these assets that should determine the credit of a *sakk* and thus drive the decision to invest. As a result, there will need to be a shift in the focus of transaction risk disclosure in offering documents from the obligor to the *sakk* assets. Financial disclosure on the obligor will remain an important aspect of *sukuk* given the fact that the creditworthiness of the obligor will have a direct impact on its ability to meet its obligations under the purchase undertaking but, in the event that the obligor is unable to meet such obligations or otherwise defaults under the *sakk*, the *sukuk*-holders will be left with the *sakk* assets.

ACCOUNTING TREATMENT OF *SUKUK* ASSETS

The February 2008 AAOIFI guidelines also had implications for the accounting treatment of *sukuk* assets in their attempt to move the classification of *sukuk* from a debt capital markets instrument to an equity-style instrument. The AAOIFI stated that the assets in a *sakk* must be transferred to the *sukuk*-holders in full and that "the manager issuing the *sukuk* must certify the transfer of ownership of such assets in its (*sukuk*) books, and must not keep them as his own assets,"[5]—i.e. *sukuk* must move toward the "true sale" securitization model.

Given the fact that an obligor will repurchase the underlying assets in the future, there is great difficulty from a purely accounting perspective in meeting the AAOIFI requirement to remove such assets from its books. International Financial Reporting Standards (IFRS) and Generally Accepted Accounting Principles (GAAP) usually

CASE STUDY

Dubai Bank's US$5 billion Trust Certificate Issuance Program[4]

One example of a more sophisticated methodology for calculating the exercise price is that used in Dubai Bank's *sukuk* program listed in September 2008. Dubai Bank utilized its *shariah*-compliant mortgage portfolio as the underlying asset in a *wakalah*-based *sakk*. The fact that a *shariah*-compliant mortgage is by its very nature a depreciating asset gave rise to complications regarding the most effective way to calculate the exercise price. To address the concerns described in this article, the purchase undertaking is drafted so that the exercise price payable in respect of the *sukuk* assets at maturity is calculated by valuing the outstanding principal amount of the underlying assets at that time (i.e. the aggregate outstanding principal amount under each mortgage). This is coupled with an obligation on the *wakeel* to ensure that the *sukuk* assets always comprise mortgages with an outstanding aggregate principal amount at least equal to the outstanding face value of the *sukuk*. Such methodology allows *sukuk* investors to share in the risk associated with the mortgages (default, etc.), but also provides comfort as to the return on their investment at maturity.

preclude accounting firms from leaving *sukuk* assets off the balance sheet of the obligor as the long-term risk associated with the *sukuk* assets will reside with it by virtue of its obligations under the purchase undertaking. Given the current economic climate, accountants are likely to take a cautious approach in relation to such treatment. However, a solution may be found where the relevant scholars are given comfort that the *sukuk* assets will be segregated in the books of the issuer and clearly identified as having been sold to the *sukuk*-holders subject to the terms of the purchase undertaking.

CONCLUSION

The challenge for the *sukuk* market going forward will be to develop valuation methodologies in respect of the exercise price that meet the *shariah* requirement that *sukuk* operate as equity-style instruments. Such methodologies will also have to address *sukuk*-holder demand for clarity on the return at maturity, as investors will not wish to invest in products that do not generate acceptable levels of return. More important, however, will be the education of the market (in particular, investors) as to what it is that is being purchased under a *sakk*. Investors will still need to look to the purchase undertaking as the key credit document (and therefore as an assurance of the creditworthiness of the obligor) in their decision whether or not to invest in a *sakk*, but the emphasis of disclosure—and therefore the basis on which an investor makes its investment decision—will need to evolve so that greater focus is given to the *sakk* assets as opposed to the obligor alone.

Such focus is likely to become ever more prevalent in the *sukuk* market as investors, chastened by recent developments, and in view of the 2008 AAOIFI announcement, begin to focus their attention on the assets underpinning a *sakk*, the creditworthiness thereof, and the revenue flows associated therewith, and not on the credit of the relevant obligor. This is not to say that the creditworthiness of the obligor is not a key factor in relation to the operation of the purchase undertaking; it will and always should remain a key consideration when deciding whether or not to invest in a *sakk*. However, in a market that has witnessed a spate of distressed *sukuk*, experience is likely to lead to a shift in focus from the obligor to the actual assets underlying a *sakk*.

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Auditing Islamic Financial Institutions

by Roszaini Haniffa

EXECUTIVE SUMMARY

- Auditing Islamic financial institutions (IFIs) covers a wider scope than statutory financial statement auditing.
- External auditors of IFIs not only conduct financial audits, but also conduct tests on the *shariah* compliance of IFIs, according to *fatawa* (religious opinions) and guidelines set by the Shariah Supervisory Board (SSB).
- *Shariah* review is unique to IFIs, due to the requirement to ensure that all business activities and operations of IFIs adhere to *shariah* precepts.
- Scope of audit of IFIs needs to be comprehensive in order to achieve *maqasid al-shariah* (wider objectives of the *shariah*).
- Challenges in auditing of IFIs include lack of standardized *shariah* guidelines, lack of independence of SSB, and lack of competence of external auditors to conduct comprehensive *shariah* audit.

INTRODUCTION

The purpose of the statutory or financial statement audit is to enhance the degree of confidence of intended users of the financial statements as to whether the financial statements are prepared in accordance with an applicable financial reporting framework. The most widely accepted and adopted auditing standards are those issued by the International Federation of Accountants (IFAC).

Following the emergence and phenomenal growth of Islamic financial institutions (IFIs) in recent years in various parts of the world, the scope of conventional statutory financial audit is inadequate to fulfill the needs of the stakeholders of IFIs. Because IFIs need to adhere to *shariah* principles in all their business transactions and operations, a new dimension in auditing, as well as auditing standards which can cope with such principles, is needed. Recognizing the limitations of the International Standards of Auditing (ISA) in addressing issues related to religious compliance, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has taken steps in producing a number of auditing standards and audit methodologies specifically for IFIs.

OBJECTIVE OF AUDITING IFIS

Auditing forms an important element in the process of securing corporate accountability and in enhancing stakeholder faith in management's stewardship. According to AAOIFI's Auditing Standard for Islamic Financial Institutions No. 1 (ASIFI 1), the objective of an audit of financial statements of IFIs "... is to enable the auditor to express an opinion as to whether the financial statements are prepared, in all material respects, in accordance with the Shari'ah Rules and Principles, the accounting standards of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and relevant national accounting standards and practices in the country in which the financial institution operates."

Unlike conventional statutory financial audit, which requires auditors to express a true and fair view that the financial statements have been prepared according to relevant auditing standards, the audit of IFIs covers a wider scope. This is because auditors must also attest that management has complied not only with the *shariah* precepts, but also with the wider objective of *shariah* (*maqasid al-shariah)*, which is to protect and improve the condition of human life in all dimensions. In other words, auditing of IFIs is not only confined to the statutory financial audit but also to what is known as the *shariah* review, which is the *raison d'être* for IFIs.

Hence, auditing of IFIs can be defined as a systematic process of objectively obtaining and evaluating evidence regarding assertions about religious and socioeconomic actions and events, in order to ascertain the degree of correspondence between those assertions and the applicable financial reporting framework, including the criteria specified based on *shariah* principles as recommended by the Shariah Supervisory Board (SSB), and communicating the results to all interested parties. Noncompliance with *shariah* principles is an area of risk for IFIs that could translate into legal, image, and reputational risks,

which would have far-reaching consequences not only for the individual IFI but also for the entire Islamic financial system.

CHARACTERISTICS OF THE AUDIT OF IFIS

Role of Key Players in the Audit

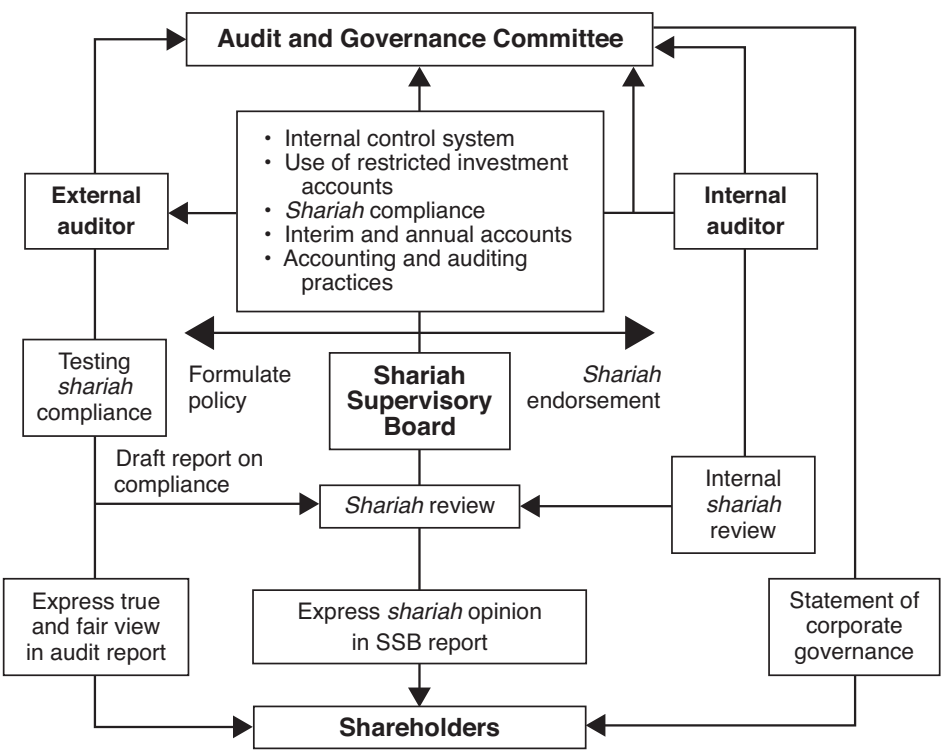
Due to the need to ensure proper adherence to the *shariah* principles in operations and activities, external auditors are not expected to conduct both types of audit for IFIs. This is because the criteria in deciding whether an activity complies with *shariah* principles or not are a matter for the SSB of the individual IFI to decide, as they have expert knowledge in Islamic jurisprudence. Given the accepted divergence in *shariah* principles between, and even within, national groups, the additional attestation of *shariah* compliance is measured against the Islamic *shariah* rules and principles, as determined by the SSB in each IFI.

The role of the external auditor with respect to *shariah* compliance is only to test for compliance based on the outlines provided by the SSB. Besides the SSB and external auditors, the other two key players involved in the audit of IFIs are the internal auditors and the Audit and Governance Committees. The role of each key player in the audit of an IFI is illustrated in Figure 1.

Shariah Supervisory Board

The SSB plays a key role in the overall audit and governance framework, both *ex-ante* and *ex-post*. Their role *ex-ante* is to formulate policy and guidelines to be followed by management in their activities, including approval of products. The *ex-post* role is to conduct *shariah* review, which is an examination to ensure that the activities carried out by an IFI do not contravene the principles of *shariah*. The *shariah* review involves three phases: planning and designing the review procedures; executing the review procedures and preparing and reviewing the working papers; and last, documenting the conclusions and producing a comprehensive Shariah Supervisory Report. When executing the *shariah* review procedures, a draft report from the external auditor regarding *shariah* compliance testing, and the internal *shariah* review report from the internal auditor, will

Figure 1. Key players and their role in the audit and governance of IFIs



help the SSB in documenting their conclusions and expressing a *shariah* opinion in their comprehensive report. In short, the *shariah* review is a comprehensive review of not only the financial statements but also of contracts, agreements, and transactions, to ensure *shariah* compliance and to add credibility to management's activities.

External Auditor

One of the unique roles played by the external auditor of an IFI, besides performing the financial statements audit, is to conduct a test of *shariah* compliance. The audit process involves a structured, documented plan involving a series of steps beginning with planning the audit and ending with expressing an opinion in an external audit report as to whether the financial statements are prepared in accordance with the *fatawa* (religious opinions), rulings and guidelines issued by the SSB of the IFI, the accounting standards of the AAOIFI, and relevant national accounting standards and practices in the country in which the IFI operates. In order to provide reasonable assurance that the IFI has complied with *shariah* rules and principles as determined by the SSB, the auditor needs to obtain sufficient and appropriate audit evidence. In order to guide the auditor in making judgment as to whether the financial statements of the IFI have been prepared in accordance with *shariah* rules and principles, the auditor will rely on the *fatawa*, and rulings and guidance issued by the SSB. However, the auditor is not expected to provide interpretation of the *shariah* rules and principles.

Hence, when conducting the audit, the auditor will include procedures in his or her examination to ensure that all new *fatawa*, rulings, and guidance, and modifications to existing *fatawa*, rulings, and guidance, are identified and reviewed for each period under examination. The auditor will review the reports issued by the SSB to the IFI concerning *shariah* compliance as well as the SSB's minutes of meetings to ensure that all types of products offered by the IFI have been subjected to a review by the SSB. The auditor must also examine the findings of all internal reviews carried out by the IFI's management, the internal audit, and the report of the internal *shariah* review. The auditor will send his or her draft report and conclusions related to *shariah* compliance to the SSB, and if the SSB's draft report indicates that compliance is lacking, the auditor may modify his or her draft report, providing adequate explanation of the nature of, and reasons for, the modification.

Internal Shariah Review

According to AAOIFI Governance Standards for Islamic Financial Institutions No. 3 (GSIFI 3), the conduct of the internal *shariah* review process may be undertaken by the internal audit department, provided that the reviewers are properly qualified and independent. Before the review process can take place, management prepares a charter containing a statement of purpose, authority, and responsibility, and sends it to the SSB for approval. Once the charter is approved, the board of directors will send the charter to the head of the internal *shariah* review, who will then appoint a team that has competence to carry out the task.

The reviewers will first plan each review assignment and the documentation. Then they will collect, analyze, and interpret all matters related to the review objectives and scope of work, including examination of documentation, analytical reviews, inquiries, discussions with management, and observations to support their review results. Working papers that document the review will be prepared by the reviewer and reviewed by the head of internal *shariah* review, who will then discuss the conclusions and recommendations with appropriate levels of management before issuing the final written report.

Audit and Governance Committee

The role of the Audit and Governance Committee (AGC), comprising nonexecutive directors, is described in detail under GSIFI No. 4. It is responsible for checking the structure and internal control processes and ensuring that the activities of the IFI are *shariah*-compliant. The duties of the AGC also include the review of the reports produced by the internal *shariah* review and the SSB to ensure that appropriate actions have been taken.

Scope and Extent of Audit

As mentioned earlier, the scope of audit for IFIs is much broader. AAOIFI defined "scope of an audit" as the audit procedures deemed necessary by the auditor in the circumstances to achieve the objective of the audit for the IFI. It further stated:

"The procedures required to conduct an audit in accordance with ASIFIs should be determined by the auditor having regard to the requirements of appropriate Islamic Rules and Principles, ASIFIs, relevant professional bodies, legislation, regulations, which do not contravene Islamic Rules and Principles, and, where appropriate, the terms of audit engagement and reporting requirements, International Standards on

Auditing (ISAs) shall apply in respect of matters not covered in detail by ASIFIs providing these do not contravene Islamic Rules and Principles."

From the above statement, it is clear that external auditors of IFIs are expected to deal with wider rules and guidelines. Since they are expected to conduct tests of *shariah* compliance, they will have to ensure that management has adhered to the interest-free and permissibility (*halal*) principles as specified by the SSBs. External auditors should also be concerned with elements of socioeconomic justice in line with *maqasid al-shariah,* even if they have not been addressed by the SSB.

CHALLENGES ON THE AUDIT OF IFIS

There are currently a number of challenges with regard to the auditing of IFIs, especially in terms of *shariah* compliance audit. First, despite the efforts of AAOIFI in promulgating auditing standards, the focus and scope tend to be on financial statements rather than the broader concept of *shariah* audit, which involves the audit of all activities of IFIs based on *maqasid al-shariah*. Furthermore, the use of the term "*shariah* review" rather than "*shariah* audit" by AAOIFI may implicate a lower level of assurance in the case of the former.

Second, based on AAOIFI's auditing standards, the functions of *shariah* audit or review are distributed to different entities, for example, external auditor, SSB, internal *shariah* reviewer, and the Audit and Governance Committee. While external auditors act as the external mechanism in monitoring compliance, their lack of competence makes them rely heavily on the SSB's *fatawa*, whereas in fact they should be making an independent judgment on the issue of compliance.

Third, the independence of the SSB has been questioned as they are involved in making *fatawa* and in setting up the guidelines on *shariah* compliance as well as in conducting a *shariah* review or audit of the IFI concerned.

Given the rapid growth of IFIs globally, there is little doubt that the auditing of IFIs will have to change to overcome these challenges and, perhaps, a new *shariah* auditing professional body will soon emerge.

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Islamic Finance Litigation by Kilian Bälz

EXECUTIVE SUMMARY

- Islamic financing agreements raise particular issues in the field of litigation and enforcement, in particular if borrowers invoke *shariah* principles to argue that an agreement was contrary to *shariah* law and is void as a consequence.
- English courts have heard several cases and developed the general principle that a contract should be governed by the contractual agreement and applicable state law; they are not prepared to validate a choice of *shariah* law, inasmuch as it is "too vague."
- Banks have reacted to the spread of Islamic finance litigation by including "waiver of *shariah* defense" clauses in loan agreements and specific risk factors on *shariah*-compliance in capital market documents.
- The current situation where *shariah*-compliance cannot be enforced in court can be seen to contradict the spirit of Islamic finance, which is based on an application of *shariah* rules to financial transactions.
- New centers for dispute resolution have emerged that specialize in Islamic financing transactions. These bring together expertise in alternative dispute resolution and *shariah* law.
- In arbitration, *shariah* law may be given preference over state law. This means that an arbitration tribunal can be a suitable forum in which to enforce the *shariah* promise.

INTRODUCTION

This article deals with litigation-related aspects of Islamic financing transactions. It focuses on those enforcement and litigation issues that arise specifically from the *shariah*-compliant nature of a certain transaction—so-called *shariah* risk. It is based on an analysis of relevant court precedents, and provides concrete suggestions of what to bear in mind when drafting *shariah*-compliant agreements and capital market documents. It concludes with some reflections on whether it makes sense to set up specialized dispute review bodies for Islamic financing transactions.

WHEN THINGS GO WRONG

Islamic finance litigation? Disputes arising out of *shariah*-compliant agreements were unheard of in the early days of Islamic finance. Banking transactions, by their very nature, are discrete, and as long as Islamic finance was confined to a small community there was no need to enforce contractual arrangements in court. The growth of Islamic finance, however, and the globalization of the Islamic finance industry, has transformed the industry from a community-based endeavor into a global business. In the global market, lenders default and banks sue and enforce. Islamic finance has become part of the global banking industry, and Islamic finance litigation is a side effect thereof.

Litigation based on or relating to Islamic financing transactions can raise intricate issues, in particular if debtors defend invoking *shariah* principles, in arguing that a contract or certain clauses are void as they do not comply with Islamic law (so-called *shariah* defenses). The spread and sophistication of the Islamic finance industry, as well as Islamic financial innovations, some of them based on controversial interpretations of the *shariah*, have further contributed to uncertainty in the Islamic finance community. Over the last decade, however, the courts have developed certain principles of how to deal with Islamic finance cases.

DEALING WITH IT

The approach of the English courts is clear, and the principles established in the Beximco Case were upheld in subsequent cases, including most recently the decision of the London High Court in Investment Dar Company KSCC v Blom Development Bank SAL, rendered in 2009 and concerning a *wakalah* agreement. According to the settled law, the transaction is governed by what is agreed in the contract, supplemented by the state law applicable to the transaction. The compliance with Islamic legal principles—the *shariah* promise—is not enforceable in court and any defense that a transaction is not compliant with Islamic legal principles will not be heard. However, the mere fact that a debtor defends in an English court by referring to *shariah* principles seriously troubled the industry. Talk of *shariah* risk spread—as did discussion of how to deal with it.

Loan Agreements

It is customary in Islamic loan agreements to provide for a choice of law clause for the benefit of the law of a certain jurisdiction (England, United States, United Arab Emirates) and a jurisdiction or arbitration clause. In addition, Islamic loan agreements regularly contain a "waiver of *shariah* defense" clause, pursuant to which the borrower "waives all and any defenses based on *shariah* law." Effectively, through this

CASE STUDY

The Beximco Case

Shamil Bank of Bahrain v Beximco Pharmaceuticals Ltd and Others (known as the Beximco Case), heard by the London Court of Appeal in 2004, is still considered to be a landmark judgment in the field of Islamic finance litigation. The underlying facts can be summarized as follows. An Islamic bank based in Bahrain had entered into a *murabahah* financing agreement with a South Asian borrower. The borrower did not repay the loan as scheduled. Negotiations over restructuring the debt all remained without success. The bank finally called in the loan and brought a claim in the English courts, which the loan agreement determined as venue. The defendant argued, *inter alia*, that the transaction was altogether void, alleging that it was only dressed up as an Islamic *murabahah* agreement, but was in fact an interest-bearing loan. Thus it violated the Islamic prohibition of *riba*. The lack of *shariah* compliance, the borrower argued, made the agreement altogether unenforceable, and freed the borrower from his obligation to repay.

Assuming that the allegation was correct, and that the particular agreement in fact was contrary to Islamic law (which, however, is difficult to determine on the basis of the facts as reported in the case), this raises the question of whether a state court will enforce the *shariah* promise given by an Islamic bank, pursuant to which a particular transaction is compliant with Islamic principles. In addition, if a state court should get involved with *shariah* issues, who then will determine the content of the *shariah* rules? This is a difficult issue that touches fundamental questions, such as the competence of state courts to opine on religious matters and the protection of parties to contractual promises to the extent that such promises are of a nonpecuniary nature.

In the Beximco Case the agreement provided that "Subject to the Principles of the Glorious *Shariah*, this Agreement shall be governed by and construed in accordance with the law of England." This clause ("Subject to") can well be read to imply that *shariah* rules are meant to override principles of English law, at least to the extent that the latter are not mandatory. Such an approach may be consistent with the intentions of the parties to enter into an Islamic transaction that is distinct from a conventional one. The Court of Appeal nevertheless declined to validate the *shariah* rules referred to in the agreement: a choice of law, the Court held, is only valid if it refers to the law of a particular state, or at least a body of black letter rules that are incorporated in the agreement. The "Principles of the Glorious *Shariah*," however, were too vague to be applied by a state court. The parties will not have intended to entrust a state court with the interpretation of religious principles, the Court continued. In view of this, the Court ruled on the basis of the provisions of the agreement and did not hear the *shariah* arguments put forth by the defendant—altogether a pragmatic approach, one can say, upholding the validity of the agreement for the benefit of the lending bank.

Whether this approach is fully consistent with the spirit of Islamic finance, however, is a different matter. On the one hand, a customer chooses an Islamic bank because of the *shariah* promise, meaning that he or she can expect transactions to comply with with Islamic principles. This may suggest that the customer's expectation should be legally protected too, and that the *shariah* promise should, at least to a certain extent, be enforceable in court. After all, Islamic law has been applied for centuries as the common law in North Africa, the Middle East, and large parts of South Asia. This suggests that it cannot be impossible for a court to apply Islamic legal rules. On the other hand, in Islamic finance the reference to *shariah* principles is more an ethical guideline than an undertaking that these rules are to be observed as hard law. Whereas normally in financing transactions the function of the law is to make an agreement enforceable, the reference to *shariah* principles in Islamic finance serves to express a religious orientation, to make the transaction compliant with a body of rules that, in most jurisdictions where Islamic banks operate, are not enforced by the state. Neither in the Islamic finance hubs of Dubai or Kuala Lumpur, nor in London, New York, Luxembourg, or Geneva, is the prohibition of *riba* part of state law.

clause the *shariah* promise is reversed: although in the preamble, Islamic financing agreements regularly make reference to *shariah* principles guiding the transaction, toward the end of the agreement, *shariah* principles are explicitly denied enforceability. *Shariah* principles are downgraded to nonbinding ethical principles that cannot be enforced in court.

Another way of addressing the issue of *shariah* risk is to explicitly agree on the content of the rules of *shariah* law. This may be seen to be more consistent with the tradition of Islamic law, where interpretative pluralism was for centuries an important source of legal development, and where the consensus and agreement on certain legal rules played an important counterbalancing role. Here, for example, a clause can be included in the agreement pursuant to which the "borrower has reviewed the *fatwa* rendered by the lender's *shariah* board," that "it had the opportunity to seek independent *shariah* advice and discuss the opinion in the bank's *fatwa* with scholars of choice." The clause then would continue to provide that "the borrower and the lender agree on the interpretation of *shariah* law as put forth in the *fatwa* of the Bank's *shariah* board." This has the effect that the content of *shariah* is contractually defined by the parties. It also would reflect that entering into the transaction, as far as *shariah* aspects are concerned, was based on an informed decision on the part of the borrower, who had the opportunity to seek professional advice. The rules of Islamic law, over history, have evolved in a discursive process and divergence of opinion always has been, and still is, one of the key sources of legal development and innovation. What, however, contributes to the development of the law as a system, what maintains its flexibility and allows for its adaption to the change of time and clime, can adversely affect the security of a specific transaction. Agreement, whether by way of contract or in the fashion of a consensus within the scholarly community, is an important source of law in Islamic jurisprudence that permits to determine rules in those areas where there are no definite prescriptions in the Qur'an and the *Sunnah*. A contractual clause in which the parties to a certain transaction agree on their interpretation of *shariah* can be seen in the context of this tradition.

Capital Market Documents

Whether the compliance of certain investments with noneconomic guidelines impacts their valuation, and thus needs to be reflected in offer documents, is a longstanding discussion in the investment and related industries. On the one hand, the classical view argues that an investment decision is based on risk and return. According to this approach, noneconomic factors do not influence the investment decision. Consequently, there is no need to make respective disclosures in an offer document relating to the respective investments. Whether an investment is *shariah*-compliant would be as irrelevant as if the respective investment certificate is printed in black, red, or blue letters. Although for some investors this may actually play a role, and a certain color may inform their investment decision, for the market at large this is completely irrelevant.

With regard to *shariah*-compliant securities, however, the situation is to a certain extent different. There are certain financial institutions, sovereign wealth funds, as well as influential private investors that would exclusively invest in *shariah*-compliant investments, and also under their constitutional documents would be prevented from entering into conventional transactions. As a result, a submarket for *shariah*-compliant investments has emerged. It may be too early to speak of a separate (global) Islamic financial system, as one often would see that conventional investors would also invest in *shariah*-compliant investments (in particular *sukuk*) and conventional banks, in turn, would offer Islamic products. Nevertheless *shariah* compliance is more than black, red, or blue letters. It defines whether a certain investment qualifies for a certain market, with a development of prices that may be decoupled from the general market.

All this supports the view that *shariah* compliance can have an influence on the valuation of a certain investment and that thus a potential lack of *shariah* compliance is a risk that must be disclosed and described in an offer document. Here again, the diversity in interpretation is a central challenge, as what may be permissible to some scholars may be prohibited according to others. This interpretation risk is normally reflected in the section on risk factors in the offer document as follows: "The investment guidelines have been defined, and their observance is controlled, by a board of religious scholars (the *shariah* board) which the fund management company has carefully selected in consideration of their professional and academic credentials. The investment guidelines have been discussed in detail with, and are approved by, the *shariah* board to comply with *shariah* principles. There is no uniform interpretation of *shariah* principles, however, and the fund management cannot exclude that

other *shariah* scholars take a different approach to interpretation of *shariah*, and that in their view certain investments in the fund, or the investment guidelines altogether, are not consistent with *shariah* principles."

THE WAY FORWARD: SEPARATE DISPUTE RESOLUTION BODIES FOR ISLAMIC FINANCING TRANSACTIONS?

The ongoing debate on *shariah* risk raises the question of whether separate dispute resolution bodies for Islamic financing transactions would be a solution. From the case law analyzed above, one can see a certain unease of state courts to get involved in *shariah* matters. This unease goes along with a dissatisfaction by many members of the Islamic finance community with how state courts have treated *shariah* law. Moreover, there is a general tendency toward specialized dispute resolution bodies, for matters such as construction, shipping, commodity transactions, sports, intellectual property, takeover rules, and trade finance. So why not set up dispute resolution bodies specializing in Islamic financing transactions, bringing together the perspectives of international finance and *shariah* law?

At present there are two dispute resolution bodies, in Dubai and Kuala Lumpur, that specialize in Islamic finance disputes, with Bahrain expected to follow soon. The aim of these Islamic finance arbitration centers is to provide a specialist forum for Islamic financing disputes. As the rules of arbitration of the Dubai-based International Islamic Center for Reconciliation and Arbitration provide: in rendering arbitral decisions, "the Panel shall exclude any provisions in the law that should be applied if such provisions are not in conformity with the rules of Islamic *Shariah*." This means that *shariah* rules, in the event that the law determined to be the proper law of the contract is in conflict with them, remain supreme. In the last instance, it is *shariah* law that applies to the subject matter of the dispute. This is a very different approach from the "waiver of *shariah* defense clauses" in standard Islamic loan agreements. At the same time, this inevitably puts the enforceability of many *shariah*-compliant transactions at risk, as it allows for an independent review of the decision of the bank's *shariah* board. It goes without saying that in many cases the arbitral body will share the board's interpretation of *shariah* law. However, this cannot be taken for granted, in particular when it comes to financial innovations, where opinions among *shariah* scholars are divided, and, as in the field of commodity *murabahah* or the *sukuk* with fixed return, the market practice is seen to conflict with an orthodox interpretation of the *shariah* by many members of the Islamic scholarly community. Whether the market will accept specialized *shariah* arbitration bodies in financial disputes remains to be seen. The establishment of any specialized dispute resolution body takes years, if not decades, and for this reason it is far too early to come up with a definite assessment. A specialized dispute resolution panel, in any event, has the advantage that it can bring together different areas of expertise, and have arbitrators that feel at home in the world of international banking and *shariah* alike.

An alternative approach, followed for example by the Malaysian central bank (Bank Negara), is to vest the financial services regulator with the

MAKING IT HAPPEN

Shariah-Compliant Agreements that Can Be Enforced in Court—A Checklist

- Determine a law as the proper law of the contract that is favorable to international lending and capital market transactions; avoid referring to the Islamic *shariah* or principles of Islamic law in the choice of law clause.
- Provide for a venue (court or arbitration tribunal) that is familiar with international financing transactions and likely to uphold the contractual agreement among the parties. Avoid a venue where a court may apply Islamic legal principles in interpreting the contract.
- Determine in the contract what is meant by *shariah* compliance and Islamic legal principles. Make reference to the view of the *shariah* board or the *fatwa* approving the transaction. Let both sides seek independent *shariah* advice.
- Include in capital market documents a risk factor dealing with divergent *shariah* interpretations. There is no guarantee that scholars will follow the opinion of the issuer's *shariah* board with regard to the permissibility of a certain transaction.
- Include a "waiver of *shariah* defenses" clause, pursuant to which the borrower waives all and any defenses based on *shariah* law.

power to supervise *shariah* boards or *shariah* compliance. This model is based on the (correct) assumption that in an Islamic financing transaction *shariah* compliance is part of the deal and must be subjected to supervision by the regulator, such as the observance of prudential rules and compliance with consumer protection rules. This approach may be even more suited to building a coherent set of *shariah* rules applicable to Islamic financing transactions.

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Best Practice

Markets

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Islamic Capital Markets: The Role of *Sukuk*

by Rodney Wilson

EXECUTIVE SUMMARY

- Conventional bills, bonds, and notes which pay interest are unacceptable from an Islamic perspective.
- Tradable financial instruments using Islamic structures were introduced in Pakistan in 1980 and Malaysia in 1990.
- The defining characteristic of *sukuk* is their asset backing.
- There remains much controversy over *sukuk* structures, especially among *shariah* scholars.
- There is growing worldwide interest in *sukuk*, including from the Treasury in the United Kingdom.

INCOMPATIBILITY OF CONVENTIONAL FINANCIAL MARKET INSTRUMENTS WITH *SHARIAH* LAW

Islamic capital markets are made up of two components, stock markets and bond markets. This contribution is primarily concerned with the latter rather than *shariah*-compliant stock determination. In particular it is *sukuk* that have become the accepted Islamic alternative to conventional bills, bonds, and notes, and hence are the major focus here.

Conventional capital market instruments such as treasury bills, bonds, and notes are unacceptable from a *shariah* Islamic legal perspective as they involve interest payments and receipts. Interest is equated with *riba*, an unjust addition to the principal of a debt, and is seen as potentially exploitative. Islamic economists prefer equity to debt financing because of the risk-sharing characteristics of the former, which is viewed as fairer to all parties. They are also concerned about the injustices that often arise with excessive indebtedness, as in the case of developing country debt, or simply the higher interest charges often faced by those with no collateral to offer and the poor more generally.

Nevertheless, government and corporate borrowing is unavoidable, and can indeed be beneficial if the finance is used productively for investment that can contribute to employment and prosperity. Bank lending, however, commits assets on a long-term basis and reduces liquidity. The advantage of using capital market instruments to raise finance is that investors can exit at any time rather than wait for assets to mature. Furthermore, the investment banks that arrange the issuances earn fees and do not have to commit their own resources, unless the bill, bond, or note issue is not taken up, in which case, as underwriters, they will have to purchase the issuance.

THE INTRODUCTION OF ISLAMIC CAPITAL MARKET INSTRUMENTS

There are no *shariah* objections to financial markets, only to the interest-based instruments which are traded in the markets. Therefore, the first attempt to develop *shariah*-compliant debt instruments involved securitizing traditional Islamic financing instruments, as with the *mudarabah* certificates issued in Pakistan from 1980 onward after a law was passed giving legal recognition to the certificates. *Mudarabah* involves the establishment of partnership companies with investors, and the company managers share in the profits, but the financiers alone bear any losses. In 2008 the original law was amended to bring the *mudarabah* companies under the regulatory supervision of the Securities and Exchange Commission of Pakistan, the aim being to ensure better investor protection.

In Malaysia, where Islamic banking started in 1983, a natural innovation was to securitize the debt instruments used, mainly *murabahah* financing, where a bank would purchase a commodity on behalf of a client and resell it to the client for a markup, with settlement through deferred payments. The first instrument was issued by the Shell oil company's Sarawak subsidiary in 1990, with Bank Islam Malaysia as the arranger. By attracting third-party investors interested in benefiting from these deferred payments, the bank could use its capital for further financing rather than having it committed on a long-term basis. This debt trading, known as *bai al-dayn,* is permitted by the Malaysian interpretation of the Shafii School of Islamic jurisprudence which prevails in Malaysia and Indonesia,

but is not permitted in Saudi Arabia or the Gulf. Scholars of Islamic jurisprudence in the Gulf believe that debtors should know who they are indebted to, rather than having their debt obligations traded in an impersonal market.

ASSET-BACKED *SUKUK*

Given the concerns with *bai al-dayn*, it became clear that an alternative approach was needed to the securitization of debt instruments, and it was this that resulted in the emergence of *sukuk*. The defining characteristic of *sukuk* is that they are asset-backed, which implies that when they are traded the investors are buying and selling the rights to an underlying real asset, usually a piece of real estate or a movable asset such as equipment or vehicles. It is this that makes the transaction legitimate, as under *sura* 2.275 in the Qur'an, it states that "God hath permitted trade but forbidden *riba*."

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has stated that for "*sukuk*, to be tradable, [they] must be owned by *sukuk* holders, with all the rights and obligations of ownership in real assets."[1]

Again, it was Malaysia that took the lead in *sukuk* issuance, the first being for Malaysian Newsprint Industries in 2000, with an eight-year maturity. It was, however, the Malaysian government's global *sukuk* in June 2002 that brought international attention, this being the first ever sovereign *sukuk*, with maturity after five years, the sum raised being US$600 million. State-owned land provided the asset backing, and an *ijarah* structure was used, with the government selling the land to a special purpose vehicle (SPV) and leasing it back, and the investors in the SPV receiving a rental income as indirect owners rather than interest payments. The returns were, however, benchmarked to the London Interbank Offered Rate (LIBOR), the return being LIBOR + 0.95%, which meant that the *sukuk* had financial characteristics similar to a floating rate note. HSBC Amanah, the Islamic finance affiliate of HSBC, acted as arranger.

Since 2002 *sukuk* issuance has risen remarkably, with *sukuk* issuance peaking at US$46.6 billion in 2007, representing 205 issuances. The subprime crisis in asset-backed securities had a negative impact on *sukuk* issuance from August 2007 onward, demonstrating that Islamic finance was not immune from global financial developments. However, it mainly affected dollar-denominated issuance, as issuers who were asked to pay much more for their financing decided to postpone or abandon planned *sukuk*. Hence, US dollar-denominated issuance fell to just over US$1 billion over the September 2007 to September 2008 period. *Sukuk* issuance in other currencies was less affected, however, with the equivalent of US$15.4 billion issued in Malaysian ringgit over the same period, and US$6.6 billion in UAE dirhams, even though the latter currency is pegged to the dollar. The need for funds for project finance continues to propel *sukuk* issuance in the Gulf, with the Saudi Arabian Basic Industries Corporation, the region's leading petrochemical producer, issuing *sukuk* worth US$1.3 billion in May 2008, with the *sukuk* being riyal-denominated and paying SAIBOR (Saudi Arabia Interbank Offered Rate) plus 48 basis points over a 20-year period.

AAOIFI has identified 14 types of *sukuk* with different risk and return characteristics. *Salam sukuk,* for example, are a short-term substitute for conventional bills, as they yield a fixed return, usually over a 90-day period, and are regarded as very low-risk instruments, not least because the issuers are usually sovereign governments rather than corporate clients. The major limitation of *salam sukuk,* however, is that they cannot be traded, unlike treasury bills, as the investors are paying in advance for the delivery of an asset in 90 days. Under *shariah* investors can only trade assets that they own, and not those that they hope to own at a future date.

With the *ijarah sukuk* cited above there is a return risk, as payments are usually linked to LIBOR which varies, and typically the issuance is for three to five years, which increases the possibility of default risk. *Ijarah sukuk* can, however, be traded as the investors have a title to the underlying assets. This also applies in the case of *mudarabah sukuk*, which in some respects are less risky than their *ijarah* equivalents as they pay a fixed return.

UNRESOLVED *SHARIAH* CONCERNS WITH *SUKUK*

Despite the success of *sukuk* there remain fundamental questions about their legitimacy from a *shariah* perspective, as the current structures have been devised by lawyers and investment bankers and are not *shariah*-based, and as the contracts in traditional Islamic jurisprudence, *fiqh*, are significantly different. The *sukuk* are *shariah*-compliant in the sense that they have been approved by the *shariah* boards of the institutions undertaking their arrangement, but the *shariah* scholars serving on the boards have not been involved in the structuring of the financial instruments.

The first concern is overpricing, as although with *mudarabah sukuk* the returns are profit

shares and with *ijarah sukuk* they are rents, the benchmarks used, whether LIBOR or SAIBOR, are interest rate proxies. These are used so that the returns to *sukuk* investors are competitive with those on comparable conventional bonds and bills, but this is driven by market considerations and not by *shariah*. The second concern is that the returns to Islamic investors are supposed to be justified by risk-sharing, the notion of taking on each other's burden. With *sukuk,* however, the main risk for the investors is of default, and in such circumstances the investors can be expected to instigate legal proceedings against the issuer to try to reclaim as much of their investment as possible. Most *sukuk* are rated, and the rating reflects the probability of default risk, which in turn is reflected in the pricing. For sovereign *sukuk,* for example, Pakistan has to pay a higher return than Qatar or Malaysia, reflecting country risk perceptions, yet it is the Government of Pakistan that can least afford the debt servicing.

Sheikh Taqi Usmani, a leading *shariah* scholar who specializes in Islamic finance, alleged in a speech in November 2007 that most *sukuk* were not *shariah*-compliant, as the investors expected to get the nominal value of their capital returned on maturity, avoiding exposure to market risk. In the case of *mudarabah* and *musharakah sukuk,* he believed that the amount the investor gets returned on maturity should reflect the terminal market value of the asset backing the *sukuk* and not simply its initial nominal value. The asset used as backing for the *sukuk* should have real financial significance and not simply be used as a legal proxy to justify *sukuk* trading.

Unlike equity investors, *sukuk* investors do not want market exposure. There may be justifiable reasons for this. First, investors may want a balanced portfolio and may be willing to risk a proportion of their capital for a potentially higher return, but they may not be willing to take excessive risk. Second, Islamic *takaful* insurance operators hold significant amounts of *sukuk* in their asset portfolios in the same way as conventional insurance companies hold bonds and notes. If their capital diminished, they would be unable to meet the claims of their members. If asset values are at risk this may also distort the type of *sukuk* which can be offered. The first Saudi Arabian *sukuk* was by HANCO, a car rental company, with the vehicles used as the underlying asset. If the original vehicles had been revalued on maturity after three years, they would have been worth less, and the investors would have lost some of their capital. Where real estate is used investors may gain, but those wanting exposure to the real estate market will invest directly, rather than through *sukuk*.

THE GLOBALIZATION OF *SUKUK*

Despite controversies over the structuring and characteristics of *sukuk*, they have become an established asset class of interest to conventional as well as Islamic financial institutions. In the United Kingdom, HM Treasury published a consultation document on *sukuk* in November 2007 declaring that such an issuance could "deliver greater opportunities to British Muslims—and also entrench London as a leading centre for Islamic finance".[2] Following responses to the consultation, another document was published in June 2008 indicating that the Treasury was planning a series of *sukuk* bills issues, probably starting in 2009, which would provide a benchmark against which sterling corporate *sukuk* could be priced.

There have been *sukuk* issues already in other Western countries, with the German state of Saxony–Anhalt issuing a euro-denominated *ijarah sukuk* in July 2004 and the East Cameron Gas Company issuing a *sukuk* in the United States in June 2006. The major potential is in the Islamic world, however, and it is notable that in the most populous Muslim country, Indonesia, interest in *sukuk* is increasing, with Metrodata Electronics issuing an *ijarah sukuk* in April 2008 to fund its expansion in telecommunications. Qatar has been particularly active in *sukuk* issuances, with major sovereign *sukuk* issued in September 2003 and January 2008, and 12 corporate *sukuk*, including by leading Doha-based real estate and transportation companies. In the years ahead the Qatar Financial Centre may well become a major center for *sukuk* trading, contributing to the country's diversification into financial services.

The temporary pause in dollar-denominated *sukuk* issuance provides an opportunity for reviewing *sukuk* structures, and in this context the debate that followed Sheikh Taqi Usmani's remarks is timely. There can be no doubt that once the market in conventional asset-backed securities revives internationally, dollar-denominated *sukuk* issuance will revive. The weakness over the 2000–07 period, however, was that although there was much new *sukuk* issuance, trading was limited, apart from in Kuala Lumpur in ringgit-denominated *sukuk*. The investment banks and regulators of financial centers in the Gulf, and indeed London, will have to consider how more active trading can be facilitated, as until this occurs *sukuk* will not fulfill their potential in providing long-term financing while maintaining investor liquidity.

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Capital Adequacy Requirements for Islamic Financial Institutions: Key Issues

by Edib Smolo and M. Kabir Hassan

EXECUTIVE SUMMARY

- The global financial crisis revealed many flaws in the conventional financial system, and many identified the Islamic financial system as a viable alternative.
- Both the Basel I and Basel II Accords were devised with an aim of improving the credibility and soundness of the financial system globally.
- The differences between conventional and Islamic banks are apparent on both the liabilities and the assets sides. Although Basel II was never intended for the Islamic financial industry, it can be taken as the foundation and improved upon with respect to the nature and characteristics of Islamic banking.
- Both the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB) tried to develop capital adequacy ratio (CAR) guidelines for Islamic banks, taking into account Basel II recommendations as their basis.
- While AAOIFI's recommendations are biased toward the liabilities side of the balance sheet, the IFSB's recommendations consider the assets as well.
- There is a dire need to differentiate between financial instruments in order to come up with an appropriate CAR for Islamic banks.
- Proper measurement of CAR and the meeting of international standards will foster the credibility and soundness of the Islamic financial system worldwide. This will lead to the future growth of the industry.

INTRODUCTION

The Islamic financial industry (IFI) has grown tremendously in the last two to three decades. In short, Islamic finance refers to financial activities that are guided by the teachings of *shariah* (Islamic law), which strictly prohibits the payment and receipt of interest. Today, Islamic finance attracts both Muslim and non-Muslim market participants. The worldwide market for *shariah*-compliant Islamic financial products is estimated to be between US$800 billion and US$1 trillion. According to International Financial Services, London (IFSL), *shariah*-compliant assets had grown to US$951 billion by the end of 2008, which is a 25% increase from US$758 billion in 2007, and about 75% up from US$549 billion in 2006. The IFI is growing at 15–20% per annum—a rate that is much greater than the growth rate of the traditional (conventional) financial industry.

While the global financial crisis revealed serious weaknesses in the international financial system around the globe, the IFI showed signs of relative resilience to the shocks. It is even argued that if the principles of Islamic finance had been followed, the financial crisis would have been prevented. Nevertheless, some impact has been felt within the industry, revealing vulnerabilities that need to be addressed urgently in order to sustain the growth of the IFI.

Despite the fact that there is no consensus on the causes of the global financial crisis, various authors have highlighted several culprits. Some argue that the complexity and intensive use of structured financial products, derivatives, and other assets with uncertain fundamentals are to blame for the current financial crisis. Others say that easy monetary policy, financial supervision, and regulation, combined with excessive leveraging and credit growth, are fundamental factors that ignited the crisis.

All of the above brought the need for prudent regulation and supervision into the limelight. Lack of both supervision and regulation of the financial sector played an important role in the crisis. This led to the growth of unregulated exposures, which in turn led to excessive risk taking and weak liquidity risk management.

Being a niche industry, Islamic finance faces considerable challenges. For example, the lack of an efficient legal framework, standards and procedures, qualified manpower, effective government support, prudential regulations and supervision, internal controls, risk management, and

external audits of Islamic banks are some of the challenges confronting the future growth of IFI.

Apart from the extraordinary growth and multiple challenges faced by the IFI, one daunting challenge is the compliance of Islamic banks with international standards and guidelines. Meeting international standards, such as the capital adequacy requirements set by the Basel II Accord, is not an easy task, as Islamic banks face different types of risks. For this reason, this article discusses the key issues in capital adequacy requirements for Islamic financial institutions.

CAPITAL ADEQUACY RATIO FOR ISLAMIC FINANCIAL INSTITUTIONS

An Overview of the Capital Adequacy Ratio

Capital adequacy is a measure of the adequacy of an entity's capital resources in relation to its current liabilities and also in relation to the risks associated with its assets. An appropriate level of capital adequacy ensures that the entity has sufficient capital to support its activities and that its net worth is sufficient to absorb adverse changes in the value of its assets without it becoming insolvent.

The initial Basel Capital Accord (known as Basel I) was concluded in 1988 with the aim of developing standardized risk-based capital requirements for banks across countries. Its aim was to encourage banks around the world to retain strong capital positions and to reduce the inequalities in this regard across countries. This fairly basic framework had many weaknesses, such as the limited use of risk-mitigating techniques—there was no distinction between high- and low-quality borrowers and no distinction between long- and short-term loans. Due to these and other shortcomings, the Basel I Accord was replaced by a new capital adequacy framework, Basel II, published in June 2004.

Basel II is still used as the basis for defining and maintaining capital for Islamic banks. Furthermore, it kept a minimum capital adequacy ratio (CAR) of 8% as an indication that a bank is adequately capitalized (although the methodology for calculating the capital adequacy ratio is completely different between the two accords). This new framework, apart from emphasizing credit risk measurement and mitigation techniques, introduces two additional types of risk: market risk and operational risk. In short, the Basel II Accord is based on three mutually reinforcing pillars that allow banks and supervisors to properly evaluate the various risks that banks face. These three pillars are as follows.

Pillar 1: minimum capital requirements, which seek to refine the present measurement framework.

Pillar 2: supervisory review of an institution's capital adequacy and internal assessment process.

Pillar 3: market discipline through effective disclosure to encourage safe and sound banking practices.

The above pillars, taken together, should lead to a greater level of safety and soundness of a financial system.

Capital Adequacy Requirements and Islamic Financial Institutions

Conventional and Islamic banks face different types of risks in their everyday operations. Nevertheless, the risks faced by Islamic banks are somewhat different from those faced by their conventional counterparts. When it comes to the conventional banks, Basel II provides a detailed framework for the calculation of risk-weighted assets, taking into account different types of risks related to their activities. However, this framework does not address the risks pertinent to the nature of Islamic banks' activities. Islamic banking goes beyond the traditional role of banks, which only provide financial intermediation. The role of an Islamic bank and the modes of financing available to it are manifold. Depending on the situation and the customer's demands, it may act as an investor, a trader, a financial advisor, or an agent. Each and every role it takes, as well as the mode of financing it chooses, has its own risk characteristics that need to be taken into account. The sharing of risk with its customers distinguishes Islamic banking from conventional banking.

Up until now, several proposals for a capital adequacy framework for Islamic banking have been devised. The first initiative came in 1999 from the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). In its "Statement on the purpose and calculation of the capital adequacy ratio for Islamic banks," AAOIFI proposed a method based on Basel II standards, but with slight modification with regard to the liabilities side of Islamic banks' balance sheets. Nevertheless, this proposal was biased toward the liabilities side of Islamic banks, without paying due attention to the calculation of risk-weighted assets.

This limitation of the AAOIFI proposal led others to come up with other proposals, such as one that suggested treating Islamic banks as mutual funds whose obligation is to pay the residual amount after taking into account gains and losses. Another proposal, which went a step further, was issued by the Islamic Financial Services Board (IFSB). This proposal was detailed in the "Capital adequacy standard for

institutions (other than insurance institutions) offering only Islamic financial services," issued in December 2005. It not only focuses on the liabilities side of Islamic banks—as was the case with AAOIFI—but also on the assets side, by assigning appropriate risk weight to each item on the asset side.

CHALLENGES IN IMPLEMENTATION OF CAR FOR ISLAMIC BANKS

As already mentioned, Islamic banking activities differ to a great extent from those of conventional banks. As such, Islamic banks generally have different risk profiles altogether. In fact, when we look into the balance sheets of Islamic banks, we find that on the liabilities side there is a mix of contracts with investment deposits that are quasi-equity in nature. These deposits are based on profit and loss sharing principles. There are demand deposits whose capital is guaranteed by Islamic banks. Based on the AAOIFI's standards, the risk of investment deposits should be shared equally by depositors and investors. Thus, the capital requirements for investment deposits are assigned a weight of only 50%. However, it is argued that this weight should be raised to 100% to determine capital adequacy, as per Basel II.

One suggestion to address this issue is to apply different capital standards for demand and investment deposits. Since demand deposits are guaranteed and need more protection than investment deposits, the capital requirements for these deposits should be higher that those for investment deposits. According to Hassan and Chowdhury (2010), the demand deposits should be kept in the banking book and the investment deposits in the trading book, or the investment deposits should be pooled into securities with different capital requirements. This would, ultimately, enhance the transparency and address several issues with regard to the nature and practice of Islamic banks.

Similarly, on the asset side of the balance sheet, Islamic banks have at their disposal a number of modes of financing that differ to a great extent to those available to conventional banks. The financing and investments of Islamic banks, therefore, can be structured based on profit and loss sharing, equity, sales, and/or lease-based contracts—with each one having different risk exposures.

Besides credit risk, market risk, and operational risk, which are covered by the Basel II framework, Islamic banks are faced with other risks such as price risk, rate of return risk, fiduciary risk, and displaced commercial risk. In order for us to determine a proper CAR for Islamic banks, we need to adequately measure these risks as well. In other words, CAR has to be adjusted to accommodate the different risk profiles of Islamic banks.

Under the Basel I accord, the individual risk weights depend on the category of the borrower—whether it is sovereign, bank, or corporate. On the other hand, when Basel II is applied, these weights are refined based on a rating provided by an external rating agency. Now the issue arises of when we are to apply these standards to Islamic banks, as they differ from conventional counterparts. Furthermore, the rating agencies themselves need to be familiar with principles of Islamic finance in order to make an accurate rating of Islamic financial institutions. Inaccurate ratings would lead to wrong impressions about Islamic banks in general.

One of the critical issues with regard to the risk management of Islamic banks is how to measure and manage the risk characteristics of profit-sharing investment accounts, which constitute one of the sources of funding of Islamic

MAKING IT HAPPEN

The current global financial system is in need of an overall restructuring. Islamic finance differs from conventional finance both in substance and form. Although the Basel II Accord improved a great deal on Basel I, it does not cater for the unique characteristics of the Islamic financial system. Not only that, but the global financial crisis revealed that Basel II also failed to devise the good market practice and discipline that was its initial objective. Therefore, many suggest that we need to come up with Basel III to enhance further the principles elaborated in Basel II.

Islamic finance, which showed great resilience to the global financial meltdown and is a viable alternative, should play a greater role in coming up with a new Basel Accord that will address the issues highlighted in this article. In this regard, AAOIFI and IFSB could assist the Bank for International Settlements in drafting the future accord. This will be beneficial not only to the Islamic financial industry, but also to the conventional one, as it can learn some lessons from Islamic finance.

banks. Here, displaced commercial risk is introduced, i.e. the extent of credit and market risk is shifted to banks instead of being borne by the investment account holders.

Apart from the issues highlighted above, regional differences play another role in trying to set up a standard approach to CAR for Islamic banks. Not only do Islamic banks operate under different regulatory regimes, but they are also faced with different views on many Islamic financial products. In other words, there is a disagreement among *shariah* scholars on what is and what is not *shariah*-compliant. This makes the job of regulatory agencies harder when trying to evaluate the performance of Islamic banks and *shariah*-compliance risk.

CONCLUSION

The Islamic financial system differs to a great extent from the conventional one. As discussed, the deposits placed in Islamic banks are exposed to risks that are not faced by those in conventional banks. At the same time, the assets of Islamic banks are utilized in a different way from the assets of conventional banks. Depending on the role that an Islamic bank assumes, the risks faced by that bank will differ. As a result, due to these structural differences between Islamic and conventional banks, the risk weights set by Basel II need to be amended in order to take these differences into account.

The AAOIFI's recommendations address only the liabilities side of the balance sheet, and as such do not offer comprehensive guidelines for calculating CAR for Islamic banks. Nevertheless, these recommendations, combined with the IFSB's guidelines, are a very good starting point for Islamic banks.

The special nature of investment accounts and the different types of risk faced by Islamic banks make the implementation of Basel II a difficult task. However, amending these standards to accommodate the nature of Islamic financial systems would bring credibility and soundness to the Islamic finance industry and foster its future growth worldwide.

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The International Role of Islamic Finance

by Andreas Jobst

EXECUTIVE SUMMARY

- Islamic finance has become mainstream, with more than US$800 billion of assets worldwide. However, it still faces distinct developmental challenges from economic and legal constraints associated with *sukuk*, banking-specific issues, and fragmented financial regulation.
- Although Islamic capital markets and banking have defied the impact of the financial crisis, some negative effects were felt in 2008 and are likely to inhibit further expansion.
- Despite current challenges, most of which arise from the infancy of the industry, Islamic finance has promising long-term prospects.

INTRODUCTION

Since the summer of 2007 the global financial system has undergone a period of dramatic turbulence, which has caused a widespread reassessment of risk in both developed and emerging economies and the price it should command across different asset classes. After a rather painful reckoning, policymakers and regulators are hastening a redesign of the financial sector architecture afflicted by the demise of self-regulation and a failure of market efficiency. As the global credit crisis continues to deepen, with investment banks and finance houses worldwide still reeling from the collapse of the US subprime mortgage market and the breakdown of the wholesale money markets, soul-searching in conventional finance has directed attention to alternative modes of finance. In this context new investors, unsettled by excessive risk-taking and asset price volatility, are turning to Islamic finance as market ruptures caused by the headlong flight to safety during the initial phase of the credit crisis seem to be receding only slowly.

Although Islamic finance did not entirely escape the implications of persistent counterparty risk concerns and deep-seated investor distrust of credit-sensitive assets, it managed to harness the current market adversity as a result of greater focus on collateralization, the contempt for excessive leverage, and the near absence of "distressed legacy assets," such as mortgage-backed securities. Islamic finance is driven by the general precept of extending religious doctrine in the *shariah* to financial agreements and transactions. Islamic finance is distinct from conventional finance insofar as it substitutes the (temporary) use of assets (or services) by the borrower for a permanent transfer of funds from the lender as a source of indebtedness. Predatory lending, empty short-selling, and a series of incentive problems between originators, arrangers, and sponsors, of which all have infested the conventional capital markets, go against fundamental Islamic principles which ensure that contractual certainty and a mutually beneficial balance are maintained between borrowers and lenders (Wilson, 2008).[1]

Until the onset of the credit crisis at the end of 2007, the Islamic finance industry was in an expansionary phase, exhibiting average annual growth rates of about 15% in recent years. This rapid growth has been fueled by surging demand for *shariah*-compliant products not only from Muslim financiers, but also by investors around the world. Besides its wide geographical scope, the rapid expansion of Islamic finance is also taking place across the whole spectrum of financial activities, ranging from retail banking to insurance and capital market investments. There is currently more than US$800 billion worth of deposits and investments lodged in Islamic banks, mutual funds, insurance schemes (known as *takaful*), and Islamic branches of conventional banks.

