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October 2009

PERSPECTIVES



ISLAMIC BANKING AND FINANCE

Insight on possibilities
for Europe



WSBI



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FOREWORD



Islamic finance represents one of the quickest growing areas of finance in the world. This area of finance is composed of practices which are consistent with the beliefs of Islam – characterised by an emphasis on socially responsible investment and the prohibition against what is called “Riba” or usury – including any form of guaranteed interest on a loan. The prohibition against interest conflicts directly with conventional banking in Europe wherein a large portion of the financial system is based upon interest earned from loans and provided for deposits. Therefore, Islamic banking has had to develop mechanisms to allow interest income to be replaced with cash flows from productive sources. These mechanisms form the basis for Islamic finance.

The growing Muslim population in Europe – estimated today at over 14 million – means that there may be a significant portion of the population for whom their religious beliefs make traditional European financial practices inaccessible. In order to serve this portion of the population, Islamic finance may be an important new avenue for delivering financial services and addressing a market vacuum.

WSBI/ESBG’s member banks decided to explore Islamic finance with the objective of finding whether it may be a realistic option which could bring benefits for WSBI/ESBG members, for the regions where they operate, and for the growing Islamic population. The study that you are about to read attempts to shed some light on this endeavour by providing general information on Islamic finance and an analysis of the current situation in Europe.

Once again, this study describes the current panorama of Islamic finance for the attention of the members of WSBI/ESBG. It does not attempt to provide a roadmap for the conversion of conventional banks into Islamic ones. Neither does it attempt to judge which financial system is better or worse. It simply aims to provide a closer examination of Islamic finance, analysing objectively the opportunities and challenges that Islamic finance can offer to savings and socially committed retail banks.

Chris De Noose
Managing Director WSBI/ESBG

October 2009

EXECUTIVE SUMMARY



The purpose of this study is to analyse and present the issues involved in Islamic banking and finance, based on desk research. WSBI/ESBG aims to bring members closer to the ongoing discussion on developing Islamic banking services and the challenges and opportunities that the business entails.

Spotlight on the market

This document provides an overview of the Islamic finance sector worldwide, presenting first of all a brief analysis of the Islamic offer in the Middle East and Africa. This is followed by an analysis of the development of the Islamic finance in Europe and the U.S.

In the majority of European countries, supervisory authorities and finance practitioners are not very familiar with the process by which Islamic finance is introduced into a conventional system. Their financial regulatory frameworks have not been adapted to allow the offering of Islamic products and services. In Europe, the exception is the UK which is the only country that has reformed laws to ensure that Shariah-compliant products and services can be offered in the country. France is also addressing the issue and since the end of 2007 several political initiatives have been proposed to adjust the regulatory and legal framework to enable Paris to become a major marketplace in Islamic finance. The Malta Financial Services Authority is also monitoring developments in Islamic finance and analysing opportunities for the Maltese financial system. Luxembourg is a special case. It has not reformed its legal framework. However, within the current framework, it is possible to offer some Islamic products and services. Finally the United States regulators' approach to Islamic banking is fairly ad hoc, with individual regulators dealing with specific issues as they are presented.

Islamic banking and finance offer

Islamic banking products such as current accounts, deposits or mortgages are quite easy to develop. They are based on a specific Islamic contract which states the exact terms for making the financial transaction. In Islamic finance, Sukuk (similar to bonds) and Takaful (insurance) are the most extended Islamic products.

Unless a financial institution is prohibited for regulatory reasons from doing so, any financial institution is permitted to offer Islamic investment products. The challenge for them is how to leverage their banking knowledge and expertise in developing products and services that fulfill the requirements of their Islamic customer base while being compliant with Islamic finance principles. In order to develop a successful Islamic banking and finance offer financial institutions have to take important decisions that will change the internal structure of the institution. Additionally, they must follow the guidance of the international Islamic supervisory authorities.

Opportunities and challenges

Islamic finance in Europe is a novel concept that some countries have seen as an opportunity to attract capital from the Middle East. At the same time it represents a chance to access a large new customer base of around 12-15 million Muslims that live in Europe. However, financial initiatives will not be successful if they are not accompanied by an adapted regulatory framework. In addition, there are a number of other issues surrounding Islamic finance. These issues include a lack of a standard accounting system, inadequate Shariah expertise, a shortage of professionals and unresolved internal ongoing discussions about the legality of some product structures.

This research document aims to shed some light on the abovementioned issues for the attention of the WSBI/ESBG members and the general community of those interested in finance issues in Europe.

1. THE PRINCIPLES OF ISLAMIC BANKING AND FINANCE



1.1. Introduction

One of the basic tenants of Islamic law (or Shariah) related to finance is the firm and clear prohibition against *Riba* or interest. Any risk-free or guaranteed interest on a loan is considered to be usury. The prohibition against *Riba* directly conflicts with conventional banking in Europe wherein a large portion of the financial system is based upon interest earned from loans and provided for deposits. Modern Islamic banking has developed mechanisms to allow interest income to be replaced with cash flows from productive sources. These mechanisms form the basis for Islamic finance.

Modern Islamic finance has existed internationally since the 1970s and has witnessed significant growth in the last three decades. According to the International Monetary Fund (IMF), it has risen from one institution in one country in 1975 to more than 300 institutions operating in more than 75 countries in 2008. The annual growth rate of assets estimated by the United Nations is between 15-20%. Islamic banking assets were calculated at USD 750 billion worldwide in 2007 and current forecasts indicate that this number will reach USD 1,000 billion by 2010. Similarly, there are about 200 Shariah-compliant mutual funds available in the market, with accumulated assets under management of about USD 250-300 billion.¹ Islamic finance growth has become particularly visible since 2000 mainly due to the evolution of oil prices and the massive repatriation of capital to the Persian Gulf region from Muslim countries around the world after the attacks of September 11, 2001.

1 Cihak, Martin and Hesse 2008a.

In some countries, such as Iran and Pakistan, Islamic banks are the only mainstream financial institutions.² In others, Islamic institutions exist alongside conventional banking institutions. Historically, the Persian Gulf region and Southeast Asia, led by Malaysia, have been the major centres for this type of finance system. In recent years, Shariah-compliant financing has expanded into Africa, particularly Sudan. Support for Islamic finance varies in the New Middle East.³ In some countries, such as Libya and Morocco, Islamic banks are considered by some to be tied to Islamic political parties and consequently have been refused licenses. Other countries – including Jordan, Tunisia and the Sudan – have been receptive to Islamic finance, viewing Islamic financial products as an opportunity to create capital and foster economic development.

Islamic finance is growing in Europe and in the United States. In August 2004, the United Kingdom's Financial Services Authority (FSA) approved a banking license for the Islamic Bank of Britain (IBB), the country's first Islamic bank. The IBB's main objective is to serve the consumer market with Shariah-compliant products.⁴ In March 2006, the FSA licensed the European Islamic Investment Bank as the United Kingdom's first independent bank for Shariah-compliant investment opportunities. However, in the rest of Europe, there are not many local actors providing Islamic banking services, particularly within retail banking.

The majority of European banks involved in Islamic finance offer mainly investment products and services through subsidiaries established in the UK or in the Middle East. Within retail banking, some British banks offer products and services in the domestic market, presumably due to the fact that it is so far the only country in Europe where the financial services regulator adapted the supervisory framework to allow an offer of Sharia-compliant financial products and services. In December 2008 France made the first reform of its fiscal framework to allow the offer of products based in a Murabaha contract and Sukuks. (Refer to Section 2.3 for more information).

2 Illias 2008; Chiu, Newberger and Paulson 2005.

3 The New Middle East (also known as "The Greater Middle East") is a political term to englobe together encompass various countries, pertaining connected to the Arab world including, Iran, Turkey, Afghanistan and Pakistan. Various Central Asian countries and the countries from the lower Caucasus (Azerbaijan, Armenia, and Georgia) as well as Cyprus and Greece are sometimes also included. The term may be used to denote areas with significant Muslim majorities, but this usage is not universal.

4 Further information about the IBB, see www.islamic-bank.com.

In the United States, financial institutions providing Islamic products and services largely concentrate on personal home mortgages. Since 2005, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Mortgage Corporation (Freddie Mac) purchased Shariah-compliant mortgage contracts from financial intermediaries, allowing providers to originate further mortgages. In 2007 and until the U.S. Federal Government placed the two government sponsored enterprises into “conservatorship⁵”, Fannie Mae and Freddie Mac reportedly purchased more than USD 250 million in Islamic home loans combined, a small but notable fraction of the enterprise’s USD 1.77 trillion in business activities. Other forms of Shariah-compliant services are offered in the U.S. as well. (Refer to Section 2.3 for more information).

Islamic finance may be an attractive option for investors as conventional finance faces challenges due to the U.S. subprime lending crisis and recession concerns.⁶ Islamic banks have avoided much of the damage from the subprime mortgage crisis by following strict Islamic principles. However, the sector has potential problems of its own, which may be tested during 2009 with the slowing of the world economy and the possible end of the real estate boom in the Persian Gulf. It is not clear whether some of the elements of the Islamic structure have legal force. Several debates are ongoing about the legality of the Musharakah contracts (a type of investment vehicle for accounts) and Sukuk’s structures (similar to a “bond” in conventional banking, but involving actual ownership) – which are explained more fully later in the text. These facts represents real challenges for the future of Islamic finance.⁷

1.2. The principles and sources of Islamic law

Islamic banking and finance typically refers to those financial activities that are compliant with the rules of Islamic law known as *Shariah*, as well as other jurisprudence known as *Fatwa*.

5 Conservatorship is a legal concept to be found in the law of many states of the US, whereby an entity is established by court order, or in the case of regulated business enterprises, via statutory or regulatory authority, that some property, person or entity be subject to the legal control of another person or entity, known as a conservator.

6 Apps 2008, Joyner 2008.

7 Stanton 2008.

The basis of Shariah related to finance which has a fundamental impact on banking and investments is the firm and clear prohibition against *Riba* or interest. Any risk-free or guaranteed interest on a loan is considered to be usury. Modern Islamic banking has developed mechanisms to allow interest income to be replaced with cash flows from productive sources.

Other prohibitions of the Islamic law which affect finance include *Gharar* (uncertainty), and *Maisar* (gambling and dealing in unlawful goods or services). Islamic institutions should therefore structure their products and processes to ensure these prohibitions are not violated.

Islamic law is based on primary sources (such as the Quran) and various secondary sources. The secondary sources may differ depending on the school of thought that formulates a specific piece of law. Annex 1: "Sources of Shariah and the Schools of Thought" provides a brief overview on the different sources and schools of thought of Islamic law.

The two largest schools of thought are the Sunni and the Shia. While the Sunni group comprises the majority of Muslims, the exact percentage of the world's Muslim population that adheres to the various Shia Schools is difficult to estimate. However, some studies have been done on the subject, as shown in Annex 2: "Demographic Distribution of Islamic Schools of Thought".

1.3. Shariah-compliant financial products

1.3.1. Islamic contracts

All Islamic financial transactions are based on an Islamic contract. The most popular are "Musharakah" which is a partnership where all partners contribute and pool their resources together to run a business, and "Murabaha", which is a contract where a financial institution buys an asset and resells it to the client at a higher price on a "cost + mark up" basis. Annex 3: "Islamic Contracts" provides a list and outlines the basic contract types.

1.3.2. Islamic retail banking products

i) **Islamic current accounts**⁸ are virtually the same as current accounts in all conventional banks. Certain amounts of deposits are guaranteed. The majority of the Islamic current accounts follow the principle of *Qard Hassan* which is a free of profit loan. Basically, this means that the current account is a loan to the bank, which is used by the bank for investment and other purposes. Clearly, this loan has to be paid back to the client, in full, on demand. Additionally the bank does not invest the money in activities that contravene Shariah principles. Like any Islamic product, the transactions have to be approved by a Shariah Supervisory Committee.

Normally, the current account is offered with a chequebook and multi-functional bank card allowing the client to withdraw and spend money at his/her convenience.

ii) **Islamic ordinary savings accounts** do not offer clients interest on their funds deposited at the bank. The most popular kind of Islamic savings account is operated under Mudaraba principles. The basic concept is that the bank places the client's funds in its pool of Islamic Shariah-compliant assets. The return that the bank obtains from these assets is shared between the client and the bank. Return is calculated based upon the average monthly balance maintained in the client account. Hence the more the client saves, the higher the return earned by the client. Instead of money, the client can receive the return in the form of gifts, vouchers or donations made in the name of the client.

In Malaysia, an Islamic savings account is normally operated under the Wadiah (rather than Mudharabah) principle. Under this concept, a client deposits his/her money for safe keeping, and the bank acts as a trustee. There are two types of Wadiah contract. The first is "*Wadiah Yad Amanah - Trustee Safe Custody*" – a contract wherein a bank acts as a custodian of client assets. A bank cannot use these assets as they are for safekeeping (e.g. jewellery). The second is "*Wadiah Yad Dhamanah - Guaranteed Safe Custody*" wherein a bank's duty is to protect clients assets but it can use them until they are withdrawn by the owner. The predominant asset item in this case is money/cash deposited by clients. Since the amount deposited cannot be physically identified by a specific client, the cash amounts received (from all depositors) are pooled and a bank can utilize them for business purposes.

8 Taken mostly from Gafoor 2005.

In both cases, a bank guarantees depositors their money back and does not promise any return on their deposits. However, a bank may – at its discretion – reward depositors with 'hibah⁹' from profits earned in utilizing customers deposits.

At the same time, there are cases where banks accept deposits based on Mudharabah (investment) principles. In this instance, all investments must be Shariah-compliant.

In the UK, the most common features and benefits of an Islamic savings account are:

- No penalties and no notice required to make a withdrawal from the savings account.
- No limit on the number of withdrawals clients can make in any month – subject to sufficient funds availability in the account.
- The money is invested ethically (i.e. following Islamic principles) and funds are never used to invest in non-Shariah-compliant businesses.¹⁰

iii) **Islamic fixed deposits** are usually offered based on the Mudaraba concept. In this principle, depositors provide the capital for investments and a bank acts as a "mudharib" – an entrepreneur with investment skills and expertise. Depositors are not allowed to be involved in making the investment decisions.

Profit Sharing Ratios are predetermined and agreed with depositors and can vary according to criteria determined by the bank.

In case of a loss on an investment, the customer bears all the losses and the bank (mudharib) will not get anything for the services rendered.

9 Hibah is a monetary gift given in the form of a dividend at the sole discretion of the bank.

10 Shariah-compliant products must fulfill 6 criteria:-1. It must exist; 2. It must be halal (non halal items – pigs and dogs & their products, carcass, intoxicating drinks, blood, vomit, faeces/urine); 3. It must have use according to Shariah (must not be too little to be of use, must not distract from remembering Allah, must not be used to propagate haram activities such as gambling and riba); 4. It must be owned by the seller.; 5. It must be capable of being delivered and free from encumbrances; 6.It must be real, known and specific by address, description or specification.

The detailed operation of these fixed deposit accounts is described as follows:

- The bank accepts deposits from its customers who are looking for investment opportunities for their funds in the form of general investment accounts based on the principle of Mudaraba.
- The deposits must be held for a specified period of time.
- The bank acts in this case as the “entrepreneur” and the customers as the “provider of capital”. Both agree on how to distribute any returns generated by the bank from the investment of the funds.
- In the event of a loss on the investment, the customer bears all the loss.
- The customer does not participate in the management of the investment of the funds.

iv) Islamic credit cards: an Islamic credit card holder does not pay interest on outstanding debt. The cardholder pays an upfront fee which represents a part of the total payment and through this mechanism it is possible to rollover the outstanding debt balance to the next payment cycle. Some Islamic banks return a part of the upfront fee to an Islamic card holder if the credit is repaid in time.

The Islamic credit card is based on the principle of *Al Bai Bithaman Ajil (BBA)* (deferred payment sale). In other words, the bank issues an interest-free and penalty free credit card. As goods are purchased using this credit card, the bank makes the transaction on behalf of the customer and simultaneously sells it back to the customer. This credit is payable over a deferred period through installments within a certain time frame.

However, the BBA principle is sometimes criticized as a two-party transaction that tries to circumvent Riba. This is because the financing of the credit amount is normally done based on the bank selling a part of its assets (based on “cost + margin”). Instead of paying cash to the credit card holder, s/he is given ‘an overdraft’ facility which can be utilised when paying using the card.¹¹

Several banks are doing away with this concept and are using Tawarruq (Commodity Murabaha) and Ijara instead. In Tawarruq, the relationship between the issuer (a bank) and borrower (credit card holder) is developed based on actual sale and purchase of a tangible asset through a third party.

11 Bhattacharya 2007.

Ijarah is a new principle used where a bank grants financing (the credit limit) to the holder with an agreed predetermined profit. The holder will then pay the bank a fee for utilizing the facility. This fee is calculated based on the total profit amount due (based on the credit limit) minus the percentages of the unutilised amount.

