Conventional?

The Relationship between Islamic Finance and the Financial Mainstream

Edited by Charles Beard

The Arab Financial Forum (AFF) brings together senior figures from the public and private sector concerned with the development of Arab capital markets. Such development is essential to the growth of Arab economies. The AFF commissions relevant research, holds workshops and briefings, and produces a fortnightly newsletter.

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Key issues are the development of Arab capital markets, the integration of Islamic finance within conventional structures, regulation and relations with non-Arab counterparts dealing with capital markets.

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Introduction: Progress and Challenges in Mainstreaming Islamic Finance

by

Charles Beard[1]

Islamic finance has been alternately described as either a minor—if lucrative—niche market or the "next big thing" in finance. The Arab Financial Forum (AFF) began this study to clarify which side of this debate, if either, is correct. If the former, Islamic finance might be a passing fad, or at most an interesting hedge investment, but it would be counterproductive to devote resources to "mainstreaming" the industry. If the latter, companies ought not to speak of mainstreaming Islamic finance, but rather adapting a significant portion of their own financial practices to conform to sharia.

It is difficult to discuss the mainstreaming of Islamic finance in this context. Fortunately, this study discovered that neither of these possibilities is likely. The leaps and bounds by which Islamic finance has grown—at least 15% per year to an estimated $1 trillion[2]—prove that it is profitable enough that mainstream financial companies ought to seriously consider, as many have, investing in Islamic finance, especially in these days of high oil prices and the resulting excess liquidity in the Gulf. However, it has not proven so profitable that it poses any sort of threat—as some have argued—to conventional finance. In this environment we can indeed speak of bringing Islamic finance into the financial mainstream.

The actual process of mainstreaming Islamic finance presents its own set of problems. As Hiba Allam argues in this study, at the risk of stating the obvious, it is impossible to separate the industry from Islam; this presents strictures that are at least perceived to be eternal and thus nearly impossible to negotiate around. Shaikh Yusuf DeLorenzo demonstrates this quite well in his case study on "sharia conversion" technology: highly creative ways of circumventing Islamic law can meet with great

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[2] Hong Kong Financial Secretary John Tsang, quoted on Forbes.com. http://www.forbes.com/markets/feeds/afx/2007/09/10/afx4097991.html. Accessed 8 July 2008.

opposition among sharia scholars. Because of these limitations, Islamic finance by definition must maintain a certain amount of separation from conventional finance.

This separation, however, does not mean that conventional financial companies cannot or should not invest in Islamic finance. While Nicholas Van Zandt tends to be skeptical of Islamic finance, he points out that the industry is useful for venture capital projects, providing the possibility of convergence with large companies in the conventional sector. Kevin Newton and Samer Budeir, both more optimistic about the industry as a whole, show how Islamic finance can benefit small business and development in both the Islamic and non-Islamic worlds. Newton argues that micro-credit—which charges simple interest— is compatible with sharia, allowing both sharia- and non-sharia-compliant industries to cooperate in helping small businesses worldwide. Budeir investigates the sukuk issued by the German state of Saxony-Anhalt and shows how Islamic finance can be used successfully to attract foreign direct investment from the Gulf and elsewhere. In these ways, Islamic finance can benefit conventional finance and vice versa.

Nor are the added risk and regulation factors insurmountable. Warren Edwardes points out that risk assessment in Islamic finance is not terribly different from that of conventional finance, and emphasizes that the worst risk to have for both industries is zero risk—that is, risk must be taken in order to make a profit. Khalid Hamad provides a very thorough article on how the Central Bank of Bahrain regulates Islamic financial companies in light of the Basel II regulations, perhaps providing a template for how other central banks can do the same. Finally Abdi Shayesteh shows that even the United States—so often accused of Islamophobia—has taken steps toward regulating Islamic finance with an eye toward making it a viable alternative to conventional finance. These articles show that Islamic finance is, if not fully compatible with the financial mainstream, at least not inimical to it, providing opportunities for each to profit from the other.

Mainstreaming Islamic finance, then, is not an exercise in subsuming it into conventional finance or the other way around. On the part of conventional finance, it involves acknowledgement of its legal and religious restrictions while at the same time respecting the fact that it can indeed be profitable. This acknowledgement ought

to bring more experienced financial professionals into the sharia-compliant industry, and improve its human capital as thereby its mainstream potential.

For Islamic finance, mainstreaming will involve better definition of those same legal and religious restrictions, as well as better regulation on the national and international levels. DeLorenzo's article is notable in part because some sharia boards at Islamic banks are giving approval to the very practice he condemns. This problem exists side by side with the progress seen in the detailed regulatory analysis put forward by bodies such as the Central Bank of Bahrain. As the reader will see in this study, the regulatory matters are resolving themselves, while sometimes vastly different interpretations of sharia remain.

I must add a word about transliteration from the Arabic. The discussion of the correct way to transliterate Arabic letters into Roman letters is interesting, but not for purposes of this study. I have kept the contributors' various transliterations intact out of respect for the authors.

I would like to thank Clifford Chance in London for the opportunity to present this study at their office. I would also like to thank Ian Walker, Director of the AFF, without whose support this study would not have been possible. Most of all, I want to thank the contributors who made this study so valuable. Finally, I wish to thank Jenn for enduring my many rants, raves, and brainstorms during this study.

Charles Beard
Arab Financial Forum
Editor

Preliminary Thoughts on "Mainstreaming" Islamic Finance

by

Hiba Allam[3]

The structuring and financing of investments in compliance with *Shari'a* is a growing phenomenon and the opportunities which lie ahead for Islamic finance are as numerous as the challenges it faces moving forward.

It is important, for the credibility and sustainable growth of Islamic finance, to understand the ultimate significance and the context of Islamic finance. Islamic finance is an integral part of a more global economic and political system based on the principles of equity and fairness as revealed in the Qur'an, and announced in the *Sunna*. However, Islamic finance is mostly viewed in isolation and is often given a wide range of definitions ranging from an interest free banking system, to ethical finance to a *Shari'a* compliant equivalent of the conventional financial system. This ambiguous approach leads to Islamic finance being criticized for its complexity, its lack of legal frames of reference and its mimicking of conventional financing and corporate transactions. Rather than modifying the common approach to Islamic finance, it has been argued that the criticisms generally opposed to such finance may be overcome by mainstreaming Islamic finance. Though there are numerous challenges to mainstreaming Islamic finance, the increasing sophistication of Islamic finance instruments and structures has rendered pertinent the consideration of the issue of the "mainstreaming" of Islamic finance.

Challenges in mainstreaming Islamic finance

The challenges faced in mainstreaming Islamic finance vary in accordance with what is actually meant by "mainstreaming".

Mainstreaming of Islamic finance may be defined as the action of bringing such finance into the norm or into the common current of thoughts of the non-*Shari'a* compliant finance. As such, the idea of mainstreaming Islamic finance (i.e. bringing

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Islamic finance in line with conventional finance) would appear to be self-contradictory. Islamic finance is the commercial activity of providing funds and capital in accordance with the teachings of Islam. Consequently, Islamic finance cannot be dissociated from the religion which underlies it and, to some extent, it cannot properly and fully operate outside the economic system ordained by the *Shari'a*. At a risk of stating the obvious, Islamic finance is what conventional finance is not. Indeed, most of the Islamic finance instruments are being rediscovered and elaborated in opposition to conventional financial instruments and as a viable substitute to conventional finance. It would be inappropriate to disentangle Islamic finance from the social and economical context within which it evolves. The principles behind Islamic finance, just like that of conventional finance, are shaped and influenced by the social, religious, political and economical structure of the society in which it were and are being developed. Therefore, it is patent that aligning the planning and the structuring of Islamic finance would be, at best, geographical and financial market specific.

Mainstreaming of Islamic finance may also be understood as the necessity to develop common *Shari'a* compliant standards and approaches that would allow greater certainty and a better cooperation amongst all the parties to modern *Shari'a*-compliant transactions. Aligning the planning and the structuring of the Islamic finance sector to the evolving industry needs is essential to maximize the growth and potential for Islamic financial services and products worldwide. However, this is not an easy task given the complexity of *Shari'a* and the historical differences between the various Muslim schools of thoughts. To give but one example, the four main Muslim schools of thoughts (Hanafi, Hanbali, Ja'afari and Shafa'i) have adopted varying approaches to the prohibition of interest and to the concept of uncertainty. As a consequence, these schools have not assumed the same position vis a vis the validity of some conventional transactions involving interest or uncertainty (such as conventional insurance).

However, in a world where global transactions are growing fast, it is critical for the Islamic financial sector to endeavor to harmonize the practice of Islamic finance in order to enable institutions to confidently offer a wide range of products and services in line with *Shari'a* principles and that meet the evolving needs of the market. One

means of achieving such harmonization is through a synchronization of the religious opinions approving or justifying the finance or corporate models (which we will refer to here as "***Shari'a*** **regulations**").

Harmonization of the *Shari'a* Regulations

The growth in the demand for *Shari'a* compliant investment products have led, over the past decades, to the rediscovery of commercial instruments accepted and used over 1400 years ago (such as *mudaraba*, *musharaka*, *murabaha*, *waqala*). However, this is not to say that the commercial instruments accepted and used at the time of the Prophet are not adapted to modern financial or corporate transactions. Such instruments are general in nature and are fairly adaptable to the needs of the modern finance and corporate deals. These instruments have quite obviously been used in the context of modern and complex financial transactions.

Islamic finance, whether at the time of the Prophet or during modern times, is essentially about real transactions which have embedded within them concepts of justice, fairness and equity. Such concepts should not be clouded by the sometimes complicated scholarly arguments.

Harmonization of the *Shari'a* regulations in Islamic finance would inevitably reduce some of the costs and time faced by financial institutions offering *Shari'a* compliant products and would, in the short term, give more credibility to the Islamic finance industry and, in the longer term, ease the progress of the Islamic finance industry and maximize the growth and potential for Islamic financial services and products worldwide. The creation of a comprehensive and conducive organizational structure, supported by well trained individuals and management teams having the necessary knowledge of the *Shari'a* Regulations and the requisite technical expertise would also work towards the demystification of Islamic finance.

However, the rationale underlying the need to harmonize the *Shari'a* regulations should remain that of justice, fairness and equity and not that of a mechanism to overcome the practical limits on Islamic investing to bring Islamic finance, as much as possible, in line with what the market is familiar with in terms of conventional finance and corporate transactions. Indeed, for Islamic finance to achieve a

sustainable growth, the harmonization of *Shari'a* regulations should not take place at the cost of sacrificing the ethical foundations of Islamic finance in order to achieve short term profits. This would only be profitable to those riding the Islamic finance wave.

The Total Returns Swap and the "Shariah Conversion Technology" Stratagem

by

Yusuf Talal DeLorenzo[4]

Summary

This study will look at Islamic values in financial decision-making by considering whether or not Shariah Supervisory Boards will approve any financial product that is delivered by ostensibly *halal* means, even if what is delivered by those means, the end product, is derived from non-compliant investments. This may be characterized as a quasi-philosophical question about means and ends. Yet, it is one that carries a myriad of practical implications and far-reaching ramifications for the growing Islamic financial industry.

This is a case study, and not a theoretical study. The focus of the study is a particular means or process for the development of products sometimes called "Shariah Conversion Technology". The reason for writing this paper is to draw the attention of scholars and industry experts to the importance of making a distinction between bringing returns from Shariah-compliant investments and bringing returns from non-Shariah compliant investments. If care is not taken, this "technology" represents a great danger to modern Islamic Finance. My own reaction to this threat, initially, was to suggest recourse to *sadd al-dhara`i*, the instrument in Islamic jurisprudence that blocks ostensibly legitimate means to illegitimate ends. On closer study, however, I have concluded that there is no need to resort to this instrument as the matter is simply one of distinguishing between what is truly lawful, *halal*, and what is truly unlawful, *haram*. In what follows, I will explain exactly what led me to this conclusion, and why I think it necessary to share my thoughts on the matter.

To date, I have shared this paper with only a handful of scholars and colleagues. In the coming months, however, Islamic banks and investment houses will look closely

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at products based on the “Shariah Conversion Technology” stratagem, and Shariah boards will be asked to deliberate and opine on the compliance of such products with the rules of the Shariah. My intention in circulating this paper is to contribute to a wider and more comprehensive understanding of this particular stratagem. At a time when Shariah scholars are increasingly being asked to opine on new and exotic products, I believe that due consideration must be given to not only the literal structure of products and processes, but also to their consequences for the future of Islamic Finance.[5] In other words, while up until now the Shariah supervisory boards of modern Islamic financial institutions have focused almost exclusively on the rules for transacting in compliance with the Shariah, it is now time for them to focus as well on the higher purposes of Islamic law or the *maqasid al-Shari`ah*.

Introduction

Recently, a financial stratagem known as “Shariah Conversion Technology” was developed, the purpose of which is to affect a total returns swap or to “Wrap a non-Shariah compliant underlying into a Shariah compliant structure.”[6] In other words, the objective of the mechanism is to use non-compliant assets and their performance to bring returns into a so-called Shariah-compliant investment or investment portfolio.

This point is key to the entire transaction, and for that reason it needs repeating. What the product proposes to accomplish is to bring to the Islamic investor returns from investments that are not compliant with Shariah principles and precepts. The questions that such a product immediately brings to mind are: How can Shariah boards approve such returns? Does the circumstance of direct or indirect delivery to the Islamic investor change the ruling? When the Shariah of Islam is understood to differ from other legal systems because it may be characterized as both positive law

[5] In an article entitled “The Black Box Syndrome” which I wrote for the April 2007 issue of *Islamic Finance*, I wrote: “I would like to see more faith in what true and diligent Shariah compliance actually means to our industry. I am dismayed by quick fixes and shortcuts which in many cases circumvent the Shariah. The industry has proved time and again that adherence to the principles of Shariah can be profitable, and that such adherence does not spell hardship. We have no need of “black boxes” and of arm's length transactions that miraculously produce results by sacrificing the spirit of the Shariah to the letter of the law.”

[6] Quoted from a term sheet presented to the author by a multinational bank seeking approval for a structured product based on this stratagem.

and morality,[7] is it possible to ignore the moral aspect of a financial transaction like this?

The means of delivery, a *wa'd* or promise, is widely seen to comply with Shariah norms. Since it is compliant, at least to the letter of the law,[8] some Shariah scholars have approved products that use a *wa'd* to deliver returns from non-compliant investments. By doing so, however, they have failed to consider the purpose of the transaction, they have failed to consider the movement of the cash and, most importantly, they have failed to consider the ramifications for the industry as a whole.

At a very fundamental level, the reason for these failings is that they have not discerned the difference between the use of LIBOR as a benchmark for pricing and the use of non-Shariah compliant assets as a determinant for returns. In June of 2007, a pioneering Islamic bank in the Gulf launched a principal protected note that was the first product using this "Shariah Conversion Technology' to be offered to the investing public. This was followed by another such product, also offered by a Gulf-based Islamic bank. Prior to this, the stratagem was used in structured products offered by multinational banks to institutional investors and the treasuries of Islamic banks and finance houses. All of these products have been approved and certified by Shariah supervisory boards. Not all of these products, however, bring to the Islamic investor returns from investments that are compliant with Shariah.

A Few Explanations

Before examining the "Shariah Conversion Technology" stratagem from an Islamic legal perspective, however, it may be helpful to make a few preliminary remarks.

1. There should be no reason to object to the use of a *wa'd* on its own. The use of promises is a matter that the Shariah boards of modern Islamic financial institutions

[7] For a discussion of how the classical jurists of Islam assumed the role of "moralists-cum-jurists" within Muslim society, see Bernard Weiss, *The Spirit of Islamic Law* (Athens and London: The University of Georgia Press, 1998) pp.165-166.

[8] "…for the jurists, letter and spirit can never be in genuine conflict if by "letter" one means the clear, unambiguous pronouncements of the authoritative texts and if by "spirit" one means a divinely ordained principle derivable from those same texts." Weiss, op. cit., p.169.

have studied in detail.[9] Therefore, it will not be necessary to discuss the definition of a promise, its purpose, or its legal characterization (in terms of *wajib*, *makruh*, etc.).

2. The financial instrument that the *wa'd* structure seeks to facilitate is called a swap. Swaps are arrangements between counterparties to exchange cash flows over time, and they are very flexible. In conventional finance, the most popular forms of swaps are interest-rate swaps and currency swaps because these allow for the effective management of both balance sheets and risk profiles. In an interest rate swap, for example, no principal is exchanged between the counterparties; only interest is exchanged. The utility of a swap comes from the ease with which it is initiated and completed, as opposed to the numerous steps required to accomplish the same thing by other means.

3. LIBOR (the London Inter-bank Offered Rate) is the rate at which international banks charge one another for dollar denominated-loans in the London market and is therefore used widely as a reference for any floating-rate loan. Depending on the credit rating of the borrower, that rate may vary from LIBOR to LIBOR plus one or more points over LIBOR.

Before discussing the purpose of the "Shariah Conversion Technology" stratagem, the movement of the cash and, most importantly, the ramifications for the industry as a whole, it will be well to look at (1) how the "Shariah Conversion Technology" stratagem is actually employed, and then (2) at the difference between the use of LIBOR as a benchmark for pricing and the use of non-Shariah-compliant assets as a determinant for returns.