The rapid evolution of Islamic finance points to the considerable profit opportunities, which have prompted a vetting process among a number of jurisdictions around the world to establish themselves as leading Islamic financial centers. In this regard, the case of London is perhaps the most remarkable insofar as it has managed to extend its leading position in world financial markets to become a center for Islamic finance. Similarly, Hong Kong, New York, and Singapore are making important advances to accommodate Islamic finance within their jurisdictions, and they aspire to join the ranks of the more established Islamic centers such as Bahrain, Dubai, and Kuala Lumpur. These developments underscore the fact that Islamic finance has established itself as a permanent element of the

global financial landscape. Nevertheless, despite the recent advances, important challenges lie ahead.

Against this background, the present article first reviews the current situation of Islamic finance before discussing some of the challenges going forward. For expository purposes, the article follows a two-pronged approach in considering these challenges through a discussion of key banking issues and then selected capital market issues.

ISLAMIC BANKING

As mentioned above, Islamic banks have increased their presence in conventional financial systems. Typically, this process has taken place in two ways: either conventional banks have increasingly tested the waters of *shariah*-compliant banking activities by opening an Islamic "window," and/or they have offered specific Islamic financial products, or fully fledged Islamic banks have been licensed as such.

One of the first concerns that arise as Islamic banking emerges within a conventional system is how to embed Islamic activities into the existing juridical and supervisory frameworks. To think about this issue, it is useful to adopt a two-tier perspective and address, first, the *legal* aspects of Islamic contracts, and, second, the *regulatory* aspects of Islamic financial transactions.

In other words, on the one hand there is the legal question of whether the existing laws in a secular jurisdiction allow financial transactions to be governed by *shariah* principles. On the other hand, there is the regulatory question of whether Islamic institutions require the same intensity and kind of prudential supervision as conventional institutions.

First, regarding the place of Islamic contractual arrangements within secular jurisdictions, it is likely that the existing legislation in conventional jurisdictions does not include all the *shariah* principles that should govern Islamic financial transactions. However, as DeLorenzo and McMillen (2007) point out, in most of the jurisdictions with modern legal systems the legal set-up is typically flexible enough to allow the parties involved to write their own contracts. Thus, in these contracts, the signing parties could explicitly specify the desired principles by which their transactions should be governed. By doing this, both parties would ensure that the principles to which they wish to adhere would be upheld in the jurisdiction where the contract is enforced.

Second, a key aspect is whether Islamic institutions require levels of supervision similar to those applied to conventional institutions. In this regard, a somewhat common misunderstanding is that, since Islamic banking is largely based on profit and loss sharing agreements, Islamic institutions do not need to be supervised at the same level as conventional banks. In fact, as pointed out by Errico and Farrahbaksh (1998), El-Hawary *et al.* (2004), and Solé (2007), there are certain features of Islamic banks that warrant a similar degree of prudential regulation as traditional banks. These considerations include moral hazard considerations, safeguarding the interests of demand depositors, and systemic considerations.

There are specific risks that need to be taken into account both by financial institutions and regulators to foster an environment where Islamic banking can offer a suitable response to investors' and depositors' demands for Islamic products (Bhambra, 2007; Sundararajan, 2007). Recognizing the need for guidance on these issues, in 2002 a number of central banks and national monetary authorities of Islamic countries inaugurated the Islamic Financial Services Board (IFSB) in Malaysia as an international standard-setting body. The IFSB's mandate is to ensure the stability and soundness of the Islamic financial services industry by developing new, or adapting existing, international finance standards consistent with *shariah* principles, and by harmonizing industry practices. In fact, parallel to the revision of the Basel Capital Accord in 2005, the IFSB issued regulatory standards on capital adequacy and risk management for Islamic institutions (IFSB, 2005a, b). It has also issued additional standards in other important areas, such as corporate governance and the supervisory review, and most recently on capital adequacy of *sukuk*.

ISLAMIC CAPITAL MARKETS

Amid a growing demand for alternative investments, there has been a surge in recent years in the issuance of Islamic capital market securities by corporates and public sector entities, owing in large part to enabling capital market regulations, a favorable macroeconomic environment, and financial innovation aimed at establishing *shariah* compliance. In some cases, governments have taken a greater role in shaping the growth prospects of the fledgling Islamic capital market (which is largely sponsored by banks). Asset securitization plays a special role in this regard.

Although the concepts of asset-backing and absolute transfer of ownership are inherent to Islamic finance, very few structured credit transactions have been executed following the precepts of the *shariah*. Islamic securitization

transforms *bilateral risk sharing* between borrowers and lenders in Islamic finance into *market-based refinancing*. Although the religious prohibition of the exchange of debt and the required conferral of ownership interest to participate in business risk still pose challenges to the development of Islamic securitization, the gradual acceptance of Islamic investment certificates, so-called *sukuk* bonds, in particular represents a successful attempt to overcome these impediments (Oakley *et al.*, 2008; Jobst, 2007a, b).

Since conventional securitization is virtually absent in Islamic countries, considerable demand for *shariah*-compliant investment assets, such as *sukuk*, has provided an untapped market for structured finance as a means to advance capital market development. While *sukuk* are structured in a similar way to conventional asset-backed securities or covered bonds, they can have significantly different underlying structures and provisions. *Sukuk* commoditize capital gains from bilateral risk-sharing between borrowers and lenders in *shariah*-compliant finance contracts—such as lending transactions (installment sale) or trust-based investments in existing or future assets—into marketable securities.

Before the financial crisis, the *sukuk* market soared in response to surging demand for *shariah*-compliant products. Gross issuance rose from US$7.2 billion in 2004 to close to US$39 billion by the end of 2007 (Moody's Investors Service, 2008). At the end of 2007, the outstanding volume of *sukuk* globally exceeded US$90 billion. However, in 2008, *sukuk* volumes declined sharply to US$17.2 billion (about 50%) as a result of challenging market conditions, liquidity constraints, and the presentation of new rules on the *shariah* compliance of *sukuk* (Jobst *et al.*, 2008). In particular, the less supportive economic environment in the Gulf Corporation Council (GCC) countries, and the regional real estate sector troubled by the slowdown of global trade and foreign direct investment have contributed to this development. Even countries that have been driving forces in the *sukuk* market in recent years witnessed sizable declines. Amid a gradual normalization of credit conditions in early 2009, incipient demand helped to stabilize the primary market for *sukuk*. During the first seven months of 2009 new issuance exceeded US$9 billion, compared with US$11.1 billion during the same period in 2008 (Damak *et al.*, 2009).

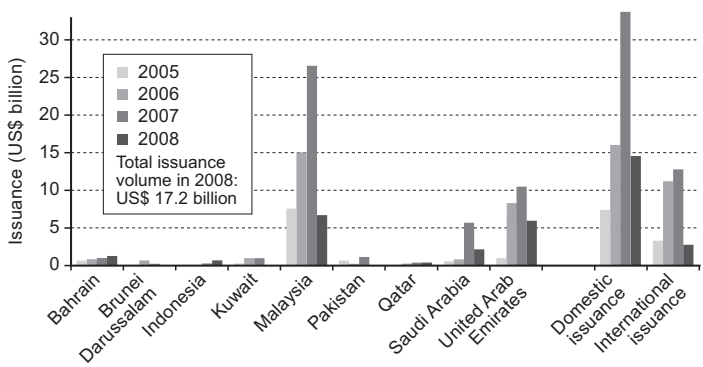
In spite of having been hemmed in by the credit crisis, the *sukuk* market is expected to gain momentum again over the medium term, with an estimated US$50 billion worth of planned transactions in the pipeline. With more than US$2 trillion of credit demand projected to be unmet in the next three years as the conventional private-label securitization market remains dysfunctional, the current market situation provides a window of opportunity for *sukuk*. Given the ongoing efforts to resolve the major difficulties impeding market development, *sukuk* is likely to register ever more as an alternative and diversified funding option that broadens the pricing spectrum and asset supply.

GENERAL CHALLENGES

What are the current challenges for Islamic finance and its continued above-average growth rates in the different regions, and across banks and products?

Recent regulatory changes concerning the structure of *sukuk* warrant careful consideration and might mute some of the recent enthusiasm

Figure 1. Global issuance of *sukuk*, 2005–08. (*Source*: IFIS, Bloomberg, Dealogic, Datastream)



for Islamic capital market products. In February 2008, the *shariah* committee of the Accounting and Auditing Organization of Islamic Finance Institutions (AAOIFI) issued new recommendations regarding the role of asset ownership, investment guarantees, and the *shariah* advisory and approval process in *sukuk* origination and trading. Most *sukuk* issued in the GCC have explicit repurchase agreements that guarantee the repayment of principal but violate the profit and loss sharing features of *shariah* law. Discussions are currently underway between the various stakeholders and some market participants to gauge the potential of these recommendations to cause permanent damage to the *sukuk* market.

The liquidity risk management of Islamic banks is an important challenge and is constrained due to the limited availability of tradable Islamic money market instruments and weak systemic liquidity infrastructure. At the moment, there is no *shariah*-compliant short-term Islamic money market (of less than one-week maturity) in local currency or in US dollars, and Islamic repo markets (for funding liquidity) have not yet developed. Islamic money markets with longer maturities sometimes suffer from an unreliable clearing and settlement process. Islamic banks also have a competitive disadvantage compared to conventional banks, as they deposit their overnight money with their domestic central bank at no interest.

The future development of Islamic capital markets could be arrested by insufficient supervisory and legal harmonization across national boundaries and the ongoing controversy about financial innovation. Governance issues, especially the *shariah* compliance of products and activities, constitute a major challenge for the Islamic finance industry. Although *shariah* rulings (*fatwas*) by legal scholars are disclosed, there are currently no unified principles on the basis of which *shariah* scholars decide on the *shariah* compliance of new products and subsequently convey their assessment. These rulings are not consolidated, which inhibits the dissemination, adoption, and cross-fertilization of jurisprudence across different countries and schools of thought. As a result, there is still considerable diversity and inconsistency in corporate governance principles and opinions of *shariah* boards.

The heterogeneity of scholastic opinion about *shariah* compliance and disparity among national supervisors continue to undermine the creation of a consistent regulatory framework. That said, recent standard-setting efforts have addressed the legal uncertainty imposed by Islamic jurisprudence and the poorly developed uniformity of market practices. Leading international organizations in Islamic finance, such as AAOIFI, have been working on aligning *shariah* principles on a consistent basis. In this regard, a fine balance is required between collective initiatives and regulatory revisions to ensure that standardization is achieved without staving off financial innovation. Also, efforts to achieve regulatory consolidation and standard setting are underway. The AAOIFI and the IFSB have moved ahead with their standardization efforts in relation to the Islamic financial services industry.

CONCLUSION

This adversity of current economic conditions is likely also to prolong the recovery of Islamic finance. As policymakers in mature markets enter the uncharted territory of dealing with troubled banks, restoring confidence in financial markets, and restarting economic growth, heightened risk-aversion and depressed asset prices portend a further contraction of credit in the near future. Islamic finance is not insulated from these fundamental developments in conventional finance. For Islamic banks in particular, the absence of government guarantees (which would violate the basic tenets of *shariah* law), and the cannibalization of term markets by an avalanche of sovereign debt, might exacerbate long-term funding pressures to overcome chronic maturity mismatches while slowing the rebuilding of their capital base and raising the risk of displaced commercial interest for depositors.

Many challenges still lie ahead, but the banks' search for profitable opportunities and the ensuing financial innovation process, in tandem with favorable regulatory developments at the domestic and international levels, will ensure that the Islamic finance industry continues to develop at a steady pace in the long run. For instance, the development of Islamic derivatives bodes well for the Islamic insurance (*takaful*) industry, whose *shariah* compliance has traditionally resulted in overdependence on equity and real-estate investment, restricting the potential of risk diversification from a wider spectrum of available assets. From a more strategic perspective, financial institutions in countries such as Bahrain, Qatar, the United Arab Emirates, and Malaysia continue to register considerable demand for *shariah*-compliant investments and structured finance on both the asset and liability sides. The jury is still out on how strongly Islamic finance will be affected by the repercussions of the global financial crisis.

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NOTE

1 Any financial transaction under Islamic law implies *direct participation in asset performance* ("asset layer") and assigns to financiers clearly identifiable rights and obligations for which they are entitled to receive a commensurate return in the form of state-contingent payments. *Shariah* law prohibits the sale and purchase of debt contracts with the aim of obtaining an interest gain (*riba*) or profit-taking without real economic activity and asset transfer, as well as legal uncertainty surrounding the enforceability of contractual claims.

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Investment Risk in Islamic Finance by Kamal Abdelkarim Hassan and Hassan Ahmed Yusuf

EXECUTIVE SUMMARY
- The unique risks within the Islamic finance investment space are described, along with the challenges faced in developing procedures and processes to address those risks.
- The categories of *shariah* risk, and the means available to mitigate this risk, are considered.
- Investment opportunities are limited due to the restricted nature of the Islamic investment universe.

INTRODUCTION

At the inception of Islamic finance, Islamic economists advocated change and developed a policy for Islamic banking practice and process, arguing that the main aspect of conventional banking—*riba* (interest)—required immediate rectification if Islamic banking was to exist. To achieve this goal, profit and loss sharing methods were introduced, along with other products such as *ijarah* (lease) and *murabahah* (cost plus). The rest of the technical banking operational procedure remained almost the same, especially in areas where there was no immediate solution, such as the application of the London Interbank Offered Rate (LIBOR) as a benchmark. This was based on the Islamic maxim *al daruuriyaatu tubihu al mahdurat* (necessity permits the unlawful). Likewise, the application of risk management within Islamic finance is not completely different from its conventional counterpart. Similarly, both Islamic and conventional financing apply the same methodology and technique in regard to risk management. It is essential to note that there are elements of risk, such as *shariah* risk, associated with Islamic finance that do not exist in its conventional counterpart due to the nature of Islamic finance and investment. As such, the challenge for the *shariah*-compliant investment and finance industry is to have procedures and processes in place to deal with risks unique to Islamic finance instruments. Based on the above, we discuss below types of Islamic investment risks unique in Islamic finance, as shown in Table 1.

UNIQUE RISKS IN ISLAMIC FINANCE

There is no the doubt that the recent financial crisis and the rapid development of financial innovation and engineering of Islamic investment instruments necessitate the need for risk management, control, and vigilant supervision. Islamic finance investment is different from its conventional counterpart because it is required to comply with *shariah* rules and guidance or it could lose its legitimacy, thereby constituting a *shariah* risk. *Shariah* risk has a deeper, more profound meaning than its current use in the Islamic finance literature, and its scope is changing relative to the pace of Islamic finance development.[1]

SHARIAH RISK AND ITS CATEGORIES

Shariah risk can occur in different stages in Islamic investment. It has subcategories and the

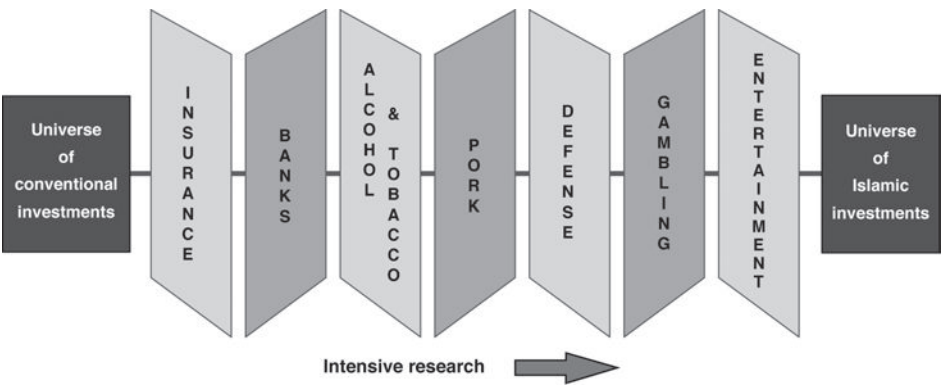
Table 1. Risks specific to Islamic investment

Shariah risk	Risk associated with not implementing Islamic investment and finance products in accordance with *shariah* principles.
Asset concentration	Investing, financing, or drawing earnings and income in a single market or a single asset class.
Default risk	Risk that a counterparty fails to meet its financial obligations as they fall due.
Rate of return risk	Risk of fluctuations in earnings where expected income targets may not be achieved due to market conditions as Islamic finance and investment concentrates more on equity.
Transparency risk	Risk of not disclosing information necessary for users in regard to financial data, risk management, business conditions, and other necessary information.
Equity investment risk	Risk associated with holding equity investment during unfavorable situations, where decline in investment caused by market conditions in turn gives volatility of earnings of *musharakah* and *mudarabah* investments. (This definition needs more clarity as it appears to include rate of return risk as well.)

impact of each category is different. To understand this better, *shariah* risk can be categorized as follows.

Category 1 relates to the minimum requirements for an investment to be deemed *shariah*-compliant and forms important distinctions between conventional and Islamic investment. Those features that are to be avoided are interest, gambling, and uncertainty. All Islamic investments should be free from dealings with interest, gambling, and excessive uncertainty. Additionally, *shariah* compliance requires abstention from investing in industries where the core business is considered illicit in Islam, such as alcohol, pork, cinemas, gambling industries, and items that are regarded as prohibited in *shariah* (Figure 1).

Figure 1. The investment selection process



Failure to comply with the minimum parameters in the first category of *shariah* risk with respect to any potential Islamic investment could have a huge impact, possibly resulting in the dissolution of the invested entity, and could cause huge reputational risk. Hence, the important responsibility of the *shariah* board to check and ensure the details of the investment and declare it legitimate before any investment commitment.

Category 2 of *shariah* risk relates to the process and implementation mechanism of finance investment products. Generally, the process starts with presentation of the financial product to the *shariah* board by the developer of the product. The product description and structure, its underlying asset securities (if any), different types of contracts, charges, fees, and other necessary details are examined by the *shariah* board. Following detailed discussions, the *shariah* board renders its advice.[2] Once the product is completed as the *shariah* board has advised, legitimacy is given and it hits the market. *Shariah* risk in this category would arise if the product failed to conform to the process approved by the *shariah* board (for instance, the procedure advised by *shariah* is sequential in order, where one step follows its predecessor, while in contrast the implementation team may feel it irrelevant that step 3 should proceed step 4).[3] This type of risk is mitigated through a *shariah* auditor or supervisor review of the process and mechanism implemented during the operational process of any product launch.

This type of risk is limited as long as *shariah* audit reviews and corrections are applied immediately. An example of this type of risk is in a *wakalah* contract offer where money is received by a *wakil* (agent) before the offer is accepted by the *muwwakil* (principal). The money cannot be invested before the acceptance of offer is signed, according to the *shariah* guidelines.

Category 3 refers to the situation where the process of a structured product presented to the *shariah* board may not be implemented as advised by the board. Here there could be some additions and/or deletions of the process by the developers which were not included in the information initially presented to the *shariah* board. Such a risk is mitigated by employing a *shariah* auditor review, or additionally making it the practice of *shariah* boards to review products after launch and during normal operations. An example of this type is a structured product approved by *shariah* but where the board has not approved part of the fees or commission received as these were not presented to the board during the initial product presentations. The impact and the risk are that the generated fees or profit not approved by the *shariah* board during that period could be canceled.

Category 4 risk is that some investments may be declared null and void by another group of scholars or a regulatory body, based on the lack of accurate product formulation or their own differing interpretation of *shariah* principles, procedures, and processes. An example of this type is *tawwaruq*,[4] as the legitimacy and the approval of the investment product was based on the *fatwa* given by the *shariah* board. Since the *fatwa* itself is in the form of *ijtihad* (the process of making a legal decision by independent interpretation of the legal sources of the scholar), there are no problems if it is right. If it is wrong, the appropriate corrections will need to be applied thereto without necessarily outlawing the product or the interpretation. This is based on the well-known principle of *fiqh* in Islamic jurisprudence (i.e. if a scholar offers a correct *fatwa*, he or she receives two rewards; if he or she gets it wrong, they get one reward only). In contrast, declaring a product illegitimate requires research and evidence, as financial transactions in Islamic investment are based on what is known. Permissibility of origin[5] and the burden of proof lie with the person asserting that the product is not permissible.

ASSET CONCENTRATION

The Islamic investment universe offers a limited choice of investment products that meet *shariah*-compliant guidelines. As a result, a primary Islamic investment vehicle for many Islamic financial institutions tends to be real estate. This type of concentration leads to risky circumstances, particularly in unfavorable market conditions as we have seen in the subprime mortgage crisis of 2008. Unsurprisingly, within the Gulf Cooperation Council (GCC), banks reached the ceiling investment limit of real estate portfolio. Such a situation clearly highlights asset concentration due to the limited choice of Islamic investment products. Currently, Islamic investment is moving toward more mature levels, and therefore is in dire need of product innovation. The impact of this type of risk could be enormous if there is a sudden change of microeconomic conditions. There are defined guidelines for addressing this risk concentration and controls that can reduce exposure to risk if properly applied and managed.

DEFAULT RISK

Default risk is when a counterparty fails to pay its investment or finance obligation. This is also classified as credit risk in conventional terminology. Similar mitigating frameworks applied in conventional finance may be applied within Islamic investment and finance. Nevertheless, within the conventional investment system, the procedure for granting credit facilities includes background checks and credit history of the past performance of applicants that is facilitated by maintaining good quality data (credit agencies). Within Islamic investment and finance, trust by way of name-lending supersedes conventional credit examination—particularly in the GCC, where a developed credit bureau does not exist. The significant downside of name-lending has long been established (for example, investments without collateral). Risk of default may be higher and, even in the face of existing genuine collateral, issues may arise in determining the real market value when required, and any liquidation of assets could entail a lengthy legal process.

RATE OF RETURN RISK

Islamic investments face rate of return risk due to the fluctuations in microeconomic conditions. Islamic investment could experience greater fluctuations and volatility in rate of return risk due to limited product choices and prefixed income, which are absent in conventional investment. Furthermore, asset classes within Islamic investment are not easily converted to cash and may be subject to commodity price risk, as some of these assets do not have ready or deep secondary markets (*sukuk*—Islamic bonds) and, as such, must be held until maturity.

OTHER RISKS

Investment in Islamic finance faces equity investment risk, largely due to the application of both *mudarabah* and *musharakah* investments. Likewise, there are other risk elements that are interrelated in Islamic investments. For instance, the lack of a wide range of *shariah*-compliant products to absorb the liquidity of Islamic investments could result in an opportunity loss for the investment. Islamic investment products are few considering the amount of available funds available for Islamic investment. This results in a low return on investment as it is invested in short-term products and thus creates mismatch problems, since Islamic investments are in long-term opportunities such as project finance, real estate, and *sukuk*. Furthermore, the lack of tradable instruments in secondary markets could also play a role.

The scope of transparency risk in Islamic investment is not confined to lack of reliability, nondisclosure, and inadequate information, but can also include the process of the approval of products in case of dispute, as we have seen in recent court cases. It also includes the stock

selection process and details and strategies for stringent risk management process employed to safeguard the interests of all parties—shareholders and depositors alike.

RISK IMPACT OF ISLAMIC FINANCE

The subprime mortgage and subsequent financial crisis in 2008 were blamed on the lack of risk management and the complete ignoring of signs of risk by senior management within financial institutions. Nevertheless, recent cases in the Islamic finance sector highlight that lapses in risk management could have detrimental results on the stability of Islamic finance institutions and damage the reputation of the industry.

The troubled Bahrain-based Gulf Finance House (GFH), once the darling of Islamic finance in the Kingdom, suffered from severe lapses in risk management.[6] Within GFH there was an absence of real diversification. In 2008 and 2009, 78.5% and 83.4% respectively of GFH's assets were concentrated in Gulf countries and were primarily real estate in nature. Furthermore, the fact that the business and earnings of GFH were directly linked to a single asset class (real estate) was a recipe for disaster. One could also argue that the presence of *shariah* risk, evident in methods of implementing *murabahah* transactions within GFH, was not complete given that the basic conditions to disclose price and markup were violated. Likewise, in the case of Dato' Haji Nik Mahmud bin Daud vs Bank Islam Malaysia,[7] *shariah* risk occurred due to the nontransferrence of ownership. This also violated the *shariah* requirement that a seller must own the title of the asset. In the Symphony Gems case,[8] the *murabahah* contract was not a valid *murabahah* contract according to the testimony of Dr Al-Samaan. In a recent case involving the Investment Dar Company (TID) vs Blom Development Bank,[9] TID's legal counsel used *shariah* noncompliance of the contract as a defense—highlighting the significance of *shariah* risk.

MAKING IT HAPPEN

- The risks faced by Islamic investments, such as *shariah* risk and equity investment risk, are unique due to the nature of such investments. Inadequate and insufficient observation of *shariah* investment guidelines could cause a risk that results in the dissolution of the investment and leads to loss of confidence, trust, and reputation of the institution. Consequently, there is a lack of development in the Islamic risk management framework that would enable it to identify, assess, and measure the risks unique to Islamic investment. Even the analysis and structure of presentation of *shariah* risk are borrowed from conventional risk management.
- There is a dire need to have a complete and comprehensive *shariah* risk management framework for Islamic finance that can capture the current process of the Islamic finance structure. Other risks faced by Islamic investment, such as rate of return, credit risk, asset concentration, commodity risk, and market volatility, can have a huge impact if not managed properly. Contained within the *shariah* principles are adequate measures that provide effective safeguards for Islamic investment.
- However, there remains a need for *shariah* to show adaptability in the face of phenomenal growth, the sophistication of product innovation, and financial engineering. This should hasten changes and the development of a suitable risk management framework that is compatible with the *maqasid al-shariah (*objectives of *shariah*).

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NOTES

1 The scope of *shariah* risk currently applied is often limited to financial transactions, but, given that *shariah* compliance is the distinctive characteristic of Islamic finance, a much broader application of this unique risk is required. As *shariah* should encompass all of an Islamic financial institution's activities, from transactional contracts to staff and vendor contracts, a broader approach to *shariah* risk is required.

2 This is one of the processes for obtaining approval of Islamic finance and investment products from the *shariah* board. Different banks have different processes for obtaining product approval from the *shariah* board. Sometimes a *shariah* compliance officer may make the presentation to the *shariah* board.

3 There was a case in a Gulf bank where written acceptance of an offer was received after the profit of that period was realized, and the *shariah* board canceled the profit from that period.

4 *Tawwaruq* is a controversial product among scholars. Recently a Gulf central bank issued written advice on the use of *tawwaruq* products, the permissible percentages of these relative to other products, and even advising that *tawwaruq* should not be used on credit cards.

5 Under *shariah* law, legality and illegality are based on either prohibition or permissibility. For example, all forms of worship are illegitimate except those allowed by *shariah*. This means that no one can use any form of worship unless that form is permitted by *shariah*. This is unlike the situation with food, where all kinds are permissible except what has been prohibited. That is why, when *shariah* considers items of food, it starts with prohibitions, as permissibility is the basis in matters of food. Similarly, financial transactions are based on permissibility. The outcome is that if the usage of something is based on permissibility, the burden of proof is on the party rejecting such permissibility, and if it is based on prohibition, the burden of proof is on the party permitting such actions.

6 Khnifer *et al*. (2010).

7 Saiful (2008).

8 Moghul and Ahmed (2003).

9 Investment Dar Company vs Blom Development Bank case.

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Middle East and North Africa Region: Financial Sector and Integration by Samy Ben Naceur and Chiraz Labidi

EXECUTIVE SUMMARY

- With a population of 345.5 million and a GDP of about US$1,593 billion in 2007, the Middle East and North Africa (MENA) region has great potential, but faces major challenges.
- By reforming their economies, most of the MENA countries have achieved macroeconomic stability and increased their growth.
- A more developed and well-functioning financial sector is essential to boosting sustainable economic growth in the region.
- Given the existing complementarities between MENA countries, there are numerous possibilities for intraregional integration. Financial integration within the region will also help deepen financial markets, and increase their efficiency.

INTRODUCTION

The Middle East and North Africa region, as defined by the World Bank in the MENA 2008 Economic Developments and Prospects (EDP) report,[1] comprises Algeria, Bahrain, Djibouti, Egypt, Iran, Iraq, Jordan, Kuwait, Lebanon, Libya, Morocco, Oman, the Palestinian Territories (West Bank and Gaza), Qatar, Saudi Arabia, Syria, Tunisia, the United Arab Emirates, and Yemen.

The World Bank classifies these countries into three groups: resource-poor, labor-abundant economies (Djibouti, Egypt, Jordan, Lebanon, Morocco, Tunisia, and the West Bank and Gaza); resource-rich, labor-abundant economies (Algeria, Iran, Iraq, Syria, and Yemen); and resource-rich, labor-importing economies (Bahrain, Kuwait, Libya, Oman, Qatar, Saudi Arabia and the United Arab Emirates).

In 2007, these 19 countries and territories represented about 5% (345.5 million) of the world's population. The region's GDP was approximately US$1,593 billion (at current exchange rates), or about 3% of world GDP.

The Gulf Cooperation Council (GCC) countries—Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates—account for less than 11% of the population of MENA countries but for some 49% of the region's GDP and around 80% of the area's stock-market capitalization.[2] The GCC region's wealth is, in large part, a product of its petroleum resources.

In 2007, the MENA region experienced GDP growth of 5.7% (see Table 1), and five years of growth at a rate higher than 5%. This performance occurred in the context of a continued rise in the oil price in recent years having important spillover effects on the financial and real-estate sectors, as well as on job creation. It has also brought more interest in intraregional integration as a means of sharing prosperity within the region, and as a catalyst for global integration and competitiveness.

However, the increased interests of MENA banks and investors in the volatile equity and real-estate markets have made some economies more vulnerable to contagion effects. During 2008, the recession in developed economies, and the slowdown in emerging markets affected some MENA countries. More precisely, the region, and especially GCC countries, experienced reduced financial liquidity and a sharp drop in share values.

Table 1. Real GDP growth (US$ '000s). (*Source*: World Bank)

	2000–04	*2005*	*2006*	*2007*
MENA region	4.6	5.8	5.8	5.7
Resource-poor, labor-abundant*	4.2	3.7	6.3	5.4
Resource-rich, labor-abundant†	5.1	6.5	5.7	5.8
Resource-rich, labor-importing‡	5.1	7.3	6.2	5.8

* Djibouti, Egypt, Jordan, Lebanon, Morocco, and Tunisia (the West Bank and Gaza are excluded because of data limitations).
† Algeria, Iran, Iraq, Syria, and Yemen.
‡ Bahrain, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

FINANCIAL SECTOR

A well-developed and dynamic financial sector is essential to achieve sustainable economic growth. Many attempts have been made in the last decade to improve the performance and efficiency of the MENA financial sector. However, there is still a wide gap by comparison to other developed and emerging regions. Although MENA countries present different levels of the financial sector's development, some broad generalizations can be made. Overall, the banking sector dominates MENA's financial system, and stock and bond markets remain a minor alternative option for raising funds.

Banking Sector

Banks dominate MENA's financial systems, and, over the past years, the exceptional increases in liquidity stemming from oil revenues have fed a rapid rise in bank deposits and a growing demand for credit from the real economy. The credit growth has supported real-estate loans and mortgage lending. This has been complemented by housing finance reform efforts throughout the region. Particularly in the Gulf economies, the banking sector has increased credit and relaxed financing terms to the real-estate sector.

The MENA financial sector is also experiencing prodigious growth in the Islamic banking sector (15–20% over the past decade), which is based on the principles of Islamic law (also known as *shariah* law). Two basic principles behind Islamic banking are the prohibition of the collection and payment of interest (known as *riba*), and the prohibition of profit-sharing or leasing without underlying tangible assets. These principles contribute to make lending more prudent and linked to real economic activity, and explain the resiliency of the sector to the credit crunch crisis.

However, according to the MENA 2008 EDP report, "These positive developments are overshadowed by a number of factors. The financial sector in MENA is still dominated by commercial banks that are vulnerable to shocks from the equity and the real markets. A disconnect between the financial sector and the real economy is still observed, public sector ownership is high, and access to banking services is low." Indeed, heavy public-sector ownership, as well as limited openness in some countries, had a significant impact on the direction of credit in MENA, as well as on operating efficiency and the ability of the banking sector to conduct robust risk analysis.

Capital Markets

The MENA capital markets are generally perceived as less developed than other emerging markets.

The privatization process launched during the 1990s has been slow, and has not reached its promise with regard to capital markets development. There are many reasons for the markedly slow privatization in the region, and its consequences in terms of capital markets underdevelopment. In some cases, there is evidence of a lack of political will, and some pressure by interest groups. More generally, the considerable involvement of governments in economic activities and related overstaffing, as well as the slow pace of job creation in the private sector, represent barriers to a rapid privatization process.

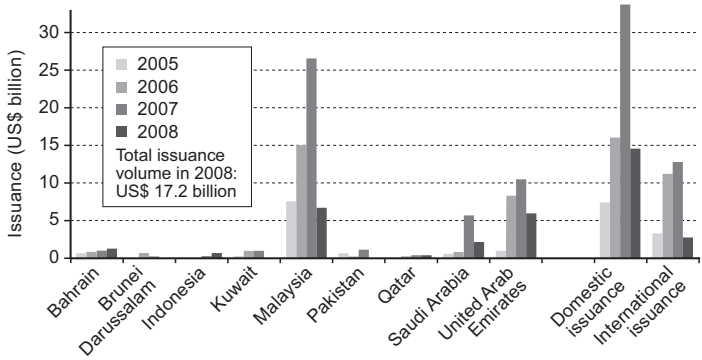
However, following continuous liberalization efforts and improvements to the underlying legal framework, some MENA stock markets have been successfully revitalized during the last few years. As shown in Table 2, market development indicators such as market capitalization, value traded, and number of listed firms have significantly increased. GCC capital markets can be considered as the most developed, and they account for about 73% of the region's stock-market capitalization (see Figure 1), but for only 40% of the total number of listed companies. There are also bond markets in almost all MENA countries, but they have not yet reached a sufficient level of development due to low governmental and institutional investors' participation, and to the relative scarcity of large private corporations able to issue debt.

Overall, a key challenge for capital markets in the MENA countries is to channel available liquidity into the real economy, boosting sustainable and efficient growth. However, academic research shows that stock-market informational efficiency (in the sense defined by Eugene Fama) is essential to achieve this goal. Lagoarde-Segot

Table 2. Stock market indicators. (*Source*: World Bank and Arab Monetary Fund (AMF))

Indicator	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*
Market capitalization (US$ millions)	361,078	620,364	1,287,696	883,497	1,333,620	765,784
Value traded (US$ millions)	230,417	568,158	1,434,908	1,684,029	1,107,177	997,331
Number of listed firms	1,723	1,549	1,616	1,571	1,498	1,503

Figure 1. Relative market capitalization (2008). (*Source*: AMF)



and Lucey (2008)[3] investigated informational efficiency in a set of seven MENA stock markets, excluding GCC countries, while other studies focused on the GCC stock markets. (See, for example, Abraham *et al.* (2002),[4] Al Loughani (2003),[5] and Al Saad and Moosa (2005).[6]) Most of these studies found evidence of a significant departure from the efficient market hypothesis. After constructing an efficiency index, Lagoarde-Segot and Lucey highlighted heterogeneous levels of efficiency in the MENA stock markets. Their results indicate that informational efficiency in the MENA markets is primarily affected by market depth, and corporate governance factors.

Indeed, in most MENA countries, stock markets are characterized by the concentration of ownership and the limited role of market forces. These aspects, among others, have a negative impact on transparency and disclosure standards, in particular, and on corporate governance practices in general. Recent surveys[7] show evidence of a corporate governance gap in the MENA region, if the benchmark of the Organisation for Economic Co-operation and Development's (OECD) corporate governance principles and practice in developed countries are considered. Despite the fact that the corporate governance framework is already in place, there is still room for improvement with respect to transparency, disclosure, protection of noncontrolling shareholders, directors' independence, qualifications, and compensation. The challenges that the region is still facing regarding legal and regulatory frameworks, and in the property rights area, can also be considered as barriers to proper corporate governance.

FINANCIAL INTEGRATION

The MENA countries share geographical, cultural, and economic similarities and, at the same time, present complementarities providing a favorable context for intraregional financial integration. Some countries in the region export capital, while others are capital importers. Some countries have small populations, are major oil exporters, and typically import labor, whereas others have large populations and face unemployment issues.

Moreover, the wealthiest countries had traditionally invested their surpluses in the major international financial centers, and are now seeking to diversify their investments by placing an increased share of their funds in the region. As a consequence, intraregional foreign direct investments (FDI) and portfolio investments have risen in many MENA countries. In particular, between 2002 and 2006, about US$60 billion, or 11% of total GCC capital outflows, went to other MENA countries.[8]

Direct foreign investment flows have been boosted by the improved business climate in some MENA countries, and many GCC investors, operating in several sectors (telecommunications, real estate, tourism, banking), are targeting countries such as Egypt, Lebanon, Syria, and Tunisia.

As for capital market integration, the amount of funds that actually flows intraregionally depends on regulatory aspects related to stock markets and foreign investments. Investors from the GCC are showing interest in stocks of non-GCC countries. However, most countries impose barriers and restrictions on foreign investments in domestic equities, preventing deeper capital market integration (for example, Amman Stock Exchange imposes a ceiling of 50% foreign ownership for companies operating in some specific sectors, foreign investors are allowed to own a maximum of 49% of United Arab Emirates corporations, and foreign ownership in Omani companies is generally limited to 70%).

CASE STUDY

Tunisia's Stock Exchange

Overview

Tunisia's Stock Exchange (TSE) is composed of an equity market and a bond market, while there are no derivative instruments traded. The equity market consists of an Official Market, which contains 51 listed firms, and an Alternative Market, which was set up in 2007 and has one listed firm. There is also an unlisted market comprising four companies. Two-thirds of the stocks, representing 63% of the market capitalization by the end of 2007, are continuously priced.

Institutions

The TSE is managed by the Bourse des Valeurs Mobilières de Tunis (BVMT), which is owned by 24 financial intermediaries, supervised by the Conseil du Marché Financier, and for which stock and bonds transactions are deposited and cleared by the Société Tunisienne Interprofessionnelle de Compensation et de Dépôt des Valeurs Mobilières.

Markets

The TSE is dominated by retail investors, and foreign participation stood at 28% of the whole market by the end of 2007. Any foreign participation above 50% of a firm's capital needs authorization. There are two market indices. The unweighted BVMT index, created in September 1990, includes the most liquid stocks on the market with at least six months' listing. The other index is TUNINDEX, which has been published since 1998 and is weighted by market capitalization. It also covers listed firms that have at least six months of quotations. In December 2007 the TSE implemented a new electronic trading platform, which uses the same trading system as the New York Stock Exchange. New trading rules have been introduced, such as the increase in the minimum daily trading margin from 4.50% to 6.09% on the equity market.

The debt market is small compared to the equity market, as it represents fewer than 10% of market transactions in the period 2003–07. Bond issues reached US$1.2 billion in 2007, with the state accounting for 83.4% of bond issues by value in 2007. The corporate bond market is monopolized by financial institutions. Banks tend to use it to finance mortgages, and leasing companies to balance their books. New legislation allowing foreign investors to own up to 20% of government bonds from January 2007 will certainly stimulate trading in the debt market.

Challenges

The main challenge for the TSE is to increase the number of listed firms and the contribution of the capital market to finance the economy[9] from 8% in 2007 to 20% by the end of 2009. The recent reallocation of the privatization program toward the stock exchange will certainly have a strong impact on developing the TSE. Besides, the creation of the Alternative Market in 2007 is expected to boost the capital market, as 100 companies from the Tunisian Modernization Program have been identified for listing in this market. Finally, the willingness of the Maghreb countries' authorities to spur regional financial integration will be another contributor to the development of the Tunisian Stock Exchange.

MAKING IT HAPPEN

- A healthy and dynamic financial sector entails achieving sustainable and efficient economic growth in the MENA region.
- Good corporate governance is crucial for the region to achieve its challenge of becoming a global player.
- The efficiency of the banking system is one of the key aspects that the MENA countries need to face the challenges of globalization and support economic growth. A more developed capital market infrastructure should make it easier for borrowers and investors to operate.
- Economic and financial integration within the region could represent stepping stones toward the ultimate goal of development and global competitiveness.

CONCLUSION

The structural and institutional reforms undertaken by many MENA countries, as well as the oil boom, have contributed to the substantial development of the financial system in the MENA region in the last decade. Despite this progress, much remains to be done, and the region is still facing a number of issues with regard to its banking sector and capital markets. Good corporate governance practices are also essential in ensuring efficient access to financing, in attracting foreign investors, and, more generally, in promoting sustainable development. In addition, more pronounced intraregional integration should enable investors throughout the region to achieve more portfolio diversification, and improve resources allocation. Hence, deeper regional cooperation should be encouraged if MENA is to keep up in an increasingly competitive global environment.

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NOTES

1 Middle East and North Africa Region. "Economic developments and prospects: Regional integration for global competitiveness." World Bank, 2008.

2 Excluding Tehran's stock exchange capitalization.

3 Lagoarde-Segot, T., and B. M. Lucey. "Efficiency in emerging markets: Evidence from the MENA region." *International Financial Markets, Institutions and Money* 18 (2008): 94–105.

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8 Source: World Bank.

9 Three possible sources of financing are considered: bank credits, bonds, and equity.

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Managing *Shariah*-Compliant Portfolios: The Challenges, the Process, and the Opportunities by John A. Sandwick

EXECUTIVE SUMMARY

- There is US$2.5 trillion or more in managed Muslim wealth worldwide, almost none managed according to the simple rules of *shariah*. Like everyone else, Muslim savers want professional investment management, but with *shariah*-compliant investments.
- About US$30 billion total assets are managed in fewer than 100 *shariah*-compliant funds that meet professional standards and are primarily composed of money market and equity funds. This is a less than optimal universe but sufficient for Islamic wealth and asset management.
- The overall goal is to produce a business model that follows the prudent-man rules of full liquidity from a transparent asset base through defined risk and reward profiles across income, balanced, and growth strategies that are feasible using the existing universe of Islamic funds.
- Modern portfolio theory can be applied to Islamic investing to achieve the same levels of sophistication and returns as conventional allocations. There is no need to introduce exotic or illiquid securities to achieve the standard investment objectives of *shariah*-compliant investors.
- Banks and asset managers everywhere can offer *shariah*-compliant investment management now. The total potential size of the Islamic wealth management market is at least US$1 trillion, and growing.

INTRODUCTION

It is still puzzling to understand why something as straightforward as Islamic wealth and asset management has eluded the professional classes to date. At the time of writing, only one single major global money center bank, and paltry few independent asset managers, had constructed credible service offerings for Muslim clients who wish to enjoy *shariah*-compliant investing along with professional investment management.[1]

This seems counterintuitive in a time when all banks are seeking to bolster their off-balance-sheet revenue with business lines that involve small capital inputs and manageable regulatory environments. It also does not match what is obviously an important new area of business development in the asset management industry, matching new supply with an apparently large demand.

SHARIAH-COMPLIANT TOOTHPASTE

Recently reported in the *New York Times*[2] was an illustration of the lengths to which marketing specialists will go to reach the market of Muslims conscious of their spiritual identity. Colgate Palmolive and Unilever, for example, have launched new lines of shampoo and toothpaste that have been approved as *halal* and acceptable to Muslims (in these cases shampoo without pork fat derivatives and toothpaste without alcohol). Nokia has lines of mobile phones that specifically cater to the interests of Muslims. There are many other examples. One marketing specialist has remarked that ignoring this vast potential market is akin to ignoring the potential of China in the early 1990s. Another said that focusing on the individual needs of Muslims is the next big thing in marketing.

Anyone who spends any time in a predominantly Muslim country can witness the proximity of spirituality to daily life among the majority of adherents of the faith. Whether in Almaty or Riyadh, Kuala Lumpur or Karachi, there are hundreds of millions of Muslims who profess a faith that fills all aspects of their personal lives. And they have a very high savings rate.

Not wanting to sound crass, it is therefore very puzzling that global consumer product companies try to achieve market penetration with *halal* toothpaste, but that global—and even most regional—banks don't offer *shariah*-compliant investing. There is a gap, a very big divide, between the consumer products now offered to Muslims and what they evidently desire for allocation of their long-term savings. Islam matters to hundreds of millions of people, and it is not a trivial matter to them, whether in consuming food or in making investment decisions.

HISTORY OF ISLAMIC WEALTH AND ASSET MANAGEMENT

Prior to the financial crisis there were some dedicated efforts in this area. Wealth management units at Citi Private Banking and Merrill Lynch were relatively advanced in creating global platforms for Islamic asset management. Citi made the greatest advances, with real-world allocations that were being tested against the bank's own conventional portfolios. Merrill Lynch, while further behind, was compiling a dataset of the world's known *shariah*-compliant funds for an open architecture offering that would involve best-of-class portfolio allocations.

Both these units, unfortunately, were disbanded. Citibank's well-known travails caused the bank to end efforts toward a global platform for Islamic asset management, while Merrill Lynch teams were in place right up to and through the early days of its takeover by Bank of America, but were then disbanded. Since then neither has progressed in this sector, perhaps due to other priorities rebuilding bank balance sheets.

A third bank, HSBC Amanah Private Banking, made more progress than the others—mainly from Dubai. There a highly professional effort led to the establishment of fully *shariah*-compliant allocations for private clients, using some innovative techniques to overcome certain allocation hurdles (in particular for fixed-income allocations). However, before the crisis this service featured high minimum balances for new clients, usually above US$3 million. Further, the unit saw the typical staff changes that were common everywhere during the financial crisis, impeding the unit's progress toward more encompassing client generation. Today, under new staff, the unit is again offering investment across the full spectrum of asset classes. However, the growth of assets under management has not been stellar, and the unit does not seem to be advertising its existence widely to the broader market.

There are some other notable efforts to consider. The Family Office in Bahrain has for several years offered a fund product that encompasses all conventional asset classes (cash, fixed-income, equities, and alternative investments), but distribution and widespread allocations of this one-for-all product have not been excessively large.[3] The new management team at Faisal Private Bank in Geneva, Switzerland, is said to soon be offering Islamic wealth management for individual customers, although the date of this service's launch is still unknown and the bank itself is recovering from zealous but failed investments in speculative real estate. It is said that the only truly dedicated Islamic wealth management unit in the world, with both size and experience, belongs to the family office of a well-known royal family in the lower Gulf region. However, its existence is not generally public knowledge, and even less is known about its allocations and track record.

When one considers that the worldwide managed wealth owned by Muslims is at least $2.5 trillion, and perhaps well above $3 trillion,[4] one has to ask why so little is available in the Islamic wealth and asset management space.

FOUNDATION WORK: A CONCEPTUAL FRAMEWORK

This section attempts to discuss the barriers to creating credible, professional *shariah*-compliant portfolios, and what steps can be taken to deliver this service to a wide audience of Muslims (and, in fact, non-Muslims, as *shariah* compliance equals social responsibility for many persons) who care about Islamic investing. It draws on earlier works by this author, in particular "Islamic wealth management" in the *Chancellor Guide to Shari'a & Legal Aspects of Islamic Finance*, and "Islamic wealth management" in the *Global Islamic Finance Report*.[5]

The first of these articles presented the conceptual framework of Islamic wealth and asset management. It pointed out that wealth management is generally a term that describes the management of savings for individuals on a planned, professional basis, and asset management as being essentially the same activity but for institutional investors such as pension funds and endowments.

The article then described the traditional, industry-wide practice of establishing first the client's objectives, whether they were the head of a household or a pension fund, using standard measurements of current wealth, current and projected income, current and projected spending, and end-term valuation objectives. By laying these out in formulas that are well known in the industry (aka financial planning), one can determine the rates of return required to achieve specific savings goals, and then model portfolio allocations that have the potential to achieve those goals.

The article also described the process of allocation, rebalancing, reporting, and maintaining or altering investment strategies over time. It is centered on modern portfolio theory and its derivative conclusions, where one seeks optimal allocations based on expected return and the expected risk of a diversified pool of assets.

The most important conclusion of the article was that none of the steps in conventional wealth

and asset management have any spiritual component, and instead are grounded in decades of scientific-type inquiry and testing, from which the modern industry was born. The lessons of wealth and asset management apply equally to people of all faiths. Only security selection causes Islamic wealth and asset management to differ from its conventional cousin.

FOUNDATION WORK: THE UNIVERSE OF *SHARIAH*-COMPLIANT ASSETS

After establishing the conceptual framework of Islamic wealth and asset management in the first article, the second article mentioned above took a more practical approach. It featured the results of an extensive survey of the *shariah*-compliant fund universe, starting with a total observed universe of more than 830 investment vehicles that were both Islamic and investment funds.

The survey continued with the typical filtering and sorting common among large asset management businesses that allow for open architecture investment, similar to what is done at, for example, Credit Suisse Fund Lab. There, third-party fund providers are invited to submit their funds for examination and possible adoption on to the bank's fund platform, which itself serves as the approved list for investment allocation decisions among the bank's many different asset management vehicles. Obtaining a position on such an approved list can mean many millions of dollars of new assets under management (AUM) for any fund, so knowing these criteria and meeting them is the goal of many fund managers worldwide.

Filtering and sorting are common practices on all mutual fund platforms, and include criteria of the number of years the fund has been actively managed (usually five years or more is required), the fund's AUM (often the minimum is set at US$100 million), and other important metrics, such as whether the fund can be internationally cleared and settled, has frequent and transparent reporting, and is relatively liquid (often such platforms require no more than monthly redemption rights).

These criteria were used to reduce the Islamic fund universe to a minimum subset that would meet standard professional requirements. However, it also added a criterion for *shariah* acceptance, i.e. whether the fund under examination had a *fatwa* with one or more signatures from about a dozen widely known and respected *shariah* scholars.

Using conventional criteria plus the *shariah* qualifying criterion, the number of funds was reduced to a minuscule 15 or so, too few to produce model portfolios that are fully allocated across all asset classes. To increase that number, the criteria were relaxed somewhat, with AUM limited to US$25 million or more and years in market at two years or more. Holding all other criteria constant, the universe of acceptable funds increased to just under 100, with almost US$30 billion total AUM, a subset deemed sufficient to achieve professional-standard allocations, as is displayed in Table 1.

Table 1. The immaturity of the Islamic mutual fund market. (*Source*: Private research, Thom Polson[6])

Fund category	*Number of funds*	*Assets under management*	*% of AUM*
Money market	15	$9,785,093,000	33%
Sukuk	3	$118,740,000	0%
Equities	60	$11,851,334,000	40%
Real estate	5	$887,250,000	3%
Commodities	8	$5,935,261,000	20%
Portfolio strategy	8	$1,220,672,000	4%
Totals	**99**	**$29,798,349,350**	**100%**

The second article concluded by stating that this subset of funds can be used to professionally allocate investment funds owned by Muslims who want *shariah*-compliant investing, and that although shortcuts were made to achieve this subset, the overall environment existed where Islamic wealth and asset management could be professionally and responsibly achieved.

ISLAMIC MODEL PORTFOLIOS: REAL-WORLD ALLOCATIONS

Now we want to explore the next logical step: what happens over time when you combine the existing universe of qualified Islamic mutual funds into a professional allocation for an institutional or individual client? In this regard, work has been done by this author and some others, although nothing approaching the parallel work that has been done to construct efficient portfolios in the conventional asset management space. Nevertheless, the preliminary results are very encouraging.

We start by taking a dataset for the years 2006, 2007, and 2008. This dataset represents a period that straddles the last days of the booming markets before the crisis and the first years of the crisis itself, so that the performance of an Islamic portfolio can be observed in both parts of the economic cycle. We have the benefit of data that truly represent the extremes of boom and bust, since what we experienced in the last few years was without precedent in modern times.

The underlying work on this dataset was performed in the last months of 2008 and the first two months of 2009. More up-to-date datasets need to be assembled to observe the performance of the portfolios in question in the post-crisis years. But it is presumed that after reading this article there will be some investment professionals who are eager to pursue further analysis of the conclusions presented here.

The dataset collected for this work represented the then-known and observable universe of Islamic investment products. The primary sources were Bloomberg, Reuters, and, importantly, Eurekahedge, although in some cases data were collected directly from fund managers themselves.

At that time the total universe represented approximately 600 funds, which have since increased by several hundred more. The same criteria explained above were used to filter and sort these funds, including years of performance history, minimum AUM, international clearing and settlement, and acceptable *fatwa*.

The data, however, also included funds with redemption rights up to three months, as it is common in the industry to permit a minority of assets in a client portfolio that do not enjoy more immediate liquidity. Some will argue that this alone causes the resulting portfolios to be unacceptable under conventional prudent-man rules common in most jurisdictions ("prudent man" refers to the appropriateness of any asset purchased for a customer, where the manager must judge whether such an asset is prudent given the underlying client's tolerance for risk and desire for reward).

However, we witnessed some very imprudent investing in the period 2003 through 2007 by some of the most respected names in wealth and asset management. What many considered prudent then would be rejected as extremely risky today. It is commonly known that one well-known second-tier Swiss bank, for example, allocated fully 50% of all client funds into hedge funds and funds of hedge funds at the peak of the boom. When one considers the oversized fees earned by the manager of these products, one has to ask whether those allocations were made for the benefit of the clients or the bank.

Further, some industry analysts claim that as much as 25% of all hedge fund assets are still highly illiquid, and may remain illiquid for years to come.[7] It is common knowledge that many hedge funds in the period up to the crash were heavily allocated into obscure assets that immediately went out of favor when the markets dropped, and have not yet returned to favor. Today there is still an unknown volume of assets in the hedge fund industry that may not see anywhere near their original valuations or liquidity for years to come.

Another phenomenon of the 2003–2007 boom was the proliferation of derivative-based structured products. It is well known that these products saw billions in sales, heavily favored in private client accounts but also present in institutional and treasury portfolios. Again, these products are among the most profitable (for banks) ever created by the banking industry, and were overwhelmingly sold through any and all channels. Today we can consider a great many of them useless to the average investor. Their appropriateness was in question at the time of sale, and remains equally dubious today. Many structured products suffered either total illiquidity or dramatic declines in valuation because of their derivative roots. The highly popular capital-guaranteed versions did indeed provide capital guarantees (unless, of course, they were guaranteed by Lehman Brothers, which many were), but at a high cost to the investor. They were virtually without value for anyone who tried to redeem them prior to expiration, which in many cases is years in the future.

So, when considering prudent-man regulations and Islamic mutual funds with only US$25 million AUM and a track record of less than five years, one has to argue over where there may or may not be substantial risk. Like their conventional cousins, most of the *shariah*-compliant funds in our qualifying subset suffered substantial losses, but also like their conventional cousins they rebounded with the markets as the crisis faded.

MODEL PORTFOLIOS AND INVESTMENT STRATEGIES

At this point it is important to remember that the disciplined, scientific-based process of asset allocation in the wealth and asset management industry begins with the creation of model portfolios, each representing the standard risk and reward appetites of common individual and institutional clients. It is not by mistake that the

most common and universal investment strategies are income, balanced, and growth, as these three strategies encompass the investment goals and risk-aversion of nearly all investors. These strategies apply to everyone because we know that there is nothing spiritual about risk-aversion or appetite for reward.

An income strategy would, as the name implies, provide a high degree of cash yields. At the same time, capital preservation is an overwhelming objective, so income portfolios are always the least risky of the three main strategies. At the other end of the scale is the growth strategy, which also as the name implies tries to achieve growth of assets while sacrificing immediate cash gains. This is the most risky of the three main strategies.

In the conventional investment industry an income portfolio would allocate a large majority to guaranteed, fixed-income securities such as bonds, bond funds, and money market funds. Only a minority would be allocated into higher-risk investments such as real estate funds, equities, equity funds, commodities, foreign exchange trading, or hedge funds. The opposite is true for growth investing.

In between is the widely accepted balanced strategy, which attempts to achieve both income and growth strategies in a balanced fashion. A balanced portfolio will have a lower percentage of cash (money market) and bond investments than income, but more than growth, along with larger amounts of more risky assets than income, and less than growth.

In fact, the balanced strategy is perhaps the most widely used template for investing anywhere, whether for Chilean pension funds, the California Endowment, Asian sovereign wealth funds, or Dutch family offices. Of course the actual percentages will vary, but not to a great degree. You will never see any prominent institutional investor heavily invested in stocks only. In sophisticated institutional portfolios one will rarely see any structured products at all. Hedge funds were increasingly visible in large institutional accounts for much of the past decade, but their growth has stalled parallel to the often dismal performance of hedge funds during the recent crisis.