The most common features of an Islamic credit card in the UK are:

- A small fee may be charged annually for the credit card.
- Customers may enjoy the value-added benefits of conventional credit cards e.g. bonus points, gifts, shopping discounts, travel cheques etc.
- Customers may need to have some kind of collateral that has been agreed upon in advance with the financial institution.
- A credit limit will be based on the customer's collateral value.
- It may be possible to obtain general Takaful (insurance) coverage.
- Some banks may provide other services such as Zakah (welfare contribution) payment via this credit card.
- It may be possible to apply for a supplementary card.

v) Islamic Mortgages: The most characteristic feature of an Islamic Mortgage is that instead of lending to Muslim businesses and families for property purchase, mortgage providers buy the property and re-sell it to them in instalments for a higher price.

The concept of interest-free housing finance is still unknown in the conventional financial system. Thus the term "mortgage" is used here in the sense of collateral and the title to the property is in the name of those that provide the funds (i.e. the banks).

Most Islamic mortgages are carried out using the Ijara, Musharaka or Murabaha models:

■ **Ijara Mortgages**

A normal Ijara mortgage is a type of 'lease to own' contract. The potential purchaser finds a property that s/he would like to buy and then agrees a price with the vendor. The purchaser's Islamic mortgage provider then negotiates a 'Promise to Purchase' agreement with the client and purchases the property at the agreed upon price on behalf of the client. Coupled with the 'Promise to Purchase' agreement is a lease agreement that defines the occupancy rights for the property.

The Islamic mortgage provider's client (i.e. the purchaser in normal parlance) makes regular repayments to the financial institution that incorporates two elements:

- payment of rent
- partial repayment of capital.

When the purchase price has been paid back in full, rental payments cease and title to the property is passed from the financial institution to the occupier. By structuring the mortgage in this way, payment of interest is avoided and Shariah law is not infringed by either party.

■ **Musharaka Mortgages**

A variant on the Ijara mortgage is the Musharaka shared ownership mortgage. As with an Ijara mortgage, the prospective homeowner locates a property that s/he would like to acquire and agrees upon a price with the seller. The Islamic mortgage provider then purchases the property on behalf of the client. Under a Musharaka agreement, the client's first capital repayment (as part of the regular monthly repayments) to the Islamic mortgage provider becomes their first share (albeit small) in the property. As repayments continue, the proportion of the property owned by the client increases over the mortgage term. After the mortgage has been repaid in full, total ownership of the property passes to the client.

In a similar manner to an Ijara mortgage, a Musharaka mortgage alleviates the requirement for interest to be paid, thus remaining compliant with Shariah law.

■ **Murabaha Mortgages**

With a Murabaha mortgage, the would-be buyer locates a property that s/he would like to purchase and agrees upon a price with the vendor – as they would for an Ijara or Musharaka mortgage. The Islamic mortgage provider then purchases the property on the client's behalf. Once this property purchase has been completed, the financial institution sells the property to their client at a higher price (at the initial cost price plus the agreed upon profit).

The following criteria are used when calculating the higher price that the homeowners must pay and hence the monthly repayments that they will be required to make throughout the mortgage term:

- the balance owed on the property after the client's original down payment (usually around 20%)
- the length of the Murabaha mortgage term;
- the size of the financial institution's agreed return (i.e. expected return on investment over the mortgage term)

1.4. Islamic Microfinance

Microfinance is considered a very effective development tool that can be adapted to the local needs of low-income people to help them engage in productive activities in every environment. It is estimated that 72% of people living in Muslim-majority countries do not use formal financial services.¹² For example in Indonesia,¹³ 94% of the estimated potential customers for microfinance have borrowing needs. However only 35% of potential customers borrow from banks, including Islamic banks. Micro enterprises and SMEs normally borrow from friends, relatives and quasi-financial institutions. In Yemen,¹⁴ according to the Al-Amal Microfinance Bank, most of the payment activity for small and micro business is conducted outside the formal financial sector.

In Malaysia, Islamic Microfinancing is provided under the concept of BBA and Murabahah. Under the BBA concepts, financing is given directly to the client and a bank has nothing to do with what he does after that. The amount given to a client is based on 'sale and deferred payment' method.

However, under the Murabahah concept, a bank buys what a client wants to buy directly from the supplier and sells it back to the client on the "cost + profit" basis. The client will then pay back the bank in installments.

12 Honohon (2007). The study also finds that in the Islamic Development Bank's 56 member countries, only 28% of the adult population uses formal or semi-formal financial intermediaries, whether through deposit accounts or borrowing. This percentage includes non-Muslims living in such countries.

13 Karim 2008.

14 Al-Lai 2008.

Some studies carried out on Islamic microfinance reveal the following common features¹⁵ among the current Islamic microfinance products and services:

- The supply of Islamic microfinance is very concentrated in a few countries, with three top countries – Indonesia, Bangladesh and Afghanistan - accounting for 80% of global demand. However, Islamic microfinance is also strong in other countries such as Jordan, Algeria, Syria and Yemen.
- In all Muslim countries, Islamic microfinance still accounts for a very small portion of the country's total microfinance outreach.
- The most popular types of Islamic microfinance products follow either Muradaha (over 70% of the products offered), Ijarah, Musharaka or Mudaraba contracts.
- For most countries, the average Islamic microloan amount is similar to conventional microloans.
- Like conventional microfinance, Islamic microfinance tends to focus on female clients.
- Among the institutions that offer Islamic microfinance products, NGOs are the dominant players followed by rural banks and commercial banks.
- There is no evidence of Islamic microfinance in Europe or in the U.S.

Islamic microfinance could potentially expand access to finance to an unprecedented level throughout Muslim countries. However, the industry has yet to demonstrate it can provide financial services that meet the needs of poor people on a large scale. A deeper base of market research and proven business models are very much needed.

1.5. Islamic finance: Sukuk and Takaful

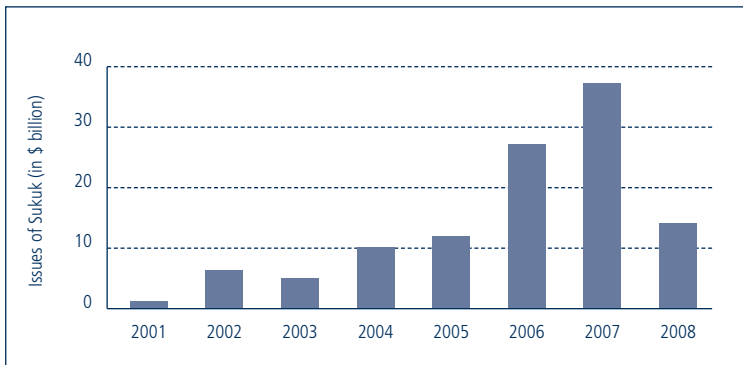
i) **Sukuk** is a financial certificate but can be seen as an Islamic equivalent of a bond.¹⁶ However, fixed-income, interest-bearing bonds are not permissible under Islamic law. Hence, Sukuk are securities that comply with Shariah law and its investment principles, which prohibit the charging or paying of interest. Sukuk may be issued on existing as well as specific assets that may become available at a future date.

15 Karim, Tarazi and Reille 2008: includes 2007 GCAP survey results on Islamic Microfinance, collecting information on over 125 institutions and contacting experts from 19 Muslim countries.

16 Wilson 2004; See also, Tariq 2004 and Tariq and Dar 2007.

The international financial crisis has affected the sustained growth of the Sukuk market. The volume of Sukuk issued in 2008 was reduced by 62%, from USD 37 billion in 2007 to USD 13.8 billion in 2008. However, the Sukuk market is not connected with subprime mortgages or with interest rates because Sukuk is backed by real assets and as such avoids the securitization chains as in collateralized debt obligations (CDOs) that have other CDOs or asset-backed security (ABS) products. The main financial marketplaces of Sukuk are in Dubai and London, followed in Europe by Luxembourg and Frankfurt. The Sukuk secondary market has an important lack of liquidity, mainly because the majority of securities are due upon their maturity.

Figure 1: Worldwide Issuances of Sukuk



Source: ESG elaboration based on Bloomberg (2009) data.

The essential concepts of a Sukuk are:

- transparency and clarity of rights and obligations;
- income from securities must be related to the purpose for which the funding is used; and
- securities should be backed by real underlying assets, and not simply paper derivatives.

The majority of Islamic financial institutions and their Shariah committees agreed on the following compliance rules for a Sukuk:

- Any collection of assets can be represented in a bond and
- This bond can be sold at a market price provided that the composition of the group of assets, represented by the security, consists of a majority of physical assets and financial rights.¹⁷

A Sukuk can be structured according to different techniques. While a conventional bond is a promise to repay a loan, a Sukuk represents partial ownership in an asset (*Sukuk Ijara*) or in a project.

Annex 4 explains how to structure a Sukuk Ijara and Sukuk Istisna. Sukuk Ijara can be seen as similar to conventional leasing.

Table 1: A Sukuk vs. Conventional Bonds

Parameter	Islamic	Conventional
The Issuer	A Sukuk issuer shall be engaged in business activities which are permissible under Shariah	An issuer of conventional bonds is not limited in its business activities
Investor Base	Sukuk issues enjoy a wider investor base from both sets of investors – Islamic (Islamic banks, takaful companies, Islamic asset management companies) & conventional	Conventional bonds can only tap the conventional bond investors
Administrative Cost	Additional fees: legal and Shariah advisory fee	No additional administrative costs associated with conventional bond issues
Financing Cost	A larger pool of Sukuk investors creates more demand, hence may help to achieve slightly more competitive pricing (Malaysia's experience)	A comparatively smaller pool of conventional bond investors will mean that there is less demand for the paper

Source: HSBC Amanah 2008

17 Kahf 1997.

Finally, it is necessary to remark that there is an on-going debate about the appropriate structure for a Sukuk. This sector is the fastest growing one on the global Islamic capital market. The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) has provided some recommendations related to the correct elements of Sukuk, which are compiled in Annex 5: Sukuk Debate.

ii) **Takaful (Islamic Insurance)**. The first Islamic insurance companies were established in Sudan in 1979 and in Malaysia in the early 1990s. Although the market is relatively new, it has grown at 20% per year thanks to the dynamism of overall Islamic finance, which has provided the necessary tools and support for its development.

Table 2: Takaful companies worldwide

Region	No. Takaful companies	In process of establishment	Total
Middle East	41	16	57
Africa	19	2	21
Asia-Pacific	40	1	41
Rest of the world	24	1	25
Total	124	20	144

Source: ESG's elaboration, based on data from Banque & Stratégie (2008)

Takaful is an alternative form of coverage that a Muslim can take to guard against the risk of loss due to misfortune. Takaful is based on the idea that what is uncertain with respect to an individual may cease to be uncertain with respect to a very large number of similar individuals. Insurance by combining the risks of many people enables each individual to enjoy the advantage provided by the law of large numbers.

The Takaful system is based on mutual co-operation, responsibility, assurance, protection and assistance between groups of participants. It is a form of mutual insurance. Theoretically, Takaful is perceived as a cooperative insurance, where members contribute a certain sum of money to a common pool.

The essential concepts of Takaful are as follows:

- Policyholders co-operate among themselves for their common good.
- Every policyholder pays his subscription to help those that need assistance.
- Losses are divided and liabilities spread according to the community pooling system.
- Uncertainty is eliminated in respect of subscription and compensation.
- The system does not derive advantage at the cost of others.

There are three models and several variations on how Takaful can be implemented: a Mudarabah model, a Wakalah model or a combination of both. The most common is the Mudarabah contract. By this principle, the entrepreneur or Mudharib (Takaful operator) accepts payment of the Takaful installments or Takaful contributions (premiums) termed as *Ra's-ul-Mal* from investors or providers of capital or funds (Takaful participants) acting as *Sahib-ul-Mal*.

The contract specifies how the return from the operations of Takaful managed by the Takaful operator is to be shared, in accordance with the principle of Mudarabah, between the participants as the providers of capital and the Takaful operator as the entrepreneur. The sharing of such profit may be in a ratio 50:50, 60:40, 70:30, etc. as mutually agreed upon between the contracting parties.

It is interesting to point out that a Takaful contract incorporates the concept of Tabarru. In essence, Tabarru would enable the participants to give up a certain proportion of his/her Takaful contributions. These contributions are dedicated to fulfil the participant obligation of mutual help and joint guarantee in the case where any of his/her fellow participants suffer a loss. The objective is to eliminate uncertainty and gambling elements which are inherent in insurance contracts.

Annex 6 compiles further information regarding other Islamic financial products, including: equity funds, private equity funds, structured products and hedge funds.

2. ISLAMIC BANKING STRUCTURES WITHIN THE CONVENTIONAL BANKING SYSTEM



2.1. Application of the Shariah law to finance

The first measure that a financial institution wishing to offer Islamic products must undertake is to appoint a Shariah Board or at least a Shariah counsellor. This initial step is crucial for the future Islamic operations of the financial institution, either through a subsidiary company or through a separate business unit. The powers of the Shariah Board differ from one Islamic financial institution to another, but the objective of complying with Islamic law for the offer of financial products is common to all Islamic financial institutions. Islamic banking can not be conducted without the guidance and assistance of Shariah scholars.

The Shariah Board members must have an understanding of Shariah rules accompanied by a reasonable knowledge of the business environment, the nature of investments, the client base, investor tastes and the culture in which business is being run. They also need to be trained in business practices. In this way, the Shariah Board will help to minimize Shariah risks. These risks emerge when some terms agreed upon in a contract do not effectively comply with Islamic law and thus are not valid under Islamic principles. As a consequence, the contract could be declared entirely or partially void in a Shariah court. In practice, the Shariah Board examines each new product or transaction and, if satisfied it is Shariah-compliant, it issues an approval.

One of the most important challenges for Shariah Boards is to satisfy customer expectations with products and services that are Shariah-compliant. This is a complex task mainly because there is not a common codification of Shariah rules for finance, which has created some confusion in the minds of customers. For this reason, Shariah scholars will need to change their existing practices and work together to face the challenges of interpreting Shariah rules.

2.2. Introducing Islamic banks into conventional banking systems

Islamic financial institutions can be divided into two types:

1. Those institutions whose entire business is conducted in compliance with the Shariah law and are full Islamic financial institutions;
2. Those institutions that offer Shariah compliant products and/or services, but whose business is not conducted in compliance with the Islamic law and are 'conventional' financial institutions.

2.2.1. Islamic window structures

An increasing number of commercial banks around the world are considering the possibility of offering Islamic financial products. At first, a commercial bank may only want to probe the potential of this market, and thus may be interested in launching a pilot project. The bank can take advantage of its existing branch network to open an 'Islamic window', through which it can reach potential new customers.

An Islamic window is simply a special facility offered by conventional banks to provide services to Muslims who wish to have an Islamic banking service. At the inception of the Islamic service, the products typically offered are deposits on the liability side of the bank and Islamic trade-finance products for small and medium sized companies on the asset side of the bank.¹⁸

Where it is necessary to deal with sources of capital, many Shariah Boards have recognised that it is acceptable for financial institutions to 'cleanse' these sources by donating the proportion of the funds derived from non-Shariah-compliant sources to charity. This is despite the fact that, under the equivalent secular law principles, only a portion of these funds may be "cleansed" in this way. This process of cleansing funds has been approved by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) in its Shariah Standard on Conversion of a Conventional Bank to an Islamic Bank.¹⁹ In order to ensure compliance with Islamic principles, conventional banks wishing to offer Islamic products must guarantee and publicise that the sources of capital devoted to conventional activities will not be mixed with those destined for Islamic activities.²⁰

18 Sole 2007.

19 Motaleb 2008.

20 Sundararajan and Errico 2002.

Other ways of separating Shariah-compliant and non-Shariah-compliant business have been guided by best practice guidelines published by other industry bodies such as the Islamic Financial Services Board (IFSB). At the same time, a number of financial services regulators (mainly the Governors of central banks of Saudi Arabia, Sudan, Qatar, Bahrain, Indonesia and Malaysia) are beginning to introduce formal regulatory rules on the subject.

As the activities of the Islamic window expand, a bank may consider fully segregating the window into a separate subsidiary. The use of Islamic windows as a take-off platform for moving into the Islamic financial industry has been a more common practice in South East Asia and Western countries than in the Middle East, where the tendency has been to establish stand-alone Islamic banks.

■ Possibility of offering Islamic funds

Any financial institution is permitted to offer Islamic investment products, unless it is prohibited from doing so for regulatory reasons. A non-Islamic bank or a non-Muslim can engage in trading or investing in a Shariah compliant manner. A conventional financial institution in London or New York is permitted, therefore, to promote an Islamic private equity fund that caters to the needs of its Muslim investors. In many instances, this does not require the creation of an independent subsidiary. Typically, a separate department within an institution can develop and offer Shariah compliant products.

