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In my career, I have been to many Islamic finance conferences across the globe. I have met dynamic individuals with creative ideas, dedicated leaders with an acute focus, and prominent policymakers that shape economic relationships. Many argue that these conferences are becoming repetitive, and serve no real benefit. I disagree. Even as I become a seasoned attendee, I still gain, however little, from these conferences. There will always be something new to learn, someone new to meet.

Conferences are also statements of intent whatever the headline topic may be. The 9th World Islamic Economic Forum, held between the 29th and 31st October, at the Excel in London was undoubtedly a statement of intent. A concordia of passionate Islamic financial practitioners, ethical businessmen, and world leaders congregated to extol the virtues and principles of Islamic economics. On the first day alone, 15 world leaders amassed creating what one commentator described as the Muslim Davos.

And in this arena, Conservative leader and British Prime Minister, David Cameron announced the UK government’s intention to make London an Islamic Finance hub through the issuance of a sukuk by 2014, and the creation of an Islamic index. The Mayor of London, with his guffawing buffoonery and strange mix of intelligence and wit, stomped through the halls of the Excel, symbolising his intent of bringing Islamic financial business into the country. Baroness Warsi, another Conservative politician, proudly witnessed the results of her efforts in bringing WIEF into the UK. In previous speeches, she has recognised the potential of Islamic economics to counter the worst aspects of capitalism.

The Islamic finance industry was delighted, pleased with such support; delighted with the grandeur of the occasion. But I felt a slight degree of sadness. Yes, I am proud Islamic finance has risen from the backwaters of Egypt to become a global industry; yes, I am proud that Muslims are securing top positions in multinational organisations; and yes, I am proud that the Islamic finance system is being acknowledged as a real alternative to the conventional system. But there remains a worry in me, eloquently summarised by the Prince of Wales.

In a speech at the WIEF, Prince Charles concisely addressed the encroaching environmental problems caused by the intense productivity resulting from global capitalism as it is practiced today. As an economist, we acknowledge that scarcity is the foundation from which the theory of demand and supply with the associated concepts of quantity and price are formulated. So with greater and more efficient extraction of resources, natural are diminishing, prices are increasing and wealth is concentrating into the hands of a few. All this does not bode well for the planet.

Without a planet that can sustain its inhabitants, then what use is finance? To put it another way, and more provocatively, what value does Islamic finance offer if it fails to address the myriad of problems that the world is currently suffering from? Prince Charles threw the gauntlet down for the industry to prove itself as a true alternative that meets the needs of society. His reference to the Quran suggests that he is well aware of what Islamic finance can offer, but by offering the challenge, beneath the lines, the Prince of Wales was expressing disappointment at the current guise of Islamic finance.

We in the industry cannot let the industry be hijacked by parochial aims and programmes that create disparity. This is not to say that the industry is doing such, but it is to say that it is a real possibility. This month’s issue of ISFIRE focuses on certain positive and negative issues in Islamic finance, and Islamic economics as a whole. The reader may feel there is some negativity in the tone. We do not wish to be. But we have to be constantly aware of the challenges. The world is crying out for a more equal system. Islamic finance cannot then rest on its growth rates and political support, especially by those whose horizons are limited by time and social pressure. There is too much good the industry, and the broader Islamic economy, is giving to the world. We celebrate this, but we should not rest on our laurels.

Given that the world’s already depleted natural capital is subject to ever rising demand, I wonder, firstly, whether you have the criteria in place, the structures and tools, to enable the effective management of the emerging threats I have mentioned? And, secondly, can you actively consider how the vast financial resources that your organizations manage could best be deployed to reduce the systemic risks and deliver better education and vocational training to create jobs and small enterprises?

- His Royal Highness, Charles, Prince of Wales

From the Editor

Professor Humayon Dar, PhD (Cambridge)
Editor-in-Chief
The issue of social responsibility in Islamic banking and finance has been under the microscope. This reflects two things: the type of expectations Muslims have from Islamic banking, and the failure of Islamic banks to perform their perceived social role. However, it is unclear whether consideration of social good is embedded in current Islamic financial transactions, so that whenever they occur in banking a social good is to be expected, or that the social good is something Islamic banking should undertake and seek. One should not overlook the fact that Islamic banks are not charitable institutions, but rather profitable ones entrusted with investing depositors' money, and that with the absence of independent charitable organizations, whose establishment is the responsibility of the Muslim treasury under the Muslim state, blame cannot be apportioned to Islamic banks. Nevertheless, the query remains valid if upholding social responsibility comes at no additional financial cost or loss to the Islamic bank and remains a matter of preference influenced by extra caution and subjective assessment of the potential returns.

Islamic financial transactions, if executed properly, genuinely and with full observance of their Shari'a rules and conditions, do carry within some embedded good. Nevertheless, contracts remain merely tools so they need to be directed to serve a particular purpose. If this purpose is towards the social good, then it must be established in advance and worked upon. The Muslim public has legitimate demands and rights over Islamic banks. If these demands are met, the social good will come about automatically. These legitimate demands relate to the right application of Shari'a rules since by using "Islamic" as an ascription grants the right to all Muslims to demand from these commercial institutions full adherence to the Shari'a.

Islamic banks, by associating their banking activities with Islam, are supposed to fully abide by Shari'a rules and uphold, at least, cost-free social responsibility. Doing so requires no show of gratitude by Muslims towards these institutions. However, based on the writer’s experience from working for Islamic banks, in order for Islamic banks to fulfill this objective, they must undergo a change in perspectives.
What to reform in Islamic banking?
Upholding a social responsibility necessitates reformation in the following fields:

A: The financed sectors
Islamic banks should do the following:
- Relax stringent criteria set by Islamic banks to provide financing to small and medium enterprises, and not favor bigger enterprises due to better credit evaluation.
- Select financed projects on the basis of their optimal outcomes and their possible contribution to the welfare of the society.
- Invest in economies of Muslim and developing countries; not in developed economies, or in ways that eventually feed evil purposes.
- Reduce the finance of luxury goods and services and opt for the finance of capital goods and assets.
- Restrict the products that normally encourage unnecessary debt like credit cards and personal financing.

B: The internal policies
In this field Islamic banks should do the following:
- Observance of justice when determining fees and fines, since high fees burden clients and may lead to a move from Islamic banks to conventional banks.
- Take genuine risk of financing underlying contracts and not shift that risk to financed clients, as this practice could unjustly burden clients and impact their ventures.
- Desist from playing around with Shari’ा rules to appropriate capital and return guarantees from the clients financed on equity basis. This practice renders the financing conventional in essence and thus leads to the same economic and social evils of usury.
- Manage the charity fund to support social causes instead of seeking fatwas to legalize redirections of funds for the benefit of the bank.

The nature of Islamic financial products
Islamic banks can never play a positive role in society unless they distance themselves from the evils of riba. However, this will never materialize if Islamic banks persist on seeking legitimacy for their products by adhering only to the technical requirements of contracts. Just like packaging and labeling a bottle of wine in the same way as a fruit juice is packaged and labeled will not eliminate the evils of wine, executing a riba-bearing transaction with the use of Shari’ा terms and technicalities will not either change the fact that it is riba. In fact, riba was prohibited for its evils and the means used to reach it has no consideration in this prohibition. In the Holy Quran we read that some Jews were punished because they persisted with riba transactions (Quran, 4: 161). Commentators mention that their persistence was indirect; i.e. through apparently valid transactions executed to reach the same end result of riba. Ibn Abbas was reported to have said that they dealt in riba through manipulation of certain sale contracts.

Therefore, maintaining a sufficient distance from riba entails a full departure from all riba tricks and means, and only then Islamic banks will be able to genuinely uphold social responsibility. Taking riba with one hand and paying charity with the other will not do society any good. No matter how benevolent and merciful Islamic banks may be in paying charity or pricing their products, they will fail to bring in prosperity to society if their products are similar to conventional products.