Among all managed accounts of all kinds worldwide, perhaps as much as 50% is allocated to the generically named fixed-income category. This includes the overwhelming majority of that 50% in the form of bonds and bond funds, including bonds of all types (sovereign, emerging market, high-grade corporate, junk, and asset-backed, plus many more). If Islamic wealth management is essentially no different from conventional wealth management—except for security selection—then one can conclude that *shariah*-compliant fixed-income should play an equally important role in Islamic wealth and asset management.

Interestingly, on a global basis it is clear that alternative investments play a relatively small role, yet have gained a disproportionate amount of media attention compared to their more boring cousins. Alternative investments feature as one of four main asset classes—cash, fixed-income, and equities being the other three. But they have rarely (with the exception of the Swiss bank mentioned above) been given more than 15% allocation in professionally managed portfolios.

Alternative investments include all hedge funds, whether or not they are delivered in a fund-of-funds structure. Also included are commodity funds, real estate funds, foreign exchange investing, and, importantly, any and all forms of venture capital (sometimes called private equity). By their nature alternative investments are high-risk and nearly always relatively illiquid, and therefore deservedly constitute the smallest portion of a professionally managed portfolio.

ASSET ALLOCATION FOR AN ISLAMIC MODEL PORTFOLIO

Money Market (Cash) Funds, 3%

Our subset of qualified *shariah*-compliant mutual funds constituted funds from all asset categories. In the cash (money market) segment we chose one of many available *murabahah* funds, such funds being invested according to *shariah* in short-term, low-risk trade finance transactions with very high-quality counterparty guarantees and producing returns equal to their conventional cousins.

Equity Funds, 35%

In the equities section we chose funds with a clear bias and overweight on emerging markets. And why not? Looking back at other allocations prior to the financial crisis, we see that many managers were also overweight in emerging markets or some other form of equity investing that had equivalent performance (and risk).

Here the selection of funds was relatively easy, as qualified Islamic equity funds by far outnumber the funds available in any other asset category. *Shariah*-compliant equity funds are no mystery: fund managers simply take the shares traded on one or many exchanges, filter them through conventional services such as the Dow Jones Islamic Market Index (DJIM), and then choose among the qualifying equities for their trading positions. The filters used by the DJIM

are nearly identical to those used by the FTSE *Shariah* Global Equity Index or the MSCI Barra Global Islamic Index (and for all three the various sub-indices as well) and exclude the typical *haram* (forbidden) companies (alcohol, gaming, financials, etc.) and overleveraged companies (typically where debt comprises 33% or more of the balance sheet, or similar formula).

Alternative Investment Funds, 20%

For our alternative investment allocations we encountered some difficulties. We are trained to accept assets such as hedge funds, forex funds, real estate funds, and the like in our conventional allocations, and there we have no shyness about buying them pre-leveraged—i.e. where the fund manager has taken leveraged positions, sometimes to the extreme, in order to amplify his or her results (and greatly increase risks).

However, in *shariah*-compliant investing such leverage is forbidden. That makes conventional-style hedge funds pretty much out of the question. It also makes most real estate funds far from acceptable, as well as nearly all foreign exchange trading, an asset category that is often heavily leveraged.

So what is left for alternative investments? We did find several real estate funds that met our criteria, one from HSBC Amanah that has since gone into lockup, another from Oasis in South Africa, and our favorite, a global real estate fund from Emirates NBD.

The second security in our model portfolio's alternative category was more difficult. We did find four *shariah*-compliant mutual funds on the Newedge platform, all sharing a single, respectable *fatwa*. But we soon discovered that one of them—from Old Mutual—had gone into liquidation, and information on the other three was difficult to obtain. Since those early allocation days we have not heard again about any of these *shariah*-compliant hedge funds and assume that they have all been shut down.

We also considered inserting structured products into this category. Structured products are based on derivatives, but as anyone from Deutsche Bank Private Banking will tell you, they can also be whipped into *shariah*-compliant versions of almost every flavor imaginable. Indeed, all major banks sold large volumes of these unusual products to thousands of investors throughout Arabia for several years. They were apparently most successful in their capital-guaranteed variety, where the investor is under the impression that he or she has no principal risk (forgetting, of course, the time value of money and opportunity cost, let alone inflation, all of which conspire to make these far from optimal investments).

The excessive fees built into almost all structured products are what finally forced us to abandon this as an acceptable asset for our model portfolio. The big banks had various levels of embedded fees, but we learned that some of them were charging as much as 10% at the time of purchase, a front-end load that's among the highest we have seen anywhere. It is hard to imagine the utility of these very expensive investments, let alone the ethical considerations of the banks that sold them.

Finally we lighted on a less than perfect solution for the second security in our alternative investments category: the NCB Capital AlManara High Growth fund of funds. In reality this fund goes into and out of other equity funds managed by NCB Capital, with the remaining balance in cash. Sometimes the cash portion is up to 70% or even more as the manager attempts to capture alpha in an active management style.

Technically this selection could well have been included in the equities section of our allocation, but in fact there were good arguments against putting it there. However, we felt that the fund was sufficiently "alternative" to merit inclusion in the alternative investment section of our Islamic model portfolio.

It is to be noted here that our selection process did not include any exchange-traded funds (ETF) or private equity funds. With regard to ETFs, there are still very few and—while we appreciate their utility in any portfolio and presumed lower trading and management costs—there were just not a sufficient number available that met our criteria for time in market. Future model portfolios would likely include one or more of the now widely available Islamic ETFs.

Private equity, a classic alternative investment, was also deliberately left out. In the conventional asset space there are almost no private equity (or venture capital) funds with any liquidity whatsoever. A hallmark of prudent-man investing—required by regulators everywhere—is the maintenance of a vast majority of a client's assets in liquid investments. Our Islamic model portfolio, therefore, would have none of this asset.

Fixed-Income Funds, 42%

I have saved the most problematic asset class, fixed-income, until last. Here we ran into serious difficulties, as in 2006 there were no *sukuk* funds that met even the minimum size or time-in-market criteria. Fixed-income comprises no less than 42% of our total allocation, so you can imagine our urgent need to find an honest proxy for the fixed-income section of the model.

Here we decided simply to insert the weighted performance of a basket of qualifying *sukuk* (i.e. investment-grade *sukuk* that had been previously issued and presumably would have been included in any professionally managed *sukuk* fund had one actually existed), less what we considered accurate fund management fees and costs, for the period January 2006 through September 2007. Thereafter we used the monthly performance of the *sukuk* fund from Jadwa Investment Co. in Riyadh, Saudi Arabia, to complete our three-year dataset. Since this model was created we have seen other *sukuk* funds appear, including what is now believed to be the biggest among them, a *sukuk* fund from the Qatar Islamic Bank in London.

PERFORMANCE OF THE MODEL ISLAMIC PORTFOLIO

We distilled the then-available data to create a single balanced allocation comprising diversified assets, and then ran our initial allocations through portfolio optimization software. Not surprisingly, the optimization exercise didn't alter our initial allocations by much, with, for example, the cash (money market) component falling from 5% to 2%, and the fixed-income component falling from 45% to 42%. We did, unfortunately, get an increased allocation in alternative investments. While we believe this was suboptimal, we ran the datasets anyway to find out the results.

The final optimized portfolio was then backtested. In other words, we used the static subset of funds in our optimized portfolio as the base as of December 31, 2008, and then looked backward for the three previous calendar years to determine how well our Islamic balanced portfolio did in terms of performance.

The results were stunning, to say the least.

As indicated in Figure 1, the Islamic balanced strategy model portfolio ended the three-year period with a positive 15.3% performance. In comparison, a hypothetical and purely imaginary benchmark created from major investible indexes to somewhat reflect conventional balanced investing had a negative 8.4% performance in the same three years.

The difference is a startling 24 percentage points (Figure 1 and Table 2). Further measurements include those listed in Table 3.

The reference benchmark was simply weighted as follows: 50% Dow Jones Commercial Bond Index, five-year, investment-grade; 35% S&P 500; and 15% NASDAQ. Why this benchmark? Though far from perfect, it does in fact strikingly resemble conventional US dollar balanced strategy portfolios common in Western private banking. Of course, a true benchmark would have included far more indices tracking precisely the style of investing in our Islamic balanced portfolio, but we strongly believe that the final results would not have been greatly different.

Figure 1. US dollar balance portfolio investing vs benchmark, 2006 through 2008

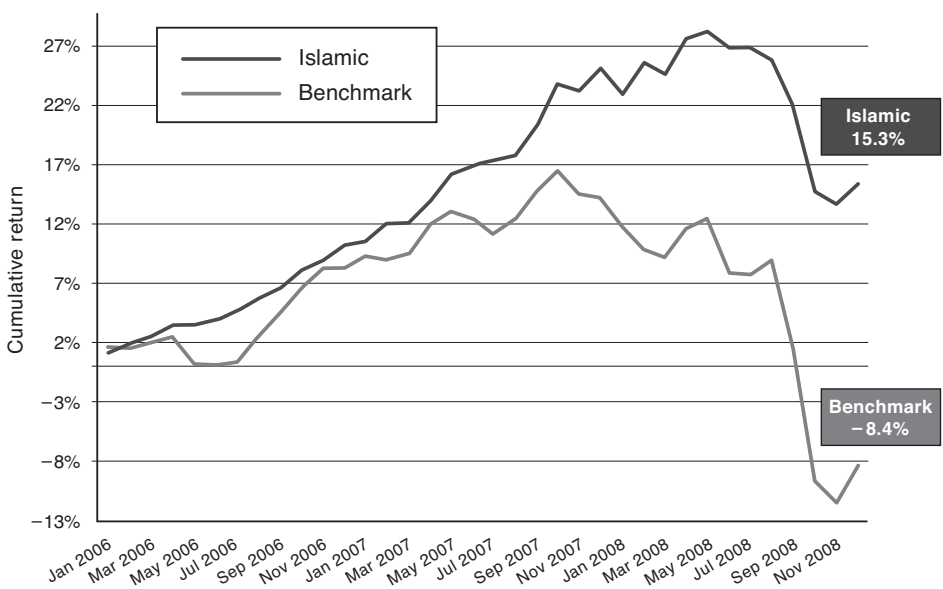

Table 2. Time-lapsed Islamic model portfolio. (*Source*: Encore Management, Geneva, 2009 Study)

	Jan	*Feb*	*Mar*	*Apr*	*May*	*Jun*	*Jul*	*Aug*	*Sep*	*Oct*	*Nov*	*Dec*	*Annual*
Islamic													
2008	–2.25	2.67	–0.97	2.98	0.67	–1.44	0.04	–1.06	–3.83	–7.25	–1.08	1.65	–9.89
2007	0.42	1.45	0.09	1.81	2.20	0.79	0.44	0.39	2.54	3.47	–0.51	1.95	15.05
2006	1.14	0.77	0.68	0.90	0.01	0.49	0.71	1.09	0.85	1.43	0.85	1.24	10.15
Benchmark													
2008	–2.48	–1.84	–0.73	2.53	0.83	–4.65	–0.07	1.13	–7.55	–11.11	–1.78	3.15	–22.56
2007	0.98	–0.26	0.46	2.44	1.10	–0.63	–1.23	1.28	2.30	1.77	–1.97	–0.34	5.89
2006	1.61	–0.06	0.49	0.41	–2.20	–0.16	0.31	2.16	1.92	2.16	1.57	0.10	8.30

Table 3. Portfolio summary statistics

	Islamic	*Benchmark*
Annualized return	5.1%	–2.8%
Annualized standard deviation	6.8%	9.8%
% of positive months	78%	56%
Sharpe ratio (4.0%)	0.16	–0.69
Correlation to Islamic	1.00	0.85
Return since inception	15.31%	–8.37%

SUMMARY RESULTS AND CONCLUSION

We have shown here that by reducing certain criteria in filtering and sorting third-party mutual funds to create a subset of professionally acceptable funds, and then allocating funds within that subset in a style replicating conventional balanced investing, we can in fact perform Islamic wealth and asset management. The performance results are superb, far beyond even our own initial estimations.

Why is this? Because:

- performance of the cash and fixed-income portions of our allocations fairly equaled their non-*shariah*-compliant conventional allocations, as did our alternative investments;
- Islamic investing completely avoided financial shares, meaning the dramatic drop in valuations of Western banking institutions during the financial crisis did not have nearly the effect on *shariah*-compliant investing that it did on conventional investing;
- Islamic investing had a heavier weighting in emerging-market shares, where there was in fact a dramatic drop in valuations during the crisis, but a sharp rebound afterward;
- Islamic investing avoided companies that were heavily indebted.

Of course further work can be done to make the benchmark above more precisely equal to our Islamic investment strategy, but there will still be massive losses in shares of over-leveraged companies and financial institutions. It is this author's opinion that no matter how a conventional benchmark is constructed, the outperformance of *shariah*-compliant investing will survive.

By any professional banker's measure, a 24 percentage point outperformance is stunning, especially when two relatively similar investment styles are compared together. Every conventional manager reading this will challenge and criticize the results, but if so, then we ask that they perform similar tests and provide the results. In our minds Islamic wealth and asset management of the kind described above gives investors real-world alternatives, without fee-heavy structured products, illiquid and opaque hedge funds, and hard-to-understand or inappropriate alternative investments such as private equity.

There will no doubt be plenty of critics of this approach to *shariah*-compliant investing. Chief among the skeptics will be those that say the results were compromised from the beginning because the filtering and sorting criteria were lowered. Some will argue that a mutual fund with less than $100 million AUM and less than a five-year track record is simply unacceptable.

To those critics this author will simply point to the many inappropriate and otherwise ineligible investment products that were thrown into client accounts over most of the last decade by some of the most respected names in wealth and asset management. Every banker reading these pages knows precisely what is discussed here.

Table 4. The path to an efficient Islamic mutual fund market

Asset category	*Actual AUM*[8]	*Capgemini allocation*[9]	*"Should be"*[10] *Islamic funds AUM*
Alternative investments	$7.1 billion	7%	$17.5 billion
Real estate	$0.89 billion	15%	$37.5 billion
Cash & deposits (*murabahah*)	$9.79 billion	20%	$50 billion
Fixed-income (*sukuk* funds)	$0.118 billion	30%	$75 billion
Equities	$11.8 billion	28%	$70 billion
Total	**$29.8 billion**	**100%**	**$250 billion**

I will not overemphasize the billions of dollars in client money placed into Madoff hedge funds, collateralized debt obligations backed by subprime mortgages, disreputable private equity funds, or overpriced structured products that eventually blew up with the collapse of AIG, Bear Stearns, and Lehman Brothers. Risk is in the process of being redefined and remeasured everywhere after some very shocking and disturbing allocation decisions in the past decade, so critics should be ready to provide more than just a critique of the criteria used to select our *shariah*-compliant subset of mutual funds.

Now we have time to reflect on what risk is and how to avoid it. To this author, the risk of a fund having only a two-year track record and less than $100 million AUM is really not in the same league at all as subprime collateralized debt obligations, structured derivative products, and private equity, of which very large volumes were sold to long-term conservative investors worldwide. In fact, one can say that greatly expanding the number of *shariah*-compliant mutual funds and their volume of AUM is not only an important goal in the Islamic banking community, but also a tremendous opportunity. One only has to compare what is currently available within the *shariah*-compliant space with what would be available if the Islamic mutual funds industry had matured.

Consider Table 4. In the "Should be" column we derive the estimated minimum amount of *shariah*-compliant assets that could have been invested in Islamic mutual funds had there been a broader, deeper, and more focused attempt to deliver these investment securities to Muslim investors. Compare that to what is actually invested in *shariah*-compliant funds, the "Actual" column. The gaps are enormous in every category.

We conclude that there is barely more than 10% of minimum market penetration today. Entrepreneurial spirits in major banks and mutual funds companies should see this for what it is—an opportunity to create and manage many more *shariah*-compliant funds, and profit from greater volumes of business in serving the interests of Muslim investors worldwide.

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Website:

Additional resources on Islamic banking and wealth management may be found at the author's website: www.sandwick.ch/ResourcesPublication.html

NOTES

1 The author apologizes for the fact that this article ignores the very substantial and real progress made in Malaysia in providing real-world solutions for Muslims seeking *shariah*-compliant investment management for their savings. No slight is intended. This article refers essentially to the rest of the world, where almost no progress has been made in developing and delivering credible Islamic wealth and asset management solutions.

2 "Advertisers seek to speak to Muslim consumers," *New York Times*, August 11, 2010.

3 For more information, see www.familyshariahfund.com.

4 See Sandwick, 2009a.

5 Sandwick, 2009a; Sandwick, 2010a.

6 Chart first published in Sandwick, 2010a.

7 Interview with Jack Schwager, author of *Market Wizards and New Market Wizards*, February 2009.

8 Chart first published in Sandwick, 2010a.

9 See Capgemini *World Wealth Report 2010*, with projections for asset allocation by category. Online at: www.us.capgemini.com/worldwealthreport2010.

10 "Should be" is based on a projection of 40% of the estimated minimum $2.5 trillion global Muslim managed wealth invested according to *shariah*, and 25% of that amount invested in *shariah*-compliant mutual funds (Sandwick, 2010a).

Small and Medium-Sized Enterprises and Risk in the Gulf Cooperation Council Countries: Managing Risk and Boosting Profit

by Omar Fisher

EXECUTIVE SUMMARY

- Small and medium-sized enterprises (SMEs) are a major pillar of the market economy and an essential building block of economic development in the Gulf Cooperation Council (GCC) region.
- Banks in the GCC region are reluctant to lend to SMEs due to higher risk and applicants' failure to meet loan conditions, meaning that 55% of SMEs do not have credit available to them.
- Effective risk management enables the avoidance of losses and maximization of the potential of opportunities. Both business and nonbusiness risks can be protected against by insurance.
- In order to assess the effect of the risks impacting your business, an internal risk audit can be performed. The benefits of this are increasing revenue, saving time, improving safety, and protecting company value.
- Risk management can be a business enabler and aid business value creation by delivering more stable earnings, resources during an emergency, and a tighter grip on the value drivers of your business.
- Implementation of these practices by SMEs will impress bankers, demonstrating a reduced risk profile, and can result in wider access to capital and/or lower cost of funds.

INTRODUCTION

Small and medium-sized businesses (SMEs) across the Gulf Cooperation Council (GCC) region, many of which are family-owned enterprises, bear the same risks as Fortune 1000 companies. A common definition of a SME is a business with fewer than 250 employees and revenues below US$68 million (Dhs 250 million), whereas the real difference lies in scale and complexity. We have found in working with many types of business that most business owners in the Middle East do not fully comprehend insurance and the importance of risk management. Yet, every day, these business owners confront risk—both business risk and nonbusiness risk. This article explores what, in the SME context, risk is and some methods to better manage nonbusiness risks to yield sustained cash flows and boost SME profitability.

PROFILE OF SMES IN THE GCC

It is well accepted that SMEs generally are a major pillar of the market economy and supply the following:

- a source of vitality and innovation;
- a pool of skilled and semi-skilled workers;
- a driver for job creation;
- promotion of economic stability as a complement to large corporations;
- a broadening and diversification of the basis of competition within the economy.

A recent research report confirms that SMEs in the GCC region are an essential building block for economic development. "Both in the European Union and the Gulf region, small and medium-sized enterprises (SMEs) are the main drivers of job creation, growth and economic diversification."[1]

Official data suggest that some 40,000 SMEs operate in Bahrain, 85,000 in Dubai/United Arab Emirates (UAE), and 700,000+ in the Kingdom of Saudi Arabia. On average, SMEs employ between 10 and 50 workers, so their impact on employment across the GCC is above 8.5 million jobs. Table 1 summarizes the size and scope of SMEs in the GCC countries.

As reported by David Morgan in *Arab–British Business* (April 2010), across the GCC region "47% of SMEs are engaged in commercial, trading and hotel businesses, 27% in construction, 12% in industry/manufacturing, 6% in social services and 8% in sundry other sectors."

The top three challenges facing SMEs in the GCC area are: (1) administrative hurdles and lack of enabling regulations; (2) limited or scarce financing; and (3) weak corporate governance and poor bookkeeping and accounting practices. Points 2 and 3 are related and, when combined, explain why banks in the Gulf region are generally reluctant to lend to SMEs. According to a study by Dun and Bradstreet, banks in the UAE

Table 1. Size and scope of SMEs in GCC countries. (*Sources*: Hertog (2010) and research by the author)

	Micro-enterprise	*Small enterprise*	*Medium enterprise*
Bahrain			
Employment	Up to 10	Up to 50	Up to 150
Assets	BD20,000 (US$53,000)	BD20,000–500,000 (≤US$1.3 million)	BD500,000–2,000,000 (≤US$5.3 million)
Saudi Arabia			
Employment	n/a	Fewer than 60	Fewer than 100
Revenue/turnover			Less than SR20 million (US$5.3 million)
Assets	n/a	Less than SR5 million (US$1.3 million)	SR5–20 million (≤US$5.3 million)
UAE*			
Trading			
Employment	Fewer than nine	Fewer than 35	Fewer than 75
Revenue/turnover	Less than Dhs9 million (US$2.5 million)	Less than Dhs50 million (US$13.7 million)	Less than Dhs250 million (US$68.5 million)
Manufacturing			
Employment	Fewer than 20	Fewer than 100	Fewer than 250
Revenue/turnover	Less than Dhs10 million (US$2.7 million)	Less than Dhs100 million (US$27.4 million)	Less than Dhs250 million (US$68.5 million)
Services			
Employment	Fewer than 20	Fewer than 100	Fewer than 250
Revenue/turnover	Less than Dhs3 million (US$0.82 million)	Less than Dhs25 million (US$6.8 million)	Less than Dhs150 million (US$41 million)
EU defintions of SME			
Employment	Fewer than 10	Fewer than 50	Fewer than 250
Annual sales/revenue	Less than US$3 million	Less than US$13 million	Less than US$67 million

*Estimate by Mohammed bin Rashid for SME development.
Currencies: Dh, United Arab Emirates dirham; BD, Bahraini dinar; SR, Saudi Arabian riyal.

in 2008 rejected 50–70% of credit applications from SMEs due to the higher risk and applicants' failure to meet basic loan conditions.[2] Because most SMEs in GCC countries have been in business for less than seven years, and many cannot muster credible financial statements for at least three years, bank loans and lines of credit are unavailable for more than 55% of SMEs.

Although the limited access to financing constrains SME growth, it also causes heightened emphasis on the cash flows that are generated and the necessity to reinvest these earnings to bolster growth. Therefore, any interruption of expected earnings and, of course, any disaster or unforeseen circumstance will seriously impact a SME's situation as a going concern. This is precisely where risk management comes in.

WHAT IS RISK?

Risk is "the possibility of something happening that impacts on your business objectives. It is the chance to either make a gain or a loss. It is measured in terms of likelihood and consequence."

The effective management of risk enables the business owner to avoid losses, maximize the potential of opportunities, and achieve the desired outcomes. SME owners and managers face both business (application of technology, skills, pricing, packaging, distribution choices, competitive positioning, etc.) and nonbusiness (compliance, legal, disasters, liability, product warranty, etc.) risks. Thus, the proactive management of an enterprise to anticipate risks is essential to creating and nurturing core business value.

Business value creation[3] occurs in the interaction between value drivers and risk drivers (Tables 2 and 3). Value drivers are simply cash inflows balancing against cash outflows.

For many SMEs, the main response to risk is to purchase insurance—i.e. protection against risk. However, insurance cannot be viewed as just another commodity, where buying at the lowest possible price means good value. Rather than approach risk as an exercise in cost containment, the SME owner or manager should adopt an attitude of becoming risk smart.

Table 2. Summary of value drivers

Cash inflows	*Cash outflows*
Core revenues	Operations/raw materials
Investment income	Capital costs (financing costs)
Supporting business income (royalties, intellectual property)	Capital expenditures
Other income	Advisory costs (legal, accounting)

Table 3. Summary of risk drivers

Risks to cash inflows	*Risks to cash outflows*
Pricing and customer behavior	Emergency resources, credit lines
Fluctuations in cost of funds	Natural disasters, catastrophes
Credit and payables	Competitive pressures
Business processes	Supervision, management, plans Corporate governance, decision-making

Table 4. Examples of SME risks. (*Source*: European Agency for Safety and Health at Work, 2010).

Risk type	*Examples*	*Possible consequences*
Personnel risks	An accident A key person leaves An entrepreneur is overburdened	Loss of work input The company loses important expertise Ability to work is reduced
Business risks	Demand for a product decreases Disruption in a customer's payments Production capacity does not correspond to a customer's needs	The company finances cannot take it Anticipated income does not arrive The customer changes supplier
Property risks	A fire in a production facility or shop Water leakage spoils the company's stocks A machine breaks down	Substantial damage, business operations are interrupted for several months Production and deliveries are disturbed Production is interrupted
Information risks	A computer hard disk breaks down The customer register is sold without permission The company's information is accidentally leaked	Order data are lost The company's reputation suffers. A competitor steals the customers The company's competitiveness suffers
Operational liability risks	An employee makes a mistake with a product or service An agreed delivery is delayed	Liability for damages to a third party The company has to pay a contract penalty
Product liability risks	A product causes damage A faulty product has to be withdrawn from the market	The company has to pay compensation Financial loss, the company's reputation suffers
Interruption risks	A power cut interrupts production A delivery from a subcontractor is delayed A load of raw material is stopped at a neighboring country's customs	The company's operations are interrupted Production is interrupted Capital is tied up, production is interrupted
Transport risks	A product is broken during transport A transport vehicle is stolen	Financial loss Deliveries are disrupted
Environmental risks	An oil container breaks Packaging proves to be unsuitable for recycling	The company's reputation suffers and it becomes liable for damages Sales to an important export country are interrupted

WHY SHOULD A SME BOTHER TO LEARN ABOUT RISK AND INSURANCE?

The purpose of insurance is risk protection—to transfer a risk that you can afford (i.e. the payment of a premium with no guarantee that it will be returned) to cover a risk whose consequences you cannot afford. To help calculate the cost–benefit of insurance, your business should have access to a dedicated and knowledgeable risk manager. Typically, the revenue of a SME does not justify hiring a full-time, in-house risk manager or insurance expert. Therefore, many businesses seek the services of an insurance broker or an insurance agent. However, a broker or agent may not be qualified in risk assessment and may not always negotiate insurance prices in the best interest of your business (because typically the insurance company will pay him or her a commission). Nowadays, when all businesses are seeking ways to reduce expenses, to lower the cost of insurance, and to boost their bottom line/profitability, it certainly would be advantageous to have a risk assessment (internal audit) performed, and to re-examine the business risks and existing insurance program in light of this risk assessment. The main goals for a SME must be to avoid overinsuring, the misalignment of risks and risk protection, incorrect limits, exclusions, and so on.

Insurance is not only very important for you and the company's assets, it is also critically important to business relationships. Your customers, suppliers, employees, and bankers will all feel more comfortable in doing business with your company when there is a solid, well-structured insurance program in place. This provides the assurance to stakeholders that your business will not disappear overnight or fail to pay for goods or services in the event of a loss that may afflict the business.

EXAMPLES OF RISKS AFFECTING SMES

Although not exhaustive, Table 4 describes numerous textbook types of risk that can hamper or destroy a SME business. Among the risks highlighted are: personnel risks, business risks, property risks, IT and information risks, operational and liability risks, machinery breakdown and interruption risks, transportation and delivery risks, and environmental risks.

As suggested earlier, to capture the effect of the risks that could impact your business, a risk assessment, or internal risk audit, should be performed. The benefits of an internal risk audit are as follows.

- *Increase revenue*. Formalizing risk management practices helps to improve risk assessment, identify real exposures, reduce claims costs, and lower insurance premiums, leading to more predictable cash flows, increased revenues, and a better bottom line.
- *Save time*. With plans, maps, risk tools, and more, an audit can bring structure and timeliness to all your risk management activities, improving operational efficiency and overall profitability.
- *Improve safety*. Actively managing risk reduces the frequency and severity of accidents, resulting in safer customers and employees and fewer claims against the organization.
- *Protect company value*. An audit can help organizations to safeguard their assets, build stronger employee loyalty, and protect themselves from reputational damage.

In December 2009, more than 75 organizations in the GCC region and Jordan were surveyed[4] to see how many had a strategy to deal with disasters. 70% admitted to not having done any contingency planning. Risks and business survival were simply ignored. The perceived risks threatening continuation of business are set out in Table 5.

Table 5. Ranking of risks of business disruption

Failure of computers and data loss	74%
Communications and network failure	59%
Power breakdown	47%
Fire	44%
Computer hacking	21%
Natural disasters	21%
Internal security breaches/theft	18%
Terrorist attacks	12%
Pandemic disease/flu	3%
Strikes and riots	3%

Figure 1 displays the categories of actual risks that adversely affected businesses in the GCC–Jordan region during 2009.

This survey provides insight into the types of occurrence that can temporarily or permanently set back SME earnings. Owners and managers should ask themselves whether they have examined these risks in relation to their business operations. The options open to them are set out in Table 6.

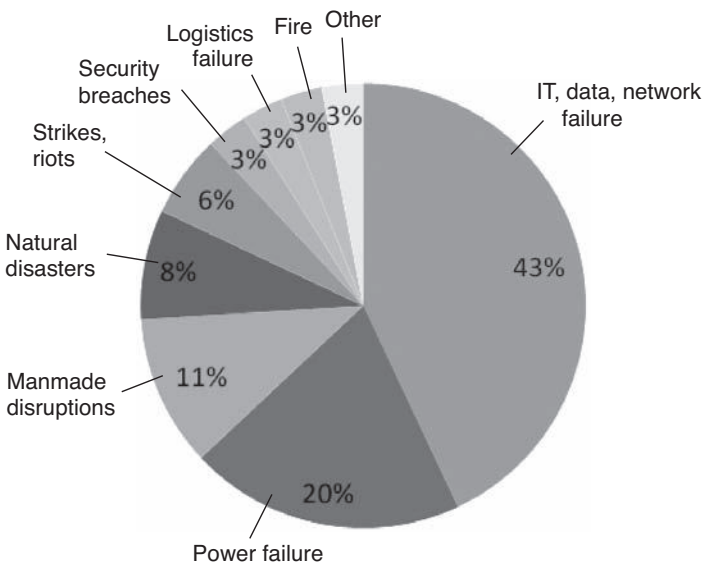
CONCLUSIONS

SMEs in the GCC region today confront huge business and nonbusiness challenges: limited access to financing, higher borrowing costs, limited collateral resources, and poor bookkeeping and accounting practices, to name a few. Risk

Table 6. What are the alternatives?

Options	*Cost*
Hiring a full time professional risk manager	Average base salary for 2009 is US$51,852 (Dhs190,000)
Buying/leasing risk software	Purchase costs can be US$250,000 and above plus annual maintenance fees
Hiring a consultant/advisor	Variable costs depending on the consultant, usually $150 to $250 per hour
Figuring it out on your own—"go it alone" Do nothing	Wasted work hours and reduced productivity. Most likely not up to industry best practices. Costs nothing, until there is serious loss…

Figure 1. Significant business disruptions in GCC countries and Jordan, 2009. (*Source*: Khan, 2009)



management can be a business enabler, not just another cost item to be controlled. Owners and managers of SMEs are advised to adapt their attitude to risk to shift toward business value creation and to focus on how risk management can deliver more stable earnings, much-needed resources to cover emergencies, and a tighter grip on value drivers. A periodic internal risk audit can be performed by a risk professional in order to:

- ensure that the business assets are properly protected;
- secure the stability of cash flows;
- underpin the longevity of the young SME business;
- enhance the bookkeeping and strengthen corporate governance;
- align the risk–reward calculation of buying insurance coverage.

In addition, the implementation of risk management practices by SMEs will impress their bankers, demonstrate that their business presents a reduced risk profile, and can result in the easier access to capital and/or lower cost of funds that is so crucial to acceleration of the growth of the core business of SMEs.

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NOTES

1 Hertog, 2010.

2 *Ibid*., p. 9.

3 Adapted from IBM Global Business Services, "Risk management," 2007.

4 Khan, 2009.

Bankruptcy Resolution and Investor Protection in *Sukuk* Markets

by Kamal Abdelkarim Hassan and Muhamad Kholid

EXECUTIVE SUMMARY

This article examines the following:

- Understanding the particular appeal *sukuk* has to investors.
- Notable defaults and near-defaults of *sukuk* and the effects on the market.
- Case study: Nakheel *sukuk*—a lesson to learn for Islamic finance.
- Issues of enforceability in light of *sukuk* defaults.
- Jurisdictional response to legal issues surrounding *sukuk*.

INTRODUCTION

According to the Kuala Lumpur-based Islamic Financial Services Board, a standards body for the Islamic finance industry, the Islamic finance industry is a roughly US$1 trillion asset that may almost triple to US$2.8 trillion by 2015. Arguably, *sukuk* is the catalyst that has put the Islamic finance industry on the global capital market map. Despite being the flagship product of the burgeoning Islamic finance industry, the *sukuk* market has not been immune to the economic downturn. Marketed often as a safer alternative than conventional bonds, the subsequent near and actual *sukuk* defaults have raised questions about *sukuk*-holders' rights, how they will be treated, and what *sukuk* entails. A closer examination is required of the structural deficiencies of some *sukuk* structures that may result in nullifying the recourse of investors and the enforceability of *sukuk* contracts. Based on the above, we discuss bankruptcy resolution and investor protection in *sukuk* markets.

SUKUK BY ANY OTHER NAME

Although a rose by any other name may well be a rose, a *sukuk* by any other name is not a *sukuk*. A commonly held description of *sukuk,* both within and outside the Islamic space, is one of an Islamic bond. Although many *sukuk* structures are designed to replicate the economic function of conventional bonds, their legal structures are different. "Any references to *sukuk* as being Islamic bonds are oxymoronic and misleading to investors who may believe they have certain bond-like remedies that, ultimately, may not be enforceable in some Islamic jurisdictions."[1] The Accounting and Auditing Organization for Islamic Financial Institutions' (AAOIFI) *shariah* Standard no. 17 on investment *sukuk* carefully distinguishes *sukuk* from equity, notes, and bonds. It emphasizes that *sukuk* are not debts of the issuer; they are fractional or proportional interests in underlying assets, usufructs, services, projects, or investment activities. *Sukuk* may not be issued on a pool of receivables. Nevertheless, the importation of provisions and conventional contractual risk transfer covenants into the overall *sukuk* structure is the primary link between *sukuk* and bonds.

Given the standardized nature of conventional bond transaction in terms of (a) the relative rights and remedies of the parties, (b) the terms of many financial and commercial risk allocations, and (c) the legal documentation, one begins to understand the rationale for embedding the conventional provisions and covenant within *sukuk* structures. *Shariah*-compliant transactions of this type have not yet obtained an equivalent degree of standardization or concomitant certainty, consistency, predictability, or transparency, especially as to enforcement of the *shariah*, hence the importance of the work of the International Islamic Financial Market (IIFM) in its development of standardized Islamic financial transaction agreements. As long as the Islamic finance industry continues to play catch-up in term of contractual standardization, the *sukuk* investor may be left with cosmetically comforting structured Islamic notes that may lack the same legal safeguards and risk profile as the conventional bond to which they are often compared. Therefore, there is all the more reason to understand the *sukuk* structures, and in the event of default to know what, if any, recourse an investor would have under those structures.

IMPORTANCE OF UNDERSTANDING THE FINE PRINT IN *SUKUK* STRUCTURES

Standard & Poor's has grouped the various *sukuk* structures into three categories.

1. ***Sukuk* with full credit-enhancement mechanisms**. These are *sukuk* that receive an irrevocable third-party guarantee, usually by a parent or original owner of the underlying collateral. The guarantor provides *shariah*-compliant shortfall amounts in case the issuing vehicle (usually a special-purpose entity) cannot make payment.[2]
2. ***Sukuk* with no credit-enhancement mechanisms**. This structure resembles an asset-backed security. The pool of underlying assets is the sole basis for the coupon and principal payment.[3]
3. ***Sukuk* with partial credit-enhancement mechanisms**. This combines the first two categories, with a third-party guarantee absorbing a limited shortfall from an asset-backed transaction.

According to a report by Moody's, many of the *sukuk* structures applied have been effectively reduced to a form that is identical to conventional unsecured bonds. Most asset-based *sukuk* may have the form of asset-backed *sukuk*, but not the substance.[4] In other words, although most *sukuk* have assets in their structures, they were only considered as asset-backed or asset-secured if key securitization elements were present to ensure that holders enjoy beneficial title and realizable security over the assets and associated cash flows.

Although terminologically similar, asset-based and asset-backed have unique differences in credit risk with respect to a potential investor in a *sukuk*. This can be seen in the case of Tamweel PJSC, where two types of *sukuk* had been issued. In the Tamweel asset-backed *sukuk*, the freehold titles to the properties were transferred to the *sukuk*-holders along with the associated *ijarah* cash flows. The property or land titles are registered in the name of the investors. Any losses on those cash flows (that arise from the sale of distressed property) are passed on to *sukuk*-holders, who are exposed to the asset risk. Nevertheless, upon the insolvency of Tamweel, the assets continue to pay the *sukuk* investors. As for the unsecured or asset-based *sukuk* issued by Tamweel, the *sukuk* does not survive the insolvency of Tamweel. Investors in these two sets of *sukuk* are taking very different risks.

INVESTOR PROTECTION IN NOTABLE *SUKUK* DEFAULTS

East Cameron Gas *Sukuk*

The first ever *sukuk* to originate from the United States was launched in 2006 to raise US$165.67 million. The US energy firm East Cameron's *sukuk* defaulted in 2008, and it subsequently filed for bankruptcy protection after its offshore Louisiana oil and gas wells failed to yield the expected returns. Interestingly, although most *sukuk* are Reg-S, the East Cameron *sukuk* was the first US 144A regulation *sukuk*, meaning that it was on a par with a bond in terms of disclosure and transparency. The issue in this case was whether the *sukuk*-holders actually owned a portion of the company's oil and gas. In this relation, East Cameron argued that there had been no real transfer of ownership of production revenues, known as royalties, into a special purpose vehicle formed to issue the *sukuk*. Instead, the company claimed that the transaction was merely a loan secured on those royalties, implying that *sukuk*-holders would have to share the royalties with other creditors in the event of liquidation.

The bankruptcy judge rejected the company's contention and ruled that the *sukuk*-holders "invested in the sukuk certificates in reliance of the characterization of the transfer of the royalty interest as a true sale."[5] Nevertheless, the judge then gave East Cameron leave to find further arguments to support its case, raising questions about whether holders own the assets underpinning the issue when the security sours.

The Investment Dar *Sukuk*

The Investment Dar was the first Gulf company to default on a *sukuk*. Investment Dar defaulted on a US$100 million *sukuk* when it failed to pay a periodic distribution, when due, to holders of an issue maturing in 2010. The irony is that the issuance took place, presumably offshore, despite the fact that Kuwait has no *sukuk* or trust laws in place.

Golden Belt 1 *Sukuk*

Citicorp Trustee Co. Ltd, trustee for a US$650 million Islamic bond sold by a unit of Saudi Arabia's Saad Trading, Contracting and Financial Services Co., said that investors agreed to dissolve the trust after the unit defaulted on the debt. The dissolution may allow investors to claim assets used to back the Islamic securities sold in 2007 by Saad Group's Golden Belt 1 Sukuk Co. BSC.

ISSUES OF ENFORCEABILITY

Nakheel

The near-default of the dollar-denominated *sukuk* from Dubai property developer Nakheel shattered perceptions that Islamic financing instruments were a safer alternative to conventional bonds. It is important to note that it was evident in the prospectus that Nakheel *sukuk* did not enjoy any government guarantee. Yet, the circumstances surrounding the Nakheel/Dubai World debacle and the events that followed highlight issues regarding the potential enforceability against *sukuk* assets or issuers. If Nakheel did default on its *sukuk*, the idea that the *sukuk* investors have any legal recourse to those assets is by no means clear. Not least, it is uncertain whether Western law, which typically allows for recourse, is more relevant and enforceable than *shariah* law in the United Arab Emirates (UAE), which implies a degree of burden-sharing for creditors. Yet, the issue of enforceability of *sukuk* contracts in the UAE also applies to conventional financing that Nakheel/Dubai World has obtained. Conventional investors would have had the same issue in securing any of Dubai World's assets in the UAE. The bankruptcy laws in the UAE, as well as the rest of the Gulf Cooperation Council (GCC) countries, have still to be developed; there is very little precedent.

The following illustrative *sukuk* transactions will help sharpen understanding of issues pertaining to enforceability of *shariah* in different jurisdictions. Assume the following: a *sukuk* issuance that is a securitization of assets located in a *shariah*-incorporated jurisdiction; the asset originator is located in that same jurisdiction; the special purpose vehicle (SPV) *sukuk* issuer is located in a purely secular jurisdiction that allows for the choice of applicable law for financial transactions; and the *sukuk* is sold to both Muslim and non-Muslim investors throughout the world. The applicable laws will include those of the *shariah*-incorporated jurisdiction and of where the originator and the assets are located, particularly with respect to whether there has been a true sale of the assets by the originator to the special purpose issuer. The bankruptcy laws of both the jurisdiction where the originator and the assets are located and of the jurisdiction in which the issuer is located will be applicable to the transaction. Further, it is likely that the securities laws of the issuer's jurisdiction, as well as those of the various jurisdictions of the purchasers of the *sukuk*, will be applicable in certain circumstances.

SUBSEQUENT JURISDICTIONAL RESPONSES

UAE

The law does not have a specific definition of bankruptcy, but merely highlights the situations in which a trader will be regarded as bankrupt. The meaning may be inferred from Article 645 of the law, which provides that "a trader who ceases to pay his debts can apply to the court for his adjudication as bankrupt." Dubai's government recently announced the new bankruptcy reorganization law in 2009 as part of the package to rescue Dubai World that included a US$10 billion bailout from Abu Dhabi.

CASE STUDY: Nakheel *Sukuk*—A Lesson for Islamic Finance

Background

Nakheel *sukuk* is chosen as a case study despite the fact that this *sukuk* never defaulted. Nevertheless, this near-default of the *sukuk* has left an indelible mark on the Islamic financial market, ushering in the Dubai Debt Crisis. On November 25, 2009, the financial world was shocked when Dubai World requested a restructuring of US$26 billion in debts. The main concern was the delay in the repayment of the US$4 billion *sukuk*, or Islamic bond, of Dubai World's developer Nakheel, which was especially known for construction of the Dubai Palm Islands.

The massive implication of the Nakheel *sukuk* default scenario to the financial world, particularly Islamic finance, has created a broad discussion among experts on the course of events and how to provide better protection to investors against bankruptcy in *sukuk* investment in the future.

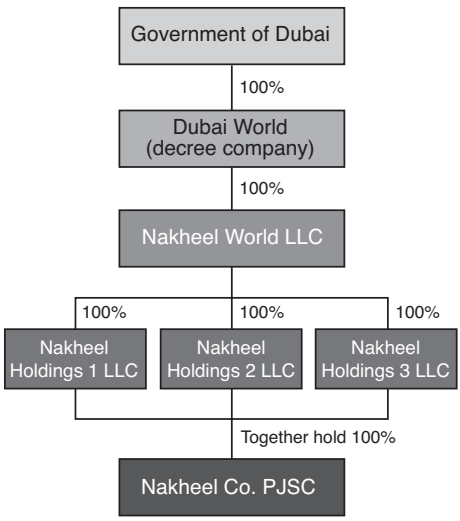
Nakheel *sukuk* were originated by Nakheel Holdings 1 LLC, one of three Nakheel World LLC subsidiaries (along with Nakheel Holdings 2 LLC and Nakheel Holding 3 LLC, these three companies together acting as co-guarantor of the *sukuk*) which are 100% owned by Dubai World, a 100% stated-owned company under the Government of Dubai. All three Nakheel Holdings companies had a subsidiary, Nakheel PJSC, which was operating in the real estate sector in Dubai. Below is the company ownership structure and the interlinking, to give a better background of the case.

(*Continued overleaf*)

The Transaction Structure—Issuance

Nakheel *sukuk* was set up as an *ijarah sukuk* based on two properties (and any buildings on the land), DWF South and Crescent Lands, both in the Dubai Waterfront development. This parcel of properties was initially valued at US$4.22 billion, based on the developments that were to be constructed on it. The *sukuk* was issued by SPV, Nakheel Development Limited (Nakheel SPV), a newly incorporated free-zone company with limited liability in the Jebel Ali Free Zone. Nakheel SPV acted as agent and trustee for and on behalf of the *sukuk*-holders, in accordance with an agency declaration and a declaration of trust.

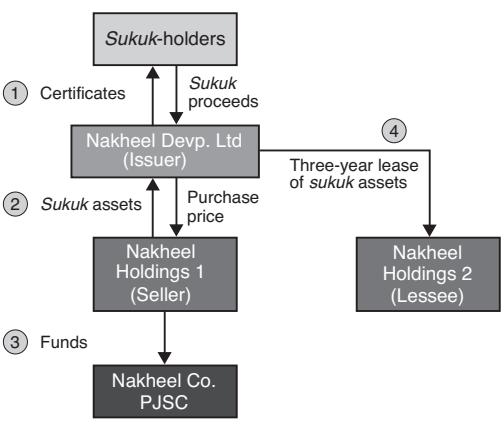
Figure 1. Ownership structure[7]



The originator, Nakheel Holding 1 LLC, sold the leasehold right on the properties of 50 years to the SPV, which in turn issued *sukuk* to finance the transaction. The funds raised of US$3.52 billion were used to pay the leasehold right from Nakheel Holding 1 LLC. The amount was injected into Nakheel Co. PJSC. Next, Nakheel SPV, as lessor, leased the *sukuk* assets to Nakheel Holdings 2 LLC, as lessee, for a period of three years to end on December 14, 2009, in concurrence with the maturity of the *sukuk*. The lease comprised six consecutive periods of six months each. The rental payments of the lease periods matched the periodic distribution payments on the *sukuk*. Half of the lease amount was paid to *sukuk*-holders through the SPV and half was deferred until maturity.

On December 14, 2009, the lessee had to purchase the *sukuk* assets from the lessor in accordance with a purchase undertaking at a certain exercise price. This is when the deferred lease payment would be made. This exercise price was equal to the redemption amount of the *sukuk* and would be used to pay back the principal amount to the *sukuk*-holders. In this way the *sukuk* were redeemed.

Figure 2. The transaction structure—issuance[7]



1. On the closing date, Nakheel Development Ltd raised US$ 3.52 billion by issuing trust certificates (*sukuk al-ijara*).
2. Nakheel Development Ltd used the proceeds of the *sukuk* to purchase a long leasehold on property at Dubai Waterfront ("*sukuk* assets") from Nakheel Holdings 1.
3. Nakheel Holdings 1 will in turn apply the cash to inject capital into/purchase assets from Nakheel Co. PJSC.
4. Nakheel Development Ltd will lease the *sukuk* assets to Nakheel Holdings 2 under a three-year lease agreement.

   Pursuant to the terms of a servicing agent agreement, Nakheel Holdings 2 will be responsible for managing the *sukuk* assets on behalf of Nakheel Development Ltd.

The Issues over Nakheel *Sukuk*

The issues over Nakheel *sukuk* comprise two sources—the *sukuk* structure and the legal concern. The *sukuk* in itself is a complicated financial product, and the laws of Dubai do not provide a clear precedent as to how investors in the *sukuk* will be treated and what recourse is provided. The

sukuk was structured under a sale and leaseback transaction, which from an Islamic perspective is referred to as an *ijarah* structure. The sale and leaseback structure in *ijarah sukuk* does not provide for a real transfer of assets from the originator to a SPV; it merely provides a leasehold interest over the tangible underlying asset for a period of, in this case, 50 years. The issue is that leasehold right is not seen as a real right or property right under UAE law as applicable in Dubai, which limits investors' claims and law enforcement.

Nevertheless, the Nakheel *sukuk* was backed by a few additional guarantees that may provide *sukuk* investors with some recourse. As such, these guarantees gave investors the confidence to invest in the *sukuk*. A guarantee from the state-owned parent company, which implicitly provides a government guarantee for the *sukuk* (despite the fact that the prospectus clearly stated otherwise), had reassured investors. This misplaced assumption misled investors in their risk–return decision on the investment. A similar scenario occurred for the holders of equity in Fannie Mae and Freddie Mac in the United States. The issue, however, does not end there; the complications worsened when the parent company that acted as guarantor found itself in a situation that made it no better placed than Nakheel to repay the *sukuk*. Dubai World is also just a holding company for a number of other companies beside Nakheel Holding 1 LLC. However, all of Dubai World's subsidiaries have their own creditors and their own debts to service, and the important thing for Nakheel *sukuk*-holders is that the creditors of Dubai World, through the guarantee, are subordinated to the creditors of the subsidiaries of Dubai World.

The sukuk-holders were also granted a mortgage over the two properties that formed the basis for the *sukuk* through a security agent. Nevertheless, this is subject to the ability of investors to pursue claims on assets that are mainly located in the UAE, as there is a general lack of precedent in how the laws will be applied. Investors are not able to touch government assets, pursuant to Law no. 10 of 2005 amending Government Lawsuit Code no. 3 of 1996 (as amended by Law no. 4 of 1997), which provides that a government establishment may be sued, but that no debt or obligation of such establishment may be recovered by way of an attachment on its properties or assets. In addition, the structure of the *sukuk* transaction (the issuance) itself could limit investors' ability to enforce the mortgage. The *sukuk* is structured under English law in which the concept of trust and beneficial interest is applied. These concepts are not recognized in Dubai.

In addition to the guarantee above, Nakheel *sukuk*-holders were granted a share pledge of 18.89% of the outstanding equity in Nakheel at the time the *sukuk* was originated. The aggregate value of the share pledge was capped at 25% of the *sukuk* issue amount (US$3.52 billion). However, this guarantee would probably be worthless should Nakheel be unable to restructure or repay the outstanding *sukuk* due on December 14 (and the Nakheel 2 and 3 *sukuk* that also become due on December 2010 and January 2011 for another $2 billion).

Kuala Lumpur

Lawyers, bankers, and *shariah* scholars in Malaysia, which has the world's largest *sukuk* market, have begun looking into civil law provisions that may conflict with *shariah* law and impede the use of Islamic finance. "We are producing Islamic products in conventional surroundings. The other laws that are applicable—land law, contract law, all other laws—are conventional laws," said a former Malaysian chief judge who is heading the expert body.[6]

THE WAY FORWARD

In order to increase protection of all parties in the *sukuk* transaction, some essential measures must be put in place.

The IIFM and other relevant international bodies such as the AAOIFI and the Organization of the Islamic Conference (OIC) Fiqh Academy should lead the Islamic capital market industry with an initiative to converge prevailing differences in *sukuk*. Note that some differences may not be converged, for example matters that relate to different *shariah* rulings might not be compromised. Nevertheless, there are many other matters for which the respective bodies could meet to find a solution. The industry could agree on a few standard structures that cover specific legal and *shariah* jurisdiction—for instance, standard structures for *sukuk* issuance in the GCC region and in South East Asia. This option is suggested with consideration for the fact that a particular region tends to have similar legal and *shariah* rulings; thus, relative convergence can be achieved to provide recourse for investors.

The issuer must be aware that *sukuk* in its pure form has different characteristics from bonds; as such, *sukuk* must be structured according to the standards of the *sukuk* structure and should not merely resemble a bond.

A provision to purchase at face value instead of market value, for instance, has effectively shifted *sukuk* from equity-based securities to debt-based securities. Therefore, the risk–return and legal consequences of *sukuk* do not reflect equity, which would eventually mislead the market. If *sukuk* were structured in such a way as to retain their equity status, disputes when bankruptcy occurred would be much less severe. This is because investors would adjust their anticipated risk–return and legal claim to reflect equity investment. Furthermore, issuers must provide a clear and definitive provision in their prospectus and agreement. For instance, the near-default Nakheel *sukuk* contains ambiguous provisions in its prospectus, basically saying that where the agreement states that English law is applicable, it is not certain that the Dubai courts would actually apply English law as opposed to local law. Second, the prospectus indicated that once an English court had given judgment, executing it in Dubai might be difficult because it is not possible to enforce measures on property owned by the government or the ruling family.

Governments—and not just those that issue sovereign *sukuk*—should put in place comprehensive and clear provisions on their regulation and a legal framework to govern *sukuk* issuance. Something that may not seem important when everything goes smoothly, but which is absolutely critical if they do not, is the enforceability of such provisions, especially with regard to claims over government interest/property. The Nakheel and Investment Dar *sukuk* are good examples in this regard.

Investors need greater education on *sukuk,* which basically have more complex structures than bonds. Investors, whether sophisticated or not, should be able to understand clearly what a prospectus is saying and not need to make their own, potentially misleading, interpretations. For instance, in the Nakheel *sukuk*, despite the disclaimer in the prospectus that "the Government of Dubai does not guarantee any indebtedness or any other liability of Dubai World," investors perceived the *sukuk* to be implicitly guaranteed by the government, whereas in fact the government declared itself to have no liability in respect of the *sukuk*. This perception led to mistaken investment decisions with regard to the anticipated risk–return and contingency claim in the event of default.

In order to reduce the severity of disputes, *sukuk* documentation should contain clear and comprehensive provisions concerning transactions in terms of the governing law, legal jurisdiction, *shariah* rulings, and legal enforcement. For instance, a *sukuk* issuance may have transactions governed by UAE law, but with an exclusive jurisdiction clause for the High Court in London, or for an arbitration panel in another location, such as Geneva, Switzerland. Such a move would bring more objectivity where uncertain questions of law arise. Different contracts in different parts of the transaction may have different jurisdiction clauses. On top of that, legal enforceability is an important factor to consider before a decision is made to invest in *sukuk*. With reference to the Dubai World case, there is still a question of the local enforceability of any judgment made elsewhere. Although the ruler of Dubai and the government are subject to court orders just like anyone else, their assets cannot be seized and sold by public auction. The UAE courts will order all to pay their debts, as everyone including the ruler and government are equal under the law. Nevertheless, as in many countries, when it comes to government debt the attachment of government assets and their sale at public auction is not allowed.

Some jurisdictions in the Islamic economic area will not enforce foreign judgments and arbitral awards. Some enforce foreign arbitral awards, but not foreign judgments. In some jurisdictions the extent and degree of enforceability of foreign judgments and awards is not entirely clear. To ensure to all the benefits of integrating the Islamic financial sphere with the Western financial sphere in a globalized economy, there must be *shariah*-compliant transactions in purely secular jurisdictions, in which the governing law will take cognizance of *shariah* as a matter of substantive and procedural law. Enforceability of *shariah* can be achieved by incorporating it into the law of the land, and then choosing the law of the *shariah*-incorporated jurisdiction as the governing law of the relevant transaction. Furthermore, to ensure recourse for investors, true ownership should pass to the individual *sukuk*-holders.

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Procedures for Reporting Financial Risk in Islamic Finance by Daud Vicary Abdullah and Ramesh Pillai

EXECUTIVE SUMMARY

- Uncertainty is a defining feature of the economic environment. Economic agents' perceptions of risk, together with their willingness and ability to bear it, fundamentally shape decisions, transactions, and market prices. Well-considered decisions should be based on information that helps to highlight existing risks and uncertainties. An important component of the information system of an organization or economy is financial reporting, through which an enterprise conveys information about its financial performance and condition to external users, often identified with its actual and potential claimants. It stands to reason, therefore, that financial reporting should provide a good sense of the impact of those risks and uncertainties on measures of valuation, income, and cash flows.
- It is important to reconcile the perspectives of accounting standard-setters on the one hand, and prudential authorities on the other, on what information should be reported, and on how it should be portrayed. The final goal is a financial reporting system that is consistent, as far as possible, with sound risk management and management practices and that can serve as a basis for well-informed decisions by outside investors as well as prudential authorities.
- Outside investors, be they equity or debt holders, would normally require certain information about the financial performance of a firm so as to guide their decisions. First, they would surely wish to form a view about the firm's past and current profitability, solvency, and liquidity at a given point in time. Second, they would probably also like to develop a picture of the risk profile of those attributes over time and, hence, of their potential future evolution. Third, they might additionally wish to gain a sense of how reliable or accurate those measures are. Combined, these three elements would provide the raw material to inform views about expected returns properly adjusted for risk and for the inevitable uncertainties that surround measurement. These three types of information correspond to the key categories into which the ideal set can be divided—namely, first movement, risk, and measurement error—and they are equally applicable to financial reporting in an Islamic finance environment.

INTRODUCTION

The key elements of Islamic finance can be summarized as follows.