2.2.2. Establishing an Islamic bank

Once a conventional bank has operated an Islamic window for some time and has gathered a sizeable customer base for its Islamic activities, it may decide to establish an Islamic subsidiary, or even convert into a fully-fledged Islamic bank. By following either of these two routes, the bank may benefit from economies of scale and concentration of knowledge and expertise. The bank will be able to offer, under one roof, a wider range of Shariah-compliant banking products than through the Islamic window alone.

The advantage of opening a subsidiary over a full conversion is that, with the former, the parent bank may continue servicing its conventional customers, while the subsidiary expands its Islamic activities in clear separation from the conventional business. Normally, in the case of Islamic windows, the treasury department of the parent bank is typically in charge of managing the liquidity requirements of the bank as a whole, which poses the threat of mixing conventional and Islamic funds. On the other hand, a full conversion signals the bank's firm commitment to operate under Shariah principles, thus enhancing its credibility.

Although it does not seem to be a widespread concern within the industry, it must be mentioned that some Shariah scholars have raised concerns regarding the legitimacy of establishing Islamic subsidiaries or banks using capital from conventional banks.²¹ The concern arises because it is not guaranteed that the funds provided by the parent bank will originate from Islamic compliant sources. Hence, the subsidiary's initial capital may be unacceptable from an Islamic point of view. Although there is an ongoing debate over this matter, one of the proposed solutions is to allow the formation of the new Islamic institution, if it commits to making future charitable donations as a way to purify the original funds.

Be that as it may, the transition from a conventional to an Islamic bank also presents operational challenges, as a number of items in the conventional bank's existing balance sheet are tied to interest-bearing transactions. The financial institution must ensure that all the items on its balance sheet are compatible with the Shariah. Probably, it will be necessary to transform all of its loans and deposits into non-interest bearing assets and liabilities - such as Murabaha contracts (in the case of assets) or Mudarabah deposits (in the case of liabilities). Annex 7 provides an example of how to transform a conventional loan into an Islam compatible instrument.

21 Rahman and Zaharuddin 2006 and Yaquby 2005.

2.3. Islamic finance in Europe

The population of Muslims in Europe is quite significant. The following table provides an overview of the Muslim population and the potential customer base in mainland Europe.

Table 3: The population of Muslims in various European countries

Country	Population (millions)	Muslim Population (millions)	Percentage
Austria	8.50	0.22	2.6%
Belgium	10.70	0.39	3.65%
Cyprus	0.95	0.24	25.26%
Denmark	5.60	0.19	3.4%
France	61.00	6.10	10%
Germany	83.60	3.25	3.89%
Italy	56.00	1.39	2.5%
Spain	42.10	0.60	1.43%
Sweden	9.30	0.31	3.33%
Switzerland	7.80	0.25	3.2%
The Netherlands	16.40	0.94	5.8%
Turkey	72.10	72.00	99.89%
UK	60.00	1.8	3%

Source: OECD 2007

■ The UK

The UK is the first country in Europe to have promoted and encouraged retail Islamic banking. It is in the process of embracing Islamic financial techniques by introducing new laws to facilitate further market entry and practice of Islamic finance in the UK.

According to the Office of National Statistics²² the UK Muslims within the UK have the following countries of origin:

- Pakistan - 43%
- Bangladesh - 16%
- India - 8%
- Other Asian - 6%
- Other - 27%

According to research carried out by The Runnymede Trust the Muslims from Middle East and Africa represent 24% of the total Muslim population in the UK.

The UK already has five licensed Islamic banks including The Islamic Bank of Britain, which was formed by a group of investors from the Middle East, and The European Islamic Investment Bank (EIIB), which is the first investment bank in Europe that offers Shariah-compliant investment banking products and services. The founding shareholders of EIIB include Persian Gulf based individuals and institutions, including a number of Islamic banks, as well as individuals and companies based in Europe. The Bank of London & the Middle East (BLME), Securities House (UK) and the European Finance House (EFH) are the other three Islamic financial institutions authorised in the UK.

The role of the UK Government in facilitating the expansion of Islamic banking in the country is remarkable. Since the early 2000s the Government has introduced a series of tax and legislative changes specifically designed to remove obstacles to the development of Islamic finance. The first significant change came in the Finance Act 2003 which introduced relief to prevent multiple payment of Stamp Duty Land Tax on Islamic mortgages. The Finance Acts of 2005 and 2006 contained further measures aimed at putting other Islamic products on the same tax footing as their conventional counterparts. Most recently, the Finance Act 2007 clarified the tax framework further in the case of Sukuk. In March 2008 the first government Sukuk was listed on the London Stock Exchange. The sovereign bond is a USD 350 million bond issued by the Gulf Kingdom of Bahrain and it is structured to avoid paying interest in line with the Islamic law. At the end of 2008 a license for an Islamic investment bank was also lodged by Gatehouse Capital PLC, a wholly owned subsidiary of Kuwait's Global Securities House.

22 UK Office of Statistics 2004.

Furthermore, the UK Government is determined to maintain its momentum on work on Islamic finance and to make clear to stakeholders its commitment to this industry. As such, it aims to publish a paper detailing the UK strategy on Islamic finance in 2009.

There are many conventional banks in the UK which provide Islamic products:

- HSBC Amanah is the global Islamic banking division of the HSBC Group. It was established in 1998 with the aim of making HSBC an international provider of Islamic banking worldwide. In the UK the HSBC Amanah Finance UK²³ is the division which provides a wide range of Islamic financial products, developed in consultation with independent Sharia scholars such as current accounts for private and business customers as well as mortgages, chequing facilities, investment opportunities, personal and corporate financial solutions.
- UBS operates the UBS Islamic Finance service²⁴ providing investors the freedom to choose a Shariah-compliant investment profile across a range of assets such as commodities, equities, fixed income, FX, indices and investment banking.
- In December 2008 Barclays launched the UK's first Shariah-compliant exchange-traded funds (ETFs) and has formed a panel of Islamic scholars to supervise such products.
- Lloyds TSB is the best example within the retail and commercial sector as they have developed a suite of Shariah approved products for their customers – including those who wish to bank ethically who are not necessarily Muslim. It offers current, business and student accounts, mortgages and investment funds. In January 2008 it launched its new current account, the Islamic Nostro Account. Related to Islamic home finance, Lloyds TSB collaborates with the Arab Banking Corporation International Bank (ABC) which provides Alburqa, a Shariah-compliant home finance service for Islamic house purchases.²⁵

23 For further information on HSBC Amanah UK, please visit: www.hsbcamanah.co.uk/amanahuk/index.html.

24 To obtain more details on the UBS Islamic offer, please visit: www.ubb.ubs.com/mc/islamicfinance/index.shtml.

25 To obtain further information on the Lloyds offer of Islamic products and services, please visit: www.lloydstsb.com/current_accounts/islamic_account.asp.

■ France

France has a Muslim population of around 6 million. However, authorities and regulators have been slow to introduce changes in the regulatory framework to accommodate Islamic financial products. Finally in 2007, France announced reforms to adapt its banking legislation to allow more traditional banks to engage in Islamic products.²⁶ In April 2008 the French Government asked the Paris Europlace, the Paris financial markets organisation, to produce a report analysing the necessary measures in order to make this marketplace a competitive one worldwide in the provision of Islamic products and services. In May 2008 France's Upper House of Parliament – the Senate – hosted roundtable discussions with politicians, bankers and Shariah scholars to discuss how to support Islamic finance by raising awareness and changing the legal and fiscal framework.²⁷ In July 2008 the Financial Markets Authority (AMF) requested the Paris Europlace to establish a working group composed of representatives of the financial industry to give market participants a clear picture of the legal and transparency requirements for listing Sukuk in France.²⁸

The findings of the Paris Europlace report (known as “the Jouini-Pastre report²⁹”) concluded that France provides a welcoming environment for Islamic finance subject to certain legal and tax adjustments. This statement is based on the cultural similarities between France and the Muslim countries. Therefore the report said that France could be among the world leaders in providing Islamic financial products if the country made a small number of legal reforms. To reach this objective it would be necessary to attract an important amount of capital to the Paris Europlace. The report estimates that this sum should be around EUR100 billion.³⁰ These conclusions complement the recommendations presented by the Chairman of the Paris Europlace Islamic Finance Committee Gilles Saint Marc³¹ to the Senate. In his recommendations, he provides a study on the compatibility between Islamic finance and the French law.

26 adnundo.com 2007.

27 Ramadier 2008.

28 Gordon 2008.

29 Paris Europlace 2008

30 The Jouini-Pastre report provides 10 proposals to reach the abovementioned objectives – see Paris Europlace (2008).

31 Gilles Saint Marc is the Chairman of the Paris Europlace Islamic Finance Committee. He presented his recommendations to the Senate on 14 May 2008. See Saint Marc 2008a for the French presentation and Saint Marc 2008b for the English version.

The main conclusions of this study state that Islamic finance represents an opportunity for France and it is necessary to make some reforms. These reforms include the enactment of a law modifying the French Monetary and Financial Code and to include adequate regulatory provisions in the next finance bill and the enactment of appropriate tax instruction.³² In addition, these modifications will benefit from other reforms currently underway (trust (fiducie) and civil transfer of receivables as security).

The study states that Islamic finance will bring the following advantages to the French financial system:

1. Access to new liquidity;
2. Positive external factors such as the integration of Muslims in France; and
3. Proof of the modernity of French law and its capacity for adaptation.

As a result of the abovementioned studies' conclusions, three measures were adopted in 2008 related to the conditions for issuing Sukuk in Euronext-Paris – the French securities market; the elimination of double taxation on registration rights in Murabaha contracts and implementation of the tax deduction on capital earned from Sukuk. In February 2009 the Paris Europlace Islamic Finance Committee published a 2009 programme, which defines 8 action points to pursue in-depth the development of Islamic finance in France.³³ These actions show that there is a clear political will to change the French financial regulatory framework to include the offer of Islamic products.

Concerning the French financial actors, some French banks have Islamic investment portfolios that operate through their branches in Muslim countries.³⁴ Only a handful of French banks, such as Société Générale or BNP and its subsidiary BNP Paribas Najmahis, currently offer Islamic products based on "Murabaha". This product is a form of credit that enables customers to make purchases without taking an interest bearing loan. The bank buys the goods for the customer and re-sells them to the customer on a deferred basis, adding an agreed upon margin of return. The customer then pays the sale price for the goods in instalments, effectively obtaining credit without paying interest.

32 Saint Marc 2008b.

33 Further details of this plan are provided in Paris Europlace (2009).

34 Fulconis-Tielens 2007.

The contract and the liquidation date of the Murabaha are fixed, and the payment to the bank is settled directly after a Murabaha liquidation. There is a potentially one Islamic retail bank – Tayseer Bank – going through the authorisation process with regulators. Negotiations began at the end of 2005 and it should be operational after the French Government carries out the necessary regulatory reforms.³⁵ At the end of 2008, Qatar Islamic Bank, Kuwait Finance House and Al-Baraka Islamic Bank (Bahrain) requested licenses to operate in France, which could be possible before the end of 2009.

■ Germany

Although it has an important Muslim population, Germany has not adopted its regulatory framework to allow for the offer of Islamic products and services in the country. Two factors can explain this situation. First, the development of Islamic finance in the country has not received the necessary political support. Second, the Muslim population of Germany is essentially composed of ethnically Turkish people (second or third generation), which in general have shown less interest in Islamic finance than other Muslims. The Deutsche Bundesbank argued that there are still some challenges confronting the financial community with regard to Islamic finance. Among the most significant factors which directly affects Germany is that the supply of Islamic products is still largely geographically constrained in the Middle East, Malaysia and London. This makes it difficult for a large number of Muslims who live in Germany and in Europe to access these services. The products are still aimed at a limited demographic target, designed for wealthy private and institutional investors. The German financial institutions that offer Islamic products do not advertise them and the product information is mostly only written in English since it is aimed at investors from Islamic countries abroad and not at the German Muslim population.³⁶ In spite of this, some Governmental initiatives can be observed. For example, in June 2004, the federal state of Saxony-Anhalt issued a EUR 100 million Sukuk to Middle-eastern institutional investors and also to attract Muslim investors to invest in their state.

35 Saddy 2007.

36 Further information in Böhmler (2007).

The Sukuk launched was structured by Citigroup's Islamic division and was backed by real estate owned by the Ministry of Finance. The rights of use of this real estate were transferred to a Dutch foundation which was offering the Sukuk. Saxony-Anhalt therefore became the first state government in Germany and Europe to issue a sub-sovereign bond under Islamic principles.³⁷

There are some Muslims banks such as the Irani Bank Sepah established in the country which have the largest share of the Islamic banking market in Germany. Recently KuveytTurk announced its interest in establishing a branch in Germany in the coming years to satisfy the financial needs of the Muslim Turks. Among conventional commercial banks, Commerzbank, Deutsche Bank and Dresdner Bank have experience offering Islamic products and services, however they are concentrating their Islamic operations on extending their presence in Islamic countries. Deutsche Bank offers Islamic products thanks to an agreement with the National Commercial Bank of Saudi Arabia that allows them to provide a unique class of investment products – the Islamic EquityBuilder Certificates™. The Certificates, which are all in compliance with Shariah principles and approved by the highly esteemed and regarded Shariah Board of National Commercial Bank of Saudi Arabia, use an objective and transparent quantitative strategy rather than an active management type of strategy. With these Certificates, investors have a choice to invest in one or more regions or globally, and are able to use them as portfolio building blocks, with the objective of building long term wealth and diversifying risk. In 2008 Deutsche Bank received the go ahead from the Bank Negara of Malaysia to set up a dedicated Islamic banking subsidiary in Malaysia. The Commerzbank focuses on Islamic investment products, however also offers a variety of interest-free competitive products meeting Islamic finance requirements such as Murabaha deposits. Commerzbank has a presence in Dubai, Cairo, Beirut and Singapore.

■ Spain

The Spanish central bank, Banco De España remarks in one of its “Financial Stability” reports³⁸ that Islamic finance offers clear opportunities for the Spanish banking sector. First, the Spanish retail banking sector could diversify their business and find new commercial opportunities thanks to the economic relationship of Spain with the Magreb (Northwest Africa) region and also, because these countries’ financial markets have a low correlation with the international financial markets. Second, there is an interesting possibility of accessing the abundant Islamic savings through the issuing of Sukuk, which can be used for financing banks or providing credit to clients.

In addition, the growth of the Muslim population in Spain could mean an extra source of funds for expanding the Spanish retail banking sector. As this population is consolidated in Spain and they increase their purchasing power, the Spanish financial institutions could extend their customer base if they are able to respond to the needs of this population. However, apart from these positive possibilities, the Banco of España provides a list of arguments remarking several risks surrounding the Islamic finance in a similar way that Germany does.

The national Islamic authority in Spain, “La Junta Islamica” has begun a process for creating an Islamic Bank in Spain. The first phase of this process consists of creating Islamic window facilities in one Spanish bank “Bancorreo” to sell Islamic financial products such as current accounts and mortgages. Currently they are offering just information and they have designed some brochures for the public in order to educate potential customers about these products.

In 2006 other Spanish banks such as Santander and the Spanish savings bank “La Caixa” announced their intentions of entering in the Islamic market. However, at the time of writing this publication, no further actions have been taken.³⁹

38 Further details in García-Herrero, Moreno and Solé (2008).

39 Contreras 2007.

■ Luxembourg

Luxembourg has not been recognised in the world of Islamic finance for a long period but it has a recent history of innovation in this field. Sukuks and products structured on contracts such as Mudaraba, Musharaka, Murabaha, Istisna and Ijara can in principle be set up within the existing legal framework of Luxembourg. Local financial institutions are increasingly entering the Sukuk market and Shariah-compliant investment funds are being launched under Luxembourg law. In 1983, Luxembourg was the chosen domicile of the first Shariah-compliant insurance company in Europe. The Luxembourg Stock Exchange was the first European stock exchange to enter the Sukuk market, having listed Sukuks since 2002. In September 2008, 14 Sukuks with a combined value of USD 5.5 billion were listed and traded on the Luxembourg Stock Exchange. In September 2008 there were 31 Shariah-compliant investment funds held in 17 Luxembourg domiciled investment vehicles.⁴⁰

■ Other European countries

In 2008 the Malta Financial Services Authority (MFSA) launched a consultation to analyse conventional Islamic funding structures and financing vehicles vis-à-vis the Maltese regime applicable to collective investment schemes, investment service providers, credit and financial institutions. At the end of 2008 and beginning of 2009 the MFSA launched two consultations related to Islamic bonds and Shariah insurance. The feedback from the first consultation was very positive and the MFSA envisages a number of opportunities for the setting up of Malta-based Islamic financial institutions as fully fledged banking institutions, as well as a number of opportunities for the setting up of Shariah-compliant funds in Malta. In fact, despite the current global financial troubles, in March 2009 investors from Dubai have started negotiations with government officials in Malta on a number of assets and projects. Malta, which joined the European Union in 2004, has also become part of the Schengen visa regime, which it makes it easily accessible, especially for investors from the Persian Gulf.

