ISLAMIC FINANCE
IN PRACTICE

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Issue 1 | Summer 2008 | **FREE**

INSIDE >

Islamic Finance Institutions

Commercial Real Estate & Project Finance

Insurance Alternatives to Conventional Financing

A quarterly magazine for professional investors, multinationals and the international business community

Published in Association with:
Middle East Association

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ISLAMIC FINANCE IN PRACTICE

ISSUE ONE: SUMMER 2008

MESSAGE FROM THE EDITOR

GMB Publishing, the leading provider of information on the business environments and practices of the world's emerging economies, is delighted to bring you this first edition of Islamic Finance in Practice, a magazine that focuses on practical issues currently being faced by leading Islamic finance providers.

Islamic Finance continues to grow at a remarkable pace. There are many drivers behind its growth – the tremendous and continuing wealth creation occurring in the Gulf region on the back of high oil prices; the increasing sophistication of Islamic investors; the rise of a new and financially powerful middle-class in the emerging economies, particularly Indonesia, Malaysia and Pakistan and also the growing trend for ethical investment which is spurring interest in Sharia'h screened financial products from non-Muslims as well.

While none of these drivers are new they are all becoming more powerful forces and this means that the Islamic finance sector will undoubtedly continue to expand in the coming years. However, with fast growth come growing pains. The demand for new products and channels of Sharia'h compliant finance will create opportunities for many – but there is still a mismatch between supply and demand. This mismatch is not just in financial flows but also in the number of products approved by Sharia'h scholars. There is a nascent friction between the demand for Sharia'h versions of conventional but sophisticated and derivative financial products and supply of products that can match their functions within an acceptable Sharia'h structure. These are the kinds of topic that we address here and more fully in our related GMB guide books.

Islamic Finance media has typically come in two basic patterns – simple overviews that run to two or three pages and give a superficial introduction to the subject or major academic treatises on Sharia'h interpretation and implementation. The GMB approach we take here is different. It is sophisticated, comprehensive but above all accessible and relevant.

Islamic Finance in Practice brings you some of the best articles from GMB Publishing's comprehensive guide Islamic Finance: A Guide for International Business and Investment which will be published later this summer, in addition we feature profiles of leading players in the sector and a listing of the major Islamic Finance institutions – plus the inevitable but indispensable glossary of Islamic finance terms.

Roderick Millar
Editor

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ISSN 1757-983X

Foreword

Michael Thomas

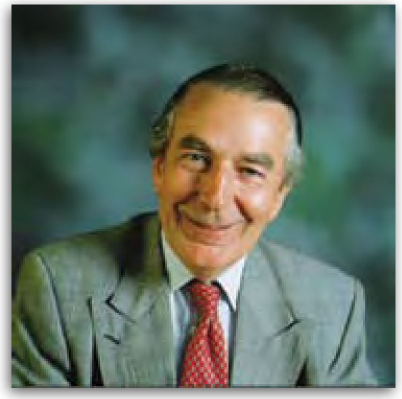
Director General

The Middle East Association

Islamic finance is one of the fastest growing segments in the international financial services industry. The figures are staggering – the Islamic banking industry is forecasted to grow at a rate of at least 20% between now and 2012; more than $600 billion of assets are held or managed by Islamic institutions, and that figure is expected to grow to $1 trillion over the next couple of years; worldwide premiums for takaful amounted to more than $4 billion in 2007, and are expected to triple by the end of the decade; and global sukuk (Islamic bond) volumes more than doubled in 2007 to $60 billion. New Islamic products and financial instruments are being introduced all the time.

Keeping up with these developments, and understanding the complex issues involved, is not easy. 'Islamic Finance in Practice' is therefore a very welcome addition to the body of information available on this subject.

The Middle East Association, the UK's premier private sector organisation for promoting trade and good relations with the Middle East North Africa, Turkey and Iran, sees the financial services sector, and Islamic finance in particular, as one of the major growth areas of co-operation between the UK and the markets in the region. Our City and the GCC Countries conference, now in its third year, is recognised as the premier event for promoting co-operation between the City of London and the GCC countries. Lead sponsors at this year's event, which is being organised in co-operation with the City of London Corporation, and will take place at the Merchant Taylor's Hall on 19 June, are Bahrain Economic Development Board, Qatar Financial Centre Authority and Emirates NBD. We held a very successful lunch as guests of the Lord Mayor of the City of London at the Mansion House in 2007, which is being repeated on 31 October 2008. The City of London of course plays a key role in the roll out of Islamic finance, being the most active creator, developer and marketer of sukuk and takaful products.



I would urge anyone interested in developing their business with the Middle East and North Africa region to consider joining the Middle East Association (MEA). The MEA is an independent and non-profit making association founded in 1961, which represents some 400 large and small companies from all business and industry sectors who together account for an estimated 70% of UK trade with the region. The Patron of the Asssociation is HRH The Duke of York, UK Special Representative for International Trade and Investment. Our strong support of Business Councils and excellent relationships with the UK Government and Arab Governments are widely recognised.

MEA activities include conferences, seminars, trade missions, and lunches and receptions with visiting Ministers from the region and Arab and UK Ambassadors. The MEA takes more businesses to the MENA region than any other organisation – in the last twelve months the Association has led ten missions to the region. We continue to break new ground – I have taken three missions to Northern Iraq in the last couple of years. Our in-house programme of events, including VIP and Ambassadors lunches, are very popular, with over 50 events held a year. On the conference front, we have recently held successful conferences on Libya, Morocco and Tunisia which were attended by high level business delegations from the country concerned. Our annual Opportunity Arabia seminar on Saudi Arabia, now in its fifth year, continues to attract large numbers of delegates – 'Opportunity Arabia 5' will take place on 28 August at 1 Great George Street and will highlight the vast opportunities in this large and growing market.

We are becoming increasingly sector focused – apart from the financial services sector, the education and skills sector is a priority, reflecting the urgency of the need to bridge the skills gap in the region. With our partner, Compass Rose, we are working on the MENA Learning & Leadership Programme (MLLP), a highly innovative programme bringing together the key pillars of private sector, government, civil society and academia to develop and deliver sustainable solutions to learning and development in the Middle East and North Africa. The programme was launched in February 2007 in the UAE and has generated a huge amount of interest. We are also working with the London Business School to organise a major conference on 'Learning & Leadership: meeting the skills needs in the Middle East and North Africa', which will take place at the London Business School on 10 July.

Another new initiative is the launch of the MEA Women in Business Network which we are developing in co-operation with Women in Business International.

There has never been a better time to do business with the Middle East /North Africa region; high oil prices have led to unprecedented growth and development. UK visible exports to the Middle East and North Africa topped £10 billion in 2007 and trade in services is also very substantial. The Middle East Association, with its unrivalled knowledge and business experience of the region, as well as its network of high level government and private sector contacts, is uniquely placed to assist you to take advantage of the opportunities on offer.

For further information about joining the Association, and our activities, please contact Rakesh Ramchurn, tel: +44 (0)20 7839 2137, email: rakesh@the-mea.co.uk, or visit our website, www.the-mea.co.uk.

Q&A

The editor of Islamic Finance In Practice, Roderick Millar, talked recently with the Majid Dawood, CEO of Yasaar Research, the 2007 Best Islamic Finance Advisory Firm winner.

About you and Yasaar

How and when did you get into Islamic Finance (IF)?
Exposure to Islamic Finance was due to my father setting up the first leasing company in Pakistan in 1983 and structuring it on the Ijara basis under the Mudaraba (Mutual Fund) concept. To date the BRR Capital Modaraba is the largest capitalised and oldest listed Mudaraba on the Karachi Stock Exchange.

What and when led to the creation of Yasaar?
I attended my first Islamic Finance conference in December 1997 in Bahrain and saw an opportunity to set up an Islamic asset management company. I was looking for an established international asset management company to partner with. Lots of interest but no commitment led me to decide to go it alone and sought asset class specialist managers to manage the fund and we would market it. Morgan Stanley agreed to manage the equity fund and within weeks they wanted to do it themselves as they could do one ten times the size of fund we contemplated. In effect we ended up as Sharia'h advisors to them in their fund and put them on the road to Islamic finance and they put us on the road to Sharia'h advisory. Dr M.A. Zaki Badawi and Dr Elgari became my partners, shareholders and directors in the company. A whole new concept in Sharia'h advice was born.

What are its main areas of activity – early partners / clients or at least their locations?
Yasaar's sole role is to advise the Finance industry on Fiqh al Muamulat, the law relating to financial transaction. We provide a comprehensive service which includes advice on products, transactions and structures, the legal and marketing documentation review, the Sharia'h Board, Fatwas, on- going Sharia'h monitoring and Sharia'h audit and market intelligence to our clients. All under one roof so to speak. We tend to make the process easier, time and cost effective for both the institutional clients and the Scholars.

Can you explain where a Sharia'h compliance specialist fits in to the IF sector?
Primarily it must be understood that without the input of a Sharia'h Board any Islamic finance initiative is a non-starter. The investors look to see who are the Sharia'h Board members and this can act as an effective marketing advantage. That is why many of the banks look to have the select few Sharia'h Scholars as their Sharia'h Board members. The reputation of the Scholars and their experience are paramount in the success of any of these initiatives as it saves and money in the long run.

Why did Yasaar choose to be based in London?
London was selected as it was an environment with international standards of governance and transparency, as well as being the financial centre where a lot of the Islamic transactions took place. In those days the choice was London or Bahrain and as I had operated in London and Dr Badawi was based there it become an obvious choice.

When Yasaar started what were the most important issues of activity – has the market now moved beyond this? ie is there a sophistication apparent in the market?
Initially there were only the basic products and funds were concentrated on equities and real estate. However, as we have seen, the market has grown more diverse and a sense of maturity has also appeared. The product development and sophistication has been part and parcel of the growth, with appearance of structured and exotic products, as well as the Islamic stock indices.

The liquidity in the Middle East is demanding more and more Sharia'h compliant means in finance and investment.

About Islamic Indices

Yasaar collaborates with FTSE in the screening and compilation of Sharia'h indices. How do you see the use of such indices developing in the coming years?
The indices have become integral in achieving standards and enabled a lot of funds to be launched on the back of them. These indices will also help foster new products based on them and practitioners are always looking for new avenues and means to provide Sharia'h compliant offerings to their clients that add value and differentiate them from their competitors.

And do you believe they have an important role to play in expanding the size of the market to users currently not engaged with IF sector through ETF's etc...?

Recently we have seen the launch of ETF's and the Singapore Exchange just launched its first Islamic ETF based on the Daiwa FTSE Sharia'h Japan 100. It was also Daiwa's first Islamic ETF. We are expecting the development of OTC products based on these indices and ETF's. We are very proud to be associated with our partners FTSE and also with SGX and Daiwa and expect to develop more products and build a long and robust relationship with them all.

About Islamic Finance Sector

What do you see as the major issues / challenges facing IF in the coming years?

- Development of new products that meet global financial requirements AND meet Sharia'h requirements
- Liquidity issues within sector (too much money chasing too little business)
- Homogenisation of IF products across different regulatory regimes (within the Gulf region and between Gulf and Malaysia and Pakistan)
- Expansion of market to predominantly non-Muslim regions (Europe and N America)

All the above are valid points and all are being addressed in one manner or other. The standardization and harmonization are crucial to the long term growth and development of the sector.
It is a sector that has laid roots and is the fastest growing sector of banking with the expectation that it will form nearly 12% of global finance by 2015. The liquidity in the Middle East is demanding more and more Sharia'h compliant means in finance and investment.

As the IF sector becomes more mainstream what are the big opportunities that lie ahead?
The Islamic finance sector has been developed from the top down, sovereign down to corporates, High Net Worth Individuals and the retail is yet to come into its own. Takaful will also become huge as the sector develops and has to invest its funds in a Sharia'h compliant manner. The grass roots of the retail sector is the true and lasting future of Islamic finance.

What needs to be done to enable this to happen?
Two words are most important for this to happen, "standardisation" and "harmonization".

What product areas do you currently see as being of most interest? Where is the demand for this coming from?
The OTC market based on the ETF's will be of most interest as this is a very cost effective means of investing for the retail sector. With many new highly capitalised Islamic banks being set up and shortage of product they will have to manage their liquidity and this will drive the demand.