[9] The modified form of the classical murabahah sale has been the mainstay of Islamic banking for the past twenty or more years, accounting for as much as 70% of all Shariah-compliant transactions (until about five years ago). The modern version of the murabahah includes a promise on the part of the client ordering the purchase, al-Amir bi'l-Shira', that it will repurchase the goods acquired by the bank on its behalf. From a modern business perspective, it is essential for the bank that such a promise be considered binding. Thus, while the notion that a promise is binding was a minority opinion in the classical jurisprudence, modern Shariah boards have almost unanimously held the promise to be binding. Nicholas Dylan Ray, Arab Islamic Banking and the Renewal of Islamic Law (London: Graham & Trotman, 1995) pp. 51-54.

"Shariah Conversion Technology" Stratagem

The stratagem developed for the exchange of non-Shariah-compliant returns for Shariah-compliant returns generally begins with the purchase by the Islamic investor of Shariah-compliant assets by means of a Shariah-compliant contract such as a salam sale or a murabahah. In most cases, the subject of these transactions will be commodities or base metals. Through such contracts, the bank can offer apparent Shariah compliance and nominal fixed returns of, say, 4-5%. Then, to give the investor the ability to enhance the returns from the investment, the bank arranges to swap the returns from the Shariah-compliant transaction with returns from another investment. The way it does this is by means of a promise, a *wa'd*. Effectively, what the promise says is that at maturity, or at the end of a certain period of time (generally three to five years) the counterparties promise to swap their returns.[10] The bank can then take the further step of protecting the principal invested by the Islamic investor by one means or another.[11]

The benefits to the Islamic investor are obvious; the principal is protected, the returns will almost certainly be at least 4-5% (from the Shariah-compliant investment), and there is a strong likelihood that the assets in the other basket will outperform the Shariah compliant investment. The benefits to the bank may not be quite so obvious, but in fact they are far greater than the benefits to the Islamic investors as we shall see later in this paper when we "follow the money."

Most importantly, however, the Islamic investor is told that the investment is completely Shariah-compliant. This is because the money invested has been used for nothing other than the purchase of Shariah-compliant commodities by means of a Shariah-compliant contract like a salam sale. The return on the investment, if it comes from the salam sale, is clearly compliant with Shariah principles and precepts. And if the return comes from the other investment, by means of the stratagem

[10] The promise may also include a condition. For example, if the returns from the other basket of assets are greater than the returns from the salam or the murabahah, then the parties promise to swap.

[11] Such principal protected products are similar in design to conventional capital guaranteed products with the obvious difference that to be Shariah compliant the capital must remain at risk. Using structured products, banks can "protect" the capital without actually guaranteeing its return. Such products have been on the market for a number of years and have won the approval of many Shariah boards. Generally speaking, principal protection employs either options or dynamic allocations among baskets of assets with varying degrees of risk.

employing a promise to exchange returns, those returns, so says the bank, may be considered legitimate, *halal*, even if the investment is non-Shariah-compliant. According to the Shariah boards that have approved such exchanges, the non-Shariah-compliant assets have been used to establish a price; and the promised exchange is for the value of the returns established by the performance of the non-Shariah-compliant assets. This, they reason, is no different than using LIBOR, an interest rate,[12] to establish the price for a murabahah or an ijarah. If the use of LIBOR has been nearly universally approved by Shariah boards, then the swap achieved by a promise, the "Shariah Conversion Technology" stratagem should also be approved.

LIBOR and How Returns are Determined

Let us now consider the difference between the use of LIBOR as a benchmark for returns and the use of non-Shariah-compliant assets as a determinant for returns. Shariah boards have approved any number of less than ideal devices if they have been convinced that these will assist in promoting the industry in general. A good example is the use of LIBOR as a benchmark for pricing a murabahah or an ijarah when floating rates are to be preferred over fixed rates. In the absence of a viable and widely-published alternative, LIBOR has been used repeatedly; and will likely continue to be used until the industry can develop and then agree upon a benchmark, or a set of benchmarks, based on criteria of its own, i.e., Shariah-compliant criteria. In the final analysis, a benchmark is no more than a standard, and therefore non-objectionable from a Shariah perspective. If it is used to determine the rate of repayment on a loan, then it is the interest-bearing loan that will be *haram*. LIBOR, as a mere benchmark, has no direct effect on the actual transaction or, more specifically, with the creation of revenues.

In modern Islamic financial transactions, LIBOR has been used to facilitate the closing of literally hundreds, if not thousands, of Shariah compliant financings. It should be noted, however, that these do not involve interest. As explained above, LIBOR is merely a convenient and highly transparent measure of the financial markets. Most importantly, the use of LIBOR as a benchmark for pricing in no way means that interest has entered the transaction itself. This is because LIBOR is a

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[12] LIBOR is the London Inter-Bank Offered Rate or the rate of interest at which banks in London offer to lend funds to other banks in London.

notional rate. The bank loans that determine this rate will under no circumstances become a part of the Shariah-compliant ijarah or murabahah transaction that is benchmarked to LIBOR. Finally, the money paid into an ijarah investment using LIBOR will never pass through to the banks whose rates contribute to the setting of LIBOR, and will certainly never finance, directly or indirectly, assets whose performance or credit rating will set that rate.

When a Muslim investor invests in a product that uses a promise to swap returns from a non-Shariah-compliant investment, however, the matter is quite different. For, while LIBOR is a benchmark used to set a price by marking value, the *wa'd* is used to actually deliver that price, even if it does so synthetically. By means of the "Shariah Conversion Technology" stratagem, the unwitting Muslim investor actually participates in the non-Shariah-compliant investment, however indirectly. This is because, when the investor agrees to exchange murabahah returns for returns from another investment, the investor indicates *qubul* or approval of the other investment.

If that investment includes non-compliant assets and instruments, like conventional bonds or treasury bills, then the investor is approving the same and the transaction must be considered unlawful. Finally, and perhaps most significantly, the money paid into an investment employing the "Shariah Conversion Technology" stratagem will most certainly be used to finance the other investment(s), however indirectly.

Therefore, even if the Muslim investor is not directly financing non-Shariah-compliant transactions, if the investment with the swap had not been made, those non-Shariah-compliant transactions would not have taken place. This will be clarified later when we consider how the cash in such a transaction actually moves.

The attempt to draw a legal analogy, *qiyas*, between the use of LIBOR for pricing and the use of the performance of non-Shariah-compliant assets for pricing is both inaccurate and misleading. The only similarity is that both are used for pricing. Where LIBOR is used to indicate the return, however, the other is used to deliver the return or, as we shall see, the other is the return. Therefore, it is simply incorrect to justify the swap of returns from non-Shariah-compliant assets by comparing the same

to LIBOR and then saying that since the one is approved by Shariah supervisory boards, the other should also be approved.

The Purpose of the Transaction

The purpose of the transaction was clarified by a spokesperson for the bank offering the product to the public who explained that it was designed to allow Muslim investors access to funds that operate in a non-Shariah compliant manner by “reflecting their performance.” The euphemistic description of what the product aims to achieve, like the simplistic explanation of how the money in the investment remains exclusively in compliance with Shariah rules, is in my opinion a manipulation and, ultimately, a misrepresentation of the truth. The term sheet for one such product states unequivocally that its purpose is to “wrap a non-Shariah compliant underlying (asset) into a Shariah compliant structure.” Nothing could be clearer. When this is the purpose, how can a Shariah board possibly approve? Does it matter if the structure and the transactional basis of these schemes are compliant with established Shariah rules if the end product is the result of prohibited investments? Does it really matter if that result is direct or indirect if the returns are from investments that do not discriminate between right and wrong, *halal* and *haram*, good and harmful? What the public is invited to invest in is a basket that will “reflect” returns from anything from wineries, to pork futures, to casinos, to who knows what else? At the present time, the matter is in the hands of the investors, many of whom are institutional investors with their own Shariah Supervisory Boards; and it is still unclear as to how those boards will decide to view the matter. In my opinion, there can be only one response; and that is to reject the “Shariah Conversion Technology” stratagem and the investment products based on this stratagem.

The Movement of the Cash

Before the reader begins to suppose that this discussion is more about *taqwa* and less about *fatwa*, or morality rather than law, let us now consider the movement of the cash. The Islamic bank that offers this product insists that the Muslim investor's money is invested in a Shariah-compliant product and that the returns are completely

halal.[13] Their claim is that the investor's money is used to purchase a principal protected note, structured by a multinational bank, which invests in simple salam or murabahah contracts. The contract for the note includes an agreement, no more than a promise actually (sometimes termed "a purchase undertaking"), that if the returns from the salam are less than the returns from a particular index, or grouping of funds, then the structuring bank will pay the investor an amount equal to the returns from the index, or group of funds. To be more precise, if the non-Shariah compliant index or funds outperform the salam investment, the investor will earn returns that are better than the salam returns. Since the bank will pay investors with its own money,[14] the investors will not receive returns directly from the conventional index or group of funds (funds which may be using strategies that are non-Shariah-compliant, investing in stocks that have never been screened, and selling securities that they borrowed but never owned, to say nothing of investing in interest-bearing bonds, futures, or any of a host of derivative instruments). In fact, the Islamic bank is happy to point out that it is not investing in any of these prohibited things! And, technically, the bank may be right. However, as we shall see, the matter is not this simple.

When the Islamic Bank takes in the investor's money, what actually happens? Let's imagine that the investor, say an Islamic pension fund, places 100 million dollars in this product. The first thing that happens is that the Islamic Bank passes the money to the structuring bank. That bank will do two things. Firstly, it will invest 100 million, after deducting some fees for management, into salam or murabahah contracts. Then, using the salam as collateral, it will make a loan to an asset managing bank, one with a prime brokerage of its own that works with hundreds of different fund managers.

The asset managing bank will then allocate that money to a selected group of fund managers. In the absence of any mandate to transact in compliance with Shariah, the asset managing bank will choose managers and strategies solely on the basis of

[13] It is interesting to see that the Prospectus for one such product clearly states the following: "Security holders will have no individual or collective recourse to the Islamic Investment Account at any time." It also states that, "… payments to Security holders in respect of the Securities (subject to and in accordance with the Product Conditions herein) will be made irrespective of the *Shari'a* compliance or otherwise of the Islamic Investment Account and the Securities at any time."

[14] The Islamic bank's Shariah board was careful to point out, quite correctly, that it is generally of no consequence to the Islamic investor where the bank's money comes from. This, however, is not the issue here.

performance; and from a risk perspective, this means that the bank will seek to diversify its allocations. Of course, what this means is that some of the money allocated will certainly go to bonds, treasuries, debt instruments, and derivatives like futures, options, and swaps. Also, the loan made by the structuring bank to the asset managing bank will be made for interest at the same rate as the salam. In this manner, the asset managing bank suffers no gap between the salam swap rate and its borrowing costs. In the middle of the transaction, the structuring bank is fully secured for its loan because the rates for the salam and the loan are matched. This means that the structuring bank, likewise, takes no risk. The structuring bank will also earn fees for the notes it has structured for the Islamic bank. The investor's money, that of the client of the Islamic bank, is placed in a salam investment. By means of a note provided by the structuring bank, the investor's principal is protected as well. The client pays fees for both of these. Some fees go directly to the Islamic bank; others go to the structuring bank, to the asset managing bank, and to the managers of the various funds. In this transaction, the greater part of the returns is shared by the funds, the asset managing bank, and the structuring bank. The Islamic bank's earnings are significantly less than all these. The reason for detailing the money trail here is to point out how the investor's money, even though it remains in salam contracts, is actually put to work in ways that are clearly not in compliance with Shariah rules.

It may be argued that this will happen anyway; that it happens whenever an Islamic bank or institution has dealings with a conventional bank. This may be so. Ultimately, what the conventional bank does with its money, when it becomes the bank's money, is its own business. But the transaction we are considering here has direct, predictable and immediate consequences. In other words, the Islamic client's investment in this product triggers a series of transactions, none of which is Shariah-compliant.

Moreover, these produce fees and earnings for other than the Shariah investor. Can the Shariah board of the Islamic bank ignore all of this, and approve the entire transaction because the first link in the series is basically a salam or a murabahah? Or is the Shariah board compelled to consider the transaction in its entirety? Consider the parties to this series. There is an investor, an Islamic bank, a structuring bank, an

asset managing bank, and a number of fund managers. Then consider how the money passes from one to the other, all the way to the fund managers. And then consider then how it passes all the way back. With each pass, more fees are added to the transaction. Consider also how the Islamic investor's money is the beginning point for the entire transaction. Without this initial investment, none of the rest will take place, no one will earn fees. It is this initial investment which ensures the participation of the structuring bank, the asset managing bank, and the fund managers because it is the initial transaction, the simple salam, which effectively creates and guarantees the capital. The irony is that no one, other than perhaps the unwitting Islamic investor, considers this transaction to be only a principal-protected note with a murabahah and a promise. On the contrary, this is a highly complex and profitable transaction involving several different parties at many different levels. In short, it is a golden opportunity for the banks because the money is virtually guaranteed and their risk is next to nothing. In short, the Muslim investor is assured that the investment product is Shariah compliant because the "Shariah Conversion Technology" stratagem, which involves a promise, apparently ensures that the Muslim investor's money never goes directly into anything prohibited. So, the Muslim investors' money may not be invested directly into the part of this transactional series that is actually performing and earning returns. Instead, a mechanism is required to bring the returns from that product to the Muslim investor indirectly. It is also clear, however, that an asset managing bank would not be allocating money to managers unless that money came from somewhere. Between the Muslim investor and the fund manager there may be an indirect link, but the cause and effect relationship is nonetheless present. In a very real sense, the promise to exchange the returns from the non-compliant funds establishes a direct link between those funds and the investor. It also identifies the series as a single transaction. As such, then, it cannot be ignored by the Shariah board. The Shariah board must consider every step in the transactional series; and when this is done, the Shariah board must reject the product.

Ramifications for the Industry

When a Shariah Board gives consideration to only one part of the transactional series, it is only natural that it should fail to consider the consequences of the product for the industry as a whole. It is an unfortunate shortcoming on the part of the Shariah board in this transaction that it has failed to consider the context of the offering. It is an

even greater shortcoming when it fails to consider the consequences the product will have for the entire industry. When it is clear that a product cannot be offered in its own form or, in other words, when it cannot be offered directly, but must be offered by means of a stratagem that is basically a derivative like a swap, red warning flags should go up. In such situations, the Shariah Board must pay careful attention to the circumstances of the offering. If the circumstances can be found to justify such a product, then it may be possible to grant approval. If not, however, approval must be withheld. In the case of promised returns from a referenced basket of assets, the assets must be Shariah compliant in order for the returns to be Shariah compliant. It really cannot be otherwise.

If consideration is not given to the underlying assets, or to the assets referenced by the swap mechanism, it could spell the end of the need for authentic Islamic products, services, and methodologies. Why should a bank bother to spend the extra time and money required to make a securitization into a sukuk? For less money and in less time, it can simply offer conventional bonds and then use the "mechanism" to match performance, appear to sanitize the money, and satisfy the investor that the investment is *halal* and lawful. If such a mechanism is available at lower costs, then why license an Islamic index for Shariah compliant stocks? Why use mutual funds that follow guidelines laid down by Shariah Supervisory Boards? Why bother with all the complex structuring and documentation that go into Shariah compliant real estate deals? Or infrastructure projects? Or private equity? Or home finance? Why expend the resources required to develop new and innovative Islamic financial products and tools? The "Shariah Conversion Technology" stratagem makes all of that unnecessary. At a very fundamental level, however, this mechanism seeks to make the *haram halal*. This is the nature of the threat to our industry. The *fatwa* giving blanket approval for this misguided stratagem may well be referred to as the Doomsday *fatwa* for Islamic Finance.

If the product described in this paper is successful, managers of all manner of funds, not just hedge funds, will never be motivated to do what is necessary to manage and invest in ways that comply with Shariah. But then why should they, if all they need to do is agree to swap returns? Asset managers can continue as before, buying and selling interest-bearing bonds, debt-based derivatives, pork futures, and bank, casino

and brewery stocks. They can trade these however they wish, even by borrowing stocks and then selling them into the market without ever owning them, or by leveraging them and incurring interest on the leverage! In other words, Islamic investors will not know what managers are doing because an Islamic bank and its Shariah board have assured them that by means of a special "technology" their money will remain separated and pure.

***Sadd al-Dhara`i*: Blocking Ostensibly Legitimate Means to Illegitimate Ends**

When I first became acquainted with the details of the "Shariah Conversion Technology" stratagem (in 2006, when I was invited to approve it by a huge multinational bank), I had thought that the best way to combat it was to have resort to *sadd al-dhara`i*, the legal device from our classical jurisprudence that blocks ostensibly legitimate means when these are employed for illegitimate ends. In other words, in the same way that the digging of a well in the middle of a road may be declared unlawful for the reason that it may lead to great inconveniences and economic losses by those who travel the road, I thought that this mechanism might be declared unlawful by Shariah boards for the reason that its use may lead to prohibited investments. So, while a promise to exchange returns may be lawful, if the returns promised have been earned by illegitimate means (by funds that invest in Treasury futures, for example), then that promise may be declared unlawful as it has become a means, an ostensibly legitimate means, for illegitimate ends.