⁴⁰ Source: Luxembourg for Finance (2008). Luxembourg for Finance is an agency for the development of the financial sector and is a public-private partnership between the Luxembourg Government and the Luxembourg Financial Industry Federation.

Related to Switzerland, in 2008 the Islamic Bank of Britain (IBB) announced a plan to capture part of the European market through the opening of branch offices in Germany and Switzerland. However the results of these negotiations have not yet seen the light. In 2006 Faisal Private Bank opened in Geneva, becoming the first in the country to operate according to Shariah principles. In 2008 the National Bank of Kuwait announced that they applied for regulatory approval to set up an Islamic bank with a Saudi partner in Switzerland. In 2009 however, due to the financial crisis, the bank stated that the process is still ongoing but has slowed.

In other European countries, the situation is similar. The Netherlands, Belgium and Italy are examples of countries where the financial regulatory framework has not been adapted to allow for the offer of Islamic products and services. The Islamic financial activities in these countries are based on investment operations carried out by subsidiary companies of Islamic banks from outside Europe – mainly in the Middle East. For example in 2008, the Dutch supervisory authorities, De Nederlandsche Bank, and the Autoriteit Financiële Markten carried out a study with respect to Islamic finance. The conclusion of this study was positive. Demand for Islamic finance exists in the Netherlands as a result of the substantial number of Muslims in the country. However, Islamic finance has not been developed in this country. Belgium has an important Muslim population – mainly of Moroccan origin – who are interested in Islamic finance. However, the Belgian financial sector estimates that this demand is not solid enough to develop a whole new Islamic retail banking activity. Banks such as Fortis and ING have some Islamic financial activities but based in Malaysia. Italy does not have any Islamic financial institution in the country, although it has been announced that the first one will be established in 2009. The new venture could be a part of the European Islamic Investment Bank gathering bankers from the Persian Gulf and Italy.

The Governments of these countries have two alternatives.⁴¹ The first is to address the current regulatory challenges that Islamic financial services have by law. This involves adapting the regulatory framework for the entire banking sector in order to support the expansion of the Islamic finance industry. The second alternative is to address the growth of Islamic finance by separately regulating unique aspects of Islamic banking. For instance, this would involve regulating how Shariah Supervisory Boards should work in the country. In parallel, Governments should keep in mind the rules introduced by the Islamic regulatory authorities that have set Islamic Shariah rules for finance and accounting (among other standards).

■ Across the Atlantic: The United States

The approach of the U.S. regulators to Islamic banking has been fairly ad hoc, with individual regulators dealing with specific issues as they are presented. This has been the case because Islamic finance is still relatively new in this country. Despite the industry's impressive growth in recent years, there are only a small number of providers and a relatively limited array of services available.⁴² At the retail level, Islamic banking has been mostly concentrated in home financing activities. Not surprisingly then, a number of the issues raised with U.S. regulators have involved this specific business line.⁴³

In the personal home mortgages market, Guidance Residential (Reston, Virginia) reportedly has financed over 5000 Shariah-compliant mortgages since 2002.⁴⁴ Other financial intermediaries that provide Islamic-based home mortgages include University Islamic Financial (Ann Arbor, Michigan), Devon Bank (Chicago, Illinois), and American Finance House Lariba (Pasadena, California). HSBC is the only large commercial bank that offers U.S. Islamic finance and is focused on New York. Since 2005 the Federal National Mortgage Association (Fannie Mae) and the Federal Home Mortgage Corporation (Freddie Mac) have purchased Shariah-compliant mortgage contracts from financial intermediaries, allowing providers to originate further mortgages. In 2007 and until the boom of the subprime crisis, Freddie Mac reportedly purchased more than USD 250 million in Islamic home loans – a small but notable fraction of the enterprise's USD 1.77 trillion in business activities.

41 Islam 2008.

42 El-Gamal 2006.

43 Rutledge 2005.

44 Aizenman 2008

Other forms of shariah-compliant services are offered in the United States as well. For instance, Devon Bank and Zayan Finance offer Shariah-compliant funds for commercial real estate. Shariah-compliant mutual funds are offered by intermediaries such as the Amana Mutual Funds Trust, Azzad Funds, and the Dow Jones Islamic Fund. In 1999, the Dow Jones presented its first Islamic market index, which follows Shariah-compliant stocks internationally. The Dow Jones maintains more than 70 indices in its Islamic series and is advised by an independent Shariah Supervisory Board counsel. International financial intermediaries also provide Islamic funds in the United States. Islamic investors from the countries of the Gulf Cooperation Council (GCC) have sought to diversify their financial portfolios geographically and to invest their oil wealth in U.S. assets. For instance, the Bahrain-based Arcapita Bank has structured many Shariah-compliant transactions in private equity and real estate in the U.S. Additionally, U.S.-based companies have taken advantage of alternative funding sources through Islamic-financing abroad. According to Standard & Poor's, Loehmann's Holdings, Inc. and East Cameron Gas Company have issued rated Shariah-compliant bonds.⁴⁵

45 Standard and Poor's 2006.

3. REGULATORY AND COMPLIANCE ISSUES

3.1. The role of the supervisory authorities

It is possible to identify three relevant supervisory authorities for Islamic finance. At an internal level, the Shariah Board of a financial institution. At an external level: the Islamic Financial Services Board (IFSB, Malaysia) and the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI, Bahrain). In addition, other international Islamic institutions are the General Council for Islamic Banking and Finance Institutions (GCIBFI, Bahrain), the Islamic International Rating Agency (IIRA, Bahrain) and the Islamic Liquidity Management Center (ILMC Bahrain).

3.1.1. The Shariah Board

The role to be played by the Shariah Board in an Islamic financial institution is two-fold: on the one hand, there is the traditional prudential supervision aspect, but there is also a vital developmental role that is equally important.

Supervisors must have an understanding of whether Islamic banks' activities are compatible with the Shariah. In some countries, private Islamic banks have their own Shariah advisors. However, setting up a Shariah consultative board within the financial supervisory authority would be beneficial in countries where Islamic banks are present.

In the developmental role of the Shariah Board, they supervise the development and creation of innovative Sharia-compliant investment and financing products and services. The Board is empowered to issue Fatwas (a religious opinion based on Islamic law) on any matter proposed to it by different business units of the bank. The Shariah auditors ensure that all the transactions are carried out in strict compliance with Islamic principles of banking.

Shariah Boards also have to address the following issues:

Moral hazard considerations: such considerations arise from the risk-sharing nature of investment deposits, in which depositors provide the funds that the bank invests in the activities it deems profitable. In Islamic finance it is easier to pass part of the investments' losses to depositors than in conventional finance. For example in an Islamic fixed deposit, the client accepts that the bank can invest his/her money in investment projects and in the event of a loss, the customer bears all the loss. The Shariah Board must ensure that the bank's investments are selected under the right criteria.

Safeguarding the interests of demand depositors: Demand depositors in Islamic banks face the same risks as demand depositors in conventional banks and thus merit the same level of protection.

Systemic considerations: While the failure of a corporation may not have contagious effects, the failure of a bank could very well result in the public's loss of confidence in the stability of the banking system as a whole, thus triggering a generalized bank run.

Other important duties of the Shariah Board include:

- Supervising the Shariah compliance of all banking and financial transactions.
- Ensuring Shariah compliance in the implementation of all transactions and to correct any breaches.
- Analysing administrative decisions, issues and matters that require the Shariah Board's approval.

3.1.2. The Islamic Financial Services Board (IFSB)

The Islamic Financial Services Board (IFSB) is an international standard-setting organisation that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry – broadly defined to include the banking, capital markets and insurance sectors. The IFSB also conducts research and coordinates initiatives on industry related issues, as well as organises roundtables, seminars and conferences for regulators and industry stakeholders.

The IFSB is based in Kuala Lumpur, Malaysia, and began operating in March 2003. It serves as an international standard-setting body of regulatory and supervisory agencies that have a vested interest in ensuring the soundness and stability of the Islamic financial services industry, which is defined broadly to include banking, capital markets and insurance. In advancing this mission, the IFSB promotes the development of a prudent and transparent Islamic financial services industry through introducing new, or adapting existing international standards consistent with Shariah principles, and recommending them for adoption.

To this end, the work of the IFSB complements that of the Basel Committee on Banking Supervision, the International Organisation of Securities Commissions and the International Association of Insurance Supervisors.

As of January 2008, the 150 members of the IFSB included:

- 37 regulatory and supervisory authorities;
- the International Monetary Fund;
- the World Bank;
- the Bank for International Settlements;
- the Islamic Development Bank;
- the Asian Development Bank; and
- 108 market players and professional firms operating in 29 countries.

Malaysia, the host country of the IFSB, has enacted a law known as the Islamic Financial Services Board Act 2002, which gives the IFSB the immunities and privileges that are usually granted to international organisations and diplomatic missions.

Since its inception, the IFSB has issued seven **Standards, Guiding Principles and a Technical Note** for the Islamic financial services industry.⁴⁶ The published documents are on the areas of:

1. Risk management
2. Capital adequacy
3. Corporate governance
4. The supervisory review process
5. Transparency and market discipline
6. Recognition of ratings on Shariah-compliant financial instruments
7. Development of Islamic money markets

⁴⁶ The standards and guidelines documents can be downloaded from the Islamic Financial Services Board website: www.ifsb.org.

The IFSB is also working on **five new standards and guidelines**. They are:

1. Special issues in capital adequacy (currently being issued as an "Exposure Draft")
2. Governance for collective investment schemes (currently being issued as an "Exposure Draft")
3. Corporate governance in Takaful operations
4. Shariah governance
5. Market conduct

The IFSB "promotes the development of a prudent and transparent Islamic financial services industry through introducing new – or adapting existing – international standards consistent with Shariah principles, and recommending these for adoption."⁴⁷

3.1.3. The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI)

Islamic financial institutions that wish to comply with the general international standard must publish regular financial statements, in accordance with Financial Accounting Standards (FAS) issued by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI). For products and activities not covered by AAOIFI, International Accounting Standards (IAS) should be followed.

AAOIFI is an Islamic international autonomous non-for-profit corporate body that prepares accounting, auditing, governance, ethics and Shariah standards for Islamic financial institutions and the industry. In its efforts to enhance the industry's human resources base and governance structures, AAOIFI now offers professional qualification programs (notably CIPA, the Certified Shariah Adviser and Auditor "CSAA", and the corporate compliance program).

AAOIFI was established in accordance with the "Agreement of Association" which was signed by Islamic financial institutions on 1 Safar, 1410 H (corresponding to 26 February 1990) in Algiers. It was then registered on 11 Ramadan 1411 H (corresponding to 27 March 1991) in the State of Bahrain.

47 IFSB 2009.

As an independent international organization, AAOIFI is supported by institutional members (155 members from 40 countries, so far) including central banks, Islamic financial institutions, and other participants from the international Islamic banking and finance industry, worldwide.

AAOIFI has gained support for the implementation of its standards, which have now been adopted in the Kingdom of Bahrain, Dubai International Financial Centre, Jordan, Lebanon, Qatar, Sudan and Syria. The relevant authorities in Australia, Indonesia, Malaysia, Pakistan, the Kingdom of Saudi Arabia, and South Africa have issued guidelines that are based on AAOIFI's standards and pronouncements.

The objectives of AAOIFI are:

1. to develop accounting and auditing "thoughts" relevant to Islamic financial institutions;
2. to disseminate accounting and auditing "thoughts" relevant to Islamic financial institutions and its applications through training, seminars, publication of periodical newsletters, carrying out and commissioning of research, etc.;
3. to prepare, promulgate and interpret accounting and auditing standards for Islamic financial institutions; and
4. to review and amend accounting and auditing standards for Islamic financial institutions.

AAOIFI carries out these objectives in accordance with the precepts of Islamic Shariah, which represent a comprehensive system for all aspects of life, in conformity with the environment in which Islamic financial institutions have developed. This activity is intended both to enhance the confidence of users of the financial statements of Islamic financial institutions in the information that is produced about these institutions, and to encourage these users to invest or deposit their funds in Islamic financial institutions and to use their services.

3.2. Licensing and compliance

Licensing Islamic banks and windows will increase the supervisory burden on the regulator since there would then be a new type of institution/activity that requires its own legislation such as the regulatory framework. In other words, in the case of Europe, in addition to the Basel II International Framework, supervisors will have to be familiar with the application of the Islamic Financial Services Board (IFSB) standards for Islamic banks.

The national requirements to grant an Islamic license vary depending on the country where the financial institution wishes to operate.⁴⁸

The UK Example⁴⁹

The first Islamic bank in Europe: the Islamic Bank of Britain, was created in the UK in August 2004. This process helped the Financial Services Authority (FSA) to redefine the **authorisation requirements** for the creation of a bank in the UK, including Islamic banks.⁵⁰ These are:

- The firm must provide a credible business plan.
- The firm must have the appropriate legal status for the activities it wishes to undertake.
- For a firm in the UK, its head office and mind and management must also be in the UK.
- If the firm has close links with another firm, these should not prevent the effective supervision of the firm
- The firm has adequate resources, both financial and non-financial, for the activities which it seeks to carry on.

The capital requirements for an Islamic and a conventional bank are applied on the same basis. Operations performed by traditional banks through Islamic windows do not require separate authorisation.

48 Please note that there are no cases of licensed Islamic banks in Europe except in the UK. Conditions in Muslim countries vary according to the national central bank requirements. Therefore, in this study the UK case is shown as the most relevant European example.

49 Information provided in Ainly et al. 2007.

50 Ainly et al. 2007.

The process of establishment of the Islamic Bank of Britain raised new questions and it took 18-24 months to complete. Areas where there was a need for more research and work were:

- Regulatory definition of products: firms need to be sure they apply for the correct range of permission for the regulated activities they wish to undertake.
- The role of Shariah scholars, which examine each new product or transaction and, if satisfied that it is Shariah-compliant, issue an approval.
- Financial promotions: especially important in Islamic finance since the products are new and differ from traditional products.

The European Islamic Investment Bank was established in London in January 2005 and received authorisation to operate from the FSA in March 2006. The bank's aim is the provision of Sharia-compliant investment banking products and services.

In general terms, a financial institution wishing to open an Islamic bank/window should consider the following issues related to corporate governance and regulatory requirements in order to ensure compliance with Shariah and national rules:⁵¹

- **Corporate governance issues:**
 - Establishment of a Shariah Board
 - Internal coordination of the administrative board's work with the new supervisory Shariah Board
 - Rewording of the financial institution objectives: including clear definition (in the case of an Islamic bank) or segregation (in an Islamic windows structure) of the bank's funds and of its uses
 - Integration of Shariah standards (e.g. AAOIFI) in business policy (code of conduct, board regulation, etc.)
- **Regulatory requirements:**
 - To offer products and services that are considered as banking activities in order to receive a national banking license.
 - To fulfill the capital adequacy requirements (national and international requirements suggested by the IFSB)
 - To fulfil liquidity requirements, subsequent to national regulation

51 See "Islamic Banking: Issues in Prudential Regulation and Supervision" by Errico, Luca and Mitra Farahbaksh. IMF Working Paper WP/98/30 (March 1998).

It is clear that in many countries there is still an inadequate legal and regulatory framework. That is true in some parts of the Islamic world, but it is certainly true in the U.S. and in Europe (with the exception of the UK). There are other European countries with larger Muslim populations than the UK, yet where the regulators have not yet come to grips with the issues in the way that the Financial Service Authority (FSA) has done.

The IFSB has provided some guidance notes on capital adequacy and risk management which are very useful, but they are not applied everywhere. Concerning capital adequacy, the IFSB suggests national supervisors should follow their recommendations when determining which external credit assessment institutions ratings may be used to calculate capital adequacy ratios under the IFSB's December 2005 Capital Adequacy Standards (CAS). The CAS of December 2005 addresses the structure and contents of Shariah-compliant products and services that are not specifically addressed by Basel II and seeks to standardise the approach to risk weighting such products and services.

The IFSB in its guidance note on capital adequacy asserts that Shariah-compliant financial assets should be regarded as a set of asset classes with distinct characteristics, and that consequently credit rating agencies (CRAs) should incorporate in their rating methodologies an explicit understanding of these distinct features, including clear explanations of how these are addressed.

Rating analysis of Shariah-compliant assets may differ from analysis of conventional assets, both in terms of the general principles that govern Shariah-compliant finance (for example, the concept of default) and in terms of the features of specific financial instruments (for example the concept of displaced commercial risk (DCR) when dealing with returns on investment accounts that are based on a Mudarabah contract).

In Islamic finance, assets may be:

- a) such that periodic payments are due contractually
- b) based on return and loss-sharing or return-sharing and loss-bearing contracts where the obligation to make a payment and the maintenance of capital are subject to investment performance.