The basic Shari’ा requirements in product structuring
For the validity of any transaction, Shari’ा dictates that the underlying contract must fulfill certain conditions. Some of these conditions relate to the contractual parties, like being eligible to initiate agreements and having legal capacity. Others relate to the contract itself being independent and unconditional on the occurrence of something else. The subject matter of the contract needs also to be in line with the Shari’ा. Having fulfilled all the structural requirements, the contract must also harmonize itself to meet, or at least not to be in conflict with the objectives of Shari’ा since an apparently valid contract may be misused to reach a prohibited end, or its implementation may result in causing serious harm to the contractual parties or society in general.

It must be carefully observed that Shari’ा clearance of products can be legitimately claimed only after two different categories of Shari’ा requirements have been fulfilled. The first category relates to the structural conditions of the underlying contracts, i.e. the form of the product, while the second category relates to the essence, spirit and implications of the product. Both categories are equally important and essential in product development. Unfortunately, this balance has not been fully observed in many Islamic financial products. It is tilted in favor of the first category at the expense of second.

The current methodology used for product development in Islamic finance
What characterizes the current methodology of product development in Islamic finance in general is failing to look beyond the product’s formal and structural conditions. Although maintaining a proper form is a Shari’ा requirement, it is also a Shari’ा requirement to maintain the proper substance. In fact, a careful study of the literature of Islamic law reveals that in contracts, the form is meant to protect the substance. In many Fiqh applications, it is noticeable that schools of Islamic law have somehow compromised some aspects of the contract’s form but never compromised the contract’s essence or spirit. Some modern practices of Islamic financing product development resemble the opposite: taking care of form and neglecting the substance of contracts.

The negligence of contract substance is reflected in different practices as in the following:
- Negligence of the contract substance by the deactivation of some contract rules

Contracts’ rules and conditions are meant
Islamic banks have to acknowledge the fact that not all conventional products can be Islamized, and that any attempt to this effect will yield nothing but a product borrowing its legitimacy from adherence to mere technicalities and complex structuring.

to enable the contract to serve its purpose in fulfilling the contractual parties’ needs in a just, positive and productive manner. This explains why contractual parties in Shari’a are not allowed to make personal stipulations that annul the contract rules. Naturally, a contractual party, when given an absolute right in making stipulations, will try to ensure his favour even if it is at the expense of the other. However, in some cases we find, especially in uqud al-ez’an (contracts of subjection), only one party of the contract formulates the contract, that some contracts rules are indirectly neutralized by adjusting some clauses or incorporating new ones as in the case of Ijara Muntahia Bittamlik.

- **Negligence of the contract substance by attaching another contract**

Contracts of finance in the Shari’a are meant to fulfill the various needs of the contractual parties, like acquiring an asset, acquiring an asset’s usufruct, investment of capital and delegation of authority. However, the objectives can be twisted especially when the basic contract is followed by reversing contracts.

Murabaha, which is a sale contract originally designed in its banking application to finance clients in their acquisition of assets, is used for a different objective altogether. It is used to provide clients with cash money. Clients receive the desired cash but remain indebted to the bank for the murabaha deferred price. To construct the contemporary murabaha, there are two independent sale contracts, each of them lawful in itself, but the end result of executing them consecutively is a cash financing technique which is effectively no different to conventional cash financing. Obviously, the result of this transaction is against the substance of the murabaha sale contract. Murabaha in this transaction does not lead to asset ownership by the client. This is a deviation from the objective and substance of the murabaha, which is intended to be a commodity financing instrument that helps clients own their desired assets.

- **Negligence of the contract substance by the misapplication of the contract**

Contemporary collective fatwas have helped structure many products that are essential for the operation of Islamic financial institutions. However, the application of some of these products has deviated from what they were originally designed for. Islamic finance has developed certain tools to hedge against some inevitable market risks. These tools include unilateral binding promises and instruments whose underlying contracts are salam contract and urbun sale. Many of these hedging instruments are hardly distinguishable from that of a conventional derivative with the speculation element embedded therein. To construct these instruments, contractual parties often speculate on the movement of the value of the reference asset, which is mostly an index. It is very likely that such structures may evolve to involve financing the client to purchase shares, then settling the deal with the loser of the two parties paying the price difference to the other.

**Reasons for neglecting the contract’s substance in some Islamic financing products**

A direct examination of Islamic banking market conditions and products reveals the following reasons for any deviation from the true rules of Shari’a.

1. **The desire to offer the same financing facilities as conventional banks**

Conventional banks treat money as a commodity. They have no problem in providing cash financing to clients for a profit. This cash financing can take the form of personal loans, overdraft facilities or refinancing, all essentially interest-bearing loans. However, since lending money on interest is prohibited, Islamic banks willing to offer these profitable financing facilities have to design certain products that serve such purposes. Logically, the designed products necessarily lose the Shari’a spirit and breach the contract’s essence because they are basically meant to fulfill unlawful objectives, i.e. profiting from providing cash to clients. The structured products rely on bogus operations of selling and buying commodities, using mostly highly controversial ina and tawarruq as their underlying contracts. In fact, the sale
contract is designed to help people acquire commodities for their own use or to resell them and make profit, but it is not designed to justify unlawful dealing in cash by buying expensive and selling cheap simultaneously. This is a deviation from the purpose of the sale contract and a defeat of the purpose behind the riba prohibition. If engaging in cash financing with a mark-up through the technicalities of sale contracts like ina or tawarruq is halal, then the whole purpose behind the riba prohibition would be defeated.

2. The unwillingness to bear genuine property/contracts risks

Being financial institutions, Islamic banks tend to avoid as much as possible the risk that is normally embedded in contracts used in product structuring. This avoidance of risk leads to depriving contracts of their Shari’a identity and rendering them spiritless. The liability risk related to the ownership of the leased asset is effectively transferred from the bank to the client and thus the essence of the lease contract is distorted. Murabaha is another example when the bank frees itself from the liabilities associated with the contract.

3. Legal constraints facing the right application of Shari’a rules in products

In some countries the legal system stands as a stumbling block to the proper application of Shari’a rules required for product structuring in Islamic finance. Some Islamic banks, for example, find it inescapable to make the purchase appear in the client’s name, because according to some laws, banks are not allowed to trade in assets. Others are prohibited from leasing assets to clients and therefore they are left with no choice but to dodge and execute ijarah in the form of sale. Imposing high taxes on registration of assets purchased is also a legal constraint as it eventually leads to increasing costs for clients when banks are commanded by law to register in their names what they buy before they sell to clients. Some banks tend to avoid payment of high taxes by reducing necessary contractual steps or faking some contracts.

Are these reasons justifiable?

Legal constraints can justify some leniency and indulgence when necessary; however, Islamic banks have no excuse in following the example of conventional banking offering the same products regardless of whether a particular product is capable of becoming Shari’a compliant. Islamic banks have to acknowledge the fact that not all conventional products can be Islamized, and that any attempt to this effect will yield nothing but a product borrowing its legitimacy from adherence to mere technicalities and complex structuring. The avoidance of inherent risks to the degree of twisting contracts and deforming their nature is not justifiable either. In fact, it is necessary for Islamic banks to note that they become distinguished from conventional banks only when they genuinely submit to Shari’a rules and maintain the nature and essence of Shari’a contracts. The mere maintenance of classical contracts, such as the murabaha, technicalities and terminologies does not render contracts in compliance with Shari’a rules. This issue is particularly important since Islamic banking derives its credibility from full adherence to Shari’a rules; therefore, compromising this notion, unless it is extremely necessary, is never justifiable.

The proper methodology needed for product development

It has become obvious from past discussions that for proper structuring of a product under Islamic finance, three aspects of the product must be taken care of.