I am now convinced, however, that this transaction is prohibited outright; and that the application of *sadd al-dhara`i* in this instance is unwarranted. This is because of a subtle point of law regarding the application of when it is possible to resort to *sadd al-dhara`i*. The classical jurists have stated that whatever leads to involvement in the unlawful will either lead to the unlawful as a certainty or lead to the unlawful as a possibility. This product includes investments, even though they are entered into indirectly, that are clearly unlawful. Moreover, there is no doubt whatsoever that the transactional series leads inevitably, and repeatedly, to what is unlawful. That being the case, that what leads to involvement in the unlawful does so as a certainty and not as a mere possibility, then *sadd al-dhara`i* is inapplicable. There is no need to resort to *sadd al-dhara`i* because the transaction is clearly unlawful.

I quote, in what follows, from *al-Bahr al-Muhit, Kitab al-Adillah al-Mukhtalif Fiha* by Badr al-Din al-Zarkashi, on the subject of *Sadd al-Dhara`i*: Blocking Ostensibly Legitimate Means to Illegitimate Ends:

> "Know that whatever leads to involvement in the unlawful will either lead to the unlawful as a certainty or lead to the unlawful as a possibility. The first of these two (that it will certainly lead to commission of the unlawful) is not to be discussed under this heading. Instead the proper place for its discussion is under the heading of "That Which there is No Way to Escape the Unlawful Except by Avoiding It" The commission of such an act (whatever will certainly lead to involvement in the unlawful) is unlawful for the reason that whatever is required to ensure the performance of a required act is itself required. (And here the required act is that one avoids what is unlawful; and what is required to ensure that it is avoided is avoidance of the act that will certainly lead to it.)"[15]

To clarify this point, the stratagem we are discussing leads, without a doubt, to the unlawful. Obviously, if fund managers are given no guidelines to follow for Shariah compliance, they will surely make investments that are not Shariah compliant, they will surely manage their cash in ways that are not Shariah compliant, and they will surely transact in ways that are not Shariah compliant. The statements given to the press by the Islamic bank offering this product admit as much. This being the case, that the product leads surely to the unlawful, there is no need to resort to *sadd al-dhara`i* to prevent the proliferation of the product because the product is already unlawful, owing to its leading directly and without doubt to what is unlawful. If there were some doubt about this, such that the product's leading to the unlawful was only a possibility, whether likely or unlikely, a strong possibility or a slight possibility, then recourse might be had by the jurists to the device known as *sadd al-dhara`i*. When the assets referenced by the "Shariah Conversion Technology" stratagem are known to be unlawful, however, the transaction is unlawful and there is no need for recourse to any legal device for its prohibition. This being the case, there is also no need to discuss the opinions of the various classical scholars in regard to *sadd al-dhara`i* and its use.

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[15] The author continues, "The second of these two, that it will possibly lead to commission of the unlawful, may be a likely possibility or an unlikely possibility, or a possibility in which both (likely and unlikely) are equal. Such a possibility may be termed "means," or *dhara`i*."

It is an established principle of Islamic Law that whatever is required to ensure the performance of a required act is itself required (مـا لا يتـم الواجـب إلا بـه فهـو واجـب). When the avoidance of the unlawful is a requirement, if there is an act that will surely lead to the unlawful, then the avoidance of that act too is a requirement. It is for this reason that it is essential, *wajib*, to avoid or to reject, the stratagem and the product. This is because the stratagem is what allows the asset manager to deploy money gathered through this transaction, however indirectly, in funds that operate in ways that are non-compliant with Shariah, and that invest in businesses that are non-compliant with Shariah, ignoring all guidelines for Islamic investing that have been developed at great expense by businesses that respect the Muslim investor's need to transact and to invest only in ways that accord with the principles and precepts of the Shariah.

Conclusion

As jurists, Shariah scholars are trained to look at texts and at classical models, especially in regard to transactions. If a question of law is not answered directly in the texts, jurists are trained to seek indirect answers, often by drawing parallels from the body of accumulated jurisprudence, or through recourse to legal maxims and principles. Then, while Islamic law may be characterized as both a moral and a legal system, the jurisprudence that has developed around modern trade and commerce relies almost exclusively on derived legal considerations; even if these may be characterized as legal means to moral ends.[16] Thus, it is difficult to suppose that jurists will make decisions on the basis of purely moral or *maqasid*-related[17] considerations.

From a practical perspective, the best way to deal with this question may be to refer it to the Shariah Council of the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI), the standard setting body for the entire industry. Since the stratagem that drives the product is based on a promise, or *wa`d*, which has applications in many modern financial instruments including the modern murabahah,

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[16] Indeed, while the prohibition of riba may be characterized as a moral prohibition, the prohibition itself is a legal matter. Once the prohibition is incorporated into law, all riba-related issues become subject to legal classification and the element of morality is marginalized.

[17] What I mean by *maqasid*-related are considerations having to do with the higher purposes of Islamic law, especially those related to the equitable distribution of wealth, the development of institutions, and the betterment of individuals and society.

AAOIFI might be requested to promulgate a standard dealing with every aspect of the *wa`d* and its uses.

The cynical stratagem described above presents Muslim jurists with a real challenge. If investor confidence is to be maintained, the industry must demonstrate its ability to regulate itself and insist upon the Islamic authenticity of all that it does, or allows to be done in its name. In the past few years, modern Islamic finance has proved itself to be viable, innovative, and profitable. The question it faces now is whether it can prove that it is moral and responsible.

Acceptance and Compatibility of Shari'a Banking in the Financial Mainstream

by

Nicholas Van Zandt[18]

Within the Western banking system, there has been a rise in the use of Islamic banking. The industry of banking and finance in the Arab and Muslim world has been doing this for years, but now there are shifts towards Shari'a-compliant banking from within North America and Europe. Some major banks like Citigroup, HSBC, Lloyds TSB and Deutsche Bank have already established departments devoted to this system.[19] With all of the criticism that has surrounded this new trend, it is important to ask what is to gain and what is to lose with a full integration of Shari'a banking in the mainstream financial industry.

While there are several complexities to the system of Islamic banking, or Shari'a compliant banking, it would probably be easiest to describe it by the prohibition of *riba* (interest) as it is considered usury. Instead of the standardized system of banking known to the West where interest is used as a way for money to make money onto itself, Islamic banking was established in a way to entirely avoid that method. The use of interest is seen as unethical and predatory. The Koran makes several references to the effect that the engagement in usury is something that only Satan has facilitated and should one engage in usury in order to gain from one's wealth that they shall not gain anything from God.[20] In a historical perspective, as stated through Koranic commentary, the practice of usury was one in which the pagan Meccans did

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[19] Wayne Arnold, "Oil Wealth Takes Islamic Banking Mainstream" *International Herald Tribune*, 21 November 2007.

[20] These concepts are in reference to verses in the Koran. Surah 2, Verse 275: "Those who gorge themselves on usury behave but as he might behave whom Satan has confounded with his touch; for they say, "Buying and selling is but a kind of usury "while God has made buying and selling lawful and usury unlawful. Hence, whoever becomes aware of his Sustainer's admonition, and thereupon desists [from usury], may keep his past gains, and it will be for God to judge him; but as for those who return to it -they are destined for the fire, therein to abide!" Surah 30, Verse 39: "And [remember:] whatever you may give out in usury so that it might increase through [other] people's possessions will bring [you] no increase in the sight of God whereas all that you give out in charity, seeking God's countenance, [will be blessed by Him:] for it is they, they [who thus seek His countenance] that shall have their recompense multiplied! Source: Muhammad Asad, *The Message of the Quran* (The Book Foundation, 2003).

so that they could acquire wealth in order to defeat the Muslims at the Battle of Uhud in 625.[21]

As a replacement to interest, Islamic finance then becomes a system of reinvestment of assets—granted that the assets to be reinvested in are not *haram* (prohibited by Shari'a law). This would include businesses that engage in alcohol, pork, pornography or gambling. As the banking industry across the West jumps into this growing market, there is likely a great deal of concern as the executives and shareholders of these haram industries watch the gradual transition into Islamic banking.

The principal reasoning for the Western banking industry's desire to expand in Shari'a banking is not by means of appeasing ideological or moral appeals by the Muslim community, as some have claimed, but rather by the recognition of an undeniable and quickly growing financial market that until recently has been limited to countries within the Muslim world. At the start of it, Malaysia, for example, began to see their economic interests being diverted to China so in 2001, the government decided to build upon its Islamic financial sector in order to draw in trade and investment from the Middle East. After seeing the estimated $1.6 trillion in oil wealth floating around the Gulf, Malaysia, and soon after Britain, Japan, Europe, and the United States, found that by providing *sukuk* (Islamic bonds), they could break into the market and draw in the petrodollar investments.[22] In order to draw in further investment, additional banking services were employed.

As it was recognized that with over 1.5 billion Muslims in the world—granted not all strictly adhere to Shari'a finance laws—that it was time to open up the banking industry to those that did before the Gulf states cornered the market. Many Muslims were banking in conventional banking methods and when given the option to convert their savings and investments into a Shari'a-compliant system, they did. The system

[21] Ibid.
[22] Wayne Arnold, "Not Only the Pious are Drawn to Interest-free Islamic Banking" *Taipei Times*, 25 November 2007.

in itself has been found to be attractive to non-Muslims as well who in some Islamic banks make up as much as 50 percent of the depositors and borrowers.[23]

In the British perspective, it was soon found by many in the mainstream banking establishment that there are approximately 2 million Muslims and 100,000 Muslim businesses in the country, and based on research conducted by Lloyds TSB, three-quarters of them wanted to engage in banking according to their faith.[24] So instead of watching this community send its money overseas to Islamic banks in the Gulf or engage in less than conventional forms of money management, these banks found that there was a service to provide. Among the services conducted, there are personal savings accounts, home loans, and business loans that are all in compliance with Shari'a law. Every bank that has gone into Islamic banking employs an advisory board of Shari'a scholars. This board will supervise every step of the process of a transaction in order to ensure that it is within Shari'a compliance.

For personal savings accounts, the depositor will not receive interest but rather shall receive returns from the bank's investment. This runs along the principles of *mudaraba*, which is an equity partnership financing instead of a debt financing scheme.[25] The contract between the bank and the depositor works by the risks and rewards being shared. Profits will be shared as agreed upon but in the case of loss, the investor will bear the loss of any capital. This scenario allows for the bank to take the deposit and redirect it into a *halal* (permissible by Shari'a) investment. The bank will then provide the depositor an agreed upon percentage of returns from that investment.[26] Unlike with the payment of interest, which generally is a fixed percentage, the profit share can increase in Shari'a banking should the investment pay off at a greater rate. Typically, the percentage of profit sharing is lower than the standard interest rate and—in the United Kingdom—the payout of shared profit to the depositor is taxed as if it were a return on a standardized loan.[27]

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[23] Ibid.
[24] Diana Brightmore-Armour speaking in her role as managing director for Lloyds TSB corporate banking with regard to the research her bank conducted. Source: "Growing Demand for Islamic Banking" *Reuters*, 4 April 2007.
[25] HSBC Amanah Website, "Financial Instruments".
[26] Islamic Bank of Britain Website.
[27] Ibid.

Islamic home finance is dealt with in a different fashion as well. Instead of a mortgage loan paid over time with interest, the bank will purchase the property for the borrower and then rent it to them at an agreed upon payment scheme. The bank typically requires a minimum of 10 percent on the down payment and then allows the borrower to pay off the rest through rental payments. Over a period of up to 25 years, each rental payment acts as a purchase of shares over the property. In order for this to work to the lender's advantage, the bank will typically buy and resell the property after a price increase.[28] Many have advocated for this system over the conventional interest-based mortgage loaning system by stating that it provides security from fluctuating interest rates that could cause problems in repayment. The banks that offer this loan all state that the house will be repossessed should payments not be made. Within the interest-based mortgage system, there is a relative level of flexibility. Borrowers are able to refinance their mortgage or even take out second mortgages before they are forced into foreclosure.

It has been argued that a more expansive Islamic banking system would have provided for an environment where crises like the sub-prime mortgage problem that afflicted the United States might not have happened. This crisis, which has been an ongoing financial problem, has caused a sharp rise in home foreclosures. It started in the Fall of 2006 and became a global financial crisis by July 2007. Many factors created the crisis, but the most immediate cause was a rising interest rate which caused people with adjustable rate mortgages to see significant increases in their mortgage payments. This left many home owners unable or unwilling to meet their financial commitments and lenders without a means to recover their losses.

It has been stated that had the banking system been one under Shari'a compliance, this crisis would have never occurred. There would have been no system of interest, thus there would be nothing to raise the mortgage payment rates. At least in this aspect, Islamic banking would have been advantageous. The entire problem, however, would not be under control. In the United States, the Federal Reserve is the primary tool to manage inflation rates. Interest rates are raised to slow the level of economic growth so that inflation rates can decrease. Interest rates were raised which

[28] Ibid.

caused the sub-prime mortgage crisis but inflation rates were mitigated. Iran, for example, claims to have a 100 percent Islamic banking system. There is no interest based system as broad as the Federal Reserve to curb inflation.[29] For this reason Iran holds a 16 percent inflation rate versus the 4.5 percent of the United States or the 3.3[30] percent of the United Kingdom.

The area of entrepreneurship thus becomes an issue when looking at the principles of business investment loans by way of Shari'a banking. This process also goes along with the risk and profit sharing principle of mudaraba. As a means of avoiding the use of interest in loans, financiers will share risks as well as the profits with the borrowers. Instead of the borrower being the sole owner of whatever business they seek to start with a business loan, the financier then becomes a de facto co-owner, earning a share of the profits. Should the business fail, it is the investor that loses everything. If the business succeeds, the investors will gain far more than if they were collecting simple interest-based repayment. In principle, the process is the same as venture capitalism. The financier will engage in what is known to them as being high risk venture but only when the reward is worth it.

A venture capitalist who is successful in staying in business, however, will not invest in every idea that comes to them; they will wait for a scenario where the risk is at a manageable level considering the level of profit. For many venture capitalists, they will likely hear hundreds, if not thousands, of proposals for investment every year and pick only a handful. Experienced business owners with a proven track record of success are typically considered a safe investment whereas borrowers inexperienced in business administration aiming at a small-business ventures, will be considered higher-risk, lower-profit and will likely not be considered. In the interest-based banking system, the bank is not required to take such risks and these higher risk, small business ventures will have a greater chance of receiving the capital they need to start their business.

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[29] Paul Wouters, "Experts Discuss the Future of Islamic Finance in Zurich" *Today's Zaman*, 11 November 2007.
[30] In May 2008. –Ed.

When placed on the individual level, the small business owner still has the option to choose the loan available to them, Shari'a compliant or not. When placed on the macro scale, in a society like Iran where business loans that are interest based are largely unavailable, it worsens the plight of the entrepreneur. Starting a food shop in a high traffic area might be considered a safe investment and would likely have no problem. Riskier businesses proposals that are attempting to break into, or create a new, market might not be given a chance. This would then have an adverse affect on the entirety of the economic system of that country.

It is through this concept that most directly impacts the small business start ups. While the conventional financial markets operate in the simple process of lending money after a credit history search and ensuring the borrower is able to repay the loan, the Islamic banking process requires a great deal more engagement with the borrower's intentions for investment on the part of the lender. Reliability and security are issues of significant concern when the bank considers to whom to provide their loans.

Lloyds TSB has provided the first Islamic Business and Corporate account at all of its 2,000 branches designed to cater to the 100,000 existing Muslim businesses in Britain and for new entrepreneurs.[31] Out of all of these businesses, the bank recognized that there was a substantial market waiting to be tapped. This is the first Shari'a business banking account in mainstream banking today. Prior to its existence, Muslim business owners went to the regular accounts. Now that it exists it has become widely popular. It is a process in which the mainstream bank itself made Islamic banking popular—and seen as necessary—rather than the Muslim community.

The question is, has the West benefited by expanding its commercial banking industry into the Muslim world to share in the wealth of oil profits or is the Muslim world benefiting more by introducing Islamic banking to the financial mainstream of the West? Is it a win-win scenario or are there serious drawbacks to come as this process evolves? Perhaps one result of Western interest in Islamic banking is that it provides a greater sense of legitimacy to the practice and then gives Middle Eastern banking

[31] Lloyds TSB Website.

systems the incentive to go ahead and provide full implementation. Only in 2006, for example, the National Commercial Bank of Saudi Arabia overhauled its entire retail business to make it Shari'a-compliant and only this year did Tunisia and Morocco have Islamic banks.[32] By the West making the decision to move into Islamic banking, it has given the Middle East the option to develop its Islamic banking system as well; an option that may not have been viable before the banking giants made the transition.

It has been estimated that over $800 billion has been transferred out of the United States and Europe into other regions where Islamic banking is more prevalent—specifically within the Muslim world.[33] As Islam has grown increasingly conservative over the past few years, matched with a greater wealth being invested into the Muslim world, there has been a reinforcing effect on both religion and economics within the region. It is in this economic revival—due to religious reasoning for halal banking—that an Islamic revival has been made possible. Now that the Western banking sector has become interested in getting involved in Islamic banking, it has given this revival a greater sense of legitimacy.

The concluding question is with regard to how—if at all—Islamic banking can be a detrimental to economic development in the long run. The simple answer would be to state that the larger banks like HSBC and Citigroup, who are actively engaged in Shari'a banking, have done their cost/benefit analysis and found that the untapped market of Muslim investors who wish to adhere by their religious code of finance is worth the risks that go along with the system.