In terms of capital adequacy calculations, the principal areas where Shariah-compliant finance may differ from conventional finance include, though are not limited to, the following:

- a) **Different meanings of ratings and the concept of default:** as a result of the different natures of default considered, the meaning of ratings may differ depending on the type of instrument being rated.
- b) **Priority of claims:** in conventional finance, priority of claim is defined in the loan documentation and by local laws. However, within Shariah-compliant finance, additional factors may come into play – such as Shariah requirements for equitable treatment of creditors.
- c) **Corporate governance and the role of the Shariah Board:** governance standards applicable to Islamic financial institutions are set out in the IFSB's "*Guiding Principles on Corporate Governance*" for Islamic financial institutions. These principles include all those that are applicable to conventional banks, as well as principles related to compliance with Shariah rules and principles. This may have implications for credit characteristics, especially as issues of reputational risk assume greater importance for Shariah-compliant issuers of financial instruments than for conventional issuers.
- d) **Risk mitigation techniques to cater for displaced commercial risk (DCR):** DCR derives from competitive pressures on the Islamic financial institution to attract and retain investors. It may respond to these pressures by creating reserves. The existence or non-existence of such reserves could have a significant impact on the creditworthiness of the institution.
- e) **Definition of capital:** an Islamic financial institution uses capital to protect the depositors and some classes of investor from losses. Therefore it is necessary that external credit assessment institutions make clear what constitutes capital in an Islamic financial institution and the extent to which depositors and certain classes of investors are protected against losses.
- f) **Trading in Sukuk does not involve trading in debt (unlike conventional bonds):** Sukuk holders derive their returns either from an underlying real asset(s) or the usufruct of such assets, which is fractionally owned by the Sukuk holders rather than being collateral for a debt as with conventional asset-backed securities; or from a securitised partnership in an underlying business venture.

- g) **Asset valuations:** many of the Islamic financial instruments used by Islamic financial institutions for financing working capital or projects have particular risk characteristics that need to be understood. For example, a Murabahah contract requires an Islamic financial institution to have ownership of assets as part of asset-based financing activities on its balance sheet for a short period of time pending resale. Such assets may be subject to substantial market risks if the contract is non-binding in nature. As a result, the risks associated with these assets are not confined to credit risk.
- h) **Loss given default:** the IFSB recognises that statistics on loss rates of defaulted Shariah-compliant instruments are at a very early stage of compilation. This may put investors in a stronger position to attach assets in the event that the issuer defaults than the investor would be if they were holding conventional instruments. In fact, this may or may not be the case, depending on the applicable legal system.

The IFBS recognises that national supervisors retain the ultimate authority in determining both recognition criteria and the recognition process.⁵²

52 Further information about regulatory capital requirements, risk management and corporate governance is available through IFSB 2007.

4. CHALLENGES, OPPORTUNITIES AND CONCLUSIONS



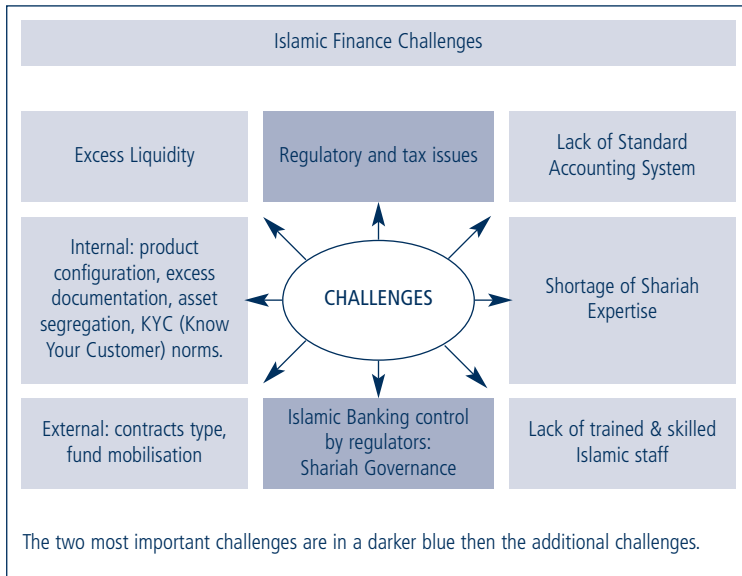
4.1. Challenges and opportunities in Islamic finance

Islamic banking and finance offers new opportunities for financial institutions to service a previously unexplored customer segment in Europe. The market continues to flourish around the world and there are sufficient Muslim investors and borrowers in both Islamic and non-Islamic countries to warrant the attention of traditional banks that seek to serve such clients and capture a potentially profitable slice of a still relatively untapped market.

The major obstacle for any new Islamic retail bank is having banking products that are competitive with conventional products offered by other retail banks.⁵³ However, to achieve this objective has been quite difficult because, despite being the fastest growing component of the financial services industry, Islamic finance presents some challenges that could threaten a path of sustainable growth. This section includes some of the most significant challenges the Islamic financial sector currently presents.

53 Cihak and Hesse 2008b.

Figure 2: Challenges for Islamic finance:



Source: ESG's own elaboration

The two most important challenges that a financial institution can face are related to regulatory and governance issues, which have been explained in the previous section (see Section 3). Other relevant challenges are:

- **A lack of a standardised accounting system:**
 - There are many and varied accounting standards and practices. The most important are produced by the International Accounting Standards (IAS) and by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), but there are also other standards.
 - There are growing concerns over the heterogeneity in accounting practice and disclosure in Islamic banking and finance practice.

■ **Inadequate Shariah expertise:**

- There is a shortage of qualified human capital.⁵⁴ Meanwhile, the strong growth in the global Islamic banking and finance sector means that the current shortage of personnel working in the sector will be exacerbated.
- There is a need for developing a substantial number of Shariah experts of high professional prudence and integrity.
- There is a need to establish one international Central Shariah Board and one external Audit Committee

■ **Excess liquidity:**

- About 95% of Shariah-compliant funds are invested on a short-term basis
- There is about 40% more liquidity in Islamic Banking and Finance institutions than in traditional banking. This can be seen as an opportunity. However, there is a serious dearth of long-term Shariah-compliant investment tools.

Besides the abovementioned general problems, there are more that traditional banks will have to face in order to provide Islamic products. In general terms, financial institutions wishing to provide Shariah-compliant products have to deal with internal and external challenges:

4.1.1. Challenges internal to the institution

■ **IT product configurations require customisation**

It is a challenge to create and maintain IT systems in such a manner that they continuously support the current products and also implementation of new product innovations on an end-to-end basis. There is a need for customised IT systems to reflect the specialist nature of Islamic finance.

- **Know Your Customer (KYC) norms require more rigour**
Know your customer (KYC) is equally important in Islamic finance. If the business for which the financial resources are being extended is prohibited in Shariah, the whole transaction would be cancelled. Also, such information about the customer can significantly contribute to the choice as to which structure is used to extend the finance. For example, if working capital finance is extended under the Musharaka structure, there is every possibility that the customer can project lower returns at the expiry term, leading to a lower share of return for the institution than is otherwise due. Hence it is very important to factor in the latest customer information prior to extending finance through a relevant structure.
- **Excessive documentation**
Islamic finance tends to be document-intensive. This is because typically each transaction has multiple phases – contract, procurement, sale, financing and servicing. Various documents are required to be completed during the various stages of the deal. At the same time, adoption of e-documentation can obviate the need for multiple physical meetings, track the time elapsed and also alleviate the need to maintain paper and related storage and retrieval costs.

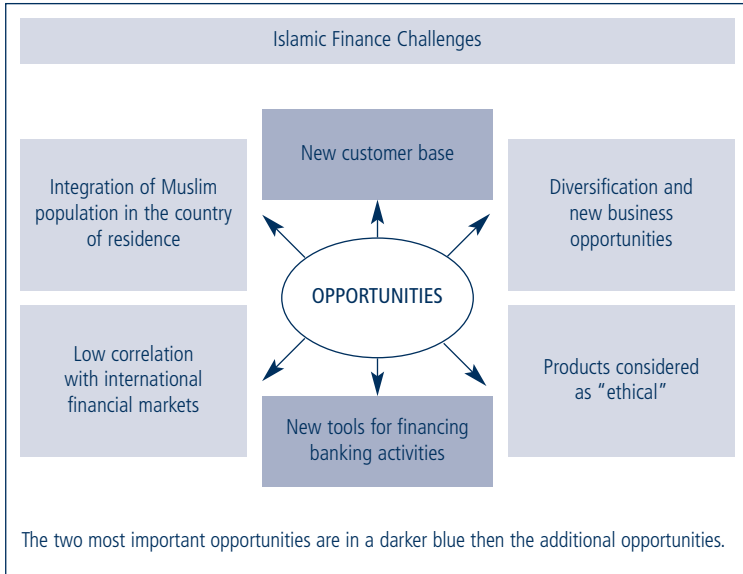
4.1.2. Challenges external to the institution

- **Fund mobilisation may require understanding by regulators:**
The ways in which Islamic banks can mobilise funds are all non-conventional and, in some ways, new to the regulators. Several issues and questions arise in the minds of regulators confronted with the task of supervising and regulating Islamic banks. Some methods for mobilising funds, for example, would require asset-management instead of the conventional concept of fund management.
- **The different nature of contracts will require new practices:**
The use of non-conventional contracts to offer products for financial services can create a whole range of issues concerning corporate governance standards, sources of new risks and how to manage them, as well as how to make Islamic banks conform to the market discipline already created for conventional banks.

Finally, it is necessary to recall the opportunities that Islamic finance can bring to financial institutions.

These opportunities have been mentioned along this report and are summarised in the figure below:

Figure 3: Opportunities related to Islamic finance



Source: ESG's own elaboration

4.2. Conclusions

Despite all the challenges that Islamic finance presents, the sector has become a dynamic and fast-growing global phenomenon. Since its inception three decades ago, the sector has moved into the limelight, evolving into a feasible and competitive segment of the overall financial industry. The dynamism of the Islamic financial services industry is being felt in both traditional Islamic financial centres and other markets, however none of these new markets are yet located in Europe, with the exception of the UK.

However, European governments are considering modifying their national financial requirements in order to incorporate Islamic banking and finance practices into their countries. The UK was the first to introduce tax and legislative changes to remove obstacles to the development of Islamic finance.

France has started to adopt the French financial regulatory framework to include the offer of Islamic products. Italy, suggests that changes in the regulatory financial framework should be discussed at European level.

The success of Islamic finance expansion in Europe could be stimulated by the structural change of the European population. Europe's population is stagnating and the percentage of ethnic minorities and migrants population is increasing. UN and European authorities estimate that there are currently 25 million migrants across the EU-27. Out of a population of 450 million, Muslims are estimated at between 15 and 25 million and the potential for the future growth of Islamic finance, in particular in the retail market, is clear.⁵⁵

It is possible to say that the interest in Islamic finance is blossoming *in Europe* and many European banks perceive it as a profitable opportunity to generate or to broad new business rather than a threat to existing business.

However, the current Islamic finance model is still under construction and in the process of standarisation by agencies located either in the Persian Gulf countries or in Malaysia. Apart from the legal difficulties that exist in many countries at present, there are also a number of other issues surrounding the Islamic banking issue in Europe, not least the business case. In effect, in many European countries, people in the Islamic communities have been residents for some time and are already integrated into the local banking system. Thus any Islamic banking product or service that may be introduced by a conventional European bank will have to be more attractive than the equivalent product offered by conventional European banks to ensure up-take. It also remains to be seen whether these products and services offered by a conventional bank will be considered attractive if they compete with similar products offered by Islamic banks in the country concerned.

Islamic finance products for European savings and retail banks could mean an opportunity to expand their retail activities. However, it looks that at this moment in time, there are still too many questions and challenges to be solved related to a possible "European-Islamic retail banking sector". Accordingly European savings and retail banks wishing to enter into the Islamic banking business have to consider regulatory and perhaps cultural issues - in addition to analysing the business case.

55 Wilson 2007.

ANNEXES



Annex 1: Sources of Shariah and the Schools of Thought

The basic pillars of Islamic finance are:⁵⁶

1) Sources of Shariah:

The **primary sources** accepted universally by all Muslims, are derived from The Holy **Qur'an** and the **Sunnah** of the Holy Prophet (PBUH). The Qur'an is considered the direct words of Allah, as revealed to and transmitted by the Prophet Muhammad. All sources of Islamic law must be in essential agreement with the Qur'an, which is the most fundamental source of Islamic knowledge. When the Qur'an itself does not pronounce directly or in detail about a certain subject, Muslims only then turn to alternative sources of Islamic law. The Sunnah is the traditions or known practices of the Prophet Muhammad. This resource includes many things that he said, did, or agreed to. During his lifetime, the Prophet's family and companions observed him and shared with others exactly what they had seen in his words and behaviours. People also asked the Prophet directly for rulings on various matters, and he would pronounce his judgment. All of these details were passed on and recorded, to be referred to in future legal rulings. Many issues concerning personal conduct, community and family relations, political matters, etc. were addressed during the time of the Prophet, decided by him, and recorded. The Sunnah can thus clarify details of what is stated generally in the Qur'an.

⁵⁶ Lau and Hinchcliffe 2005: Chapter 3.

The **secondary sources** of Islamic law are: '*Ijmah*' and '*Qiyas*'. **Ijmah** means **consensus among the jurists**: In situations when Muslims have not been able to find a specific legal ruling in the Qur'an or Sunnah, the consensus of the community is sought (or at least the consensus of the legal scholars within the community). **Qiyas** means **analogy**: In cases when something needs a legal ruling, but has not been clearly addressed in the other sources, judges may use analogy and legal precedent to decide new case law. This is often the case when a general principle can be applied to new situations.

Further sources of secondary law are '*Ijtihad*', "*Istihsan*" and "*Istisah*". **Ijtihad** is **reasoning**: it is a technical term of Islamic law that describes the process of making a legal decision by independent interpretation of the primary sources, the Qur'an and the Sunnah. A person who applies Ijtihad is called a *Mujtahid*, and traditionally must be a scholar of Islamic law. To become a Mujtahid in theological terms is similar to having a doctorate in divinity in *Islamic Kalam*, or – in legal terms – equivalent to reaching the status of a high or supreme court judge. **Istihsan** (meaning juristic "preference") recognises that a legal rule derived by one source, for example Qiyas (i.e. analogy), could occasionally lead to unattractive results. These results could be a conflict with another principle of Islamic law laid down by some other text, or the legal rule itself might in the eyes of the jurist be unsuitable for the situation at hand because it was too narrow or caused hardship. Istihsan allows a jurist to accept a rule that in his own opinion would produce a better result. Istihsan is confined to the **Hanafi**⁵⁷ school of law. The **Malikis**⁵⁸ developed a similar principle of equitable jurisdiction that they called Istisah. However, in contrast to the Hanafis, the Malikis never took full advantage of this form of judicial preference or equitable jurisdiction but applied it very cautiously.

57 For an explanation of the Hanafi School, please see the next subsection: 2) Schools of thought.

58 For an explanation of Malikis School, please see the next subsection: 2) Schools of thought.

2) Schools of thought

The historical circumstances of the emergence of Islamic law in the seventh century AD continue to determine the essential features of Islamic law today. Distances between the different areas under Muslim rule grew and as a result different centres of learning emerged. These centres of learning consisted of groups of religious persons who surveyed the existing law and engaged in *Fiqh* (i.e. the science of law). These groups were initially geographically determined but later became known by the name of the individual jurists followed by the members of these groups. Basically there are two recognised schools of thought: the *Sunni* and the *Shia* schools:

There are **four Sunni schools** of law: *Hanafi*, *Maliki*, *Shafi* and *Hanbali*. The Hanafi school frequently relies on analogical deduction and independent reasoning. The Maliki and Hanbali schools generally use the *Hadith* (oral traditions relating to the words and deeds of the Islamic prophet Muhammad) instead. The Shafi school uses Sunnah more than Hanafi and analogy more than the two others (Maliki and Hanbali). The doctrine of the Hanbali school is that *Ijma* (consensus among jurists) is binding only when it is the consensus of the entire Muslim community. Accordingly, in the Hanbali school, the role of *Ijma* is restricted to matters of religious belief and religious practice.

In the **Shia school** of thought, the *Usuli* school is the most important and it uses the two primary sources, which are the Qur'an and Sunnah. It also uses as secondary sources *Ijmah* and *Aql* (i.e. *intellect and reasoning*). They use *Ijmah* under special conditions and rely on *Aql* to find general principles based on the Qur'an and Sunnah. Other schools within Shia Islam are the *Ithna'asharis*, the *Ismailis* and the *Zaydis*, but they represent a small minority within the Shia school.

Despite these considerable differences in the principles of jurisprudence between Shia and the four Sunni schools of law, there are fewer differences in the practical application of jurisprudence elaborated.

ANNEX 2: Demographic Distribution of Islamic Schools of Thought

1) Table 4: “Distribution of Shia and Sunni population among the Muslim population worldwide” shows the population of the countries which have Muslim populations. It includes the percentage of Muslims to the total population and the percentage of Shia and Sunni population to the total of Muslim population. The data is estimated as of mid-2007 for countries with the largest Muslim populations. Unless otherwise noted (by a number in parentheses – e.g. (1)), the population figures and percentages for Muslim populations are taken from CIA (2009).