- Materiality and validity of transactions: there is no profit sharing without risk taking, and earning profit is legitimized by engaging in economic venture. Money is not a commodity but a medium of exchange, a store of value, and a unit of measurement.
- Mutuality of risk sharing: clearly defined risk and profit sharing characteristics serve as an additional built-in mechanism. There are clearly laid out terms and conditions.
- Avoidance of *riba* (interest), *maysir* (gambling), and *gharar* (uncertainty).

The key elements of Islamic financial risk can be summarized as follows.

- The reporting of financial risk in an Islamic financial institution (IFI) requires greater transparency and disclosure than its conventional counterpart.
- This is particularly true with respect to additional *shariah* governance and some risk areas that are unique to Islamic finance.
- IFIs have greater fiduciary duties and responsibility to their stakeholders than conventional institutions.
- The additional duties and responsibilities of IFIs are overseen by the IFI's *shariah* board.

First-movement information describes income, the balance sheet, and cash flows at a point in time. It is the type of information with the longest tradition by far in accounting.

Risk information is fundamentally forward-looking. Future profits, future cash flows, and future valuations are intrinsically uncertain. Risk information is designed to capture the prospective range of outcomes for the variables of profit as measured at a particular point in time.

Measurement error information designates the margin of error or uncertainty that surrounds the measurement of the variables of profit,

including those that quantify risk. The need for this type of information arises whenever these variables have to be estimated. For instance, measurement error would be zero for first-movement information concerning items that were valued at observable market prices for which a deep and liquid market existed. However, it would be positive if, say, such items were marked to model and/or traded in illiquid markets, since a number of assumptions would need to be made to arrive at such estimates.

There has been a wide array of change and development in Islamic finance in recent years. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has tackled several of the pertinent issues in its Financial Accounting Standards (FAS). In particular, FAS 1 relates to general presentation and disclosure in the financial statements of Islamic banks and financial institutions. FAS 5 relates to the disclosure of bases for profit allocation between owners' equity and investment account holders. FAS 17 concerns investment. FAS 22 and FAS 23 deal with segment reporting and consolidation, respectively. AAOIFI Governance Standards 1–6 also provide relevant guidance. In particular, Governance Standard 6, Principles of Governance Section 7, gives guidance in respect of risk management.

Understanding Islamic Banking Risk

IFIs are exposed to all the risks that a conventional one is. However, there are some fundamental differences, particularly in the aspect of *shariah* compliance, where noncompliance can lead to reputational risk and worse.

Typical banking risk exposure includes the following.

- Financial: balance sheet, capital adequacy, credit, liquidity.
- Operational: fraud, product, business services, system failure, delivery, and process management.
- Business: country, reputational, regulatory, legal, macropolicy.
- Event: political, banking crisis, contagion.

BASIC RISK ANALYSIS

Ratios and analytics are in a constant state of evolution in order to reflect the growing challenges of Islamic finance and the constant stream of new products. In particular, the convergence of international supervisory standards, initiated by the Islamic Financial Services Board (IFSB) since its inauguration in 2002, has contributed to this developing landscape. Typical ratios relate to liquidity, capital adequacy, insider and connected financing, financing portfolio quality, large exposures, and foreign exchange positions.

Peer group benchmarking is a relevant measurement criterion. Here, the behavior of an individual institution can be measured against peer-group trends and industry norms. Significant areas such as profitability, product risk, the structure of the balance sheet, and capital adequacy come to mind. Any significant deviations of the individual institution from what is considered to be the norm must be investigated and understood, as they may well represent an early warning of negative trends in both the IFI and the industry.

What's Different in an IFI?

Islamic contracts and the allocation and sharing of risk. The analysis described above should also include the nature of the Islamic contracts included in the balance sheet and a basic understanding of how the risk is allocated or shared. Therefore a fundamental understanding of the IFI's balance sheet is required.

Liabilities. These include equity capital, reserves, investment accounts (*mudarabah* and *musharakah*) and demand deposits (*amanah*). Money is deposited in investment accounts in the full knowledge that the deposit will be invested in a risk-bearing project, where the profit will be divided between the institution and the depositor on a prearranged profit-sharing ratio. The depositor is also exposed to the risk of loss if the projects invested in do not perform. In many ways these types of deposit have a similarity with an equity investment in the bank, and it is this lack of clarity between shareholders and investors/depositors that can lead to a perception of increased riskiness. IFSB and AAOIFI guidelines have provided significant help in clarifying this issue.

Assets. These include short-term trade finance (*murabahah* and *salam*), medium-term financing (*ijarah*, *istisna'a*, etc.), long-term partnerships (*musharakah*) and fee-based services (*kafalah*, etc.).

These asset and liability contracts carried in the balance sheet of an Islamic financial intermediary give a clear indication of two fundamental differences between Islamic financial intermediaries and their conventional counterparts. First, the relationship between the depositors and the bank is based on profit and loss sharing principles; and second, the asset side of the bank may include "risky" assets such as *mudarabah* and *musharakah* that a conventional bank may not carry.

KEY ELEMENTS OF GOOD CORPORATE GOVERNANCE

Good corporate governance is defined by the set of relationships between the institution's senior management, its board, its shareholders, and other stakeholders.

- Corporate strategy defines how success can be measured.
- Responsibilities include assignment and enforcement.
- Strong financial risk management should be independent of the business, with good internal control and separation of duties.
- Good values and a code of conduct should be well articulated and maintained, especially in the area of related parties.
- Proper incentives must be consistent with objectives, performance, and values.
- The roles of stakeholders must be clearly set out.

The Roles of Stakeholders

- Regulators monitor the statutory environment and help to create an enabling environment.
- *Shariah* boards protect the rights of all stakeholders in accordance with the principles of *shariah*.
- The board of directors sets the direction of the bank and ensures its soundness.
- The executive management executes the direction of the board and has sufficient competence and knowledge to manage the financial risks.
- The board audit committee and internal audit are logical extensions of the board's risk management function. They assist executive management in identifying and managing risk areas.
- External auditors are responsible for validating the results and providing assurance that appropriate governance processes are in place.
- Market participants should accept responsibility for their own investment decisions. They therefore need transparent disclosure of information from financial institutions.
- Shareholders can appoint officers in charge of the governance process, subject to appropriate screening on related party transactions.

THE ROLE OF *SHARIAH*

Shariah boards are unique to IFIs. They have a responsibility to monitor the activities of the financial institution and to ensure compliance with *shariah* principles. As such, the *shariah* board acts as a governance body to protect the rights of the stakeholders in the IFI.

In some jurisdictions, national *shariah* boards have been formed, which work closely with regulators and supervisors in protecting the rights of all investors.

Transparency and Disclosure

Practices in IFIs have improved significantly in recent years, but there is still room for improvement in a number of areas.

- Quantitative methods for the measurement of risk still need improvement. AAOIFI is driving changes in this area.
- The decisions and methodology of the *shariah* boards should be disclosed more publicly. This will enhance the credibility of IFIs and also help to educate the public on the *shariah* decision-making process.
- There needs to be a clear demarcation between equity and depositors' funds.
- The financial information infrastructure requires constant improvement to ensure that a "virtuous cycle" of information continually forces practitioners to adopt sound corporate governance practices.
- Standardized reporting practices throughout IFIs would significantly assist in improving the collectability and analysis of data from them.

MAKING IT HAPPEN

Good financial risk management is about changing behaviors and attitudes. Boards and executive management are responsible for setting the implementation process, and regulators are responsible for creating a conducive environment. For example:

- the board must set the direction;
- regulators must ensure a supportive environment that encourages transparency and good market discipline, thereby creating a virtuous cycle;
- the market must value good financial discipline and risk management and must reward compliant companies accordingly;
- all stakeholders must recognize their responsibilities.

CONCLUSION

There are many similarities between conventional and Islamic risk management, as well as some significant differences, which have been highlighted above. The risk management process itself in an IFI does not differ much from conventional banking practices. However, it is the analysis and the identification of the risk environment that differ.

The balance sheet of the IFI needs to be structured in a way that will allow the easy identification of risk, particularly in the area of sources of funding and in the application of those funds for financing purposes.

The role of the *shariah* board is significant in protecting the rights of all stakeholders and ensuring that the business of the IFI is conducted in accordance with the principles of *shariah*.

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The Emergence and Development of Islamic Banking by Umar Oseni and M. Kabir Hassan

EXECUTIVE SUMMARY

- Islamic banking is an interest-free banking system which emerged on the global scene barely four decades ago.
- The definition of the Islamic banking system is essentially a banking system that complies with the economic value system of Islam.
- The Islamic banking business has emerged as an ethical banking system which is designed to cater for the interests of about a quarter of the world's population.
- Islamic banks engage in three major services: free services; services rendered by banks on fixed exchange, commission, or discount; and creation and development of funds.
- The development of the Islamic banking system has demonstrated its potential to be used as a viable global financial intermediary.
- The crystallization of the Islamic banking system in the 21st century has made it a force to be reckoned with to avert any future global economic crunch.

INTRODUCTION

As an alternative banking system, Islamic banking emerged in the global landscape with the advent of Islam. This form of interest-free banking has developed over a long period of time with the introduction of new products in the industry. The crystallization of interest-free banking based on Islamic legal principles has won a positive global image for Islamic banking in the modern world. The underlying philosophy in Islamic banking is to facilitate financial intercourse and spur symbiotic commercial relations that will ultimately bring benefit to the parties involved. One must work for whatever he or she earns in the long run. According to Rodney Wilson, "The Islamic banking industry has grown rapidly since the 1970s, reflecting the demand by pious Muslims to manage their finances in a way that avoids interest and complies with Islamic law" (Wilson, 2006). This emerging discipline of banking business in the modern world has reached a crescendo where it has become a force to be reckoned with in the global banking business. The best practices in the Islamic banking industry are worth exploring with a view to harmonizing practices in global banking to strengthen the world economy.

It is, however, important to emphasize that Islamic banking and Islamic finance are two inextricable disciplines in Islamic commercial law, but it is believed by most experts that the former is a subset of the later. Meanwhile, the global banking business needs several alternative banking models in order to cushion the effects of economic meltdown that may arise in the future. The experiences of Islamic banking in Muslim countries as well as Muslim-inhabited countries in Europe and America have been very encouraging, even though some problems were encountered at the outset (Hassan, 1999). The emergence and development of Islamic banking in the modern world has witnessed dramatic changes, especially in the recent global financial plummet. As an urgent step toward cushioning the effects of the global financial crisis, American International Group Inc. (AIG) had to offer Islamic insurance to the United States. This was after it had earlier reached two major bailout agreements, worth US$152.5 billion in taxpayer dollars. As a further move to step up its deals, AIG has established subsidiaries in some Muslim-majority countries such as Bahrain, Malaysia, and the United Arab Emirates. It is axiomatic to observe that Islamic insurance (*takaful*) is an aspect of Islamic finance which was one of the Islamic financial mechanisms embraced during the troubled times that engulfed most financial-cum-insurance heavyweights in recent years.

EMERGENCE OF ISLAMIC BANKING

Although Islamic banking was practiced during the classical period, the modern experiment of profit and risk-sharing business, which is the cornerstone of Islamic banking business, was first undertaken in 1963 in Mit Ghamr, a city in the Nile Delta in Egypt. "Its purpose was to explore the possibilities of mobilizing local savings and credits as an essential requirement for socio-economic development in the area." (El Naggar, 2005). The ripple effects of this successful

experiment were felt in some other Muslim countries after some years. "Few years before the bank consolidated its services in 1981, other banks such as the Islamic Development (IDB) and Dubai Islamic Bank opened their doors to customers in 1975. Also, Malaysia followed suit with the enactment of the Islamic Banking Act 1983. This brought about the establishment of the first formal financial institution in Malaysia in 1983 known as the Bank Islam Malaysia Berhad (BIMB)" (Oseni, 2009). The Islamic banking and finance industry has continued to grow in leaps and bounds over the years. The industry grows at a rate of 10–15% per year (Khan *et al.*, 2007). It is now the fastest-growing segment of the global financial system, with the unremitting establishment of Islamic banks in the Muslim world and beyond.

WHAT IS ISLAMIC BANKING?

In simplified form, Islamic banking and finance can be defined as "banking and finance in consonance with the ethos and value system of Islam. Hence, it is governed, in addition to the conventional good governance and risk management rules, by the principles laid down by the Islamic Sharī'ah" (Ayub, 2007). In a similar vein, it has been described as "a financial institution whose statutes, rules and procedures expressly state its commitment to the principles of Islamic *Sharī'ah* (Jurisprudence) and forbids of the receipt and payment of interest on any of its transaction" (Islam, 2006). This is the nature of the Islamic banking business. Although interest is proscribed in Islamic banking business, there are specific avenues through which the bank gets its returns.

One may wonder how Islamic banks make profits and ensure that they stay in business. In general, banking services can be classified into three categories: free services; services rendered on fixed exchange, commission, or discount; and the creation and development of funds. In Islam, free services are part of the role of banks, so they are required to render this service as part of their customer care service, which is in line with the spirit of Islamic commercial transactions (for example, benevolent loans without interest). The second category of services, which attract some sort of commission, fixed charge, or fee, is considered an important source of income for banks. Therefore the sources of funding for Islamic banks are mainly owner's equity, deposits, and special funds. This is illustrated in Table 1.

WHY AN ISLAMIC BANKING SYSTEM?

The Islamic banking system is unique, with its own features. Even though some of the products look similar to conventional modes of finance, there is a need for an alternative banking system

Table 1. Sources and deployment of bank funds. (*Source*: Islam, 2006)

Source of funds	*Use of funds*
1. Owner's equity } Total fund	
2. Deposits a) Current account	1. Deployment of funds a) *Qard al-hasanah* (i) Overdraft } Where PLS method is not possible (ii) Cash credit application } Where PLS method is not possible (iii) Demand loan (iv) Priority sectors, individuals, and the poor
b) Profit/loss sharing (PLS) accounts	b) Profit/loss sharing investments (i) Equity financing (ii) Leasing (iii) Hire purchase (iv) Normal rate of return
	c) Direct investment by banks (i) Bank's own projects (ii) Investment auctioning (iii) Commodity trade (iv) Spot transaction in foreign exchange (v) *Bai-muajjal* (vi) *Bai-salam* (vii) Discounting equity
Special 3. a) *Zakat* c) Social welfare fund	2. *Zakat* (a) Charity to target groups (b) Project for eligible target groups

to suit the needs of Muslims and non-Muslims alike who prefer the interest-free option. The global banking system must have alternatives for all sorts of customers with different religious and sociocultural backgrounds.

Against this backdrop, the Islamic banking business has emerged as an ethical banking system that is primarily intended to cater for the interests of about one-fourth of the world's population. The universal welfare and profit and loss sharing principles of Islamic banking are meant for humankind. The need for Islamic banking in the modern world cannot be overemphasized. "Modern businesses need huge amounts of funds, while people at large have mostly small savings. This necessitates the presence of such financial intermediary institutions through which business needs can be directly and indirectly fulfilled with savers' pooled money in such a way that savers/investors can also get a just return on their investments and business and industry can get the funds required for ensuring a sufficient supply of goods and services for the welfare of mankind" (Ayub, 2007). This is the value-added feature of Islamic banks that makes them a socially responsible financial intermediary within the economy.

ESSENTIAL REQUIREMENTS FOR ISLAMIC BANKING

The Islamic banking system is an integral part of the Islamic economic system. Provided that certain key requirements are complied with, Islamic banking can be established in any part of the world. Hussain Lawai identified nine essential requirements for a successful Islamic banking system. According to him, for a successful Islamic banking system there must be: a supportive legal framework and swift judicial system; disciplined entrepreneurship; a conceptual change from credit risk to overall risk management; strong ethical values; a Supreme *Shariah* Council; uniform accounting standards, committed management, and a progressive and modern outlook; and a body to evaluate Islamic financial institutions (Lawai, 1994). The principles of Islamic banking as contained in the Qur'an and the *Sunnah* are summarized thus: any predetermined payment over and above the actual amount of principal is prohibited, and the lender must share in the profits or losses arising from the enterprise for which the money was lent (except in benevolent loans). Making money from money is not allowed since it is a mere medium of exchange that has no value in itself, transactions involving *gharar* (deception) and *maysir* (gambling) are prohibited, and investments should only support practices or products that are not forbidden or even discouraged by Islam (Ahmad and Hassan, 2007).

BRIEF OVERVIEW OF MODES OF FINANCING IN ISLAMIC BANKING

There are numerous modes of financing in Islamic banking. Many more products are being certified periodically by the *Shariah* advisory councils of the banks to meet the modern challenges posed by the conventional banking system. The modes of financing in Islamic banking are based on certain terminologies introduced by Muslim jurists. Although it may not be necessary to examine each of the modes of financing in Islamic banking, it suffices to give an overview of

MAKING IT HAPPEN

The Islamic banking business is becoming more complex, with new products appearing from time to time. Stakeholders in the Islamic financial industry must face the challenges headlong if contemporary demands are to be met. The process begins with the introduction of a robust legal framework to strengthen the Islamic financial houses.

- The regulatory challenges posed by the Islamic banking business must be addressed to further enhance the productivity of the business.
- The duties of the *shariah* advisory councils should be properly defined to ensure the efficiency of their work.
- A proper framework must be formulated to ensure a sustainable means of dispute resolution for the banks. Legal reforms may be required here to further streamline practices in the industry.
- Amicable resolution of disputes arising from customer–banker relationships should be encouraged, backed up by an arbitral tribunal of industry experts.
- Support should be given to a degree of standardization in the Islamic banking industry through uniform practices that are generally agreed by Muslim jurists and experts in the field.
- Care should be taken to see that products are genuine and do not simply mimic conventional products.

some of the notable modes of financing. Table 2 gives a general outline of some basic terminologies in Islamic banking upon which the modes of financing are built.

BEST PRACTICE: THE CRYSTALLIZATION OF ISLAMIC BANKING

It goes without saying that best practice in the Islamic banking industry must be standardized and universalized with a degree of benchmarking. The development of the Islamic banking system has demonstrated its potential to be used as a viable global financial intermediary (Siddiqi, 1988). The sustainable and profitable practice of Islamic banking is based on ethical norms of Islamic financial transactions (*fiqh mu'amalat*). The banking operations have "positive socio-economic implications through real sector development and just and equitable pricing policies, in addition to cost efficiency and profit adequacy" (Ayub, 2007).

CONCLUSION

With the gradual shrinking of world banking toward a global hamlet, it is important to emphasize the growing need for the recognition

Table 2. Islamic banking: basic terminology. (*Sources*: Errico and Farrahbaksh, 1998, and El-Hawary *et al.*, 2004)

Term	*Explanation*
Amanah (Demand deposits)	Deposits held at the bank for safekeeping purposes. Their capital value is guaranteed and they earn no return.
Bay mu'ajal (Predelivery, deferred payment)	The seller can sell a product on the basis of a deferred payment, in installments or in a lump sum. The price of the product is agreed upon between the buyer and the seller at the time of the sale and cannot include any charges for deferring payment.
Bay salam (Prepayment, deferred delivery)	The buyer pays the seller the full negotiated price of a product that the seller promises to deliver at a future date.
Ijarah (Lease, lease purchase)	A party leases a particular product for a specific sum and a specific time period. In the case of a lease purchase, each payment includes a portion that goes toward the final purchase and transfer of ownership of the product.
Istisna'a (Deferred payment, deferred delivery)	A manufacturer (contractor) agrees to produce (build) and to deliver a certain good (or premise) at a given price on a given date in the future. The price does not have to be paid in advance (in contrast to *bay salam*). It may be paid in installments or part may be paid in advance with the balance to be paid later, based on the preferences of the parties.
Ju'ala (Service charge)	One party pays another a specified amount of money as a fee for rendering a specific service in accordance with the terms of the contract stipulated between the two parties. This mode usually applies to transactions such as consultations and professional services, fund placements, and trust services.
Kafalah	A pledge given to a creditor that the debtor will pay the debt, fine, or liability. A third party stands surety for the payment of the debt if unpaid by the person originally liable.
Mudarabah (Trustee finance contract)	The *Rabb-ul-mal* (owner of the capital) provides the entire capital needed to finance a project, while the entrepreneur offers his or her labor and expertise. Profits are shared between them at a certain fixed ratio, whereas financial losses are exclusively borne by the *rabb-ul-mal*. The liability of the entrepreneur is limited only to his/her time and effort.
Murabahah (Markup financing)	The seller informs the buyer of his or her cost of acquiring or producing a specified product. The profit margin is then negotiated between them. The total cost is usually paid in installments.
Musharakah (Equity participation)	The bank enters into an equity partnership agreement with one or more partners to jointly finance an investment project. Profits (and losses) are shared strictly in relation to the respective capital contributions.
Qard hasana (Beneficence loans)	These are zero-return loans that the Qur'an encourages Muslims to make to the needy. Banks are allowed to charge borrowers a service fee to cover the administrative expenses of handling the loan. The fee should not be related to the loan amount or maturity.

of more Islamic banking products to prepare for the likelihood of any future economic crunch. The crystallization of the Islamic banking business in the 21st century has made it a force to be reckoned with in the world economy. The Islamic banking business is not only meant for Muslims; non-Muslims have patronized Islamic banks as shareholders and customers in many countries across the world, and many are still transacting business with them. The recent global economic crunch, and the quick adoption of some Islamic finance products by some giant corporations, is an important example of the dire necessity and unfeigned relevance of Islamic banking and finance in global finance. Islamic banking has indeed survived the test of time as a viable global financial intermediary in the world economy.

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Islamic Finance and the Global Financial Crisis

by Bilal Rasul

EXECUTIVE SUMMARY

- The growth of Islamic financial institutions (IFIs) has been steady, but the full potential for deposit-raising remains untapped.
- The resilience of IFIs is a direct consequence of transactions being backed by real assets and prescribed financing contracts/agreements.
- Disparity between the creation of wealth and underlying real assets is countered through socially and ethically responsible investments propagated by Islamic finance.
- The report of the IFSB–IRTI Task Force on Islamic Finance and Global Financial Stability gives recommendations for keeping vigilant and creating global financial stability through IFIs.
- The participatory/risk-sharing nature of Islamic finance is the mainstay of the system.
- The projection and promotion of Islamic finance philosophy is the key to success.
- Emphasis should be on the fiduciary responsibility of IFIs to market products that are authentic (*shariah*-compliant) so that wealth and the distribution of profits is equitable.

ISLAMIC FINANCE

Islamic finance is a safe financial doctrine that promises justice and equity. The theme of Islamic finance is popular among those economies that are either interested in following the *shariah* tenets or are exploring alternative investment opportunities that have a sound basis and a promising potential.

The principles of Islamic finance fundamentally uphold the corporate governance and social responsibility philosophies: that is, accountability, transparency, and equitable distribution of wealth. They are derived from the *shariah* and the financial laws enabled by the Qur'an. The Qur'an, a complete code of life, is not just for the believers or for Muslims; it is for all mankind (*linnaas*):

"The month of Ramadan in which the Qur'an was revealed, a guidance for mankind, [a Book of] clear proofs of guidance and the criterion [distinguishing right from wrong]..." *Sura Al-Baqarah*, *ayat* 185. (English translation by the Nawawi Foundation, Chicago/Ibn Khaldun Foundation, London).

The stipulations of the Qur'an pertaining to the economic and financial system, too, are for the benefit of all mankind. Adherence to this conduct may not necessarily mean adhering to the faith—a misconception that needs to be addressed in the most benign manner.

Islamic finance is a subject that has reached out to a reasonable number of Muslims, as well as non-Muslims and financial planners. It is now accepted as an international form of financial intermediation. The growth of the industry, 20% annually,[1] has been the swiftest seen by any industry in the last few years. The innovation and product development have been dynamic.

In order to exploit the versatility of the corporate sector, an appropriate strategy is required to reveal the window of opportunity that exists for investors which, undoubtedly, would also launch Islamic finance to larger proportions. The practitioners and scholars of Islamic finance are expected to devise an unprejudiced approach for the purpose. Under the auspices of the Islamic Development Bank (IDB), the Task Force on Islamic Finance and Global Financial Stability was formed in October 2008, on the recommendation of the Forum of the Global Financial Crisis and its Impact on the Islamic Financial Industry, organized by the IDB Group. The Task Force was mandated to: (1) examine the conceptual aspects of Islamic finance and its role in enhancing financial stability; (2) conduct a stocktaking of the state of the Islamic financial services industry following the global financial crisis; and (3) examine the financial architecture of the Islamic financial industry amid the more challenging post-crisis environment.[2] Since then the Task Force has thoroughly examined these areas and documented them in a report submitted to them by the three working groups. The report is a public document and can be accessed for a better understanding of the current stability issues that Islamic finance addresses, the state of the Islamic financial industry, and the challenges that lie ahead.

The events transpiring in the last two years leave little doubt that Islamic finance is the way forward and that the discipline should be explored. The role of the IFIs and Islamic regulatory organizations is critical in promoting an ethics-based financial system to provide the solution for the ailing conventional financial system.

RESILIENCE THROUGH THE CRISIS

The resilience of the Islamic financial system has been put to the test at the evolutionary stage of its life. The incidence of default and financial instability in IFIs was significantly reduced due to the nature of Islamic finance, which is manifested in limited debt leverage, risk and profit sharing, and financial transactions backed by real assets, coupled with legislative restrictions on derivative-like products. Written contracts that emphasize the possession and ownership of real assets are a fundamental source of credibility for transactions and provide disclosure and transparency for investors to *shariah* standards. "The Islamic financial system is driven by trade and production and is intimately linked to the real sector ('Main Street' and not 'Wall Street')."[3]

Regulatory oversight, absence of governance, and pitiable rating structures failed the conventional financial system. Lapses in prudential standards and risk mitigating factors added to the tribulations. The hedging instruments that were designed to absorb the risk ended up manufacturing risk. By and large, however, the IFIs remained resilient.

IS ISLAMIC FINANCE A CLEAR WINNER?

The bailout of international financial institutions by way of acquisitions by the government, capital injection, and liquidity injection is unprecedented. In the new global financial and economic scenario IFIs may have survived the 2008–09 financial crisis, but whether they have capitalized on the remnants of the defunct capitalist financial system is a question that needs to be probed.

Is it a foregone conclusion that Islamic finance has appeared as the panacea to the collapsed global financial system? Theoretically, the answer is in the affirmative, but realistically and practically, the size of the industry suggests otherwise. A trillion dollar industry though it may be, the asset base of the IFIs figures minutely against the gargantuan conventional financial industry. It would be naive to think that the IFIs survived the financial crisis due to their authentic product lines, good governance, and regulatory frameworks. Systematic risks such as exchange rate risk, market risk, and liquidity risk are externalities that cannot be isolated from IFIs and have a spillover effect, and must be managed by them.

Nevertheless, the Islamic financial paradigm may be the long-term solution. "The solution lies in disciplining the creation of money, limiting the self-interest with social aspects and the business ethics, transforming the corrupt financial system to make it free of exploitation and games of chance and thus enabling mankind to optimally use the resources for benefits at a larger scale."[4]

POST-CRISIS RELAUNCHING OF ISLAMIC FINANCE

While the conventional banking and finance industry recuperates from the exigencies of the global financial crisis, this is the opportune time for Islamic finance to prove its competitiveness and enhance its profile. The pull-factor must be rediscovered and employed to attract investors

EXTRACT FROM ERNST & YOUNG REPORT

- Market capitalization of the top 10 conventional banks declined by 42.8%, in contrast to the 8.5% decline of that of Islamic banks between 2006 and 2009.
- The profits of conventional banks fell from US$116 billion in 2006 to a net loss of US$42 billion in 2008. By comparison, Islamic banks' net profits increased 9% during the same period, from US$4.2 billion to US$4.6 billion. No Islamic bank suffered a loss in 2008.
- The total assets of conventional banks grew by 36% to US$17.4 trillion, whereas assets of the Islamic banks grew by 55% from US$94 billion to US$147 billion between 2006 and 2008. The growth in total equity during this period was 24% and 36% for conventional and Islamic banks, respectively.
- Conventional banks' leverage ratio (assets/equity) was 16.6 times in 2006, which increased further to 18.2 times in 2008. This was nearly three times the leverage ratio of Islamic banks, which was 5.8 times in 2006 and 6.6 times in 2008.
- Five of the top 10 conventional banks received government financial assistance to the extent of US$163 billion in aggregate, while only one IFI required government assistance to restructure. No Islamic bank needed any support from government for bailout.

(From the Report of the Task Force on Islamic Finance and Global Financial Stability, Ernst & Young, 2009.)

and borrowers toward IFIs to service their financial requirements and avoid the risk-sharing, highly complex hedging investment opportunities offered by the conventional banking institutions.

Researchers and scholars of Islamic finance are endeavoring to create products that are equitable and attractive. However, the discord in transactional issues presented by the varied interpretations of the various schools of thought prevents this system from evolving and being effectively marketed. It must be truly understood and implemented in substance that adoption of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) standards is a precursor to claiming *shariah*-compliant status. This cardinal principle, in itself, is the key for the harmonization issue.

The Islamic Financial Services Board (IFSB), being the international Islamic financial regulator, also shoulders the responsibility for playing the lead role in marketing and establishing credibility for Islamic finance. International summits and conferences are consistently held around the financial centers of the world to promote and enhance the image of Islamic finance as an ethical and stable financial system. While awareness creation may no longer be the need of the hour, what is required are measures to incentivize IFIs at an industry-wide level: for example, the provision of corporate tax relief to IFIs; capital gains tax exemptions on *shariah*-compliant securities; withholding of tax exemptions on dividends of *shariah*-complaint companies; etc. These incentives require the patronization of those governments interested in adopting Islamic finance. Memoranda of Understanding should be inked through the regulatory agencies acting as representatives of their respective countries on the Islamic Financial Services Board (IFSB).

THE WAY FORWARD

The lessons for IFIs and Islamic financial markets are clear. If financial stability is to be achieved, the separation of risk from the real asset, as embodied in the conventional system, needs to be countered. Adherence to the risk-sharing philosophy preached by Islamic finance needs to be marketed, and the Islamic infrastructure has to place clear and unambiguous restrictions on questionable transactions. The Task Force has recommended that an Islamic Financial Stability Forum (IFSF) be established to serve as a platform for the deliberation of issues relevant to the ensuring of financial stability in the Islamic financial system.

To grow, adoption of the best practices and international standards prescribed for IFIs is a priority. The intrinsic principles of Islamic finance ensure that the allocation of resources is efficient and equitable, which inexorably will prevent exposure to the market shocks that have afflicted the conventional banking and finance sector. Islamic finance is rationally the next dimension of the financial world.

CASE STUDY

Camouflage

A commonplace apprehension among the general public toward IFIs, and Islamic finance in general, is the authenticity issue. This is due to the mimicking or camouflaging of conventional products by the IFI. Although some mimicking may be justified, products need to be totally aligned to the *shariah* framework that regulates them.

The worker vs his/her tool dilemma presents itself here again, where the tool is the Islamic finance philosophy, which lays down the roadmap for just and equitable distribution of wealth, and the worker is the IFI manager. It is the workman who has to reposition his or her attitude and *niyah* (intent) toward achieving the prescribed goal of Islamic finance. Highlighting and redefining the fiduciary responsibility of the IFI is critical. The fiduciary responsibility adds another component over and above the regular role of the corporate manager—that is, accountability and subscription to the prescriptions of the *shariah*. Dubious products marketed by IFIs undermine the credibility of the system. Exploitative and unjust products that disguise *riba* (usury), *gharar* (uncertainty), and *maysir* (gambling) need to be identified, and the *shariah* boards must censure those who promote them. The *shariah* boards also need to be regulated by the overseeing regulatory authority to ensure that they are not simply rubberstamping products.

The *sukuk* (Islamic bonds) issuances around the world, now a popular Islamic financial product, are also not devoid of structural issues. Similarly, *tawarruq* (reverse *murabahah* or monetization), wherein a sale is made for deferred payment, has been held as impermissible by the OIC Fiqh Academy.[5]

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1 Islamic Develoment Bank, 2010.

2 *Ibid*., p. 34.

3 Venardos, 2010, p. 2.

4 Mohammad Ayub. "Islamic finance must turn to the roots." *Journal of International Banking and Finance*, p. 27.

5 Resolution 179 (19/5), 19th session, April 2009, Organisation of the Islamic Conference (OIC) Islamic Fiqh Academy.

Checklists

Instruments

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Alternatives to *Riba* in Islamic Finance

DEFINITION

Riba (financial interest obtained by charging money from the lending of money) is prohibited by Islamic law. Under *shariah* principles, money is regarded purely as a means of exchanging goods or services, without value itself. Islamic law acknowledges and values human effort, initiative, and cooperation in a business above the financial value of the money used to finance it.

To comply with this fundamental principle, Islamic finance has developed practices based on custom and fairness that do not involve the paying and charging of interest. Initially these were restricted to profit-sharing arrangements, also known as *musharakah* and *mudarabah*.

However, these have now diversified and include leasing, equity sharing, and asset trading techniques such as *murabahah, salam*, and *ijarah*-based finance.

Musharakah and *murabahah* can be used for the purposes of overseas trade financing or single transaction financing. More specifically, *murabahah* in mainly used in import/export finance, whereas *musharakah* is most widely used for joint venture finance and syndications. *Salam* is widely used in the farming sector for the finance of agricultural products and farmers.

Ijarah, another permitted form of finance, is an Islamic form of leasing. The banks first buy and maintain the assets, and then they dispose of them in accordance with the Islamic law. *Ijarah wa iqtinah* is an extension of *ijarah* to cover hire and purchase agreements.

A combination of *ijarah* and diminishing *musharakah* can present a *shariah*-compliant alternative to conventional mortgages. Under the *musharakah* partnership principle, the financial institution acquires the property. Although ownership remains in the hands of the institution, the client can occupy the property throughout the pre-arranged period of the agreement, typically 20–30 years, in return for a monthly payment. These arrangements have similarities to variable shared equity plans, with the client's ownership share steadily increasing with each monthly payment, while the institution's progressively falls. The client only gains full ownership when the final payment has been made.

ADVANTAGES

- *Musharakah* and *mudarabah* are the most approved contracts under *shariah* law and their application is encouraged by *shariah* scholars.
- *Salam*-type arrangements enhance production by encouraging the seller to produce enough to at least settle the loan, and also help to stabilize pricing in commodities markets.

DISADVANTAGES

- In Islamic finance, buybacks and rollover are not allowed, being viewed as a backdoor means of charging interest and providing less flexibility of investment.

ACTION CHECKLIST

✔ Assess carefully the contracts and products offered and whether they are too expensive to operate. Often smaller scale transactions cost more to operate, process, and regulate than larger ones.

✔ Investigate and understand local customs and financial practices, as these can vary widely between countries and even regions.

✔ Muslims living in Western countries—where conventional banking practices are the norm—need to be extra vigilant over the risk that interest is being levied on them without their knowledge, for example, by utility companies or local authorities for any inadvertent late payments.

DOS AND DON'TS

DO

- Encourage communication and dialogue between *shariah* experts and the financiers in order to ensure that the products offered are compliant with *shariah* law.
- Providers should consider establishing formal panels of Islamic scholars who have the expertise to oversee and audit the products to ensure *shariah* compliance.
- Expect variations between schemes available in different countries according to local attitudes and conventions.

DON'T

- Don't underestimate the help that local religious leaders can provide in explaining to potential users how the financial products offered are *shariah* compliant. Their help can provide valuable reassurance to potential users of the products.

(*Continued overleaf*)

DON'T (*cont.*)

- Don't succumb to competitive pressures by introducing new products that have been successful in other regions until you are confident of their acceptability to local Islamic scholars.

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Key Islamic Banking Instruments and How They Work

DEFINITION

The need to fully conform to *shariah* law has created both challenges and opportunities for financial institutions aiming to serve their growing Muslim client base. Requirements that money cannot be used for the purposes of making money (effectively forbidding the charging of interest), and the need for investments to deliver some form of collective or community benefit, have necessitated a high degree of innovation from Islamic financial institutions to develop a range of new products for customers seeking full compliance with *shariah* law.

Among the leading Islamic banking products are the following.

Murabahah

A kind of "cost-plus" transaction in which the bank buys the asset then immediately sells it to the customer at a pre-agreed higher price payable by installments. This price is set at a level that takes account of the time value of money until the customer's monthly payments cover the bank's selling price, less any deposit paid. This facility is often used in the way that mainstream banking customers might seek a mortgage when buying property.

Bai Salam

A kind of forward sales contract which requires the buyer to pay in advance for goods that are to be supplied later. *Bai salam* contracts are often used in manufacturing; a buyer would expect to receive a more attractive price when paying in advance with funds that can be used in the meantime by the producer.

Istisna'a

Istisna'a, another form of forward sales contract, is a longer-term financing mechanism under which a price is agreed before the asset described in the agreement is actually built. Sellers can then either create the asset themselves or subcontract, with buyers also having the option of paying the entire sum due either in advance or as installments during the manufacturing process. *Istisna'a*, meaning "asking someone to manufacture" in Arabic, is a common form of financing in the construction industry.

Ijarah

A form of *shariah* law-compliant leasing involving rights over the use of an asset under which the bank buys the asset then leases it to the customer over a fixed period in return for a pre-agreed monthly price. Provisions can be made for the customer to buy the asset at the end of the agreed period. Thought needs to be given to issues such as the provision of insurance, as the asset is effectively owned by the bank during the lease period.

Mudarabah

A form of investment partnership between a bank and a business that shares the risk and losses or profits between both parties at pre-agreed levels. A *mudarabah* transaction, bringing some of the benefits of a business loan to *shariah*-compliant business customers, effectively requires the bank to take a stake in the business, with clients investing their time and expertise in running the enterprise.

ADVANTAGES

- Islamic banking instruments permit Muslims to benefit from a growing range of financial products in compliance with *shariah* law.
- Some products require a partnership between the client and the bank, encouraging both parties to take a longer-term view.
- Islamic banking dictates that transactions should serve to provide some form of benefit to the community at large, rather than setting pure profit as the aim.

DISADVANTAGES

- With some financial aspects of *shariah* law open to interpretation, some instruments may be offered by some institutions, but not by others.
- Some non-Muslim clients could find that the conditions imposed by Islamic banks prevent them from taking advantage of shorter-term opportunities.

ACTION CHECKLIST

✔ When entering into leasing-style arrangements, ensure that all "grey" areas are covered by the agreement, such as the insurance and maintenance costs of the asset.

(*Continued overleaf*)

✔Islamic banking is by definition more stable than conventional mainstream banking in that it outlaws involvement in speculation or short-term industry "trends." However, clients must ensure that they are committed to operating within the boundaries set by *shariah* law before using Islamic banking services.

DOS AND DON'TS

DO

- Appreciate that the stability of the Islamic banking sector can come at the price of a slower pace of product innovation.
- Recognize that the rapid growth in Islamic banking globally could present an attractive source of funds for businesses prepared to make a long-term commitment to operation under *shariah* principles.

DON'T

- Don't ignore the aim of Islamic banking to bring a wider benefit to society.
- Don't see Islamic banking institutions as financial services providers for Muslims only; such banks can be valuable long-term commercial partners for a range of individuals and companies.

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Key Principles of Islamic Finance

DEFINITION

The principles of Islamic law derive from interpretations of two sources: the Qur'an and the *Sunnah*. The central pillars of Islamic finance are that wealth must be generated from legitimate trade and asset-based investment, while the use of money for the purposes of making money is expressly forbidden. Crucially, the latter means that Islamic finance does not permit the charging or paying of interest (*riba*). Under Islamic principles, investment must have a social and an ethical benefit to wider society, with short-term speculative investments (known as *maysir*) strictly forbidden. Islamic finance also prohibits investment in sectors classified as inappropriate on moral grounds by *shariah* law. These include industries involving alcohol, gambling, or drugs, but can extend well beyond these narrow boundaries. Each Islamic bank's adherence to the principles of *shariah* law is governed by its own *shariah* board, a body charged with the responsibility of overseeing all processes of the bank. While some aspects of *shariah* law may be subject to individual interpretation, the board also has the responsibility to decide which proposed deals are acceptable to the bank on *shariah* grounds, and which are not.

Given that Islamic finance forbids the charging of interest, banks must earn their profits through the provision of fee-based services, or through a kind of partnership with clients in which both the risk and the profits or losses are shared between the bank and the customer, according to pre-agreed conditions. Such arrangements typically allow the client to draw a salary from the business, which is then deducted from profits. *Shariah* law permits a range of leasing-style agreements under which the bank can buy an asset on behalf of a customer, then charge a regular, pre-agreed rental fee. As in mainstream Western banking, these agreements can be fixed-term operating leases or lease purchases, with the latter obliging the client to buy the asset at the end of the period, at a predetermined price. While some leasing arrangements can be relatively straightforward, others can become more complex, depending on how the asset is originally purchased by the bank. Given that Islamic finance does not permit the charging of interest, a bank originally buying the asset on the basis of a variable interest rate may seek an arrangement by which the rental charge is increased, to effectively compensate any increase that it faces in financing costs. However, some *shariah* boards may refuse to sanction such agreements, potentially leaving the bank with exposure to interest rate risk.

ADVANTAGES

- Islamic finance provides a basis for commercial transactions for followers of Islam to enter into, which would be impossible on conventional banking terms.
- The adoption of Islamic finance principles gives banks access to a substantial new customer base.
- The partnership basis on which some Islamic businesses are established with banks ensures that the bank has a direct stake in the success of the venture.
- The rejection of deals involving short-term, speculative activity encourages businesses to invest for the longer term.
- Islamic finance contracts offer flexibility in terms of the applicable legal jurisdiction.

DISADVANTAGES

- Some financial aspects of *shariah* law can be open to interpretation, with the result that some Islamic banks may agree transactions that would be rejected by other banks.
- These "grey" areas, resulting from inconsistencies in interpretation, can create more uncertainty for clients than under conventional banking arrangements.
- Some leasing arrangements can become appreciably more complicated when trying to ensure conformity to Islamic principles.
- Given that the banks are the legal owners of assets under rental or leasing agreements with clients, issues such as liability for insurance and risk can be complications.

ACTION CHECKLIST

✔ Non-Muslims should consider how Islamic finance can provide them with access to financial backing from those seeking *shariah*-compliant funds.

✔ As more institutions launch products compliant with *shariah* principles, investors should take time to assess their best choice of potential banking partners.

✔ Understand that adherence to interpretations of Islamic principles can create complications over the medium term.

DOS AND DON'TS

DO

- Recognize that the ethical considerations and long-term partnership advantages offered by Islamic finance can come with the price of greater complexity and uncertainty.
- Take professional advice as to the tax treatment of Islamic finance transactions within your particular jurisdiction.
- Appreciate that the prohibition of activities perceived as speculative could limit the business's scope to capitalize on potentially lucrative short-term opportunities.

DON'T

- Don't regard Islamic finance as purely "specialty" banking; the market is fast becoming mainstream with a rapidly expanding range of products available.
- Don't look at Islamic banking in isolation, as deals can be structured with a combination of conventional and *shariah*-compliant finance.

MORE INFO

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Murabahah Sale Instruments and Their Applications

DEFINITION

Murabahah is a transaction in which a buyer purchases items at a profit margin agreed by both parties. The profit made by the seller is not regarded as a reward for the use of his or her capital, since it is not permissible to rent out money in Islam, but is instead seen as a profit on the sale of goods.

It is important to note that the profit in *murabahah* can be determined by mutual consent either in terms of a lump sum or through an agreed ratio of profit, which will be charged above the cost of the item.

All the expenses incurred by the seller in acquiring the commodity, such as freight, customs duties, and other costs, may be included in the cost price, and the markup can be applied to the aggregate cost.

Murabahah is valid only when it is possible to determine the exact cost of a commodity. If the exact cost cannot be ascertained, the commodity cannot be sold on a *murabahah* basis. In such an eventuality, the commodity must be sold on the basis of *musawamah* (bargaining), i.e. without any reference to the cost or to the profit/markup ratio. The price of the commodity in such cases shall be determined in lump sum by mutual consent.

In modern Islamic financial practice, *murabahah* has become an established mode of asset financing with an agreed and known markup. Being the most prevalent financing mechanism in Islamic finance, the *murabahah* sale instrument has provided a *shariah*-compliant alternative to interest-based financing mechanisms. The *murabahah* contract has also been applied for deposit-taking and issuance of *sukuk*.

Murabahah can be applied to large-scale projects. For example, it may be used to fund a plantation, whereby participants purchase seedlings and fertilizers and then sell these seedlings and fertilizers to the plantation operator at an agreed markup.

It can also be used to facilitate liquidity management, risk management in the Islamic financial market, and Islamic financial product offerings. For example, an Islamic bank can buy a commodity from the commodity market at the spot price and sell it to a corporate client on a deferred basis. This client can then sell the commodity back to the commodity market at the spot price for cash, returning to the bank the original sum plus an agreed markup.

ADVANTAGES

- *Murabahah* is not an interest-bearing loan, which is considered *riba* (excess). *Murabahah* is an acceptable form of credit sale under *shariah*. The agreement is similar in structure to a rent-to-own arrangement, with the intermediary retaining ownership of the property until the loan is paid in full.
- Because the Islamic bank that arranges a *murabahah* transaction does so as a partner, it is, in theory, concerned to ensure that the person who receives the money to make purchases is able to repay it. This should ensure that it behaves more cautiously than Western institutions, providing greater financial stability.
- Muslims can take advantage of the interest-free loans available from Western institutions if the seller decides not to charge a markup.

DISADVANTAGES

- *Murabahah* is not applicable in all cases. For example, it cannot be used when the price of the good cannot be determined.
- The agreed markup is not subject to inflation or fluctuations in the currency.

ACTION CHECKLIST

✔ Determine the markup, in the form of an absolute amount or a certain percentage of acquisition cost, and make sure that it is specified before the conclusion of the *murabahah* contract.

✔ Determine the benchmark to be used to find the agreed markup. Any mutually agreed benchmark, including but not limited to conventional financial benchmarks such as the base lending rate, may be used to determine the markup in the *murabahah* contract.

DOS AND DON'TS

DO

- Ensure that you understand the full acquisition cost, which may include direct expenses (costs incurred to enable the acquisition of goods) such as storage and delivery.
- Ensure that indirect expenses, such as staff wages and labor charges that are not part of the cost of acquisition, are not included in the acquisition cost. They are not allowed to be included.
- Note that in the contract, the asset transfer date and the title transfer date may not coincide.

DON'T

- Don't forget that whenever a purchase order involves a transaction requiring the issuance of a letter of credit, the commission for issuing the letter is not part of the acquisition cost.
- Don't forget that any additional direct expenses not specified in the agreement relating to a *murabahah* contract and incurred after the conclusion of the contract shall be borne by the customer, provided that a clause to that effect is already incorporated in the contract.

MORE INFO

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An Overview of *Shariah*-Compliant Funds

DEFINITION

Shariah-compliant funds are investment vehicles which are fully compliant with the principles of Islam. The funds are prohibited from making investments in industries categorized as morally deficient, such as those related to gambling or alcohol. Because Islam does not permit any form of exploitation, any kind of investment in conventional banking is outlawed. With the concept of debt also contrary to the principles of Islam, investment in highly leveraged companies is also not permitted for *shariah*-compliant funds. The exclusions extend to potential investments in other funds which offer guaranteed returns. Any use of futures and options, either by the fund managers or by companies in which the funds invest, is also likely to attract close scrutiny by the funds' supervisory *shariah* boards.

Due to the rapid growth in Islamic finance over recent years, the available range of *shariah*-compliant funds has expanded as financial services providers seek to tap into the increasing demand for investment products that respect the principles of Islam. The most common forms of *shariah*-compliant funds are described below.

Ijarah

Ijarah (also transliterated *ijara*) is a leasing-type fund that acquires assets such as real estate or equipment and then leases them out to another party in return for a regular rental payment. In all cases the fund retains ownership of the asset and must ensure that usage of the asset is at all times in accordance with Islamic principles.

Murabahah

Murabahah (or *murabaha*) is a kind of development fund that acquires assets and then sells them to a client at a predetermined price which reflects the fund's cost of acquiring the asset plus a profit margin. Sometimes described as "cost-plus" funds, *murabahah* investment vehicles do not hold long-term ownership of the assets, but instead generate a financial return from the payment obligations taken on by clients for a pre-agreed period.

Equity

Equity funds invest directly in companies through the purchase of shares. Given the difficulties involved in scrutinizing every aspect of how a company operates to verify *shariah*-compliance, this new, more progressive attitude allows investment in companies that operate in permitted industries, with the proviso that a proportion of the returns generated for the fund from any interest-bearing deposits held by the company must be donated to charity.

Commodity

Commodity funds invest in physical commodities, although speculative activities such as short-selling are not permitted. However, the fund manager may make use of *istisna'a* contracts, pre-agreeing the price of goods to be manufactured and delivered at a specified future date, with the manufacturer benefiting from advance receipt of the agreed sale price. Commodity fund managers can also use *bai salam* contracts. These can be compared to conventional forward contracts, though the key *shariah*-compliant differentiator is that the seller's position is protected because payment is passed to the seller on agreement of the contract rather than on its completion. However, in return for the effective transfer of contract risk, the buyer is compensated by the fact that the agreed delivery price is set at a discount to the physical spot price.

ADVANTAGES

- *Shariah*-compliant investment funds provide a means of investing while still honoring the high morals and principles of Islam.
- *Shariah*-compliant funds promote large-scale investment along lines similar to the niche ethical funds available to Western consumers.

DISADVANTAGES

- The funds can be more expensive to develop and administer than mainstream funds due to the need for greater verification of compliance with *shariah* principles.

ACTION CHECKLIST

✔ Assess the full range of available *shariah*-compliant investment products before selecting the type you wish to use.

✔ Consider how much risk you are prepared to assume before investing.

✔ Mainstream investors may wish to consider potential investments in *shariah*-compliant funds.

DOS AND DON'TS

DO

- Compare fund management charges between different providers.
- Consider using index products such as exchange-traded funds to gain exposure to Islamic investment indices.

DON'T

- Don't feel you have to verify the compliance of a fund yourself—contact a fund provider for advice.
- Don't expect guaranteed attractive returns, even from the most ethical forms of investment.

MORE INFO

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Possibilities for *Shariah*-Compliant Derivatives

DEFINITION

The market in derivatives—financial products with characteristics and pricing based on an underlying instrument—has grown rapidly over recent decades. Derivatives can be based on financial instruments such as bonds, equities, and currencies as well as commodities and alternative investment such as infrastructure. Derivatives allow the transfer of risk between parties, either in the form of futures, via a recognized financial exchange or, typically in the case of swaps, on an over-the-counter basis between investors.

Used correctly, derivatives such as futures and options can be used to hedge risk; for example, soft commodity derivatives can be used for a variety of beneficial purposes, such as protecting producers from adverse price declines, or enabling food processors to invest in long-term infrastructure in the knowledge that they have some protection against erratic price movements. Given that *shariah* stipulates the need for a wide public interest in financial dealings, compatible instruments that help to reduce uncertainty and risk are compliant with the Islamic principle of *maslahah* (public interest). However, some Islamic scholars take the view that as one party seeks to lower risk using derivatives, the counterparty is assuming risk in return for a potential reward. Therefore, given that *shariah* prohibits speculation, the compatibility and use of derivatives remains a hotly contested subject. Margin calls on futures can be a further source of controversy for some scholars, given that the party bearing an adverse price movement has to lodge money with a clearing house without any corresponding transfer of the underlying asset.

However, Islamic financial services providers can attempt to overcome many of the problematic issues surrounding conventional derivatives through the use of *shariah*-compatible transactions within specific Islamic derivatives. For example, Islamic swaps can be constructed from specific types of *murabahah* contracts traded between two parties, specifying the actual transfer of underlying assets, with the sales price paid on a specified future date (to include a premium related to the payment timeframe). Some finance providers also offer *arboun*, a kind of option contract normally offered in conjunction with *murabahah*. Under the latter, the provider buys the asset for the client with an agreement to sell at a particular price on a future date. Under an *arboun* contract, in return for a nonrefundable deposit, the investor has the option (but not the obligation) to purchase the asset at a specified price at any time until the contract matures.

ADVANTAGES

- Some *shariah* scholars believe that Islamic derivatives can play a *shariah*-compliant beneficial purpose by offering users, such as farmers, protection from adverse price movements.
- Derivatives can be used to offset risks for producers, and they can therefore be used as tools in support of long-term investment plans that can be of benefit to communities.
- *Shariah*-compliant transaction structures can be used to create synthetic derivatives that win wider acceptance over their compatibility with Islamic principles than conventional derivatives.

DISADVANTAGES

- Derivatives such as futures and options are widely used for speculative purposes—activities that can equate to gambling, and therefore run contrary to the principles of Islam.
- Most *shariah* scholars maintain that, by their very nature, derivatives—both conventional and Islamic—are priced according to assets that are not in the possession of the seller, in violation of the *hadith* principle. Most scholars therefore believe that Muslims should not trade in derivatives.
- Specialist Islamic synthetic derivatives can suffer from severe liquidity shortages because they are unattractive to conventional investors.
- The noncompliance of conventional derivatives with *shariah* meant that some Islamic institutions were less able to employ hedging strategies to protect their interests during the global banking industry crisis in the wake of Lehman Brothers' collapse in late 2008.

ACTION CHECKLIST

✔ Users of futures and options seeking *shariah* compliance should demonstrate that their transactions constitute true hedging activities to protect against adverse price movements in assets they already own.

(*Continued overleaf*)

✔ The use of derivatives is more likely to gain the approval of Islamic scholars where changes in the asset value can bring some kind of benefit to both parties, rather than one party gaining while the counterparty loses (a so-called "zero-sum" situation).

✔ Derivative structures should be kept as simple and transparent as possible to help improve the prospects of acceptance.

DOS AND DON'TS

DO

- Remember that speculative activity and gambling of all kinds are prohibited under Islamic law.
- Acknowledge that variations of opinion exist between scholars as to the compatibility of different derivatives with Islamic principles.

DON'T

- Don't underestimate the potential complexity of derivates such as swap transactions, particularly synthetic swaps, aimed at gaining acceptance with Islamic principles.
- Don't expect the range of available Islamic derivatives to be as comprehensive as those available to conventional investors.

MORE INFO

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Financial Times special report on Islamic finance: www.ft.com/reports/islamic-finance-2010

The Role of the *Shariah* Advisory Board in Islamic Finance

DEFINITION

The *shariah* board is a key element of the structure of an Islamic financial institution, carrying the responsibility of ensuring that all products and services offered by that institution are fully compliant with the principles of *shariah* law. The role of the board also involves the reviewing and overseeing of all potential new product offerings. Additionally, the board may be called on to make a judgment on individual cases referred to it, relating to whether specific customer business requests are acceptable to the institution. Given that *shariah* law is derived from studies of both the Qur'an and the *Sunnah*, inconsistencies can occur in the interpretations of precisely where the boundaries of compatibility lie, with the result that some *shariah* boards may deem unacceptable proposals that may be approved by other boards.

With demand for *shariah*-compliant financial services growing at a faster rate than mainstream banking, the board can play a vital role in helping to develop new procedures and products to position the institution to adapt to industry trends, and customers' expectations. The board should be closely involved in overseeing *shariah*-compliant training programs for employees. Board members also participate in the preparation of an annual investors' report on the bank's balance sheet, with particular reference to its compliance with *shariah* principles.

Given the importance of the role of the *shariah* boards in ensuring the conformity of the institution's offerings, boards typically include acknowledged experts, such as contemporary Islamic scholars. It is common for such scholars to sit on the *shariah* boards of multiple institutions; some senior scholars may sit on the boards of 15 or more institutions. The activities of individual boards are supervised by an independent body, the International Association of Islamic Bankers. This association's Supreme Religious Board examines the judgments, or *fatwas*, of individual *shariah* boards to ensure conformity to *shariah* law.

ADVANTAGES

- The board's role is well defined; ensuring that an institution's activities are fully compliant with *shariah* law is its responsibility.
- Given the speed of change in the financial services industry, the board plays a vital role in advising the institution as to the feasibility of potential new products and services.
- *Shariah* audits can be undertaken in conjunction with the board to give greater reassurance to customers.

DISADVANTAGES

- *Shariah* law is highly subject to interpretation, particularly in relation to its significance in the demand-driven financial services industry.
- Inconsistencies occur between different boards in their interpretations of what is and is not permissible.
- Precedents are not binding in Islamic jurisdictions, with the result that personnel changes to a board may shift the balance of collective opinion over time.

ACTION CHECKLIST

✔ Some Islamic investors may seek reassurance that products and services which have been approved by *shariah* boards outside their own jurisdictions are truly compliant with their own *shariah*-compliant objectives.

✔ Given the complexity of some Islamic *sukuk* structures (the arrangements established to create the Islamic equivalent of a bond), it is important that *shariah* boards are given the considerable resources needed to ensure the true compliance of these instruments.