There has been a great deal of debate on this matter and some have advocated that the introduction of Islamic banking is part of a larger ploy to Islamicize the West. Providing ammunition to these types of arguments are groups like Hizb ut-Tahrir, an organization in Britain that has publicly advocated for the totality of the West to be run by Shari'a law, that have in fact advocated on their website that events like the

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[32] Wayne Arnold, "Islamic Banking Rises on Oil Wealth, draws non-Muslims" *International Herald Tribune*, 22 November 2007.
[33] Wayne Arnold, "Oil Wealth Takes Islamic Banking Mainstream" *International Herald Tribune*

financial crisis in America under would have never happened under an Islamic system and that capitalism is the seed of the devil.[34]

In a brief analysis, however, it is not necessarily the society that is entirely at risk. Investors engaged in Shari'a banking are no longer protected and can incur greater loss but stand to gain a great deal more. Borrowers, in effect, may very well find it more challenging to acquire the capital they need if their investment plans are less than solid. It is a trade-off for both sides, as directed by the original principles of the Koran. For Muslims who wish to conduct their finance adhering to Islam with less than attractive investment proposals, they will likely find it hard to launch their businesses whereas conventional loans might be their saving grace. From the bank's point of view, on the other hand, an attractive investment plan, one which looks to be of low-risk and high profit, could provide a far better rate of return than if it were the standard interest based loan. Investors in this case recognize a profitable opportunity and the fact that interest is not involved makes it no less capitalistic.

The concern is not as much with the processes of Islamic banking but rather by the surge of interest by Western banks. It is highly unlikely that Shari'a banking will become fully compatible to mainstream banking due to the requirement for a total economic reformation, but with every action brings a reaction within the financial industry. When the largest banks begin to implement Islamic banking practices at the international level, country based banking systems in the Muslim world will alter their systems to a greater degree towards Shari'a banking. In time, the problem this could present is a conflict in commercial trade and banking when mainstream banking cannot complete transactions with countries in the Middle East because they are not Shari'a compliant. As stated, the West will not and cannot make a full transition into the Islamic banking system due to the nature of change needed, but as their smaller scale integration provides legitimacy to the practice, thus bringing a revival in Islamic finance, it could provide for complicated trade and commercial dealings down the road.

[34] Hizb ut-Tahrir Website, "Financial Meltdown".

A Gram(een) of Hope: Micro-credit in Bangladesh

by

Kevin Newton[35]

Islamic investments have increased several-fold over the past years. While much of the actual amount certainly comes from the financing of endeavors built by construction giants in Dubai and other sites throughout the Islamic World, these mega-projects offer little assistance to the average Muslim. A great deal of attention has recently been focused on the emerging practice of micro-credit, which provides small loans to the poor that allow them to gain the economic ability to not only pay the loan back easily, but to raise their economic standing as well. This form of investment for the destitute has been used to great effect by Grameen Bank, founded by Muhammad Yunus. However, Yunus and the vast majority of the bank's Bangladeshi members are Muslim, and therefore subject to strict economic controls concerning *riba*, partnerships, and contract law. Yet ultimately the goal of economic independence for all that Grameen Bank encourages is not only consistent with that of Islam, but actually encouraged by *Shariah*.

Yet before examining micro-credit's ability to conform to the *Shariah*, one must understand what makes micro-credit different from other types of financing. Most noticeably, the loans are unusually small in comparison with the loans that more traditional banks offer, and designed especially for the poor.[36] The loan inevitably must be paid off completely, even if payments must decrease during times of hardship.[37] Additionally, the poor are organized into support groups on the village level that have actual control over the funds.[38] These groups are largely comprised of women, as Grameen hoped that the majority of its investors would be women.[39] Also, in stark contrast to other institutions, literacy would not be a prerequisite for a loan

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[36] Muhammad Yunus. *Banker to the Poor: Micro-lending and the Battle Against World Poverty*. New York Public Affairs, 2003: 49.
[37] Yunus 236
[38] Yunus 62
[39] Yunus 78

from Grameen.[40] Finally, and perhaps most controversially, the loans issued by the bank would carry interest, a point that caused much debate within the Islamic world.[41]

A frequent criticism of Grameen Bank is that because it charges interest, it is subject to the Islamic laws against *riba*. *Riba*, the term most often used to describe any sort of economic inequity, including interest, within the Islamic context, is clearly prohibited in the Qur'an. Several verses declare that *riba* is firmly *haram*, or forbidden. Qur'an 2:275 states "God has…prohibited usury," just as *riba* is "deprived of all blessing."[42] Additionally, any profits earned by *riba* are considered *haram* as well.[43] The *Sunnah* of the Prophet Muhammad also strongly condemns *riba*. When explaining to a follower the meaning of his dream, he describes those "in the river of blood were those dealing in *riba*."[44] Also, it does not seem to matter whether a person is given or provides funds for *riba*.[45] Indeed, the consumption of *riba* is named as one of the "seven great destructive sins" that the Prophet preached about.[46] In placing the crime as *haram li-dhatih*, or "that which is forbidden for its own sake," the Qur'an places *riba* in the same category as murder and theft.[47] In doing so, the Qur'an is clear that *riba* is completely *haram*.

However, the *Shariah* offers little as to an actual working definition of *riba*. In the Qur'an, *riba* is described as "doubling and quadrupling the sum lent."[48] Further, it is also described as a practice that Jews of the region practiced.[49] Also, if a loan is granted, the borrower must be given extra time to repay the debt if he/she falls into economic hardship.[50] The *Sunnah* is more useful, describing usury as a crime that occurs when unequal amounts of goods, be they differing or similar, are exchanged.[51] While one may not be sure of a precise definition of *riba*, one may infer that it is a

[40] Yunus 52
[41] Yunus 69
[42] Qur'an 2:275-276
[43] Qur'an 30:39
[44] Bukhari Hadith Volume 2, Book 23, Number 468
[45] Bukhari Hadith Volume 7, Book 63, Number 259
[46] Bukhari Hadith Volume 8, Book 82, Number 840
[47] Mohammad Hashim Kamali, *Principles of Islamic Jurisprudence*. Cambridge: Islamic Texts Society, 2003: 423.
[48] Qur'an 3:130
[49] Qur'an 4:161
[50] Qur'an 2:280
[51] Bukhari Hadith Volume 3 Book 34 Number 344, also Volume 3 Book 34 Number 379, Also Muslim Hadith Book 10 Number 3689

form of economic inequity, due to both the Qur'an's definition concerning the "doubling and quadrupling" of the capital, and the Prophet's description of *riba* as an inequitable exchange. More specifically, and important for Grameen Bank, is that with the prohibition of "doubling and quadrupling," it is apparent that mechanisms such as compound interest are deemed forbidden. Naughton and Naughton further the definition, stating that *riba* applies to any unfairness in all economic dealings.[52] Therefore, *riba* should be considered as a definition not only of interest, but to unfair economic practices as a whole.

As was stated above, Grameen Bank does charge interest on its loans, yet the program ought to be considered *halal*, or permitted, under Islamic Law. According to Yunus, this rate is fixed at two percent over the course of the loan, and is charged throughout the loan period.[53] According to the above *Hadith*, this practice seems to be against the principle that unequal sums of goods (in this case, money) should not be exchanged.[54] However, contemporary Islamic *ulema*, or scholars, have ruled that such a fixed rate system over time is legal under *Shariah*, as it does allow for *Murabaha*, a situation in which a bank owns a good and slowly resells it to a borrower who pays both principle and a small fee.[55] Indeed, given the fact that Grameen Bank uses simple interest in lieu of compound interest, the interest charged by the bank is an amount agreed upon at the formation of the contract, much like the small fee in a *murabaha*. Additionally, Grameen's loans are designed explicitly for economic improvement, something that is encouraged by the Qur'an in verse 2:280.[56] Indeed, the original loan made by Yunus charged no interest, as the party to be repaid was an outside individual, not the group that would come into being later.[57] The new income gained by the granting of the loan more than pays for the interest that is charged, leaving both the borrower and the creditor in better economic standing, as evidenced by a similar program in the Philippines, where investors often earn better than 117% return on their initial loan.[58] Furthered by the fact that as only members of

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[52] Shahnaz Naughton and Tony Naughton, "Religion, Ethics, and Stock Trading: The Case of an Islamic Equities Market," in *Journal of Business Ethics*. Volume 23 (2000): 145
[53] Yunus 68
[54] Bukhari Hadith Volume 3 Book 34 Number 344
[55] Bill Maurer, *Pious Property: Islamic Mortgages in the United States*. New York: Russell Sage Foundation, 2006: 36.
[56] Yunus 49
[57] Yunus 51
[58] Yunus 160

the bank may borrow from the bank, the creditors are essentially their own debtors. As both sides of the Grameen agreement profit from the endeavor, there is no unfairness in the arrangement. Therefore, the element of *riba* that deals with unfairness in economic dealings may be disregarded

Yet more proof that denounces the argument that Grameen's loans are *riba* exists. As a central tenant of Islam is the establishment of justice, one must constantly strive for methods to eliminate injustice. This concept of the establishment of the greater good, known as *istislah*, is permissible as a way to allow judges to make rulings that are in the benefit of the public interest.[59] Few greater injustices exist than the economic status of Grameen's clients before the bank granted them a loan. Often, they are forced to work for middlemen who supply them with the raw materials necessary for their work only if they in return sell the middlemen their finished product, usually for only a miniscule profit.[60] Again, reference must be made to the *Hadith* that describe *riba*-like behavior of inequity in payment. In addition, *Hadith* exist that condemn the exchange of goods that are similar but unequal in nature without some form of intermediary.[61] The middlemen clearly violate both of these rulings put forth in the *Hadith*. In another example, Yunus writes about middlemen who would loan a bag of rice as seed for the beginning of a growing season, only to demand twice the amount by the end of the harvest.[62] This also violates the *Shariah* in that goods of an unequal quality are exchanged, in direct violation of the verse condemning the doubling of goods.[63] By doing so, they certainly create injustices within the community. To this end, *istislah* performed by Grameen may be used to eliminate these inconsistencies by doing away with the middleman who causes suffering to the community through economic inequalities. By using methods such as *istislah* to lend money, instead of through the methods of *riba* that were common in the past, Grameen works to establish economic justice.

However, moneylenders and economic middlemen are not alone in their use of *riba* against the poor; large established banks are guilty of the practice as well. Among the

[59] Kamali 351
[60] Yunus 47
[61] Muslim Hadith Book 10 Number 3687
[62] Yunus 49
[63] Qur'an 3:130

most accepted of these inequitable economic practices is a point that Yunus finds remarkably biased against the poor: banks in Bangladesh require any borrower to fill out a form. By doing so, banks discourage commerce from the poor, in direct opposition to the Qur'an's mandates that commerce is to be encouraged.[64] As Yunus points out, this is an absurd requirement, especially when considering the country's literacy rate of 25%.[65] Additionally, such a practice is in violation of *maslaha*, or public interest, as it limits the number of people who can improve their well-being by drawing a loan that is not subject to the *riba* practices of local moneylenders. The banks of the country therefore practice *riba* by discriminating against a majority of the population. By its mere existence, Grameen demonstrates an improvement of *maslaha* by working to end *riba* in the country. However, not every aspect of the Grameen banking arrangement falls directly into the realm of preventing *riba*.

Grameen Bank also requires that all of its borrowers enter into a partnership with others in their community. It is into this pool that the interest of all those involved with the Bank be deposited, such that future loans may be drawn from an increasing pool of funds, and from this partnership that all loans must be approved.[66] Yunus focuses heavily on the psychological aspects of the group versus the individual.[67] However, the Islamic value of the partnership for commercial purposes, or *shirkah*, is well entrenched in Islamic society.[68]

This permission to do business within a *shirkah* is allowed because the *Shariah* overwhelmingly encourages commerce. Indeed, the Prophet Muhammad was a caravan driver in partnership with a widowed merchant before he was called to become a messenger. However, all trade must be fair, as opposed to the *riba* discussed earlier.[69] Further, the Qur'an, after establishing that business should be done fairly, also sets forth that loans may be granted on terms that do not penalize the borrower for being tardy on a payment due to economic hardship.[70] Indeed, by

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[64] Qur'an 2:275
[65] Yunus 52
[66] Yunus 65
[67] Yunus 63
[68] Muhammad Akram Khan, *Islamic Economics and Finance: A Glossary*. New York: Routledge, 2003: 168.
[69] Qur'an 2:275
[70] Qur'an 2:280

forming a Grameen Bank, a specific form of *shirkah*, a *shirkah al-mafalis* (partnership of the penniless), is initially formed that is allowed to do business on credit.[71] Further, the terms of loans offered by Grameen fulfill the requirement that the borrower should not be penalized due to financial strains.[72] Grameen Bank is permissible as a *shirkah* because regulations set forth in the *Shariah* that allow Muslims to perform commerce are followed, and when combined with the laws prohibiting *riba*, the program takes steps that permit all interested Muslims to take part in business via partnerships.

More recently, international jurists have approved the use of the type of partnership that each Grameen local group resembles after it has built up a reserve of funds from previous investments. The basic business model of Grameen is that borrowers form a group that owns the funds that are borrowed. The interest gained off of these funds, in addition to the repaid principle, is returned to the general fund of the group, thus allowing the group's capital to increase with each successful loan repayment. This is similar, though not identical, to many forms of finance available on larger Islamic markets, such as the *ijarah*. This instrument of finance allows investors to place money in a bank from which borrowers can draw. They then pay a small fee, or *sukuk*, which returns to the investors, along with the capital. However, in the case of Grameen Bank, the investors and borrowers are one in the same, meaning that they are effectively paying themselves instead of an outside party that provides capital. Due to the acceptance of *ijarah* by current jurists, there can be no argument that Grameen's micro-credit system, by which the funds withdrawn and deposited by the investor remain the same.

Yunus's insistence that borrowers always repay their loans on a schedule may appear to exist out of simple necessity, but it actually does have Islamic roots. According to the Qur'an, loans must be repaid by borrowers, even if allowance is given for hardships.[73] However, this does not give the creditor the right to raise the amount of the principle of the loan in question.[74] Grameen Bank provides different methods for insuring that the loan is always repaid in order to keep with the requirement that the

[71] Khan 169
[72] Yunus 238
[73] Qur'an 2:280
[74] Bukhari Hadith Volume 3 Book 34 Number 344

lender should give such allowance. One of the easiest for the both the bank and the borrower is a reduction of payment during hard times. The lost revenues for a hard period simply extend the time of the loan.[75] Such a plan is permissible under Islamic law because it does not result in an increase in the amount to be paid back. Additionally, it insures that the loan is repaid under terms that are favorable to both the borrower and to the bank. Through this repayment plan, Grameen fulfills the *Shariah* requirement that those who take out loans repay them when able, but not be placed under undue pressure to do so. This also maintains one of the most important facets of Islamic financial law: the honoring of all contracts.

Contract law is absolutely essential to *Shariah*, granted that the terms are agreeable to all parties involved. One verse states that it is a duty of the righteous to fulfill contracts that they have made.[76] God orders that humans should always write the contents of contracts and have witnesses present.[77] Further, those who break treaties and contracts are accused of disrespecting God.[78] Obligations to fulfill a contract extend even to those agreements made with pagans and others who do not believe in God.[79] In addition the *Hadith* make reference to those who keep their contracts being upstanding believers. In one, the "treasurer who gives willingly what he is ordered to give" is upheld as one of the most virtuous citizens.[80] Clearly, any who would break their contracts with another human, be they believer or not, faces punishment from God for swaying from the *Shariah*. Grameen Bank certainly takes strides such that both the bank and the borrowers are free of concerns of breaking *Shariah*. Indeed, Grameen Bank stresses the importance of contracts because they are essential to its existence. That these contracts are made to favor all parties is quite peculiar to finance. Yunus proclaims that whereas most banks expect their borrowers to fail to meet payments, Grameen Bank expects that its clients will do the utmost to meet the set requirements.[81]

[75] Yunus 238
[76] Qur'an 2:177
[77] Qur'an 2:282
[78] Qur'an 8:56
[79] Qur'an 9:4
[80] Bukhari Hadith Volume 3 Book 36 Number 361
[81] Yunus 70

Worthy of a great deal of attention is the emphasis that Grameen Bank placed on the economic power of women. Throughout Bangladesh, Islamic and local traditions have downgraded the economic role of women. In fact, Yunus reports that less than 1% of loans from traditional banks in Bangladesh are held by women and any efforts by a woman to acquire a loan is met by the demands of the bank for her husband to come in to negotiate the terms of the deal.[82]

However, the power of women in the economy is stressed throughout *Shariah* and by Grameen. Perhaps most noticeable is the role that the Prophet's wives played in their economic communities. As noted earlier, the first wife of Muhammad, Khadija, was a wealthy widow who traded via caravans, and hired Muhammad to manage her roaming merchandise. Additionally, 'Aisha, the last wife of the Prophet, concluded her own business deals, consulting with her husband not for permission to act, but to insure that her actions were within the scope of *Shariah*.[83] Further, evidence in the Qur'an that doubts the "lack of economic skills of women [concerning commerce] is simply an example, not an eternal idea."[84] By the insistence to always talk to a woman's husband, the bankers were ignoring the precedent set by the Prophet's wives, a valuable part of the *Sunnah*. On the other hand, by encouraging women to use Grameen, the bank recalls the economic power that women possessed during the time of the Prophet, and the ultimate equality of men's and women's deeds in the eyes of God.[85] By doing so, Grameen respected the rights of women as established in the *Shariah*.