The percentages of Shia and Sunni populations within countries are provided to provide a general idea of the ratio of Sunni to Shia Muslims in a number of countries. The CIA’s World Factbook (2009) provides a Sunni-Shia breakdown only for countries where Shia are a significant minority. As noted within the table, the source for many of these percentages is wikipedia.org (2009) which is not a scientific source – though the source is well-cited – so there is potential for the percentages to be inaccurate. Furthermore, the difficulty of establishing reliable, up-to-date census data in many of these countries compounds the likelihood of inaccuracy. However, the various percentage breakdowns can provide a general picture of the distribution of Muslims in various countries.

Table 4: Distribution of Shia and Sunni populations among the Muslim population worldwide (Only countries with notable Muslim populations are noted here – Sources at the end of the table).

Country	Population	Muslim (%)	Muslims - Approximate	Shia to Muslim (%)	Shia Population	Sunni to Muslim (%)	Sunni Population
Afghanistan	33,609,937	99%	33,273,838	19%	6,322,029	80%	26,619,070
Albania	3,639,453	70%	2,547,617	30% ⁽⁴⁾	764,285	70% ⁽⁴⁾	1,783,332
Algeria	34,178,188	99%	33,836,406	0% ⁽⁴⁾	-	100% ⁽⁴⁾	33,836,406
Angola	12,799,293	0.7%	85,000 ⁽³⁾	-	-	-	-
Argentina	40,913,584	1.0%	409,136	10% ⁽⁴⁾	40,914	90% ⁽⁴⁾	368,222
Armenia	2,967,004	0.2% ⁽¹⁾	5,953 ⁽¹⁾	-	-	-	-
Australia	21,262,641	1.7%	361,465	10% ⁽⁴⁾	36,146	90% ⁽⁴⁾	325,318
Austria	8,210,281	4.2% ⁽⁴⁾	344,832	-	-	-	-
Azerbaijan	8,238,672	93.4%	7,694,920	72% ⁽⁴⁾	5,540,342	31% ⁽⁴⁾	2,385,425
Bahrain	727,785	81.2%	590,961	92% ⁽⁴⁾	543,685	8% ⁽⁴⁾	47,277
Bangladesh	156,050,883	83%	129,522,233	5% ⁽⁴⁾	6,476,112	95% ⁽⁴⁾	123,046,121
Belarus	9,648,533	1% ⁽¹⁾	102,930 ⁽¹⁾	-	-	-	-
Belgium	10,414,336	3.8%	400,000 ⁽³⁾	-	-	-	-
Benin	8,791,832	24.4%	2,145,207	1% ⁽⁴⁾	21,452	99% ⁽⁴⁾	2,123,755
Bosnia and Herzegovina	4,613,414	40%	1,845,366	0% ⁽⁴⁾	0	100% ⁽⁴⁾	1,845,366

Table 4: Continued

Country	Population	Muslim (%)	Muslims - Approximate	Shia to Muslim (%)	Shia Population	Sunni to Muslim (%)	Sunni Population
Botswana	1,990,876	0.3%	5,000 ⁽³⁾	-	-	-	-
Brazil	198,739,269	1.0% ⁽⁴⁾	1,987,393	30% ⁽⁴⁾	596,218	70% ⁽⁴⁾	1,391,175
Brunei	388,190	67%	260,087	-	-	-	-
Bulgaria	7,204,687	12.2%	878,972	10% ⁽⁴⁾	87,897	90% ⁽⁴⁾	791,075
Burkina Faso	15,746,232	60% ⁽³⁾	9,447,739	1% ⁽⁴⁾	94,477	99% ⁽⁴⁾	9,353,262
Burundi ⁵⁹	8,988,091	10%	898,809	-	-	-	-
Cambodia	14,494,293	2.1%	304,380	-	-	-	-
Cameroon	18,879,301	20%	3,775,860	-	-	-	-
Canada	33,487,208	1.9%	636,257	10% ⁽⁴⁾	63,626	90% ⁽⁴⁾	572,631
Central African Republic	4,511,488	15%	676,723	-	-	-	-
Chad ⁶⁰	10,329,208	53.1%	5,484,809	-	-	-	-
China	1,338,612,968	1.5% ⁽⁴⁾	20,079,195	8% ⁽⁴⁾	1,606,336	92% ⁽⁴⁾	20,079,195
Colombia	45,644,023	0.1% ⁽¹⁾	43,593 ⁽¹⁾	-	-	-	-
Comoros	752,438	98%	737,389	1% ⁽³⁾	7,374	99% ⁽³⁾	730,015
Congo, Democratic Republic of the	68,692,542	10%	6,869,254	-	-	-	-

59 Majority is Sunni according to CIA (2009).

60 90-95% Sufi Brotherhood of Tijaniyah according to the United States Department of State (2008).

Table 4: Continued

Country	Population	Muslim (%)	Muslims - Approximate	Shia to Muslim (%)	Shia Population	Summi to Muslim (%)	Summi Population
Congo, Republic of the	4,012,809	2.0%	80,256	-	-	-	-
Cote d'Ivoire	20,617,068	38.6%	7,958,188	1% ⁽⁴⁾	79,582	99% ⁽⁴⁾	7,878,606
Croatia	4,489,409	1.3%	58,362	-	-	-	-
Cuba	11,451,652	0.01% ⁽¹⁾	1,138 ⁽¹⁾	-	-	-	-
Cyprus	796,740	18%	143,413	-	-	-	-
Czech Republic	10,211,904	0.2% ⁽¹⁾	20,471 ⁽¹⁾	-	-	-	-
Denmark	5,500,510	2.0%	110,010	-	-	-	-
Djibouti	516,055	94%	485,092	0% ⁽³⁾	-	100% ⁽³⁾	485,092
Egypt	83,082,869	90%	74,774,582	1% ⁽⁴⁾	822,520	99% ⁽⁴⁾	73,952,062
Eritrea	5,647,168	50% ⁽³⁾	2,823,584	0% ⁽³⁾	-	100% ⁽³⁾	2,823,584
Estonia	1,299,371	0.1% ⁽¹⁾	1,324 ⁽¹⁾	-	-	-	-
Ethiopia	85,237,338	45% ⁽³⁾	38,356,802	0% ⁽³⁾	-	100% ⁽³⁾	38,356,802
European Union	491,582,852	2.8%	14,000,000	-	-	-	-
Fiji	944,720	6.3%	59,517	-	-	70% ⁽⁴⁾	41,662
Finland	5,250,275	0.1% ⁽¹⁾	5,231 ⁽¹⁾	-	-	-	-
France	64,057,792	7.5% ⁶¹	480,433,440	6% ⁽⁴⁾	28,826,006	94% ⁽⁴⁾	451,607,434

Table 4: Continued

Country	Population	Muslim (%)	Muslims - Approximate	Shia to Muslim (%)	Shia Population	Sunni to Muslim (%)	Sunni Population
Gabon	1,514,993	12% ⁽³⁾	181,799	-	-	-	-
Gambia, The	1,782,893	90%	1,604,604	-	-	100% ⁽³⁾	1,604,604
Gaza Strip	1,551,859	99.3%	1,540,996	-	-	-	-
Georgia	4,615,807	9.9%	456,965	-	-	-	-
Germany	82,329,758	3.7%	3,046,201	20% ⁽⁴⁾	609,240	80% ⁽⁴⁾	2,436,961
Ghana	23,832,495	15.9%	3,789,367	13% ⁽⁴⁾	482,007	87% ⁽⁴⁾	3,307,359
Greece	10,737,428	1.3%	139,587	-	-	-	-
Guinea	10,057,975	85%	8,549,279	1% ⁽⁴⁾	85,493	99% ⁽⁴⁾	8,463,786
Guinea-Bissau	1,533,964	50%	766,982	-	-	-	-
Guyana	772,298	7.2%	55,605	-	-	-	-
Hong Kong	7,055,071	1% ⁽¹⁾	69,404 ⁽¹⁾	-	-	-	-
Hungary	9,905,596	0.1% ⁽¹⁾	9,981 ⁽¹⁾	-	-	-	-
Iceland	306,694	0.04% ⁽¹⁾	120 ⁽¹⁾	-	-	-	-
India	1,166,079,217	13.4%	156,254,615	15% ⁽⁴⁾	23,438,192	85% ⁽⁴⁾	132,816,423
Indonesia	240,271,522	86.1%	206,873,780	1% ⁽⁴⁾	2,068,738	99% ⁽⁴⁾	204,805,043

61 The CIA (2009) lists the Muslim population for France as 5-10%. The median of this range is used here.

Table 4: Continued

Country	Population	Muslim (%)	Muslims - Approximate	Shia to Muslim (%)	Shia Population	Summi to Muslim (%)	Summi Population
Iran	66,429,284	98%	65,100,698	89%	57,939,622	9%	5,859,063
Iraq	28,945,657	97%	28,077,287	64%	18,091,036	36%	9,995,514
Ireland	4,203,200	0.1%(1)	4,062(1)	-	-	-	-
Israel	7,233,701	17.6%	1,273,131	-	-	-	-
Italy	58,126,212	0.5%(4)	290,631	5%(4)(4)	14,532	95%(4)	276,100
Japan	127,078,679	0.1%(1)	127,464(1)	-	-	-	-
Jordan	6,342,948	94%	5,962,371	2%	119,247	98%	5,835,512
Kazakhstan	15,399,437	47%	7,237,735	5%(4)	361,887	95%(4)	6,875,849
Kenya	39,002,772	10%	3,900,277	7%(4)	273,019	93%(4)	3,627,258
Korea, South	48,508,972	0.2%(1)	97,694(1)	-	-	-	-
Kosovo	1,804,838	90%(2)	1,624,354	-	-	-	-
Kuwait	2,691,158	85%	2,287,484	30%	686,245	70%	1,601,239
Kyrgyzstan	5,431,747	75%	4,073,810	3%(4)	122,214	97%(4)	3,951,596
Laos	6,834,942	0.5%(1)	31,842(1)	-	-	-	-
Lebanon	4,017,095	59.7%	2,398,206	60%(4)	1,438,923	37%(4)	887,336
Lesotho	2,130,819	5%(1)	101,117(1)	-	-	-	-

Table 4: Continued

Country	Population	Muslim (%)	Muslims - Approximate	Shia to Muslim (%)	Shia Population	Summi to Muslim (%)	Summi Population
Liberia	3,441,790	20%	688,358	-	-	-	-
Libya	6,310,434	97%	6,121,121	0% ⁽⁴⁾	-	100% ⁽⁴⁾	6,121,121
Lithuania	3,555,179	0.5% ⁽¹⁾	17,930 ⁽¹⁾	-	-	-	-
Luxembourg	491,775	0.1% ⁽¹⁾	474 ⁽¹⁾	-	-	-	-
Macedonia	2,066,718	33.7%	696,484	1% ⁽⁴⁾	6,965	99% ⁽⁴⁾	689,519
Madagascar	20,653,556	7.0%	1,445,749	-	-	-	-
Malawi	14,268,711	12.8%	1,826,395	-	-	-	-
Malaysia	25,715,819	60.4%	15,532,355	2% ⁽⁴⁾	310,647	98% ⁽⁴⁾	15,221,708
Maldives	396,334	100%	396,334	5% ⁽⁴⁾	19,817	95% ⁽⁴⁾	376,517
Mali	12,666,987	90%	11,400,288	-	-	-	-
Mauritania	3,129,486	100%	3,129,486	0% ⁽⁴⁾	-	100% ⁽⁴⁾	3,129,486
Mauritius	1,284,264	16.6%	213,188	-	-	-	-
Mexico	111,211,789	0.1% ⁽¹⁾	107,450 ⁽¹⁾	-	-	-	-
Moldova	4,320,748	0.1% ⁽¹⁾	4,467 ⁽¹⁾	-	-	-	-
Mongolia	3,041,142	4.0%	121,646	5% ⁽⁴⁾	6,082	95% ⁽⁴⁾	115,563
Montenegro	672,180	17.7%	118,976	-	-	-	-

Table 4: Continued

Country	Population	Muslim (%)	Muslims - Approximate	Shia to Muslim (%)	Shia Population	Summi to Muslim (%)	Summi Population
Morocco	34,859,364	98.7%	34,406,192	0% ⁽⁴⁾	-	100% ⁽⁴⁾	34,406,192
Mozambique	21,669,278	17.8%	3,857,131	-	-	-	-
Myanmar	48,137,741	4%	1,925,510	-	-	-	-
Namibia	2,108,665	2% ⁽¹⁾	40,883 ⁽¹⁾	-	-	-	-
Nepal	28,563,377	4.2%	1,199,662	-	-	-	-
Netherlands	16,715,999	5.8%	969,528	-	-	-	-
New Zealand	4,213,418	0.5% ⁽¹⁾	20,381 ⁽¹⁾	-	-	-	-
Niger	15,306,252	80%	12,245,002	5% ⁽⁴⁾	612,250	95% ⁽⁴⁾	11,632,752
Nigeria	149,229,090	50%	74,614,545	5% ⁽⁴⁾	3,559,114	95% ⁽⁴⁾	71,055,431
Norway	4,660,539	1.8%	83,890	-	-	-	-
Oman ⁶²	3,418,085	99% ⁽¹⁾	3,383,904	3% ⁽⁴⁾	93,734	21% ⁽⁴⁾	710,620
Pakistan	176,242,949	95%	167,430,802	21%	35,160,468	74%	123,898,793
Philippines	97,976,603	5.0%	4,898,830	-	-	-	-
Poland	38,482,919	0.1% ⁽¹⁾	38,537 ⁽¹⁾	-	-	-	-
Portugal	10,707,924	0.2% ⁽¹⁾	21,212 ⁽¹⁾	-	-	-	-

62. Ibadi Muslims make up 75% of population (CIA 2009).

Table 4: Continued

Country	Population	Muslim (%)	Muslims - Approximate	Shia to Muslim (%)	Shia Population	Summi to Muslim (%)	Summi Population
Qatar	833,285	77.5%	645,796	21% ⁽⁴⁾	135,617	79% ⁽⁴⁾	510,179
Romania	22,215,421	0.9%	199,939	-	-	-	-
Russia	140,041,247	12.5% ⁶³	17,505,156	8% ⁽⁴⁾	1,400,412	92% ⁽⁴⁾	16,104,743
Rwanda	10,473,282	4.6%	481,771	-	-	-	-
Saudi Arabia	28,686,633	100%	28,686,633	15% ⁽⁴⁾	4,302,995	85% ⁽⁴⁾	24,383,638
Senegal	13,711,597	94%	12,888,901	2% ⁽⁴⁾	193,334	99% ⁽⁴⁾	12,695,568
Serbia	7,379,339	3.2%	236,139	-	-	-	-
Sierra Leone	6,440,053	60%	3,864,032	-	-	-	-
Singapore	4,657,542	14.9%	693,974	-	-	-	-
Slovakia	5,463,046	0.2% ⁽¹⁾	10,879 ⁽¹⁾	-	-	-	-
Slovenia	2,005,692	2.4%	48,137	-	-	-	-
Somalia	9,832,017	99%	9,733,697	0%	86,000	100%	9,733,697
South Africa	49,052,489	1.5%	735,787	10% ⁽⁴⁾	73,579	90% ⁽⁴⁾	662,209
Spain	40,525,002	0.5% ⁽¹⁾	201,989 ⁽¹⁾	-	-	-	-
Sri Lanka	21,324,791	7.6%	1,620,684	-	-	-	-

63 The CIA (2009) lists the Muslim population for Russia as 10-15%. The median of this range is used here.

Table 4: Continued

Country	Population	Muslim (%)	Muslims - Approximate	Shia to Muslim (%)	Shia Population	Sunni to Muslim (%)	Sunni Population
Sudan	41,087,825	70%	28,761,478	1% ⁽⁴⁾	287,615	99% ⁽⁴⁾	28,473,863
Suriname	481,267	19.6%	94,328	-	-	-	-
Swaziland	1,123,913	10%	112,391	-	-	-	-
Sweden	9,059,651	1.5% ⁽¹⁾	135,249 ⁽¹⁾	-	-	-	-
Switzerland	7,604,467	4.3%	326,992	-	-	-	-
Syria	20,178,485	90%	18,160,637	18% ⁶⁴	3,268,915	82%	14,891,722
Tajikistan	7,349,145	90%	6,614,231	6%	370,397	94%	6,243,834
Tanzania ⁶⁵	41,048,532	50% ⁽⁴⁾	20,524,266	6% ⁽⁴⁾	1,231,456	94% ⁽⁴⁾	19,292,810
Thailand	65,905,410	4.6%	3,031,649	-	-	-	-
Timor-Leste	1,131,612	1.0%	11,316	-	-	-	-
Togo	6,019,877	20%	1,203,975	-	-	-	-
Trinidad and Tobago	1,229,953	5.8%	71,337	-	-	-	-
Tunisia	10,486,339	98%	10,276,612	0% ⁽⁴⁾	0	100% ⁽⁴⁾	10,276,612
Turkey	76,805,524	99.8%	76,651,913	20% ⁽⁴⁾	15,330,383	80% ⁽⁴⁾	61,321,530
Turkmenistan	4,884,887	89%	4,347,549	4% ⁽⁴⁾	173,902	96% ⁽⁴⁾	4,173,647