What are your views regarding new derivative-style products such as arboon and wa'ad?
Both of these contracts and those based on them are valid, the issue arises when the underlying assets to these are un-compliant under Sharia'h criteria. Imagine a plastic bottle of water, where the water is poured into an empty glass, this is compliant. But once you add a drop of an unacceptable liquid then the whole becomes un-compliant. The pass through for the entire structure needs to remain compliant.

The grass roots of the retail sector is the true and lasting future of Islamic finance.

The issue of non-Muslim interest in Sharia'h products is becoming more prevalent – while the theoretical connection is real, how real is the demand from non-muslims for these products, and how much is wishful thinking on the part of the IF sector?
Well the conventional market is huge but it loses the Sharia'h market whereas the Sharia'h market is open to both the conventional and Sharia'h investors. At the end of the day a product needs to stand on its merits and if it appeals then the investor will partake of it. Do not forget that the entire SRI and Ethical market finds the IF market attractive.

This is particularly an opportunity with ethical investment funds – how much overlap is there between ethical funds screening and Sharia'h screening?
The Sharia'h screening is more conservative than the criteria required by the Ethical market as that segment permits conventional banking and finance and other sectors that do not pass the Sharia'h screening criteria. The other aspect is that Sharia'h screening is on a negative basis and the \ethical and SRI markets also look for the positive screening basis. However, I believe there is, a considerable opportunity for the IF practitioners.

Majid Dawood is chief executive of Yasaar, the first Sharia'h compliance services company. Yasaar assists financial institutions structure cost-effective Sharia'h compliant financing structures around the globe. He is a Director of BRR Investments, set up in the early 1980s with shareholders including Robert Fleming and the International Finance Corporation, who are the managers of the first and largest Islamic leasing company in Pakistan. Prior to setting up Yasaar, Majid held the position of country representative for Credit Lyonnais Securities (Asia) Ltd as well as capital markets consultant to Credit Lyonnais and Jardine Fleming, advising on privatisation and capital market issues.

Majid is a well known and much sought after speaker on Islamic finance and Sharia'h, having presented on these topics globally as well as having authored numerous articles for industry journals. In 2004, Majid was presented the Deloitte & Touche award for the most innovative Islamic finance product for the Caravan 1 Sukuk. Under his leadership and guidance in December 2007 Yasaar was voted "The Best Islamic Finance Advisory Firm" by the readers of Islamic Business and Finance magazine. Majid holds a BA (Economics) from the University of Massachusetts.

For further details contact Yasaar at www.yasaar.org or on +44 (020) 7956 2014

Patron: HRH The Duke of York KG

The Middle East Association (MEA) is the UK's premier private-sector organisation for promoting trade and good relations with the Middle East, North Africa, Turkey and Iran. The MEA is an independent and non-profit making association founded in 1961 and based in London. It represents some 400 large and small companies from all business and industry sectors who together account for an estimated 70% of UK trade with the region. The Patron of the Association is HRH The Duke of York, UK Special Representative for International Trade and Investment.

Membership is open to individuals as well as companies. Conferences, seminars, trade missions, and receptions with visiting Ministers from the region and Arab and UK Ambassadors are some of the activities of the Association. For more information and a full programme of events in 2007, please contact the Membership and Marketing Manager on +44 20 7839 2137 or visit our website, www.the-mea.co.uk.

MEMBERSHIP BENEFITS:

➢ MARKET INFORMATION

- A full programme of seminars and in-house market briefings
- A general enquiry and business support service
- A specialised reference library and information centre, with free Internet access

➢ PUBLICATIONS

- A fortnightly newsletter signposting events and issues relevant to members' interests
- "Opportunity Middle East" magazine, circulated quarterly to over 5000 subscribers
- An annual Handbook listing members and their areas of activity
- Middle East Business Focus, an essential reference guide for the MENA region

➢ FUNCTIONS

- Informal networking receptions held on the first Wednesday of every month (except January and September). Guests from Middle East diplomatic missions in London and British Government departments are invited
- Lunches at which visiting Ministers or UK and Arab Ambassadors brief members on the latest political and economic developments in their country/region
- A full programme of trade missions throughout the year, open to all industry/business sectors

WHO CAN JOIN

Membership is primarily for firms owned either in the UK or in the countries with which the Association is concerned; those owned in third countries may be admitted if they have a substantial presence in the UK and if their Middle Eastern activities contribute significantly to the British economy. A number of leading Middle Eastern businessmen have also become Overseas Members. The MEA will shortly be opening a regional office in the UAE to cover the GCC countries. **A membership application form can be downloaded from our web page** www.the-mea.co.uk/join.asp.

WHERE WE ARE

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CALENDAR OF FORTHCOMING EVENTS

Please visit our website www.the-mea.co.uk regularly for an updated list of events

COUNTRY / REGION	EVENT	DATE(S)	*Please send further information*
	RECEPTIONS AND CONFERENCES		
GCC	3rd City and GCC Conference	19 June 2008	☐
IRAQ	VIP Reception with H.E. Mr Fawzi Al-Hariri, Iraqi Minister of Industry & Minerals	7 July 2008	☐
ALL	Middle East Education & Skills Conference	10 July 2008	☐
SAUDI ARABIA	Opportunity Arabia 5 Conference	28 August 2008	☐
ALGERIA	Algeria Trade & Investment Conference	Oct/Nov 2008	☐
	VIP LUNCHES		
KUWAIT	Ambassadorial Luncheon with H.E. Mr Khaled Al-Duwaisan GCVO, Ambassador of the State of Kuwait	12 June 2008	☐
LIBYA	Ambassadorial Luncheon with H.E. Sir Vincent Fean, HM Ambassador to Libya	15 July 2008	☐
OMAN	Ambassadorial Luncheon with H.E. Dr Noel Guckian OBE, HM Ambassador to Oman	16 July 2008	☐
IRAN	Ambassadorial Luncheon with H.E. Mr Rasoul Movahedian Attar, Ambassador of the Islamic Republic of Iran	22 July 2008	☐
KUWAIT	Ambassadorial Luncheon with H.E. Mr Stuart Laing, HM Ambassador to Kuwait	4 September 2008	☐
OMAN	Ambassadorial Luncheon with H.E. Mr Hussain Ali Abdullatif, Ambassador of Oman	22 October 2008	☐
ALL	MEA/City of London Luncheon at Mansion House	31 October 2008	☐
	TRADE MISSIONS		
AZERBAIJAN	High Level Trade Delegation to Azerbaijan	Date tbc	☐
N. IRAQ	Trade Mission to Northern Iraq (tbc)	10 – 16 October 2008	☐
MOROCCO	Tourism Sector Trade Mission to Morocco (tbc)	14 – 17 October	☐
IRAN	Trade Mission to Iran (tbc)	26–29 October 2008	☐
SAUDI ARABIA	Trade Mission to Jeddah, Riyadh & the Eastern Province (tbc)	7–17 November 2008	☐
EGYPT	Trade Mission to Egypt (tbc)	30 Nov – 4 Dec 2008	☐
LIBYA	Trade Mission to Libya (tbc)	15 – 19 February 2009	☐
SYRIA/JORDAN	Trade Mission to Syria & Jordan (tbc)	8 - 11 March 2008	☐
	OVERSEAS EVENTS		
MOROCCO	Sustainable Tourism & Investment Conference in Tangiers	16 October 2008	☐

For more information, tick the relevant boxes and fax back to +44 20 7839 6121, call us on +44 20 7839 2137 or visit http://www.the-mea.co.uk/events-forthcoming.asp

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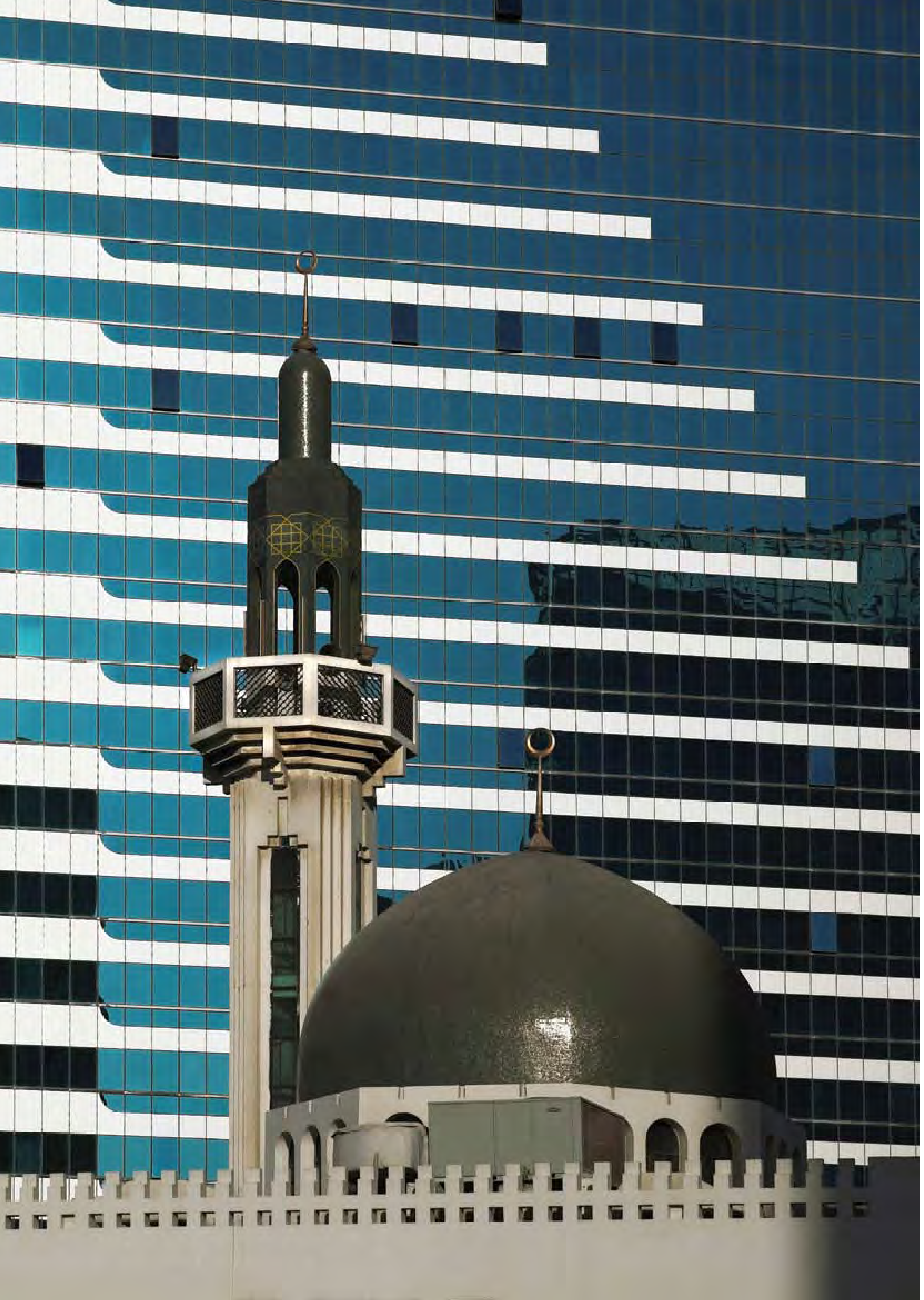

THE INSTITUTIONAL INFRASTRUCTURE SUPPORTING THE ISLAMIC FINANCE INDUSTRY

Professor Rodney Wilson, Durham University, UK

There are four major international institutions concerned with the Islamic finance industry:

- The Fiqh Academy;
- The Islamic Development Bank;
- The Islamic Financial Services Board; and
- The Accounting and Auditing Organization for Islamic Financial Institutions.

The role and significance of these institutions is reviewed here, together with other major organizations providing data and information on Islamic finance. In terms of education and training, institutions providing professional qualifications in Islamic finance include:

- The Institute of Islamic Banking and Insurance in London;
- The International Centre for Education in Islamic Finance in Kuala Lumpur; and
- The Chartered Institute of Management Accountants, based in London but with worldwide offices, which launched a certificate in Islamic finance in 2007.