First is form, and form relates to fulfilling basic structural requirements and conditions imposed on transactional contracts by the Shari’a. A contract whose form is invalid should produce no legal consequences and be considered as null and void. Second is substance, which is concerned with the essence and the spirit of the structured product, especially when more than one contract is involved in the product. This may result in the creation of a controversial product as in the cases of ina or tawarruq. Two sale contracts are involved, each independently valid in essence, but the total outcome of having them consecutively executed is a highly controversial cash financing product.

Third is the result of the structured product that has passed the form and substance test. The structured product must not lead to contravening Shari’a rulings, or has unfavorable or negative implications. Just like selling weapons to a criminal, or grapes to a wine maker, does not comply with Shari’a although the contract itself may have fulfilled all of its structural conditions, an Islamic banking product cannot be truly labeled Shari’a-compliant unless it is free from Shari’a repugnant implications. For example, in the absence of sufficient controlling measures on share trading in the stock market, the market can become an arena for gambling and zero-sum games; therefore, developing a financing product that helps finance clients willing to participate in such a market becomes impermissible, although the product itself may be sound in its structure and essence.

In other words, for a product to be truly labeled as Shari’a compliant the underlying contract and tools used in its structuring and developing must be valid in form and essence, and the usage and implementation of the developed product must also be in line with Shari’a rules and principles. Reexamination of the current Islamic banking and finance products in light of this elaborated benchmark is deemed extremely necessary, since there exists among the current Islamic banking products ones which have successfully fulfilled the Shari’a requirements in terms of form, but unfortunately failed to fulfill that of spirit. Unless Islamic banks review their products and reform them to meet the criteria of this proposed methodology, Islamic banks role in achieving the social good will remain very limited.

On a final note, the recent trend of distinguishing between a Shari’a compliant product and a Shari’a based product is inaccurate and lacking Shari’a bearing. What complies with the Shari’a is only what is halal, and a contract that is structurally valid but eventually leads to an unlawful end can never be regarded as halal. In other words, when we say that something is Shari’a compliant, it means that it fits within the Shari’a rules and principles. But how would a product that carries the same economic evils of riba or gambling fit within Shari’a set of rules and principles even if it has a valid structure? If a distinction is ever made in Shari’a contracts acceptability, then it is the juristic distinction between the two legal terms within the framework of Islamic law: valid and permissible. A valid contract is the one that has a valid form regardless of the validity of its purpose or the contractual party’s intention. Conversely, a permissible contract is the one that has a valid form, purpose and objective. A valid contract may not necessarily be permissible.

Therefore, a contract is acceptable to Shari’a, or is compliant with the Shari’a, only if it is valid and permissible, since both concepts are necessary elements of Shari’a clearance, and Shari’a does not admit a contract or a structure that is invalid in essence or implications.

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The Global Islamic Finance Report 2013 (GIFR 2013) is a comprehensive annual review of the activity, trends, new developments and thinking in the Islamic finance industry. It commissions contributions from leading global practitioners and thinkers in the field combining technical experience and invaluable knowledge and insight to propel Islamic finance forward in the post-recessionary global financial markets. Edbiz Consulting is proud to announce the release of the GIFR 2013 continuing the tradition of erudition and incisive analysis expected of the GIFR. The core theme of this year’s report is “Islamic Finance and the halal industry” with chapters on, halal logistics, fund management in the halal industry, international law and the halal industry, branding the halal industry, the challenges of developing the global halal food market, and other pertinent topics. Along with the customary sections, “Review of Industry Segments” and “Country Sketches”, the GIFR 2013 will endeavour to educate and incentivise those with a stake in the industry to continue pushing the boundaries of knowledge and innovation.

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OFFICIAL ARABIC BROADCASTER
Synthesising Law and Spirit in Islamic Finance

Islamic finance is growing steadily throughout the world, and this is impressive given its relatively recent inception. However, in its growth there is a fear that the various products on offer are perpetuating a capitalistic mindset. Rizwan Rahman explores this dilemma and argues that Islamic law can be directed towards money making which often ignores the spiritual aspects of Islamic law.

Mahmoud El Gamal believes "Islamic Finance as it exists today is a prohibition-driven industry, which attempts to provide Muslims with permissible analogues of conventional financial services and products that are generally deemed impermissible in Islamic jurisprudence"¹. He argues that "Islamic alternatives or modifications of conventional practice are sought whenever the latter is deemed forbidden"². Thus for the product development process in Islamic Financial Institutions (IFI), there is a recognition that an interest based or speculative financial product is impermissible under Islamic law but its end result is desired, that of generating profits or managing risk for the IFI or the client.

This presupposition influences how Islamic scholars in the industry, whether as part of a Shari’a Board of an IFI or a regulatory organisation, determine and create products. Thereafter, the process of creating a financial product which balances the prescriptions of Islamic law and profit maximisation, becomes a creative exercise involving the scouring of Islamic jurisprudence to effectuate the desired outcome. Consequently, scholars have modified classical contracts to replicate the economic substance of conventional products. The contractual form of the transaction appears to be in line with the dictates of Islamic law, but the end result produces similar returns to a conventional product.

In the end, it is the legal form of the products that distinguishes an Islamic product from a conventional product and it is on this point that critics such as Gamal and Haider Ala Hamoudi³ see Islamic finance as an exercise of legal formalism. Hamoudi contends that the juristic process in Islamic finance mirrors the formalistic approach of Christopher Columbus Langdell. He enumerates three modalities of Langdellianism, which according to him, resonates in the Islamic financial context. Firstly, there is disdain for judicial discretion. Rules can be deduced from the textual sources making judicial creativity inexpedient and abhorrent. Secondly, public interest is a marginal consideration and should not trump the letter of the law. Lastly, Langdellianism does not account for broader social and economic developments. Accordingly, Hamoudi sees contemporary Islamic finance as having scant regard for discretionary preference and practical reality and sees the rules as being "arbitrary and senseless, designed for no purpose and serving no function other than to complicate already elaborate commercial transactions".

Certainly, Islamic finance is formalistic in its utilisation of the law in that it is rule based. But in deriving law it has broader considerations. The juristic process seeks to synergise Islamic jurisprudence with commercial realities, taking account of social and economic developments and endeavouring

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¹ Mahmoud A. El-Gamal "Limits and Dangers of Shari’a Arbitrage" http://www.ruf.rice.edu/~elgamal/files/Arbitrage.pdf
to create a financial system that is efficient and rooted in Islamic law. The end result is just as important as remaining authentic and text based, thus giving Islamic finance jurists much discretion. Recognising the success of the western financial system, which has, broadly speaking, proven to be resilient and efficacious, jurists sought to almost prove that Islamic law has the tools to meet the needs of modern society: to help them be both Islamic, as an identity, and financially active, as a modality. Thus judicial formalism is only a means in order to maintain authenticity; the purpose was to remain competitive and profitable.

The quite creative ploughing of classical Islamic law led to a new form of jurisprudence which respected the interpretive achievements of the four classical schools of legal thought but broke the limitations that were placed by them. To explain this further, the example of the modification of the classical murabaha illustrates the extent to which contemporary jurists have gone to ensure Islamic law remains relevant to the financial markets. It is now a common tool used by Islamic banks for an array of products including assisting customers to buy homes or increasing bank liquidity.

**Presuppositions informing the judicial process**

Walid Hegazy sees the evolution of Islamic finance from the 1920s onwards transitioning from socio-economic idealism to pure legalism⁴. The manifestation of this legalism is exemplified by the modification of the classical murabaha contract. The classical murabaha was regarded as a trade instrument, and a sale of trust, where a merchant would request another merchant to buy goods from a distant location. The second merchant would buy the good and sell to the first merchant for the cost plus a mark up to account for the risk borne by the second merchant in transporting and storing the goods. The first merchant would provide a revocable promise (wa‘ad) to buy the goods and thus effectively grant an opportunity to reject the goods once delivered.