64 The Shia population in Syria is predominantly Alawite and Druze (CIA 2009).

65 In Tanzania, 35% of the mainland is Muslim while more than 99% of Zanzibar is Muslim (CIA 2009).

Table 4: Continued

Country	Population	Muslim (%)	Muslims - Approximate	Shia to Muslim (%)	Shia Population	Sunni to Muslim (%)	Sunni Population
Uganda	32,369,558	12.1%	3,916,717	7% ⁽⁴⁾	274,170	93% ⁽⁴⁾	3,642,546
Ukraine	45,700,395	0.1% ⁽¹⁾	46,711 ⁽¹⁾	-	-	-	-
United Arab Emirates	4,798,491	96%	4,606,551	17%	769,294	83%	3,837,257
United Kingdom	61,113,205	2.7%	1,650,057	10% ⁽⁴⁾	165,006	90% ⁽⁴⁾	1,485,051
United States	307,212,123	0.6%	1,843,273	20% ⁽⁴⁾	368,655	85% ⁽⁴⁾	1,566,782
Uzbekistan	27,606,007	88%	24,293,286	6% ⁽⁴⁾	1,457,597	94% ⁽⁴⁾	22,835,689
Venezuela	26,814,843	0.1% ⁽¹⁾	25,730 ⁽¹⁾	-	-	-	-
Vietnam	86,967,524	0.1%	86,968	-	-	-	-
West Bank ⁶⁶	2,461,267	75%	1,845,950	-	-	-	-
Western Sahara	405,210	100%	405,210	0% ⁽⁴⁾	-	100% ⁽⁴⁾	405,210
Yemen ⁶⁷	23,822,783	97% ⁽¹⁾	23,108,100	46%	10,629,726	54%	12,478,374
Zambia	11,862,740	20% ⁽¹⁾	2,300,402 ⁽¹⁾	-	-	-	-
Zimbabwe	11,392,629	1.0%	1,139,263	-	-	-	-
TOTAL	6,790,062,216	21%	1,426,592,072	Unavailable	Unavailable	Unavailable	Unavailable

66 In the West Bank, the predominance of Muslims are Sunni but exact percentages were unavailable (CIA 2009). These statistics do not include Israeli settlers.
67 Shaf'i (a form of Sunni Islam) and Zaydi (A form of Shia Islam) predominate in Yemen (CIA 2009).

Sources:

- Principal source:
CIA (Central Intelligence Agency). 2009. The World Factbook. [https://www.cia.gov/library/publications/the-world-factbook/index.html] Accessed August 2009.
- Additional sources:
 - (1) Asoon.org. 2006. Muslim Population in World Population Ranking. [http://www.asoon.org/a-world.htm] Accessed August 2009.
 - (2) BBC News. 2005. Muslims in Europe: Country guide. 23 December 2005. [http://news.bbc.co.uk/2/hi/europe/4385768.stm] Accessed August 2009.
 - (3) United States Department of State. 2008. 2008 Report on International Religious Freedom. [http://www.state.gov/g/drl/rls/irf/2008/index.htm] Accessed August 2009.
 - (4) Wikipedia.org. 2009. Demographics of Islam. Wikipedia. [http://en.wikipedia.org/wiki/Demographics_of_Islam_-_Data_by_Percentage] Accessed August 2009.

The map below illustrates the distribution of the Shia and Sunni worldwide:

Figure 4: Map showing the distribution of predominantly Shia and Sunni Muslim communities



Source: www.mapsorama.com/muslim-distribution-map/

ANNEX 3: Islamic contracts

It should be noted that there might be some degree of *Ikhtilaf* (i.e. disagreement)⁶⁸ on the specific modalities of the instruments mentioned here. Below are only the basic outlines of these contract types:⁶⁹

Ijara: a form of leasing whereby the property owner transfers the 'usufruct' (the right to benefit from the use of the property) to a person in exchange for an agreed upon rent. The rental amount and the length of the lease are agreed upon in advance.

Ijara-wa-iktana: a type of ijara leasing – in some ways similar to “hire purchase” – where the lessee agrees in advance to purchase the property at the end of the lease. Usually the lease payments will include a contribution that goes towards paying off capital so that the final payment will be relatively small.

Musharaka: means partnership, where all partners contribute and pool their resources together to run a business. It does not necessarily involve lessor/lessee relationships as all partners can participate in running the business. Profits are shared in a predetermined ratio. Contributions from each partner can be a basis in determining the profit sharing ratio. In this contract, a bank contributes capital to the business and hence is a partner. It may choose to be actively involved in the running of the business or otherwise.

Ijara with diminishing Musharaka: the principle of Ijara with diminishing Musharaka can be used for home-buying services. Diminishing Musharaka means that the bank reduces its equity in an asset with any additional capital payment that the client makes over and above his/her rental payments. The client ownership in the asset increases and the bank's ownership decreases by the same amount each time the client makes an additional capital payment. Ultimately, the bank transfers ownership of the asset entirely over to the client.

68 According to one or other school of thought, the term conditions of an Islamic contract can be different. On this basis, Islamic law recognises the existence of *Ikhtilaf*. Islam teaches that when there is a scholarly disagreement on a certain issue, it is impermissible to condemn a person who follows a position that is different from one's own.

69 Sources: Dinar Standard 2009, Islamic-Finance.com 2002.

In the Malaysian context, this is applied under Musharakah Mutanaqisah. In practice, there are not many differences between the two. However, conceptually, Ijarah refers to leasing whilst Musharakah Mutanaqisah is based on partnerships.

Murabaha: also known as Murabha, is a trading arrangement where a financial institution acquires an asset and then resells it to a client at a higher price (effectively cost price plus a mark up to give a return on investment), which the client repays over an agreed upon term. The mechanics of the contract are similar to a mainstream interest-free credit deal.

Mudaraba: also known as Qirad or Muqaradah, is a contract where one party (usually a financial institution) makes capital available to another party who provides expertise for a business transaction. Any profits generated are shared between the parties on a basis agreed upon when the contract is initiated; any losses are normally borne by the capital provider.

Istisna: is a Shariah mode of financing widely used by Islamic banks and financial institutions to finance the construction of buildings, residential towers, villas and related products, as well as the manufacturing of aircrafts, ships, machines and equipment.

Wakala: Wakala is an agency contract, which usually includes in its terms a fee for the expertise of the agent. The bank may use it for its large deposit accounts: the client owns the capital invested, appoints the bank as his/her agents and pay a fee for the bank's expertise.

'Al-Bai' Bithaman Ajil': This term refers to a buying and selling transaction between the bank (or financial institution) and the customer, whereby the bank/financial institution buys a property (or an asset, e.g. a house) at the prevailing market price and sells it to the customer at a mark-up price where payments are made by installments over a period of time agreed upon by both parties. The profit earned by the bank is legitimate from the Shariah point of view since the transaction is based on a sale contract rather than a loan contract. Any predetermined profit arising from a loan is prohibited in Islam as it amounts to Riba.

ANNEX 4: Sukuk Ijara and Sukuk Istisna

■ Sukuk Ijara (Islamic leasing)

Under an Ijarah contract, the usufruct (the legal right to use an asset to make a profit) of a particular asset - for example a property - is transferred from the owner to another person in exchange for a rental payment. It is a leasing agreement under which the owner of the property – the lessor – is called the "*Mujir*". The lessee is named the "*Mustajir*" and the rent paid to the lessor is the "*Ujrah*". Shariah law imposes restrictions on Ijarah agreements that are not present in conventional leasing contracts in order to protect the parties as far as possible from uncertainty and to ensure there is no ambiguity in the agreement.

In practice Ijarah leasing agreements have many clauses that are similar to conventional leasing arrangements:

- In particular, the duty to repair and maintain the leased property remains with the lessor as the owner. If the lessee was liable, this would introduce an additional element of uncertainty with respect to the costs to the lessee as maintenance payments could be regarded as an extra rental element.
- Expenses related to the operation of a leased asset are, however, the responsibility of the lessee, such as fuel in the case of a leased vehicle or aircraft, or fertiliser and seeds in the case of leased land.
- Where a leased asset is accidentally destroyed or its usufruct value reduced, as in the case of leased farmland during periods of prolonged drought, then Ijarah contracts can be cancelled by the lessee, but in modern practice leased assets usually are insured against such contingencies.
- If lessees are negligent in using the asset, which results in a reduction or the complete destruction of its value, they may be liable to compensate the owner.
- Where payments are late, the lessor cannot impose a penalty, as any gain from this would represent an additional burden for the lessee and a gain for the owner that would be comparable to Riba. However, the lessee may be obliged to donate an amount to charity as recognition that there has been a delay in the rental payment. If no payment is made, then use of the leased asset will revert to the owner, and the lessee may still be liable for the rental payments stipulated in the original contract.

An Ijarah contract is for a predetermined period, as the rent provides a regular income, therefore it is well suited to be covered by the issue of securities that have many of the characteristics of bonds. As Ijarah bonds are securities representing the ownership of well-defined assets subject to a lease contract, they may be traded in a secondary market at the prevailing price determined by market forces. There can be many issuers of Ijarah securities and securities have maturity periods of five years.

■ **Sukuk Istisna (Islamic investment certificate in a project)**

Project financing can be undertaken through an Istisna contract, whereby funds are advanced to pay for the supplies and labour costs by an Islamic bank. Once the project is completed, the advances are repaid from the revenue derived from the project. Originally, Istisna was seen as an appropriate way of financing manufacturing products since goods have to be produced and costs incurred before they are sold.

ANNEX 5: The Sukuk debate

From a Shariah perspective, certificates of debt are not tradable⁷⁰ and certain structuring elements for Sukuk based on a debt (*Sukuk Murabaha*), business (*Sukuk Musharaka*) or investment (*Sukuk Istithmar*) faced severe critics in 2007 by Sheikh Muhammad Taqi Usmani⁷¹ in a meeting of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI). Arguably, these structures should be designated as notes as the returns will be variable rather than fixed. However, holders of these types of Sukuk will not enjoy the same rights and benefits as equity investors as they are only entitled to a profit share and there is no provision for capital gains based on the market valuation of the company.

On the other hand, Sukuks are regarded as controversial due to their perceived purpose of evading the restrictions of Riba, since a bond requires payment for the time that the money is not used. This can be seen as the fundamental test of whether it is interest. Sukuk offer investors a fixed return on their investments which is also similar in appearance to interest.

According to the AAOIFI Newsletter (2008)⁷² Sukuk should be an asset backed by and reflecting a true ownership by the Sukuk holders in the underlying assets. Current practices such as lending in the case of shortfall by the manager or providing a repurchase guarantee at face value are strictly prohibited.

70 Please note that in Malaysia there is a different view about certificates of debt, where they are tradable.

71 Sheikh Muhammad Taqi Usmani is the Chairman of Sharia'a Board of Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) and sits on a number of Sharia'a boards of other institutions. He was a member of the Sharia'a Cassation Board at the Supreme Court in Pakistan from 1982 - 2002; he has been Vice President of Dar Al Uloom University, Karachi since 1974; Chairman of Islamic Economy Centre in Pakistan.

72 The AAOIFI newsletter published in March 2008 compiled the conclusions agreed by the AAOIFI Shariah Committee on the right structure for a Sukuk.

The recommendations of the AAOIFI Shariah Committee, agreed upon in a series of meetings in 2007 and 2008 are:

- Tradable Sukuks must represent ownership for Sukuk holders, with all of the rights and obligations that accompany ownership, in real assets, whether tangible or usufructs or services, that may be possessed and disposed of legally and in accordance with the Shariah. The manager of a Sukuk issuance must establish the transfer of ownership of such assets in its books, and must not retain them as his/her own assets.
- It is not permissible for a tradable Sukuk to represent either revenue streams or debt except in the case of a trading or financial entity that is selling all of its assets, or a portfolio which includes a standing financial obligation such that debt was incurred indirectly, incidental to a physical asset or a usufruct.
- It is not permissible for the manager of a Sukuk, regardless of whether the manager acts as an investment manager, a partner, or an investment agent, to undertake to offer loans to Sukuk holders when actual earnings fall short of expected earnings. It is permissible, however, to establish a reserve for the purpose of covering such shortfalls to the extent possible, on condition that the same be mentioned in the prospectus.
- It is not permissible for the investment manager, partner, or investment agent to agree to purchase assets from Sukuk holders or from whoever represents them for a nominal value of those assets at the time the Sukuk are extinguished at the end of their tenors. It is permissible, however, to agree to purchase the assets for their net value, or market value, or fair market value, or for a price agreed to at the time of their purchase, in accordance with Shariah rules of Partnership and modern partnerships, and on the subject of Guarantees.
- It is permissible for the lessee in a Sukuk Al Ijara to agree to purchase the leased assets when the Sukuk are extinguished for their nominal value, as long as the lessee is not also an investment partner, investment manager, or agent.
- Shariah supervisory boards must not consider their responsibility to be over when they issue a Fatwa on the structure of Sukuk. Rather, they must review all contracts and documentation related to the actual transaction, and then oversee the ways that these are implemented in order to be certain that the operation complies at every stage with Shariah guidelines.

ANNEX 6: Other financial products

6.1. Islamic Equity Funds

The Islamic investment equity funds market is one of the fastest-growing sectors within the Islamic financial system with a growth of around USD 20 billion in assets under management.⁷³ In 2008 there were approximately 300 Islamic equity funds worldwide.

The concept of equity funds in Islamic countries has its roots in “Musharaka”, an Islamic investment vehicle wherein a syndicate of investors invest their capital in one or more projects/companies to share profits (and possible losses) called profit-loss-sharing (PLS) ventures.⁷⁴ In Islamic countries at the moment, PLS ventures are associated products offered mostly by the investment branch of Islamic banks or by the Islamic window of Western banks.

An Islamic equity fund is managed by an investment company which initially raises money from shareholders and invests in a group of assets according to the restrictions of Islamic law. The second step is to open the fund to public investment via the sale of shares in the case of open-ended equity funds. In close-ended funds, the investment opportunities are offered to a limited set of investors or simply require investors to keep their shares or wait for a buyer (meaning the investments are rather illiquid). Subsequently, the money raised is used to acquire a diverse set of stocks and other Shariah-compliant securities. Participants in the fund become shareholders and receive an equity position on the underlying securities of the fund. The performance of the fund is measured through their daily/monthly returns. Most equity funds bring diversification and benefits and for those considerations, they charge a fee (management and load fees) and some charge a redemption penalty.

⁷³ Abderrezak 2009.

⁷⁴ Islamic banking is structured as a PLS system whereby banks serve as investment agents on the behalf of depositors and work closely with companies to ensure successful ventures. Investors participate in the upside as well as in the downside if any losses occur.

The universal set of investments available to Muslims is limited due to Shariah restrictions. Thus Islamic investors enjoy a lower diversification benefit than their conventional counterparts. The Shariah Board's duties in order to supervise Islamic equity funds are:⁷⁵

1. **Portfolio Purification:** impure earnings from investments are to be purified through a donation to charity, called *Zakah* (purification). Interest-bearing investments are one example. The Shariah Board separates the impure earnings from the capital gains and/or dividends and redistributes the rest to investors.
2. **Adequate Selection of Stocks:** stocks need to comply to Shariah principles by every standard. The Dow Jones Islamic Market Indexes⁷⁶ and the FTSE Global Islamic Index Series⁷⁷ provide good industry standards. Most Islamic funds rely on those. Other indices are: the S&P Shariah Index, the Global GCC Islamic Index, and the Dar Al-Maal Al Islami (DMI) 150 Index.
3. **Monitoring Management:** the Shariah Board can help to coordinate the investment strategies, make sure fund managers stick to Islamic precepts, and correct mistakes. Similarly to conventional equity funds, the Shariah's board acts in a manner similar to the board of directors, which assess the management of the fund, evaluate the investment strategies, establish orientations and possibly order the liquidation of positions.
4. **Information Reporting:** in their moral function, the Shariah Board ensures consumers have at their disposal sufficient information regarding the: fees, the fund's performance, portfolio diversification, the purification process and the charities which benefit from it. They also help in the preparation of filings for regulatory agencies.⁷⁸

75 Abderrezak 2008.

76 See www.djindexes.com/mdsidx?event=showIslamic.

77 See www.ftse.com/Indices/FTSE_Shariah_Global_Equity_Index_Series/index.jsp.

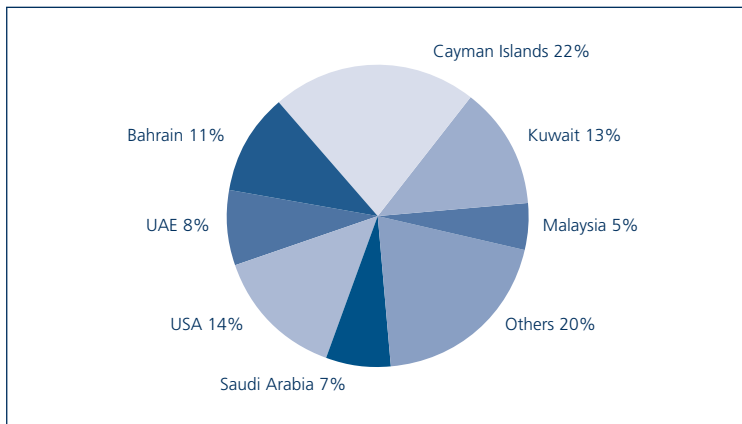
78 Delorenzo 2000.