Finally, it is through *istislah* that the greatest case for the entire existence of the Grameen Bank micro-credit program can be made. Through this plan, the lives of thousands of poor people are bettered by improving the *maslaha* of the community as a whole. Islamic law measures the improvements through *istislah* through a rubric known as the *maqasid al-shariah*, or objectives of *Shariah*. These *maqasid* include religion, life, intellect, family, and property.[86] The Grameen Bank most directly impacts property in that it allows individuals to not only own the means of their own

[82] Yunus 71
[83] Bukhari Hadith Volume 3 Book 50 Number 889
[84] Tamara Sonn, *A Brief History of Islam*. Maldan: Blackwell, 2004: 17.
[85] Qur'an 48:6
[86] Kamali 351

production, but some even aspire to own land.[87] Yet other aspects of the *maqasid al-shariah* requirement for protection of property are enhanced. The quality of life and assurance of family for Grameen borrowers is improved as it allows individuals to feed, clothe, and shelter themselves and their families.[88] Interestingly, education is protected on distinct levels. Foremost, it allows the borrower to use what knowledge he/she possesses to its greatest benefit.[89] However, Grameen also strongly encourages that the children of recipients attend school, providing an investment in future education.[90] Finally, religion is protected as the borrowers are no longer subject to the truly *riba*-plagued practices of money-lenders, as accepting *riba* is *haram*.[91] By protecting these five *maqasid al-Shariah*, the implementation of Grameen Bank's micro-credit opportunities is considered within the *maslaha* of the community.

Verily the practices of Grameen Bank are within the realm of *Shariah*. While a great deal of debate exists over the nature of *riba*, a broad definition of 'unfavorable economic practices' certainly exempts Grameen from this charge. Instead, the economic practices are indeed favorable to all involved parties, adhering to the requirement of *Shariah* that commerce is promoted. Additionally, the partnerships that are formed through the practice of such commerce are in within the scope of both classical and contemporary *Shariah* thought. Classically, these *shirkah* draw on the experiences of the Prophet Muhammad, himself in a partnership that traded differing but equal goods. In more modern times, *Shariah*-compliant practices such as *Ijarah* and *Murabaha* contain many of the same themes as micro-credit lending, yet are approved for use in larger economies. Indeed, the contractual nature of the micro-credit agreement also demonstrates adherence to *Shariah* based on both its guarantee to the lender than the capital will be repaid, but also its promise to the borrower that economic difficulty will not penalize him/her in the future. Also, by allowing women to take a greater part in the economy of Bangladesh, Grameen Bank not only demonstrates compliance to the standards of Shariah, but alludes to a return to true Islamic values. Finally, through *istislah*, one must permit the actions of Grameen

[87] Yunus 201
[88] Yunus 136
[89] Yunus 140
[90] Yunus 136
[91] Yunus 108

Bank even if the low interest rates it charges are proven to be *riba* by the fact that its operations allow those in the deepest poverty to escape the clutches of moneylenders who damage society through their usurious methods.

Ijara-based Sukuk: Sound Structure Prevails Over Limitations

by
Samer Budeir[92]

Today, sukuk have become the most widely publicized and hotly debated mechanisms in the innovative world of Islamic finance. Over the past few years, it has been impossible to follow the rapidly-developing field without reading about the latest mega-sized sukuk offering, with some surpassing $1 billion in total value. Since late last year, however, the Islamic securities market has been tempered by two separate events. The first has been the ongoing global credit crunch, which has reduced the amount of capital available for borrowing. This is likely to have a negative effect on the sale of sukuk, which could lead to a decline in the market's annual growth rate that is currently projected to exceed last year's mark of $47 billion in sales.[93] The second event was a report published by Sheikh Muhammad Taqi Usmani, chairman of the influential Shari'ah board of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in Bahrain. Usmani warned that up to 85 percent of all sukuk issued to date may not be in compliance with Islamic law. The report criticized musharaka-based and mudaraba-based sukuk structures, particularly the repurchase agreements present in their contracts. These repurchase agreements stipulate that issuers would pay back the face value of the sukuk issued upon maturity or in the event of a default. Such contracts mirror the existing structure of conventional bonds, which guarantee lenders a positive return on investment, thereby violating a basic Islamic economic principle whereby lenders and borrowers must

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[93] *Sukuk issuance continues to rise despite slowdown-IFIS Report*, http://www.ameinfo.com/147369.html (February 2008).

share a percentage of the risk present in any financial dealing. Usmani also criticized the fact that assets were not always transferred from the borrower to the lender, leaving the borrower to exclusively shoulder the risk of owning the asset. Usmani viewed the popular ijara-based sukuk structure as being in compliance with the Shari'ah because it is based upon a sale and leaseback agreement involving physical assets such as real estate, which earns investors a return based upon a prevailing market rate.[94] So what impact will recent developments have on the sukuk market? One fear may be that the market's growth rate will gradually decline given the continuing credit crisis and the tightening of the rules and regulations of Islamic finance by influential Shari'ah scholars such as Usmani. Others believe that the sukuk market will continue to grow, although the market may split between pious investors seeking to comply with religious rulings and investors comfortable with the already established and profitable structures.[95] However, despite the recent scholarly criticism and apparent uncertainty facing the sukuk market, sukuk—whether corporate or sovereign—will likely remain at the forefront of financing innovation that has simultaneously raised market liquidity and benefited societies across the world, nudging Islamic finance ever closer to the mainstream spotlight. The issuance of sovereign sukuk by the German state of Saxony-Anhalt—the first sukuk offering by a non-Muslim state—serves as a unique example of the truly global and competitive nature of sukuk, particularly ijara-based sukuk, that have formed the backbone of success by proving to be both profitable and compliant with spirit and letter of the Shari'ah.

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[94] David Oakley, *Clarification of rules does market a favour*, http://www.ft.com/cms/s/0/5ff7ee10-3da6-11dd-bbb5-0000779fd2ac.html?nclick_check=1 (June 2008).
[95] Will McSheehy, *Islamic Bond Scholars Toughen Rules on Sukuk Sales*, http://www.bloomberg.com/apps/news?pid=20601213&sid=aXIXRsgaUP0E&refer=home (March 2008).

In 2001, officials from the central German state of Saxony-Anhalt began studying ways of increasing the level of foreign direct investment in their state of approximately 2.5 million inhabitants. Saxony-Anhalt remains one of the poorer former East German states with a 2007 GDP per capita of only €20,988, significantly lower than former West German states such as Bavaria, which enjoyed a 2007 GDP per capita of €34,716.[96] In 2001, officials from Saxony-Anhalt's Ministry of Finance traveled to Bahrain to persuade Gulf investors—many of whom already held conventional bonds issued by the German state—to invest further by offering them a stake in what were previously state-owned buildings used by the ministry. After an initial delay in 2003 resulting from a politically-charged post-September 11, 2001 environment, €100 million worth of ijara-based sukuk were issued to investors in the GCC, Malaysia, Turkey, UK, and US in 2004.[97] The event marked the first time that sovereign sukuk were issued by a European government, providing Saxony-Anhalt with the opportunity to reduce its internal financing costs and increase foreign direct investment.

In order to understand the ijara-based sukuk structure employed by Saxony-Anhalt, one must first understand the concept of ijara in Islamic finance. An ijara is a financing lease where the rentals during the term of the lease are sufficient to amortize the leasing company's investment, while also serving as a source of profit, particularly in cases of hire-purchase rentals. For example, an Islamic bank would "buy equipment or machinery and lease it out to other clients who may opt to buy the items eventually, requiring monthly payments that include both the rental charge for

[96] *Invest in Germany – Federal States*, http://www.invest-in-germany.com/homepage/germany-at-a-glance/federal-states/bavaria/?backlink=0 (June 2008).
[97] Mushtak Parker, *Saxony-Anhalt to Launch Europe's Debut Islamic Bond*, http://www.arabnews.com/?page=6§ion=0&article=48589&d=19&m=7&y=2004 (July 2004).

use of the equipment and installments towards the purchase price."[98] The rent is fixed in advance prior to the use of the equipment or machinery, although incentives aimed at earning greater profits may be offered. The client can also negotiate the price of the asset if he or she wishes to purchase it at the end of the period, where the lease rentals paid in advance will be part of the price of the tangible asset available for purchase, excluding bank remuneration. The profit element in ijara is permissible despite its apparent resemblance to an interest charge because the product being bought and sold is a tangible asset, not a financial asset, whereby the bank takes on risk through its ownership of such an asset.[99]

The five-year ijara-based sukuk structure offered by Saxony-Anhalt is derived directly from the ijara structure. The structure involves the sale of real estate to a special purpose vehicle (SPV), which represents a transfer of ownership of tangible assets to investors, and a leaseback by the SPV to the government of Saxony-Anhalt. The SPV would then pay investors a return based on the amount of rent collected from the state. This ensures that any future income resulting from the structure will not be guaranteed in absolute terms given the risks shouldered by investors through their ownership of tangible assets and the issuer through their payment of fixed rentals.[100] In this particular transaction, the master lease pertaining to the real estate in question was sold for 100 years to the special purpose vehicle, which was incorporated in the Netherlands for tax purposes, and rented back to the Ministry of Finance for five years with the debts of the state being guaranteed by the German government. It is also important to note that the sukuk were listed on the Luxembourg Stock Exchange

[98] Mervyn K. Lewis and Latifa M. Algaoud, Islamic *Banking*, (Northampton, MA: Edward Elgar, 2001), p. 56.
[99] Ibid., p. 57.
[100] Mushtak Parker, *Saxony-Anhalt to Launch Europe's Debut Islamic Bond*, http://www.arabnews.com/?page=6§ion=0&article=48589&d=19&m=7&y=2004 (July 2004).

as freely tradable certificates, which is not in violation of the Shari'ah since the sukuk represent underlying physical assets and not debts, allowing sukuk to be viewed favorably by investors as flexible capital market instruments.[101] With regards to the rental fee that would be charged to the state, the structure stipulated that investors would receive a variable rent benchmarked to the EURIBOR over the rental period of five years.[102] The EURIBOR, or Euro Inter-bank Offered Rate, is defined as the "rate at which euro inter-bank term deposits within the euro zone are offered by one prime bank to another prime bank."[103] The issue of how the rental fee in ijara-based sukuk is to be determined has been a point of contention among scholars. Indeed, ijara-based sukuk have been structured to give either a fixed or variable return, with a variable return rate often being pegged to a benchmark such as EURIBOR, as in the case of the sukuk issued by Saxony-Anhalt. Some Shari'ah scholars do not object to using interest-based benchmarks as mere lease-pricing reference points, despite the fact that these benchmarks are the prime rates used by banks to calculate interest. These scholars argue that landlords and tenants often agree to raise or lower the lease price on a physical asset such as a building over the period of tenancy.[104] Other scholars, however, believe such benchmarks should not be used since they are directly linked to interest rates that would too closely mimic returns earned on interest-bearing bonds.[105] One can suggest using annual market-based fluctuations relevant to the physical assets in question to determine an increase or decrease in the leasing price. In general, critics of Islamic finance have argued that the return earned on such

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[101] Abradat Kamalpour, *Islamic Capital Market Instruments: Moving Beyond the 'Ijara Sukuk,'* http://www.gtnews.com/article/5509.cfm (June 2004).
[102] Rory Todd, *Sukuk: Emergence as a Multi-Purpose Shariah Compliant Financing Product*, http://www.worldservicesgroup.com/publications.asp?action=article&artid=2153 (November 2007)
[103] Euribor Homepage, http://www.euribor.org (June 2008).
[104] Abradat Kamalpour, *Islamic Capital Market Instruments: Moving Beyond the 'Ijara Sukuk,'* http://www.gtnews.com/article/5509.cfm (June 2004).
[105] Abdel-Khaleq, Ayman H. and Christopher F. Richardson, *New Horizons for Islamic Securities: Emerging Trends in Sukuk Offerings*, Chicago Journal of International Law, January 2007, Vol. 7, No. 2, www.vinson-elkins.com/uploadedFiles/VEsite/Resources/IslamicSecurities.pdf (June 2008).

transactions is very similar to the return earned on conventional bonds, claiming that Islamic financing options merely alter the route that reaches the same end. While this may be true in many cases, such criticism ignores the fact that the mechanism by which a given return is achieved is as important to Muslim investors as the return itself.[106] Such Shari'ah compliant mechanisms are required to pass through specific avenues that promote profit-sharing by spreading the risk among issuers and investors, which in turn minimize the possibility of exploitation; such mechanisms facilitate direct investment in *halal* goods or services that are backed by underlying tangible assets that remain free from excessive uncertainty, risk, or speculation.

As Islamic finance continues to grow throughout the world, the question as to why non-Muslims may opt to pursue Islamic financing options should be addressed. A segment of the non-Muslim population may find itself in agreement with the spirit of Islamic finance based upon ethical grounds and therefore attracted to the various Islamic financing vehicles currently available. However, the incentive to earn a profit—one shared by all investors regardless of their faith—coupled with the opportunity to attract investment to one's community are arguably two of the strongest incentives. This was undoubtedly the driving motivation for the Ministry of Finance in Saxony-Anhalt. Edgar Kresin, the treasurer at the ministry, revealed that the sukuk offering was not only issued to raise capital, but also to serve as a marketing tool in the hopes of increasing the level of foreign investment in the state. Kresin noted that there would have been little reason for his state to opt for sukuk over conventional financing instruments if the state's goal was only to raise capital. He stated, "You need another target besides just funding. It doesn't make so much

[106] Abdel-Khaleq, Ayman H. and Christopher F. Richardson, *New Horizons for Islamic Securities: Emerging Trends in Sukuk Offerings*, Chicago Journal of International Law, January 2007, Vol. 7, No. 2, www.vinson-elkins.com/uploadedFiles/VEsite/Resources/IslamicSecurities.pdf (June 2008).

sense just from a funding perspective, but from a strategic way of thinking it may make sense for a state."[107]

So is the success of the Saxony-Anhalt sukuk offering an anomaly or will it be replicated in other non-Muslim jurisdictions? As of July 2007, the 2004 Saxony-Anhalt sukuk remained the only sovereign sukuk issued by a non-Muslim state.[108] Such a fact appears to be puzzling given the recent flush of petrodollars that has left many Gulf investors with an unprecedented level of capital that others would naturally seek to attract. In 2004, some had hoped that the success of the Saxony-Anhalt sukuk offering would entice other European states to quickly follow suit, despite the fact the principal on is not due in full until 2009. The fact that other governments may be waiting to see whether the sukuk are, in fact, profitable may be one reason for the lack of issuance of sovereign sukuk by non-Muslim governments around the globe. An obvious reason, of course, may be the lack of ethical incentive on the part of non-Muslim states to invest in accordance with the Shari'ah if such investments do not produce equal or greater profitability in comparison with debt-based financing. Similar to Saxony-Anhalt's reason for postponing its issuance of the sukuk in 2003, other non-Muslim states may also hesitate in pursuing Islamic financing options if anti-Muslim sentiment is prevalent in their respective societies, which may spur negative political repercussions. Yet another reason may be the willingness of Muslim investors to sign onto both Islamic and conventional financing vehicles, particularly in well-established and profitable markets that are inherently a source of attraction for investment; such markets would not be in a rush to pursue

[107] Mushtak Parker, *Saxony-Anhalt to Launch Europe's Debut Islamic Bond*, http://www.arabnews.com/?page=6§ion=0&article=48589&d=19&m=7&y=2004 (July 2004).
[108] Rory Todd, *Sukuk: Emergence as a Multi-Purpose Shariah Compliant Financing Product*, http://www.worldservicesgroup.com/publications.asp?action=article&artid=2153 (November 2007).

Islamic financing options as part of a greater marketing strategy to attract investment and increase liquidity. Finally, there exists a general lack of knowledge and awareness of the multitude of Islamic financial products available and how best to tailor a given vehicle to fit the needs of the state. The problem is further compounded by a lack of local experts in the field, which adds further pressure to their cost base as oversight by a concentrated number of international financial institutions and law firms is likely to be required.[109]

However, the Islamic finance industry and the sukuk market in particular continue to enjoy double-digit percentage growth year after year. Indeed, it is been estimated that the number of sukuk offerings is likely to grow by 15 to 20 percent in 2008, "driven by petrodollars and infrastructure funding in Malaysia and the Middle East."[110] Ernst & Young has estimated that Islamic finance assets have been growing over twenty percent a year and, having reached $900 billion in 2007, are projected to surpass $2 trillion by 2010.[111] While sovereign sukuk offerings by non-Muslim states have yet to be routinely issued, sovereign sukuk are being issued throughout the Muslim world, a phenomenon that began with Malaysia's $600 million Global Sukuk in 2002, Qatar's $700 million Global Sukuk in 2003, and Bahrain's $250 million Global Leasing Sukuk in 2004.[112] The increase in corporate sukuk offerings involving Muslim and non-Muslim investors alike has also been well-documented, including the $3.52 billion ijara-based sukuk offering by Dubai's Nakheel and the first US-based sukuk

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[109] Alexander Campbell, *Seeking Sukuk*, http://db.riskwaters.com/public/showPage.html?page=438758 (March 2007).
[110] *Global Sukuk Issuance Can Grow by 20 Percent a Year,* http://in.reuters.com/article/asiaCompanyAndMa rkets/idINKLR11122620080507?pageNumber=1&virtualBrandChannel=0 (May 2008).
[111] Ibid.
[112] Abdel-Khaleq, Ayman H. and Christopher F. Richardson, *New Horizons for Islamic Securities: Emerging Trends in Sukuk Offerings*, Chicago Journal of International Law, January 2007, Vol. 7, No. 2, www.vinson-elkins.com/uploadedFiles/VEsite/Resources/IslamicSecurities.pdf (June 2008).

offering issued by the East Cameron Gas Company in 2006.[113] The $165.7 million musharaka-based sukuk offering was backed by US oil and gas sets raised new questions concerning the types of assets that can be used when structuring sukuk.[114] Although inherent disadvantages to ijara-based sukuk exist—including limited access to the underlying assets, limited freedom to divest the underlying assets, and issues related to taxation and auditing throughout the duration of the transaction—the structure is deemed to be Shari'ah-compliant in both spirit and letter and has proven to be popular with religious scholars and profitable with investors.[115] Other sukuk structures, including musharaka and mudaraba-based sukuk, are likely to be modified in light of criticism by Shari'ah scholars in order to obtain what is a highly prized attribute in today's world of Islamic finance—credibility.