Contemporary murabaha, a popular tool used by Islamic banks, is now a financing tool. Unlike the classical murabaha it can no longer be considered a sale of trust as a series of contracts are used to facilitate a transaction, protecting the bank from possible default by the buyer. Where the second merchant, as seller of the good to the first merchant in a classical murabaha, bore the risk, in a contemporary murabaha, it is the buyer who bears most, if not all, the risk. To achieve this, scholars located a minority opinion from an early Maliki scholar, Ibn Shubruma, who opined that the promise (wa‘ad) to buy was irrevocable. Thus, we have a reversal of the position of the wa‘ad in the classical murabaha, which was generally agreed to be revocable amongst most jurists. This change allowed a credit element to be inserted into the contemporary transaction where the bank would purchase the asset and sell it to the buyer, who promises to pay the cost plus mark up at a point in the future. The promise has become legally binding.

This mark up is typically based on an inter bank offering rate such as LIBOR, thus making the contemporary murabaha virtually similar to a loan with interest, and, more importantly, competitive to its conventional counterpart. In addition, the overall structure of the murabaha would align with English or New York law provisions on enforcing promises provided there is consideration, thus making the contract more secure, and making the murabaha acceptable under a foreign law.

From the preceding discussion, we can deduce the presuppositions that inform the interpretative process. Firstly, there is an acknowledgement that conventional products achieve a desired outcome but the means are considered impermissible. Secondly, prices have to be competitive with their conventional counterparts and therefore using conventional systems of pricing are acceptable; thirdly, there is a discomfort with utilising the systems of law in Muslim countries to govern the contract. In any event, the systems of law regarding commercial aspects, is predominately based on civil or common law. Finally, it is expedient to find the right opinion, irrespective as to whether there is a consensus upon it. Consequently, the Islamic financial interpretive process maintained the methodological tools (usul) and the results (furū) of Islamic law but adapted them to serve modern, empirical needs. As we see with the murabaha, jurists were creatively looking for ways to be competitive, and this as a starting point for the creation of products will have an esoteric effect on the outcome, one that can be considered profit orientated.

**Interpretative Communities**

Yet, the juristic process is often criticised with many arguing that scholars have moved beyond the boundaries imposed upon them by their respective schools of law. The utilisation of minority opinions or the discreet structuring of products to create an impermissible outcome has brought accusations of talfiq (combining opinions from two different schools to create a new outcome which would have been proscribed by both

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⁴ Wald Hegazy “Contemporary Islamic finance: From socioeconomic idealism to pure legalism” Chicago Journal of International Law Volume 7, Number 2, Winter 2007
The argument is seductive, reformist in nature. It gains strength in that the laymen do not understand the financial markets well, allowing the scholars in the industry to claim expert knowledge of both conventional finance and fiqh, and the reconciliation of the two. One may feel uncomfortable with the product offerings as they seem similar in economic substance to a conventional counterpart but would be assumed to have misunderstood the subtle realities of both finance and fiqh.

With this in mind, in Islamic finance there is the creation of a juristic culture holding special knowledge. The Shari’a Supervisory Boards, that contain several Islamic scholars who issue a fatwa on the Shari’a compliancy of a product, then becomes what the legal scholar, Khaled Abou Fadl, calls ‘a persuasive authority’—one that influences people to believe, act or refrain from acting in a certain fashion by persuading them that this is what ought to be⁵. For an individual who wishes to adhere to Islamic rules in his financial transactions, the Shari’a board and their pronouncements imbues the product and services with authenticity and a connection to the Islamic sources. There is a presumption that the scholars are trained in Islamic law and have the authority to grant binding legal opinions. By their existence, the boards create the justification of having the Shari’a background inducing the individual to follow their opinion, and this predominates over other choices, such as remaining with a conventional financial provider even though the economic substance of the products are the same. It would be difficult not to see this as an example of what Fadl further states as being “authoritarian tendencies that invoke and utilize the persuasive effect of the juristic tradition, and, thus, force it into the realm of the relevant and the authoritative”.

Continuing on with Fadl’s analysis of authority in Islamic law, he writes⁶ that authoritativeness is produced within a context, and this context forces the authoritative to speak in a communal, rather than an individual voice, thereby producing ‘communities of interpretation’. In the realm of Islamic finance, these communities comprise of not only Islamic scholars but also financial service practitioners such as bankers and lawyers, as well as regulatory authorities, who are predominately non-Muslim and have only a cursory knowledge of Islamic law. Nevertheless, each party has an equal contribution to the interpretative process. A banker would come up with a product and present it to the Board. If the Board is not satisfied, the banker would attempt to tweak it to meet the approval of the Board. In this way, products will go to and from Boards before landing upon a satisfactory solution.

The process reveals the tension within the Islamic finance juristic process. Jurists have to adhere to the legal methodology of Islamic law even after the influence of bankers looking to induce consumer demand and generate profits. An adherence to Islamic legal rules precludes accusations of arbitrariness and subjectivity while resulting in an outcome desired by the bankers. Accordingly, it follows Sherman Jackson’s argument that ‘the putative formalism implied by Islamic legal theory could not hope to exclude the impact of presupposition on legal interpretation’⁶.

**The failures of capitalism**

In Islamic commercial law, when a contract has multiple intentions, there is disagreement between the schools as to the legal position on the effects of the contract. The Hanafis and the Shafis are of the opinion that subjectivity should not play a role in determining the validity of the contract; and that a formalistic adherence to the rules is sufficient to validate the contract. Imam Shafi states in his Al-Umm that if an intention to do something considered invalid under the Shari’a is made explicit in the contract, then this would invalidate the contract; however, if the intention is not manifest, then Imam Shafi would accept the validity of the contract. The Hanbalis and the Malikis disagreed, opining that subjective motives can invalidate a contract, even if not expressed in the contract. Ibn Qayyum Al Jawzi states that “the evidence of the law and its rules concur that intentions in a contract do count and they affect the validity and invalidity of the contract, determining whether a contract is legal or illegal”. The former approach is more formalistic while the latter approach is moralistic, leading to a restriction to the choice of contracts available⁷.

One can therefore see that by affording the leeway, Islamic finance adoption of a formalistic approach allows the complex creation of products which replicate the economic substance of their conventional counterparts. The formalistic approach consolidated a profit-maximising intention and gave it credence within the Islamic legal framework. However, the predominating intention of endeavouring to make profits is commensurate with the objectives of capitalism, which according

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⁵ Khaled Abou Fadl “Speaking in God’s name: Islamic law, authority and women” One-world Publications 2001


to the economist, John Maynard Keynes is contrary to religious paradigms. He writes: "modern day capitalism is absolutely irreligious, without internal union, without much public spirit, often, though not always, mere congeries of possessors and pursuers". For conventional financial institutions, profit maximisation is the essential objective and they have been successful in achieving this. By being so successful, it has attracted IFIs but in following the ethos of these capitalistic institutions, the religious underpinnings of the Islamic financial system are severely undermined.

For Keynes, living at the turn of the 20th century, he witnessed the gradual decline of religion in society leading to a shift in purpose, which did not share the same level of probity exhibited by religions. Keynes continues his essay by writing "the moral problem of our age is concerned with the love of money, with the habitual appeal to the money motive in nine-tenths of the activities of life, with the universal striving after individual economic security as the prime object of endeavour, with the social approbation of money as the measure of constructive success, and with the social appeal to the hoarding instinct as the foundation of the necessary provision for the family and for the future." This was for Keynes a worrisome state. If "love of money" is preeminent, then the result will be a system creating an individualistic society, what Keynes calls "egotistic atomism". In fact, Keynes believed that while modern capitalism had only been moderately a failed to take humans into "human paradise...comparatively free of economic cares". For Keynes, capitalism had divided business and religion into "separate compartments of the soul" and the resulting material advantages paralleled a moral denigration. Charles Eisenstein takes the argument further. He believes that there has been a "conversion of life, world and spirit into money". Money, in its creation, is accompanied by interest bearing debt, which produces a sense of scarcity within the individual and a drive to accumulate more money. In such a situation, there is a separation of man with himself and his environment, causing a failure to see the world as sacred or transcendent; rather seeing it as a means of making money.