There are also universities offering academic qualifications in Islamic finance, such as the International Islamic Universities in Kuala Lumpur, Islamabad and Chittagong, and the CASS Business School, which has an Islamic finance stream for its executive Masters in Business Administration (MBA) offered in Dubai. The Faculty of Islamic Studies in Qatar is launching a Masters of Science (MSc) in Islamic Finance in September 2008. Postgraduate research degrees, including at PhD level, are offered by Durham University.

The Fiqh Academy

To determine whether financial products comply with Shari'a, the opinions of scholars trained in Islamic jurisprudence (fiqh) are sought. Their rulings, or fatwa, are regarded as definitive, but as Islam is not a centralized or hierarchical religion, there are many competing, and sometimes contradictory fatwas. It was to resolve these conflicts that the Islamic Fiqh Academy was established in Jeddah in January 1981. Its mandate was agreed by the Organization of the Islamic Conference, which now serves 57 Muslim majority countries. The Islamic Fiqh Academy is therefore widely regarded as the appropriate international institution to provide guidance on moral issues of concern to the Muslim faithful. This includes guidance on medical ethics, social issues and economic matters, including finance.

> **There are many competing and sometimes contradictory fatwas**

Its rulings on finance are respected by the Shari'a board members of leading Islamic banks and takaful (insurance) operators. Notable rulings include those on the permissibility of deposit or down payment subscriptions and foreign exchange transactions, bank deposits and investment in equities, and leasing contracts. The issue of whether credit cards are permissible has also been addressed at several meetings. As the issues considered are often complex, it is not merely a matter of ruling whether a financial product or activity is permissible, but the terms under which it is permissible.

For example, in leasing ijara operating leases is permissible as the owner of the asset has responsibility for its maintenance, which justifies the rental payment, whereas with a pure financing lease all the obligations are devolved to the lessee, invalidating the contract. Similarly, credit cards that involve riba payments are forbidden, a

The Accounting and Auditing Organization for Islamic Financial Institutions

Financial reporting for Islamic financial institutions is also challenging because of the unique nature of their assets and liabilities. There is the question, for example, of whether murabaha assets should be valued at their cost to the bank or their cost to the client, which includes the mark-up. The relevant Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) standard suggests the latter. Similarly there is the issue of whether income from murabaha, ijara and istisna'a assets should be booked as it accrues, or at the end of the period when the financial institution has its funding returned. Again, AAOIFI suggests the former.

AAOIFI was established in Bahrain in March 1991 to support the Islamic financial services industry, and its standards are now mandatory in Bahrain, Qatar, Jordan, Lebanon, Sudan and Syria, as well as being implemented by the Dubai International Financial Centre. The regulatory authorities in Saudi Arabia, Indonesia, Malaysia, Pakistan, Australia and South Africa have issued guidelines based on the AAOIFI standards. To date, AAOIFI has issued 22 accounting standards, five auditing standards, four governance standards and two codes of ethics. It has also issued 21 Shari'a standards that were approved by its own Shari'a board.

The aim of AAOIFI is not to replace the International Financial Reporting Standards (IFRS), but rather supplement them with respect to Shari'a compli-

ant assets and liabilities and the income flows associated with these. Even in jurisdictions where AAOIFI standards are not mandatory, most Islamic financial institutions implement them in practice, and refer to AAOIFI in their annual financial reports and interim reports. As with the IFSB, as leading Islamic banks expand beyond their countries of origin, a consistent set of accounting standards facilitates the consolidation of their financial statements, which is helpful for both their shareholders and the regulatory authorities.

Other stakeholder groups are also important to AAOIFI, such as the investment mudaraba account holders with Islamic banks who earn a profit share. They are entitled to know the basis of how the profit share is calculated, and the amount placed in the profit equalization fund from which they may benefit in the longer term, but at the expense of a smaller profit distribution in the short term. AAOIFI sponsors an annual Islamic finance conference in Bahrain, and organizes regular training sessions for accountants where its standards are explained.

Information sources

There are comprehensive news and data sources serving the Islamic financial services industry. Online subscription services include the Islamic Finance Information Service (IFIS) of ISI Emerging Markets, which is a Euro-money affiliate based in London, and Islamic Finance News (IFN), based in Kuala Lumpur. IFIS provides comprehensive information, including data on sukuk issuance, managed funds,

There is no need to attend classes

syndications and takaful. The annual reports and interim statements of most Islamic banks can be accessed through it, as can legal reports, supervisory documents and research materials. The databases within the system can be searched by year, country and product. IFN provides a weekly newsletter covering the latest developments in the industry, with historical information also available online. It contains interviews with industry leaders, and a forum where topical questions are addressed by a number of professional and academic specialists.

There are three major print magazines on Islamic finance:

1. New Horizon, the publication of the Institute of Islamic Banking and Insurance (IIBI) in London;
2. Islamic Business and Finance, published by CPI Financial; and
3. Business Islamica, published by Tradewind.

Both Islamic Business and Finance and Business Islamica are located in Media City, Dubai. Islamic Business and Finance and Business Islamica are published monthly, whilst New Horizon has become a quarterly publication. All are largely funded by advertising, although Business Islamica has a nominal newsstand price. New Horizon is the longest established, as it has been published continuously since 1991 with features and regular items including a news round-up, details of IIBI lectures, appointments, a calendar of events and questions and answers. All three contain articles and interviews, with Islamic Business and Finance employing its own journalists, but much of the New Horizon and Business Islamica material outsourced. Islamic Business and Finance is organized into separate sections on capital markets, Islamic funds and takaful, with each edition containing an editorial and at least one interview.

Professional qualifications

The IIBI Diploma in Islamic Finance is the oldest established professional qualification, and over 1,000 students have enrolled since the early 1990s. It is accredited by the Open and Distance Learning Quality Council in the UK, and recognized as a professional qualification. There is no need to attend classes; rather busy professionals can work at their own pace through the materials prepared by experts. Progress is monitored through periodic question papers sent to those who enrol, with completed answers to be returned by email or post.

In 2007, the Chartered Institute of Management Accountants (CIMA) launched a new Certificate in Islamic Finance in London, Bahrain and Kuala Lumpur. Although an accountancy body, the modules cover most areas of Islamic finance, with assessment taking place through online, multiple-choice questions. Compulsory study modules include Islamic commercial law, banking and takaful, Islamic capital markets and instruments and accounting for Islamic financial institutions. Detailed study guides are provided for each module, including glossaries of Islamic finance terms, illustrations of how practice is derived from theory, and a step-by-step approach linked to specified learning outcomes. The study guides contain extensive case-study materials, chapter summaries, revision sections and full length mock examinations, consisting of 40-50 questions.

The International Centre for Education and Islamic Finance (INCEIF) based in Kuala Lumpur offers a Chartered Islamic Financial Professional programme with both on-campus study and distance learning. The structured programme involves three parts; the first part stresses basic knowledge leading to associate membership, the second involves skills acquisition resulting in proficient membership on completion, and the third building competency and experience resulting in practising membership. The courses take between one and a half to six and a half years to complete. First stage modules include Islamic economics and finance, Islamic financial institutions and markets, Islamic finance regulations and governance, applied Shari'a in financial transactions, deposit mobilization and financial management and wealth planning. The subject skills at level two include structuring financing requirements, issuing and managing Islamic securities, Shari'a compliance and audit, customer relationship management and the role of technology and issues in Islamic financial institutions and markets. At level three, participants are articled to participating Islamic financial institutions to gain practical experience, with validation involving problem solving, restructuring exercises, simulation and management games, product conversion and interviews.

Academic programmes

The International Islamic University of Malaysia has undergraduate programmes in economics, accounting and business administration that enable students to get some exposure to Islamic economics and finance, although most of the course contents are conventional. At postgraduate level more specialized study in Islamic finance is possible, as is the case with the International Institute of Islamic Economics located within the International Islamic University in Islamabad, which offers a one year Postgraduate Diploma in Islamic Banking and Finance through evening study, as well as an MSc over three years with scheduled morning classes.

The London based CASS Business School launched an executive MBA with an Islamic finance stream in 2007. The programme is offered in Dubai in collaboration with the Dubai International Financial Centre. The two-tier programme involves established MBA modules in accounting, marketing, finance and business economics, with the Islamic finance options coming near the end of the course. The three specialist components are in Islamic economics, Islamic banking and finance and Islamic law of business transactions. In neighbouring Qatar, the Faculty of Islamic Studies, which is sponsored by the Qatar Foundation, is adding an MSc in Islamic Finance to its existing MA programmes in Islamic Studies from 2008 onwards. The new faculty is separate from the University of Qatar, but will be moving to the new Education City in Doha once its buildings are completed. Details of the new degree structure are not yet finalized.

For research degrees in Islamic finance, Durham University in the UK has become the leading international centre, attracting suitably qualified applicants from throughout the world, including Malaysia and the Gulf. A master's degree by research is offered at the university, which involves students writing a thesis of 30,000 words on an Islamic finance topic that they can negotiate with their supervisor. Doctoral degrees involving a minimum of three years of supervised study are also offered, with students writing a thesis of 80,000 words. There are dedicated research support workshops and a module on Islamic political economy and Shari'a compliant finance that students are expected to attend. PhD students spend part of their first year in Durham, but during the second and third years they often undertake fieldwork in their country of origin or elsewhere, as most of the research involves empirical studies.

This article is an extract from the forthcoming handbook Islamic Finance: A Guide for International Business and Investment, to be published by GMB Publishing Ltd. *www.gmbpublishing.com*

ISLAMIC FINANCE IN PRACTICE

DDCAP Limited

DDCAP Limited is a joint venture between the Dawnay, Day Group and ICAP Private Group Limited "IPGL". IPGL is a significant shareholder in ICAP plc, the world's leading electronic and voice broker, a FTSE 100 Company, with approximately 3000 employees throughout the world.

DDCAP is focused on the Islamic financial sector and has responsibility for its shareholders' strategic business initiatives in the Islamic marketplace, as well as representing Dawnay, Day in the expansion and development of its Middle Eastern business in both the conventional and Islamic financial systems.

DDCAP's wholly owned subsidiaries include DD&Co Limited "DD&Co" (formerly Dawnay, Day & Co. Limited) and DDGI Limited "DDGI" (formerly Dawnay, Day Global Investment Limited).

Established in 1928, DD&Co provides commodity and asset based facilitation services to Islamic financial sector participants and acts as a counterparty for Islamic transactional requirement. DDGI is involved in arranging financing solutions for the wholesale Islamic marketplace and engages in strategic, direct investments in Islamic financial sector opportunities. Amongst these, DDGI is a founder shareholder in Islamic Bank of Britain plc and a joint venture partner in Global Islamic Clearing Company, Bahrain.

DDCAP's experienced management team has worked with Islamic institutional and private clients since the early 1980s. DDCAP's expertise is combined, as required, with complementary and specialist skills from its joint shareholders. The firm positions itself as an intermediary in the Islamic financial services industry, providing structuring support and value added services to its clients across a diverse range of products and asset classes:

- DDCAP's investment asset focus for Islamic clients includes cash management, commodity, structured trade, real estate, bonds (Sukuk), quoted and private equity.
- DDCAP facilitates wholesale, structured investment opportunities for Islamic and other institutional clients and has assisted clients directly and through third party relationships, with placement of over US$25bn in asset based transactions.
- Working with conventional and Islamic banks, DDCAP has arranged over US$3.5bn of Sharia'a compliant finance for institutions and international corporates during the past year.
- DDCAP also provides asset facilitation services, as a principal, to over 250 third party institutions, funds and private offices. Through its trade execution services, its clients are offered appropriate solutions for liquidity management and funding requirements and are also supported in their risk management and hedging strategies.
- In joint venture with ICAP plc, DDCAP offers a secondary market capability in Sukuk. (Bloomberg: ICSU <GO>)

Financing

2006
Value USD 250mn
Structured and arranged a one year Morabaha facility for a Saudi corporate privately placed with three international banks

2007
We assisted WestLB in the structuring of the Morabaha arrangements and, thereafter, provided asset facilitation for the acquisition of the Aston Martin Lagonda group by a consortium, led by The Investment Dar (Kuwait)

2007
We are commodity facilitator for the US$300mn syndicated Morabaha financing arranged in November 2007 for Qatar Islamic Bank by Standard Chartered Bank and ABN Amro

2007
We are commodity facilitator for a US$450mn syndicated, committed, Morabaha facility arranged and lead managed by Calyon, Abu Dhabi Islamic Bank and Fortis for Awal Bank, Bahrain in August

Asset Facilitation

2006
We are commodity facilitator for the US$850mn 5 year syndicated Murabaha financing arranged for Kuwait Finance House by Deutsche Bank, Citigroup, Calyon and Standard Chartered Bank

2007

ARCAPITA

We are commodity facilitator for the US$ 1.1bn 5 year syndicated Morabaha facility arranged for Arcapita Bank by - West LB, Standard Bank, Standard Chartered Bank, Barclays Capital, Development Bank of Singapore and European Islamic Investment Bank

2007
We assisted Kuwait International Bank (formerly Kuwait Real Estate Bank) with its conversion to operating as an Islamic Bank and facilitated the balance sheet conversion trade aggregating KWD 700mn

Asset Management

2007

Through DD&Co Limited, we are mandated Commodity Facilitator for the Almaz Fund OEIC, a DIFC governed Fund sponsored by National Bank of Dubai Investment Bank to invest in commodities and other Sharia'a compliant liquid investments. The Almaz Fund was launched in October 2007

2007
We are facilitator and counterparty to an innovative Salam based commodity Fund sponsored in joint venture by a global investment bank and an Islamic financial institution in Kuwait. The Fund has just commenced its launch period.