So what is the future of Islamic finance and the sukuk market? Can sukuk be structured in various ways that increase liquidity in the markets and remain in compliance with the Shari'ah? Although still clearly in its infancy, Islamic finance is a rapidly evolving field that is growing and expanding across the globe. Indeed, much of this report focused on the issuance of the Saxony-Anhalt sukuk offering—its background, structure, and significance—in order to provide a detailed example of the impact Islamic finance changing has and will continue to have on global banking and finance. The fact that a former East German state sought to finance their own public infrastructure through the issuance of ijara-based sukuk totaling €100 million speaks volumes about the soundness of Islamic economic principles and the extent to which

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[113] *Sukuk–A New Dawn of Islamic Finance Era*, Global Investment House, January 2008, www.menafn.com/updates/research_center/Regional/Special_Ed/gih0108.pdf (June 2008).
[114] Abdel-Khaleq, Ayman H. and Christopher F. Richardson, *New Horizons for Islamic Securities: Emerging Trends in Sukuk Offerings*, Chicago Journal of International Law, January 2007, Vol. 7, No. 2, www.vinson-elkins.com/uploadedFiles/VEsite/Resources/IslamicSecurities.pdf (June 2008).
[115] Abradat Kamalpour, *Islamic Capital Market Instruments: Moving Beyond the 'Ijara Sukuk,'* http://www.gtnews.com/article/5509.cfm (June 2004).

they can effectively function in the twenty-first century. Islamic finance has also managed to attract Muslims and non-Muslims alike to an ethically-based system of banking that can serve as either a complement or an alternative to the global debt-based system. Sukuk in particular have proven to be both flexible in structure and competitive in the marketplace. However, if Islamic finance is to thrive, the field must continue to bring forth new ideas and vehicles that expand financing options that meet the needs of society. Islamic finance must also begin to substantially cater to medium and small-sized business owners that wish to invest their money in accordance with the Shari'ah. Finally, above all else, scholars and non-scholars alike must continue to evaluate and criticize those structures that appear to violate the Shari'ah in order to establish credibility, which is required to ensure the long-term profitability of the industry.

Risk Checklist: Figuring Out What Can Go Wrong for Islamic Finance Practitioners

by

Warren Edwardes[116]

Basel II, or The New Accord, is certainly changing the banking landscape and will also have an impact on the real world. Up until now, there has been a "one size fits all" approach to the capital backing required for risk. Capital allocation is now more sensitive to risk in all its guises. In investment management, it would be unthinkable if investments or projects of different risks were treated equally in terms of determining the required return. Under Basel II, lending now falls into line with investment principles.

But Basel II is about regulatory capital and it would be imprudent to rely on it to determine your own risk profile. While it is impossible for an individual or bank to plan for absolutely every eventuality, by careful assessment of all risk exposures, you can be in the best possible shape to address adversity if and when it comes by paying attention to some of the risk factors below.

Does Islamic banking risk differ from Western banking risk? Not really, but there are a few special cases. Risk is much the same as for a French bank branch in Singapore or an Australian bank subsidiary in the US.

Acquisition Risk: Do you really know what you are buying? The Enron saga shows that accounting can be highly creative. On the other hand, as the target of acquisitive companies, are you spending too much management time fending off predators? Can you marry the different cultures between banks?

Careless Error Risk: Overconfidence leads to errors. I still vividly remember, as a raw but confident dealer more than twenty years ago, saying "Buy dollars" when I

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meant “Buy pounds.” It was highly embarrassing, but it was quickly sorted out. Human error should be forgiven, but law does not cover this.

Competitive Risk: Don't put off that product too long, even if it is going to compete with existing products. Somebody else will build a better home loan product if you do not. Be innovative or ready to immediately react to competitors.

Commodity Risk: Are your customers subject to gold or oil prices? Gold producers have their liabilities linked to the gold price. If you take delivery under an Islamic contract, can the commodity price be managed?

Communication Risk: Send that confirmation now and avoid jargon! Define terms clearly. Is it murabaha or tawarruk that you are dealing with? Are your liabilities deposits or managed funds?

Competence / Understanding: Are the latest guaranteed investor products really understood by the bank’s senior management? Do you understand your dealers? Don't be afraid of your own ignorance. Go on a course or buy a book. And don't be afraid to ask seemingly stupid questions.

Concentration of Assets Risk: Large exposure risk is obvious, but sometimes governments direct banks to lend to champion industries. This is a problem for Islamic finance, as the avoidance of tobacco, banking and alcohol investments can lead to heavy weighting in property and technology. Non-correlated investments need to be identified.

Concentration of Liabilities Risk: Does your fund depend on one or two investors? Retail bankers have fewer liquidity problems than wholesale bankers. Do not place yourself at the mercy of a few lenders.

Concentration of Business Type Risk: Financial supermarket or nimble niche player are both fine. If market appetite or regulations change, can you reinvent your institution?

Convertibility Risk: Can the currency be converted and delivered into a freely tradable currency?

Country Risk: Is lending carried out in local emerging markets really riskier from your bank's perspective than an investment in the US?

Credit Risk: How much has the customer borrowed elsewhere? Has your client used off-balance sheet finance excessively? Will the parent really stand behind that "letter of comfort"? Do you understand the terms behind credit derivatives? In Islamic banking, risks are perhaps not loans, but rather, equity risks. Look at the documentation. The reality may be that they are loans dressed up to look like equity.

Cultural Risk: Contracts are sometimes seen as a basis for negotiation. Remember that there is a difference between the Middle East and Malaysia in Islamic banking.

Currency Economic Risk: GCC currencies are US dollar-based, but will they become euro linked with an increase in politically driven trade? Economic exposure is seldom hedged.

Currency Transaction Risk: This is the risk that future foreign currency receivables will change in home currency terms. If derivatives are not permitted, then an Islamic institution cannot hedge the exchange rate. However, a number of institutions (including Delphi) are developing derivatives substitutes for Islamic institutions.

Currency Translation Risk: This concerns the risk of revaluation of foreign assets or liabilities as a result of a movement in currency value. If GCC currencies de-link from the US dollar, the balance-sheet value of dollar assets or liabilities will fluctuate in home currency terms.

Customer Satisfaction Risk: Do your customers like doing business with you? Will they come back for more of the same? Do they call you for other products? If you are running an Islamic profit-and-loss product and you make a loss, will you pass that on to your customers? If a bank pays no dividends, customers will get angry. There is a moral hazard.

Energy Price Risk: Mexico has had the interest rate on its liabilities linked to the price of oil. Most Islamic countries' economies are linked to the oil price.

Environment Risk: If you lend to polluters, you may be faced with competition from a bank such as the Co-operative Bank of the UK that does not. Are environmentally unfriendly policies haram?

Equity Market Risk: Islamic banking is ideally profit-and-loss sharing. This is venture capital or equity investment. If the funds are own account, then beware, as equity investments have a higher capital requirement than loans.

Fraud (Banker) Risk: Make sure you tape all conversations. Transparency is a must. Avoid the risk of misinterpretation and mis-selling

Fraud (Customer) Risk: Will your client say that he did not understand that complex structure? All will be fine if the client is winning. He will only cry "foul" if he loses. I am a regular expert witness in cases and there are only complaints when deals go sour.

Fraud (Staff) Risk: This often follows a covered-up disaster. Watch staff who don't take holidays, as many an irregularity has surfaced when a banker who never takes a holiday falls ill and his position is taken over by a colleague. Reward whistle-blowers.

Image / PR Risk: Recovery from bad publicity is extremely difficult. Keep the media, rating agencies and your counterparties fully informed of any potential difficulties. No fund manager or treasurer wants to hold an asset or do business with a bank that suffers from adverse reporting in the media. There was an initial global reaction against all Gulf banks in the aftermath of September 11th. There should have been proactive PR. Something approved by Shariah scholars as halal may be deemed by the market as haram.

Inflation Risk: Putting up real assets as security in an asset-backed Islamic transaction may lead to over-securitization.

Interest Rate Risk: Property is linked to interest rates. Islamic finance is not a closed economy. If interest rates rise sharply in relation to mark-up rates, deposits will flow out of Islamic banks and into conventional banks, and vice versa.

Interaction Risk: Are GCC currencies really fixed to the US dollar? Could Gulf countries become linked to the euro?

Language Risk: The same Arabic or English word can have different meanings in the other language.

Legal Risk: Are credit derivatives insurance contracts and therefore prohibited to banks in many countries?

Liquidity Risk: Liquidity is much less about holding liquid assets than about managing and diversifying liabilities. Remember Continental Illinois and recently, Northern Rock. Manage diversification of both assets and liabilities. Events such as September 11th can lead to a freeze on lending. This is a major problem for Islamic banks in the absence of a developed Islamic money market. With oil prices heading to $150 per barrel and ever more cash available in oil-rich countries, this is not an immediate problem. But what happens when oil falls to $50 per barrel?

Mortality Risk: Catch separate flights on trips, and don't even think about buying key-man insurance. A sure sign of a badly run firm or team is when such insurance is even considered. It may be good for the ego of the person in question, but the solution is not the purchase of insurance, but rather internal hedging. Just make sure that at least two people can do the job.

Operational Risk: This covers everything other than market or credit risks. Are strong procedural systems in place?

Performance Measurement Risk: Any banker worth hiring can manage his management accounts and can show book profits at the expense of real losses. Just make sure you check the character of the person you are hiring. Most measures of

performance are crude, and slavish adherence to rules can lead to poor real performance.

Political Risk: September 11th and events in Palestine, Lebanon and Iraq have made an impact on Middle East banking. What would be the impact of a US or Israeli attack on Iran?

Property (Real Estate) Risk: Do your property asset-backed loans have sufficient cover? Is the property liquid?

Rating Agency Risk: A downgrading or even credit watch can impact on liquidity and the entire business. Investment grade bonds do not default; they become junk and then default. On the other hand, an upgrade can have an impact on appetite for other regional debt.

Regulatory Risk: If you operate in several countries, you may face different rules.

Religious Risk: A halal product may later be deemed haram. Zero coupon bonds were halal. Non-Islamic banks may have to become Islamic.

Resignation Risk: Will the star team move to a competitor after you buy the bank? This has happened on several occasions in the Gulf and in Islamic banks in London.

Settlement Risk: This is the risk that you meet your part of the bargain and your counterparty does not. Escrow accounts could have averted the only murabaha default case to have gone to court.

Tax Risk: Islamic banking has a tax impact in Western countries. Do sale and repurchase transactions face purchase tax? Are economically identical products treated differently in an Islamic and conventional bank in the same country?

Technological Risk: Can your systems manage in a disaster or war? Can you cope with system failure? Are your fax confirmations going to your customer or a competitor? Email can take a long time – perhaps days.

Weather Risk: Iraq's burning oil fields probably had an adverse impact on employees' health and tourists. Weather derivatives are being traded, but are haram. Is weather takaful an option?

Zero Risk: This final risk is the most insidious and dangerous risk. Zero risk is the risk of having a risk manager who always says "No" and who comes up with 50 ways not to do the business. Of course, you will never appear to lose money. You will never be known for making a wrong decision. It is just that the business will go elsewhere and your firm will find itself with unemployed capital!

Special Risks for Islamic Banks

Islamic banks are really not so different from conventional banks, but there are some variances. What are the main risks for Islamic banks?

- Liquidity. There is still an underdeveloped money market
- Interest-rate risk.
- Commodity risk. If the circular murabaha contracts are unwound, the individual deals are expressed in commodity terms.
- Communication risk. There are varying definitions of products.
- Equity risk. Is the bank engaging in fund management or banking?
- Operational risk.
- Religious. Halal or haram? Can interpretations change?

Risk Management Issues in Islamic Banks

by

Khalid Hamad[117]

Introduction

Bahrain's reputation as an international financial centre of excellence extends over three decades, first with the development of offshore banking in the 1970's and 1980's and then accompanied by the development of Islamic banking commencing with the establishment of Bahrain Islamic Bank in 1978. The 1990's was the decade when Islamic banks really grew in size and in number. The issuance of the Prudential Regulations for Islamic Banks framework in 2001, followed by the Islamic Banking Prudential Rulebook in 2005 marked the maturing of the Islamic Banking Sector in Bahrain. Islamic banks finally had their own regulatory framework customised for their products and their unique risk structure.

Islamic banks enjoy a sound international best practice framework through the work of AAOIFI (the Auditing & Accounting Organisation for Islamic Financial Institutions) and the Islamic Financial Services Board which both set global standards for auditing and supervisory matters respectively. The CBB is proud to be a member of both organisations and plays an active role in their many committees and initiatives.

Risk Management Issues

Islamic banks may offer products that appear similar to conventional products; however Islamic banks differ from conventional banks in that the key principle underlying their relations with customers is the principle of profit and loss sharing. Islamic banks share the yield resulting from the use of investors' funds and allocate profits according to a predetermined ratio (but not at a predetermined rate of interest). Liabilities which fund the assets of an Islamic bank must be designed to expose the investors to losses as well as profits on the underlying investments. Because of this

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participatory risk relationship by the investor, the financial institution is not as exposed to credit risk as is a conventional bank. This relationship also has implications for the structure of an Islamic bank's balance sheet compared with a conventional bank. Assets financed by investment accounts may be viewed as "off-balance sheet" if the investment accounts are restricted in some way (by where, how or for what purpose funds may be invested for example). These funds are therefore managed like mutual funds by a conventional bank and are not regarded as part of the concerned bank's on-balance sheet assets. There are separate income statements and balance sheets for these off-balance sheet investments.

Types of Risk

Finance provided by Islamic banks is asset-backed. It is connected to the value of tangible assets such as buildings, or machinery or aircraft. These assets are subject to volatility in their values (as distinct from depreciation). This means that banks are exposed to not only the risk of default by a customer, but also to volatility in the amount of credit mitigation available from the asset in the event of the need to realise their value. This means that there are not just risk weighted assets for the book value of the outstanding credit facility, but also s-called "market risk charges" in respect of the value of the assets collateralising the finance facility, at the start of the life of a facility, sometimes during the life of a facility and at termination of the facility if the customer returns the assets to the bank and does not take title. This means that the regulatory risk-weighting framework for Islamic banks is more complex than for conventional banks and that the Islamic banks need additional risk management policies and procedures to manage these risks.

Internal Risk Management Systems

Just like their conventional counterparts, Islamic banks are required to have in place a comprehensive risk management process in order to identify, measure, monitor, report and control different types of risks. However, Islamic products and transactions entail full compliance with Shari'ah rules and principles especially the prohibition of interest. Also Islamic products entail a unique fiduciary relationship between the banks and their customers, and thus require additional risk management measures. All these additional risks to those faced by conventional banks may be categorized

under the following headings; namely Shari'ah compliance risk, fiduciary risk, displaced commercial risk and reputational risk.

The main categories of Islamic instruments/transactions are; (1) asset-based products such as Murabaha, Salam, Istisna'a, and Ijarah; (2) profit sharing relationships in the case of Musharaka and Mudarabah; and (3) Sukuk (which are sometimes referred to as "Islamic bonds"). The major categories of risk associated with Islamic products are given below:

1. Credit risk

Islamic banks must have in place a framework for credit risk management. This framework should include a strategy for identifying the various potential credit and other risk exposures that may arise at different stages of financing agreements. Examples of financing exposures that have variable risk profiles include Murabaha and Ijarah and working capital financing transactions such as Salam and Istisna'a.

2. Equity investment risk

This is a particular type of credit risk related to the risks and potential liabilities of the equity investments in partnership with third parties, including Mudarabahh and Musharakah. Islamic banks should have in place appropriate strategies, risk management and reporting processes related to the risk characteristics of joint equity investments. Potential risks are related to the initial and ongoing assessment of the quality of the partner the risks and potential liabilities of the underlying business activities and ongoing operational matters. These risks are in addition to the normal credit assessment measures that must be carried out.

3. Market risk and Asset Valuation Volatility

For a conventional bank, market risk is the risk of losses in on-and off-balance sheet positions arising from movements in market prices of financial instruments and positions in the trading book. However the scope of market risk for Islamic banks includes asset valuation volatility on assets held as collateral for financing transactions.