Ghazali and the true intents of fiqh
Building on the points of Keynes and Eisenstein, an institutional framework built on the paradigms of money making leads to a society bereft of religion and sacredness. According to Keynes, the only way capitalism could be successful was to be more efficient than its competitive systems, and in this regard,

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8 John Maynard Keynes "Essays in Persuasion" W.W Norton & Company (1963)
Islamic jurisprudence, are creating products which reflect the economic substance of conventional financial products, then the starting point for the interpretative process tilts more towards profit maximisation – the ab initio intent of most, if not all, conventional financial products – and not towards a religio-centric goal.

For the polymath, Abu Hamid Al Ghazali, piety was the fruit of fiqh, not of giving judgements and opinions. According to Ghazali, the intents and purposes of fiqh, as understood by the Prophet and his companions, had gradually changed to a more formalistic conceptualisation, and had jettisoned mystical knowledge and purification of spiritual diseases, which he felt should be the purpose of fiqh. The two were meant to work in tandem, though not necessarily together. Ghazali felt jurists should concentrate on forms and not on the states of the heart. He gives an interesting anecdote about the Hanafi Jurist, Abu Yusuf. Reportedly, Abu Yusuf would evade payment of the zakat by using his knowledge of jurisprudence to circumvent the obligation. Ghazali felt this was acceptable from a worldly perspective but not from an eschatological one. He writes “…its harm in the next abode is greater than every kind of trickery. It is knowledge like this which is harmful” Ghazali later says “the science of jurisprudence is near to the science of the way to the next abode, because it considers bodily actions; and the source and origin of physical actions are the qualities of the heart. Praiseworthy acts issue from praiseworthy character which saves in the next abode, while blameworthy acts issue from blameworthy character. The union of the limbs and the heart is not hidden”. While he accepted the independence of a formalistic approach to the law – even if fundamentally based on legal trickery - he saw that it was from the heart that actions emanated. If the intents of the jurists are purposed in a certain direction, then this will be reflected by the resultant legal opinion.

To buttress his argument, he emphasises the superior qualities of five authoritative jurists: Abu Hanifa, Al-Shafi’i, Malik ibn Anas, Ahmed ibn Hanbal and Sufiyan A-Ithawi. Ghazali identifies five qualities: acquaintance with jurisprudence, worship, ascetism, knowledge pertaining to the next abode, and sincerity. Jurisprudence was only sufficient for this world; the latter four qualities were more important in securing the next abode, but these four qualities were absent from the followers of the aforementioned scholars in the time that Ghazali lived. Ghazali disparagingly spoke of the pedantry involved in deriving legal opinions, seeing a parochial focus upon it would lead to a removal of “godly piety”.

He criticises the jurists who have avoided knowledge of the next abode and the qualities of the heart as it is “abstruse and difficult to follow, and … nearly impossible to reach ones ambition to rule, judge and win reputation and wealth by it”.

Such condemnation of the jurists, and analysis of what he regarded as the ideal jurisprudents, reveals Ghazali’s perceptions about how the legal interpretation process should be conducted. Fundamentally, the jurist has to have within the five qualities mentioned above. This will inform his presuppositions and the manner in which he derives legal opinion from the texts. For Ghazali, the ideal jurist has to induce within his students a palpable fear and love of God and an understanding that improving internal qualities are superior to improving externals. The importance was on an ongoing remembrance of, and obedience to, God. If the focus was on the formalistic elements of Islamic law, then for Ghazali, this was a slippery slope to corruption of one’s faith.

**Conclusion**

By presupposing profit maximisation and an acceptance of the commercial benefits of conventional financial products at the starting point to the legal interpretation process, the interpretative communities in Islamic finance have produced goods which reflect the economic substance of their counterparts. The formalistic approach conveys the sense of working within the boundaries of Islamic law, but the spirit was far from the Islamic spirit, Ghazali would have felt appropriate. The spirit and substance of these products follow capitalistic paradigms of money-making which to both Keynes and Eisentein leads to a morally dysfunctional world, denuded of religion and spirit. Ghazali accepted the formalistic process but realised that this does not necessarily lead to a religiocentric outcome. For him, an eschatological appreciation and a commitment to purification of spiritual diseases were the true objectives of fiqh. The dilemma for Islamic finance is that in their pursuit to be competitive, they had inadvertently employed a spiritual framework which is antithetical to an eschatological appreciation, irrespective as to whether the law was followed. The Ghazalian approach subordinated Islamic jurisprudence to that of spiritual cleansing, although he acknowledged improving spiritual states was difficult. Nevertheless, focusing on this was far more important than worldly success and any approach to law which ignored spiritual effects would suffer.

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This paper argues for issuance of prudential guidelines for the use of Islamic legal contracts in developing Islamic banking and financial products. While a number of bodies have started issuing Shari’a standards for players in the Islamic financial services industry, the actual product development and assurance of Shari’a compliance, by and large, are left to the discretion of the individual institutions and their Shari’a supervisory bodies. This market-based approach has spurred Islamic financial innovation. However, many industry observers have criticised the differences in Shari’a opinions, the consequent variations in the products, and the levels of Shari’a compliance. This paper argues in favour of prudential guidelines for the use of Islamic legal contracts, and makes a case for taking into account an economic analysis of Islamic law.

1. Introduction
A number of organisations¹ have issued Shari’a standards governing various Islamic legal contracts used by Islamic banks and financial institutions to structure Shari’a compliant products. However, detailed guidelines as to how such contracts should be employed and combined to ensure that the end products remain within the ambit of Islamic law have by and large been ignored. Consequently, the Islamic banking and finance industry employs diverse (and in some cases inconsistent) approaches to product development and structuring.

The prevalent approaches to product development are criticised by many Islamic economists and industry observers. For example, a leading Islamic economist, Nejatullah Siddiqi, has repeatedly shown concerns, arguing:

“Whatever the legal opinion, the economic role of the [tawarruq-based] transaction can hardly be different from that of lending and borrowing money. As the credit price on which the client buys the asset is invariably higher than the cash price on which the asset is sold, tawarruq (as the method is called) is functionally identical to interest based lending and borrowing. Islamic economic analysis has shown that, even in the case of a loan for business purposes, exchange of money now with more money later is unfair because of the uncertainty that accompanies the passage of time. Money needs being converted into goods and services before it can enter the process of production—the source of possible growth/value increase. The results of the process of production have to be reconverted into money before money can be paid back to the one who gave it in the first instance. This amount of money, resulting from conversion of the product into money, may be more than, equal to or less than the original amount of money” (Siddiqi, 2006).

This paper highlights such concerns on product development and suggests a need for devising a comprehensive prudential framework for the use of Islamic nominate contracts for product development in Islamic banking and finance. While Shari’a standards and parameters have been developed by different organisations in different countries, this paper is perhaps the first attempt to develop prudential guidelines for the use of the most widely employed Islamic contracts for structuring products. These guidelines ensure that such products remain not only legally Shari’a compliant, but also can be differentiated from their conventional

¹ Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) has issued 45 Shari’a standards, which cover a range of contracts, products and processes related with Islamic banking and finance. A few countries (like Bahrain) have adopted them as guiding principles, while others (like Pakistan) have adapted them to develop their own Shari’a standards. Bank Negara Malaysia (BNM) has also issued its own Shari’a parameters (recently renamed as Shari’a standards) that bind Islamic banks and takaful companies in the country to develop their products consistent with these parameters. Relatively less elaborated Shari’a guidelines are issued by the State Bank of Pakistan (SBP) for the Islamic banking industry in the country.
counterparts in terms of their economic profiles and general characteristics.²

The prudential guidelines are based on economic explications of different prohibitions in the Islamic law (El-Gamal, 2001). The economic rationale employed here for product development may support those who emphasise consideration of maqasid al-Shari’a in Islamic banking and finance.