Capital Markets

2005/2006/2007
We provided asset facilitation to enable Islamic investors' participation in a series of GCC IPO's

2007
We provided asset facilitation and intermediary trade services for currency hedging structures provided by several major banks to Islamic institutional clients. These aggregated US$650mn

Investment

2006 / 2007
We are providing advice and structuring assistance to the Malaysian Islamic banks seeking to introduce commodity backed liquidity management solutions

Private Equity & Venture Capital

2003
Became a Founder Shareholder in Islamic Bank of Britain plc, the first Islamic bank licensed in the UK for more than a decade

2004
Took up rights to shares through increased investment in Islamic Bank of Britain IPO

2005
Acquired a 50% shareholding in Global Islamic Clearing Company, Bahrain

EUROMONEY Islamic Finance Awards 2005
Best Commodities House

EUROMONEY 2007 Islamic Finance Awards
Best Liquidity Manager
Best Commodities House

EUROMONEY 2008 Islamic Finance Awards
Best Commodities House

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ISLAMIC ALTERNATIVES TO CONVENTIONAL FINANCE: An Analysis of the Basic Contracts

Muhammad Ayub, Institute of Islamic Banking and Insurance

Islamic financial products are increasingly being adopted by the global banking and non-banking financial industry, attracting both Muslims and non-Muslims. Charging any return on loans is prohibited in the Holy Scriptures of all major religions, including Islam. Ethical proscriptions provided in these religions also encourage usage of such financial products that encompass judicious return and risk-sharing among investors and fund users. In addition, financial engineering or innovation of investment products over the last decade is one of the most forceful factors providing impetus to this fast emerging financial discipline. Product development, or financial engineering in line with an overall Shari'a compliance framework, requires deep knowledge of the primary Islamic financing modes that form the basis of contracts being undertaken by Islamic financial institutions (IFI).

Below, an attempt has been made to analyse these basic modes in terms of their essential features for Shari'a compatibility, as well as their scope as a means of financing, and the implications for financial intermediation, profitability of financial institutions and their possible role in socio-economic development.

Essential features of modes of business

The basic contracts used in Islamic finance are of a number of categories, including:

- Loans;
- Selling goods on credit or forward purchases, thus creating debts;
- Leasing assets against rentals;
- Equity-based financing for sharing of profits and absorbing business losses; and
- Fee or commission-based agency services.

A large number of products are being used by IFIs either individually or as combination of various modes, and the Islamic law on contracts provides a framework for such combinations.

Loans

Loaning is a virtuous act and not a business mode in Islamic finance because of the prohibition of interest. The lender (or the creditor) has rights related to loans and debts only as by Shari'a. As IFIs cannot charge any return, they can use loans on financing as a part of their social services only, if authorized by the fund owners to do so. This is where they differ from conventional institutions whose major activity is taking and advancing loans against interest.

With regards to deposits, current account deposits which IFIs manage as trusties are treated as loans that must be paid back on demand, irrespective of the profit or loss caused to their business as a result. IFIs have to guarantee the principal of such deposits, as against the investment deposits whose profit or principal cannot be guaranteed.

The mainstream Islamic finance theory requires that such deposits are not entitled to any return in any form. But there are some exceptions mainly because gracious repayment of loans by the debtor without any explicit or implicit precondition or expectation from the lender is commendable under Shari'a law. As non-remunerative deposits are a source of strength for IFIs, they can give gratis return to the account holders solely at their discretion. But it cannot take the form of a system or a regular practice to mean that the deposit would necessarily yield a profit.

Trade-credit and forward sales

IFIs can engage in spot, credit or forward trading, subject to the observance of prescribed rules. The modes that cover valid trade contracts include credit sales (with agreed profit margins for the bank on the cost price, in the form of murabaha or muajjal), forward sale with pre-payment in full (salam) and order to manufacture or purchase with a flexible payment schedule (istisna´a).

Murabaha as a credit sale

This is a credit sale of goods by a bank to its client at an agreed profit margin on the cost of the goods; hence it implies bargaining on the profit margin. The goods being sold must be owned by the IFI and in its physical or constructive possession, implying that it must have assumed the risks of ownership before selling the same to the client.

Musawamah as a credit sale

This is a sale with deferred payment of price, in which banks bargain with clients on price, not on profit margin as in murabaha. It can be used where the bank is not in a position to ascertain precisely the costs of the commodities it is going to sell, particularly in respect of high value assets or consumer durables. In the case of consumer durables, IFIs usually get a discount from the supplier over the normal retail price, but do not bring this to the attention of their customers. In such cases, they should use musawamah and not murabaha, because the latter is a fiduciary contract in which the seller is obliged to tell the buyer the exact cost price of the goods.

Salam (forward purchase)

Salam is a forward sale or purchase, and the best alternative to interest for financing the cash and overhead expenses of commodity-producing sectors. Banks have to make pre-payment in full against goods that their clients have to deliver on agreed future dates. Salam can be used for homogenous goods that are normally available in the market and whose quality can be specified, such as raw materials, agricultural products or manufactured goods of homogeneous nature. Salam provides a genuine tool for economic hedging and risk management by integrating investments with real value-adding activities, not for gambling or speculation.

Istisna´a (order to manufacture)

This is also a forward-trade agreement, whereby the purchaser places an order to manufacture or construct an asset to be delivered at a future date. Both unique and homogeneous types of assets are covered under istisna´a, provided their specifications are mutually agreed. IFIs may undertake financing based on istisna´a by getting the subject of istisna´a manufactured through a parallel istisna´a contract. It is not necessary that the price is paid in advance; it can be deferred or paid in instalments as the parties may agree. Shari'a law allows this, unlike in salam, because the completion of an istisna´a project involves a personal commitment and effort on the part of the manufacturer, who might not give his full time and attention to a job due to similar contracts with other parties. Hence, it does not involve "sale of debt-for-debt," even if full pre-payment is not made by the purchaser as the case could be in salam.

Leasing

Leasing (ijarah) is the mode with the highest potential amongst all modes in terms of profitability, risk management, enhancement of fixed capital formation and promotion of Islamic finance. In ijarah, the amount of the leased asset, ownership related expenses and risks remain with the lessor and its usufruct is transferred to the lessee, against which the latter has to pay rental. IFIs normally purchase the asset in response to specific requests from customers to get the asset on lease with ownership transferring to them at the end of the lease term. They consider all expenses, including takaful (insurance) premiums, to determine the rentals.

Islamic leasing is valid in respect of those assets whose corpus remains intact, is not consumed and does not alter its form with use. Hence, yarn, for example, is not valid for leasing. Similarly, money cannot be leased, and any amount taken as rent on it is prohibited as it would constitute interest. Rentals in ijarah can be fixed for the whole of the lease term, variable for the sub-terms or floating with any known benchmark subject to mutual understanding. The main distinction between ijarah from conventional leasing is that in the former, IFIs are responsible for expenses and risks incidental to ownership and title to the asset is transferred to the lessee under a separate sale or gift deed. However, in ijarah, the lessee is responsible for all risks and expenses, rentals start accruing as soon as the banks makes payment for purchase of the asset and the title transfer is a part of the lease contract.

Equity-based partnership modes

Partnership-based contracts, namely musharaka and mudaraba, are considered to be the best alternatives to interest and hence form the basis of Islamic finance, particularly on the deposits side of Islamic banking.

In musharaka, all partners contribute funds (not necessarily equally) and have the right to work for their joint business, but in mudaraba, only one party (or a group) provides funds and the other manages the business to earn profit. Profit to any partner cannot be in the form of a fixed amount or a percentage of the capital employed; it can be shared in any proportion stipulated in advance, but the loss has to be borne by the investor(s) pro-rata, in proportion to their invested capital.

Fee-based agency services

This includes service or agency-based activities covered under ujrah (services against wages), jualah (rewards against performing a job) or fees against agency services. IFIs can provide a number of services against fees, such as fund management, remittances and correspondence services. However, no charge can be taken against financial guarantees; Islamic banks may get only the management or agency charges. An investment agency is the best example of such contracts in which IFIs get a fixed fee for management, giving all profit or losses to the investors.

Debt creating contracts

Debt creating modes can be divided into trading and leasing contracts. Trade-based modes entitle fixed return to the banks as the price of goods has to be stipulated (without any ambiguity) at the time of the execution of any sale. While fixing the price, IFIs can keep in view the cost incurred and the time involved for performance by the client. The credit price of the goods can genuinely be higher, whilst the forward price in salam can be lower than the spot payment price. Furthermore, banks are allowed to appoint a client agent for purchase of the goods in murabaha, and the sale of goods in salam. IFIs have to bear asset risk, market risk and all counter-party risks; although they can mitigate, they cannot eliminate such business risks.

Once the contract is executed, they have to give or receive delivery and possession, irrespective of upward or downward movement of the prices. If the general rate of return or price levels in the economy rise, they can loose in terms of murabaha receivables as prices once finalized cannot be increased. This is why long term murabaha is avoided in economies with inflationary trends. For short-term and asset based financing, murabaha is considered as a safe and an efficient contract.

Long term murabaha is avoided in economies with inflationary trends

So long as goods remain under a IFIs' ownership, they are responsible for any damage to them. To mitigate credit risk, it can be provided in contracts that in case of a delay in payment or delayed delivery (in forward sales), the client would pay penalty that could be any absolute amount, or per cent (per annum) of the defaulted amounts. The penalty amount goes to a charity account maintained with the bank and cannot become a part of the bank's income, except in the case of istisna´a wherein decreases in the price of the asset due to delay in its delivery can benefit the purchaser's profit and loss account (this exemption is available due to specific features of istisna´a, and performance in this case depends upon the personal commitment of the manufacturer or seller, and does not come under the prohibited category of "sale of debts-for-debts," despite deferment of price payment).

Among the trade-based contracts, bai al inah (buy-back) and tawarruq (obtaining cash through purchase and sale) are considered highly controversial contracts. It is widely believed that buy-back is a "trick" to circumvent the prohibition of interest and therefore not a Shari'a compliant contract. It is a double sale; a person in need of cash sells a commodity on spot payment and buys it back forthwith at a higher price on credit, with the net result of a loan with interest. Tawarruq is buying goods on credit and selling it to a buyer other than the seller for a spot price to get cash. It is legally permissible, according to majority of the contemporary Shari'a scholars.

Tawarruq as being used by some IFIs takes the form of reverse murabaha, generally known as "commodity murabaha." It is carried out through the commodity exchanges wherein only brokers undertake some agency services, and the goods normally remain in the place where they were without transfer of ownership from the seller to the buyer. A number of conditions of a valid sale may be lacking in such transactions. Hence, Shari'a scholars (and cautious persons in Islamic finance in terms of compliance with tenets of the Shari'a) advise that tawarruq practice must be limited only for meeting unavoidable liquidity needs of the corporate sector, and should not be used for consumer financing.