For example, in operating Ijarah, a lessor is exposed to market risk on the residual value of the leased asset at the term of lease or if the lessee terminates the lease earlier (by defaulting), during the contract. In **IMB**, a lessor is exposed to market risk on carrying value of the leased asset (as collateral) in the event that the lessee defaults on the lease obligations.

In Salam, banks are exposed to commodity price fluctuations on a long position after entering into a contract and while holding the subject matter until it is disposed of. In the case of parallel Salam, there is also the risk that a failure of delivery of the subject matter would leave the bank exposed to commodity price risk as a result of the need to purchase a similar asset in the spot market in order to honour the parallel Salam contract.

4. Liquidity Risk

The liquidity risk management framework needs to take into consideration separately and on overall basis the liquidity positions of different types of accounts (i.e. current accounts, unrestricted and restricted investment accounts, sukuk obligations, and owners' equity). There are two major types of non-equity providers of funding; (a) current account holders; and (b) unrestricted investment account holders. These account holders require a degree of liquidity to be maintained by the bank to meet their requirements for withdrawals. Subject to contractual conditions, restricted investment account holders (while not strictly speaking on-balance sheet fund providers) may also give rise to liquidity management considerations, in so far as bank may need to replace funds that investor wishes to withdraw prior to realization of the related assets.

Unrestricted investment account holders (IAH) are investors who participate in the uncertainties of the general business of bank on a day-to-day basis; therefore, they share in profits and bear losses arising from investments made on their behalf, to the extent of their share. Apart from general withdrawal needs, the withdrawals made by IAH may be the result of (a) lower than expected or acceptable rates of return; (b) concerns about the financial conditions of the bank; and (c) non-compliance by the bank with Shari'ah rules and principles in various contracts and activities.

5. Rate of Return Risk

The risk management framework should be able to assess the potential impacts of market factors affecting rates of return on assets. Banks are exposed to rate of return risk in the context of their overall balance sheet exposures. An increase in benchmark rates may result in IAHs having expectations of a commensurate higher rate of return. Rate of return risk differs from interest rate risk in that investors in the bank are concerned with the result of their investment activities at the end of the investment-holding period rather than having an immediate reactive concern to shifts in the yield curve. Results cannot be pre-determined immediately. Rate of return risk is therefore more difficult to quantify than interest rate risk for a conventional bank.

A consequence of rate of return risk may be **displaced commercial risk**. Banks may be under market pressure to pay a return that exceeds the rate that has been earned on assets financed by IAH when the return on assets is under-performing as compared with competitors' rates. Banks may decide to waive their rights to part or their entire Mudarib share of profits in order to satisfy and retain their fund providers and dissuade them from withdrawing their funds. Displaced commercial risk derives from competitive pressures on banks to attract and retain investors or fund providers. The decision of banks to waive their rights to part or all of their Mudarib share in profits in favour of IAH is a commercial decision, the basis for which needs to be subject to clear and well defined policies and procedures approved by the bank's board of directors, to ensure fairness and transparency to the various categories of IAHs.

6. Operational Risk

Banks are exposed to risks relating to Shari'ah non-compliance and risks associated with the banks' fiduciary responsibilities towards different fund providers. These risks expose banks to the possibility of withdrawals by fund providers, or to loss of income or voiding of contracts leading to diminished reputation or the limitation of business opportunities.

Shari'ah non-compliance risk is the risk that arises from banks' failure to comply with the Shari'ah rules and principles determined by the Shari'ah Board of the bank or the relevant body in the jurisdiction in which the banks operate.

Shari'ah compliance is critical to banks' operations and such compliance requirements must permeate throughout the organisation and their products and activities. Shari'ah compliance risk may extend into the companies in which a bank invests on a Musharaka or Mudarabah basis. Banks therefore need to monitor their investments for Shari'ah compliance. An obvious example would be an investment in a food company that used pork in new product line.

Conflicts of interest are also an ongoing part of operational risk. Banks therefore must establish and implement a **clear and formal policy for undertaking their different and potentially conflicting roles** in respect of managing different types of investment accounts. The policy relating to safeguarding the interests of their IAH should include the identification of investment activities that contribute to investment returns and taking reasonable steps to carry on those activities in accordance with the bank's fiduciary and agency duties and to treat all their fund providers appropriately and in accordance with the terms and conditions of their investment agreements.

Expanding the Scope of Reporting Accountants

An essential part of good risk management is a credible and effective assessment process of the internal system and controls in banks. The CBB uses its Inspection Directorate to carry out reviews of banks' internal systems and controls, but may complement these where appropriate by the use of external consultants (usually from audit forms). These "reporting accountants" carry out assessments of targeted areas of bank's operations to review among other things the effectiveness of the risk management framework.

Banks may be selected for such reviews based upon their systematic risk potential or by virtue of shortfalls revealed in audit reports, management letters, Central Bank inspection reports, supervisory reviews or operational risk events. These assessments

are carried out, as a matter of policy, by consultants who are unrelated to the concerned bank.

The bank is then given the opportunity to reply to the report and make remedial measures as applicable. The CBB does not make routine use of such reports, preferring to utilize them on a selective basis, always after discussion with the concerned institution,

Compliance Review Road Map

Furthermore, and towards achieving same objectives, the CBB has put more emphasis in ensuring that new licensees set up its internal systems and controls and that adequate measures are in place to safeguard both shareholders' and clients' funds.

In the immediate short-term, this means that the board and management must carry out a "compliance review" of the CBB's requirements on the bank's current internal systems and controls. This compliance review might be performed by way of constructing a "compliance roadmap", outlining the CBB's requirements (as stated in the Rulebook) and showing the measures in place to achieve compliance (or the gaps which need to be filled) and the responsibility for monitoring and maintaining compliance.

The following are examples of the areas where the CBB places great emphasis:

Board Level

- Corporate Governance
- Corporate Strategy
- Business Plan
- Policies & Procedures including, but not limited to:
  - Investment
  - Large Exposure
  - Credit Culture
  - Human Resources
- Risk Management Function

- Internal Audit Function
- Compliance Function

Management Level

- IFSB (CAS)/Basel II Implementation Plan
- Information Technology Major Projects

In line with the above, the new licensees are required to present the compliance review in a form of a roadmap.

Basel II Pillar I/IFSB

The Central Bank of Bahrain (CBB) issued a consultation on implementation of Basel II/IFSB, the new international regimen on capital adequacy and risk management for banks in January 2007.

The consultation paper contains CBB's policy for implementing Basel II/IFSB requirements related to Pillar One, which deals with minimum capital requirements for Islamic banks. The Pillar One requirements were finalized and the CBB implemented Basel II/IFSB in January 2008.

The proposals contained in the consultation paper cover revised requirements concerning credit and market risk, consolidation and deduction issues and new capital requirements for operational risk.

The proposals followed from extensive dialogue which had been taking place between the CBB and Bahrain's banks over the past one year.

A key highlight of the CBB proposals included a new risk-focused approach to credit and operational risk. It is the intention of the CBB to review the current industry-wide 12% trigger (and 12.5% target) minimum capital adequacy requirements and to set individual minimum trigger and target capital ratios for each bank based on supervisory reviews of all locally incorporated banks which will take place in 2007 and 2008.

There is also greater recognition of credit risk mitigation in Basel II/IFSB. The CBB proposals allow the increased use of external credit assessments for risk weightings of banks' assets. There are also new risk weighting arrangements for past due receivables, low-rated sovereigns and holding of securitization tranches below investment grade in the consultation paper.

In order to identify credit and market risks inherent in Shari'ah compliant products at various stages of their respective contracts, the CBB has approved the use of the standardized approach as given in Basel II/IFSB for credit risk and adopted the IFSB's guidelines for market risk or asset valuation volatility related to assets used as collateral in Islamic financing products.

The new regulations not only comply with Islamic concepts but also provide a framework which effectively captures risks inherent in Islamic transactions. The key points for the main categories of Islamic products are given below:

Murabahah and Non-binding Murabahah for the purchase orderer (MPO):

Credit Risk

The credit exposure is based on accounts receivable in Murabahah (the term used herein includes MPO), which is recorded at their cash equivalent value i.e. amount due from the customers at the end of the financial period less any provision for doubtful debts.

The accounts receivable (net of specific provisions) amount arising from the selling of a Murabahah asset are assigned a RW based on the credit standing of the obligor (purchaser or guarantor) as rated by an ECAI that is approved by the CBB. In case the obligor is unrated, a RW of 100% applies.

Binding MPO

In a binding MPO, the bank is exposed to default on the purchase orderer's obligation to purchase the commodity in its possession. In the event of the orderer defaulting on its promise to purchase (PP), the bank will dispose of the asset to a third party. The bank will have recourse to any hamish jiddiyah (HJ) paid by the orderer, and (a) may

have a right to recoup from the orderer any loss on disposing of the asset, after taking account of the HJ, or (b) may have no such legal rights. In both cases, this risk is mitigated by the asset in possession as well as any HJ paid by the purchase orderer.

In case (a), the bank has the right to recoup any loss (as indicated in the previous paragraph) from the orderer, that right constitutes a claim receivable which is exposed to credit risk, and the exposure shall be measured as the amount of the asset's total acquisition cost to the bank, less the market value of the asset as collateral subject to any haircut, and less the amount of any HJ. The applicable RW shall be based on the standing of the obligor as rated by an ECAI that is approved by the supervisory authority, and in the case the obligor is unrated, a RW of 100% shall apply.

Market Risk

Generally assets are subject to a "market risk" charge of 15% or 8% of their Carrying Value subject to any buyback arrangements with the vendor of the assets.

Murabahah and Non-binding MPO

In the case of an asset in possession in a Murabahah transaction and an asset acquired specifically for resale to a customer in a non-binding MPO transaction, the asset would be treated as inventory of the bank and using the simplified approach the capital charge for such a market risk exposure would be 15% of the amount of the position (carrying value), which equates to a RW of 187.5%. The 15% capital charge is also applicable to assets held by a bank in respect of incomplete non-binding MPO transactions at the end of a financial period.

Assets in possession on a 'sale or return' basis (with such an option included in the contract) are treated as accounts receivable from the vendor and as such would be offset against the related accounts payable to the vendor. If these accounts payable have been settled, the assets shall attract a capital charge of 8% (i.e. a RW of 100%), subject to (a) the availability of documentation evidencing such an arrangement with the vendor, and (b) the period for returning the assets to the vendor not having been exceeded.

Binding MPO
In a binding MPO the orderer has the obligation to purchase the asset at the agreed price, and the bank as the seller is only exposed to credit risk.

Salam:

Credit Risk
The amount paid for the purchase of a commodity based on a Salam contract is assigned a RW based on the credit standing of the counterparties as rated by an ECAI that is approved by the CBB. In case the counterparties are unrated, a RW of 100% applies.

The credit exposure amount of a Salam contract is not offset against the exposure amount of a Parallel Salam contract, as an obligation under one contract does not discharge an obligation to perform under the other contract.

Market Risk
The price risk on the commodity exposure in Salam can be measured in two ways, either the maturity ladder approach or price risk. Under the price risk, the capital charge will equal to 15% of the net position in each commodity, plus an additional charge equivalent to 3% of the gross positions, long plus short, to cover basis risk and forward gap risk. The 3% capital charge is also intended to cater for potential losses in Parallel Salam when the seller in the original Salam contract fails to deliver and the bank has to purchase an appropriate commodity in the spot market to honour its obligation.

The long and short positions in a commodity, which are positions of Salam and Parallel Salam, may be offset under either approach for the purpose of calculating the net open positions provided that the positions are in the same group of commodities.

Istisna'a:

Credit Risk

Full Recourse Istisna'a

The receivable amount generated from selling of an asset based on an Istisna'a contract with full recourse to the customer (buyer) shall be assigned a RW based on the credit standing of the customer as rated by an ECAI that is approved by the CBB. In case the buyer is unrated, a RW of 100% shall apply.

Limited and Non-Recourse Istisna'a

When the project is rated by an ECAI, the RW based on the credit rating of the buyer is applied to calculate the capital adequacy requirement. Otherwise, the RW shall be based on the 'Supervisory Slotting Criteria' approach for Specialised Financing (Project Finance).

Market Risk

Full Recourse Istisna'a

Istisna'a without Parallel Istisna'a

A capital charge of 1.6% (equivalent to a 20% RW) is to be applied to the balance of unbilled WIP inventory to cater for market risk, in addition to the credit RW stated above. This inventory is held subject to the binding order of the Istisna'a buyer and is thus not subject to inventory price.

Ijarah and Ijarah Muntahia Bittamleek:

Credit Risk

In a binding promise to lease (PL) contract, when a bank is exposed to default on the lease orderer's obligation to execute the lease contract, the exposure shall be measured as the amount of the asset's total acquisition cost to the bank, less the market value of the asset as collateral subject to any haircut, and less the amount of any 'urbun received from the lease orderer. The applicable RW shall be based on the

standing of the obligor as rated by an ECAI that is approved by the CBB, and in the case the obligor is unrated, a RW of 100% shall apply.

In applying the treatment as set out above, the bank must ensure that the PL is properly documented and is legally enforceable. In the absence of a proper documentation and legal enforceability, the asset is to be treated similarly to one in a non-binding PL which is exposed to market (price) risk, using the measurement approach described below.

Operating Ijarah

When the leasee gets the right to use the asset, the lessor is exposed to credit risk for the estimated value of the lease payments in respect of the remaining period of ijarah. This exposure is mitigated by the market value of the leased asset which may be repossessed. The net credit risk exposure shall be assigned a RW based on the credit standing of the lessee/counterparty as rated by an ECAI that is approved by the CBB. In the case that the lessee is unrated, a RW of 100% shall apply.

IMB

When the lessee gets the right to use the asset, the capital requirement for IMB is based on the total estimated future ijarah receivable amount over the duration of the lease contract. This exposure is mitigated by the market value of the leased asset which may be repossessed. The net credit risk exposure shall be assigned a RW based on the credit standing of the lessee/counterparty as rated by an ECAI that is approved by the CBB. In the case that the lessee is unrated, a RW of 100% shall apply.

Market Risk

In the case of an asset acquired and held for the purpose of either operating Ijarah or IMB, the capital charge to cater for market (price) risk in respect of the leased asset from its acquisition date until its disposal can be categorised into the following:

Non-binding PL

The asset for leasing will be treated as inventory of the bank and using the simplified approach the capital charge applicable to such a market risk exposure would be 15% of the amount of the asset's market value (equivalent to a RW of 187.5%).

Binding PL

In a binding PL, a bank is exposed to default on the lease orderer's obligation to lease the asset in its possession. In the event of the lease orderer defaulting on its PL, the bank will either lease or dispose of the asset to a third party. The bank will have recourse to any hamish jiddiyyah paid by the customer, and (i) may have a right to recoup from the customer any loss on leasing or disposing of the asset after taking account of the hamish jiddiyyah, or (ii) may have no such right, depending on the legal situation. In both cases, this risk is mitigated by the asset in possession as well as any hamish jiddiyyah paid by the lease orderer.

In case (i), the bank has the right to recoup any loss (as indicated in the previous paragraph) from the customer, that right constitutes a claim receivable which is exposed to credit risk, and the exposure shall be measured as the amount of the asset's total acquisition cost to the bank, less the market value of the asset as collateral subject to any haircut, and less the amount of any hamish jiddiyyah. The applicable RW shall be based on the standing of the customer as rated by an ECAI that is approved by the CBB, and in the case the obligor is unrated, a RW of 100% shall apply.

In case (ii) the bank has no such right, and the cost of the asset to the bank constitutes a market risk (as in the case on a non-binding PL), but this market risk exposure is reduced by the amount of any hamish jiddiyyah that the bank has the right to retain.

Operating Ijarah

The residual value of the asset will be risk weighted at 100%. Upon expiry of the lease contract, the carrying value of the leased asset shall carry a capital charge of 15% until the asset is re-leased or disposed of.

IMB

In the event that the lessee exercises its right to cancel the lease, the lessor is exposed to the residual value of the leased asset being less than the refund of payments due to the lessee. In such a case, the price risk, if any, is already reflected in a "haircut" to

be applied to the value of the leased asset as collateral in credit risk. Therefore, the price risk, if any, is not applicable in the context of the IMB.

Musharakah/Mudarabahh and Diminishing Musharakah:

Equity Position Risk

Musharakah/Mudarabahh

Musharakah or Mudarabahh exposures, unless deducted for regulatory capital purposes according to the CBB's Prudential Consolidation and Deduction Requirements, will be treated as follows:

Musharakah or Mudarabahh exposures in the nature of specialized financing will be risk-weighted as per the supervisory slotting criteria. Other Musharakah or Mudarabahh exposures will be risk-weighted using the simple risk weight method.

Diminishing Musharakah

The equity exposure in Diminishing Musharakah contract, where the bank intends to transfer its full ownership in movable assets and working capital to the other partner over the life of the contract, is calculated based on the remaining balance of the amount invested (measured at historical cost including any share of undistributed profits) less any specific provision for impairment. The exposure shall be risk weighted according to the nature of the underlying assets as ser out in above. If a third party guarantee exists, to make good impairment losses, the RW of the guarantor shall be substituted for that of the assets (if lower) for the amount of any such guarantee.