The paper is organised as follows. Section 2 elaborates on the nature of the problem in light of some of the most prevailing Islamic financial products. Section 3 draws some general principles from the discussion in its preceding section, for product development. Section 4 is a brief description on the impact of the prudential guidelines on innovation in product development in Islamic banking and finance. The last section concludes.

2. The Nature of the Problem

In order to highlight the nature of the problem in product development, we refer to the dichotomy between economics and law, combining of contracts, third party syndrome, and the excessive use of promises in Islamic banking and finance.

2.1 Economics and law

To understand the nature of the problem this paper discusses, it is important to understand what, within finance, is prohibited in Islam. It is equally important to look into what is actually encouraged and prescribed in an Islamic economic system. The exact nature and objectives of different proscriptions and prescriptions must properly be understood in order for the products offered and used by Islamic banks and financial institutions to follow the Shari’a requirements in letter and spirit.

At the same time, the inherent ambivalence of what can be constituted as the ‘spirit’ of the law, and the difficulties of delineating the maqasid make the whole debate between formalistic adherence and pursuing certain objectives irresolvable. It has to be admitted that in the structuring of Islamic financial products, there are replications of conventional products. The most well known example is Sami Hamoud’s (1976) formulation of the murabaha lil-‘amr bil-shira’ (mark up sale to the one who ordered the purchase), argued to have little dissimilarity to a conventional interest based loan except for legal minutiae (Hegazy, 2007). The economics of both products are the same, but the murabaha is structured in order to meet Islamic legal standards. In this lies the paradox. There is an implicit acceptance that conventional interest-based tools are economically acceptable, but not acceptable according to the Shari’a.

This dichotomy stems from the divergent needs of the Islamic bank and the client. The starting point of the product development process is determining the bank’s own objectives in supplying Islamic financial products. For any bank, Islamic or otherwise, the aims are profit maximization and risk minimization. To achieve both, products need to offer compatible incentives to justify issuance. The relative dearness of Islamic financial products as compared to conventional products is evidence of incentive compatibility as these products have no recourse to offering interest, and are only viable for banks if prices are raised.

Dar (2007) points out basic Islamic structures mined from the classical texts such as murabaha, ijara, salam, etc offer reduced incentives for banks to offer these products. By modifying these contracts through the execution of other contracts in parallel or separate (but still part of the overall transaction), the incentives for the bank to offer Islamic financial products increases. Contracts can be combined in a permutation that resembles a conventional product as these have a track record of providing the right incentives for a conventional bank. Hamoud’s reformulation of the murabaha involved combining the murabaha, with a bai mu’ajjal (deferred payment sale) contract and a unilateral wa’ad (promise). It offered the right set of incentives for Islamic banks, and has proven to be the most popular product

² AAOIFI has issued a Shari’a standard on combining contracts (Shari’a Standard No. 25), which discusses some of the issues raised in this paper. However, this paper remains first of its kind of attempt to analyse how product development in Islamic banking and finance can still remain flawed even if Shari’a Standard No. 25 is implemented. Hence, it argues insufficiency of the rules governing Islamic financial product development.
in the industry. Crucially, the product followed Islamic legal rulings: any flouting of Islamic legal rules would be recognized and criticized by Shari’a scholars rubber-stamping products. Consequently, the product development process in Islamic banks is a delicate process of modifying classical contracts, but not egregiously going beyond the purview of acceptability.

Nevertheless, controversy still arises in the modification of contracts. Aboozaid (2012) argues that in attempting to create a hybrid Islamic financial contract and ensuring that it closely resembles the economic profile of a conventional product, there is a deactivation of certain rules of the contract. He uses the example of ijara mutahia bittamlik in which the bank, as lessor, effectively transfers the liabilities related to ownership to the lessee by accruing the costs of ownership to the lessees rent. Under the original ijara contract, ownership costs were the responsibility of the lessor.

He continues by identifying reasons for the Islamic bank's syncretic approach. Firstly, in order to stay competitive with conventional banks and remain capitalized and liquid, Islamic banks need to offer the same financing facilities as conventional banks. Part of the problem is the overall system that Islamic banks find themselves in the financial infrastructure is geared towards the notion of building credit and increasing money supply. Banks are the centrifuge in circulating cash to maintain the economy. Without regular cash flows or investment, banks are required to sustain themselves through their assets including loans, marketable securities, and cash. The focus is on money accumulation, perfectly attainable through charging interest. This is not possible for Islamic banks.

Secondly, Islamic banks are unwilling to bare the risks of the asset. This is directly related to the first point. The trade-orientated nature of the original classical contracts has been replaced by a focus on cash financing. In fact, the Islamic financial industry attempts to synthesise the two together, but this raises a host of issues. Primarily, the risk profiles of the two commercial methods differ. The risks of trade orientated contracts, if payment is done on spot, relate to the quality of the product or service. Payment in the future, as is the case in bai’ mu’ajal or ijara, adds a new dimension, which makes these contracts conducive to cash financing. The creditor in these situations, as seller or lessor, would want to reduce the magnitude of the risk. It therefore makes sense that any risk borne from the asset itself (such as bearing the liabilities of a property), the bank would wish to avoid.

For these reasons, it makes it difficult for the Islamic bank to operate within strict parameters of the Shari’a, and means are often found to neutralize certain aspects of classical trade-orientated contracts. But to continue in this manner can dilute the proposition of Islamic finance and attract ontological criticisms of Islamic finance (Kuran, 2004). To challenge this, Islamic banking products need to be economically as well as legally different to conventional products.

2.2 Combining contracts and their payoffs

While everyone tends to accept that combining two or more impermissible contracts or combining an impermissible contract with a permissible contract will never result in permissible arrangements from a Shari’a viewpoint, it is not widely acknowledged that there are situations in which combining permissible contracts may end in an impermissible arrangement. Examples of combining two impermissible contracts to get economic effects of a permissible contract abound. One such example is the use of an interest-based loan with a gambling contract (e.g., one with pay-off contingent upon the outcome of a stochastic process) that allows the lender to receive a share in the profit of the venture in which the borrower invests the money borrowed, if the realised profit is such that the lender’s share exceeds the principal sum plus the stipulated interest. If, however, the realised profit is below a threshold, the lender receives only the amount he lent. This arrangement can symbolically be written as: \( s(N; N, N + \alpha[1]) \), meaning a party contributes \( N \) (notional amount) to a stochastic process to receive \( N \) or \( N \) plus a share \( \alpha \times 1 \) in the net profits \( [1] \), depending on the outcome of the stochastic process.

An alternative to \( s(N; N, N + \alpha[1]) \) involves the use of a profit sharing contract, which stipulates that the money provider receives a share in the profit if the realised profit exceeds a threshold, and receives only the amount he invested if the realised profit is less than the stipulated threshold. This alternative arrangement can be written as \( [s(N; N, N + \alpha[1])] \), which appears to be equivalent to \( [g(N; N, N + \alpha[1])] \) in terms of its economic outcome.

While both \( g(.) \) and \( s(.) \) have similar profit distribution and provide for capital protection, the former is based on two prohibited contracts (i.e., gambling and interest) and the latter is based on a permissible contract (i.e., profit sharing based on mudaraba) and a void condition (i.e., capital protection). Both \( g(.) \) and \( s(.) \) are not acceptable in Shari’a. The former is an example of combining two prohibited contracts, i.e., haram + haram = halal; and the latter may be seen as combining mudaraba with kafala, which are acceptable contracts separately but their combination is not acceptable because it results in a guaranteed mudaraba, i.e., halal + halal ≠ halal. Table 1 presents some possible scenarios of combining different contracts.