Tawarruq practice must be limited only for meeting unavoidable liquidity needs

According to some writers "arbun" can become a basis for developing some kinds of Shari'a compliant options. The Organization of the Islamic Conference (OIC) Fiqh Academy has allowed arbun as a part of actual business involving real goods or assets, provided a time limit is specified, and conventional options have not been allowed due to involvement in gharar and riba. Some scholars have erroneously considered the earnest money taken by Islamic banks in "promise to purchase" in murabaha as arbun as deriving the permissibility of conventional options; rather it is hamish jiddiyah from which only the actual loss can be recovered. They allow adjustment of the actual loss to the seller from the hamish jiddiyah, and confiscation even of the whole amount of part money paid (also known as arbun) in case of revocation of the executed contract by the buyer. A call option may seem to be like bai al arbun; but actually there are a number of differences. Jurists have indicated six differences between the two. Furthermore, the subject matters in these options are not the goods – these are the rights representing even notional assets.

The subject matter in all valid sales must be valid assets. Accordingly, conventional swaps that are based on an agreed notional principal amount are not acceptable in Islamic financing. A forward rate swap agreement between two parties is an agreement on interest rate for a specified period from a specified future settlement date. The exposure to both parties is only the difference between the agreed interest rate and the rate applicable at the date of settlement.

Leasing is a highly useful contract and IFIs are extensively using it for a number of benefits and flexibilities. The contract can be reviewed periodically due to permissibility of any variable or floating rate of rental in ijarah. But, the actual and net rental income of banks might not be fixed and predetermined because of the asset-related expenses and responsibilities as owner of the assets. It can be used directly for plants and machinery, automotives, housing, consumer durables, etc, and indirectly for sukuk issues by corporate and the government sectors. Ijarah sukuk can be traded like stocks in the secondary market at price higher or lower than their face value.

The arrangement of "sale and lease back" that is valid (as against the "sale and buy-back") is very useful for issuance of ijarah sukuk. Through it, a customer may get finance on the basis of an asset already in his ownership; for example, a corporate body may sell an asset to an IFI or a special purpose vehicle (entity) and then lease it back to get required finance.

Receivables constitute a large portion of Islamic banks' asset portfolios. The mainstream Shari'a view does not allow sale of such receivables and debts, except at their face value along with recourse to the original debtor. Similarly, all instruments based on asset portfolios representing cash and debts more than 33 per cent are not eligible for trading.

Partnership modes

Equity-based contracts are the best alternatives to interest in terms of their validity and impact on socio-economic development of economies. Besides serving as a better tool for distribution of income among factors of production, they can also play a vital role in addressing many socio-economic problems and just and sustainable growth by efficiently and equitably channelling financial resources towards productive opportunities and employment generation. However, the permissibility of debt-creating modes is accepted without any doubt, provided the Shari'a essentials of the respective modes are taken care of.

In equity-based contracts, no party can guarantee the investment of any partner or any profit thereafter. Any independent third party can guarantee to make up loss of capital, but this guarantee can neither be provided for any consideration nor linked in any manner to the partnership contract.

Mudaraba is the best basis for fund raising by IFIs from savers and investors. But the deposits are managed in such a way that investors do not normally bear the loss different pools of depositors are created keeping in view their risk profiles, proper weightings are given (the longer the tenor of a deposit, the greater the weighting) and profits are distributed first between the bank and the pool and then among the depositors. Reserves can be created for mitigating the impact of loss in subsequent periods. IFIs can also give a part from their profit for better profit to the depositors.

On the financing side, Islamic banks seldom use musharaka or mudaraba agreements, mainly because of the risk that their clients may not show their real profits. It is due to a systemic problem in almost all jurisdictions that while interest expenses lead to reduction in income tax amount, profits add to the tax liability of the clients getting funds on partnership basis.

However, IFIs can easily use partnership contracts for financing on a consignment basis in the case of import or export trade where the profit margin is known to the parties. Furthermore, use of a hybrid contract comprising partnership and leasing is increasing in the form of "diminishing musharakah" for long term financing of the construction sector and all other fixed assets. This type of contract has the benefit of a lease – rentals can be fixed or floating and the unit price of the banks' share in the property can be determined in advance in the framework of "partnership by ownership," as against the rules applicable to the general contract partnership. The use of equity-based modes for fund management is also on increase; corporate bodies are using partnership for raising funds by issuance of participatory sukuk or term certificates.

This article is an extract from the forthcoming handbook Islamic Finance: A Guide for International Business and Investment, to be published by GMB Publishing Ltd.

COMMERCIAL REAL ESTATE FINANCING AND PROJECT FINANCE

Richard T. de Belder, Denton Wilde Sapte

The commercial development of real estate will often involve the acquisition of real estate interests, usually coupled with the construction and onward sale or leasing of a building. Project finance will invariably involve a real estate interest and will often be coupled with some exploitation rights, such as a concession agreement. The term "project finance" is usually also associated with financing on a non-recourse basis; in other words the financiers will primarily look to the project assets and revenues as being the main source of repayment (although there can be other methods of support, such as equity contributions by the sponsors, shareholder guarantees, etc).

Islamic finance offers enough flexibility for different structures to be created to meet with the customer's requirements. The structures will usually be a mix of Islamic financing techniques, with the choice being determined by a variety of factors, some commercial, some legal and some Shari'a driven.

The Islamic finance techniques that are considered in this chapter are as follows:

- *Istisna'a*;
- Forward lease (*ijara*);
- *Murabaha*
- *Tawarruq*;
- *Mudaraba*; and
- *Musharaka*.

Depending on the situation, other techniques can be employed, such as Shari'a compliant currency exchange techniques, and the underlying Islamic financing techniques can be packaged in the form of sukuk.

Istisna'a

This is a contract for the sale of an asset that is still to be constructed or manufactured. Payment can be immediate or deferred, and payment by instalments is also possible. It differs from a s*alam* contract, however, in various respects, such as:

- The purchase price does not have to be paid when the contract is entered into;
- There is no requirement to stipulate when the asset is to be delivered; and
- The asset need not be an item that is commonly available in the market.

On the face of it, therefore, this form of Islamic financing is well suited to a building that has yet to be constructed. However, from a financier's perspective, there is a significant drawback in that, as the sale price must be fixed, it is not possible to mimic a variable rate of return as is found in a conventional loan. If the period of construction extends over a long period of time (as will likely be the case) the fixed nature of the return to the Islamic financier may not be attractive.

Using this structure, the Islamic financier would be the manufacturer (*al sani*). The customer is the purchaser (*al mustasna*) of the building to be constructed. Usually the Islamic financier will not have the capability to construct the building. Therefore, it will in turn enter into a back-to-back *istisna'a* or construction contract to construct the building. The Islamic financier will need to ensure that the price it pays in the back-to-back arrangements is less than the price it receives from the customer under the *istisna'a*.

There are various risks that the Islamic financier will face as the *al sani* which include the following:

- Various warranties will attach to the constructed buildings that it is selling often statute prevents them being excluded by contract;
- There are likely to be statutory liabilities that relate to the structural aspects of the construction; these often cannot be excluded by contract due to statutory restrictions; and
- The customer, as the *al mustasna*, may be able to reject the building if it does not comply with the specifications described in the *istisna'a*.

The rationale for an Islamic financier making a profit under an *istisna'a* is that it is taking on risks and liabilities as the seller of the constructed building. However, and especially in large scale projects, these risks and liabilities can be substantial and, therefore, an Islamic financial institution will need to carefully consider them to see if the projected profit is adequate compensation.

Accordingly, the Islamic financier must ensure that the contractual arrangements that it enters into with the entity actually constructing the building for it, provide enough protection so that, if the customer as the *al mustasna*, were to reject the building under the *istisna'a* or to bring a warranty claim, the Islamic financial institution can make itself whole by seeking compensation from the entity that actually constructed the building.

Another important issue which is often overlooked is that the Islamic financier can only agree to sell a constructed building to the customer (*al mustasna*), if it has some legal right to the land on which the building is to be constructed. This can raise rather complex issues as to the type of land grant it requires, what legal liabilities are attached to that grant, whether any registration of that right is required (and the consequences that attach to that registration) and payment of any fees (both in relation to the initial registration and on any deregistration).

Forward Lease (ijara)

A forward lease is a lease that relates to the leasing of an asset that does not exist when the forward lease is entered into. On the face of it this would seem to violate the rule against *gharar* (uncertainty) in that the general proposition (subject to certain limited exceptions) is that an asset must exist when a contract is entered into which relates to that asset.

The way that a forward lease is framed, however, is that the leasing of the building does not commence until it has been constructed. There will also usually be a drop-dead date after which, if the building has not been constructed so that it is substantially completed and ready for use, the lessee will not be under an obligation to lease the building. It is therefore incumbent on the Islamic financier, as the lessor, to ensure that the building is constructed in accordance with specifications and on time, otherwise its customer, as lessee, will not be obliged to lease.

It is possible during the construction phase for the Islamic financier to require the lessee to pay advance rent (which is often calculated based on a benchmark that refers to a conventional interest rate). However, if the building is not constructed in accordance with the specifications or available on time for leasing, and the lessee lawfully refuses to lease the building, the advance rent must be returned to the lessee. If the leasing of the constructed building does commence, then the advance rent must be taken into account and offset against the rent payable as from the commencement date of the leasing. From an Islamic financier's perspective, this is usually not attractive because it means that during the construction phase, it would not receive any financial return.

To deal with this issue, the rent that becomes payable after the lessee takes possession and starts to use the completed building, is normally increased (usually in the first or second lease period) by an amount that equals the advance rent. This increased rental amount is, therefore, set off against the obligation of the lessor to credit the lessee with the advance rent. The end result is that the Islamic financier effectively does obtain a return that relates to the construction period.

If the leasing does not take place (due to the building not being in compliance with the specifications or due to delay) then the Islamic financier will be in a difficult position. It will have a building that it owns and also could face claims brought by the customer. One technique that has been used is for the customer to enter into an *istisna'a* with the Islamic financier, in which it agrees to sell to the Islamic financier the building (subject to the same specifications and delivery date as in the forward lease). The customer in turn will usually enter into a contract with the main contractor. The financing of the project is therefore achieved by the Islamic financial institution making payments under the *istisna'a* (which are then passed down to the main contractor). To the extent that there are any claims by the customer (as lessee under the forward lease) there would be equivalent claims against the customer (as the *al sani* under the *istisna'a*).

Under Shari'a principles, once leasing arrangements have commenced, the Islamic financier must remain liable to perform and pay for structural and major maintenance, to take out and pay for property insurance and to pay ownership taxes. Practically speaking it will usually not be in a position to handle these matters and also will not want to bear the cash flow effects of these payments. It will, therefore, usually appoint the customer (the lessee) to be its service agent to perform these functions and to make the payments.

Under the Shari'a (and most legal systems) an agent is entitled to be repaid expenses that it incurs on behalf of its principal. This means that any payments made by the service agent must be reimbursed by the Islamic financial institution. In reality the Islamic financier will usually not want to bear the ultimate liability for such costs. Accordingly, the rental payments will include a component (often called supplementary rent), which will equal the amount that the Islamic financier must pay by way of reimbursement to the service agent. As the lessee and the service agent are the same party, these two payment obligations are set off, with the result that the economic burden of these payments is borne by the customer.

There are issues that need to be considered in the context of the reimbursement obligation relating to the last rental period. Expenses incurred during this last rental period cannot be added to a rental amount (by way of supplementary rent) because the reimbursement obligation only arises at the end of the last rental period (i.e. at the end of the lease). Normally this amount is clawed back by being added to the exercise price that is paid by the lessee when the property is transferred to it at the end of the lease.

There will usually be two forms of undertakings or promises as part of these ijara arrangements. The first will be given by the Islamic financial institution and will usually permit the customer to terminate the leasing arrangements at any time upon notice and have the title to the property transferred to the customer against payment of a price.