DOS AND DON'TS

DO

- Ensure that *shariah* boards have a high level of autonomy and independence, protecting them from commercial pressures.
- See that *shariah* boards are sufficiently resourced to ensure full compliance with both legal and religious requirements.

DON'T

- Don't expect every board member to be an expert on every aspect of Islamic finance.

(*Continued overleaf*)

DON'T (*cont.*)

While *shariah* boards require a range of members with a diverse range of religious and financial knowledge, institutions should not expect individual board members to be experts in every aspect of their wide-ranging brief. However, board members with specialized knowledge of particular aspects can work very effectively on sub-boards related to particular initiatives or projects.

- Don't overlook the need to ensure that *shariah* board members are well informed about developments and trends in the global financial marketplace.

MORE INFO

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Ebrahim, M.-Shahid, and A. El-Jelly. "Debt financing in Islam." *American Journal of Islamic Finance* 5:1 (1994): 11.

Websites:

Harvard Law School Islamic Legal Studies Program—Islamic Finance Project: www.hifip.harvard.edu

Islamic Financial Services Board: www.ifsb.org

Sukuk: Islamic Bonds

DEFINITION

Sukuk, an Arabic word meaning financial certificates, refers to the *shariah*-compliant equivalent of interest-bearing fixed-income instruments. Following the first issue around a decade ago, *sukuk* have become one of the fastest-growing areas of Islamic finance as borrowers and investors increasingly look to meet their requirements while ensuring compliance with their principles and values.

Given that the charging of interest is strictly forbidden by *shariah* law, *sukuk* securities are instruments constructed in such a way as to avoid the accrual of interest and thus be fully compliant with Islamic principles. *Sukuk*, the plural form of the Arabic word *sakk*, represent claims to the ownership of assets, or a pool of underlying tangible assets, proportionate to the size of the investment. In contrast, conventional bonds are debt obligations, valued on the basis of cash flows derived from the issuer's contractual commitment according to pre-agreed dates, interest, and principal repayment. Investors in *sukuk* hold the right to both a share of revenues generated by the underlying asset and a share of any realization of the underlying *sukuk* asset. While *sukuk* bear many similarities to conventional fixed-income assets, a *sukuk* investment is founded on the part-ownership of an approved asset in return for a price which offers the investor the potential to benefit from a rise in the price of the underlying asset. The key difference between *sukuk* and conventional bonds is that *sukuk* are always asset-backed.

Since the turn of the millennium, *sukuk* have emerged as a key means for banks, sovereign borrowers, and multinational corporate borrowers to raise finance as an alternative to conventional syndicated financing, in a way fully compliant with Islamic principles.

Sukuk come in various forms, according to the issuer's requirements. Project-based *sukuk* can be issued to help finance specific new projects, while asset-specific *sukuk* are often employed to sell the beneficiary right of existing assets. Quasi-government organizations can also make use of balance sheet-specific *sukuk* to raise finance for multiple projects.

Sukuk deals typically fall into four main categories: *ijarah*, *mudharabah*, *musharakah*, and *istisna'a*. *Ijarah sukuk* are commonly employed in longer-term financing, typically leasing arrangements. *Mudharabah sukuk* are often used for profit-sharing between investors and entrepreneurs in ventures. *Musharakah sukuk* are used to finance businesses on the basis of partnership contracts, and *sukuk istisna'a* are frequently used in the financing of major infrastructure projects. *Sukuk* are issued in many forms, such as *ijarah* floating-rate *sukuk*, *murabahah* fixed-rate *sukuk*, and *salam sukuk*, a form of bond which cannot be sold and must therefore be held until maturity.

ADVANTAGES

- The development of the *sukuk* market over recent years has provided opportunities for both borrowers and investors who would be unable to access conventional bonds markets due to their noncompliance with *shariah* principles.
- Given the dramatic growth of the market over the last decade, *sukuk* instruments are now both liquid and readily tradable.
- *Sukuk* securities are rated by mainstream credit agencies, making their risk profiles comparable with mainstream fixed-income instruments.

DISADVANTAGES

- Under certain circumstances, *sukuk* can present additional taxation or stamp duty costs for the issuer, given the introduction of the asset ownership issue into the *sukuk* structure.
- Islamic law's broad exclusion of the trading of instruments at above or below par (their redeemable value on expiration of the particular issue) can severely restrict the structures available for *sukuk* issuers. However, interpretations differ between countries and regions as to what is acceptable practice; for example, *sukuk* are traded on the secondary market in Kuala Lumpur at levels above or below their par values.

ACTION CHECKLIST

✔ *Sukuk* issuers must ensure that their securities are fully compliant with *shariah* law; otherwise they run the risk of being categorized alongside conventional interest-bearing bonds.

✔ *Sukuk* are by their very nature controversial in that some more conservative Islamic scholars believe that *sukuk* infringes the *riba* principle by effectively putting a time value on money.

(*Continued overleaf*)

Issuers should therefore take advice from *shariah* experts on how best to avoid compromising the risk and profit/loss sharing requirements to ensure the widest possible investor base for their issues.

✔ Where the *sukuk* are a debt owed to the investor by the issuer, the investor can either hold the *sukuk* until maturity or sell the issue at par, without the option of selling on the secondary market.

DOS AND DON'TS

DO

- Expect some ongoing debate over the suitability of *sukuk* for Muslims. Despite their rapid growth over recent years, some Islamic scholars contend that *sukuk* may not be truly compliant with Islamic law, given that pricing still factors in the time value of money.
- Issuers should remember that *sukuk* investors have an inherent right to transparency in how their funds are being used and should therefore be fully prepared to keep investors informed about how the underlying assets are being employed.

DON'T

- Don't expect liquidity in the secondary *sukuk* market to be as high as that of most conventional bonds, as *sukuk* securities are typically acquired by long-term holders.
- Don't ignore the risk that the issuer could default, despite the well-intentioned principles behind *sukuk*.

MORE INFO

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Takaful Insurance

DEFINITION

Takaful, an Arabic word meaning "guaranteeing each other," is a form of mutual insurance that is fully compliant with *shariah* principles. *Takaful* works on the basis of members cooperating with and protecting each other, but it can also be used by investors seeking returns while adhering to the principles of Islamic law. Members of the *takaful* scheme pool their individual contributions together to create a pot of money which is then available to cover any subsequent loss or damage claims. Any surplus, after the costs of running the scheme, is then distributed between the *takaful* operator and members or investors on pre-agreed terms.

Conventional commercial insurance contravenes *shariah* law on multiple grounds, chiefly the banning of gambling (*al-maisir*), the charging of interest (*riba*) and attempting to profit from uncertainty (*al-gharar*). However, *takaful* insurance is founded on the principle of shared responsibility and has been practiced in one form or another for well over 1,000 years. As a mutual-style concept, *takaful* does not function on conventional profit-making lines, instead typically working on the basis of *mudharabah* or *wakalah*, or sometimes even a combination of the two. However, conventions and acceptable practices for *takaful* may vary widely between different countries. Today, *takaful* is most developed in Malaysia following the country's introduction of legislation in 1983.

Under *mudharabah*, the *takaful* operator collects regular installments from the *takaful* members. In keeping with the *mudharabah* principle, a contract between members specifies how any surplus gathered by the collector after any payouts is to be distributed. The contract canspecify whether each member's contributions are purely to cover potential liabilities, or alternatively to include some element of investment. To ensure full *shariah* compliance, under the *tabarru* (contribution) principle, any payout is determined only after all members suffering a defined loss have been compensated. Under the *wakalah* model, *takaful* operators collect a prearranged fee in advance, in addition to a share in the profits from the investment element of the scheme. However, the *wakalah takaful* operator does not benefit from the insurance underwriting.

Variations on the above models include the *waqf* methodology, which can specify that a percentage of any surplus is to be retained by the scheme to help protect against any future loss. Schemes may also work on the basis that a share of any surplus be donated to community or charity projects each year.

In response to the surge in demand for *shariah*-compliant finances services over recent years, both in traditional Muslim countries and Western nations, a number of new providers have emerged, including specialist *takaful*-only providers as well as companies offering *takaful* alongside a range of conventional insurance services.

ADVANTAGES

- *Takaful* is flexible in its range of applications, covering areas such as residences, places of business, cars, and inventory, as well as accident and life cover.
- It provides a form of financial protection for Muslims unable to access conventional insurance.

DISADVANTAGES

- While shunning conventional insurance schemes, some Muslims believe that even *takaful* is unnecessary, as it is the duty of all Muslims to help compensate others' losses.
- Some Muslims may be uncomfortable with the scope for *takaful* to be used for investment purposes on the basis that investors are effectively speculating that low accident payouts will generate a surplus or profit.

ACTION CHECKLIST

- ✔ Potential *takaful* operators should consider how their own resources could be put to work to ensure some kind of true competitive advantage in *takaful* provision.
- ✔ *Takaful* operators are likely to benefit from regular contact with *shariah* experts to ensure that the schemes remain compliant with Islamic law.
- ✔ Providers should seek to address the unique challenges of governance of *takaful* schemes with the establishment of a supervisory board.

DOS AND DON'TS

DO

- Be prepared for some operating differences between principle-based *takaful* theorists and those employed by *takaful* providers to operate the schemes and deal with the processing of individual claims.
- Understand that distinctions will arise between *takaful* schemes in different countries according to local attitudes and conventions.

DON'T

- Don't regard *takaful* as some kind of niche market; given the suspicion with which some consumers regard conventional financial services companies, *takaful* could be attractive as a mutual-based protection and/or investment scheme for many consumers.
- Don't think that the growth potential in *takaful* is limited to Middle Eastern or South East Asian countries, as the scope for development in Europe and US markets is considerable.

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International Cooperative and Mutual Insurance Federation guide to Takaful: www.takaful.coop

Malaysian Takaful Association: www.malaysiantakaful.com.my

Checklists

Markets

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Business Ethics in Islamic Finance

DEFINITION

The overarching principles of Islam set the operating framework for every aspect of how business is conducted in the Muslim world. While the shifting boundaries of acceptable behavior in conventional Western business are set by laws, regulations, and corporate governance guidelines, Islamic business is governed by divine principles covering values such as fairness, equality, and morality dating back more than a thousand years. More specifically, Islamic finance adopts a long-term partnership approach between businesses, often based on investors essentially taking an equity stake in businesses. *Shariah* law outlaws the charging of interest of any kind, while in the wider context the use of money to generate interest is not permitted. Speculation of any kind is also forbidden, while investments are required to deliver social benefits to the community. Islam also forbids activities in prohibited areas such as gambling or alcohol, instead specifying that *shariah*-compliant businesses should focus on legitimate trade-based activities.

The ethical standards to which Islamic businesses operate reflect the same standards and principles of the Qu'ran, which every Muslim is expected to follow in every aspect of their lives. Therefore, Islamic businesses must operate on a basis of fairness and integrity, while treating everyone equally. The need for honesty, truthfulness, and fair dealing is inherent in Islamic business, requirements which have wide-ranging implications across the full spectrum of business activities, from advertising to after-sales customer service. Islamic companies must also respect the principle of trusting others to be as good as their word. However, this puts the responsibility on businesses to cover their liabilities promptly, honoring their word with timely payment, given the exclusion of credit facilities. The emphasis on the partnership approach to business is further underlined by the need for companies to look after their investors' interests, thus protecting them whenever possible from *dharar* (any kind of harm). The "stakeholder" element of Islamic financing is reflected in the onus on working in tandem with other businesses whenever possible, while markets should generally be free and prices competitive. For example, attempting to squeeze suppliers on price would be unacceptable behavior, as would any attempt to capitalize on others' misfortune by raising selling price excessively should, for example, the supply of goods be temporarily interrupted.

ADVANTAGES

- Business ethics in Islamic finance reflect the moral principles and standards which every Muslim must follow in every aspect of their lives.
- Islamic business encourages a long-term partnership approach, based on mutual interest and a spirit of cooperation.
- Honestly, integrity, and a sense of genuine fair play are ingrained in the operating principles of Islamic business.

DISADVANTAGES

- Muslim businesses may be less able to capitalize on short-term market opportunities given that speculative activities are not permitted by Islamic ethical standards.
- Islamic business managers do not enjoy the same financial incentives which drive managers of many mainstream Western businesses, though they are motivated by moral objectives and standards.
- Given the moral and ethical goals of Islamic businesses—rather than the pursuit of pure profit—less efficient businesses (in purely financial terms) could hamper the development of newer, more entrepreneurial, customer-focused start-ups.

ACTION CHECKLIST

✔ In view of the increasing global influence of Islamic finance, companies aiming to do business with *shariah*-compliant organizations should gain some understanding of their guiding principles and ethics.

✔ Understand the importance for Islamic business of building long-term partnerships, rather than the pure pursuit of short-term profit.

✔ Compliance with Islamic principles may create complications for non-Muslims in the short term. However, it is important to understand that Islamic business aims to bring collective benefit to wider society.

DOS AND DON'TS

DO

- Recognize the importance that Islamic business ethics place on high moral values, while bringing collective benefit to the wider community, rather than the objective of making short-term profits.
- Appreciate that while high ethical standards are enshrined in the principles of Islamic businesses, the interpretation of the conformity of some financial products to *shariah* law may vary slightly between institutions.

DON'T

- Don't make the mistake of thinking that conventional Western business ethics are fully compatible with the ways of Islam: managers shouldn't enter into partnerships with Islamic businesses without first understanding and appreciating how attitudes to the pursuit of profit differ.
- Don't adopt a "pick-and-mix" approach to business ethics: the way Muslim businesses operate reflects their owners' deep-rooted attitudes, beliefs, and commitment to the principles of Islam.

MORE INFO

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International Institute of Islamic Business & Finance: www.iiibf.org

Islamic Commercial Law

DEFINITION

Given that Islam-derived laws encompass all aspects of how Muslims should live their lives and instill a strong sense of the highest moral values, it should be no surprise that Muslims are expected to conduct commercial transactions according to the same principles of equality, justice, and general sense of fair play. Exploitation of any kind is expressly forbidden, including any attempt to capitalize on a counterparty's poor negotiating position due to unforeseen circumstances. Speculative activity of any kind is banned, as are transactions or investments of any kind involving products or services prohibited by Islam, such as alcoholic drink, pork-derived foods, gambling, or pornography. Laws are also structured in such a way to prohibit the charging of interest of any kind, given that Islam expressly forbids any usage of money to make money. Instead, Islamic commercial law supports a partnership-based approach to business with, for example, finance providers treated as stakeholders with an interest in the success of a business rather than external lenders charging interest for the use of their money. Inspired by the Prophet Mohammed's experience as a merchant in Mecca, laws strictly govern agreements such as leasing deals, partnerships, and currency exchanges.

Although aspects of Islam-derived commercial laws bear close comparison with their Western counterparts, other features intended to defend the interest of the counterparties stand in marked contrast to the basic principles of Western commercial laws. For example, while under mainstream Western jurisdictions signed commercial agreements would be binding on both parties unless specific exit clauses are triggered, when applied in modern finance, many basic Islamic contracts can be nonbinding in nature.

Given the trend of increasing commercialism in many Muslim countries as their economies have developed, developments in Islam-inspired commercial law have sought to cater for the needs of Muslims to engage in transactions such as buying their homes, or investing for their future, yet without in any way compromising the principles and moral values enshrined by Islam. Some relatively liberal countries such as Qatar and Bahrain have sought to strike a balance between these potentially conflicting objectives, introducing commercial legal frameworks to enable transactions involving, for example, acceptably low levels of interest or permitting forms of insurance contracts to cover certain types of risk. However, these reforms are not reflected in other countries such as Iran, which retain a strict interpretation of Islamic-led commercial law.

ADVANTAGES

- Islamic commercial law provides a framework for commercial transactions while upholding the high moral values and principles of Islam.
- Laws are structured to support a longer term stakeholder approach, rather than a short-term, "quick return" attitude to business.
- Some countries have chosen to adopt a more business-friendly, progressive attitude to their interpretation of Islamic-inspired law.

DISADVANTAGES

- Some elements of Islam-derived commercial law can be confusing to non-Muslims, notably the nonbinding nature of contracts under certain circumstances.
- While reflecting Islam's rejection of involvement in speculative activities, it could be argued that laws potentially expose businesses to risk, given restrictions on products such as conventional insurance.
- Adherence to traditional ways of overseeing business could mean that Muslim businesses are hampered by legal restrictions.

ACTION CHECKLIST

✔ Recognize how faith and business practices are intertwined in Muslim countries.

✔ Accept that the interpretation of some aspects of *shariah*-inspired laws may be subject to slightly different interpretations in different countries.

✔ Acknowledge the importance of equality, fairness, and compassion in commercial activities in Muslim jurisdictions. Businesses do not simply pay lip service to these concepts; rather, they are fundamental principles on which all transactions are based.

✔ Recognize that individual attitudes to financial products may differ between national jurisdictions. Products such as futures and options may be classed as speculative instruments and, therefore, prohibited in some countries, while others may permit their use as tools to hedge risk.

DOS AND DON'TS

DO

- Acknowledge that law in Muslim countries has a broader role in governing how people live their lives than in the West.
- Take qualified legal advice as to the applicable Islam-inspired law in any particular jurisdiction.

DON'T

- Don't think of Islam-inspired law as a relict of the past. In reality, the influence of *shariah*-inspired law is growing as the prosperity of the followers of Islam across the world grows.

MORE INFO

Books:

Ballantyne, William M., and Howard L. Stovall. *Arab Commercial Law: Principles and Perspectives*. Chicago, IL: American Bar Association Publishing, 2002.

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Article:

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Islamic Equity Funds

DEFINITION

Islamic equity funds (IEFs) are similar to traditional equity funds in that investors pool their funds to invest in shares. However, the main difference between IEFs and standard equity funds is that investors in IEFs earn *halal* profits in strict conformity with the precepts of Islamic *shariah*.

Returns are achieved largely through the capital gains earned by purchasing shares and selling them when their price increases. Profits are also achieved from the dividends distributed by the relevant companies.

Of course, these funds are not allowed to invest in certain areas. They cannot, for example, invest in companies involved in areas that are not lawful in terms of *shariah*, such as alcohol, gambling, or pornography. They also have a restricted ability to invest in areas such as financial companies and fixed-income securities, due to the *shariah* ban on usury. These funds generally avoid bonds and other interest-bearing securities, while seeking protection against inflation by making long-term equity investments.

The first IEF was the Amana Income Fund, established in June 1986 by members of the North American Islamic Trust, the historical Islamic equivalent of an American trust or endowment, serving Muslims in the United States and their institutions. The fund is still in existence today. Prior to the growth of IEFs, few investment alternatives were available to Muslim investors.

A wide variety of investment managers, including major financial institutions, now offer these funds. Examples include Citibank, Deutsche Bank, HSBC, Merrill Lynch, and UBS. Following the growth of IEFs, credible equity benchmarks have been established, including the Dow Jones Islamic Market (DJIM) index and the FTSE Global Islamic Index Series.

Fund managers can use indices, such as the DJIM index, to screen stocks. The DJIM tracks *shariah*-compliant stocks from around the world. It eliminates those that fail to meet *shariah* guidelines, including financial ratio filters.

The Islamic equity funds industry had grown to around US$20 billion in assets under management by February 2008, according to Failaka Advisors, a fund-monitoring company. Failaka Advisors said that the IEFs had grown rapidly, tripling over the previous five years, driven by Gulf Cooperation Council investors. Saudi Arabian funds and fund managers dominate the industry, accounting for nearly 75 funds out of around 300 IEFs worldwide. Bahrain has become the favored center for fund registrations in the Gulf.

ADVANTAGES

- These funds have obvious advantages to Muslims, who can invest their money safe in the knowledge that the fund will not compromise any of their religious beliefs.
- Many funds have been around for a long time and have a good track record of generating healthy returns for their investors.
- It can be argued that, over the long term, IEFs will tend to perform better than conventional funds, since the former avoid investing in heavily leveraged companies.

DISADVANTAGES

- The restricted ability of IEFs to invest in certain market sectors limits opportunities and may increase the risk of losses during economic downturns.
- Since Islamic principles preclude the use of interest-paying instruments, the IEFs do not maximize current income because reserves remain in cash.
- Most of the funds target high net worth individuals and corporate institutions, rather than the small investor. Minimum investments range from US$50,000 to as high as US$1 million.

ACTION CHECKLIST

✔ As with traditional equity funds, the value of an IEF rises and falls as the value of the stocks in which the fund invests goes up and down. Therefore, only consider investing in an IEF if you are willing to accept the risk that you may lose money.

✔ Research sites that monitor the performance of IEFs to ascertain which fund is most likely to suit your needs and which have performed the best over a number of years. However, remember that past performance does not necessarily provide a guide to how well the fund will perform in the future.

DOS AND DON'TS

DO

- Analyze these funds in the same way as you would any other equity investment. Ask yourself whether you are looking for income or capital gain and whether you are prepared to tie up your money for a long period—most investment managers believe that anyone investing in an equity fund should be prepared to commit for at least five years.
- Ask yourself whether you are prepared to accept the risk involved in investing in equities—stocks go down as well as up.

DON'T

- Don't invest without exploring the wide range of funds on the market to find out which is best suited to your needs.
- Don't invest without consulting an independent financial advisor. However, make sure that they are truly independent and do not earn a commission by recommending clients to a certain fund.

MORE INFO

Books:

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Website:

Failaka Advisors monitor the performance of Islamic equity funds and provide a comprehensive list of Islamic funds worldwide: www.failaka.com

Islamic Joint Ventures

DEFINITION

Joint ventures and partnerships in the Islamic world can take a variety of forms, as described below.

Mudarabah (Profit Sharing)

This is an arrangement whereby a capital provider (*rabb-ul-maal)* provides capital to an entrepreneur (*mudarib*), who uses the capital for a business activity. Any profits that accrue will be shared between the capital provider and the entrepreneur according to an agreed ratio, while losses are borne solely by the capital provider. This is because the *mudarib* is considered to have lost the time and hard work he or she has invested in the partnership. However, if the *mudarib* has not worked with due diligence and is guilty of negligence or dishonesty, he or she will be liable for the loss caused by his or her negligence or misconduct. The capital provider has no right to participate in the management of the business, which is carried out by the *mudarib* only. The liability of the *rabb-ul-maal* is limited to his or her investment, unless he or she has allowed the *mudarib* to incur debts on his or her behalf. In addition, any goods purchased by the *mudarib* are solely owned by the *rabb-ul-maal*, and the *mudarib* can earn his or her share of the profit only if he or she sells the goods at a profit.

There Are Two Types of *Mudarabah*

The *rabb-ul-maal* may specify a business in which to invest, in which case the *mudarib* is restricted to this business. This is called restricted *mudarabah*, or *al-mudarabah al-muqayyadah*.

If the *rabb-ul-maal* does not specify a particular business in which he or she wishes to invest, the *mudarabah* is considered unrestricted, or *al-mudarabah al-mutalaqah*.

The two parties agree on how the profits are to be distributed. The amount of profit given to either of the parties must be independent of the capital amount, and dependent solely on the actual profit generated by the commercial enterprise. It cannot be calculated as a percentage of the capital invested in the business, as that would be considered a fixed return, or interest. Neither can the profit be given as a lump sum, since this would constitute interest. Thus, the share of the profit that either party receives must be based upon the actual profit earned by the enterprise. *Shariah* does not restrict or specify proportions to be distributed between the parties, leaving it to the judgment of the two parties.

The *mudarabah* contract can be terminated by either of the parties at any time as long as notice, as specified in the contract, is given to the other party. However, there are some differences of opinion between Islamic scholars regarding other aspects of termination. Some believe that a maximum term of the *mudarabah* contract can be set, and the contract is terminated automatically thereafter. However, others believe that no term restriction can be added to the *mudarabah* contract.

Musharakah (Joint Venture)

This concept is normally applied to business partnerships or joint ventures, and is used instead of interest-bearing loans. The profits made are shared in an agreed ratio, while losses incurred are divided based on the equity participation ratio. The main difference between *musharakah* and *mudarabah* in terms of investment is that in *musharakah* it comes from all the partners, while in *mudarabah* the investment is the sole responsibility of the *rabb-ul-maal*. In addition, and unlike *mudarabah*, in *musharakah* all the partners can participate in the management of the business and can work for it. Furthermore, all the partners in *musharakah* share in the loss based on the ratio of their investment.

Partners in *musharakah* are also exposed to unlimited liability. Thus, if a business is liquidated and the liabilities exceed its assets, all the exceeding liabilities are borne (on a pro rata basis) by all the partners. The only exception is if the partners have agreed that no partner shall incur any debt during the course of business, and that any excess liabilities will be the responsibility of the partner who has incurred a debt on the business.

All the assets of the *musharakah* are jointly owned by all of the partners according to the proportion of their respective investment.

ADVANTAGES

- These partnerships are *shariah*-compliant. *Musharakah,* for example, allows the financier to achieve a return in the form of a portion of the actual profits earned, instead of charging interest as a creditor, which is banned by *shariah*.
- The two different types of joint ventures should ensure that the individual needs of financiers and clients can be met.

DISADVANTAGES

- The partnerships can be more cumbersome than some simplified arrangements available in non-Islamic countries.
- *Mudarabah* tends to attract more risky projects and provides an incentive to the project manager to understate profits.
- Companies seek to minimize the cost of funding and so may be reluctant to enter into *musharakah* financing. They may prefer a fixed-rate type product such as *murabahah*.

ACTION CHECKLIST

✔ Explore all of the options available to ascertain which form of joint venture is best suited to your needs.

✔ Carry out counterparty and credit checks as one would under a non-Islamic arrangement.

DOS AND DON'TS

DO

- Take legal advice before entering into any arrangement.
- Make sure you sign a legally binding contract before carrying out any transactions or activities.

DON'T

- Don't forget that it takes time and effort to build the right relationship and that partnering with another business can prove challenging.
- Don't assume that the objectives of the venture are 100% clear and have been communicated to everyone involved.

MORE INFO

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Islamic Law of Contracts

DEFINITION

The basic prerequisites to establish a valid contract agreement under Islamic law relate to the legal status of the parties seeking to sign the contract, the way the contract is presented or accepted, and finally the subject and consideration of the actual contract.

Parties seeking to engage in a contract may only do so if they are considered legally fit to do so—essentially, adults of sound judgment. Both written and verbal contracts can be considered acceptable, with the proviso that the offer and the acceptance must be performed at the same meeting session, without any interruption or venue change before immediate acceptance. In contrast to Western conventions, Islamic law permits acceptance by conduct; under some circumstances, even not responding to a proposal can imply acceptance. Even once an offer has been accepted during a single session, Islamic law includes the principle that parties retain the right to revoke the contract until the moment either party physically departs the venue. However, interpretation of how this principle can be best applied in practice in the modern era can vary between countries.

In terms of the contract content, Islamic-derived law stresses that the subject of the contract must not relate to prohibited items (such as alcohol, tobacco, or gambling equipment), must be legally owned by one party in the contract and in existence at the time of the contract agreement (i.e. items yet to be built may not be the subject of a standard contract), and must be physically deliverable. As with other legal systems, the exact nature of the goods must be clearly defined in terms of quality and specifications. With the exception of money-exchange deals, the price at which goods will change hands must be agreed at the time of the contract—agreements cannot be based on either future market rates or on the opinion of any external party. While many different types of contract exist, the most common contract for the sale of goods is the *mu'awadat* contract of exchange. These can include a barter-style exchange of goods, a sale of goods in exchange for money, or a money-exchange deal. Another common form of contract is *ijarah*, which is commonly used in leasing, either for equipment, real estate, or to provide access to labor.

ADVANTAGES

- Contracts in Islam-derived law fully respect the high moral principles of values expected of all Muslims.
- Islamic contract law is regarded as a product of divine intervention and has been in use for many centuries across North Africa, the Middle East, and Asia.
- Contract law in Muslim countries supports only transactions which would be classified as "ethical" in the West.

DISADVANTAGES

- Islamic contract law can be highly complex, both in terms of its jurisprudence and in its application.
- Technological innovations such as fax and e-mail systems have created some grey areas as to what constitutes a single session of contract discussions.
- Careful consideration needs to be given to the implications of one party failing to honor the contract, given that Islam prohibits any exploitation of another party's genuine misfortunes.

ACTION CHECKLIST

✔ Variations in the details of contract law do occur from country to country. Therefore, acknowledge potential differences in the implementation of Islamic contract law in more liberal Muslim nations such as Qatar, compared to more conservative peers such as Yemen.

✔ When considering potential agreements, *shariah* committees in Islamic financial institutions may pass a judgment on the compatibility of the proposed contract with the ideals of Islam. However, given the subjectivity element, you should appreciate that variations may occur in contracts acceptable to different institutions.

DOS AND DON'TS

DO

- Understand the practicalities of "penalty" clauses that you may wish to insert in a contract. *Shariah* law does not permit the charging of interest (*riba*), and any penalties due may need to be paid to charity under some circumstances.
- Seek expert advice related to Islamic contract law. Given the complexity of many elements of Islamic law of contract, particularly the definition of what constitutes acceptance of a verbal proposal, expert qualified advice should be sought before contract discussions begin, let alone any contract is signed.

DON'T

- Don't assume that the principles of Islamic law bear close comparison with those of Western laws. Contracts agreed under Muslim-derived laws can be less binding in nature than most contracts drawn up under Western legal systems. Take professional advice to determine the circumstances in which the agreed contract may not apply in practice.
- Don't assume that the implementation of Islam-derived law takes the same form throughout the Muslim world. Western-leaning countries such as the United Arab Emirates may adopt a more progressive approach to contract law than nations such as Iran or Pakistan.

MORE INFO

Books:

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Islamic Microfinance

DEFINITION

Islamic microfinance refers to a system of localized finance arrangements set up as an alternative source of funds for small, low-income Islamic clients. Typically, users of Islamic microfinance have little or no collateral, as they do not possess significant assets, and would therefore be excluded from other forms of financing, including Islamic bank financing. Thus, Islamic microfinance provides a means of accessing funds for those who are unlikely to qualify for other forms of finance, yet are still seeking full compliance with Islamic law and the Islamic way of life.

In essence, key Islamic microfinance contracts are based on *musharakah* and *mudarabah*, while microfinance users can also take advantage of *takaful* Islamic insurance.

Musharakah can be used either for assets or working capital. In principle it involves an equity participation in a business. The parties involved will share any profits or losses resulting from the business according to a pre-established ratio.

A *mudarabah* contract is basically a trustee financing scheme. The financier invests the funds while the other party supplies the expertise for the project. The contract requires rigorous following and transparency to ensure a fair distribution of profits.

Takaful insurance is based on the principle of shared responsibility and has been practiced in one form or another for well over 1,000 years. As a mutual-style concept, *takaful* does not function on conventional profit-making lines. It derives from the Arabic word *kafalah*, which means a joint guarantee. According to the *takaful* principle of insurance, each member of a scheme contributes to a fund that is used to help in case of need such as accidents, loss of crops, or death.

ADVANTAGES

- Islamic microfinance can play an important role in helping to address poverty in some parts of the Muslim world.
- Islamic microfinance contracts can be operated individually or combined, giving greater flexibility to their application.
- Islamic microfinance contracts provide an alternative to low-income Muslim clients.
- *Musharakah* and *mudarabah* are the most approved contracts under *shariah* law and their application is encouraged by *shariah* scholars.
- *Takaful* is flexible in its range of applications, covering areas such as residences, places of business, cars, and inventory, as well as accident and life cover.

DISADVANTAGES

- *Mudarabah* arrangements require a high level of regulation and transparency to ensure a fair distribution of profits and therefore can be expensive to operate.
- Some Muslims may be uncomfortable with the scope for *takaful* to be used for investment purposes on the basis that investors are effectively speculating that low accident payouts will generate a surplus or profit.
- In general, Islamic microfinance is seen as more a social support system based on philanthropic principles rather than a business.
- Like other forms of microfinance, Islamic microfinance needs support to ensure its sustainability. Typically this support entails some form of ongoing subsidy, normally from a government or nongovernment organization, such as a *waqf* endowment.

ACTION CHECKLIST

- ✔ Assess carefully the contracts and products offered and whether they are too expensive to operate. Often smaller-scale transactions cost more to operate, process, and regulate than larger ones.
- ✔ Investigate and understand local customs and financial practices, as these can vary widely between countries and even regions.
- ✔ Gain an understanding of local cultural attitudes to maximize the potential of microfinance; for example, some schemes have more success than others in introducing microfinance to women.
- ✔ Certain Muslim countries actively encourage Islamic microfinance. Potential users should investigate whether state support is offered to promote local microfinance schemes.

DOS AND DON'TS

DO

- Encourage communication and dialogue between *shariah* experts and the financiers in order to ensure that the products offered are compliant with *shariah* law.
- Understand that there will be differences between schemes in different countries according to local attitudes and conventions.
- Be realistic in assessing that Islamic micro-finance has potential for growth but currently is still exercised on a very small scale.

DON'T

- Don't underestimate the help that local religious leaders can give in explaining to the local population that the financial contracts offered are *shariah*-compliant, which will increase confidence in the use of the products.
- Don't assume that limited-income clients will accept any products offered on unattractive terms; they often drive a hard bargain.

MORE INFO

Books:

Al-Harran, Saad. *An Islamic Microfinance Enterprise: The Financial Vehicle That Will Change the Face of the Islamic World*. London: Xlibris, 2008.

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Websites:

Consultative Group to Assist the Poor (CGAP): an independent policy institute promoting financial access for the world's poor: www.cgap.org

Microfinance Management Institute: www.themfmi.org

Managing Risk in Islamic Finance

DEFINITION

There are differences between Islamic finance and conventional finance, but some fundamental principles involved in managing risk apply equally to both. In particular, rigorous risk management and sound corporate governance help to ensure the safety and soundness of financial institutions in both the Islamic and non-Islamic worlds.

The key difference between Islamic finance and conventional finance is that Islamic finance involves risk sharing rather than risk transfers. Thus, all parties involved in a transaction must share the rewards and the risks equitably. Furthermore, institutions in the former category must ensure that their activities are always compliant with the restrictions imposed by *shariah* law. This is complicated by the fact that scholars can and do change their minds over what is permitted under *shariah*.

Islamic institutions are confronted with unique risks as a result of the asset and liability structures that compliance with *shariah* law imposes upon them.

Operational risk is significant for *shariah* financial institutions due to their specific contractual features.

Liquidity risk is also more complicated than in conventional finance. This is because Islamic bank funding comes from personal customer accounts, the vast majority of which are on call or very short notice. In addition, until very recently hedging risk by using conventional methods was not in compliance with *shariah*. Furthermore, there is no central receiver and provider of liquidity to and from the Islamic financial market. Finally, and again unlike the conventional market, most debt is not tradable.

In addition, some of the tools used to manage risk in Western financial institutions either cannot be used or have limited use in the Islamic world because they contravene *shariah* law. Thus, derivatives have been few and far between in Islamic countries, despite their widespread use in the West to protect against market volatility. Islamic institutions have had limited access to derivative products, mainly because *shariah* law requires the underlying assets in any transaction to be tangible. This excludes most of the mainstream derivative instruments.

However, Islamic finance is developing apace, and products are being launched that can have useful risk management attributes and even mimic risk tools used in the West without contravening *shariah* law.

In March 2010, for example, the Bahrain-based International Islamic Financial Market, in cooperation with the International Swaps and Derivatives Association, launched the *Tahawwut* (Hedging) Master Agreement, which gives the global Islamic financial industry the ability to trade *shariah*-compliant hedging transactions such as profit-rate and currency swaps, which are estimated to represent most of the current Islamic hedging transactions.

Under *shariah* principles, the *tahawwut* or hedge must be strictly linked to underlying transactions and cannot be a transaction that has the sole purpose of making money from money. The lack of hedging products for managing risk has put many investors and institutions involved in Islamic finance at a disadvantage.

The *Tahawwut* Master Agreement should pave the way for quicker and cheaper Islamic risk management and more frequent cross-currency transactions. The contract creates a standard legal framework for over-the-counter (OTC) derivatives in the Islamic market, whereas currently contracts are arranged on an ad-hoc basis.

ADVANTAGES

- The lack of risk tools that are widely used in the West, such as derivatives, and the avoidance of certain sectors, such as banks, means that Islamic financial markets have a low correlation to other financial markets. This has provided protection from market turbulence, such as that seen during the subprime crisis.
- Many argue that the use of risk tools such as derivatives does not protect against volatility but simply increases it, while financial institutions earn vast profits through their deployment to the detriment of clients. Thus, the lack of such tools in Islamic finance may benefit investors.

DISADVANTAGES

- The Islamic finance industry is governed by a patchwork of national banking regulations, its own standard-setting bodies, and scholars interpreting Islamic laws, making contracts much more complicated.
- Islamic scholars are split on the legitimacy of risk tools such as derivatives; some see them as permissible instruments to hedge risk, but others regard them as speculative transactions, which Islam forbids.

- While Islamic banks have avoided the complex instruments that were central to the credit crisis, they have still been susceptible to the downturn. Nonperforming loans and investment impairments in the region have mounted, partly due to inadequate risk-monitoring systems.

ACTION CHECKLIST

✔ Ensure that risk-management tools and systems are in place to ensure high standards of corporate governance and transparency.

✔ Establish whether compliance with *shariah* law creates unique risks, and create systems and tools that can monitor and protect against such threats.

DOS AND DON'TS

DO

- Ensure that any risk-management methods are compliant with local *shariah* rules governing finance. Rules can vary widely from one jurisdiction to another.
- Establish whether *shariah*-compliant tools for managing risk are available. The market is developing at a very rapid pace.

DON'T

- Don't ignore the fundamentals of risk management, including credit and counterparty checks.
- Don't assume that *shariah* law governing financial management is rigid. It is partly a question of interpretation, and there are usually solutions to even the most complex problems.

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Regulatory and Capital Issues under *Shariah* Law

DEFINITION

Following the early development of Islamic finance in the Middle East, the growth in *shariah*-compliant financial services over the last decade has been dramatic. Local and national banks in predominately Muslim countries have sought to introduce compliant products and services to their customers. International banks also have been quick to recognize the potential in adding Islamic products to their range.

The relentless advance of *shariah*-compliant finance has generated debate on how Islamic finance should respond to developments in the international financial regulatory environment. Although at first glance amended regulatory standards and governance requirements may seem unworkable in the context of Islamic finance, in many instances, the amended standards and expectations can be easily integrated. In fact, the biggest challenge towards achieving greater compatibility between international regulatory and capital standards and Islamic finance is frequently how to change providers' attitudes to greater integration.

The Dubai Financial Services Authority provides a good example of how a new regulatory framework can be developed to be compatible with both mainstream and Islamic finance companies. Dubai, a major centre for *sukuk* investment, has created a common law-based legal system and a regulatory environment which is based on existing international structures, yet is supportive of the key aspects of Islamic finance. Given its leading position in the *sukuk* market, the Emirate also enforces high standards of disclosure and transparency.

Product and industry trade bodies have shown the value of international collaboration on regulatory progress. Given rising interest in Islamic derivative trading over recent years, the International Swaps and Derivatives Association (ISDA) has been working with the International Islamic Financial Market (IIFM) toward the goal of creating a guideline framework for the industry. The work under development is to be called the ISDA/IIFM *ta'hawwut* (hedging) master agreement and, as at January 2009, is on course to be the standard contract for international cross border Islamic derivatives transactions. However, despite the progress towards these standard contracts, the ISDA has stressed the need for individual Islamic jurisdictions to strengthen their own regulatory and legislative environments to ensure that the agreed transactions are legally enforceable. The ISDA has also highlighted that issues related to regulatory capital, and accounting policies surrounding Islamic derivatives transactions, need to be addressed by local regulators.

ADVANTAGES

- Improved regulatory and capital structures can play an important role in the ongoing success of Islamic finance.
- Increased transparency and better governance should boost the uptake of new financial products.
- Collaboration between states and organizations can result in major advances to promote the growth of Islamic finance.

DISADVANTAGES

- Conventional Western risk management often views Islamic finance as carrying very specific risks related to issues such as the lack of consistent *shariah* compatibility standards. Particular concerns have been raised over the application of the Basel II Accord/capital adequacy requirements, which were originally created for mainstream Western banks, with no regard to the very specific risks faced by Islamic institutions.
- Regulatory attitudes between Western and Islamic systems can differ greatly. For example, a Western regulator may question whether a *shariah* board's role is advisory, and if it has executive powers.
- Difficulties can arise for regulators as to how to classify some Islamic financial products. For example, *musharakah* home purchase products may not be approved as a regulated mortgage product.

ACTION CHECKLIST

✔ Recognize the compatibility between many aspects of Western and Islamic systems. In other aspects, differences may not be as stark as they first appear. For example, Islamic corporate governance standards may appear weak by formal western standards, but some could argue that, in practice, these are underpinned by the Islamic emphasis on integrity and sense of fair play.

(*Continued overleaf*)

✔ Appreciate that excessively tight regulatory structures could hamper the development of innovative new products.

DOS AND DON'TS

DO

- Acknowledge that improved regulatory structures can only be achieved where a supportive political backdrop for change exists.
- Consider whether Islamic products also could appeal to non-Muslims.
- The increasing overlap of Western and Islamic finance could be demonstrated when a non-Muslim country eventually issues *sukuk*. Mooted for some years by the UK government, the form of any future issue could be worthy of close scrutiny as Western sovereign issuers look to tap into massive demand for *shariah*-compliant investment products.

DON'T

- Don't expect regulation to generate product innovation.
- Don't expect a true "single market" for Islamic products.

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Website:

Harvard Law School Islamic Finance Project: ifp.law.harvard.edu

Country Profiles

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Shariah Law: An International Perspective

SHARIAH LAW AND CONTRACTS

Shariah means path or way and represents the sacred laws of Islam. It is God's law according to all Muslim beliefs and cultures.

Shariah rules and guides an individual's private and personal matters such as religion, hygiene, diet, dress code, and family life, as well as the general matters of community and society such as politics, crime, financial, and economic issues.

As a matter of fundamental principle, *shariah* law forbids any practices that are considered unfair and exploitative, and it promotes and encourages the welfare of the population. It forbids the giving or receiving of any fixed or predetermined rate of return on financial transactions. Under *shariah* law money is not a commodity and cannot be an asset by itself. Any investors and fund providers must share the risk of the asset or the business; therefore, financial transactions must be linked and backed by assets. They must lead to a real economic activity. Another essential thing in Islamic culture is compassion. When someone is bankrupt or going through financial difficulties, no pressure is put on them to pay as soon as possible. As in contractual law, a contract should be very clear in defining the terms and conditions and be entered into by the mutual agreement of the parties.

In recent years Islamic finance has seen an increased level of development and sophistication, with certain Islamic governments taking an active role in promoting wider access to financial products. Most transactions, however, remain within the realms of microfinance, where small financial arrangements are set up as an alternative for low-income clients.

Islamic microfinance uses certain financial contracts, the five best-known and most used of which are *murabahah*, *musharakah*, *mudarabah*, *ijarah*, and *takaful*.

Murabahah is the most widely available contract of sale. In essence, a client wants to acquire certain tangible goods from the market. The financier buys these directly from the market and then sells the goods to the client either in one transaction with one payment or in a transaction with several equal payments. The ownership of the goods, and therefore the risk, remains with the financier until full payment has been made.

The financier adds a markup to the cost of the goods for the service he or she provides. This markup will not increase even if the client pays after the due date. Sometimes the financier will appoint the client as his or her agent via another contract and the client can buy the goods from the market.

Musharakah can be used either for assets or working capital. In principle it involves an equity participation in a business. The parties involved will share any profits or losses arising from the business according to a pre-established ratio.

A *mudarabah* contract is basically a trustee financing scheme. The financier invests the funds while the other party supplies the expertise for the project. The contract needs rigorous adherence and transparency to ensure a fair distribution of profits.

In an *ijarah* contract the financier acquires and maintains the asset before its disposal in accordance with Islamic law.

Takaful insurance is based on the principle of shared responsibility and has been practiced in one form or another for well over 1,000 years. As a mutual-style concept, *takaful* does not function on conventional profit-making lines. It derives from the Arabic word *kafalah*, which means a joint guarantee. According to the *takaful* principle of insurance, each member of a scheme contributes to a fund that is used to help in case of need such as accidents, loss of crops, or death. *Takaful* insurance most highly developed in Malaysia, which passed legislation for its implementation as early as 1983.

A widely used contract in Islamic countries is the *mu'awadat* exchange, which, in effect, is a barter or exchange of goods for money or an exchange of money.

INTERNATIONAL DIFFERENCES

According to *The Banker* (2007), the Islamic financial market amounts to a total of US$500.5 billion. This is distributed as follows: 35% is located in the Gulf Cooperation Council (GCC) countries such as Bahrain, Kuwait, Oman, Qatar, the United Arab Emirates, and Saudi Arabia; 35% is concentrated in other countries of South West Asia and in North Africa; and the rest in South East Asia (Malaysia and Brunei) and Pakistan.

Bangladesh was one of the first countries to set up a microfinance program, led by the well-known Nobel Prize winner Mohammed Yunus. This has prompted other countries, such as Pakistan and Indonesia, to encourage such programs in principle. Microfinance agreements are also popular in Syria, Yemen, and Afghanistan.

Indonesia provides a good example of how Islamic microfinance can work, as it offers a dual

conventional and Islamic microbanking system in which conventional rural banks and *shariah*-compliant banks coexist. The latter are usually privately owned and regulated by the Bank of Indonesia. They offer loans and savings services in certain areas, and in general they offer *murabahah* products. They are, however, more expensive to supervise and operate.

The principle of freedom of contract is widely recognized in Islamic law, the only exception being when a contract contravenes *shariah* law. Only actual and direct damages can be recovered as a result of breach of contract. Any speculative or consequential damages are not allowed. The same applies to punitive damages, which can never be charged. Also, interest on damages cannot be charged.

Most Islamic countries have a historical link with the European model of law whereby a distinction is made between civil and commercial law through separate adopted codes. These allow more flexibility in commercial agreements, which are not seen as having to comply strictly with principles of *shariah* law in the way that civil law has to. In Morocco, for example, interest cannot be charged in contracts made between individuals but it can be charged in contracts between legal persons.

The United Arab Emirates has adopted both a Civil and a Commercial Code. The Commercial Code has jurisdiction over all commercial transactions, and certain *shariah* law principles have been codified and instituted within it. This has allowed for a more consistent application of the law. For example, the charging of interest in a commercial loan is allowed if it is expressly written into the contract and it does not exceed 12% (Article 76 of the Commercial Code).

Malaysia also offers both Islamic and non-Islamic financial institutions and banks. The Malaysian legal system is based on English common law, resulting in greater flexibility in its structure and approach.

Indonesia's Commercial Code and Civil Code both derive from Dutch law. Indonesia recognizes that *shariah* law does not apply to commercial transactions that are governed by the Commercial Code. Like Malaysia, Indonesia offers a dual system of banking.

Morocco, Egypt, and Algeria have a semi-secular application of business law.

Saudi Arabia applies Islamic law most extensively. Its laws are mostly unwritten and even legal precedent is not always followed. The Saudi courts recognize the literal wording of contracts, and foreign companies use lengthy literal contracts to avoid uncertainty and confusion.

ISLAMIC EQUITY FUNDS

In recent years Islamic finance has experienced rapid and progressive growth, and the available range of *shariah*-compliant funds investing in equity or commodities has expanded due to an increased demand for investment products that respect the principles of Islam.

Equity funds invest directly in companies through the purchase of shares. Historically, investments were limited by the need to ensure that all companies in which a fund invested did themselves operate in compliance with *shariah* law. This has changed, with some funds gradually adopting a more flexible, progressive approach that allows investment in companies that operate in permitted industries. This practice is allowed under the condition that a proportion of the returns generated for the fund from any interest-bearing deposits held by the company must be donated to charity.

Commodity funds invest in physical commodities. Short selling is not allowed. The fund manager may make use of *istisna'a* contracts, pre-agreeing the price of goods to be manufactured and delivered at a specified future date, with the manufacturer benefiting from advance receipt of the agreed sale price. Commodity fund managers can also use *bay al-salam* contracts. These remain *shariah*-compliant due to the fact that the seller's position is protected because payment is passed to the seller on agreement of the contract rather than on its completion. The buyer is compensated by the fact that the agreed delivery price is set at a discount to the physical spot price.

Another type of fund is *ijarah,* a leasing-type fund that acquires assets such as real estate or equipment and leases them out to another party in return for a regular rental payment. In all cases the fund retains ownership of the asset and must make sure that the asset is at all times used in accordance with Islamic principles (for example, it must not be used for gambling).

Murabahah is a development fund that acquires assets and then sells them to a client at a predetermined price which reflects the fund's cost of acquiring the asset plus a profit margin. Such investment vehicles do not hold long-term ownership of the assets.

In recent years important institutions have emerged within the Islamic banking system, such as the Islamic Development Bank, which plays an important role in the promotion of economic development in Islamic country members. The Bank has been set up by the Islamic Solidarity Fund for Development and it actively promotes Islamic finance programs.

CONCLUSIONS

Financial promotion and activity within Islamic countries are on the increase. Some countries are more liberal than others in their approach and interpretation of *shariah* law; however, the main principles of fairness, moral justice, and compassion are thoroughly respected. With the benefit of hindsight, the recent banking crisis that has shaken the Western world suggests that it might be wise to reflect on and appreciate such values even more.

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Algeria

ECONOMY AND TRADE

Algeria's economy is heavily reliant on the hydrocarbons sector, which accounts for 60% of the country's revenues and some 30% of GDP. It also accounts for a massive 95% of Algeria's exports, by value. The Algerian government is committed to opening up trade, and to encouraging inward investment, particularly by Western companies interested in using Algeria as a manufacturing base, or in undertaking joint ventures with local companies to help them boost export activities.

When he came to power in 1999, on the promise of implementing a range of political, economic, and social reforms, President Abdelaziz Bouteflika boosted the country's ailing economy with a US$18 billion public-sector spending program. This generated four years of steady growth and won Bouteflika a second term of office. It also reduced the country's massive unemployment, bringing it down to 23%. In 2009, the jobless rate fell to just over 10%.

ECONOMIC POLICY OVER 12 MONTHS

The International Monetary Fund (IMF) and the World Bank want to see Algeria spending more money on education, and on the creation of jobs for those entering the economy. Success on both these fronts, but particularly on the former, is seen as crucial to the country's ability to sustain its growth, and its efforts to diversify its economy beyond the oil and gas sector. Considerable progress has already been made, with education being free to all, and school attendance more than doubling to in excess of 5 million students. However, Algeria still needs to spend more on teacher training if it wants a skilled workforce capable of attracting sustained inward investment.

The government is seeking to upgrade the country's infrastructure. The budget for 2010 includes a 12.9% increase in public spending, which will support growth. Capital outlays will increase by more than 16% to fund a series of major infrastructure projects in transport, housing, and healthcare, as well as education. The government is also seeking to increase revenues by 10.6%, with most of this coming from non-oil sectors. The government expects to incur a budget deficit of 25% of GDP. This will be financed by the funds set aside in the Revenue Regulation Fund, which was established in 2000 using surplus revenues caused by any overshoot in energy prices. The budget deficit is also based on a highly conservative forecast oil price of US$37 in 2010.

STATISTICS

GDP growth: 2% (2009)
GDP per capita: US$7,000 (PPP, 2009)
CPI: 4.1% (2009)
Key interest rate: 4% (commercial bank prime rate, December 31, 2008)
Exchange rate versus US dollar: DA72.5695 (2009)*
Unemployment: 12.4% (2009)
FDI: US$15.46 billion (2009)
Current account deficit/surplus: US$5.523 billion (2009 est.)
Population: 34,586,184 (July 2010 est.)

*Algerian dinar
Source: CIA World Factbook except where stated

In May 2009, Algeria amended its foreign investment policy. Foreign companies are now obliged to sell to local partners 51% of their participation in investment in the country and 30% of the capital in their import companies. In order to protect local production of pharmaceuticals, the government also places restrictions on the import of nearly 400 drugs that can be produced locally.

The government has succeeded in privatizing certain sectors of the Algerian economy, and has encouraged industry to form joint ventures with some state-owned and operated organizations. Algeria wants to become a member of the World Trade Organization (WTO), a step that is seen as very positive in its implications both for domestic business and for inward investment.

The vast majority of the population lives along the Mediterranean coast, which occupies some 12% of the country's land mass. This of itself creates a large urban population, with some 45% of the country's population living in cities such as Algiers. The government's economic policy has some challenges in trying to stem the mass migration of people from the poor rural areas to the more affluent cities. In part, support for Algeria's agricultural sector is designed both to accomplish this and to generate greater wealth in a potentially lucrative sector.

The banking sector has been liberalized since 1990, and there are some 22 public and private-sector banks, 12 of which are foreign-owned. Reforms at the end of 2003 paved the way for investment banks and leasing companies. Similarly, a massive reform of the telecommunications and

postal sector since 2000, and a new legal and regulatory framework for a multi-operator telecommunications infrastructure, are now in place. The World Bank currently rates Algeria's telecommunications market as the most liberalized in the Middle East and North Africa (MENA) region.

ECONOMIC PERFORMANCE OVER 12 MONTHS

Algeria has enjoyed several years of strong economic performance driven by public spending. However, declining demand for energy exports affected the economy in 2009. While the non-hydrocarbon sector enjoyed growth of around 9% in 2009, due to a good cereal harvest and the strength of the service and construction sectors, hydrocarbon production fell by up to 7%, and the overall economy grew by an estimated rate of just 2%, down from a provisional 2.4% in 2008.

However, the slowdown had a positive impact on inflation, which fell to an annual rate of 5.5% in February 2010, down from 5.7% in the same period in 2009. Inflation would have fallen to even lower levels but for a surge in fresh food prices in 2009, caused by structural shortcomings in the supply chain.

Thanks to its oil and gas exports, Algeria currently runs a trade surplus. However, lower global oil prices reduced Algeria's trade surplus to US$4.2 billion in the first 11 months of 2009 from US$36.35 billion in the same period of 2008, according to official figures. The country recorded a small current account surplus in 2009, and official reserves have grown by US$3 billion since the end of 2008, reaching US$146 billion at the end of September 2009 (equivalent to three years of imports).

The country's GDP, in terms of purchasing power parity, amounted to in excess of US$240 billion in 2009, and Algeria continues to build up its foreign reserves, despite the downturn.

France currently provides more than 30% of Algeria's imports, and some 60% of Algeria's trade last year was with the European Union. An agreement between Algeria and the EU envisages the creation of a free-market area, with the phasing out of tariff barriers over the next decade. The Algerian government has also said that it intends to dismantle all monopolies in the country by 2010—a necessary condition of its joining the WTO.

Algeria's bid to be accepted into the WTO hinges in part on the country's ability to introduce robust intellectual property protection laws. As a current hotbed for the illegal copying of software and music CDs—dubbed as Algeria's parallel economy by Temmar—the country has its work cut out in this area.

Apart from hydrocarbons, areas that could be attractive to investors and to companies looking for joint venture deals in Algeria include housing, agriculture, and some mining of local ores. Algeria is also cited by the World Bank as having considerable potential as a manufacturing base, given its proximity to Europe.

SUPPORT FOR INWARD INVESTMENT AND IMPORTS

Algeria's Supplementary Finance Law of August 1990 introduced a system of concessionaries and wholesalers that were entitled to represent foreign companies as part of a process to liberalize imports. Importers also gained the right to hold foreign currency accounts to carry out their legitimate business. Today, the entity responsible for foreign direct investment in Algeria is the National Investment Development Agency (ANDI), created in 2001.

TAX EXEMPTIONS

All discussions on tax breaks should be taken up with ANDI. The country has five free trade zones where investments are exempt from all customs, taxes, and other fees.

MORE INFO

Websites:

IMF Staff Report, March 2010: www.imf.org/external/pubs/cat/longres.cfm?sk=23672.0
National Investment Development Agency (ANDI): www.andi.dz
Trade advice on a range of countries, including Algeria: www.alibaba.com
Trade website for MENA region: www.animaweb.org

Bahrain

ECONOMY AND TRADE

An archipelago of 36 islands, the Kingdom of Bahrain was the first Gulf state to discover oil, but its reserves are due to run out within the next 10 to 15 years. With its highly developed communication and transport facilities, Bahrain is home to numerous multinational firms with business in the Gulf. Today, petroleum production and refining account for more than 60% of Bahrain's export receipts, more than 70% of government revenues, and 11% of GDP (exclusive of allied industries).

The production and refining sector has underpinned Bahrain's strong economic growth in recent years. Aluminum is Bahrain's second major export after oil. Other major segments of Bahrain's economy are the financial and construction sectors. Bahrain is focused on Islamic banking and competes on an international scale with Malaysia as a worldwide banking center. Continued strong growth hinges on Bahrain's ability to acquire new natural gas supplies as feedstock to support its expanding petrochemical and aluminum industries. Unemployment, especially among the young, and the depletion of oil and underground water resources are long-term economic problems.