It is interesting to note that AAOIFI allows for the combination of a mudaraba agency contract3 (in a mudaraba, the mudarib, as investment manager, is seen as an agent for the investor) with a kafala as long as the two contracts are separately entered into, whereby the investment manager may in his personal capacity provide guarantee of profit or the principal sum, as long as the two contracts (i.e. mudaraba and kafala) are separately entered into and are independently of each other. This provision has been used in a number of Islamic financial transactions, allowing an investment manager to guarantee (in their personal capacity) the notional amount of investment and/or profit4.

While some contracts marginally used, and discussed in the classical Islamic law, are now being used in the contemporary practice of Islamic banking to become a basis for investments of billions of dollars, many industry observers and Shari’a scholars are not entirely happy with the way in which such supportive contracts like agency (wakala), gift (hiba) and promises or undertakings (wa‘ad) are used in product development and structuring.

3 “It is not permissible to combine agency and personal guarantees in one contract at the same time (i.e. the same party acting in the capacity of an agent on one hand and acting as a guarantor on the other hand), because such a combination conflicts with the use of these contracts. But if a guarantee is not stipulated in the agency contract and the agent voluntarily provides a guarantee to his clients independently of the agency contract, the agent becomes a guarantor in a different capacity that of agent.” Shari’a Standard No 5, 2/2/2 AAOIFI Shari’a Standards for Islamic Financial Institutions (2008).

4 The recent sukuk issued by Al Bayan Holding is one such example. Please see http://www.reuters.com/article/2013/04/24/saudi-sukuk-ringgit-idUSL6N0DB3HS20130424.
The prohibition of riba implies that the two transacting parties are not allowed to exchange unequal quantities of an asset, whether it is a tangible commodity or financial (i.e., money). Circumvention by way of buying and selling an asset should also be proscribed. For example, if it is prohibited for two parties to exchange $100 for $110 (or $90), then it should not be allowed for a party A to sell an asset X for $100 to another party B and then buy it back for another amount (say $90 or $110) either at spot or on a deferred payment basis. If they do so, this will be viewed as what is known as bai al-'ina in the Islamic legal framework. The prohibition may not sustain if the party A sells an asset X for $100 to the party B, and buys from B another asset Y for a price of $110 on a future date, as long as the two sales are not conditional upon each other, or the second trade is not consequential of the first trade. In other words, independence of the two sales is a requirement for the two trades not to give rise to the prohibited riba. If the two trades are dependent upon each other, even if the two parties enter into separate sale contracts, they will be considered to constitute the prohibited riba. In other words, i.e., exchange of X from a party A to another party B for a price of P1, and i.e., exchange of Y from the party B to the party A for a price of P2, will give rise to the prohibited riba, if the two trades are conditional and/or dependent.

Similarly, the use of mudaraba in Islamic financial products should imply profit loss sharing, without guaranteeing of capital and

### Table 1: Combining Contracts and Their Consequences

<table>
<thead>
<tr>
<th>Constituting Contracts</th>
<th>Resultant Contract</th>
</tr>
</thead>
<tbody>
<tr>
<td>Case A: Haram + Haram ≠ Halal</td>
<td><strong>An interest-bearing loan contract that entitles the lender to receive a higher amount</strong> ((1 + \alpha)N) in return for notional contribution of <strong>N</strong></td>
</tr>
<tr>
<td><strong>Haram + Haram ≠ Halal</strong></td>
<td><strong>[(l(N: N + \alpha N)): (\forall \alpha &gt; 0)]</strong></td>
</tr>
<tr>
<td><strong>Case B</strong></td>
<td><strong>[(l'(N: N))]</strong></td>
</tr>
<tr>
<td><strong>Haram + Haram ≠ Halal</strong></td>
<td><strong>An interest-free loan that entitles the lender to receive back only the principal sum lent</strong></td>
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<tr>
<td><strong>Case C</strong></td>
<td><strong>[(l'(N: N))]</strong></td>
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<tr>
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<td><strong>An interest-free loan that entitles the lender to receive back only the principal sum lent</strong></td>
</tr>
</tbody>
</table>
return by the party utilising and managing the funds. In the contemporary practice of Islamic banking, however, there is a tendency to combine different contracts to structure mudaraba-based products that offer guaranteed return to investors. There has been an earlier attempt to use mudaraba-based structures in sukuk to offer not only guaranteed returns but also capital protections, which was opposed by different stakeholders in the industry and hence was rectified by AAOIFI, which issued a guideline note on sukuk.

There are some other examples of rather aggressive use of trading in debt (bar’ al-dayn), particularly in Malaysia, whereby the sale of debt is considered similar to sale of a commodity, and hence subject to price negotiation. This point of view clearly ignores its implications for the prohibition of riba.

2.3 Third party syndrome

A number of Islamic financial products require a facilitating entity for the structure to work from a Shari’a viewpoint. In sukuk, for example, a special purpose vehicle (SPV) is required to buy and sell, and/or hold assets for either issuers or investors. It is important to look into the exact role of such a facilitating party in the structural operations of the product. This should be done with a view to develop prudential guidelines for such a party to play a role within the Shari’a domain, and not to circumvent Shari’a requirements. While the use of a SPV in sukuk may provide an example of creating a facilitating party, there are some other examples where a third party is used to circumvent Shari’a requirements in product development.

There are a number of structured products developed by many Western investment banks involved in Islamic banking and finance, which suffer from this third party syndrome. Tawarruq is another excellent example given its extensive use in the industry.

It is important to highlight the role of circumvention in Islamic banking and finance, and differences between circumvention and genuine innovation to provide alternative solutions in situations where choices are restricted due to explicit prohibitions. For example, the prohibition of interest implies disallowing a party A to receive a smaller sum to be paid by A to pay B on a later date.

A solution (to be discussed in Section 3 below) to this case of restricted choice is tawarruq, whereby party B sells something of lesser value (say £90) for a deferred price of £100 to party A who then sells it in the market (to a third party C) for £90. This obviously does not attract any Shari’a objections at all, and may in fact be a preferred Shari’a option in some circumstances. It is important to emphasise that tawarruq in this simple form is not an example of innovation, as Shari’a allows its use and in fact recommends it to avoid riba (or the prohibited interest).

2.4 The use of promises in product structuring

Promise – or wa’ad in Arabic – has emerged as an interesting structuring tool in Islamic banking and finance. A promise is in general a non-binding arrangement between two parties unless the promisee calls upon the promisor to honour its undertaking to perform, in which case it becomes binding on the promisor to do so.

The use of promises has become ubiquitous in Islamic financial product development. However, it is important to use promises with caution. While it is true that a promise is not a complete contract, and that it can be combined with another contract with a lot of flexibility, care must be exercised to ensure that doing so does not result in the creation of a prohibited or undesired product, or a product that looks and behaves like a prohibited one. It is also important that the promises must not be used in such a way that they alter the nature of a main contract with which they are combined. For example, it is in the nature of musharaka that allows two partners to pool their resources to share in profit and loss of a business venture. If a musharaka contract is wrapped with two promises, which allows one party to retain profit in excess of a threshold in exchange for providing capital protection to the second partner, the end result is a fixed return musharaka. A fixed-return musharaka can be structured by way of one partner A undertaking (promising) to relinquish his right to the profits over and above an amount or percentage of his share of investment in favour of partner B, if the realised profit exceeds a threshold. Partner B, in exchange, undertakes to buy partner A’s share (in full or partially) in the venture for a price that makes the loss good for him, in case the realised profit is less than the chosen threshold. Alternatively, partner B may in his personal capacity provide a guarantee of profit and/or capital protection to partner A, as long as this personal guarantee is independent of the partnership between the two. In the notation used earlier, the above arrangement can be written as \[ I(N: (1 + α)N), \]

which is not dissimilar to an interest-bearing lending contract \[ I(N: (1 + r/N) \]

in terms of its economic profile.