The other is provided by the customer in favour of the Islamic financial institution in which the customer undertakes, upon notice from the Islamic financial institution, to purchase the title to the property for a price. It will also often deal with the transfer of title at the end of the lease for a nominal amount (and often including an amount that equals any reimbursement obligation owed to the customer, as the service agent, which has not been clawed back through rent).

There has been a debate recently within the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) about these types of undertakings in the context of *sukuk* and certain principles were included in a statement issued by AAOIFI on Sukuk. The principles mentioned in the statement may well also be applicable to *ijaras* that are not part of *sukuk* issues. The debate is still on-going as to the exact meaning of this statement and its actual implementation. However, in the context of *ijaras*, the general principle contained in the fifth paragraph of that statement that it is acceptable to calculate the exercise price by reference to the balance of unpaid fixed rent (the equivalent of principal), should be noted.

Murabaha

It is possible to use murabaha in relation to the financing of assets that are required as part of a construction project. This would, however, normally be a short-term facility.

Tawarruq

This structure has been used to create working capital facilities for certain projects. It is not a favoured product and many Islamic scholars do not accept it.

It involves the use of commodity contracts,

such as metals. The Islamic financier will purchase, at spot, various metals contracts for, say, $100,000. It will then sell those contracts to the customer on a *murabaha* basis (with title passing immediately and with payment being deferred for the agreed financing period – often short term). The customer will immediately sell the metals contracts to a broker (usually not the broker that sold the contracts to the Islamic financier) for spot (i.e. $100,000 less the brokers' charges). If increasing amounts of financing is required over an extended period, then, as each *murabaha* contract ends, it is replaced with a *murabaha* for a larger amount.

However, as stated above, many Islamic scholars do not accept this type of structure.

Mudaraba

A *mudaraba* is a contract in which an investor gives a cash amount to another person in order to use the asset to generate a profit which will be split between the parties. The person supplying the asset (such as money in the case of an Islamic financier, or investor) is called the *rabb al maa,l* and the manager is called the *mudarib*.

The *mudarib* will not, in that capacity, provide funds but will contribute its skill and expertise in deploying those assets to make a return. If there are no profits then the *mudarib* will not receive anything. It is acceptable for the *mudarib* to share in the profits as it is taking the risk of receiving nothing if the venture is not successful.

If there is a loss, the *mudarib* will not be responsible unless it was caused due to its negligence or default. It would appear that, under Shari'a principles, if a loss is proven, then the burden of proof is on the *mudarib* to show that it was not responsible for the loss.

The capital provided to the *mudarib* remains the property of the *rabb al maal*, which is why it bears any loss to the property (subject to the *mudarib* being liable on the grounds mentioned above). While the property is in the hands of the *mudarib*, he acts as a trustee in relation to that property in the sense that he is obliged to take care of it but he is not liable for any loss unless caused by his negligence or default. He can also be viewed as acting as the agent of the *rabb al maal* in deploying the property of the *rabb al maal*. It is also possible for the *mudarib* to be paid an incentive fee which is a technique often used to reduce the return to the Islamic financier to what would have been achieved under a conventional financing.

The *mudarib* should produce a business plan and a feasibility study relating to the proposed venture. It would normally be expected that projected (although not guaranteed) profits would be detailed. These documents could be very important if there were a loss because an analysis as to whether the *mudarib* had been negligence might be benchmarked against statements contained in these documents.

In the context of project financing, this structure has been used, including in relation to *sukuk*. Using this approach the investors would pass their funds to the developer. There would be a business plan and a feasibility study in which the developer would describe the types of real estate projects that it intended to invest in. The funds would be used to construct the properties and the proceeds from their sale or leasing, would be shared between the Islamic financier and the developer (as the *mudarib*).

Often there will be an undertaking or promise from the *mudarib* to purchase the interest of the *rabb al maal* at an exercise price but the same issues as have already been discussed with this type of undertaking or promise in relation to *ijaras*, also applies to *mudaraba* arrangements.

It is important to note that some Shari'a schools are of the opinion that the *mudaraba* contract cannot stipulate that the *rabb al maal* will have a role with the *mudarib* in the management of the *mudaraba* property. If there were such a condition, then the *mudaraba* would be void. It would appear that if a *rabb al maal* volunteers to perform such functions (and there is no obligation for it to perform such functions contained in the *murabaha* contract) then this would be acceptable.

The burden of proof is on the mudarib to show that it was not responsible for the loss

Musharika

In the context of real estate and project financing, a *musharika* would likely take the form of a partnership or joint venture (*sharikat al aqt*). Under this arrangement, the Islamic financier would contribute funds and the customer would contribute another asset, such as real estate or some other valuable Shari'a compliant asset related to the project.

The agreement would need to describe the capital contributions and the split of profits and losses, as well as the management responsibilities (which would normally be undertaken by the client who has the required knowledge and expertise).

The customer, as the managing partner, would then undertake the project using the funds and the other contributed assets in the construction and operation of the project. During the construction phase there would be no income being generated and so no profits. As such this type of structure would not usually, in and of itself, be attractive to an Islamic financial institution. In some instances, the Islamic financial institution's share in the partnership or joint venture has been leased to the customer and, in this way, the Islamic financial institution has been able to achieve the required returns, both during and after the construction phase.

Often there can be difficulties with this type of structure when tested against the applicable governing law(s). Some of these issues include the following:

- Does the partnership or joint venture need to be licensed and, if so, are there any fees to be paid, accounts to be filed, etc – all of which an Islamic financial institution would normally not want;
- In whose name would the assets be held? If it is an unincorporated joint venture, the assets might have to be held in the name of the customer – this raises credit risks on the customer;
- Does the transfer of property or property interests into and out of the partnership or joint venture trigger any transfer or documentary taxes or value-added or sales tax?;
- What liability issues attach to the Islamic financial institution being a partner owning the project?; and
- Would any critical documents (such as concession agreements) be capable of being terminated by the grantor if they had to be transferred to the *musharika*?

The resolution of these issues is sometimes not easy, especially if there are cross border matters to consider.

This article is an extract from the forthcoming handbook ***Islamic Finance: A Guide for International Business and Investment****, to be published by GMB Publishing Ltd.*
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Takaful

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Introduction

The word "takaful" means "guaranteeing each other". The concept of takaful or Islamic Insurance has been around for centuries and was practised by Muhajin of Mecca and the Ansar of Medina following the hijra of the Prophet over 1400 years ago. The main concept of takaful is to pool resources to pay for events/losses that individually none of the members of the pool could afford e.g. a group of people would collectively use their combined money to pay for one off events and large expenses such as births or marriages or if a financial loss were occur to a member of the group. It is a form of mutual insurance and is not dissimilar to the mutual co-operative schemes that existed in the Europe and the US.

The main principles of takaful are:

1. The customers (policyholders) of the takaful business agree to pool their contributions and share the liability of each policyholder. So if one policyholder has to be paid a claim, this is paid out of the combined pool of the policyholder contributions. This eliminates the principle of uncertainty ("Gharrar") which is not allowed within Islam as the policyholders agree to allow their contributions to be used to fulfil his/her obligations of mutual help to a fellow policyholder should they suffer a defined loss.
2. As with mutual insurance, the policyholders share in the profit and loss of the takaful business i.e. the policyholders all share the insurance risk – they do not give the risk to the takaful company (as occurs in a conventional shareholder insurance company). Consequently, if at the end of a financial year, the takaful business makes a surplus, this is shared between the takaful policyholders
3. If at the end of the financial year the participant fund makes a loss, this deficit is funded by a Qard Al-Hassan (interest free loan) from the shareholders. The shareholders are then repaid the loan from any future surpluses of the policyholders fund. The shareholders cannot access the capital from the policyholders fund except when the Qard Al-Hassan is being repaid.
4. The assets of the takaful business have to be invested in Sharia' compliant assets For example, investments can't be made in gambling institutions, businesses that make alcohol, businesses that sell weapons or assets that pay interest (or "Riba")
5. The operators of the business are paid explicit fees for setting up and running the company on behalf of the policyholder. These fees should cover all the setting up costs, running costs and profit loading of the shareholders and ar the only way that the shareholders are remunerated. After the fees are deducted, any surplus arising from the takaful business is shared amongst the policyholders only. These explicit fees are in the takaful contract that each policyholder signs with the takaful company and are fully transparent.

The takaful market is currently concentrated in Malaysia and the Middle East and has been experiencing significant growth rates. Some estimates are that the global takaful industry is growing at 10-20% per annum, compared to forecasts for the growth of conventional insurance of around 9% per annum in emerging markets and 5% per annum in OECD countries. Moody's has predicted that total takaful premiums will rise to $7bn by 2015. Some of the world's largest takaful companies envisage that about a third of their premiums will come from the West by 2020. The first pure takaful company (Principle Insurance Company Limited) has just been authorised by the FSA in the UK.

One of the key characteristics of takaful is that its products are price competitive with conventional insurance products. In developed takaful

markets (e.g. Malaysia), a significant proportion of the customers are non-muslim for this reason. Furthermore, takaful business is by its nature ethical – it's structured to benefit the policyholder, the funds are invested in ethically compliant funds and an independent group of advisors (Sharia' Board) opine that all of the ethical considerations have been met. In the UK, Europe and the US where consumers are increasing spending a greater proportion of their disposable income on ethical products (e.g. organic food), a competitively priced ethical insurance has the potential to be just as successful with non-muslim customers as it does with muslim customers.

Takaful – the key stakeholders

The key stakeholders in a modern takaful operation are the:

- Policyholders – the customers of the takaful business. They pay contributions to obtain a Sharia' compliant insurance policy; and
- Shareholders – the people who operate the business on behalf of the policyholders and provide the initial money to start running the business
- Sharia' Board – the Islamic scholars who opine on whether the products and operations of the Takaful business are sharia' compliant

Policyholders

The policyholders pay contributions to cover them for a sharia' compliant insurable loss (e.g. damage to their car in a motor accident).

As described above, the policyholders pool their contributions in a "policyholder fund" and use these pooled contributions to pay all the insurance claims of the company, as well as brokerage fees and reinsurance fees. At the end of the year any surplus excluding all claims and fees is distributed amongst the policyholders. This can occur in several ways:

1. To distribute the surplus to all the participants depending on the percentage of their contribution to the total contributions received;
2. To distribute to policyholders who did not make

any claim during their contract depending on the percentage of their contributions to the total contributions;

3. To distribute to all the participants but in the case that a policyholder made a claim then the policyholder will get a share of the surplus if the claim amount is less than the contributions;
4. Another methodology approved by the sharia' Board and the company's board of directors.

The surplus distribution can either be paid directly to the policyholder or be deducted from the policyholders next contribution (i.e. if they renew their Takaful contract).

Commonly both the shareholders fund and the policyholders fund are both within the takaful business.

Shareholders

The shareholders set up the takaful company for the purpose of managing the insurance risk of the policyholders. They are paid explicit fees by the policyholders to operate the takaful business on behalf of the policyholders. These explicit fees cover the expenses of running the company, plus an allowance for profit for the shareholders. Examples of expenses include the costs of recruiting and employing staff, the costs of providing IT systems, rent for buildings for the staff to work in and so on.

There are three major models for the shareholders to be paid by these fees and they are described in Section 3 below.