ECONOMIC POLICY OVER 12 MONTHS

The authorities adopted expansionary monetary and fiscal policies in response to the global economic slowdown. The national budget moved into deficit for the first time in five years in 2009. The government increased public spending as private sector spending and investment faltered, while revenues also declined as the oil price slid.

Meanwhile, the central bank announced rate cuts that were largely in line with those adopted by the Federal Reserve in the United States. The cuts were needed to support the US dollar peg for the Bahrain currency, but were also helpful in terms of the economic slowdown. In July 2010, the governor of the central bank affirmed that Bahrain was committed to maintaining its exchange rate peg to the US dollar, while at the same time continuing talks with several states of the Persian Gulf region to achieve monetary union.

In January 2010 Bahrain, along with three others of the six-member Gulf Cooperation Council (GCC), agreed to create a joint central bank, but the introduction of a single GCC currency remains a distant goal. Although Kuwait, Qatar, and Saudi Arabia, as well as Bahrain, want to push ahead with the central bank, Oman said that it was not able to meet the prerequisites needed for monetary union, while the United Arab Emirates objects to locating the headquarters of the central bank in Saudi Arabia.

Facing the near-term exhaustion of its oil reserves (gas reserves should last another 50 years), Bahrain is actively working to diversify and privatize its economy in an attempt to reduce the country's dependence on oil. As part of this effort, in August 2006 Bahrain and the United States implemented a free trade agreement (FTA), the first between the United States and a Gulf state.

Without doubt, however, the biggest element in Bahrain's diversification program has been its emergence as a major financial center. International financial institutions operate in Bahrain, both offshore and onshore, with considerable freedom. The sector contributes 27.6% of GDP and is host to both Western finance houses and one of the Middle East's most developed Islamic banking centers, having played a major part in standardizing the regulatory elements of the Islamic banking industry.

In addition to banking, the country is putting substantial resources into developing service industries such as information technology (IT), healthcare, and education. It has made use of oil revenues to build an advanced infrastructure in transportation and telecommunications, according to the US State Department.

The privatization effort has focused particularly on water and electricity utilities. In 2006, the government licensed Al Ezzal to construct an independent power plant at a cost of US$500 million.

STATISTICS

GDP growth: 2.9% (2009 est.)
GDP per capita: US$29,800 (2009 est.)
CPI: 3% (2009 est.)
Key interest rate: 8.35% (December 31, 2008)
Exchange rate versus US dollar: BD0.376 (fixed)*
Unemployment: 15% (2009)
FDI: US$16.18 billion (December 31, 2009 est.)
Current account deficit/surplus: US$1.808 billion (2009 est.)
Population: 738,004 (July 2010 est.)

*Bahraini dinar

Source: CIA World Factbook except where stated

Earlier that year, it sold the Al Hidd power plant to a consortium of British, Japanese, and Belgian companies for US$753 million.

ECONOMIC PERFORMANCE OVER 12 MONTHS

Economic growth slowed sharply in Bahrain in 2009 but the country was still able to post positive growth of around 3%, down from 6.8% in 2008. The property sector was the worst affected by the slowdown. It declined throughout 2009 as expectations of future demand were reduced and financing became more difficult. The finance sector also contracted, but the decline was relatively mild, and was almost entirely accounted for by weakness in the offshore banking sector in the first half of 2009.

However, clouds hung over the financial sector in 2010 in the shape of doubts over the viability of the Bahrain-based investment bank Gulf Financing House (GFH), which is one of the country's foremost financial institutions. The authorities have refused to bail out the bank, but it is unlikely that they would allow the institution to fail, given the systemic risks that such a development could pose to the financial sector, which is home to more than 370 offshore banking units and representative offices, including a large number of US firms and 32 Islamic commercial, investment, and leasing banks. In August 2010, GFH reached an agreement with a group of banks led by West LB for a new US$100 million Islamic loan, giving the investment house more time to sell assets and find new sources of revenue.

The Economic Development Board (EDB) forecast in July 2010 that the economy would expand by 4% in 2010 and that the rate of expansion would accelerate, rising to 7.2% in 2015. The EDB, a government body responsible for setting Bahrain's economic policies, also said that GDP grew 5.2% during the first quarter year-on-year and by 1.4% compared to the last quarter of 2009. The EDB expects that household consumption will be the main driver of growth over the coming years, while investments will remain subdued as investors are still suffering from the regional property crash that began in 2008. The EDB added that it expected the country's financial sector to recover slowly, acknowledging the troubles facing Bahraini investment houses. Petroleum output declined sharply in the first quarter of 2009 but picked up over the remainder of the year.

The success of ventures such as the Bahrain Grand Prix has raised the Kingdom's international profile, and, combined with the boom in Islamic banking, has encouraged major airlines to resume services to the country. Bahrain's international airport is one of busiest in the Persian Gulf, serving 22 carriers. A modern, busy port offers direct and frequent cargo shipping connections to the United States, Europe, and the Far East.

SUPPORT FOR INWARD INVESTMENT AND IMPORTS

The EDB is the public agency responsible for formulating and overseeing economic development strategy in Bahrain and has responsibility for attracting direct investment into the Kingdom. It offers an investor facilitating service to first-time investors.

TAX EXEMPTIONS

The Kingdom operates a policy of zero corporate taxes. More information can be obtained from the EDB.

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Bahrain Economic Development Board: www.bahrainedb.com
Business Friendly Bahrain: www.bahrain.com
Ministry of Industry and Commerce: www.moic.gov.bh

Bangladesh

ECONOMY AND TRADE

Bangladesh, one of the world's poorest and most densely populated countries, faces some difficult challenges. With much of the country situated on low-lying land on the delta of the confluence of three rivers, the Ganges, the Brahmaputra, and the Meghna, around one-third of the country is subject to annual flooding. Nevertheless, the economy has grown by between 5% and 6% per year since 1996, despite inefficient state-owned enterprises, delays in exploiting natural gas resources, insufficient power supplies, slow implementation of economic reforms, and a turbulent political scene that saw the army taking a caretaker role prior to fresh elections on December 29, 2008. Although more than half of GDP is generated through the service sector, nearly two-thirds of Bangladeshis are employed in the agriculture sector, with rice as the single most important product. Garment exports and remittances from Bangladeshis working overseas, mainly in the Middle East and East Asia, have been the main source of economic growth.

STATISTICS

GDP growth: 5.6% (2009 est.)
GDP per capita: US$1,600 (2009 est.)
CPI: 5.1% (2009 est.)
Key interest rate: 13% (September 30, 2009)
Exchange rate versus US dollar: Tk69.047
Unemployment: 2.5% (2009 est.)
FDI: US$7.235 billion (December 31, 2009 est.)
Current account deficit/surplus: US$2.808 billion (2009 est.)
Population: 158,065,841 (July 2010 est.)

*Bangladeshi taka
Source: CIA World Factbook except where stated

ECONOMIC POLICY OVER 12 MONTHS

In June 2009, Bangladesh announced a Tk1.14 trillion ($16.5 billion) budget for the 2009/10 fiscal year beginning July 2009, with the aim of shielding the economy from the global economic crisis. It was the first budget of Prime Minister Sheikh Hasina's government, which won office in a December 2008 election with promises of price cuts, improved utilities, jobs, higher civil servant pay, and poverty alleviation. Finance Minister Abul Maal Abdul Muhith said that the budget would focus on cutting poverty, boosting agriculture, enhancing rural and industrial development, and boosting the social safety net for the poor. He said that efforts would be strengthened to create more jobs and curb corruption and crime, to attract more foreign aid and investment.

In April 2010, the finance minister said that the 2010/11 budget would be around Tk1.30 trillion (US$18.7 billion), 14% bigger than the 2009/10 budget. The minister said the budget would aim to achieve 6.7% growth and keep inflation within 6.5%. He added that improving power supplies and the energy sector and controlling prices of essential goods would be top priorities for the government's next budget. Annual inflation in January 2010 increased to 8.99% from 8.51% in the previous month on a spike in food prices, which is a major concern for the government, given that 40% of Bangladeshis live on less than US$1 a day and spend 70% of their income on food.

The government helped the vitally important textile sector during the global economic outturn by announcing nearly US$650 million of support during the course of 2009.

Raising power supplies is also a major objective for the government, given that the country faces 1,500 megawatts of electricity shortages a day, which the World Bank estimates costs it up to 2% in lost GDP growth each year. About 80% of electricity is produced from natural gas, but at present the country faces up to 300 million cubic feet of gas shortages a day. Industrial production including that of apparel, ceramics, fabrics, steel, and particles, is being affected.

In 2009, the Bangladesh Bank adopted a relatively loose monetary policy to support the economy and offset the impact of the global economic downturn. Faced with a possible pickup in inflation and a rapid rise in share prices, monetary conditions were tightened from the later summer onward. In April 2010, the central bank stepped up its efforts to curb inflation in the country, introducing a slew of new measures to mop up excess liquidity. Among other measures, the central bank resumed the auction of its 30-day bills after a hiatus of nearly two months, and raised interest rates on government securities, especially bonds.

ECONOMIC PERFORMANCE OVER 12 MONTHS

Bangladesh's agricultural sector is largely focused on rice and jute production, with the country just about keeping pace with the food requirements

of its population. Yields of rice and vegetables, together with the cash crop of jute for fiber production, have gone up in recent years, thanks to better flood control and irrigation, and the more efficient use of fertilizers.

Bangladesh's economy held up remarkably well, despite the global recession. Growth decelerated only modestly from the pace recorded in recent years, helped by a favorable harvest in the fall of 2009, when rice output grew by more than 12% year on year. In addition, remittances continued to grow strongly—increasing by more than 10% year on year in January 2010—further boosting domestic consumption. Consequently, the economy is expected to grow by 6% in the fiscal year ending June 2010, according to official estimates, while the finance minister said in April 2010 that he anticipated an expansion of 6.7% in the fiscal year beginning July 2010.

The export sector suffered in 2009, but textiles, which account for 80% of exports, are well placed to benefit from the global economic upturn. The industry gained global market share in 2009 as US and EU demand shifted toward lower-priced Bangladeshi garments. The textile industry also weathered the global downturn well by implementing aggressive price cuts. Even so, around 100 factories closed down between August and October 2009 because of falling orders.

The readymade garment sector, which is growing at around 20% a year, is one of the better performing sectors of the Bangladesh economy over the long term. This industry gained from the ending of quotas under the Multi-Fiber Arrangement. However, the whole sector is under enormous cost-cutting pressure globally, and Bangladesh has to keep driving down costs if it wants this sector to stay competitive internationally.

Rising income inequality, as shown by a series of household income and expenditure surveys, is becoming a real problem for the government and is frustrating its poverty reduction programs. Although the country achieved poverty reduction of 2% per year from 2000 to 2005, for example, income inequality continued to rise. The situation worsened in 2006 to 2008. The Centre for Policy Dialogue estimates that some 8.5% of Bangladeshi homes have experienced a high enough degree of income erosion over the period (mainly through rising food prices) to push them below the poverty line.

SUPPORT FOR INWARD INVESTMENT AND IMPORTS

The body set up to promote and facilitate both domestic and foreign investment in the private sector is the Board of Investment (BOI), founded in 1989. It is headed by the prime minister and is part of the Prime Minister's Office.

TAX EXEMPTIONS

There is a range of tax exemptions, with exemptions from tax for the first five to seven years being possible by arrangement. Power-generation ventures can obtain 15 years' general exemption from taxation. Contact the BOI for further details.

MORE INFO

Websites:

Board of Investment, Bangladesh: www.boi.gov.bd
Centre for Policy Dialogue: www.cpd.org.bd
National web portal of Bangladesh: www.bangladesh.gov.bd

Brunei

ECONOMY AND TRADE

Bordering the South China Sea and Malaysia, the Sultanate of Brunei became a British protectorate in 1888 and achieved independence in 1984. The same family has ruled the country for more than six centuries, and now presides over an economy that boasts one of the highest per capita GDPs in Asia. Brunei last held elections in March 1962. It is a constitutional sultanate, with the Legislative Council consisting of members appointed by the sultan. The economy encompasses a mixture of foreign and domestic entrepreneurship, government regulation, welfare measures, and village tradition. Crude oil and natural gas production account for just over half of GDP and more than 90% of exports. Substantial income from overseas investment supplements income from domestic production. The government provides all medical services, together with free education through to university, and also subsidizes rice and housing. Brunei's leaders are concerned that steadily increasing integration into the world economy will undermine internal social cohesion.

ECONOMIC POLICY OVER 12 MONTHS

The country is rich in natural resources and has a strategic location within the region. Most of the country is covered in tropical rainforests, and ecotourism is gaining importance in Brunei's economic activities. The government recognizes that its future wealth, beyond oil and gas, lies in the knowledge and skills of its people, which is one of the main reasons why university education is free. Having a highly skilled workforce has been central to the government's desire to transform Brunei into a diversified, industrialized economy, and skilled workers remain in short supply.

Plans for the future include upgrading the labor force, reducing unemployment, strengthening the banking and tourism sectors, increasing agricultural production, and, in general, further widening the economic base beyond oil and gas. The main focus of attention on the development of human resources has been a focus on managerial and industrial skills, with particular emphasis on entrepreneurial skills (source: official government website).

Brunei's main exports consist of three major commodities—crude oil, petroleum products, and liquefied natural gas—which are sold largely to Japan, the United States, and Association of Southeast Asian Nations (ASEAN) countries.

STATISTICS

GDP growth: −1.9% (official, 2008)
GDP per capita: US$50,100 (2009 est.)
CPI: 1.8% (official, 2009)
Key interest rate: 5.5% (December 31, 2008)
Exchange rate versus US dollar: B$1.45 (2009, fixed 1:1 against the dollar)
Unemployment: 3.7% (2008)
FDI: n/a
Current account deficit/surplus: US$7.024 billion (2008 est.)
Population: 395,027 (July 2010 est.)

Source: CIA World Factbook except where stated

The government's move to promote nonoil and gas activities gathered momentum in the 1990s, and has continued ever since. The success of its early initiatives can be seen from the fact that in 1996, nonoil and gas activities were already contributing 64% of GDP, compared to just 24.3% in 1991.

The sultanate also sees encouraging more foreign direct investment foreign direct investment as a way of strengthening the country's underdeveloped private sector. Boosting the activities of this sector will greatly assist in the movement away from a reliance on nonrenewable resources. As a member of Asia-Pacific Economic Cooperation (APEC), which includes a number of countries in the region, Brunei is benefiting from the overall efforts being made by APEC to understand and encourage foreign direct investment flows right across the region. The sultanate has a strong legal infrastructure backed by a competitive market environment, both of which will be attractive to foreign investors. The Brunei Investment Incentive Act 1975 provides tax advantages for start-up businesses and ongoing incentives throughout a company's growth and expansion. These tax advantages are rated by APEC as "comparable, if not better, than those already offered by other countries in the region." Foreign investors are allowed to own and operate companies, and there are flexible forms of joint venture and minority participation available as well. No foreign ownership of land is allowed. Instead, foreign companies can apply to lease land for industrial development. Importantly, the Brunei dollar is a convertible currency, and the government does not maintain any

currency controls. Neither does it limit remittances, loans, or lease payments, according to APEC.

ECONOMIC PERFORMANCE OVER 12 MONTHS

In April 2010, the Asian Development Bank (ADB) forecasted that the economy would expand by 1.1% in 2010 and 1.5% in 2011. It said that the recovery was based on an expected gradual rise in global demand for energy, higher oil and gas prices, and the start-up in the first half of 2010 of a large methanol plant, which has been under construction for the past six years. The ADB projected that inflation would edge up to 1.7% in 2010 before moderating to 1.5% in 2011. Inflation fell to 1.8% in 2009, from 2.7% in 2008, reflecting softer commodity prices and subdued domestic demand. A generally stable Brunei dollar, which is pegged to the Singapore dollar, helped to contain inflation.

The economy shrank by 1.9% in 2008 as oil and natural gas production fell by 6.2%. The fall in hydrocarbon production, for the second consecutive year, reflected the maturity of the country's oilfields and a government decision to use reserves more sparingly to extend the life of energy production. The economy contracted by 2.8% year-on-year in the first quarter of 2009 (the latest period for which data are available). Oil and gas production fell by a further 6.7%, and growth slowed in the nonenergy sector.

Until the sudden fall in oil prices as the global slowdown took hold in late 2008, high oil and gas prices had driven large fiscal and current account surpluses. Preliminary trade data for 2009 indicate that exports to Japan, Indonesia, the Republic of Korea, and Australia, which accounted for 87% of Brunei's exports, fell by 45%, while imports from Singapore, Malaysia, Japan, the People's Republic of China, and Thailand, which accounted for 73% of total imports, dropped by 1.2%. Consequently, the current account surplus is likely to have narrowed to a still large 35% of GDP in 2009.

The country's main medium-term challenge, apart from the global downturn, is finding ways of deepening and strengthening the diversification of the economy. Key reforms will include developing domestic capital markets, introducing education and training programs to achieve a more appropriate labor skills mix, and improving the business environment. Brunei has also put in place a strong financial supervisory and regulatory framework, including an anti-money-laundering regime. It has worked to harmonize Islamic banking and insurance law and regulations with conventional regulation to create a level playing field for all the country's banks.

SUPPORT FOR INWARD INVESTMENT AND IMPORTS

In November 2001, the Brunei Economic Development Board was formed, with the primary responsibility of attracting and retaining local and foreign direct investment to further diversify the economy. Its primary focus is in attracting investment in advanced technology industries and skill-intensive services with good export market prospects.

TAX EXEMPTIONS

Further information on these can be obtained from the Brunei Economic Development Board.

MORE INFO

Websites:

Brunei Economic Development Board: www.bedb.com.bn
Ministry of Industry and Primary Resources: www.industry.gov.bn
Official government site: www.brunei.gov.bn

Egypt

ECONOMY AND TRADE

Egypt has endured as a unified state for more than 5,000 years, and archeological evidence indicates that a developed Egyptian society has existed for much longer. Egypt acquired full sovereignty with the overthrow of the British-backed monarchy in 1952. The completion of the Aswan High Dam in 1971 and the resultant Lake Nasser have altered the time-honored place of the Nile River in the agriculture and ecology of Egypt. A rapidly growing population (the largest in the Arab world), limited arable land, and dependence on the Nile all continue to overtax resources. With the installation of the 2004 parliament, the Government of Egypt began a new reform movement following a stalled economic reform program begun in 1991 but moribund since the mid-1990s.

Over the last few years, the government has improved the transparency of the national budget, revived stalled privatizations of public enterprises, and implemented economic legislation designed to foster private sector-driven economic growth and improve Egypt's competitiveness. Despite these achievements, the economy is still hampered by government intervention, substantial subsidies for food, housing, and energy, and bloated public-sector payrolls. Moreover, the public sector still controls most heavy industry.

ECONOMIC POLICY OVER 12 MONTHS

Egyptians take pride in their "pharaonic heritage," and in their relationship to what they consider to be mankind's earliest civilization. However, the country today faces some very severe economic challenges. The government has struggled to meet the demands of Egypt's growing population through economic reform, and massive investment in communications and physical infrastructure. The economy was highly centralized during the rule of former president Gamal Abdel Nasser, but it opened up considerably under his successor, Anwar El-Sadat, and President Mohammad Hosni Mubarak has continued this process.

However, since 2005, Cairo has aggressively pursued economic reforms to encourage inflows of foreign investment and facilitate GDP growth. In 2005, Prime Minister Ahmed Nazif's government reduced personal and corporate tax rates, reduced energy subsidies, and privatized several enterprises. The stock market responded enthusiastically and GDP grew by about 7% per year for the next two years, until the growth momentum began to feel the effects of the global slowdown toward the end of 2008.

STATISTICS

GDP growth: 4.7% (2009 est.)
GDP per capita: US$6,000 (2009 est.)
CPI: 10.1% (2009 est.)
Key interest rate: 8.25% (August 2010)
Exchange rate versus US dollar: E£5.6 (2009)
Unemployment: 9.7% (2009 est.)
FDI: US$66.43 billion (December 31, 2009 est.)
Current account: −US$3.32 billion (2009 est.)
Population: 80,471,869 (July 2010 est.)

Source: CIA World Factbook except where stated

However, according to an International Monetary Fund (IMF) report published in March 2010, Egypt weathered the global financial crisis relatively well and financial market pressures eased after the initial outflow. The economy was supported by the fact that the government reacted quickly to the crisis by providing a sizable fiscal stimulus in the second half of 2008/09, based mainly on accelerating investment projects. Key fiscal reforms, such as introducing the property tax, broadening the value added tax, and phasing out energy subsidies, were postponed. The 2009/10 budget provided further support.

However, reducing the fiscal deficit and public debt are key medium-term objectives. Egypt's public debt remains high in comparison with many other emerging market countries. Although much of the debt is denominated in local currency, the maturity structure is short, creating an annual rollover requirement of 20% of GDP. The government is aiming to reduce the deficit to about 3% of GDP by 2014/15.

Monetary policy was also supportive with the central bank cutting policy rates six times between February and September 2009 as inflation subsided. Interest rates were unchanged by April 2010.

The financial sector weathered the crisis well, helped by banking reforms introduced between 2004 and 2008 that strengthened supervision, restructuring, and consolidation, and a cleanup of nonperforming loans—reducing financial vulnerabilities. Limited reliance on short-term wholesale funding channels and relatively traditional portfolios also enable Egyptian banks to avoid the worst impact of the crisis.

ECONOMIC PERFORMANCE OVER 12 MONTHS

The economy held up relatively well in the face of weaker external demand, achieving growth of around 5% in 2009/10. Resilient domestic consumption, and production in the construction, communications, and trade sectors, helped to sustain growth, according to the IMF.

The economy has also rebounded strongly in 2010, growing by 5.9% in the fourth quarter of 2009/10, up from 5.8% in the third quarter and 5.1% in the second, with forecasts for growth to reach at least 6.5% in 2010/11.

Higher revenue and stronger economic growth would result in a slight cut in the budget deficit to 7.9% of GDP in 2010/11, although the deficit would still be higher in nominal terms than in 2009/10, officials said. They added that the increase in revenue (in 2010/11) is due to an expected increase in revenue from exports of about E£3 billion, from petroleum and petroleum products of about E£2 billion, from tax revenue of about E£1 billion, and from other sources of about E£4 billion.

Inflation in Egypt remained unchanged in July 2010, supporting the central bank's decision to keep its benchmark interest rate at the lowest level since 2006. Urban inflation, the main rate monitored by the central bank, was 10.7% in July.

Performance from the country's agricultural sector has been strong in recent years. Warm weather and plentiful water permit several crops a year. Further improvement is possible, but land is worked intensively, and yields are already high. Cotton, rice, wheat, corn, sugarcane, sugar beet, onions, and beans are the principal crops. Increasingly, a few modern operations are producing fruits, vegetables, and flowers, in addition to cotton, for export. While the desert hosts some large, modern farms, more common traditional farms occupy one acre each, typically in a canal-irrigated area along the banks of the Nile. Many small farmers also have cows, water buffalo, and chickens, although larger modern farms are becoming more important.

In addition to the agricultural capacity of the Nile Valley and Delta, Egypt's natural resources include petroleum, natural gas, phosphates, and iron ore. Crude oil is found primarily in the Gulf of Suez and the Western Desert. Natural gas is found mainly in the Nile Delta, off the Mediterranean shore, and in the Western Desert. Oil and gas account for approximately 12% of GDP. Crude oil production has been in decline for several years, from a high of more than 920,000 barrels per day (bpd) in 1995, to an estimated 675,000 bpd in 2009.

SUPPORT FOR INWARD INVESTMENT AND IMPORTS

The Egyptian Ministry of Investment has been involved in a series of reform and promotional programs to improve both local and foreign investment in Egypt. Around 3% of all foreign direct investment in Egypt goes into the textile sector, but there are opportunities for investment across the economy. Further information can be obtained from the Ministry.

TAX EXEMPTIONS

The tax structure in Egypt is complex, and potential investors will need to seek professional advice. Further information can be obtained from the Ministry for Investment, which operates a number of exceptional incentive schemes. These schemes are aimed particularly at foreign investors who wish to take a stake in existing state-owned schemes as part of Egypt's privatization initiatives.

MORE INFO

Websites:

Egyptian People's Assembly: www.parliament.gov.eg
Ministry of Investment: www.investment.gov.eg

Indonesia

ECONOMY AND TRADE

Indonesia's economy, South East Asia's largest, has grown robustly since Asia's 1997–1999 financial crisis. Economic reforms and better fiscal management became a priority from 2004, after the succession of President Susilo Bambang Yudhoyono, following the country's first direct election which ended decades of authoritarian rule. GDP growth rose from 5.5% in 2006 to 6.3% in 2007, the highest in a decade, but in 2008 it dipped to an estimated 5.9%. Indonesia's debt/GDP ratio has fallen and, in 2003, it graduated from the International Monetary Fund (IMF) loan program. Although the region's main oil and gas producer, it became a net importer of oil in 2004, as a result of ageing wells and low levels of investment. Exports include oil and gas, plywood, textiles, rubber, and palm oil. Indonesia, which is Asia's third most populous country, has faced costly natural disasters, including the 2004 tsunami and three earthquakes in 2005 and 2006. Its legal system remains weak, and bureaucracy and lack of infrastructure impede foreign investment. The economy shrugged off the impact of the global downturn in 2009, expanding by 4.5%.

ECONOMIC POLICY OVER 12 MONTHS

The high oil price dented the Indonesian government's budget in 2008 because of high fuel subsidies. In March 2008, the fuel subsidy was forecast to cost US$11.53 billion for that year, more than double the original forecast. The government announced in May 2008 that Indonesia would leave the Organization of the Petroleum Exporting Countries (OPEC), and focus instead on boosting its own lagging oil and gas industry. This was, in part, a political move to highlight escalating oil prices. In an unpopular development during the same month, the government also raised domestic fuel prices by 29%.

In February 2009, the government sanctioned a US$6 billion stimulus package that included tax breaks, cuts in electricity subsidies, and increased spending on transport and infrastructure. Suharso Monoarfa, deputy chairman of the parliamentary committee, said that the package would curb rising unemployment, sustain consumer spending, and strengthen businesses.

Despite the increase in spending, the debt/GDP ratio of the national government fell to 28% in 2009, continuing a decline that had cut the ratio by half in five years. The deficit in 2009 followed several years of prudent fiscal management, including primary fiscal surpluses of about 2% of GDP per year. The fiscal stimulus will be reined in during 2010, when the government expects to run a budget deficit of 2.2% of GDP, down from an estimated 4.9% in 2009.

Monetary policy was also relaxed in 2008 and 2009. Bank Indonesia, the central bank, lowered its policy interest rate by 300 basis points from November 2008 to August 2009, to 6.5%, where it remained at April 2010. At this time, the bank said that it might keep interest rates low for the next few months, given the benign inflation outlook. Declining inflationary pressures in 2009—the central bank targets an inflation range of 4% to 6%—allowed the bank to cut rates.

In April 2010, President Susilo Bambang Yudhoyono said that Indonesia would continue to improve its investment climate, as the country strives to attract private sector participation to jointly develop its infrastructure. Indonesia is expected to increase the development of roads, ports, airports, and power plants to boost its economic growth in the next five years. To meet the demands, the World Bank estimates that Indonesia needs US$50 billion a year, or about 10% of its GDP.

ECONOMIC PERFORMANCE OVER 12 MONTHS

Indonesia is weathering the international financial storm better than many other countries. The economy grew by 5.9% in 2008, and expanded by a further 4.5% in 2009, only one percentage point below the average growth seen in the previous five years. South East Asia's biggest economy was one of the few Asian

STATISTICS

GDP growth: 4.5% (official, 2009)
GDP per capita: US$4,000 (2009 est.)
CPI: 5% (2009 est.)
Key interest rate: 6.5% (December 2009)
Exchange rate versus US dollar: Rp10,399.2 (2009)*
Unemployment: 7.7% (2009 est.)
FDI: US$73.02 billion (December 31, 2009 est.)
Current account deficit/surplus: US$10.7 billion (2009 est.)
Population: 242,968,342 (July 2010 est.)

*Indonesian rupiah
Source: CIA World Factbook except where stated

countries to post positive growth in 2009. The strength of the economy reflected its greater dependence on domestic consumption rather than exports. The economy also received a big boost in the first quarter from election-related spending, which provided strong support for private consumption.

The economic slowdown reached its nadir in the second quarter of 2009 and the economy rebounded in the fourth, driven by accelerating exports and a pickup in the price of export commodities. Stimulatory fiscal and monetary policy also drove growth. Good harvests (which bolstered rural incomes), low inflation, government cash transfers to poor households early in 2009, election-related spending, and tax cuts (adopted as part of a fiscal stimulus package) drove private consumption.

Growth appears to be accelerating rapidly in 2010. In April, Finance Minister Sri Mulyani Indrawati said that Indonesia's economy was likely to have expanded by between 5.7% and 5.8% in the first quarter against the previous year, thanks to strong domestic consumption and a pickup in investment. At the same time, Economics Minister Hatta Rajasa said that full-year 2010 GDP growth was also seen at 5.7%.

A surge in foreign investor interest drove up the value of the currency in 2010. The robust investor interest reflects the fact that the Indonesian authorities had steadily lifted their forecasts for growth in 2009, on the back of strong demand for Indonesia's natural resources and improving domestic consumption.

Indonesia's annual inflation remained below 3.5% in the first quarter of 2010, allowing the central bank to keep interest rates at the record low of 6.5%. The central bank forecasted year-end inflation of 4.8% for 2010 if the government did not raise electricity prices, and at 5.2% if it did hike power prices.

SUPPORT FOR INWARD INVESTMENT AND IMPORTS

The Indonesia Investment Coordinating Board oversees foreign direct investment, and can provide information on incentives and details of potential commercial partners. The Board oversees Indonesia Investment Promotion Centers in cities including London, Osaka, and Los Angeles. However, foreign investors face significant restrictions. In 2007, Indonesia updated its restricted investment list of sectors in which foreign investment is prohibited or restricted. Details can be found on the Board's website.

TAX EXEMPTIONS

The government said in March 2009 that it will provide additional incentives for investment in oil refineries. Indonesia needs to build new refineries and wants to encourage investment in the sector in order to reduce its dependence on imported oil. The top corporate tax rate is 30%. Other taxes include a value added tax (VAT) and a tax on interest. The March 2009 stimulus package included reduced tax tariffs, government-borne VAT, import duties, and incentives related to income tax.

MORE INFO

Websites:

Indonesia Investment Coordinating Board: www.bkpm.go.id
Indonesia Investment Coordinating Board (regional): www.regionalinvestment.com/sipid/en/index.php
Ministry of Industry: www.depperin.go.id/ENG2006
National Agency for Export Development: www.nafed.go.id

Iran

ECONOMY AND TRADE

Iran, a theocratic Islamic republic with strained relations with the West, is a major producer of oil and gas, and has had one of the Middle East's best-performing economies. A founding member of the Organization of the Petroleum Exporting Countries (OPEC), it has the world's third largest proven reserves of crude oil and the second largest proven reserves of natural gas. Oil accounts for 80% of foreign exchange receipts, while oil and gas contribute 70% of government revenue. Iran also produces textiles, construction materials, metals, armaments, and agricultural produce. The state controls most economic activity, and spends about half of its budget on subsidizing basics, including fuel, electricity, bread, and rice. Bordered by Iraq to the west and Afghanistan and Pakistan to the east, Iran is subject to UN, EU, and US sanctions as a result of its nuclear ambitions and as an alleged sponsor of terrorism. Its main trading partners are China, Japan, Germany, Italy, South Korea, and the United Arab Emirates.

STATISTICS

GDP growth: 0.5% (private economists' estimates, March 2010)
GDP per capita: US$12,900 (2009 est.)
CPI: 16.8% (2009 est.)
Key interest rate: n/a
Exchange rate versus US dollar: IR9,900 (2009)*
Unemployment: 12.5% (official, 2008 est.)
FDI: US$7.854 billion (December 31, 2009 est.)
Current account deficit/surplus: US$2.249 billion (2009 est.)
Population: 67,037,517 (July 2010 est.)

*Iranian rial
Source: CIA World Factbook except where stated

ECONOMIC POLICY OVER 12 MONTHS

Ultra-conservative President Mahmoud Ahmadinejad, elected in 2005 on a populist platform, has vowed to transform Iran into a regional economic powerhouse. With oil output limited by OPEC quotas, Iran has been striving to increase gas production, especially in the South Pars field in the Persian Gulf. In the longer term, Iran also plans to increase oil-refining capacity from 1.5 million barrels per day (bpd) in 2008 to 3 million bpd by 2012.

Critics accuse Ahmadinejad of squandering the windfall oil revenues that Iran received when crude prices soared in the first half of 2008, leaving the country vulnerable now that it faces possible additional UN sanctions over its nuclear program. In June 2010, the UN passed a fourth set of sanctions (the first was implemented in December 2006) against Iran as a result of its failure to suspend its nuclear enrichment program. The international community believes that Iran is trying to produce a nuclear weapon, while Tehran insists that its program is purely for peaceful purposes. The new sanctions target a further 40 companies and organizations.

Furthermore, the EU and the United States have announced additional measures. In August, EU ambassadors agreed to a new package of sanctions, which includes a ban on investing or selling equipment to Iran's energy industries, as well as restrictions on export-credit guarantees and insurance. Earlier, on July 1, President Barack Obama signed legislation that punishes foreign suppliers of Iran's gasoline and blocks access to the American financial system for banks that do business with the country.

In August, the government reacted to the increasing pain of economic sanctions, with Supreme Leader Ayatollah Ali Khamenei urging greater efficiency and motivation, and Iran's vice-president threatening to stop doing business in dollars and euros.

In July, the government said that it would cut subsidies for fuel and basic consumer goods in the second half of the new Iranian year, which started on March 21. The plan, which involves phasing out subsidies over five years, may reflect the growing economic pressure on Iran resulting from the sanctions. Subsidies have been a tenet of the Islamic establishment since it took power in 1979.

The budget for the fiscal year beginning March 21, 2010, forecasts revenues of US$59.6 billion, which will result in a US$6 billion deficit. It includes plans to phase out costly subsidies on food and energy, which the government has said would add 15 percentage points to its average inflation forecast of 10% in 2010/11.

ECONOMIC PERFORMANCE OVER 12 MONTHS

President Ahmadinejad has repeatedly lashed out at the West for the current financial crisis—a tactic that analysts say is intended to deflect criticism from his mismanagement of Iran's

economy. However, his rhetoric has landed him in trouble domestically, as critics have accused him of spending too much time castigating the West and not enough time fixing domestic problems.

Iran is the world's fifth largest crude oil exporter, but while oil prices have surged, Iran's economy has slowed as a result of the global economic downturn, its political isolation, and sanctions over its nuclear energy program. It is likely to have grown by just 0.5% in the year ending March 2010.

Sanctions have undermined Iran's economy. Imported commodities and technology are estimated to cost 10–20% more than they should as a result. US sanctions, first imposed after the 1980 hostage-taking in Tehran, prohibit most business with Iran. They also make it hard for non-US oil and gas companies investing in Iran to win US business.

Real GDP growth averaged an estimated 5.6% a year during 2005/06 to 2008/09, according to an IMF report published in March 2010. High oil prices supported this relatively robust rate of growth. Gross official reserves reached US$80.5 billion (about 12 months of imports) by the end of September 2009, reflecting the strong oil revenues. However, a sharp drop in oil prices in the first half of 2009, as well as rising inflation, prompted the authorities to rein in monetary and fiscal policy. Consequently, the IMF believes that real GDP growth fell to between 2% and 2.5% in 2008/09, from almost 7% in 2007/08. Domestic activity and demand growth also slowed significantly, due to the global economic slowdown and lower credit growth.

The tight fiscal and monetary policy curbed inflationary pressures, with consumer price index (CPI) inflation falling from almost 30% in October 2008 to 9.1% in July 2010. Iranian economists blame President Ahmadinejad for stoking inflation with his expansionary policies during his first four-year term. They accuse Ahmadinejad, who was re-elected in June 2009, of directly fueling price rises by plowing huge amounts of cash into the economy for local infrastructure projects and by offering low-interest loans.

SUPPORT FOR INWARD INVESTMENT AND IMPORTS

Any business considering commercial dealings with Iran must make itself acquainted with any relevant sanctions, such as those imposed by the United Nations, the European Union, or the United States. The Iranian government's Organization for Investment, Economic, and Technical Assistance for Iran (OIETAI) offers advice on tax and other fiscal incentives. Information about Iran's 17 Special Economic Zones and Free Zones can be obtained through the Secretariat of the High Council of Iran Free Trade-Industrial Zones.

TAX EXEMPTIONS

Fiscal incentives for investing in Iran include reduced income tax rates—from 65% down to a flat, fixed 25% rate. (See the Ministry of Economic Affairs and Finance website.)

MORE INFO

Websites:

Organization for Investment, Economic, and Technical Assistance of Iran (OIETAI): www.investiniran.ir

Ministry of Economic Affairs and Finance, tax information: www.cito.ir/site/en/download/guide.pdf

Secretariat of the High Council of Iran Free Trade-Industrial Zones: www.freezones.ir

Iraq

ECONOMY AND TRADE

Formerly part of the Ottoman Empire, Iraq was occupied by Britain during the course of World War I. In 1920 it was declared a League of Nations mandate under United Kingdom administration. Iraq attained its independence as a kingdom in 1932. It was proclaimed a republic in 1958, but in actuality a series of strongmen ruled the country until 2003. The last was Saddam Hussein, who was deposed following the Gulf War. In October 2005, Iraqis approved a constitution in a national referendum and, pursuant to this document, elected a 275-member Council of Representatives in December 2005. Decreasing insurgent attacks and an improving security environment in many parts of the country are helping to spur economic activity. Iraq's economy is dominated by the oil sector, which has traditionally provided more than 90% of foreign exchange earnings. Oil exports are around levels seen before the United States and its allies launched Operation Iraqi Freedom.

ECONOMIC POLICY OVER 12 MONTHS

Historically, Iraq's economy was characterized by a heavy dependence on oil exports, and an emphasis on development through central planning. Prior to the outbreak of the war with Iran in September 1980, Iraq's economic prospects were bright. Oil production had reached a level of 3.5 million barrels per day (bpd), and oil revenues were US$21 billion in 1979 and US$27 billion in 1980. At the outbreak of the war, Iraq had amassed an estimated US$35 billion in foreign exchange reserves.

The Iran–Iraq war depleted Iraq's foreign exchange reserves, devastated its economy, and left the country saddled with debt of more than US$40 billion. After hostilities ceased, oil exports gradually increased, with the construction of new pipelines and the restoration of damaged facilities. Iraq's invasion of Kuwait in August 1990, subsequent international sanctions, damage from military action by an international coalition beginning in January 1991, and neglect of infrastructure drastically reduced economic activity. Government policies of diverting income to key supporters of the regime and sustaining a large military and internal security force further impaired finances, leaving the average Iraqi citizen facing desperate hardship.

The occupation of the US-led coalition in March–April 2003 resulted in the shutdown of much of the central economic administrative structure. The rebuilding of oil infrastructure, utilities infrastructure, and other production capacities has proceeded steadily since 2004, despite attacks on key economic facilities and continuing internal security incidents. Despite uncertainty, Iraq is making progress toward establishing the laws and institutions needed to make and implement economic policy.

Iraq's economy is dominated by the oil sector, which has traditionally provided about 95% of foreign exchange earnings. Current estimates show that oil production averages 2.1 million bpd.

In its March 2010 report on the country, the International Monetary Fund (IMF) commended the Iraqi authorities for the progress in rebuilding its economy under extremely difficult security and political conditions. The report said that "substantial progress has been made since 2003, despite the difficult security situation," and that "inflation has been reduced to single digits, the international reserves position has improved markedly, and direct fuel subsidies were eliminated, while the pension system was put on a sustainable footing, which created room for priority spending on investment and the social sectors." The IMF also said that several steps had been taken "to strengthen public financial management, improve transparency in the oil sector, and rebuild capacity at the central bank," and that "the authorities have initiated the restructuring of the two largest state-owned banks."

STATISTICS

GDP growth: 4.2% (IMF, 2009)
GDP per capita: US$3,600 (2009 est.)
CPI: −4.4% (IMF, end 2009)
Key interest rate: 7% (December 31, 2009)
Exchange rate versus US dollar: ID1,170 (2009)*
Unemployment: 15.2% (2008 est.)
FDI: n/a
Current account deficit/surplus: −US$19.9 billion (2009 est.)
Population: 29,671,605 (July 2010 est.)

*Iraqi dinar
Source: CIA World Factbook except where stated

ECONOMIC PERFORMANCE OVER 12 MONTHS

The Iraq economy grew by 4.2% in 2009, according to IMF estimates, down from 9.5% in

the previous year. The decline reflects the drop in oil prices from their peak levels in mid-2008, as well as the fact that oil production and export volumes have not risen as much as planned, due to insufficient investment. However, the IMF believes that Iraq's longer-term economic outlook is strong, as oil prices and production are projected to increase markedly in the coming years.

The decline in oil prices and lower than expected production inevitably had an adverse impact on the country's external accounts. Iraq's external position weakened in 2009, with oil export proceeds falling to US$39 billion, and both the external current account and the overall balance of payments moved into large deficits.

Oil export receipts account for around 85% of government revenues, and thus the lower oil prices also undermined the government's budget. Indeed, the IMF believes that the government recorded a fiscal deficit of more than 20% of GDP in 2009. The country's international reserves also fell, declining by almost US$7 billion in 2009, to about US$44 billion by the year end, reflecting the use of government deposits at the Central Bank of Iraq to finance the budget deficit.

Inconclusive parliamentary elections, held in March 2010, resulted in a stalemate that remained unresolved by August 2010. The lack of a government means that foreign investors eager to win contracts to rehabilitate Iraq's idle factories and infrastructure are delaying decisions. The economy also remains hampered by the lack of a reliable electricity supply. Regular insurgent attacks and steady increases in demand have led to shortages, with much of the country receiving just a few hours a day. The government imposed a 100% hike in tariffs in early June in a bid to reduce demand, but this does not address the issue of the shortage of supply, which is unlikely to be resolved for a number of years.

On a brighter note, Iraq's inflation rate remained subdued in 2010, reaching its lowest point in three decades for the second straight month in May (at 3%), due to lower prices for food, nonalcoholic beverages, communications, and energy. However, announcing the figures in July, the central bank said that it had no plans to cut interest rates. Iraq's central bank last cut its base interest rate by 100 basis points to 6% in April 2010. The central bank also said that it has no intention to change the exchange rate of the Iraqi dinar, which has been at 1,170 to the US dollar for more than a year, in the foreseeable future.

SUPPORT FOR INWARD INVESTMENT AND IMPORTS

Inward investment is handled by the Iraq Economic Development Group (IEDG) via its website. It aims to develop high-quality, commercially feasible projects to encourage investments into Iraq, mainly targeting critical Iraqi infrastructure to fuel economic growth, create jobs, and provide the basis for continued employment growth. Investors should have projects in mind that address these interests. The IEDG advertises projects internationally, and claims that no project advertised has an annual return on investment of less than 30%, though this can be a five-year average on larger projects. It can arrange direct investment, or take a general investment that leverages all ongoing projects. It will also help investors to promote products, and will assist in getting products to market.

TAX EXEMPTIONS

Further information can be obtained from IEDG.

MORE INFO

Websites:

Iraq Economic Development Group (IEDG): www.investmentsiraq.org
Official website of the United States force in Iraq: www.us-iraq.com
US Department of State country profile on Iraq: www.state.gov/r/pa/ei/bgn/6804.htm

Israel and the Palestinian Territories

ECONOMY AND TRADE

Israel has a diversified, export-based economy with a strong high-tech bias. The main exports are software, electronics, biomedical goods, polished diamonds, military equipment, and agricultural products. Relatively isolated from its neighbors, its top trading partners are the Palestinian Territories (the West Bank and Gaza Strip, with which peace has been elusive), the United States, the European Union, and China. The Territories primarily export agricultural produce to Israel. The dotcom bust and the intensified Israeli–Palestinian conflict of the early 2000s prompted a short recession. Steady growth was then promoted through structural reforms and tighter fiscal controls, although public debt remained high. Foreign aid and loans, mostly from the United States, are sizable. The Territories, racked by poverty, have faced economic embargoes and extensive damage to capital due to the conflict.

ECONOMIC POLICY OVER 12 MONTHS

Although Israel was well placed economically when the global financial crisis started to unfold in 2007, the country's vulnerabilities had come into sharp relief by mid-2008. A small, open economy, it had a total external gross debt of about 50% of GDP and public debt of some 80% of GDP in the third quarter of 2008, according to the International Monetary Fund (IMF).

However, the government adopted strong policy measures in response to the impact of the global crisis. Near-term fiscal targets for expenditure and deficit were relaxed in the 2009–2010 budget, even though an increase in some excises and a temporary 1% rise in the value added tax (VAT) rate—programmed to be reversed at the end of 2010—acted as a partial offset. In the event, the authorities reduced the VAT rate by half a percentage point to 16% from the end of December 2009, bringing forward by one year a half of the cut that had been planned for the end of 2010.

Meanwhile, as inflationary prices subsided, the Bank of Israel rapidly reduced policy rates, from 4.25% in February 2008 to 0.5% in April 2009. The central bank adopted unconventional monetary measures, intervening in the foreign exchange market and purchasing long-dated government bonds. It also launched initiatives to support the financial sector, setting up public–private bond funds and offering guarantees for banks' capital raising.

STATISTICS

GDP growth: 0.7% (official, 2009)
GDP per capita: US$28,400 (2009 est.)
CPI: 3.3% (official, 2009)
Key interest rate: 1.75% (August 2010)
Exchange rate versus US dollar: INS3.93 (2009)*
Unemployment: 7.3% (official, 2009)
FDI: US$60.68 billion (December 31, 2009 est.)
Current account deficit/surplus: US$7.2 billion (2009 est.)
Population: 7,353,985 (July 2010 est.)

*Israeli new shekel
Source: CIA World Factbook except where stated

In May 2010, Israel was admitted to the Organisation for Economic Co-operation and Development (OECD), membership of which should bring various economic advantages, including: lower borrowing costs on international markets; potentially attracting increasing flows of foreign direct investment and short-term investment; and encouraging more reforms in the economic and commercial environment.

According to a British Foreign Office report, the West Bank experienced a limited revival of economic activity in 2009, but overall standard of living measures remain worse than prior to the start of the second *intifada* in 2000. The almost decade-long downturn has been largely a result of Israeli closure policies, which have disrupted labor flows, manufacturing, and trade.

The report added that high population density, limited land and sea access, and strict internal and external security controls have kept economic conditions in the Gaza Strip even more degraded than in the West Bank. There are many shortages of goods, due to the severe restrictions imposed by Israel at its border crossings into Gaza. Some goods are smuggled through the tunnel trade under Gaza's border with Egypt.

ECONOMIC PERFORMANCE OVER 12 MONTHS

Israel weathered the global economic downturn relatively well. Its economy expanded by 0.7% in 2009, when many more advanced economies suffered significant contractions. While the economy shrank by 1.5% in the first half of the year, there was 3.3% growth in the second half. Economic growth resumed in the second quarter

of 2009, partly in response to the fiscal and monetary boost given to the economy. Moreover, in April 2010 the IMF said that Israel was one of the economies recovering fastest from the global recession. The organization raised its growth forecast for 2010 to 3.7% from 3.5%, citing a boost in exports.

Furthermore, Israeli economic growth unexpectedly accelerated to an annualized 4.7% in the second quarter of 2010. Officials said in August 2010 that they expected the economy to expand by 3.7% overall in 2010. However, the Bank of Israel said that it anticipated that the fiscal crisis in some European countries would impact upon Israel's economy, due to its potential effect on demand for the country's exports, and the effect on Israel's capital markets, which have close links with financial markets around the world.

The strength of the recovery is underlined by the fact that the central bank has tightened monetary policy far earlier than in other countries. In March 2010, the Bank of Israel raised the benchmark interest rate for the fourth time since August 2009, as inflation expectations increased and the economy expanded. In July, it increased rates by a further quarter point to 1.75%, citing a rapid increase in housing prices. In August 2010, the central bank forecasted that inflation would average around 2.6% over the next 12 months, at the high end of the government's 1% to 3% target range.

The strength of the economy has had a positive effect on the government's finances. In 2009, the fiscal deficit amounted to around 5% of GDP, much better than had been expected, while the public debt level reached around 80% of GDP for 2009, also better than budgeted.

Unemployment peaked at 7.9% in mid-2009, but declined to 7.3% by the end of the year. The IMF expects Israel's unemployment rate to fall from 7.7% in 2009 to 7.4% in 2010, and to 7.1% in 2011. It predicts that the average unemployment rate in developed economies will be 8.4% in 2010 and 8% in 2011. It also predicts that Israel's inflation rate will be 2.3% in 2010 and 2.6% in 2011. Israel's inflation was 4.6% in 2008 and 3.3% in 2009.

The current account balance will widen to 3.9% of GDP in 2010 from 3.7% in 2009, the IMF said. The forecast for 2011 is 3.7%.

The IMF said that Israeli banks—characterized by robust balance sheets—remained relatively resilient during the global financial crisis, although nonbank financial institutions and the domestic corporate bond market were strained. The Bank of Israel report for 2009 said that Israel's "conservative and closely supervised banking system," and the absence of mortgage-backed assets in its capital markets, had cushioned it from the worst of the storm.

SUPPORT FOR INWARD INVESTMENT AND IMPORTS

Invest in Israel, part of Israel's Ministry of Industry, Trade, and Labor, promotes investment to foreign-based individuals and companies interested in direct investment or joint ventures. The Palestinian Investment Promotion Agency similarly offers help to those interested in investing in the West Bank and Gaza Strip.

TAX EXEMPTIONS

Israel has several free trade agreements, including ones with the United States and the EU. The corporate tax rate was reduced to 25% in 2010, with further reductions planned over the next few years. Sizable tax benefits are available for foreign investment, venture capital, and expenditure on research and development. In the Palestinian Territories, companies and businesses are taxed at a rate of 20%. Companies with annual revenues greater than US$12,000 pay 17% VAT. The Bank of Israel's website has information on tax rates for inward investors.

MORE INFO

Websites:

Bank of Israel: www.bankisrael.gov.il/firsteng.htm
Federation of Israeli Chambers of Commerce: www.chamber.org.il/Default.aspx?lan=en-US
Invest in Israel: www.investinisrael.gov.il
Palestinian Investment Promotion Agency: www.pipa.gov.ps

Jordan

ECONOMY AND TRADE

Following World War I and the dissolution of the Ottoman Empire, the United Kingdom received a mandate to govern much of the Middle East. Britain separated a semi-autonomous region of Transjordan from Palestine in the early 1920s, and the area gained its independence in 1946; it adopted the name of Jordan in 1950, and was ruled by King Hussein from 1953 until 1999. King Abdullah II, the son of King Hussein, assumed the throne following his father's death in February 1999. Since then, he has consolidated his power and undertaken an aggressive economic reform program. Jordan acceded to the World Trade Organization in 2000, and began to participate in the European Free Trade Association in 2001. Unlike other countries in the region, the Kingdom of Jordan has no oil of its own and few other natural resources. The economy depends largely on services, tourism, and foreign aid, for which the United States is the main provider. Yet Jordan has one of the best health services in the region.

STATISTICS

GDP growth: 2.8% (official, 2009)
GDP per capita: US$5,300 (2009)
CPI: 1.7% (2009 est.)
Key interest rate: 4.25% (August 2010, central bank)
Exchange rate versus US dollar: JD0.709 (fixed)*
Unemployment: 13.5% (2009 est.)
FDI: US$17.81 billion (December 31, 2009 est.)
Current account deficit/surplus: −US$1.401 billion (2009 est.)
Population: 6,407,085 (July 2010 est.)

*Jordanian dinar
Source: CIA World Factbook except where stated

ECONOMIC POLICY OVER 12 MONTHS

Since graduation from its most recent International Monetary Fund (IMF) program in 2002, Jordan has continued to follow IMF guidelines, practicing careful monetary policy, making substantial headway with privatization, and opening the trade regime. In December 2009, King Abdullah appointed a new premier, Samir Rifai, to push through economic reform, shortly after dissolving the parliament midway through its term. Under King Abdullah, Jordan's reforms have already included taking the initiative for the phased elimination of fuel subsidies, passing legislation targeting corruption, and instituting tax reform.

In 2010, the government introduced austerity measures after the budget deficit doubled to US$2 billion in 2009—equal to 9% of GDP. It announced budget cuts of US$1.4 billion for 2010, with the aim of reducing the deficit to 6.3% of GDP. The administration also cut corporate taxes and introduced long-term tax breaks for foreign direct investment in industrial and free zones, which it expects will spur capital inflows and domestic investment.

Jordan operates an exchange rate peg that has been fixed to the US dollar since 1995. Nevertheless, there is some room for flexibility in operating monetary policy in the short run, where the Central Bank of Jordan has some autonomy in determining the spread between domestic and US interest rates. Following the onset of the global financial crisis in the final quarter of 2008, the central bank loosened monetary policy significantly. By April 2010, the central bank had cut rates by 250 basis points since November 2008 and the rate stood at 4.25%.

King Abdullah dissolved parliament in November 2009—halfway through its four-year term—citing its failure to carry out far-reaching political and economic reforms. Abdullah appointed Samir Rifai as a caretaker prime minister in early 2010. Rifai drafted a new constitution and set the date of November 9, 2010, for new elections. However, the Muslim Brotherhood and army veterans are calling for a boycott of the elections.

The Muslim group is demanding the inclusion of about 1.2 million Palestinians who came to Jordan after the 1967 Six Day War. The army veterans, who number more than 700,000, are totally opposed to the participation of those displaced Palestinians in the next elections, saying that Jordan would be taken over by Palestinians. The political crisis will inevitably have an impact on the economy.

ECONOMIC PERFORMANCE OVER 12 MONTHS

Jordan is a small open economy with a limited industrial base and it relies heavily on foreign aid and workers' remittances for foreign currency resources; it has inevitably been affected by the downturn in global trade. Jordan's macroeconomic performance was generally favorable

in 2008. Real GDP growth averaged 7.8%, while sharply lower world fuel and food prices brought inflation down.

The economy expanded by just 2.8% in 2009, slowing from 7.8% growth in 2008, and its worst performance since an economic crisis in 1989 when the country was forced to seek help from the IMF. Growth accelerated in the second half of the year, with the economy expanding by 2.9% in the fourth quarter of 2009, up from a 2.1% rise in the third quarter. The construction sector is leading the revival, expanding by 12.8% in the final three months of 2009.

High fuel and food prices and softening domestic revenues put pressure on the fiscal position in 2008, with the deficit excluding grants reaching 11.2% of GDP, against 8.9% in 2007. Domestic demand, exports, tourism, and remittances from abroad all came under pressure in 2009, further undermining the government's revenues, and resulting in a deficit of 9% of GDP.

In April 2010, the IMF forecasted that the Kingdom's GDP would grow by 4.15% in 2010 and by 4.5% in 2011, compared to a Ministry of Finance prediction of 4% growth in 2010. The IMF predicted that the consumer price index (inflation) rate for Jordan would reach 5.3% in 2010, before easing to 4.6% in 2011. The Kingdom's current account deficit was envisaged to rise from 8.9% in 2010 to 9.7% in 2011.

Jordan's trade deficit in the first half of 2010 widened to 18% from the same period in 2009 to US$3.9 billion, due to a higher bill for imported Saudi oil, according to official data. The current account deficit has traditionally been covered by strong foreign direct investment and portfolio inflows, including remittances from tens of thousands of Jordanians living abroad, mainly in the Gulf Arab region.

The government's finances also failed to improve as markedly as had been expected in 2010. Jordan's tax revenues rose 1.8% to JD1.428 billion (US$2 billion) in the first half of the year, compared to the same period in 2009. Officials said that total taxes—corporate and sales tax—had been expected to rise at a faster pace, but projections of healthy growth have been slashed due to weak domestic demand and lower profitability by the country's top firms.

SUPPORT FOR INWARD INVESTMENT AND IMPORTS

The Jordan Investment Board (JIB) was established in 1995 as a governmental body enjoying both financial and administrative independence. Its aim is to encourage foreign direct investment into Jordan and to enhance local investment.

TAX EXEMPTIONS

Tax exemptions are at the discretion of the Jordanian Council of Ministers, and depend on the sector invested in and its impact on the Jordanian economy. More information can be obtained from the JIB.