6.2. Islamic Private Equity

Although the first Islamic equity fund was established as far back as 1986, it is only fairly recently that the sector has started to expand rapidly. The key reason for the growing interest in Shariah-compliant private equity in the last years is the sheer size of the current pool of available Islamic capital. Fuelled by high oil and gas prices and with production at almost maximum capacity, an ever-increasing amount of cash has been streaming into the Middle East, which needs to be invested responsibly.

In terms of assets under management, the bulk of the assets – over 70% – have been directed towards private equity, with 30% of the balance going into real estate (leasing funds indeed representing a very small component). The majority of these funds originate from the Middle East (at least 39% from the UAE, Kuwait, Bahrain, etc.). Offshore jurisdictions are also prominent (the Cayman Islands being one of the most popular domiciles with 21%), as shown in Figure 5. At the same time, the U.S. dollar remains greatly preferred as a base currency as shown in Figure 6. This is a trend that is perceptible across Islamic products globally and is evident in both real estate and private equity launches (only a minority of funds being denominated in local currencies).⁷⁹

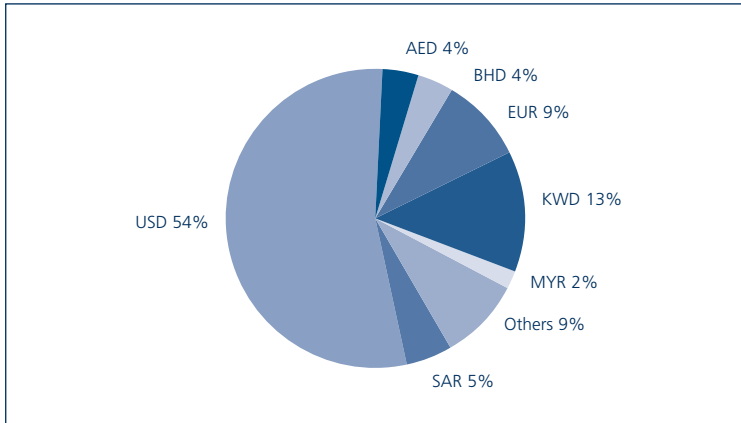
Figure 5: Funds by domicile



Source: Vizcaino (2007)

79 Vizcaino 2007.

Figure 6: Funds by base currency



Source: Vizcaino (2007)

Shariah precepts encourage risk taking by prohibiting guaranteed and fixed income returns on investment (whether interest-based or interest-like). Venture capital and private equity funds that do not utilise conventional leverage instruments are ideal tools for making investments in an Islamic-compliant manner. Another appropriate tool is early stage investments in start-up companies because investors have considerable scope to negotiate the structure and conditions of their investment to ensure Shariah compliance. An indication of the acceptance of these vehicles for making Islamic-compliant investments is the number of conventional private equity and venture capital funds that have passed Shariah compliance tests with only minor adjustments made to the investment policies of the funds themselves. In each instance, a Shariah supervisory board is appointed and detailed Shariah compliance criteria are incorporated into the offering and operational documents.

■ Leverage

Another Shariah investment requirement relates to acceptable leverage ratios. An investment manager of an Islamic private equity fund must ensure that the ratio of the total debt of a target company to its total assets must be **less than 33%**. For this purpose, total debt includes interest-bearing debt, which comprises short-term and long-term conventional debt, convertible bonds, preference shares, off- balance sheet debt and similar instruments.

It must be noted in this context that some Shariah advisers insist that if an Islamic private equity fund acquires control over a leverage-burdened target company, the fund must promptly pay off the conventional debt even if the percentage of such debt to the total assets of the company is less than 33% or, subject to strict repayment plans and schedules, undertake to pay off the conventional debt within a limited period of time (up to three years in most cases). It must be noted that the nature of Islamic finance is such that a typical Islamic finance transaction is structured as an investment arrangement (asset-based) as opposed to a loan agreement. In other words, the lender, acting as a commodity trader, is rewarded for taking the risk of purchasing a commodity for price X and selling it on to the borrower (though on deferred payment terms) for price Y. This stems from the view that the assumption of control over the target company creates the responsibility to ensure that the operations of the target company are structured in an Shariah-compliant manner. Hence, non-Islamic operations, including borrowing, must be restructured to comply with Shariah.

■ **Income from interest and unpermissible activities**

Under Shariah precepts, non-operating interest income and the income from incidental unpermissible activities by the target company **cannot exceed 5%** of the total income of that company. Any interest income or income from incidental unpermissible activities under 5% can be purified by donating that amount to specified charities.⁸⁰

■ **Fixed returns**

Under Shariah precepts, a fund manager is not permitted to guarantee a fixed return that is linked to the face value of the issued instrument but is permitted to develop mechanisms to protect (as opposed to guarantee) the capital. This is primarily due to the fact that Shariah requires that any return on funds invested by an investor, or lent by a lender, be linked to the outcome of a commercial transaction in which the investor or the lender risks its capital. Thus, capital guaranteed funds and investments are not Shariah-compliant.

80 Zaman 2007.

Most Shariah-compliant capital-protected funds utilise two investment mechanisms to achieve the required investment objective:

1. A *Murabaha* (cost plus finance) instrument which involves the investment of the bulk of the money raised from investors in a fixed-term commodity trade transaction or a series of such transactions; and
2. A *Bai Al-Arboon* (a Shariah alternative to call options) transaction in which the fund invests a small percentage (for example 5 to 10%) of the money raised from the investors to purchase an option over a basket or portfolio of Shariah-compliant shares or commodities.

Murabaha transactions, which are customarily viewed as low risk investment transactions, are structured to generate the required capital protection. Bai Al-Arboon transactions, on the other hand, are intended to increase returns. If the basket of shares subject to the Bai Al-Arboon depreciates, the fund manager will not exercise the option and the price of the option (i.e. the Bai Al-Arboon advance payment) will be lost. The Murabaha transactions, however, are structured to compensate for the lost option payment. Hence, they protect, but do not guarantee, the capital.

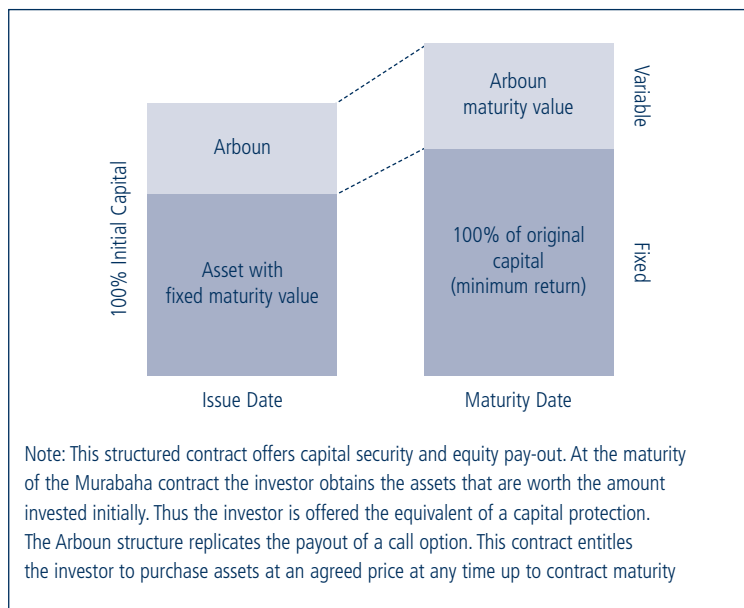
Finally, investments made by Islamic private equity funds require ongoing Shariah audits to ensure that the Shariah investment guidelines are strictly adhered to and that, where necessary, suitable purification mechanisms are put in place. Promoters of Islamic funds and issuers of Islamic instruments, including conventional banking institutions, should develop a generalised understanding of Islamic law and work closely with Shariah advisers to ensure that they have a sufficient understanding of Islamic investment structures.

6.3. Structured products

The vast majority of Islamic structured products launched to date are capital-guaranteed, equity-linked structures, generally referenced to equities selected from the Dow Jones Islamic Index. These structures typically use concepts already accepted in Islamic finance as building blocks.

The most typical structured product is one that comprises a **Murabaha deposit** to provide the guarantee, while an **Arboun contract** is used for the equity or fund-linked payout. A Murabaha is effectively the forward sale of a physically owned commodity. In the case of structured products, the investor pays the value of the commodity, which is sold by the bank at a deferred date. At maturity, the investor receives the assets, which are worth the same as the amount initially invested. Arboun, on the other hand, entitles the investor to purchase an asset at an agreed price at any time up to the maturity of the contract – effectively an option. Combining these concepts, some banks have structured a number of capital-guaranteed products that offer investors participation in the upside of a basket of stocks from the Dow Jones Islamic Index. These products have many of the same characteristics of conventional structured investments, such as profit lock ins, look-back and call features.

Figure 7: Arboun + Murabaha structure*



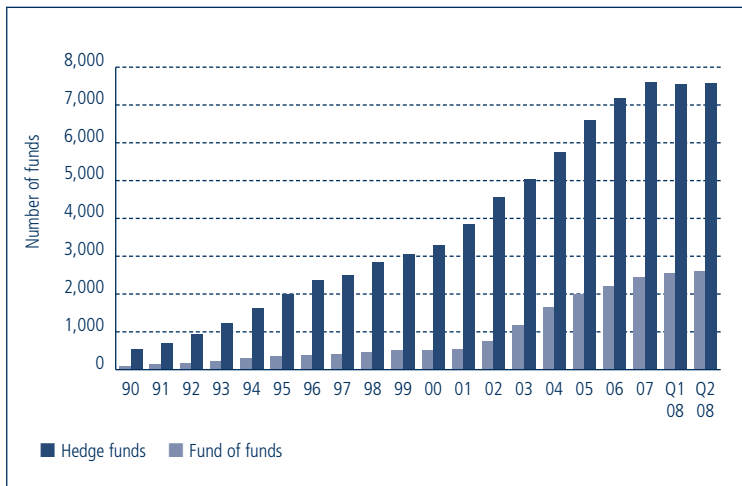
Source: BNP Paribas 2005

The task of structuring Islamic structured products is one of the most controversial areas in Islamic finance but, increasingly, structured products are gaining acceptance in the market and new products are being approved by eminent Shariah scholars.

6.4. Islamic Hedge funds

Hedge funds have received a lot of publicity in recent years due to their influence in conventional capital markets. In 2007 their total volume exceeded that of the Islamic finance industry altogether, with more than USD 1000 billion in assets under management, while Islamic finance was estimated to be at about USD 250 – 500 billion in 2008.⁸¹ It is expected that the demand for Islamic hedge funds will increase rapidly by 20% per year.⁸² However, there have also been a wide range of famous failures in hedge funds in general which may also affect Islamic hedge funds – such as LTCM, the Quantum Fund, and Amaranth, with a USD 6 billion loss.⁸³

Figure 8: Estimated growth of assets/net asset flow in equity hedge funds (1990 – Q2 2008)



Source: Hedge Fund Research 2008

81 Barclays Bank PLC 2008.

82 Barclays Bank PLC 2008.

83 Gassner 2007.

At first glance, hedge funds and Islamic finance appear irreconcilable. The majority of hedge funds pursue long/short strategies and/or employ derivatives such as futures, swaps and options. To attract Islamic investors, however, the funds must be Sharia-compliant. Furthermore, all transactions must be asset-backed. However, these barriers are not impossible to overcome. Hedge fund managers can still replicate some of the conventional hedge fund strategies by employing some of the already accepted concepts in Islamic finance.

It seems that Islamic hedge funds are a good option if access to the top managers of hedge funds can be assured. Historic performance is not necessarily an indication of the future. To identify superior managers and to access them is a true challenge.

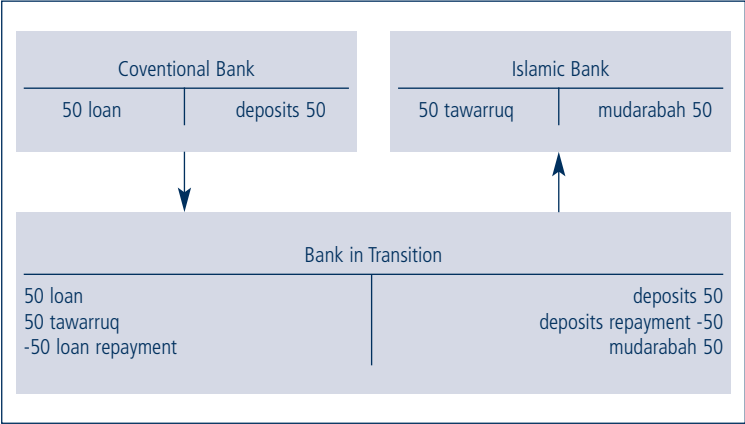
ANNEX 7: Example: The use of Tawarruq to make the transition from conventional to Islamic balance sheets

When a conventional bank decides to fully convert into an Islamic institution, it must ensure that all the items on its balance sheet are compatible with the Shariah. Therefore, it will have to transform all its loans and deposits into non-interest bearing assets and liabilities. For instance, in the case of assets, this would mean converting them to murabaha (cost plus financing) contracts. For liabilities, this means converting conventional deposits to mudarabah (profit-and-loss sharing) deposits.

The bank could use a *Tawarruq* instrument in order to convert an existing loan (bearing interest) into an Islam compatible instrument. A *Tawarruq* is a contract whereby a customer requests a bank to acquire a specific commodity (e.g. metal or wool) on his behalf. The customer will repay the bank the cost of the commodity plus an agreed margin in installments. The customer then requests that the bank sell the commodity right away in the commodity spot market. Hence, through this transaction, the customer can obtain immediate financing (via the spot sale of the commodity) which will be repaid at a later date (via the installment payments to the bank).

A *Tawarruq* can be used to transform an existing debt contract into an Islamic instrument. The procedure is best explained with an example (see Figure 9 below). Suppose that some years ago, the bank had extended a loan for an amount of \$100 to be repaid over 10 years at a 5 percent interest rate. Suppose also that at the time of the bank's conversion, the customer had already paid half of the loan principal, and so s/he has a remaining debt of \$50 with the bank. The bank and the customer then enter into a *Tawarruq* contract by which the bank will buy \$50-worth of commodities for the customer and then sell them on his behalf. The customer then uses the \$50 received from the spot sale to cancel its loan with the bank. Note that at this point the customer owes the bank \$50 by virtue of the *Tawarruq* contract, but not as an interest-bearing loan. In repayment for the bank's purchase of the commodities, the customer will include in the installment payments to the bank an amount commensurate with the forgone interest on the loan. It must be acknowledged that, although the *Tawarruq* accomplishes the goal of transforming interest bearing contracts into interest-free instruments, it is seen as controversial by some Shariah scholars.

Figure 9: Transforming conventional assets and liabilities into Shariah-compliant assets and liabilities



Source: Sole 2007

ANNEX 8: Bibliography/Works cited

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WSBI (World Savings Banks Institute) is one of the largest international banking associations and the only global representative of savings and retail banking. Founded in 1924, it represents savings and retail banks and associations thereof in 92 countries of the world (Asia-Pacific, the Americas, Africa and Europe – via ESBG, the European Savings Banks Group). It works closely with international financial institutions and donor agencies and promotes access to financial services worldwide – be it in developing or developed regions. At the start of 2008, assets of member banks amounted to more than €10,000 billion, with operations through more than 380,000 branches and outlets.

ESBG (European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising about one third of the retail banking market in Europe, with total assets of over € 6,000 billion (1 January 2008). It represents the interests of its members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

WSBI and ESBG members are typically savings and *retail* banks or associations thereof. They are often organised in decentralised networks and offer their services throughout their *region*. WSBI and ESBG member banks have reinvested *responsibly* in their region for many decades and are one distinct benchmark for corporate social responsibility activities throughout Europe and the world.



WSBI



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Rue Marie-Thérèse, 11 ■ B-1000 Brussels ■ Tel: +32 2 211 11 11 ■ Fax: +32 2 211 11 99
info@savings-banks.com ■ www.savings-banks.com

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