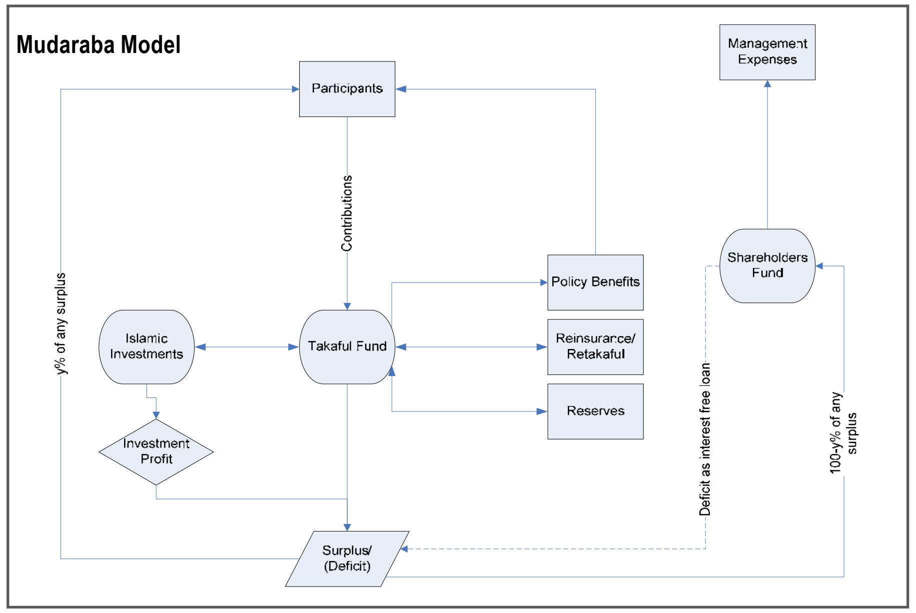
Sharia' Board

The Sharia' Board ensures that the operation of the takaful business complies with sharia' i.e. the Board opines on whether the business is "takaful" or whether it is acting in a way that would not be permissible within the sharia' rules. The Sharia' Board consists of a minimum of three economically educated sharia' scholars. Their main duties are to:

1. Ensure that all the Takaful products are compliant with sharia' rules;
2. Approve the sharia' compliance of technical operations of the company;
3. Approve that the structure of the takaful business (see section 3 below for examples of different takaful structures) is compliant with sharia';
4. Advise the company on the sharia' compliance and provide any fatwa if needed;
5. Check the company's files on an ad-hoc basis to ensure sharia' compliance; and
6. Publish a report if required at the end of each financial year to confirm the sharia' compliance of the company's activities.

Main Takaful Models/Structures

Several models have been developed around the world to allow the shareholders and policyholders to set up takaful businesses in an sharia' compliant manner.



All the models described below allow the shareholders to be paid explicit fees by the policyholders. These fees generally cover two areas:

1. Fees paid to the shareholders for setting up and running the company on behalf of the policyholder; and
2. Fees paid to the shareholders for investing the policyholders fund on behalf of the policyholder.

Mudaraba Model

This is known as the profit sharing model. The shareholders share in the profit or loss with the policyholder. In this model, the shareholders are paid:

1. A pre-agreed proportion of any surplus generated by the policyholder's fund in return for running the insurance operations of the takaful business on behalf of the policyholders. If the policyholder fund makes a loss, the operator does not share the losses although it will provide the Qard Al-Hassan to cover this loss; and
2. A pre-agreed proportion of any investment income from investing the policyholders' fund's assets on behalf of the policyholder.
3. The pre-agreed proportions are agreed at the beginning of each financial year.

Wakala Model

In the Wakala model the shareholders acts as an agent (wakil) to the policyholders. In this model, shareholders are paid:

1. A pre-agreed proportion of the contributions paid by the policyholders in return for running the insurance operations of the takaful business on behalf of the policyholders. As with the Mudaraba model, if the policyholder fund makes a loss, the operator does not share the losses although it will provide the Qard Al-Hassan to cover this loss; and
2. A pre-agreed proportion of the policyholders' investment fund in return for running the investment of the policyholders' investment fund on behalf of the policyholder.

The figure gives an overview of the model.

Hybrid Model

This is a mix between the Wakala and Mudaraba model and is widely used in the Middle East countries excluding Saudi Arabia:

1. A pre-agreed proportion of the contributions paid by the policyholders in return for running the insurance operations of the takaful business on behalf of the policyholders i.e. "Wakala" model for the contributions; and
2. A pre-agreed proportion of any investment income from investing the policyholders' fund's assets on behalf of the policyholder i.e. "Mudaraba" model for the investments.

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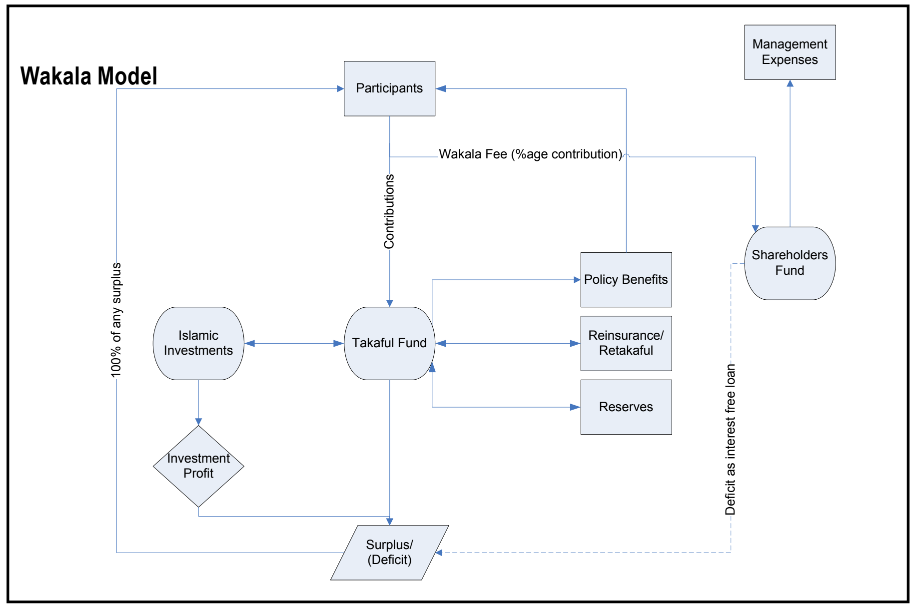

Waqf Model

There was considerable debate within Pakistan amongst Islamic Scholars as to whether "contributions" were really charitable donations. In response to this, the Sharia' scholars in Pakistan developed a model called Wakala Waqf Model (known as the Waqf model).

In the Waqf model, the policyholders fund is replaced by a charitable trust fund i.e. the Waqf fund. Under the Waqf model, part of the capital of the shareholders fund is donated to create the Waqf fund. In all other respects, the Waqf model works as the Hybrid model.

The Waqf model is currently only used in Pakistan and South Africa.

Practical considerations

Shareholder incentivisation

The takaful structures described in Section 3 are theoretical structures. In practice, there are often variatins to the above models to incentivise the shareholders of the company to generate increased surpluses for the policyholders. For example, shareholders can often be paid "incentivisation fees" which can take the form of:

- bonus pre-agreed share of any surplus generated if the surplus is greater a certain proportion of the policyholders fund
- bonus pre-agreed share of any investment income if the investment income return is greater than a pre-agreed percentage

Further in some companies, the Wakala and Mudaraba fees are defined as being to cover the shareholders' profit expectations i.e. the expenses incurred by the shareholders in running the company and in running the investment of the policyholders fund are paid by the policyholders and additional fees are paid to the shareholders. This was used by some companies to stop the shareholders running the risk of being paid fees that didn't cover the expenses of running the company.

Qard Al-Hassan

In all of these variations, the Qard Al-Hassan is still paid if the policyholders fund makes a deficit in one financial year.

There is at least one takaful company where the policyholders fund is not paid a Qard Al-Hassan if the policyholders fund makes a deficit in one financial year. In this scenario, the policyholders fund will contain some of the money from the shareholders ("contingency fund") to cover the possibility of the policyholder fund going into deficit. Essentially the shareholders have made a Quad Al-Hassan at the beginning of the life of the takaful business. As the policyholders fund make surpluses, it will replace the shareholders contingency fund with some of this surplus money and repay the shareholders for putting their money in the policyholders fund.

Retakaful

As with conventional insurance, often the takaful business may need to Islamically insure itself in case it suffers a lot of unexpected losses at the same time (e.g. floods in an area where many policyholders have personal household takaful policies) or a very large unexpected loss (e.g. if the takaful business insured an oil rig offshore and this oil rig sank), This islamic insurance of the takaful business is known as retakaful.

Currently there is a dearth of strongly rated insurance retakaful companies. A strong insurance rating is important as the takaful company would only Islamically insure itself if it knew that the big loss(es) that may impact the takaful company adversely would not impact the retakaful company adversely and they may look to the insurance rating as a proxy for this insurance strength. At the time of writing, there are only three retakaful companies and retakaful windows that have a rating of A- or above and there are less than 20 retakaful entities in the world.

This lack of retakaful capacity and strongly rated retakaful capacity presents takaful companies with a quandary as they need to buy retakaful but there isn't the capacity. Sharia' boards have recognised this problem and are currently allowing takaful companies to reinsure their business with conventional reinsurers.

Investment Compliance

As part of Sharia' compliance, takaful businesses should invest their assets within Sharia' compliant assets. However, given the rapid growth of takaful entities, it may not be possible to invest all the assets within Sharia' compliant assets and also meet local regulatory rules on asset investment which are designed to protect policyholders by ensuring that companies don't invest within risky investments or have too great a reliance on one asset.

Many of these investments that are allowable under local regulatory requirements (e.g. bonds) are not Sharia' compliant. Even if there are suitable Sharia' investments, there may not be enough of them e.g. if there is only one Sukuk bond available for a takaful company to invest in, the company may fall foul of local regulations concerning "concentration risk" i.e. the local regulator may want its companies to be invested in at least three Sukuk bonds – not just one. Currently there is a shortage in Sharia' compliant investments that Takaful business can invest in. The only option for Takaful businesses in the short term is for their Sharia' boards to allow them to invest in non-Sharia' compliant but ethically allowable investments.

*This article is an extract from the forthcoming handbook **Islamic Finance: A Guide for International Business and Investment**, to be published by GMB Publishing Ltd.*

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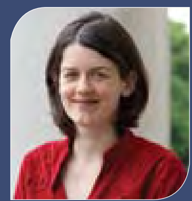

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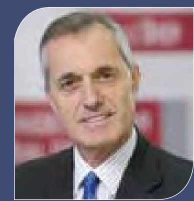

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Glossary of terms

Arboon See Bai Al Arboon

Al Ajr A commission, fees or wages levied for services.

Amana/Amanah Reliability or trustworthiness. Important value of Islamic society in mutual dealings. It also refers to deposits in trust. A person may hold property in trust for another, sometimes by implication of a contract.

Al Wadia Resale of goods at a discount to the original cost.

Al Wakala Absolute power of attorney.

Al Rahn Al Arrangement where an asset is used as collateral for a debt, similar to pawn broking. In default the asset can be sold to repay the debt.

Bai al Arboon Form of sale contract similar to an option, where only a small portion of the price is paid. The buyer will then hold an option for a specific length of time (days or months but not more than one year) to either go through with the purchase or cancel the contract. If he decides, during or at the last day of the option period, to go through with the purchase, he will than have to pay the rest of the price. If he decides to walk out then the portion of the price, which has been paid, is retained by the seller.

Bai al Muajjal Deferred Payment Contract, where the bank or lendor buys the assets on behalf of the business owner. The bank then sells the assets to the client at an agreed price, which will include a mark-up since the bank needs to make a profit. The business owner can pay the total balance at an agreed future date or pay by installments over a pre-agreed period. This is similar to a Murabaha contract since it is also a credit sale.

Bai al Dayn Debt financing: the provision of financial resources required for production, commerce and services by way of sale/purchase of trade documents and papers. Bai al-Dayn is a short-term facility with a maturity of not more than a year. Only documents evidencing debts arising from bona fide commercial transactions can be traded.

Bai al Muzayadah Sale by auction, other names for this principle used by past Islamic jurists include bai al fuqara', bai al` man kasadat bidha'atuhu, bai al mahawij, and bai al mafalis.

Bai al Salam This term refers to advance payment for goods which are to be delivered later. Normally, no sale can be effected unless the goods are in existence at the time of the bargain. But this type of sale forms an exception to the general rule provided the goods are defined and the date of delivery is fixed. One of the conditions of this type of contract is advance payment; the parties cannot reserve their option of rescinding it but the option of revoking it on account of a defect in the subject matter is allowed. It is usually applied in the agricultural sector where the bank advances money for various inputs to receive a share in the crop, which the bank sells in the market.

Bai Bithaman Ajil This contract refers to the sale of goods on a deferred payment basis. Equipment or goods requested by the client are bought by the bank which subsequently sells the goods to the client an agreed price which includes the bank's mark-up (profit). The client may be allowed to settle payment by instalments within a pre-agreed period, or in a lump sum. Similar to a Murabaha contract, but with payment on a deferred basis.

Baitul Mal Treasury.