MORE INFO

Website:

Jordan Investment Board (JIB): www.jordaninvestment.com

Kuwait

ECONOMY AND TRADE

Kuwait is an almost entirely flat, desert plain. Britain oversaw foreign relations and defense for the ruling Kuwaiti Al-Sabah dynasty from 1899 until independence in 1961. Kuwait was attacked and overrun by Iraq on August 2, 1990. Following several weeks of aerial bombardment, a United States-led UN coalition began a ground assault on February 23, 1991 that liberated Kuwait in four days. After the liberation, Kuwait had to spend more than US$5 billion to repair oil infrastructure damage which occurred during the Iraqi occupation. The Al-Sabah family has ruled since returning to power in 1991. It re-established an elected legislature that, in recent years, has become increasingly assertive. More than 90% of the population lives within a 500-square-kilometer area surrounding Kuwait City and its harbor. Although the majority of people residing in the State of Kuwait are of Arab origin, fewer than half are originally from the Arabian Peninsula. The discovery of oil in 1938 drew many Arabs from nearby states. Kuwait's 93.3% literacy rate, one of the Arab world's highest, is the result of extensive government support for the education system.

ECONOMIC POLICY OVER 12 MONTHS

Kuwait has a small, relatively open economy, dominated by the oil industry and the government sector. Approximately 90% of the Kuwaiti labor force works in the public sector, and 90% of private sector workers are non-Kuwaitis. Kuwait's proven crude oil reserves of about 100 billion barrels—9% of world reserves—account for nearly 45% of GDP, 95% of export revenues, and 90–95% of government income. The country has the fourth largest oil reserves in the world. Kuwait puts 10% of its annual oil revenue into a Fund for Future Generations, in preparation for transition to the period after its oil resources are depleted. Kuwait's economy has benefited from high oil prices in recent years, as well as the economic activity generated following Operation Iraqi Freedom (Kuwait is a major logistical and transit hub for coalition operations in Iraq). Nonoil sectors such as banking, financial services, logistics, telecommunications, and construction have enjoyed strong growth in the past three to four years.

However, the government is seeking to diversify the economy, and in February 2010 parliament approved a KD30 billion (US$104 billion), four-year development plan that includes KD4.5 billion to be spent in the fiscal year starting April 1, 2010. The government expects companies to meet half the total cost of the plan, which includes investment projects to boost oil and gas production and to build a railway network, cities, and a port.

In March 2010, the government also launched Kuwait Vision 2035, a long-term economic development plan covering the years leading up to 2035, which sees the emirate as a major business and financial hub. The plan proposes reforms to the oil, trade, and finance sectors, to the business environment, and to health and education systems. Former UK prime minister Tony Blair, who advised the government on its Vision 2035 plan, said that Kuwait could be a "regional powerhouse of the future," but that if reforms were not implemented, then "the future of this great country will be uncertain."

In June 2010, the national assembly approved a budget for the 2011 fiscal year, which is designed to boost economic growth. Public spending will rise by around 22% on the previous year (excluding one-off transfers to the Public Institution for Social Security (PIFSS)). The increase in spending is concentrated in capital spending.

ECONOMIC PERFORMANCE OVER 12 MONTHS

Kuwait's economy relies mainly on oil for growth; therefore, weak oil prices (which reached a low of about US$34 a barrel in December 2008) undermined the economy in 2009. Indeed, in April 2010 the central bank said that the economy may have contracted by between 1.5% and 2% in 2009. However, by April 2010, oil prices had rebounded to around US$80 a barrel and

STATISTICS

GDP growth: 1.5 to 2% (central bank, 2009)
GDP per capita: US$54,100 (2009 est.)
CPI: 4% (central bank, 2009)
Key interest rate: 2.5% (August 2010)
Exchange rate versus US dollar: KD0.283 (2009)*
Unemployment: 2.2% (2004 est.)
FDI: US$1.099 billion (December 31, 2009 est.)
Population: 2,789,132 (including 1,291,354 non-nationals, July 2010 est.)

*Kuwaiti dinar
Source: CIA World Factbook except where stated

the central bank forecasted that the economy would expand by around 5% during the course of the year.

The country's economic performance was not as bad as had been feared, however, thanks to the improvement in oil prices that occurred during the course of 2009. Thus, the government had forecasted a budget deficit of KD4.8 billion for the fiscal year beginning April 2009, based on an oil price of US$35 a barrel. However, during the first 11 months of the fiscal year it had achieved a surplus of KD8.3 billion (US$28.7 billion).

The annual rate of inflation slowed to 4% in 2009, its lowest level since 2006, and down from a peak of 10.6% in 2008. By May 2010 it had fallen to 2.9%. Inflation is expected to pick up during the remainder of 2010, but it should stay in low single digits due to sluggish credit growth.

Moody's Investors Service raised Kuwait's sovereign ratings outlook to "stable" in August 2010 after the country's parliament approved long-awaited legislation on the fiscal and trade fronts. The new legislation includes laws dealing with privatization, capital markets, and labor, as well as the four-year development plan. These laws should help to develop the country's limited private sector and attract foreign investment, according to the rating company.

The country has had "impressive fiscal and current account surpluses" despite some effects from the global financial crisis, Moody's said. Kuwait's government budget and trade surplus will remain strong over the medium term based on current oil price projections even as public investment spending rises, the agency added.

SUPPORT FOR INWARD INVESTMENT AND IMPORTS

Investors seeking to do business in Kuwait need to apply for a license from the Ministry of Commerce and Industry, and these are only available to Kuwaiti nationals and to Gulf Cooperation Council (GCC) nationals and companies. Any joint ventures with Kuwaiti citizens have to be structured to give the Kuwaiti partners not less than 51% of the total capital. However, there is a Kuwait Free Trade Zone in Shuwaikh, which allows 100% foreign ownership of businesses within the zone, with no import duties or foreign corporate income tax.

TAX EXEMPTIONS

Tax exemptions are available in the Kuwait Free Trade Zone (see above). Further information can be obtained from the Ministry of Commerce and Industry.

MORE INFO

Website:

Guide to Kuwait, including information on business matters: www.kuwaitiah.net

Ministry of Information guide to Kuwait: www.kuwait-info.com

Lebanon

ECONOMY AND TRADE

Following the capture of Syria from the Ottoman Empire by Anglo–French forces in 1918, France received a mandate over this territory, and separated out the region of Lebanon in 1920. France granted the area independence in 1943. A lengthy civil war (1975–1990) devastated the country, but Lebanon has since made progress toward rebuilding its political institutions. Under the Ta'if Accord—the blueprint for national reconciliation—the Lebanese established a more equitable political system, particularly by giving Muslims a greater voice in the political process, while institutionalizing sectarian divisions in the government. Following the Israeli invasion in 2006, the international community agreed to support an ambitious Lebanese program of reconstruction and macroeconomic stabilization. Army Commander Michel Sulayman was elected as president in May 2008, and a unity government was formed in July 2008, with Fuad Siniora as prime minister. Lebanon has a free market economy and a strongly laissez-faire commercial tradition.

ECONOMIC POLICY OVER 12 MONTHS

According to an International Monetary Fund (IMF) report published in December 2009, progress in implementing structural reforms in 2009 was limited due to the political impasse in the period leading up to the June 2009 parliamentary elections and subsequent protracted negotiations toward the formation of the new national unity government.

The new unity government is committed to implementing economic reforms and improving public infrastructure and services. The IMF believes that continued debt reduction will be key to addressing Lebanon's main vulnerabilities. The government certainly faces many economic challenges. Lebanon's government debt to GDP ratio (at nearly 150%) remains among the highest in the world, its large banking system (with assets of more than three times GDP) is excessively exposed to public debt issued by the Government of Lebanon (56% of assets) and dependent on inflows of nonresident deposits, while the country also lies at the crossroads of regional political tensions.

In April 2010, the government proposed a 14% increase in spending over the coming fiscal year and said that it expects public debt to rise to US$55 billion. Finance Minister Raya al-Hassan said that the draft budget allocated US$4.3 billion for debt servicing, and added that the country's projected deficit in 2010 is set to increase to US$3.7 billion (10.7% of GDP), from US$3.25 billion (8.6% of GDP), in 2009.

Public debt in 2009 stood at US$51 billion. However, Hassan said that the increase to US$55 billion in 2010 would barely change the debt to GDP ratio, which stood at 147.98% of GDP in 2009.

The government has maintained a firm commitment to the Lebanese pound, which has been pegged to the dollar since September 1999. The IMF believes that due to "large government and private sector currency mismatches, the maintenance of the Lebanese pound's peg to the US dollar remains essential for continued financial stability." Lebanon's central bank resumed the sale of certificates of deposit in March 2010 to help absorb excess liquidity in the banking system and keep control of inflation, which it estimates will be 3% or lower this year. The bank also reduced the overnight lending rate to 2.75% from 3.25% to try to curtail investment inflows into the country.

In April 2010, Moody's Investors Service upgraded Lebanon's sovereign rating one notch, from B2 to B1, citing sustained improvement in external liquidity, the banking system's strengthened ability to finance deficit, and the formation of a new government.

ECONOMIC PERFORMANCE OVER 12 MONTHS

Real GDP is estimated to have grown by around 7% in 2009, helped by prudent policies and an improvement in the political and security situation after the May 2008 Doha Agreement (which ended six months of political stalemate

STATISTICS

GDP growth: 7% (IMF, 2009)
GDP per capita: US$13,100 (2009 est.)
CPI: 3.4% (2009)
Key interest rate: 10% (December 31, 2009)
Exchange rate versus US dollar: L£1.507.5 (fixed)
Unemployment: 9.2% (2007 est.)
FDI: n/a
Current account deficit/surplus: n/a
Population: 4,125,247 (July 2010 est.)

Source: CIA World Factbook except where stated

that followed the departure of President Emile Lahoud in November 2007), according to an IMF report published in December 2009. Large capital inflows and high confidence have fueled a boom in real-estate investment and tourism activity in 2010 and 2011.

According to the World Investment Report for 2010, issued by the UN Conference on Trade and Development in July, Lebanon's foreign direct investment rose 11% in 2009, with US$5 billion entering the economy, compared to an overall decline of 24% in the Middle East region, with only Qatar and Lebanon posting an increase in capital inflow.

In August 2010, regional investment bank EFG Hermes forecasted growth for Lebanon at 6.5% in 2010 and 5% in 2011. The bank added that renewed tensions between Israel and Lebanon in early August were increasing risks to the country's economic outlook, which were already exacerbated by rising domestic political tensions in July in relation to the UN tribunal probing the assassination of former premier Rafik Hariri.

EFG's optimism has been mirrored by the IMF, which in August 2010 raised its growth forecast for the country to 8% from 6%, ranking the country second regionally after Qatar and fourth globally.

EFG Hermes projected the inflation rate to average 3.5% in 2010 and 4% in 2011, and forecasted the annual growth of money supply at 9.7% in 2010 compared to 19.5% in 2009. Furthermore, it projected the fiscal deficit to widen from 8.9% of GDP in 2009 to 10.2% in 2010 and 9.8% in 2011. The bank also forecasted the external debt to decline from 64% of GDP at end 2009 to 58% of GDP by end 2010 and to 53.2% of GDP by end 2011, and for the domestic debt to reduce from 89% of GDP in 2009 to 87% at the end of 2010 and to 85.4% by end 2011.

Despite receiving substantial aid, the government made little progress in reforming its economy, and by 2006, even before the war between Hezbollah and Israel, the debt problem had grown worse. After the war, US$940 million in relief and early reconstruction aid was pledged to Lebanon on August 31, and was followed by the additional US$7.6 billion in assistance for reconstruction and economic stabilization, already mentioned, from the Paris Club.

The IMF signed an Emergency Post-Conflict Assistance (EPCA) program with Lebanon to support the government's economic reform program in 2007, and a second EPCA for 2008–2009 to monitor the progress of reforms and to advise donors on the timing of aid delivery.

SUPPORT FOR INWARD INVESTMENT AND IMPORTS

The Investment Development Authority of Lebanon (IDAL) was established in 1994 to spearhead Lebanon's investment promotion efforts, and in 2001 Lebanon passed the Investment Development Law 360, which seeks to stimulate Lebanon's economic and social development by regulating investment promotion for both foreign and domestic entities.

TAX EXEMPTIONS

There is a wide range of development investment incentives, including exemptions from income tax and tax on the distribution of dividends. Further information can be obtained from IDAL.

MORE INFO

Websites:

Central Bank of Lebanon: www.bdl.gov.lb

Global Investment House of Kuwait: www.scribd.com/doc/8656152/Lebanon-Economic-Outlook-Nov-2008-by-GIH

Investment Development Authority of Lebanon (IDAL): www.idal.com.lb

Official site of the Presidency of Lebanon: www.presidency.gov.lb/english

Libya

ECONOMY AND TRADE

The Italians took over control of the area of Libya around Tripoli from the Ottoman Turks in 1911. After World War II, Libya passed to UN administration, and achieved independence in 1951. Following a military coup in 1969, Colonel Muammar Abu Minyar al-Qaddafi began to espouse his own political system, the Third Universal Theory. The system is a combination of socialism and Islam, derived in part from tribal practices, and is supposed to be implemented by the Libyan people themselves in a unique form of direct democracy. Qaddafi has always seen himself as a revolutionary and visionary leader. His dream of changing the world through subversion and support for terrorism had Libya declared a rogue state until Qaddafi began to rebuild his relationship with Europe during the 1990s.

In December 2003, Libya announced that it had agreed to reveal and end its programs to develop weapons of mass destruction and to renounce terrorism. Since then, Qaddafi has made significant strides in normalizing relations with Western nations. He made his first trip to Western Europe in 15 years when he traveled to Brussels in April 2004. The United States rescinded Libya's designation as a state sponsor of terrorism in June 2006, which paved the way for Libya's economy to start to prosper. After the United Kingdom and Libya signed a prisoner-exchange agreement in 2009, Libya requested the transfer of the convicted Lockerbie bomber Abdelbaset Ali al-Megrahi; he was freed from jail on compassionate grounds and returned home in August 2009.

ECONOMIC POLICY OVER 12 MONTHS

The Libyan economy depends primarily upon revenues from the oil sector, which contribute about 95% of export earnings, about 25% of GDP, and 60% of public-sector wages. Libya has taken advantage of its improved ties with the West to attract foreign investment, and a primary aim of government policy is to reduce dependence on oil and reduce the government's role in the economy.

Libya faces a long road ahead in liberalizing the socialist-oriented economy, but initial steps—including applying for World Trade Organization (WTO) membership, reducing some subsidies, and announcing plans for privatization—are laying the groundwork for the transition to a more market-based economy.

STATISTICS

GDP growth: 4% (official, 2009)
GDP per capita: US$15,200 (2009 est.)
CPI: 2% (2009 est.)
Key interest rate: 5% (December 31, 2008)
Exchange rate versus US dollar: LD1.2641 (2009)*
Unemployment: 30% (2004 est.)
FDI: US$13.65 billion (December 31, 2009 est.)
Current account deficit/surplus: US$6.502 billion (2009 est.)
Population: 6,461,454 (including 166,510 non-nationals, July 2010 est.)

*Libyan dinar
Source: CIA World Factbook except where stated

As part of this process, the central bank said in February 2010 that it planned to grant two licenses for foreign institutions to set up units in Libya as part of promoting the role of the private sector in the country. The foreign banks will control 49% of their Libyan subsidiaries and have full management control, while the remaining 51% holding will be owned by domestic investors. The central bank said that banks interested in applying for the two licenses must have an established international presence and a credit rating of at least Baa2 by Moody's Investors Service, or BBB by Standard & Poor's or Fitch Ratings. HSBC Holdings Plc and Standard Chartered are among the international banks that have applied to set up in the country.

In August 2009, the central bank announced that Italy's UniCredit SpA had won preliminary approval to open a subsidiary. It had also shortlisted two banks from the United Arab Emirates and one from Qatar (Mashreq, Emirates NBD, and Qatar Islamic Bank) as well as HSBC and Standard Chartered for the other license.

The 2009 budget envisaged a small nominal decline in public expenditure, putting an end to three years of large fiscal expansion. The small decline in overall expenditure reflects a 20% reduction in capital spending and a 25% increase in current outlays, which includes a 16% projected increase in the wage bill. The latter is due in large part to the return to the civil service payroll of a portion of the public employees that were previously transferred to a central labor office for retrenchment to the private sector. The overall fiscal position is expected to register a surplus of

about 10% of GDP in 2009, despite the projected decline in oil revenue by almost 40%.

The nonoil manufacturing and construction sectors, which account for more than 20% of GDP, have expanded from processing mostly agricultural products to include the production of petrochemicals, iron, steel, and aluminum. Climatic conditions and poor soils severely limit agricultural output, and Libya imports about 75% of its food.

ECONOMIC PERFORMANCE OVER 12 MONTHS

Libya's overall macroeconomic performance in 2008 was strong, with real GDP growing by about 3.8%. However, lower oil prices caused growth to slow to 4% in 2009, according to Minister of Economy, Industry, and Commerce Mohamed Hweji (speaking in April 2009). The minister added that the government expects growth to accelerate to 6% in 2010.

The government dominates Libya's socialist-oriented economy through complete control of the country's oil resources. Oil revenues constitute the principal source of foreign exchange. Much of the country's income has been lost to waste, corruption, conventional armaments purchases, and attempts to develop weapons of mass destruction, as well as to large donations made to developing countries in attempts to increase Qaddafi's influence in Africa and elsewhere. Although oil revenues and a small population give Libya one of the highest per capita GDPs in Africa, the government's mismanagement of the economy has led to high inflation and increased import prices. These factors resulted in a decline in the standard of living from the late 1990s up to 2003.

Muammar Qaddafi's most recent economic plan for Libya is the Wealth Distribution Plan, in terms of which the government aims to eliminate the majority of Libya's key ministries in favor of the direct distribution of oil wealth to the people. Instead of channeling oil revenues to the people through layers of bureaucracy, the idea is to streamline and transform the whole state apparatus. So far, despite efforts to diversify the economy and encourage private sector participation, there remain extensive controls on prices, credit, trade, and foreign exchange, all of which act to constrain growth and discourage private investment. Import restrictions and inefficient resource allocations by government departments and agencies have caused periodic shortages of basic goods and foodstuffs.

Although agriculture is the second-largest sector in the economy, Libya imports most foods. Climatic conditions and poor soils severely limit output, while higher incomes and a growing population have caused food consumption to rise. Domestic food production meets about 25% of demand. The Libyan government has announced ambitious plans to increase foreign investment in the oil and gas sectors, with the aim of significantly boosting production capacity from 1.2 million barrels per day (bpd) to 3 million bpd by 2012. The government is also pursuing a number of large-scale infrastructure development projects such as highways, railways, air and seaports, telecommunications, water works, public housing, healthcare, and hotels.

SUPPORT FOR INWARD INVESTMENT AND IMPORTS

Investing in Libya is handled by the Libyan investment promotion agency, the Libyan Foreign Investment Board (LFIB, telephone: +218 (21) 360-8183-360-9613).

Investment opportunities in Libya at present are limited to the oil and gas field, and associated areas. Telecommunications and the financial sector remain government monopolies, although in March 2009 news services were reporting that Libya could be opening its banks to foreign operators (source: www.animaweb.org).

TAX EXEMPTIONS

Information is available from the LFIB.

MORE INFO

Websites:

Central Bank of Libya: www.cbl.gov.ly
Great Man-Made River Authority (GMRA): www.gmmra.org
Libyan Foreign Investment Board (LFIB): www.investinlibya.com
Libyan stock market: www.lsm.gov.ly

Malaysia

ECONOMY AND TRADE

Malaysia is part of southeastern Asia, and comprises the Malay Peninsula bordering Thailand, plus the northern third of the island of Borneo bordering Indonesia, Brunei, and the South China Sea. In 1826, the British settlements of Malacca, Penang, and Singapore were combined to form the Colony of the Straits Settlements. From these strongholds, in the 19th and early 20th centuries the British established protectorates over the Malay sultanates on the peninsula. During their rule, the British developed large-scale rubber and tin production, and established a system of public administration. British control was interrupted by World War II and the Japanese occupation from 1941 to 1945. After the war, the territories of peninsular Malaysia joined together to form the Federation of Malaya in 1948, and eventually negotiated independence from the British in 1957. In 1963, the British colonies of Singapore, Sarawak, and Sabah joined the Federation, which was renamed Malaysia. Singapore's membership, however, ended when it left in 1965 and became an independent republic. Since independence, the economy has diversified away from reliance on the export of raw materials such as rubber and tin, with the development of a thriving manufacturing base and a strong tourism industry.

ECONOMIC POLICY OVER 12 MONTHS

Due to prudent economic management, Malaysia was well placed when the global financial crisis exploded in late 2008. The country had ample foreign exchange reserves; the balance sheets of banks, corporations, and households were generally in good shape; trade had become more diversified; and internal demand had gained importance as a driver of growth.

In March 2010, the Malaysian Prime Minister, Najib Razak, unveiled long-promised economic reforms, with plans to reduce race-based programs, in what he described as a bold transformation. Prime Minister Razak said that his New Economic Model would reform a race-based economic system that has favored the majority Malay population for four decades, but which critics say has hurt investment and fostered graft. However, he gave few details on the measures, designed to transform Malaysia into a developed nation by 2020. In 1969, Malays staged anti-Chinese riots in the context of increasing frustration over the economic success of the ethnic Chinese. These riots led to the implementation of economic policies that favored the Malay majority in the country.

STATISTICS

GDP growth: −1.7% (official)
GDP per capita: US$14,800 (2009 est.)
CPI: 0.4% (2009 est.)
Key interest rate: n/a
Exchange rate versus US dollar: RM3.55 (2009)*
Unemployment: 5% (2009 est.)
FDI: US$86.43 billion (December 31, 2009 est.)
Current account deficit/surplus: US$27.76 billion (2009 est.)
Population: 26,160,256 (July 2010 est.)

*Malaysian ringgit
Source: CIA World Factbook except where stated

The World Bank, in an April 2010 report, warned that Malaysia faces a rising debt burden and risks damage to its economic growth potential unless it implements tough reforms and tackles its subsidy regimes. It said that the country's economic growth rate could fall back to as little as 4.2% annually if reforms were not implemented. Prime Minister Razak has pledged to restructure subsidies, introduce new taxes, and tackle the country's race-based system of economic preferences, but the government has failed to implement some key tax and subsidy reforms.

Although Malaysia's ability to finance its public sector deficit is not in doubt due to the country's strong domestic bond market, the bank warned that government debt would continue to rise. Subsidies cost Malaysia RM24.5 billion (US$10.56 billion) in 2009 out of total operating spending of RM160.2 billion.

The Malaysian financial system exhibited noteworthy resilience to the 2008 global financial crisis: Malaysian banks are well capitalized and have no measurable exposure to the US subprime market. The central bank maintains high levels of foreign exchange reserves and a conservative regulatory environment, having prohibited some of the riskier assets in vogue elsewhere. Malaysia unpegged the ringgit from the US dollar in 2005.

ECONOMIC PERFORMANCE OVER 12 MONTHS

Since it became independent, Malaysia's economic record has been one of Asia's best. GDP

grew by an average of 6.5% per year from 1957 to 2005. Performance peaked from the early 1980s through to the mid-1990s, as the economy experienced sustained rapid growth averaging almost 8% annually. High levels of foreign and domestic investment played a significant role as the economy diversified and modernized. Once heavily dependent on primary products such as rubber and tin, Malaysia today is a middle-income country with a multisector economy based on services and manufacturing. Malaysia is one of the world's largest exporters of semiconductor devices, electrical goods, and information and communication technology (ICT) products.

The Malaysian economy contracted by 1.7% in 2009 due to the impact of the global downturn. However, growth strengthened markedly in the second half of the year, with GDP expanding by 4.5% in the fourth quarter of 2009. The rebound in the economy was aided by a marked revival in exports. In April 2010, the World Bank said that the manufacturing sector had been the locomotive of growth, while the services sector had been a beacon of strength throughout the global economic crisis for Malaysia. The World Bank also upgraded its 2010 growth forecast for the Malaysian economy to 5.7%. The upgrade reflected growing investor confidence and improving business sentiment toward the Malaysian economy.

However, local firm AmResearch forecasted in April 2010 that the Malaysian economy would expand by 8.0% in 2010, buoyed by strengthening domestic and external conditions. The prime minister expects the economy to grow by not less than 6% during the year. During the first quarter of 2010, AmResearch estimated that the economy expanded by 9.8%, the highest in the last 10 years, with private sector spending by households as well as exports leading the way.

Political uncertainty in Malaysia since the 2008 elections hit net portfolio and direct investment outflows to the tune of US$61 billion in 2008 and 2009, according to official data. The United Malays National Organization, the main party in the coalition that has governed Malaysia since 1957, suffered its worst election result for 50 years in 2008, only narrowly keeping its grip on power.

SUPPORT FOR INWARD INVESTMENT AND IMPORTS

The Malaysian Industrial Development Authority (MIDA) is the first point of contact for investors who wish to set up projects in the manufacturing and services sector of Malaysia. Headquartered in Kuala Lumpur, MIDA has a global network of 19 overseas offices covering Asia, Europe, the United States, and Australia to assist investors.

TAX EXEMPTIONS

Malaysia reduced corporation tax for the 2009 assessment year to 25%, and brought down the rate of individual taxation from 28% to 27%. The Promotion of Investments Act 1986 offers a range of tax incentives. More information can be obtained from MIDA.

MORE INFO

Websites:

Malaysian Industrial Development Authority (MIDA): www.mida.gov.my
Ministry of International Trade and Industry: www.miti.gov.my
Office of the Prime Minister of Malaysia: www.pmo.gov.my

Morocco

ECONOMY AND TRADE

Morocco has achieved considerable economic progress over the past 30 years. Since the 1970s, gross national income per person has more than quadrupled, from US$550 to US$2,300, while average life expectancy has increased from 55 in 1970 to 72.4 in 2007, according to the World Bank. The institution also says that Morocco is one of the leading economic reformers in the Middle East and North Africa (MENA) region, and that this reflects "a clear ambition to project Morocco to new heights in terms of competitiveness and growth."

Morocco has the world's biggest phosphate reserves, a large tourist industry, and a growing manufacturing sector. However, agriculture accounts for about 20% of GDP and employs roughly 40% of the labor force. Agriculture is highly dependent on rainfall, which can vary considerably from year to year. Morocco's trade is oriented toward the European Union, which buys around two-thirds of Moroccan exports. Major imports include oil, wheat, consumer goods, and capital goods.

ECONOMIC POLICY OVER 12 MONTHS

The government's economic strategy is to shift the economy away from its dependence upon agriculture, and to create jobs and find new engines of growth. It has thus followed a policy of reform, liberalization, and modernization aimed at stimulating growth and creating jobs. Morocco needs to accelerate growth to reduce high levels of unemployment and underemployment. Although overall unemployment stands at around 10%, this figure masks significantly higher urban unemployment, as high as 33% among urban youth.

Morocco's government has increased spending on basic infrastructure to MD400 billion for 2008–2012, from MD80 billion in the previous period. The investment aims to upgrade basic infrastructure, including the highway network, power grids, ports and airports, the farming sector, and telecoms.

In 2009, the government loosened fiscal policy in response to the global downturn, while proceeding with reforms that included tax rate reductions and increases in wages for the lower end of the civil servant salary scale. Revenue fell sharply—reflecting the economic downturn, tax policy changes, and the absence of certain one-off factors present in 2008—but this was in part offset by a fall in subsidies due to lower world commodity prices.

STATISTICS

GDP growth: 5.1% (official, 2009)
GDP per capita: US$4,600 (2009 est.)
CPI: 0.5% (official, 2009)
Key interest rate: 3.25% (central bank discount rate, April 2010)
Exchange rate versus US dollar: MD8.064 (2009)*
Unemployment: 9.9% (2009 est.)
FDI: US$42.68 billion (December 31, 2009 est.)
Current account deficit/surplus: −US$3.795 billion (2009 est.)
Population: 31,627,428 (July 2010 est.)

*Moroccan dirham
Source: CIA World Factbook except where stated

In 2009, monetary policy remained geared toward maintaining low and stable inflation, in the context of the pegged exchange rate. The central bank lowered its benchmark interest rate by a quarter of a percentage point to 3.25%, reflecting easing inflationary pressures. The central bank sought to boost liquidity by gradually reducing reserve requirements from 15% to 8% in 2009. In April 2010, it lowered reserve requirements further to 6%, while maintaining interest rates at 3.25%.

Morocco's financial system is sound and well managed, and has avoided the problems seen in many advanced economies. Banks are generally well provisioned and have little foreign exposure on either the asset or liability side, minimizing the transmission of risks from global financial markets to the real economy, the International Monetary Fund reported in 2010.

ECONOMIC PERFORMANCE OVER 12 MONTHS

The economy rebounded in 2008, growing by 5.6%; this compared to growth of 2.7% in the previous year, in which a drought afflicted the key agricultural sector. The level of rainfall doubled in 2008, boosting crop production and farm incomes over 2007. Indeed, overall private consumption grew by 7.8% in 2008, up from 3.8% in 2007. Nonagricultural sectors such as telecommunications, financial services, and construction also experienced vigorous growth.

The economy expanded by 7.8% in the final quarter of 2009, as a record grain harvest boosted domestic consumer demand and export

industries began to recover from the global downturn. This growth in GDP compares to 3.1% in the same quarter a year earlier, the state High Planning Commission said in a statement. Overall, the economy expanded by 5.1% in 2009, down from 5.6% in 2008.

Nonfarm GDP growth was 4.9%, up from 1.4% in the last three months of 2008, as manufacturing industries resumed growing and construction sector growth accelerated. Moroccan industry relies heavily on trade with the eurozone, where recession in 2009 led consumers to tighten their belts and factories to cut output. The central bank expects the economy to grow by 3–4% in 2011, despite a fall in farm income after the record cereals harvest seen in 2009.

Inflation fell to 0.5% in 2009, down from 3.9% in 2008, when it reached its highest level in a decade due to high food and energy prices. Food prices account for more than 40% of the inflation gauge.

In March 2010, the credit ratings agency Standard & Poor's raised Morocco's long and short-term foreign currency sovereign credit ratings to BBB– and A-3 respectively, citing increased economic flexibility. Standard & Poor's also raised Morocco's long-term local currency credit rating to BBB+ from BBB on March 23, and its short-term local currency credit rating to A-2 from A-3. The upgrade reflects the organization's view of the Moroccan government's improved economic policy flexibility as a result of its track record in reducing the country's fiscal and external debt burdens over the past decade.

Morocco's combined foreign and domestic debt stock has been slashed as a proportion of GDP, to 48% in 2009 from 68% in 1998.

SUPPORT FOR INWARD INVESTMENT AND IMPORTS

The government's Investment Office can help potential investors. It provides economic, financial, and statutory information for realizing investment projects, of whatever size, in Morocco. It can also advise on the advantages of foreign investment legislation. These services, available in English, are provided free of charge. Contact details are as follows: The Investment Office, Direction des Investissements Exterieurs, Angle Avenue Michelifen et Rue Hounain, 4th Floor, Agdal, Rabat, Morocco (tel: +212 37 673375 or +212 7 673420/1; fax: +212 37 673417/42).

The government has also established regional investment centers in 16 cities, including Casablanca, Rabat, Marrakech, Fes, Meknes, Agadir, Settat, Tangier, Oujda, Kenitra, and Safi.

For information on the government's import policy, please see the website of the Moroccan customs service: www.douane.gov.ma.

TAX EXEMPTIONS

The government has sought to reduce the plethora of tax exemptions and incentives in favor of a low corporate tax rate. Information about the numerous incentives that still exist can be obtained from the Investment Office.

MORE INFO

Websites:

Ministry of Finance: www.finances.gov.ma

US State Department report on Morocco, covering political background as well as economic and trade issues: www.state.gov/r/pa/ei/bgn/5431.htm

Pakistan

ECONOMY AND TRADE

The World Bank classifies Pakistan as a low-income country, with around 33% of the population of 162 million living below the poverty line. It says that around 50% of adults are illiterate. High population growth (of around 1.81% per year), poor governance, weak security within the country, and a turbulent political environment have contributed to the country's poor economic performance.

Agriculture accounts for more than 21% of GDP and provides employment for over 40% of the labor force. Most of the population, directly or indirectly, is dependent on this sector. The most important crops are cotton, wheat, rice, sugarcane, fruit, and vegetables, which together account for more than 75% of the value of total crop output. Despite intensive farming practices, Pakistan remains a net food importer. It is also heavily dependent on oil imports, which account for around half its energy needs. Textiles account for around 70% of manufacturing output.

ECONOMIC POLICY OVER 12 MONTHS

Until the economic crisis broke out in 2008, Pakistan had enjoyed a relatively robust economic performance. However, economic policymakers in Pakistan spent much of 2008 and 2009 grappling with the latest crisis to hit the country. Surging oil prices in the first eight months of 2008 caused the current account deficit to increase alarmingly, triggering a plunge in the value of the rupee, as well as concerns that the country could default on its foreign debt.

In October 2008, Pakistan was forced to seek an emergency bailout from the International Monetary Fund (IMF) after key allies—China, the United States, and Saudi Arabia—refused to provide funds to the country. The government had been reluctant to tap the IMF. Past IMF programs, requiring Pakistan to agree to austerity measures, were deeply unpopular. Islamabad had hoped that, as a frontline state in the War on Terror, allies would come to its aid.

Under the IMF agreement, Pakistan was given immediate access to US$3.1 billion of the loan under a 23-month facility, with the rest phased in, subject to quarterly review. In February 2009, Pakistan asked the IMF to increase its loan from US$7.6 billion to US$12.1 billion.

In August 2009, the IMF extended the program to 25 months and raised its support to US$11.3 billion to help address increased risks and financing needs. The program aims to:

STATISTICS

GDP growth: 2.7% (2009 est.)
GDP per capita: US$2,600 (2009 est.)
CPI: 14.2% (2009 est.)
Key interest rate: 12.5% (central bank, April 2010)
Exchange rate versus US dollar: Rs81.41 (2009)*
Unemployment: 15.2% (2009 est.)
FDI: US$27.95 billion (December 31, 2009 est.)
Current account deficit/surplus: −US$2.42 billion (2009 est.)
Population: 177,276,594 (July 2010 est.)

*Pakistani rupee
Source: CIA World Factbook except where stated

- restore financial stability through a tightening of fiscal and monetary policies to bring down inflation and strengthen foreign currency reserves;
- protect the poor by strengthening the social safety net—this is a key element of the government's policy strategy;
- raise budgetary revenues through comprehensive tax reforms, to enable significant increases in public investment and the social spending required to achieve sustainable growth.

The IMF said in an April 2010 report that the program had got off to a good start and Pakistan's economy has made progress toward stabilization. Macroeconomic imbalances have shrunk and inflation fell below 10% in mid-2009. More recently, however, inflation has been on the rise and reached 13% in March 2010. The exchange rate has become somewhat more flexible, and the current account deficit has narrowed considerably, helped by the decline in oil prices and a robust increase in workers' remittances.

However, in April 2010, the IMF delayed disbursement of the fifth installment of its US$11.3 billion standby loan to Pakistan, after disagreements with Islamabad over Pakistan's burgeoning budget deficit and the introduction of new revenue-raising measures.

ECONOMIC PERFORMANCE OVER 12 MONTHS

Pakistan's economic statistics generally cover the country's fiscal year, which ends in June. The figures here refer to fiscal years unless otherwise stated.

Pakistan's already troubled economy came under severe pressure during the calendar year 2008, due to the sharp hike in oil prices and the impact of the global financial crisis. Economic growth fell from 6.8% in fiscal 2007 (year ending June 2007) to 5.8% in fiscal 2008. The economy grew by just 2% in fiscal 2008, reflecting the impact of the global slowdown. However, the agriculture sector grew by 4.7%, due to better weather conditions and a good wheat support price.

The IMF said in its April 2010 report that modest signs of recovery in manufacturing (mainly in the textile sector) and exports suggested that the Pakistani economy was regaining momentum, and that economic growth in fiscal 2010 would reach or even exceed 3%, and could rise to 4% in fiscal 2011. However, the IMF warned that adverse security developments continue to hurt domestic and foreign investors' confidence, and electricity shortages continue to prevent the economy from achieving its potential.

According to Pakistan's central bank, the country's GDP will grow between 2.5% and 3.5% during fiscal year 2010. When Pakistan's rapid population growth is taken into account this amounts to virtually no growth, and this in a country marked by extreme poverty and social inequality.

The government's finances deteriorated along with the economy in 2008. The budget deficit rose to 7.4% of GDP in fiscal 2008, from 4.3% in fiscal 2007. However, in 2009 the budget deficit narrowed to 4.3%. Pakistan's budget deficit may reach 5.5% of GDP in the 2009/10 fiscal year, overshooting a 5.1% target agreed with the IMF, officials said in April 2010. High security-related spending and a shortfall in aid promised by allies were the main reasons for the growing deficit, the official said. The government's original budget deficit target for fiscal year 2009/10 was 4.9% of GDP. Analysts and officials have also identified low revenue collection as another reason for the widening deficit.

Inflation remained high in early 2010, and well in excess of government forecasts. According to the Federal Bureau of Statistics, the consumer price index was 13.02% higher in February 2010 than a year earlier, mainly due to hikes in electricity, energy, and food prices. A key condition of the IMF loan is that the Pakistan People's Party-led coalition government must reduce, and ultimately eliminate, gasoline and electricity price subsidies.

SUPPORT FOR INWARD INVESTMENT AND IMPORTS

The government encourages foreign investment. The Board of Investment assists firms that wish to invest in Pakistan. It offers a number of services, including the provision of information on potential investment opportunities within the country. It can also facilitate introductions to joint-venture partners.

The tariff is Pakistan's main trade policy instrument. The authorities have reduced tariffs significantly during the current decade, particularly with regional trade partners.

TAX EXEMPTIONS

Pakistan has come under pressure from the IMF to repeal tax exemptions in recent years, and few now exist. (For more information on the country's tax policy, see the website of the Pakistan Federal Board of Revenue.).

MORE INFO

Websites:

Board of Investment: www.pakboi.gov.pk
Federal Board of Revenue: www.cbr.gov.pk
IMF program note on Pakistan, April 2010: www.imf.org/external/np/country/notes/pakistan.htm
The Ministry of Commerce website has information on trade policy: www.commerce.gov.pk/Tradepolicy.asp
US State Department profile of Pakistan: www.state.gov/r/pa/ei/bgn/3453.htm

Qatar

ECONOMY AND TRADE

Qatar, once one of the poorest Gulf states, is now one of the world's fastest growing economies, and the wealthiest country in the world measured by GDP per capita, due to the exploitation of large oil and gas fields since the 1940s. The country was a British protectorate until 1971, when it declared independence, after following suit with Bahrain and refusing to join the United Arab Emirates. Oil, gas, and upstream and downstream industries are the mainstay of the Qatari economy. Qatar is the world's largest exporter of liquefied natural gas (LNG). The government is seeking to exploit revenues from oil and gas to diversify the economy. It is also seeking to encourage the development of the private sector and a knowledge economy. Qatar is home to the Qatar Financial Centre (QFC), a financial and business center established by the government in 2005 to attract international financial services and multinational corporations, and develop the market for financial services in the region.

STATISTICS

GDP growth: 9% (IMF, 2009)
GDP per capita: US$121,700 (2009 est.)
CPI: −3.9% (2009 est.)
Key interest rate: 5.5% (December 31, 2009)
Exchange rate versus US dollar: QR3.64 (fixed)*
Unemployment: 0.5% (2009 est.)
FDI: US$20.75 billion (December 31, 2009 est.)
Current account deficit/surplus: US$3.786 billion (2009 est.)
Population: 840,926 (July 2010 est.)

*Qatari riyal
Source: CIA World Factbook except where stated

ECONOMIC POLICY OVER 12 MONTHS

In its annual assessment of Qatar, published in February 2010, the International Monetary Fund (IMF) praised the authorities for "successfully steering the economy through the global financial crisis and enhancing the growth prospects and financial stability of the Qatari economy." The organization noted that supportive macroeconomic policies have helped to maintain investment, which contributed to strong growth, and to sizeable fiscal and external surpluses. The central bank's "macro-prudential policies, as well as timely and decisive intervention helped moderate the impact of the global crisis on the domestic banking system."

However, the IMF warned that the key challenge facing the authorities is to dampen the potential risk of overheating stemming from their growth strategy and gradual recovery of international commodity prices. The IMF encouraged the authorities to prioritize infrastructure projects carefully in order to mitigate the emergence of supply bottlenecks and cost-push inflation. The IMF also underlined the need for sustained efforts to increase absorptive capacity and diversify the economy away from hydrocarbon production and exports.

The central bank is focusing on reducing inflation, and has said that it intends to calibrate its interest-rate and liquidity instruments carefully to ensure that this goal is achieved, while at the same time the growth of assets, credit, and deposits in the banking system is not undermined. The Qatari riyal is pegged to the US dollar (90% of the country's imports are invoiced in dollars), but the central bank did not cut interest rates in line with the US Federal Reserve in 2008 and 2009 because of the need to balance the goal of reducing inflation with the need to maintain liquidity.

However, in August 2010, the central bank cut its overnight deposit rate by half a percentage point to 1.5%, its first such move in two years, after the United States repeated its pledge to keep rates low for an extended period. The lending rate, which is the key measure used by the central bank to convey signals to the market, was held at 5.5%.

In June 2008, the government launched its National Vision 2030, "which aims, through sustainable development, to transform Qatar into one of the world's most advanced countries within two decades." The vision has four pillars: social, economic, environmental, and human development. In March 2009, the Qatar Science and Technology Park (QSTP) opened. The Park is an integral part of Qatar's National Vision 2030, and involved an investment of more than US$800 million.

ECONOMIC PERFORMANCE OVER 12 MONTHS

Qatar continued to deliver an impressive economic performance in 2009, despite the global slowdown. The IMF has estimated overall real GDP growth at 9%, following 16% growth in 2008 underpinned by expansions in the production of liquefied natural gas (LNG) and condensates,

and a strong performance in the nonhydrocarbon sector. On the back of ballooning revenues from LNG exports, Qatar's economy is expected to grow 16% this year, making it by far the best performing country in the region.

However, the IMF pointed out that a sharp fall in domestic rents had led to deflation in 2009, with prices falling by 5.5% in 2009. The IMF said that the price declines reflected large decreases in domestic rents and falling international prices for food and raw materials, and that the sharp deflation was the result of both positive supply shocks (increase in housing supply; reduction in import prices) and slowing demand, although domestic activity was supporting prices of nontradable goods.

The IMF believes that the growth outlook remains strong. It said that Qatar remains committed to diversifying the economy by building related industries around the full LNG value chain, and linking upstream, midstream, and downstream components (including by acquiring ships and building ports). The IMF added that nonhydrocarbon real GDP is expected to record double-digit growth over the medium term, buoyed by continued strong activity in services and a pick-up in manufacturing and construction. Hydrocarbon output is expected to grow by 25% in 2010 and by 13% in 2011–2012, as LNG production peaks at 78 million tonnes by 2012.

The IMF said that the main risks to this optimistic economic outlook include a disruption in Qatar Petroleum's supply of LNG due to unexpected delays in the construction of gas trains, a large negative demand shock from a prolonged global recession, persistent low hydrocarbon prices, and a further large decline in real estate prices. A persistent downturn in the domestic economy could adversely affect the outlook for credit risk. It added that additional unexpected adverse financial developments in the region, particularly in Dubai, could impact negatively on global investor sentiment toward Gulf Cooperation Council (GCC) countries.

The Qatari government has predicted that inflation will accelerate to 1% in 2010 from deflation of 5.5% in 2009.

SUPPORT FOR INWARD INVESTMENT AND IMPORTS

The Ministry of Economy and Commerce says that it is seeking to make the country an ideal oasis for investors and investment activities. The Qatar Investment Promotion Department, part of the Ministry of Economy and Commerce, provides information and support to foreign investors.

TAX EXEMPTIONS

Qatar provides a wide range of incentives to investors. These include: no custom duties on the import of machinery, equipment, and spare parts; exemption from income tax for companies for 10 years; and no export duties or taxes on corporate profits for predetermined periods.

MORE INFO

Websites:

BBC profile of Qatar: news.bbc.co.uk/1/hi/world/middle_east/country_profiles/791921.stm
IMF Annual report on Qatar, February 2010: www.imf.org/external/pubs/ft/scr/2010/cr1041.pdf
Qatar Investment Promotion Department: www.investinqatar.com.qa
Qatar Financial Centre Authority: www.qfc.com.qa
Qatar Financial Centre Regulatory Authority: www.qfcra.com

Saudi Arabia

ECONOMY AND TRADE

Saudi Arabia was established in 1932 by King Abdul Aziz. Since his death in 1953, he has been succeeded by various sons. Covering much of the Arabian Peninsula, Saudi Arabia has transformed itself from an underdeveloped desert kingdom into the world's dominant oil producer, and owner of the world's largest hydrocarbon reserves. Proven reserves are estimated to be 263 billion barrels, more than a quarter of the world's known oil reserves. Despite efforts to diversify the economy, oil accounts for around one-third of GDP, more than 90% of the country's export earnings, and nearly 75% of government revenues.

Saudi Arabia continues to pursue rapid industrial expansion, focusing on the petrochemical sector. Saudi Aramco, a parastatal petrochemical company, is one of the world's leading petrochemical producers. Other industries, including construction, transport, finance, and communications, are also being developed. The government is seeking to encourage privatization, liberalize foreign trade, and reform the investment regime. Saudi Arabia is a member of the Gulf Cooperation Council (GCC), which also includes the United Arab Emirates, Kuwait, Oman, Bahrain, and Qatar.

ECONOMIC POLICY OVER 12 MONTHS

Saudi Arabia has used revenues from the oil-price boom of recent years more wisely than some of its neighbors, and has thus been relatively well placed to weather the global financial crisis and the collapse in oil prices of late 2008 and early 2009.

Nevertheless, with the Saudi economy not entirely immune to the effects of the severe banking crisis and the wider global downturn, in August 2010 the government unveiled a new medium-term development plan, which calls for SR1,444 billion (US$384 billion) in spending over the following five years, primarily on housing, health, and education.

The Kingdom's ninth development plan, which runs from 2010 until 2014, is aimed at "combating poverty and spreading education and making housing, work and medical treatment available for everyone," according to the authorities. The Kingdom faces severe social and economic challenges, with the largest population in the Arab Gulf, high unemployment, and a growing lower-income population. The government hopes to almost halve unemployment by the end of 2014 through the plan.

STATISTICS

GDP growth: 0.15% (official, 2009, est.)
GDP per capita: US$20,400 (2009 est.)
CPI: 5% (2009 est.)
Key interest rate: 2% (central bank, May 2010)
Exchange rate versus US dollar: SR3.75 (2009)*
Unemployment: 11.6% (2009 est.)
FDI: US$149.3 billion (December 31, 2009 est.)
Current account deficit/surplus: US$24.56 billion (2009 est.)
Population: 29,207,277 (including 5,576,076 non-nationals, July 2010 est.)

*Saudi riyal
Source: CIA World Factbook except where stated

Two-thirds of Saudi nationals are under 30 years of age, and the Kingdom has struggled to create jobs for them, partly because of a state education system focused more on religion than job skills, and partly because local firms often decide to hire non-Saudis at lower wages. The Saudi government pledged to remain engaged in supporting economic activity, including US$400 billion via a five-year investment program intended to support the domestic economy.

With the Saudi economy still heavily biased toward energy revenues, the doubling of oil prices from the US$40-lows of early 2009 has been a major driver of government revenues. As there is no income tax in Saudi Arabia, the government's only fiscal lever is to increase spending to boost demand—it clearly cannot cut taxes. Thus, the highly expansionary 2010 budget included a 13.7% rise in state expenditure over 2009.

The monetary authorities have sought to stimulate the economy through lower interest rates. The Saudi Arabian Monetary Agency cut the repurchase rate to 2% in 2009, the lowest level in five years, also cutting the reverse repurchase rate to 0.25%.

While the global economic recovery and rising inflationary pressures triggered interest rate rises in some countries—such as China and Australia—in mid-2010, the Saudi Arabian central bank governor, Dr Muhammad Al-Jasser, reassured that the authorities have no plans to tighten policy. With the Saudi Arabian currency pegged to the dollar, interest rates look set to stay on hold until the United States begins to tighten, a move seemingly unlikely in the near term, given the Federal Reserve's commitment

to keep rates at highly accommodative levels for an extended period. The Saudi finance minister also pledged to continue pumping money to boost growth in 2010.

ECONOMIC PERFORMANCE OVER 12 MONTHS

Although the national finances have benefited from the recovery in oil prices since the second quarter of 2009 as the global economic revival has spurred demand, the country was not immune to some effects of the global banking crisis. A fall in bank lending weighed on confidence and the wider economy in 2009, though early 2010 brought signs that higher loan activity, together with rising prices and production in the oil sector, were feeding through to bolster economic activity.

Having grown at more than 4% in 2008, the Saudi Arabian economy expanded by an estimated 0.15% in 2009, despite the substantial government support package, as the earlier slide in oil prices and tumbling levels of global economic growth weighed on the Saudi economy. However, higher oil revenues and the state-supported growth in domestic demand are likely to contribute towards GDP growth of 3.8% in 2010, according to forecasts from Saudi Arabia investment group Jadwa.

Inflation continued to slide for much of 2009, following its peak at around 10% in 2008. The rate bottomed out at 3.5% in October 2009, and subsequently edged higher to 4.7% at the end of March 2010. It has risen since, hitting a 13-month peak of 5.5% in June 2010.

Despite the oil boom of the past few years, unemployment remains worryingly high. Official figures show that the unemployment rate was 11.6% at the end of 2009. However, the true rate may be closer to 20%, according to a BBC report. The jobless rate is thought to be even higher among those aged under 30, who make up two-thirds of the population, and it is staggeringly high among women. Saudi women comprise 55% of graduates but only 5% of the workforce in the sexually segregated society. The education system, which is heavily influenced by the conservative religious establishment, may be partly to blame for the high unemployment rate, according to the BBC. Around 80% of graduates study subjects such as history, geography, Arabic literature, and Islamic studies, while the country does not have enough graduates in science, engineering, or medicine.

SUPPORT FOR INWARD INVESTMENT AND IMPORTS

The government is keen to improve the investment climate as part of a broader program to liberalize the country's trade and investment regime, to diversify an economy overly dependent on oil and petrochemicals, and to boost employment levels. The government encourages investment in transport, education, health, information and communication technologies, life sciences, and energy, and in six "Economic Cities" that are in various states of development. There is a list of sectors that are off-limits to foreign investors. There are also considerable barriers to investing in the country, including a formidable bureaucracy, a government insistence that companies hire Saudi workers, a conservative cultural environment, slow payment of government contracts, and a very restrictive visa policy. The Saudi Arabian General Investment Authority (SAGIA) was established in 2000 to provide information and assistance to foreign investors.

Almost all Saudi imports are covered by a general import tariff rate of 5%. Saudi infant industries, including furniture, cooking salt, mineral water, and plastic pipes, will continue to enjoy 20% tariff protection. Imported cigarettes and tobacco products are charged 200%, wheat and flour 25%, and dates and long-life milk 40%. Despite Saudi Arabia's membership of the World Trade Organization, the US Department of Commerce says that Saudi businesses and laws still favor Saudi citizens, and Saudi Arabia still has trade barriers (mainly regulatory and bureaucratic practices) that restrict the level of trade and investment. For more information on importing goods into Saudi Arabia, see the website of the Saudi Customs Department.

TAX EXEMPTIONS

Saudi Arabia no longer offers tax holidays to foreign investors. For more information on the incentives that are available, see the SAGIA website.

MORE INFO

Websites:

Australian Department of Foreign Affairs Political and Economic brief: www.dfat.gov.au/geo/saudi_arabia/saudi_brief.html
Ministry of Economy and Planning: www.mep.gov.sa
Saudi Arabian General Investment Authority (SAGIA): www.sagia.gov.sa
Saudi Customs Department: www.customs.gov.sa/CustomsNew/default_E.aspx

Syria

ECONOMY AND TRADE

Syria is a lower-middle-income country with an estimated GDP per capita of US$1,365. It is led by the petroleum and agricultural sectors, which together account for about one-half of GDP. The government has implemented modest economic reforms in the past few years, including cutting lending interest rates, opening private banks, consolidating all of the multiple exchange rates, and raising prices on some subsidized items, most notably gasoline and cement. Syria has made progress in easing its heavy foreign debt burden with its key creditors in Europe, most importantly Russia, Germany, and France. The country has also settled its debt with Iran and the World Bank.

Long-term barriers to growth include a high level of state control, declining oil production, high unemployment and inflation, rising budget deficits, and increasing pressure on water supplies caused by heavy use in agriculture, rapid population growth, industrial expansion, and water pollution.

ECONOMIC POLICY OVER 12 MONTHS

The Syrian government started its reform efforts by changing the regulatory environment in the financial sector. In 2001, Syria legalized private banking, and the sector, while still nascent, has been growing quickly since. Controls on foreign exchange continue to be one of the biggest impediments to the growth of the banking sector, although Syria has taken gradual steps to loosen those controls. The government is increasingly aware of its declining energy margin. It has recently focused on boosting the country's hydrocarbons sector by attracting foreign direct investment and foreign technologies to improve the productivity of oil and gas fields, and substituting oil with natural gas in domestic power generation.

As a result of these efforts to liberalize the economy, the private sector has been growing rapidly, with major investment in services, trade, and light industries. Between 2000 and 2007, the private sector's contribution to national production rose from 52.3% to 60.5%. Syria's reform efforts have been rewarded by a sharp increase in foreign direct investment in recent years. However, a few large companies continue to dominate the public sector and to take a leading role in strategic sectors such as metallurgy and materials, chemicals, textiles, and agribusiness.

STATISTICS

GDP growth: 4% (IMF, 2009 est.)
GDP per capita: US$4,600 (2009 est.)
CPI: 2.5% (IMF, 2009 est.)
Key interest rate: n/a
Exchange rate versus US dollar: S£46.8599 (2009)
Unemployment: 11% (IMF, 2009 est.)
FDI: n/a
Current account deficit/surplus: −US$1.521 billion (2009 est.)
Population: 22,198,110 (July 2010 est.)

Source: CIA World Factbook except where stated

Syria implemented a five-year plan (FYP) for 2006–2010, focusing on economic and social reform. The FYP contained a number of innovative guiding principles, such as: the promotion of a partnership between government, the private sector, and civil society; the principle of decentralized decision-making; and the use of indicative planning. Long-term objectives include social justice, attraction of foreign capital, and empowering women in society.

Under the 11th FYP covering 2011–2015, Syria will focus on rebuilding the country's infrastructure and on securing energy security. It seeks annual economic growth at an average of 8% and a rate of unemployment of 4%. The cost of the plan is US$130 billion, of which US$77 billion will be drawn from the private sector.

In February 2010, the Deputy Prime Minister for Economic Affairs, Abdullah al-Dardari, said that Syria had already signed several contracts, worth US$5 billion, to produce 5,000 megawatts of electric power by the end of 2013.

The introduction of value added tax (VAT), which was initialy planned for 2009, has been delayed until 2011. This was partly to avoid contributing to inflationary pressures, in view of the ongoing phasing out of fuel subsidies.

Syria opened a stock exchange in March 2009. The government hopes to attract new investment in the banking, tourism, insurance, and gas sectors to diversify its economy away from dependence on oil and agriculture.

Tourism holds the potential to become a significant source of foreign exchange. During the first seven months of 2010, tourist numbers increased by 55% compared to the same period in 2009. In 2009, 6 million tourists visited Syria,

generating US$0.2 billion. The tourism sector accounted for 11.2% of GDP.

ECONOMIC PERFORMANCE OVER 12 MONTHS

The global financial crisis had a limited impact on Syria. GDP growth fell to around 4% in 2009 from 5% in 2008, largely due to lower export growth to trade partners in Europe and the Middle East. However, lower growth in manufacturing, construction, and services was partially offset by a moderate recovery in agriculture and a small increase in oil production, according to an International Monetary Fund (IMF) report published in March 2010.

The IMF estimates that unemployment increased to almost 11% in 2009, from 9% in the previous year. Inflation declined sharply to about 2.5%, reflecting trends in global prices. Fiscal policy was aimed at mitigating the impact of the global crisis. The fiscal deficit increased by about 2.5 percentage points to 5.5% in 2009, reflecting a 5% rise in expenditure due to increases in public investment, the public wage bill, and transfers to compensate for the raising of fuel prices and removal of petroleum subsidies. Nonoil revenue increased, partly due to strong tax collection, which resulted from improved administration and incentives to settle arrears, according to the IMF.

US sanctions imposed by the Bush administration in 2004 are one of the major obstacles to reforming the Syrian economy. The sanctions restrict the export of US-made products to Syria, except for some food and medicine products. Syria is also barred from importing products containing more than 10% of components made in the United States, whatever the origin of the product. In May 2010, President Barack Obama renewed these sanctions for another year. The president cited Syria's "extraordinary threat" to US security and foreign policy. However, during the same month, President Obama dropped US opposition to Syria's World Trade Organization application, hinting at some thawing of relations.