Sukuk:

For calculation of the capital changes, Sukuk can be treated as follows:

Where the principal amount of the Sukuk is guaranteed, it will be considered as a financing instrument and RW applicable to the rating of the guarantor will be applied (100% for unrated).

Where the principal amount of the Sukuk is not guaranteed, it will be considered as an equity instrument and, unless deducted for regulatory capital purposes according to the Prudential Consolidation and Deduction Requirements Module.

Sukuk exposures in the nature of specialized financing will be risk-weight as per the supervisory slotting.

Operational Risk

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events which includes but is not limited to, legal risk and Shari'ah compliant risk. This definition excludes strategic and reputation risk.

Shari'ah compliant risk is an operational risk facing Islamic banks which can lead to non-recognition of income and resultant losses.

Basic Indicator Approach

Banks using the Basic Indicator Approach must hold capital for operational risk equal to the average over the previous three years of a fixed percentage (denoted alpha) of positive annual gross income. Figures for any year in which annual gross income is negative or zero should be excluded from both the numerator and denominator when calculating the average. The charge may be expressed as follows:

$K_{BIA} = [\sum GI_{1..n}\, \acute{\alpha}\, n]/n$

Where:

K_{BIA} = the capital charge under the Basic Indicator Approach

GI = annual gross income, where positive, over the previous three years

N = number of the previous three years for which gross income is positive

$\acute{\alpha}$ = 15% related the industry wide level of required capital to the industry wide level of the indicator.

Gross income is defined as:

a) Net income from financing activities which is gross of any provisions, operating expenses and depreciation of Ijarah assets;

b) Net income from investment activities; and

c) Fee income (e.g. commission and agency fee)

Less:

d) Investment account holders' share of income

In case of a bank with negative gross income for the previous three years, a newly licensed bank with less than 3 years of operations, or a merger, acquisition or material restructuring, the CBB shall discuss with the concerned licensed bank an alternative method for calculating the operational risk capital charge. For example, a newly licensed bank may be required to use the projected gross income in its 3-year business plan. Another approach that the CBB may consider is to require such licensed banks to observe a higher CAR.

The Standardized Approach

In the Standardized Approach, banks' activities are divided into eight business lines: corporate finance, trading & sales, retail banking, commercial banking, payment and settlement, agency services, asset management, retail brokerage. The business lines are defined in detail in Appendix CA-4. The bank must meet the requirements detailed in section OM-1.3 to qualify for the use of standardized approach.

Within each business line, gross income is a broad indicator that serves as a proxy for the scale of business operations and thus the likely scale of operational risk exposure within each of these business lines. The capital charge for each business line is calculated by multiplying gross income by a factor (denoted beta) assigned to that business line. Beta serves as a proxy for the industry-wide relationship between the operational risk loss experience for a given business line and the aggregate level of gross income for that business line. It should be noted that in the Standardized Approach, gross income is measured for each business line, not the whole institution, i.e. in corporate finance, the indicator is the gross income generated in the corporate finance business line.

Prudential Consolidation and Deduction

Investment in banking, securities and other financial entities

Significant investments (20%-50%) in banking, securities and other financial entities, will be consolidated on a pro-rata basis for regulatory capital purposes unless deducted.

However, the CBB must be satisfied that the parent bank with significant minority ownership is expected to support the entity to the extent of its proportionate ownership only. The parent bank will be required to demonstrate that other significant shareholders have the means and the willingness to proportionately support the financial entity. The bank should have joint control in the invested entity along with other parties. If there is no joint control and a single party can exercise control, prorate-consolidation for regulatory capital purposes can not applied.

Investments in banking, securities and **other financial entities** below 20% of the investee's capital must be risk-weighted at a minimum risk-weight of 100%.

Investments in instruments of a banking, securities and financial entities, other than equity, which are allowed as regulatory capital for the investee must be risk weighted at a minimum risk-weight of 100% unless such investments (including any other equity investment in that entity) exceed 20% of the eligible capital of investee entity, in which case the investments in other regulatory capital instruments of that investee entity must be deducted from the bank's capital adequacy purposes.

Significant investments in insurance entities

When measuring regulatory capital for banks, the equity holdings in an insurance entity of 20% or more of the investee's capital shall be required to be deducted from bank's capital for regulatory capital purposes. Holdings less than 20% will be risk weighted under the applicable credit risk weighting rules.

Majority–owned or controlled insurance subsidiaries must be adequately capitalised to reduce the possibility of future potential losses to the parent bank. The parent bank

will monitor actions taken by the subsidiary to correct any capital shortfall and, if it is not corrected in a timely manner, the shortfall will also be deducted from the parent bank's capital for regulatory capital purposes.

Significant investments in commercial entities

Investments in commercial entities include:

(a) all kinds of equity and long term financing (including long-term financing in the nature of Musharakah, Mudarabahh and /or Sukuk)

(b) underwritten amounts

Significant minority and majority investments in commercial entities which exceed certain materiality levels must be deducted from the bank's capital for regulatory capital purposes. If the investments exceed a materiality level of 15% of the bank's capital on an individual basis, the concerned bank is required to deduct the excess amount from its capital. If the aggregate amount of all such investments exceeds a threshold of 60% of the bank's capital, then such excess amount is also to be deducted from the bank's capital. The application of the materiality levels will be undertaken in the order of deduction of amount in excess of 15% of bank's capital followed by 60% of capital.

Investments in commercial entities below the materiality level noted herein will be risk-weighted under the applicable credit risk weighting rules. The risk-weighting treatment will follow the accounting method in the concerned bank's audited financial statements.

Basel II Pillar Two and Pillar Three

Across the world, the majority of attention has centred on Pillar One over the past five years. However the majority of work for banks and regulators alike lies in the four Principles of Pillar Two and the so-called Supervisory Review Process contained therein.

Pillar Two requires banks to carry out self-assessments of their capital requirements over a given time period (a reasonable timescale is three years). Banks must then

produce plans and strategies on how to meet these capital requirements. The supervisor must then assess the risk profile of the banks, taking into account the significant risks that the banks are exposed to in their activities. The supervisor will then take into account any other supervisory information in addition to the self assessments provided by the banks and set individual minimum regulatory capital adequacy requirements for the banks to follow. Some regulators have been employing this so-called risk-based approach for some years, whilst for others, Basel II makes the introduction of this approach. In Bahrain, we have had systemic minimum regulatory industry-wide 12% trigger and 12.5% target under Basel One. Under Basel II, some Bahraini banks have lower regulatory capital ratios whilst others have to comply with higher regulatory capital requirements. We issued a preliminary guide on ICAAP, and required all locally incorporated banks to (a) assess themselves against various criteria applicable to a well-run bank, covering policies and procedures, systems, management and board committees, required functions/departments, key management positions, proactive compliance function, effective internal audit and risk management functions, internal controls, etc.—this was done already—and (b) required all of such banks to commission third party consultants with proper experience in risk management to assess them using detailed questionnaires on several types of risk. Consultants have been commissioned already. We are still continuing the enhancement of our risk profiling methodology, which will lead to a scientific way of allocating target and trigger ratios.

Pillar Three is probably the most straightforward Pillar to implement. In Bahrain, we already have quite extensive disclosure standards which include quantitative as well as qualitative risk disclosures. Pillar Three will entail some significant increases in some disclosure levels, but these are manageable. IRB banks face a somewhat higher benchmark, as do Islamic banks which must comply not only with Basel II's requirements, but also IFSB's disclosure requirements with particular emphasis on disclosure in respect of Investment Account Holders' funds. The CBB issued final disclosure requirements already in 2008.

US Regulation of Islamic Banking: Prospects for Success

by

Abdi Shayesteh[118]

Introduction

Although US regulators and public officials may not be as direct in advocating their support for the Islamic banking industry as public officials have been in the United Kingdom, US regulators have taken several significant initiatives towards the accommodation of Islamic banking products and services in the United States. A list of their informal and educational activities is impressive, including participation by high-level government officials at several public events and working group engagements.[119] More importantly, these informal activities have had a positive influence on the formal regulatory approval process, and this has opened the doors for various US institutions currently offering Islamic products and services. Islamic banks *can* continue to grow and prosper in the United States and US regulators have expressed their eagerness to continue to accommodate such objectives. Notwithstanding this encouraging news, depending on an Islamic bank's business plan, there are some outstanding regulatory and supervisory matters to still explore. This article briefly examines these matters and provides an overview of US regulatory involvement with Islamic banking to date, including the market's reaction to such activities.

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[119] *See* Table 1 for a Timeline of Recent Informal US Regulatory Involvement with Islamic Banking.

US Regulatory Involvement and Market Reaction

Informal US regulatory involvement has positively influenced the formal regulatory approval process for Islamic banking products and services.

In 1997 and 1999, the Office of the Comptroller of the Currency (the "OCC"), through interpretive letters approved, on a case-by-case basis the offering of *Ijarah Wa Iqtina* and *Murabaha* mortgage products. The New York State Banking Department also approved similar products in 1999 and 2001. In all of these approvals, the big issue at hand for US regulators was the fact that a retail commercial bank would acquire and hold title to real estate property in the proposed transactions. In the United States, banks are restricted from owning real estate property, unless it is related to foreclosure activities or the operations of the bank itself. These restrictions were designed to prevent banks from becoming involved in the risks associated with the speculative nature of real estate investment activities. Nevertheless, US regulators were accommodating in their review of these proposals and focused on the economic substance of the transaction, rather than the form. In their final approval the OCC concluded that the risks associated with these products were not the type of risks that the statutes were originally designed to prevent, and, as a result, permitted the offering of such products.

Formal US regulatory approvals to date have positively influenced the market for Islamic banking products and services in the United States.

As a result of these formal approvals, many US banking institutions are now offering *Shari'ah*-compliant products and services, including University Bank in Ann Arbor, Michigan, Devon Bank in Chicago, Illinois. University Bank, for example, started offering *Shari'ah*-compliant finance products in 2003 and by 2005 it launched the first US *Shari'ah*-compliant banking subsidiary exclusively focused on selling *Shari'ah*-compliant home financing products, profit sharing deposit accounts, and shares of Islamic mutual funds. Other financial institutions have also emerged in the market place such as LaRiba-American Finance House and Guidance Financial Group, offering a variety of home, automobile and business finance products in throughout the United States. To access more liquidity, some of these institutions are also reporting that they sell their *Shari'ah*-compliant mortgages to Freddie Mac and Fannie Mae.

Table 1:

TIMELINE OF RECENT INFORMAL US REGULATORY INVOLVEMENT	
• 1996	US regulators participated at the Islamic Finance and Investment Conference in New York City, hosted by the Arab Bankers Association of North America ("ABANA"). Then General Counsel of the Federal Reserve Bank of New York, Ernest Patrikis, announced that regulators are "open to working with Islamic bankers" towards launching an Islamic bank in the United States.
• 2000:	The Federal Reserve Bank of Minneapolis held a seminar for Muslim homebuyers in their region in order to facilitate a stronger bridge with the Muslim community.
• 2001:	Federal Reserve Bank of Minneapolis hosted a public working group on Islamic finance.
• 2004:	US Treasury launched the Islamic Finance Scholar in Residence Program and appointed Dr. Mahmoud El-Gamal to serve its first term. Position is aimed at promoting broader awareness of Islamic finance practices internationally and domestically. US regulators also participated at the Islamic Financial Services Board (IFSB) Summit on Islamic Financial Services and the Global Regulatory Environment, held in London, England.
• 2005:	US regulators participated at the ABANA Conference on Islamic Finance in New York City and the Conference on Corporate Governance and Islamic Finance in Qatar, sponsored by the Qatar Central Bank. The Federal Reserve Bank of New York also co-sponsored the Seminar on Legal Issues in the Islamic Financial Services Industry in Kuwait.
• 2006:	The US interagency group on Islamic banking was formed consisting of various federal and state banking regulators. The group held a special forum on Islamic banking, hosted by the Federal Reserve Bank of New York, where representatives from a number of banks located in the United States and abroad attended to address some of the outstanding regulatory issues. US regulators also participated at the 3rd Annual Islamic Financial Services Board Summit in Beirut, Lebanon.
• 2008	Federal Reserve Bank of New York hosts a public seminar on Islamic banking and finance, sponsored by the New York State Bar Association, International Law & Practice Section.

Deposit Products and Risk Sharing

Certain Shariah-compliant deposit products exist in the United States, but the question of developing a more risk-sharing deposit product within the US regulatory framework is still unresolved.

Today the only Islamic deposit products available in the United States are products in which the customer shares in the profits of the investment but not in any of the losses as required under the Profit-Loss-Sharing ("PLS") provision of *Shari'ah* law. In order to fit within Federal Deposit Insurance Corporation ("FDIC") regulations, the principal must not be at risk and, as a result, FDIC insurance must apply. To accommodate these restrictions for University Bank, SHAPE Financial Corporation, an Islamic banking consulting firm, modified their PLS deposit product such that the principal deposit is guaranteed and deposit holder only shares in the bank's profits, not losses. In the United Kingdom, customers at the Islamic Bank of Britain ("IBB") have the option to sign a waiver which allows them to keep or give away the portion of the guaranteed principal and return that may have been lost under a full PLS program. This may be one way to resolve the issue in the United States, as well.

The following is a summary of some of the different *Shari'ah*-compliant deposits products currently being offered under various conventional regulatory structures outside of the United States. How do these products fit within the US regulatory regime?

Current Accounts

Under this type of account the principal is not at risk (i.e., it is guaranteed) and no return is earned on the principal. There are no problems with this type of account under US regulations, as it is similar to typical demand deposits currently offered by other banks in the market. The principal is not at risk, and consequently, it would be deemed as a deposit in the United States, subject to FDIC deposit insurance provisions.

Profit Sharing Deposit Programs

Under this type of account the principal is not at risk and the return on principal is tied to the offering bank's investment performance. The FDIC should not have any

problems with this product, given that the principal is not a risk. There may be, however, certain federal and state securities regulations, as well as consumer protection and compliance regulations that govern the distribution of these products to the public.

Profit Sharing Deposit Programs (with Waiver Option)

Under this type of account the principal is not at risk and the return on principal is tied to the bank's performance, but the consumer has the option to waive the deposit guarantee and insurance provision, if the offering bank incurs a loss in connection with its investment efforts. Consumers usually get a disclosure and waiver form at some point in the account relationship. The Financial Services Authority has granted approval for IBB to offer such a product in the United Kingdom. To date, no known institution in the United States is offering such a product.

US Supervision of Islamic Banking Products and Services

The application of US-based capital adequacy standards to Islamic mortgages and profit-sharing investment accounts present unique challenges.

To date, no US regulator has taken a formal position on the capital treatment of Islamic mortgages. In practice, US institutions have been risk weighting them equivalently with conventional mortgages at 50% on the basis that they are prudently underwritten residential mortgages. Because the percentage of Islamic mortgages currently offered by these institutions are relatively small compared to the conventional mortgages they offer, supervisors have treated these products as conventional mortgages for the purposes of risk-based capital rules. Although in substance these products resemble conventional mortgages, regulators question whether these products should receive more risk weight, given the ownership position the bank takes on the property.

It is also unclear how a profit-sharing investment account would be considered for risk weighing purposes given that they are a hybrid of deposit accounts and investment accounts. Some argue that since they bear risk in similar ways to equity capital (since investors bear the risk), they should be allowed to be included in a

bank's capital calculation. However, in most cases regulators have required that they be held on the bank's balance sheet and be treated as a quasi-deposit.

Islamic banks are limited on the types of investments they can hold, which may impact their asset and liability management options in the United States.

Islamic banks cannot acquire treasury securities, municipal securities and corporate bonds like conventional banks can. Instead, Islamic banks abroad use *sukuks* to manage assets and liabilities in the long-term. Though the secondary market for trading *sukuks* is still in its infancy, once it develops, can Islamic banks operating in the United States engage in investing and trading in sukuks as a permissible activity? Under existing US banking law, PLS arrangements such as *musharaka* and *mudarabah* may be difficult to implement since commercial banks are generally restricted from entering partnerships or taking equity stakes.

Islamic banks are restricted from accessing certain types of conventional funding mechanisms that are interest based such as inter-bank and the discount window.

Without access to conventional interest-based funding sources, an Islamic bank's liquidity strategy is limited. Can regulators accept *Shari'ah*-compliant inter-bank lending arrangements or even develop a *Shari'ah*-compliant discount window? Can regulators accept inter-bank arrangements between two bank subsidiaries or a fund of funds to utilize among Islamic banks? Can regulators accept commodity arrangements between banks as a liquidity mechanism?

Islamic banks are limited in using conventional risk mitigation strategies.

An Islamic bank is limited with respect to engaging in conventional insurance and derivatives market products, such as forwards, futures, options and other derivative securities, as they are inappropriate under Islamic banking principles. It is unclear what alternative products are available for an Islamic bank to utilize in mitigating its portfolio risk.

Conclusion

In summary, while the implementation of Islamic banking is still relatively new in the United States as an industry, it is not a new topic for US regulators. Since 1996 US

regulatory involvement has accommodated the growth of US Islamic banking activities. More importantly, given the current positive climate among regulators, it is anticipated that the industry will continue to grow with US regulatory support. While there are still unanswered questions as to how regulators will react to a more risk-sharing deposit product, or how supervisors will eventually evaluate Islamic banking products, none of these questions are impossible to overcome with serious commitment and carefully thought legal solutions.