Fatwah A religious opinion or decree, which can be either positive or negative

Fiqh Islamic jurisprudence. The science of the Shariah. It is an important source of Islamic economics.

Gharar Uncertainty, hazard, chance or risk. Technically, sale of a thing which is not present at hand; or the sale of a thing whose consequence or outcome is not known; or a sale involving risk or hazard in which one does not know whether it will come to be or not, There are several types of gharar, all of which are haram The root Gharar denotes deception. Bai' al-Gharar is an exchange in which there is an element of deception either through ignorance of the goods, the price, or through faulty description of the goods. Bai' al-Gharar is an exchange in which one or both parties stand to be deceived through ignorance of an essential element of exchange. Gambling is a form of Gharar because the gambler is ignorant of the result of his gamble.

Halal That which is permissible. In Islam there are activities, professions, contracts and transactions which are explicitly prohibited (haram). Barring them, all other activities, professions, contracts, and transactions etc. are halal

Hawala Bill of exchange, promissory note, cheque or draft.

Haram Unlawful.

Ijara Leasing, where the bank or financier buys and leases equipment or other assets to the business owner for a fee. The duration of the lease as well as the fee are set in advance. The bank remains the owner of the assets. The benefit and cost of the each party are to be clearly spelled out in the contract so that any ambiguity (Gharar) may be avoided.

Ijarah wa Iqtina Lease to purchase, where a lendor finances an asset against an agreed rental together with an undertaking from the client to purchase the equipment or the facility. The rental as well as the purchase price is fixed in such a manner that the bank gets back its principal sum along with some profit which is usually determined in advance.

Ikhtilat Combining of invested capital in a partnership into one single amount so that individual contributions cannot be identified.

Istisna Progressive financing, a contract where goods are purchased in part progressively in accordance with the progress of a job. This type of financing along with bai salam are used as purchasing mechanisms, and murabaha and bai muajjal are for financing sales.

Ju'alal Lit: stipulated price for performing any service. Technically applied in the model of Islamic banking by some. Bank charges and commission have been interpreted to be ju'ala by the jurists and thus considered lawful.

Juzaf Goods sold in bulk

Mal Wealth

Maqasah Clearance of mutual debts.

Maslahah Public interest, social welfare – a condition of society that Shari'a is committed to protect and maintain

Mudaraba / Modaraba Trust Financing, a business contract in which one party brings capital and the other effort. The proportionate share in profit is determined by mutual agreement. But the loss, if any, is borne only by the owner of the capital, in which case the entrepreneur gets nothing for his labour. See Rab-al-Maal as well.

Mudarib The manager of the investment in a mudarabah contract – the entrepreneur rather than the investor.

Mu'amalah / Mu'amalat Economic transaction.

Murabaha / Morabaha Cost-Plus Financing. Technically a contract of sale in which the seller declares his cost and profit. Where the client asks the lendor to purchase a specific asset for them. The lendor does this for a defined amount over the cost of the asset, which is agreed in advance.

Musharaka Similar to venture capital. Musharaka is a technique of financing partnership, where two or more financiers provide finance for a project. Profits are shared in a mutually agreed ratio however, the losses, if any, are to be shared exactly in the proportion of capital proportion.

Diminishing Musharaka - permits equity participation and sharing of profit on a pro rata basis but also allows a method through which the bank keeps on reducing its equity in the project and ultimately transfers the ownership of the asset on of the participants. Musharaka form of financing is being increasingly used by the Islamic banks to finance domestic trade, imports and to issue letters of credit.

Permanent Musharaka – where an Islamic bank participates in the equity of a project and receives a share of profit on a pro rata basis. The period of contract is not specified. This technique is suitable for financing projects on a longer term where funds are committed over a long period and gestation period of the project may also be protracted.

Muthman Subject of a sale

Qard A loan. Shari'a practice is that loans should be made free of charge, ie with no interest payable – Qard Hasan below.

Qard Hasan Interest free loans. Islamic banks normally provide interest free loans (Qard Hasan) to their customers. If this practice is not possible on a significant scale, even then, it is adopted at least to cover some needy people. Islamic view about loan (Qard) is that it should be given to borrower free of charge.

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

Qist Fair dealing

Rab-al-maal In a mudaraba contract the person who invests the capital.

Riba Effectively means "interest" and is one of the three fundamentals prohibitions in Islamic finance (the other two being Gharar and Maysir). Literally meaning an "increase" or "addition", technically it denotes any advantage obtained by the lender as a condition of the loan. Any risk-free or "guaranteed" rate of return on a loan or investment is riba. Riba, in all forms, is prohibited in Islam.

Rukn Cornerstone of a contract, an essential requirement

Sadaqah Charitable giving.

Shariah / Sharia / Shari'a Islamic law derived from three primary sources: the Quran; the Hadith (sayings of the Prophet Muhammad); and the Sunnah (practice and traditions of the Prophet Muhammad), and three secondary sources Qiyas (Analogical deductions and reasoning), Ijma (Consensus of Islamic Scholars) and Ijtihad (Legal reasoning).

Shariah Board The committee of Islamic scholars available to an Islamic financial institution for guidance and supervision on religious interpretation and application in the development of Shariah compliant products.

Shirkah A contract between two or more persons who launch a business or financial enterprise to make profit. Shirka = musharaka.

Suftajal A banking instrument used for the delegation of credit and was used to collect taxes, disburse government dues and transfer funds by merchants. In some cases suftajahs were payable at a future fixed date and in other cases they were payable on sight. Suftajah is distinct from the modem bill of exchange in some respects. Firstly, a sum of money transferred by suftajah had to keep its identity and payment had to be made in the same currency. Exchange of currencies could not take place in this case. Secondly, Suftajah usually involved three persons. 'A' pays a certain sum of money to 'B' for agreeing to give an order to 'C' to pay back to 'A'. Third, a Suftajahs could be endorsed.

Sukuk Equivalent to an asset backed fixed income bond. A certificate entitling the holder to the benefits of the income stream of the assets backing the certificate. Sukuks can be listed and rated, though this is not necessary, depending on the target investor market. Sukuks are typically issued by corporate issuers, and some Financial Institutions, and also by Governments.

Takaful This is a form of Islamic insurance based on the Quranic principle of Ta'awon or mutual assistance. It provides mutual protection of assets and property and offers joint risk sharing in the event of a loss by one of its members. Takaful is similar to mutual insurance in that members are the insurers as well as the insured. Conventional insurance is prohibited in Islam because its dealings contain several haram elements including gharar and riba, as mentioned above.

Tawarruq Reversed murabaha.

Tawliyah Sale at cost

Wa'ad Literally a "promise". In Islamic finance associated with "swaps", a promise agreement with which returns from one basket of assets are swapped with returns from another; controversially this mechanism is being used to give Shariah compliant investors exposure to returns from haram, or non-Shariah compliant, assets.

Wadiah Safekeeping, in which the bank is deemed as a keeper and trustee of funds.

Wakala An agency contract

Wakil An agent or general representative

Waqf Similar to placing an asset, particularly property, in Trust. Technically appropriation or tying-up of a property in perpetuity so that no proprietary rights can be exercised over the usufruct. The Waqf property can neither be sold nor inherited or donated to anyone. The plural of Waqf is Awqaf.

Zakah/Zakat Zakah is the third pillar of Islam, it is a levy on wealth which is defined by the Quran on all people having wealth above a prescribed level, the levy must be spent on any of eight categories of beneficiaries. The purpose is to redistribute wealth from the wealthy to the needy. It is levied on cash, cattle, agricultural produce, minerals, capital invested in industry, and business etc. The distribution of Zakah fund has been laid down in the Qur'an (9:60) and is for the poor, the needy, Zakah collectors, new converts to Islam, travellers in difficulty, captives and debtors etc. It is payable if the owner is a Muslim and sane. It is an obligatory contribution which every well-off Muslim is required to pay to the Islamic state, in the absence of which individuals are required to distribute the Zakah among the poor and the needy as prescribed by the Shariah.

Islamic Finance Standard Setting and International Organisations

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) www.aaoifi.com
an Islamic international autonomous non-for-profit corporate body that prepares accounting, auditing, governance, ethics and Shari'a standards for Islamic financial institutions and the industry. It is based in Bahrain.

Arbitration and Reconciliation Centre for Islamic Financial Institutions (ARCIFI)

General Council of Islamic Banks and Financial Institutions www.cibafi.org (under construction at time of publication)
an international autonomous non-profit corporate body represents Islamic banks and financial institutions and the Islamic financial industry globally. It is based in the Kingdom of Bahrain.

International Islamic Financial Market (IIFM) www.iifm.net
an infrastructure institution with the mandate to take part in the establishment, development, self-regulation and promotion of Islamic Capital and Money Market. was founded with the collective efforts of the central banks and monetary agencies of Bahrain, Brunei, Indonesia, Malaysia, Sudan and the Islamic Development Bank based in Saudi Arabia. It is based in Bahrain.

Islamic Financial Services Board (IFSB) www.ifsb.org
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 banking, capital markets and insurance sectors. It is based in Kuala Lumpur, Malaysia.

Islamic International Rating Agency (IIRA) www.iirating.com
is the sole rating agency established to provide capital markets and the banking sector in predominantly Islamic countries with a rating spectrum that encompasses the full array of capital instruments and specialty Islamic financial products, and to enhance the level of analytical expertise in those markets. It is owned by a spread of Islamic financial institutions and is based in Bahrain.

Islamic Development Bank (IDB) www.isdb.org
a Multilateral Development Bank (MDB), established to foster the economic development and social progress of its member countries and Muslim communities in non-member countries in accordance with the principles of Shari'ah (Islamic Law). It is Headquartered in Jeddah, Saudi Arabia.

Islamic Corporation for the Development of the Private Sector
Established by the IDB in 1999, the mandate of ICD is to support economic development of its member countries through provision of finance to private sector projects in accordance with principles of the Sharia'h through promoting private sector development. ICD also provides advice to governments and private organizations to encourage the establishment, expansion and modernization of private enterprises.

The Islamic Corporation for Insurance of Investments and Export Credits (ICIEC) www.iciec.com
Shariah compatible Export Credit and Investment Insurance and Reinsurance in Member Countries. It is affiliated to the IDB.

Islamic Research and Training Institute (IRTI) www.irti.org
Established in 1981 to undertake research and provide training and information services in the member countries of the Islamic Development Bank and Muslim communities in non-member countries to help bring their economic, financial and banking activities into conformity with *Shari'ah* and to further economic development and cooperation amongst them. It is a subsidiary organisation of the IDB.

International Islamic Trade Finance Corporation (ITFC)
Established to promote trade of the IDB member countries through providing trade finance and engaging in activities that facilitate intra-trade and international trade. It is part of IDB.

The World Waqf Foundation (WWF)
A leading international institution that seeks to preserve and develop Awqaf in conformity with Sharia, sound economic and practical thinking, professional and transparent method. It is part of IDB.

Liquidity Management Centre (LMC) www.lmcbahrain.com
established for the purpose of facilitating the investment of the surplus funds of Islamic banks and financial institutions into quality short and medium term financial instruments structured in accordance with the Shari'a principles. It is based in Bahrain.

Organisation of the Islamic Conference (OIC) www.oic-oci.org
the second largest inter-governmental organization after the United Nations which has membership of 57 states spread over four continents. The Organization is the collective voice of the Muslim world, ensuring to safeguard and project the interests of the Muslim world in the spirit of promoting international peace and harmony among the various peoples of the world. Its General Secretariat is based in Jeddah, Saudi Arabia.

As well as these Sharia'h focused organizations there are a large number of bodies that are involved with financial provision on a global scale and that have Islamic Finance responsibilities as part of their remit. These include:

Bank for International Settlement (BIS) incl Financial Stability Forum www.bis.org

Basel Committee on Banking Supervision (BCBS) www.bis.org/bcbs

International Accounting Standards Board (IASB) www.iasb.org

International Association of Deposit Insurers (IADI) www.iadi.org
which has a dedicated Islamic Deposit Insurance Committee for carrying out research for its members and other stakeholders.

International Association of Insurance Supervisors (IAIS) www.iaisweb.org

International Monetary Fund (IMF) www.imf.org

International Organization of Securities Commissions (IOSCO) www.iosco.org