In 2009, the external current account deficit widened to about 4.5%, as the decline in exports exceeded that of imports. However, tourism receipts were buoyant, and both foreign direct investment and remittances dropped only slightly. Gross reserves remained comfortable, at about US$17 billion, according to the IMF.

The central bank said in May 2010 that the economy could expand by 5% in 2010 and that inflation would fall to 3%. The IMF concurs with the growth forecast, but believes that inflation will reach 5%.

SUPPORT FOR INWARD INVESTMENT AND IMPORTS

Syria has only been open to external trade since 2000, although the current government is making a strong effort to attract foreign investment. More information on investing in Syria is available on the website of the Syrian Investment Agency, the government body responsible for attracting investment into the country.

TAX EXEMPTIONS

Syria has created several investment zones, and has lifted several customs and income tax levies for companies investing in the country. Further information is available from the Syrian Investment Agency.

MORE INFO

Websites:

IMF Public Information Notice, March 2010: www.imf.org/external/np/sec/pn/2010/pn1042.htm
Information on Syria and links to local resources: www.animaweb.org/en/pays_syrie_en.php
Syrian Investment Agency: www.investinsyria.org

United Arab Emirates

ECONOMY AND TRADE

The United Arab Emirates (UAE) is a confederation of seven emirates formed in 1971 by the then Trucial States after gaining independence from Britain. Each state—Abu Dhabi, Dubai, Ajman, Fujairah, Ras al Khaimah, Sharjah, and Umm al Qaiwain—maintains a large degree of independence, but the UAE is governed by the Supreme Council of Rulers, made up of the seven emirs, who appoint the prime minister and the cabinet.

Before oil was discovered in the 1950s, the economy was based on fishing and a declining pearling industry. However, since 1962, when Abu Dhabi became the first of the emirates to begin exporting oil, the UAE's fortunes have been transformed. The oil industry has attracted a large influx of foreign workers who, together with expatriates, now account for more than three-quarters of the population. The confederation's growing business sector and its tourist industry have helped to fuel a construction boom, with billions of dollars being pumped into showpiece schemes.

The best known of the emirates is the business center of Dubai. The largest, Abu Dhabi, covers 80% of the land mass, and holds most of the UAE's vast oil and gas reserves. The UAE has the world's third-largest conventional oil reserves, and its fifth-largest natural gas reserves. The UAE is the Middle East's second-largest economy after Saudi Arabia.

ECONOMIC POLICY OVER 12 MONTHS

The Government of Abu Dhabi, which dominates the economy of the UAE, set out a long-term, strategic, economic development program in a document entitled Abu Dhabi Economic Vision 2030, published in 2008. This program seeks to diversify the economy so that nonoil growth outstrips oil-sector growth within 20 years. The government aims to create a sustainable, knowledge-based, and globally integrated economy by 2030, with the nonoil sector of the economy accounting for 64% of GDP.

The role of government over this period will change: it will become a regulator, rather than a provider of public services—a goal intended to facilitate the development of the private sector. The government will seek to encourage the development of industries and services in which the emirate has a competitive advantage, including tourism and logistics, and will also focus on enhancing the quality of healthcare, education, and training in the country.

However, the global economic slowdown inflicted considerable pain on the UAE, and in particular on Dubai. Unlike its neighbor Abu Dhabi, Dubai does not have vast oil and gas reserves to fall back on. Dubai's growth was thus financed with debt, not oil money. It embraced globalization, and aggressively diversified its economy into nonoil sectors such as financial services, tourism, and real estate. Dubai is home to some of the most ambitious building projects on the planet, including the world's tallest tower and the world's biggest shopping mall.

The real-estate market in Dubai began to unravel in 2008 as the credit crisis deepened. Potential buyers could no longer raise mortgages, and prices began to tumble, leading to funding problems for some Dubai developers. Thousands of construction workers subsequently lost their jobs, while expats returned home, further undermining the property market. The tourism market is also being hit. Western tourists are cutting back on spending, and occupancy rates at many of Dubai's luxury hotels are down.

In March 2009, however, the Dubai government launched a US$20 billion bond program, and sold the first US$10 billion tranche to the UAE central bank, a move that calmed worries that Dubai could default on some US$15–20 billion in debts due for refinancing in 2009. However, at the end of November 2009, the state-owned conglomerate Dubai World announced that it was freezing repayment of debts of almost US$60 billion. In March 2010, the Dubai government announced that it would provide US$9.5 billion in funding to help its Dubai World investment vehicle to restructure its debt. In June, Dubai World reached an agreement on restructuring the debt. Dubai World is the centerpiece of Dubai's economy and helped to drive the emirate's economic expansion. However, the markets remain wary of debts associated with Dubai corporate entities.

STATISTICS

GDP growth: −0.7% (IMF, 2009 est.)
GDP per capita: US$42,000 (2009, est.)
CPI: 1.64% (average, government figures)
Key interest rate: 1% (IMF, 2009 est.)
Exchange rate versus US dollar: Dhs3.673 (2009)*
Unemployment: 2.4% (2001)
FDI: US$67.69 billion (December 31, 2009 est.)
Current account deficit/surplus: US$2.558 billion (2009 est.)
Population: 4,975,593 (July 2010 est.)

*United Arab Emirates dirham
Source: CIA World Factbook except where stated

ECONOMIC PERFORMANCE OVER 12 MONTHS

The economy contracted by around 0.7% in 2009, according to an IMF report published in February 2010. By contrast, at the end of May 2010, the UAE said that the economy expanded by 1.3% in 2009. The figures were significantly higher than market expectations and were treated with skepticism by analysts who believe that the figures will be later downgraded. During the same month, the IMF confirmed that it believed that the economy had contracted by 0.7% during the year.

The IMF said that the UAE was adversely affected by a series of external and domestic shocks in 2009, including the global economic slowdown, the shutdown of international capital markets, and the impact of the bursting Dubai property bubble in mid-2008. Oil receipts plummeted, global trade and logistics contracted, as did property and construction activities. It added that a second bout of disruption arose when Dubai World announced in late November 2009 that it would seek a debt standstill through May 2010, including bonded debt owed by its Nakheel property subsidiary. Since then, the IMF continued, access to financial markets by Dubai entities has become more difficult, and it will take some time for the Government of Dubai to design and implement a strategy on the operational restructuring of its government-related entities.

According to the IMF, hydrocarbon GDP declined by 6.25% in 2009, while nonhydrocarbon growth, which had averaged 8% in the three previous years, is estimated to have slowed to about 1%. However, the organization added that these figures masked the diverging fortunes of Abu Dhabi (where growth was sustained by public sector investment spending) and the northern emirates (in particular Dubai and Sharjah), where economic activity dropped owing to the bursting property bubble and the contraction in world trade.

However, the economic slowdown had a positive impact on inflation, which after peaking at about 12% in 2008, declined to a nine-year low of 1.9% in 2009, reflecting lower import prices and a reduction in rents arising from an increased supply of buildings, as well as the renewal of contracts at deflated market prices.

The IMF estimates that the external current account balance shifted to a deficit of 2.7% of GDP in 2009, the first deficit in decades. As a result of Organization of the Petroleum Exporting Countries (OPEC) mandated production cuts and lower prices, hydrocarbon export revenues dropped by about 45% in 2009, while imports fell by 22%, owing to a sharp contraction in consumer goods imports and despite the large public infrastructure projects in Abu Dhabi. The reopening of capital markets in the second quarter of 2009, and external borrowing—particularly by Abu Dhabi entities—helped to stabilize the international reserves position by the end of 2009.

SUPPORT FOR INWARD INVESTMENT AND IMPORTS

The government is keen to encourage private investment from both local and foreign investors. The government says that, to facilitate investment, it has focused on the provision of first-class industrial facilities and business support services, reducing bureaucracy and streamlining administrative procedures, as well as updating commercial laws and regulations to meet international obligations. It has also sought to increase transparency and ensure effective protection for investors. The Abu Dhabi Chamber of Commerce and Industry can provide information and guidance on investing in the UAE.

The UAE is a member of the World Trade Organization. The UAE's applied tariff, based on the common external tariff of the Gulf Cooperation Council (a trade bloc of six Arab states on the Persian Gulf), is low, at an average of 5%; most of the UAE's applied most favored nation (MFN) tariffs (except on alcohol and tobacco) are zero or 5%. The entire tariff is bound, but some 30 applied rates exceed bindings. Customs procedures are simple, facilitating trade. (For further information on importing into the UAE, see the website of the country's customs service.)

TAX EXEMPTIONS

There is no federal tax legislation in the UAE. Each emirate has its own tax regime. (For further information, see the website of the UAE's Ministry of Finance.

MORE INFO

Websites:

Abu Dhabi Chamber of Commerce and Industry: www.adcci-uae.com
Government information on UAE's business environment: www.uae.gov.ae/government/business.htm
Portal for government ministries and agencies: www.government.ae/gov/en/index.jsp
UAE Customs: www.dxbcustoms.gov.ae/content/home
UAE Ministry of Finance: www.uae.gov.ae/mofi/e_home.htm

Information Sources

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Information Sources

BOOKS

The Art of Islamic Banking and Finance: Tools and Techniques for Community-Based Banking

Yahia Abdul-Rahman

Wiley Finance Series
Hoboken, New Jersey: Wiley, 2010
432pp, ISBN: 978-0-470-44993-6

A comprehensive exploration of Islamic banking and finance, this book looks in detail at how Islamic finance principles are being incorporated into Western banking and investment approaches. It provides the background and theological foundations of prohibiting interest, as well as examining *riba*-free banking, and topical issues such as how fiat money is created, the role of the Federal Reserve, and how Islamic finance functions with the banking system in the United States.

The Chancellor Guide to the Legal and Shari'a Aspects of Islamic Finance

Humayon A. Dar, Umar F. Moghul (editors)

London: Chancellor Publications, 2009
372pp, ISBN: 978-1-899217-09-0

This is a useful reference to how *shariah* legal principles are applied in the Islamic financial sector, and provides a guide to avoiding the potential financial, legal, and reputational pitfalls of operating in these markets. The analysis consists of separate chapters by a team of Islamic finance legal practitioners and advisers, who offer a comprehensive and practical overview of all the legal issues in these markets.

Critical Issues on Islamic Banking and Financial Markets: Islamic Economics, Banking and Finance, Investments, Takaful and Financial Planning

Saiful Azhar Rosly

Bloomington, Indiana: AuthorHouse, 2005
634pp, ISBN: 978-1-4184-6930-6

This is an accessible guide to modern Islamic finance, which provides a practical discussion of the underlying principles of *shariah* financial instruments and Islamic banking, insurance, and fund management. It examines the growth of Islamic funds and transactions, and their integration into the international financial system, and explains key concepts and terms, such as *shariah*, *sukuk*, *riba*, *al-bay'*, and *maysir*.

Current Issues in Islamic Banking and Finance: Resilience and Stability in the Present System

Angelo M. Venardos (editor)

Singapore: World Scientific Publishing, 2010
328pp, ISBN: 978-981-283-392-1

This timely investigation of the growing Islamic banking and finance sector reviews the different capital, retail, or wealth management markets involved, with a focus on Malaysia, Singapore, Brunei, Indonesia, and emerging players such as Japan and the United States. It comprises separate analyses by many leading practitioners in each field, who offer an insight into the key developments and issues affecting Islamic banking in South East Asia, from both global and regional perspectives.

Financial Risk Management for Islamic Banking and Finance

Ioannis Akkizidis, Sunil Kumar Khandelwal

New York: Palgrave Macmillan, 2008
256pp, ISBN: 978-0-230-55381-1

This guide to risk management in Islamic finance presents a methodology for assessing and managing risk in *shariah*-compliant financial products and services. It details how to practically implement a risk management framework for Islamic financial institutions, how to manage the increase in financial products and services, and the number of Islamic financial institutions managing funds.

Frequently Asked Questions in Islamic Finance

Brian Kettell

Chichester, UK: Wiley, 2010
334pp, ISBN: 978-0-470-74860-2

This guide provides a host of useful and interesting answers to the main FAQs in the world of Islamic finance. It offers a range of practical and focused insights into such areas as the Qur'an, *shariah* law, and traditional and modern Islamic financial concepts and terms, as well as Islamic financial instruments and services. It addresses these questions with a

clear overview of the product or service, and an example or illustration where appropriate.

Globalization and Islamic Finance: Convergence, Prospects, and Challenges
Hossein Askari, Zamir Iqbal, Abbas Mirakhor
Wiley Finance Series
Singapore: Wiley, 2009
224pp, ISBN: 978-0-470-82349-1

This title sets out ideas for reforms to the financial system, as well as advocating further financial globalization and the convergence of Western and Islamic financial systems. For both academics and practitioners, this is a timely book, especially in the context of the recent financial and economic crises, as it also examines the growth of Islamic finance and the effects that globalization has had on its development.

A Guide to Islamic Finance
Munawar Iqbal
Risk Executive Reports Series
London: Risk Books, 2007
138pp, ISBN: 978-1-904339-85-4

This focused and practical report explains the basic theory, practice, and limitations of Islamic banking and finance. It shows how to develop products that comply with Islamic principles and perform financial intermediation functions without the involvement of interest. It also explains the objectives and sources of Islamic law, gives guidelines for business contracts, and offers an extensive glossary of relevant Arabic terms.

Gulf Capital and Islamic Finance: The Rise of the New Global Players
Aamir A. Rehman
New York: McGraw-Hill, 2010
352pp, ISBN: 978-0-07-162198-4

This comprehensive guide to Gulf capital and Islamic finance for financial investment professionals investigates the background and context of capital in Gulf Cooperation Council (GCC) countries. It provides an understanding of how Gulf capital operates, the *shariah*-compliant finance industry, and the growing relevance to the global economy of Gulf capital and Islamic finance. It also discusses the sector's growth potential, and key institutional investors such as sovereign wealth funds, specialist investment vehicles, and private investors.

Handbook of Islamic Banking
M. Kabir Hassan, Mervyn K. Lewis (editors)
Cheltenham, UK: Edward Elgar Publishing, 2007
462pp, ISBN: 978-1-84542-083-3

This authoritative handbook examines how Islamic banking and finance operates, and assesses its role within the international banking and capital markets as an alternative to conventional interest-based financing methods. It details the variety of financial instruments and investment vehicles, and other key topics such as governance and risk management, securities and investment, structured financing, accounting and regulation, economic development, and globalization.

The International Handbook of Islamic Banking and Finance
Elisabeth Jackson-Moore
London: Global Professional Publishing, 2009
250pp, ISBN: 978-1-906403-31-7

This comprehensive guide provides an overview of current practices in Islamic banking and finance, and the essential elements of *shariah* compliance. It examines the issues faced by bankers, scholars, regulators, and others interested in understanding the objectives and challenges of Islamic finance and its growing role in the global financial markets.

Introduction to Islamic Banking and Finance
Brian Kettell
London: Islamic Banking Training, 2008
252pp, ISBN: 978-0-9558351-0-0

This comprehensive primer on Islamic banking and finance details the fundamental points of convergence and divergence between *shariah*-compliant finance and conventional interest-based finance. It analyzes the key principles, components, and techniques of the industry, the introduction of services free from interest, and the use of profit and loss sharing as a method of resource allocation and financial intermediation.

An Introduction to Islamic Finance: Theory and Practice
Zamir Iqbal, Abbas Mirakhor
Wiley Finance Series
Singapore: Wiley, 2007
346pp, ISBN: 978-0-470-82188-6

This is a concise resource on the fundamental principles of Islamic finance, an economic and

financial system governed by *shariah* Islamic law. It provides guidance and insight on all the main essential topics, products, and processes, discusses the context of Islamic finance within modern finance and banking practices, and examines Islamic tenets that influence economic behavior in the fast-growing Islamic financial services industry.

Islam and Mammon: The Economic Predicaments of Islamism

Timur Kuran

Princeton, New Jersey: Princeton University Press, 2004
214pp, ISBN: 978-0-691-12629-6

This examination of Islamic banking and economics provides a practical introduction to the main themes in the sector, arguing that it does not present an effective alternative to today's global economic problems, but is too simplistic, incoherent, and focused on creating an Islamic identity that is resistant to cultural globalization. It also discusses the links between Islam and economic performance in relation to issues of the underdevelopment of Islamic economics, and the benefits or otherwise of Islamic economic development.

Islamic Banking: A Practical Perspective

Kamal Khir, Lokesh Gupta, Bala Shanmugam

Petaling Jaya, Malaysia: Pearson Longman, 2008
344pp, ISBN: 978-967-3-00399-0

This practical analysis of Islamic banking examines its evolution into a viable alternative to traditional banking products. It provides a useful reference to Islamic banking products and services, with the information being presented in the form of an introductory guide, making it accessible to all. It also offers a range of examples, case studies, and illustrations of the main Islamic banking products and business models, as well as discussing recent trends, developments, and challenges in the sector.

Islamic Banking and Finance

Natalie Schoon

London: Spiramus Press, 2009
218pp, ISBN: 978-1-904905-11-0

This short but focused guide details the main principles of Islamic banking and finance, and examines products and concepts such as *istisna'a*, *murabahah*, *sukuk*, *musharakah*, *mudarabah*, *ijarah*, and *salam*. It also looks at the application of Islamic financial products to different contexts, including risk management, treasury, asset management, raising finance, and tax, and explains the regulatory frameworks for Islamic finance.

Islamic Banking and Finance in South-East Asia: Its Development and Future, 2nd ed

Angelo M. Venardos

Asia-Pacific Business Series
Hackensack, New Jersey: World Scientific Publishing, 2006
256pp, ISBN: 978-981-256-888-5

This analysis of Islamic banking puts into context the development of a financial system based on the Qur'an, *shariah* law, and Islamic jurisprudence, before explaining Islamic banking and finance in South East Asia in terms of its differences from the conventional banking system and the financial products and services involved. It also provides an overview of the challenges and opportunities in Islamic banking and finance for both Muslims and non-Muslims.

Islamic Banking and Finance in the European Union: A Challenge

M. Fahim Khan, Mario Porzio (editors)

Studies in Islamic Finance, Accounting and Governance Series
Cheltenham, UK: Edward Elgar Publishing, 2010
252pp, ISBN: 978-1-84980-017-4

This is a multidisciplinary overview of the inherent problems of harmonizing the legal and regulatory structures of Western banking systems and Islamic finance. It offers practical insights into key topics from both perspectives, and analyzes whether Islamic banking and finance complies with the European framework. It also explores the origins of Islamic and Western traditions in commercial and banking transactions, and discusses how Islamic banking can make the financial industry more inclusive.

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

Tarek El Diwany (editor)

Bolton, UK: 1st Ethical Charitable Trust, 2010
536pp, ISBN: 978-0-9565186-0-6

This comprehensive exploration of Islamic banking and finance takes in all the main themes, services, products, and terms. It discusses the historical context for the sector,

as well as relevant theological, commercial, legal, institutional, and macroeconomic factors. Written by a team of experts, a wide range of views and analysis are offered, and a number of reforms are discussed at the institutional and contractual levels.

Islamic Bonds: Your Guide to Issuing, Structuring and Investing in *Sukuk*

Nathif J. Adam, Abdulkader Thomas

London: Euromoney Books, 2005
192pp, ISBN: 978-1-84374-128-2

This short but focused introduction to Islamic bonds and *sukuk* provides a useful overview of their innovation in Islamic finance. It discusses the potential of the *sukuk* range of securities, as well as how the market for these bonds has developed so far, and how it is expected to gain new investors and issuers as they become more accepted.

Islamic Capital Markets

Brian Kettell

Petersfield, UK: Harriman House, 2009
296pp, ISBN: 978-0-9558351-1-7

This primer on Islamic capital markets provides a useful introduction to all aspects of this growing financial sector. It covers the fundamental principles underlying the markets, and identifies the main relevant issues underpinning a market where the instruments traded are asset-backed, defaults are practically unknown, and a range of innovative new asset classes are emerging.

Islamic Capital Markets and Risk Management

Michael Mahlknecht

Risk Executive Reports Series
London: Risk Books, 2009
250pp, ISBN: 978-1-906348-17-5

A practical guide to current developments in Islamic capital markets and risk management in Islamic finance, this book also provides a comprehensive overview of investment opportunities in the Islamic financial markets. It discusses the fundamental principles of *shariah* law, and explains the structuring of most Islamic financial products and the existing risks associated with these instruments. The analysis is presented in an accessible way for non-Muslim investors and non-Islamic institutions.

Islamic Economics and Finance: A Glossary, 2nd ed

Muhammad A. Khan

Routledge International Studies in Money and Banking Series
London: Routledge, 2003
208pp, ISBN: 978-0-415-45925-9

An updated and enlarged edition of this useful glossary, it explains the terms—from Arabic, Urdu, Turkish, Malaysian, and English sources—used in Islamic banking, taxation, insurance, accounting, and auditing by Muslim scholars, historians, and legal experts. It provides a reference for all interested in Islamic economics and finance, including economists, bankers, accountants, students, and researchers.

Islamic Finance: A Guide for International Business and Investment

Roderick Millar, Habiba Anwar (editors)

London: GMB Publishing, 2008
236pp, ISBN: 978-1-84673-078-8

This guide to Islamic financial practice aimed at banking professionals and corporate investors examines the tenets of Islamic investment that exclude areas such as gambling, alcohol, weapons, and products that are high-risk and high-return. It analyzes the differences between Islamic and conventional banking and the reasons why investors and asset managers are becoming increasingly attracted to financial products and institutions that comply with *shariah* principles.

Islamic Finance: A Practical Guide

Rahail Ali (editor)

London: Globe Law and Business, 2008
176pp, ISBN: 978-1-905783-13-7

This practitioner approach to Islamic finance analyzes market trends, key developments and structures for *sukuk*, syndications, types of *shariah*-compliant fund, *takaful*, project financing, and Islamic liquidity management, as well as the relevant legal issues. It provides a practical guide for sovereigns, financial institutions, multinationals, and corporates on the essentials of Islamic finance, including Islamic bonds, and corporate, retail, and acquisition.

Islamic Finance and Banking System: Philosophies, Principles and Practices

Sudin Haron, Wan Nursofiza Wan Azmi

Kuala Lumpur: McGraw-Hill, 2009
400pp, ISBN: 978-983-3850-61-7

This introduction to Islamic finance and banking examines the key tenets, practices, theory, and investment opportunities of this rapidly expanding sector. It also provides a guide to the range of institutions, products, and services involved in Islamic finance, and presents an analysis of how *shariah*-compliant finance will develop over the coming years.

Islamic Finance in a Nutshell: A Guide for Non-Specialists

Brian Kettell

Chichester, UK: Wiley, 2010
360pp, ISBN: 978-0-470-74861-9

Offering a straightforward guide to the basics of Islamic finance, this guide is both practical and informative on the workings of Islamic financial markets and their differences from the Western financial system. It presents the fundamentals, identifies the leading financial institutions in Islamic markets, and explains the main themes and terminology that govern Islamic finance, such as financial statement analysis, *shariah* law, the lack of interest, and regulation.

Islamic Finance in the Global Economy, 2nd ed

Ibrahim Warde

Edinburgh, UK: Edinburgh University Press, 2008
284pp, ISBN: 978-0-7486-2777-6

This is a comprehensive reference to the political economy of Islamic finance for those interested in Islamic and Middle Eastern economics, business, and finance. It provides an overview of modern Islamic finance, analyzes the connections between Islamic finance and politics, explores the underlying economic, cultural, and political principles, and discusses Islamic finance in the context of the global political and economic system.

Islamic Finance: Law, Economics, and Practice

Mahmoud A. El-Gamal

Cambridge, UK: Cambridge University Press, 2006
240pp, ISBN: 978-0-521-74126-2

This overview of Islamic finance practices analyzes the constraints that Islam imposes on financial relations in attempting to replicate financial instruments, markets, and institutions, arguing that this is failing to serve the objectives of Islamic law. Instead, it proposes a fundamental reform in Islamic finance to focus more on issues of community banking, microfinance, and socially responsible investment.

Islamic Finance: Principles and Practice

Hans Visser

Cheltenham, UK: Edward Elgar Publishing, 2009
196pp, ISBN: 978-1-84542-525-8

This is a topical discussion of the principles of Islamic finance, the key instruments, how Islamic institutions and markets operate, and recent developments. It also explores the ways in which Islamic finance has evolved and the challenges facing Islamic forms of finance, such as how to reconcile activities such as liquidity management, monetary policy, and government finance with Islamic principles.

Islamic Finance: The Regulatory Challenge

Rifaat Ahmed Abdel Karim, Simon Archer (editors)

Wiley Finance Series
Singapore: Wiley, 2007
440pp, ISBN: 978-0-470-82189-3

This title examines the regulatory aspects of Islamic finance and the development of structured regulatory, supervisory, and legal frameworks appropriate for the Islamic financial services industry worldwide.
It discusses principles of Islamic commercial jurisprudence, the role of the Islamic Financial Services Board, the potential for growth in Islamic financial services, corporate governance and supervision issues, and the nature of risk in Islamic banking.

Islamic Finance: Why It Makes Sense

Daud Vicary Abdullah, Keon Chee

Singapore: Marshall Cavendish, 2010
312pp, ISBN: 978-981-261-599-2

This new exploration of the growth of Islamic finance discusses the growth of the sector, offering a contextual framework for the use of ethical principles and strong corporate governance based on *shariah* law. It also details the workings of conventional finance, such as mortgages, leases, trade finance, and insurance, and compares them to the Islamic finance versions, providing a comprehensive introduction to the main principles involved.

Islamic Insurance: A Modern Approach to Islamic Banking
Aly Khorshid
London: RoutledgeCurzon, 2004
248pp, ISBN: 978-0-415-44450-7

This book provides insights into the key themes and concepts of Islamic insurance in the context of Islamic finance in general, and explores the integration of insurance into Muslim society. It uses extracts from the Qur'an and *Sunnah* to compare the arguments of pro- and anti-insurance jurists, arguing that Muslims can benefit from an Islamic insurance structure. It also appraises Islamic finance as a viable alternative to conventional insurance and examines the relevant legal and practical issues from an Islamic perspective.

Islamic Money and Banking: Integrating Money in Capital Theory
Iraj Toutounchian
Wiley Finance Series
Singapore: Wiley, 2009
410pp, ISBN: 978-0-470-82319-4

This book explains the role of money and capital in Islamic economics, arguing that the principles of institutional economics support the case of Islamic finance as a solution to the greed of liberal capitalism. It propounds the view that there is a fundamental need to reconsider the global economy and adopt Islamic banking as a system that can generate profit, benefit global economies, and still be based on principles of virtue and benevolence.

An Islamic Perspective on Governance
Zafar Iqbal, Mervyn K. Lewis
New Horizons in Money and Finance Series
Cheltenham, UK: Edward Elgar Publishing, 2009
384pp, ISBN: 978-1-84720-138-6

This examination of governance under an Islamic system provides an authoritative overview of how Islamic finance can provide financial and economic stabilization during times of market turmoil, including theories of justice, budget deficits, taxation, public and private accountability, and corruption. It explores the key issues surrounding economic and financial governance, focusing on how concepts such as responsible behavior and the condemnation of material greed for its own sake can benefit approaches to public, corporate, financial, and fiscal governance.

Islamic Retail Banking and Finance: Global Challenges and Opportunities
Jaffer Sohail (editor)
London: Euromoney Books, 2005
238pp, ISBN: 978-1-84374-198-5

This is an international treatment of Islamic finance and banking which details the development of the sector over the last few years, as well as issues such as the increasing focus by Western banks on Islamic financial services and the development of Islamic retail banking in Europe. It provides an overview of the creation of Islamic mortgages, savings, insurance, and retail investment products in terms of increasing competition with conventional financial products, and their basis in Islamic law.

A Mini Guide to Islamic Banking and Finance
Centre for Research and Training
Kuala Lumpur, Malaysia: CERT Publications, 2006
124pp, ISBN: 978-983-42785-4-0

This concise introduction to Islamic banking, finance, and accountancy examines the basic requirements, obligatory prohibitions, and *shariah*-compliant transactions, as well as permissible investment and insurance alternatives. It also offers a useful set of Q&As, bibliography, and glossary.

A New Financial Dawn: The Rise of Islamic Finance
Joseph DiVanna, Antoine Sreih
Cambridge, UK: Leonardo and Francis Press, 2009
178pp, ISBN: 978-1-905687-10-7

This important analysis of the global economic crisis examines the impact that Western financial markets have had on the development of Islamic finance, and discusses issues such as Islamic monetary union and alternative forms of currency. It also considers current financial problems as offering an opportunity for further innovation in *shariah*-compliant financial services, and the possibility of Islamic finance becoming an effective, ethically based replacement for the current Western financial system.

New Issues in Islamic Finance and Economics: Progress and Challenges
Hossein Askari, Zamir Iqbal, Abbas Mirakhor
Wiley Finance Series

Hoboken, New Jersey: Wiley, 2008
320pp, ISBN: 978-0-470-82293-7

This review of the main issues and challenges facing Islamic finance focuses on governance, institutions, public finance, and economic development within an Islamic financial system. It looks at the development of Islamic finance, and argues that its future success will depend on factors such as economic and financial reform in Islamic countries, institutional reform, governance and regulatory oversight, and research into suitable financial products.

The Politics of Islamic Finance

Clement Henry, Rodney Wilson (editors)

Edinburgh, UK: Edinburgh University Press, 2004
314pp, ISBN: 978-0-7486-1837-8

This exploration of the political aspects of Islamic finance examines the experiences of Islamic banking in a range of countries, and the political implications of the increase in Islamic capital. It also explores the connections between Islamic finance and Islamic political movements, the perceived connection between Islamic finance and money laundering and terrorism, and common misconceptions about Islamic banking and finance.

Risk Analysis for Islamic Banks

Hennie van Greuning, Zamir Iqbal

Washington, DC: World Bank Publications, 2007
334pp, ISBN: 978-0-8213-7141-1

This is a focused exploration of the assessment, analysis, and management of various types of risks in the field of Islamic banking. It introduces a high-level framework that takes into account the current realities of changing economies and Islamic financial markets, and discusses the accountability of key players in the corporate governance process in terms of the management of different dimensions of Islamic financial risk.

Risk Management in Islamic Finance: An Analysis of Derivatives Instruments in Commodity Markets

Muhammad al-Bashir Muhammad al-Amine

Brill's Arab and Islamic Laws Series
Leiden, The Netherlands: Brill, 2009
360pp, ISBN: 978-90-04-15246-5

This examination of the use of derivatives in Islamic finance explores the benefits of working with these instruments, looking specifically at the forward, futures, and options contracts in commodity markets, and the pros and cons of their implementation. It also recommends the use of *khiyar al-shart* and *bay al-arbun* as risk management tools and as an alternative to options, and assesses the legal aspects of risk management in Islamic finance.

The Stability of Islamic Finance: Creating a Resilient Financial Environment for a Secure Future

Zamir Iqbal, Abbas Mirakhor, Noureddine Krichenne, Hossein Askari

Wiley Finance Series
Singapore: Wiley, 2010
258pp, ISBN: 978-0-470-82519-8

This authoritative examination of the economic implications of Islamic finance explores the main themes that link Islamic finance to traditional Western economics, and discusses the stability properties of Islamic financial instruments and key Islamic concepts from an economic standpoint. It also examines the growth of Islamic finance in recent years, arguing the case for the inherent stability and efficiency of Islamic finance.

Structuring Islamic Finance Transactions

Thomas Abdulkader, Stella Cox, Bryan Kraty (editors)

London: Euromoney Books, 2005
254pp, ISBN: 978-1-84374-213-5

This book explains the fundamental principles of Islamic finance instruments and compliance with Islamic law in the context of recent financial developments and the growth of Islamic financial institutions. It discusses the complex structures and applications of Islamic transactions, such as *sukuk* and debt-like products, risk management and derivative-like products, and the emerging regulatory environment for Islamic finance products and transactions.

Takaful Islamic Insurance: Concepts and Regulatory Issues

Simon Archer, Rifaat Ahmed Abdel Karim, Volker Nienhaus (editors)

Wiley Finance Series
Singapore: Wiley, 2009
336pp, ISBN: 978-0-470-82352-1

This is an overview of Islamic insurance

provided by a group of leading international experts, which examines the main issues facing the *takaful* markets as they undergo a period of rapid growth. It discusses the development of *takaful* insurance, and the challenges in developing an appropriate legal and regulatory infrastructure, as well as problems regarding financial reporting and corporate governance.

Theory and Practice of Modern Islamic Finance: The Case Analysis from Australia

Abu Umar Faruq Ahmad

Boca Raton, Florida: BrownWalker Press, 2009
322pp, ISBN: 978-1-59942-517-7

This technical overview of Islamic finance in an Australian context investigates the difference between modern Islamic finance and the traditional *shariah*, with a particular emphasis on Islamic financial services providers. It also examines the regulation of Islamic finance in Australia in terms of the financing instruments used, the certainty of transactions between participants in the system, and the institutional risk management of Islamic financial institutions.

Understanding Islamic Banking: The Value Proposition that Transcends Cultures

Joseph A. DiVanna

Diversity in Global Banking Series
Cambridge, UK: Leonardo and Francis Press, 2006
192pp, ISBN: 978-1-905687-00-8

This is a guide to the principles and practice of Islamic banking, which provides a framework for contemporary retail banks to be accessible for investors of any faith. It also explores the essentials of a bank's value proposition, such as brand, innovation, investment strategy, and shareholder and consumer value, as attributes of Islamic banking identifiable by Muslims and non-Muslims.

Understanding Islamic Finance

Muhammad Ayub

Wiley Finance Series
Hoboken, New Jersey: Wiley, 2007
532pp, ISBN: 978-0-470-03069-1

This introduction to Islamic finance explains all the key concepts, principles, products, and processes of this growing market. It presents a clear background and history, exploring how the concepts are rooted in Islamic law, the Islamic economic system, and *shariah* compliance. It discusses Islamic economics as a rule-based system better understood as a set of contracts, and examines how to design financial instruments compatible with Islamic jurisprudence.

Venture Capital, Islamic Finance and SMEs: Valuation, Structuring and Monitoring Practices in India

Mansoor Durrani, Grahame Boocock

Basingstoke, UK: Palgrave Macmillan, 2006
240pp, ISBN: 978-1-4039-3638-7

An investigation into how the venture capital sector operates to support the growth and development of small and medium-sized enterprises (SMEs), this book provides a practical overview of the techniques used by venture capitalists to value, structure, and monitor their investments. It also considers how Islamic finance can be an alternative source of risk finance for SMEs, and is backed up by empirical data from India.

MAGAZINES

Arab Banker

Arab Bankers Association

43 Upper Grosvenor Street, London, W1K 2NJ, UK
T: +44 (0) 20 7659 4889
F: +44 (0) 20 7659 4658
www.arab-banker.com
ISSN: 0261-2925

This magazine, published twice yearly by the Arab Bankers Association, covers current affairs, commentary, people in the news, company news, and bank results.

Business Islamica

Business Enterprise for Media and Publishing

Damaa Center, 6th Floor, Kaslik, Lebanon
T: +961 9 211895
F: +961 9 211740
www.islamica-me.com

This monthly magazine covers all aspects of Islamic business and finance, both regionally and internationally. It aims to highlight initiatives and help educate on the latest developments in the industry, and provides interviews with key industry leaders, case studies, and features on a range of Islamic finance topics.

Global Islamic Finance

Business Media Group
Marble Arch Tower, London, W1H 7AA, UK
T: +44 (0) 20 7859 8201
F: +44 (0) 20 7183 4004
www.globalislamicfinancemagazine.com

This monthly magazine is aimed at bankers, business professionals, brokers, insurers, corporate advisers, and providers of financial services working in the Islamic financial sector. It provides news, balanced market intelligence, reviews, research, comment, analysis, and sources of business funding.

Islamic Banking and Finance

New Millennium Publishing
69 Grand Parade, Brighton, East Sussex, BN2 9TS, UK
T: +44 (0) 560 116 9695
F: +44 (0) 700 603 4010
www.islamicbankingandfinance.com
ISSN: 1814-8042

This magazine, published six times each year, reports on all aspects of Islamic banking and finance, and core topics such as *takaful*, law, software, and property. It features news, analysis, microfinance, viewpoints, business scope, latest products and services, data from the latest Dow Jones Islamic Market Indexes, and regular special country reports.

Islamic Finance Asia

REDmoney
21/F, Menara Park, 12, Jalan Yap Kwan Seng, 50450
Kuala Lumpur, Malaysia
T: +603 2162 7800
F: +603 2162 7810
www.islamicfinanceasia.com

This bimonthly global magazine is distributed free to all qualified corporate individuals within the Islamic finance market. It provides research and commentary on *takaful* and re-*takaful*, retails, ratings, and funds, and features information on Asian and global activity, as well as reviews, moves, and events.

Islamic Finance News

REDmoney
21/F, Menara Park, 12, Jalan Yap Kwan Seng, 50450
Kuala Lumpur, Malaysia
T: +603 2162 7800
F: +603 2162 7810
www.islamicfinancenews.com

This weekly e-newsletter focuses on the global Islamic financing market and related instruments. It produces news briefs, detailed country and industry sector reports, a research review, retail news, legal updates, and information on moves and promotions, events and training courses, and league tables. Its website carries all content from the newsletter, in addition to useful supplements, books, directories, and a database.

NewHorizon

IBS Intelligence
8 Stade Street, Hythe, Kent, CT21 6BE, UK
T: +44 (0) 1303 262636
F: +44 (0) 1303 262646
www.islamic-banking.com/IIBI_magazine.aspx
ISSN: 0955-095X

A quarterly magazine from the Institute of Islamic Banking and Insurance, *NewHorizon* focuses on the Islamic financial services industry, offering news, views, and new trends that affect the industry worldwide. Each issue provides a country focus, academic articles, interviews, in-depth features, job moves, Islamic indices, and forthcoming training programs.

Quantum

Camel5 Publishing
The Heymarsh, Britford, Salisbury, SP5 4DU, UK
T: +44 (0) 20 8670 1922
www.quantummagazine.com

This quarterly magazine, published on behalf of the Qatar Financial Centre Authority, presents a global perspective in its analysis of significant international and regional trends in the financial services industry. It encourages debate and provides a forum for leading decision makers to present arguments and challenge conventional wisdom. Its contributors include senior market practitioners, analysts, academics, and journalists.

True Banking

Al Huda Center of Islamic Banking and Islamic Economics
192 Ahmad Block, New Garden Town, Lahore, Pakistan
T: +92 42 591 3096
F: +92 42 591 3056
www.truebanking.com.pk

This is a bimonthly magazine dedicated to the banking and financial services sector, focusing on industry news and analysis, new financial products, research and development, market analysis, training, and education in Islamic banking, *takaful*, and investment.

JOURNALS

International Journal of Islamic and Middle Eastern Finance and Management

Emerald Group Publishing
Howard House, Wagon Lane, Bingley, BD16 1WA, UK
T: +44 (0) 1274 777700
F: +44 (0) 1274 785201
www.emeraldinsight.com/products/journals/journals.htm?id=imefm
ISSN: 1753-8394

This quarterly journal provides original research and analysis into the growth of Islamic banking, finance and financial services, and personal finance, including hedge funds, Islamic bonds, retail and corporate lines of Islamic credit and derivatives, mortgages, auto financing, and consumer finance. It offers dedicated sections on news, new products, market/sector reports, and extended book reviews.

Islamic Economic Bulletin

Indian Association for Islamic Economics
4/1914, Faridi House, S. S. Nagar, Aligarh, 202002, India
T: +91 571 240 1028
www.iafie.net/bulletins.html

This academic newsletter, published six times each year by the Indian Association for Islamic Economics, aims to create awareness of the latest development in theory and practice of Islamic economics.

Islamic Economic Studies

Islamic Research and Training Institute
PO Box 9201, Jeddah 21413, Saudi Arabia
T: +966 2636 1400
F: +966 2637 8927
www.irti.org/irj/portal/anonymous/irtijournal
ISSN: 1319-1616

This journal, published biannually in Muharram and Rajab, according to the Islamic calendar, offers papers that make a contribution to Islamic economics, either theoretical or applied, or discuss an economic issue from an Islamic perspective.

ISRA International Journal of Islamic Finance

International Shari'ah Research Academy for Islamic Finance
ISRA @ INCEIF, 2nd Floor, Annexe Block, Menara Tun Razak, Jalan Raja Laut, 50350 Kuala Lumpur, Malaysia
T: +603 2781 4000
F: +603 2691 1940
www.isra.my/publications/journal/366.html
ISSN: 0128-1976

This journal covers contemporary research issues in Islamic finance, with the objective of assisting the development of knowledge and original thought in the sector, particularly in the area of *shariah* methodologies and processes. It offers academic papers that explore the main aspects of Islamic finance, as well as providing insights and practical solutions for the various challenges and issues faced by the industry.

Journal of Islamic Accounting and Business Research

Emerald Group Publishing
Howard House, Wagon Lane, Bingley, BD16 1WA, UK
T: +44 (0) 1274 777700
F: +44 (0) 1274 785201
www.emeraldinsight.com/products/journals/journals.htm?id=jiabr
ISSN: 1759-0817

This new journal (first published in 2010) seeks to provide a forum for the advancement of accounting and business knowledge based on *shariah* law and principles. It covers the interplay between Islamic business ethics, accounting, auditing, and governance through technical papers on theoretical and empirical research and practice.

Journal of Islamic Banking and Finance

International Association of Islamic Banks
Karachi, Pakistan
T: +92 21 5837315
F: +92 21 5823465
ISSN: 1814-8042

This quarterly journal publishes research and analysis of Islamic principles relating to banking, finance, and economics, and produces reports about financial institutions and banks in the Middle East and other Islamic countries.

Journal of Islamic Economics, Banking and Finance

Islami Bank Training and Research Academy
13A/2A, Block B, Babar Road, Mohammadpur, Dhaka 1207, Bangladesh
T: +88 02 9139299
F: +88 02 9139952
www.ibtra.com/journal_index.html
ISSN: 2070-4658

Published quarterly, this technical journal from the Islami Bank Training and Research Academy offers applied research on theoretical and applied aspects of conventional and

Islamic economics, finance, and banking. It focuses on papers that cover the potential for promoting and expanding economic and technical cooperation among various financial institutions around the world.

Review of Islamic Economics

International Association of Islamic Economics and the Islamic Foundation
Markfield Conference Centre, Ratby Lane, Markfield, Leicestershire, LE67 9SY, UK
T: +44 (0) 1530 244944
F: +44 (0) 1530 244946
www.islamic-foundation.org.uk/User/Journals.aspx?id=21
ISSN: 0962-2055

This biannual journal, published by the International Association of Islamic Economics and the Islamic Foundation, presents research articles in the field of Islamic economics, banking, and finance. It focuses on theoretical issues in economics dealt with from an Islamic perspective, empirical studies about the economies of Muslim countries, applied Islamic economics, and survey articles in various fields of Islamic economics.

So Far: The Journal of Strategic Thinking in Islamic Finance

Yasaar Media
DIFC, The Gate District, Precinct Building 3, 607 Level 6 East, PO Box 506765, Dubai, United Arab Emirates
T: +971 4 370 0701
F: +971 4 370 0702
www.yasaarmedia.com/products.html

This is a new online journal on strategic thinking in the Islamic financial and banking sector. Established in 2010, it is published bimonthly.

INTERNET

American Journal of Islamic Finance
www.ajif.org

The American Journal of Islamic Finance is an online resource on Islamic finance, which provides a range of useful information on the operations of Islamic banking, securities, and finance. It offers research papers on subjects such as money management, capital markets, economics, regulation, and treasury.

Global Center for Applied Islamic Finance
www.applied-islamicfinance.com

This online resource on Islamic banking, trade, and finance, as well as regulatory and legal aspects, provides practical research solutions to Islamic corporate issues. It also presents details on specialist areas, consultancy and advisory services, global updates, research, and publications.

HazaRiba.com
hazariba.com

This blog focuses on the issues of *riba* and Islamic banking, and provides information, articles, and downloads on the main themes and concepts.

Islam Online
islamonline.com/islamic-finance/islamic-finance.html

This respected information resource includes a section covering the Islamic finance and banking industry, offering news from a variety of sources.

The Islamic Banker
www.theislamicbanker.com

This is a respected, professional online magazine covering the Islamic financial services industry. It focuses on promoting the Islamic banking industry, enhancing employee and organizational performance through the provision of Islamic financial news, information, and details about events and conferences.

Islamic Banking and Finance News
www.alhudacibe.com/magdetail.php

This monthly online magazine has the objective of promoting a better awareness of the Islamic banking and finance industry worldwide. It provides national and international news, analysis, research, interviews, round table discussions, and product reviews, as well as partnering with different international Islamic financial institutions to offer Islamic banking and finance information services to financial institutions.

Islamic Banking Information
islamicbanking.info

This website provides information and analysis on all aspects of Islamic banking, as well as areas such as Islamic insurance, investment, mutual funds, and mortgages. It focuses on

modern Islamic banking and finance, discusses the various financial products that are now available, and outlines how Islamic economic models are changing the face of modern finance.

Islamic Banking Portal
www.islamicbankingportal.info
This portal provides a comprehensive and useful list of Islamic banks and financial institutions, and gathers news from a variety of international sources.

Islamic Banks and Financial Institutions Information System
www.ibisonline.net
This is aimed at researchers and finance professionals working in the area of Islamic economics and finance. It presents news, data, and information on the activities of Islamic finance and banking institutions, up-to-date research and literature, and a glossary, as well as tools for online analysis and download.

Islamic Business and Finance Network
www.iibf.org
IBF Net is a global network of students, researchers, bankers, and finance professionals interested in Islamic business and finance. It offers an online discussion forum and sponsors the International Institute of Islamic Business and Finance in its educational, training, and publication programs in India and overseas.

Islamic-Finance.com
www.islamic-finance.com
This is an independent online resource that features news and commentary, as well as articles, research, institutional information, market updates, a glossary, and details of events, books, jobs, and resources.

IslamicFinance.de
www.islamicfinance.de
This news and networking resource provides a portal for the Islamic finance industry, offering a forum for discussion of Islamic finance issues, as well as news, a wiki, events listings, forums, articles, links, blogs, and a FAQ.

Islamic Finance and Banking World
www.islamicfinanceandbankingworld.com
This website is an information portal with links to all the main websites on Islamic finance and banking. It provides an introduction to key concepts and trends, as well as a database of organizations that offer Islamic financial products, training, consulting services, banking systems and IT, company and market information, networks and professional associations, and supervision and legal frameworks.

Islamic Finance Information Service
www.securities.com/ifis
This information resource provides key Islamic research and features news and company information. It also covers Islamic bonds, banking, deals and transactions, capital markets and investments, funds, insurance, and finance league tables.

The Islamic Finance Portal
ifresource.com
This independent resource presents news and information on Islamic finance, as well as useful book lists, a glossary, an introduction to Islamic finance, and information on *shariah* scholars.

IslamiCity
www.islamicity.com/finance
This website aims to encourage international understanding of Islam and Muslims, and offers a wide range of information and services, including financial news, products, banking, loans, investment, and insurance.

Muslim Investor
muslim-investor.com
This website focuses on the provision of practical information about Islamic investment, banking, finance, and insurance for Muslims around the world. It presents basic information on banking, investment, and insurance services, and key financial and investment terminology in the sector.

World Database for Islamic Banking and Finance
www.wdibf.com
This online database provides information on websites related to Islamic banking and finance.

ORGANIZATIONS

Europe

Academy for International Modern Studies

244 Robin Hood Lane, Blue Bell Hill, Chatham, Kent, ME5 9JY, UK
www.learnislamicfinance.com

AIMS is an international organization that promotes industry professionalism and best practice in Islamic banking and finance. Its academic partnership program, developed in response to the growth of the Islamic finance industry, is led by a committee of Islamic *shariah* scholars, and it offers customized training programs, seminars, and workshops, as well as several certifications in areas of Islamic banking, finance, and insurance.

Arab Bankers Association

Chair: Antoine Sreih
43 Upper Grosvenor Street, London, W1K 2NJ, UK
T: +44 (0) 20 7659 4889
F: +44 (0) 20 7659 4658
E: arab-bankers@btconnect.com
www.arab-bankers.co.uk

This association seeks to develop ties between Arab professionals working in the financial services sector, and encourages the exchange of views, information, and expertise between the banking and financial sectors in the Arab world and their counterparts in the United Kingdom and other countries. It also provides services to the Arab banking and financial community, and fosters an awareness of recent financial developments in the region.

Institute of Islamic Banking and Insurance

12–14 Barkat House, 116–118 Finchley Road, London, NW3 5HT, UK
T: +44 (0) 20 7245 0404
F: +44 (0) 20 7245 9769
E: iibi@islamic-banking.com
www.islamic-banking.com

This UK-based organization provides professional education, training, research, and related activities with the purpose of increasing knowledge and understanding of Islamic principles in international finance. It contributes to the education and training of people in Islamic banking and insurance through a postgraduate diploma course, publications, lectures, seminars, workshops, research, *shariah* advisory services, and a website.

USA

Institute of Halal Investing

Chair: Mohammad Saeed Rahman
1234 SW 18th Avenue, Suite 105, Portland, OR 97205, USA
T: +1 503 548 4800
F: +1 503 548 4805
E: info@halalinvesting.org
instituteofhalalinvesting.org

This think tank on Islamic banking, finance, and investment offers research on *shariah*-compliant financial products, as well as being a central resource for the industry. It has a library of the latest research and white papers on Islamic banking, finance, and investing, organizes courses and seminars on all relevant topics, and publishes a newsletter.

International

Accounting and Auditing Organization for Islamic Financial Institutions

Block 304, Al Muthana Road, Yateem Center, Building 71, 4th Floor, Office 403, Manama, Bahrain
T: +973 244 496
F: +973 250 194
E: aaoifi@batelco.com.bh
www.aaoifi.com

AAOIFI is an Islamic independent, international, nonprofit organization that prepares accounting, auditing, governance, ethics, and *shariah* standards for Islamic financial institutions and the industry, and which also offers professional qualification programs.

Al Huda Center of Islamic Banking and Economics

Chair: M. Zubair Mughal
192 Ahmad Block, New Garden Town, Lahore, Pakistan
T: +92 42 585 8990
F: +92 42 591 3056
E: info@alhudacibe.com
www.alhudacibe.com

This organization provides education, training, workshops, awareness, and practice on Islamic banking, finance, *takaful*, and *sukuk*, mostly in Pakistan. It aims to train and develop bankers and finance professionals in the spiritual and intellectual heritage of Islam, and promote professional growth in this sector.

Association of Islamic Banking Institutions Malaysia

23rd Floor, Menara Tradewinds (Menara Tun Razak), Jalan Raja Laut, 50350 Kuala Lumpur, Malaysia
T: +60 3 2694 8002

F: +60 3 2694 8012
E: admin@aibim.com
www.aibim.com

This national organization promotes the establishment of sound Islamic banking systems and practices in Malaysia in cooperation with Bank Negara Malaysia and other regulatory bodies in the country. It also represents the interests of its members and encourages education and training in Islamic banking.

Ethica Institute of Islamic Finance

Chair: Atif R. Khan

Level 25, Monarch Office Tower, 1 Sheikh Zayed Road, PO Box 127150, Dubai, United Arab Emirates
T: +97 14 305 0782
F: +97 14 305 0783
E: contact@ethicainstitute.com
www.ethicainstitute.com

This accredited institute delivers online, standardized Islamic finance training and certification for both individuals and organizations, and trains and certifies professionals and students in Islamic finance through its website and training facilities in Dubai. As a dedicated Islamic finance training portal, it offers training videos, certification, career counseling, recruiting assistance, live webinars, and a library of scholar-approved answers.

General Council for Islamic Banks and Financial Institutions

Chair: Mohamed Ben Youssef

Building 2886, Road 2843, Block 228, Busateen, Bahrain
T: +973 1735 7300
F: +973 1732 4902
E: ekhoja@cibafi.org
www.cibafi.org/NewsCenter/English/

This is an international, nonprofit organization formed jointly by the Islamic Development Bank and other Islamic financial institutions to improve public awareness of Islamic *shariah* concepts, rules, and provisions related to the development of the Islamic financial industry. It works to enhance cooperation among its members and provides information related to Islamic financial institutions.

International Association of Islamic Banks

Jeddah, Saudi Arabia

This association promotes links among Islamic financial institutions and promotes cooperation in the industry. It also fosters the concept of Islamic banking, coordinates with Islamic banks to resolve common problems, provides assistance in manpower development, maintains a databank of all Islamic financial institutions, offers technical assistance in Islamic banking, and represents the interests of Islamic banks at all levels.

International Institute of Islamic Business and Finance

Chair: Ausaf Ahmad

G-51/3-B Fourth Floor, Abul Fazal Enclave II, Shaheen Bagh, Okhla, New Delhi 110025, India
T: +91 989 102 9390
E: shafeeq@iiibf.org
www.iiibf.org

IIIBF, sponsored by IBF Net, offers education, training, workshops, seminars, and publication programs in India and overseas.

International Islamic Financial Market

Chair: Khalid Hamad

PO Box 11454, Bahrain Tower, Office 171, 17th Floor, Building 20, Al Khalifa Avenue Block 305, Road 385, Manama, Bahrain
T: +973 17 500 161
F: +973 17 500 171
E: iifm@batelco.com.bh
www.iifm.net

IIFM is an organization founded by the central banks and monetary agencies of several countries, which advocates the establishment, development, self-regulation, and promotion of Islamic capital and money markets. It focuses on the advancement and standardization of Islamic financial instrument structures, contracts, product development, and infrastructure, as well as the issuance of guidelines and recommendations for the enhancement of Islamic capital and money markets globally.

Islami Bank Training and Research Academy

Chair: M. Nazrul Islam

13A/2A, Block # B, Babar Road, Mohammadpur, Dhaka 1207, Bangladesh
T: +88 02 9139299
F: +88 02 9139952
E: journal@ibtra.com
www.ibtra.com

This organization provides training and research on Islamic finance for Islami Bank employees and other financial institutions in the region.

It conducts training courses, seminars, workshops, and development programs, a motivational program for clients, publishes the *Journal of Islamic Economics, Banking and Finance*, and has a library of relevant books, journals, and research articles.

Islamic Banking and Finance Institute Malaysia

Chair: YBhg Tan Sri Dato' Azman Hashim
3rd Floor, Dataran Kewangan Darul Takaful, Jalan Sultan Sulaiman, Kuala Lumpur 5000, Malaysia
T: +603 2031 1010
F: +603 2031 9191
E: info@ibfim.com
www.ibfim.com

IBFIM is an industry-owned institute dedicated to improving the training and competence of those working in the Islamic finance and banking industry, with the aim of assisting the growth and professionalism of the sector.

Islamic Financial Services Board

Chair: Hamad Al-Sayari
3rd Floor, Block A, Bank Negara Malaysia Building, Jalan Dato' Onn, 50480 Kuala Lumpur, Malaysia
T: +603 2698 4248
F: +603 2698 4280
E: ifsb_sec@ifsb.org
www.ifsb.org

This organization serves as an international standard-setting body of regulatory and supervisory agencies focused on ensuring the soundness and stability of the Islamic financial services industry. It promotes the sector through international standards consistent with *shariah* principles, and ensures that its work complements regulatory development by other international institutions.

Islamic International Rating Agency

Chair: Khaled M. Al-Aboodi
Al-Zamil Tower, 7th Floor, Government Avenue, Manama 305, PO Box 20582, Bahrain
T: +973 1721 1606
F: +973 1721 1605
E: iira@iirating.com
www.iirating.com

IIRA is a credit rating agency that assists the Islamic financial services industry in gaining recognition, both locally and internationally, as strong and capable financial institutions, and promotes greater standards of disclosure and transparency. It also supports the development and functioning of the regional capital market, and acts as a resource for credit ratings in accordance with *shariah* principles.

Islamic Research and Training Institute

Chair: Ahmad Mohamed Ali Al-Madani
PO Box 9201, Jeddah 21413, Saudi Arabia
T: +966 2636 1400
F: +966 2637 8927
E: irti@isdb.org
www.irti.org

IRTI undertakes research on economic, financial, and banking activities in Muslim countries, to conform to *shariah*, and offers training facilities for professionals engaged in Islamic economics and banking in Islamic Development Bank member countries. It also organizes and coordinates research on models and their application in economics, finance, and banking.

Malaysia International Islamic Financial Centre

Bank Negara Malaysia, Jalan Dato' Onn, 50480 Kuala Lumpur, Malaysia
T: +603 2692 3481
F: +603 2692 6024
www.mifc.com

MIFC is a community network of financial and market regulatory bodies, government ministries and agencies, financial institutions, human capital development institutions, and professional services companies that are participating in the field of Islamic finance. It also works to promote Malaysia as a hub for Islamic finance in the region.

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