As combining a musharaka contract with a couple of promises (or a promise and a personal guarantee) results in a fixed return arrangement, this cannot be deemed as profit loss sharing as provided by a simple musharaka contract.

3. Drawing General Prudential Guidelines for Product Development

It is important to use well-known examples of products to draw some general prudential guidelines for product development in Islamic banking and finance. In the previous section, tawarruq was used an example. Hence, this section will continue with this example. The following conditions must be applicable to a tawarruq-based solution:

1. The party A must buy (and indeed receive) the commodity from party B, on the basis of a deferred payment of price.

2. The money that party A receives must come from an independent third party C, and must not come directly or indirectly from party B.

3. The trading parties must not play any role for each other apart from buying and selling of the commodity. In other words, they must not serve as an agent for each other to buy or sell the commodity.

4. Tawarruq must not be organised by any of the parties involved in the transaction.

For tawarruq to be considered as a Shari’a acceptable arrangement involving true sale, the requirements 1-4 must be observed; otherwise it may be seen as circumventing the Islamic prohibition of riba.

Condition 1 is necessarily about possession. In order to ensure that tawarruq is not abused to circumvent riba, possession by the seller of the commodity and its transfer to the purchasing party must be made a strict Shari’a requirement; otherwise a series of trades will result in movement of cash only without any requirement of mobility of the commodity.

Condition 2 does not imply that the credit seller (party B) is prevented from buying the commodity from someone whom party A later sells the commodity to on cash. Rather what it requires is that the credit seller must not supply cash directly or indirectly to the party seeking liquidity around the time of the credit sale. If he does so (whether it is with or without the sale of a commodity), the transaction would involve riba if the price in the credit sale is higher than the spot price.
Here, the concept of a “spurious party” must be employed. In an organised three-party transaction, a party would be considered “spurious” if its involvement in the transaction makes an otherwise prohibited transaction seemingly valid. If in a transaction, a spurious third party is brought in to allow two transacting parties to exchange unequal amounts of money, the transaction would be considered to involve riba, even if the whole transaction is structured around (a series of) commodity trades.

Hence, although from a Shari’a viewpoint it is acceptable for a party B to buy a commodity from a party C on a spot basis, to sell it on credit for a profit (higher price) to a party A who then sells it on spot to party C for a lower price, the condition 2 above renders the whole transaction Shari’a repugnant.

The above-mentioned four Conditions may be considered as prudential guidelines for using tawarruq in contemporary practice of Islamic banking and finance. The Principle of Impossibility of Riba ensures that these prudential guidelines rule out circumventing Islamic prohibitions in banking and finance transactions.

Apart from the above tawarruq-specific prudential guidelines, any legal-cum-economic analysis of Islamic financial products must come up with a set of criteria that must be used to assess their permissibility. The permissibility criteria may include the following elements:

1. For any financial transaction to be Shari’a compliant it must ensure that it does not involve exchange of money for money in unequal quantities between the two parties, whether money is exchanged directly or indirectly (i.e., with the help of a facilitating third party).

2. For any commodity trade involving a credit sale to be Shari’a compliant, it should ensure that the seller must only deliver the commodity, and not provide cash to fund the credit sale, either directly or indirectly (i.e., through a facilitating third party).

3. For any trade to remain Shari’a compliant the transacting parties must not combine an agency role to circumvent the transfer of ownership and possession of a commodity being traded between the two parties.

4. In any transaction, where more than two parties are involved, it should be ensured that none of them is a spurious party (as defined above).

Conditions 1 and 2 above are required to ensure that riba is not circumvented through any innovative combination of otherwise permissible contracts. Condition 3 is important because it ensures that the requirement of avoidance of possession is properly and effectively observed. In the absence of such conditions, any analysis of commodity murabaha will result in acceptance of many of the legal tricks that have become pervasive in product development in Islamic banking and finance.

Principle of Irrelevance of Trades

An outcome (Ć), such that Ć ≈ C, where C is Shari’a repugnant, would still be considered Shari’a repugnant, even if it is achieved by combining Shari’a compliant trades, like A and B, such that Ć = A + B, if the individuals trades A and B render themselves irrelevant immediately after the outcome (Ć) has been realised.

Principle of Irrelevance of Trades

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Principle of Preference of Characteristics Over Contracts

We draw this principle form the discussion in Section 2.4. It states:

In any arrangement that combines two or more permissible contracts in such a way that it significantly alters the nature of the main nominate contract used, it should not be named after the main contract. In case of the combining of the contracts results into an economic profile similar to a prohibited arrangement, the arrangement should not be allowed in Shari’a.

4. Prudential Guidelines and Innovation

One may argue that the above prudential guidelines are restrictive as to stifle innovation and hence growth of Islamic banking and finance. But this is indolent, and prevents creative thinking within parameters that attempt to ensure authenticity of the industry. Replication of conventional banking and finance products by the usage of legal tricks can eventually reduce the value proposition of Islamic banking and finance; already many Muslims have shunned the industry. In this regard, it is not sufficient to add the prefix “Islamic” or “Shari’a Compliant” in bid to lure customers; customers will want the mechanisms behind a product, and the outcomes of a product to be unique and beneficial. Prudential guidelines are an important and necessary step towards creating a more authentic, efficient and profitable product suite for the industry.

The prohibition of riba could have constrained Muslim traders in pre-modern societies, but creative legal thinking resulted in innovations in trade relationships. The various structures used, including mudaraba, were effective in enabling trade. The prohibition was not an inhibitor.

In the same vein, the industry needs to accept the fundamental prohibition of riba, and avoid creating structures that produce the same effects. Departing from this as a starting point, and not from the idea of replication, more creative thinking will be required to innovate. Sukuk is an example of the potential of innovation. AAOIFIs guidance on sukuk was to avoid dilution of its value proposition insofar as many sukuk had become mimicry of interest based debt. Hence, the three principles developed above along with other prudential guidelines mentioned above offer the foundation from which innovative Islamic financial products can be created.

5. Conclusion

In the Islamic finance industry, products are being creating by the combination of contracts. It allows the synthesis of the economic profile of a conventional product, but requires the neutralisation of certain aspects of the contract in order to create a cash financing relationship. In the absence of an Islamic economic system, to avoid replications, the rules of a contract need to be followed, even if this leads to a less than desired situation. Nevertheless, creating the product and gathering demand, will provide more authenticity, as well pushing for more innovation given the Shari’a constraints in finance.

The four general prudential guidelines and three principles developed in this chapter should help in developing Islamic financial products that are not only Shari’a compliant but also are differentiable in their economic profiles from the conventional financial products.

References


ACADEMIC PROGRAMMES:

- Bachelor of Islamic Finance and Banking -BIFB (Hons) with Islamic Financial Planner (IFP)
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To start with, please share with us your personal story. How did you end up leading Amanah Ikhtiar Malaysia (AIM), an organisation of tremendous national importance?

I began my career at Bank Bumiputra and then moved to Bank Muamalat. It was at Bank Bumiputra that I got my first exposure of microfinance. I was involved in the disbursement of a RM4 million to, ironically, AIM. It was my first involvement with the organisation that I would later join as an independent director in 2002. The initial experience was heartening and distressing at the same time. I witnessed the hard lives of the poor and the hardcore poor who toiled endlessly and without support. Without doubt, the microfinance loans assisted many within the targeted localities, and I saw how disbursements were used. This experience made an indelible impression on me. By joining AIM as an independent director, I was able to give input. In 2006, I was offered by the Ministry of Finance to lead AIM as the managing director. This was a great honour.

The people who are involved in microfinance initiatives have a lot of heart-warming stories to share. Do you have any? If yes, please share one with us.

There is one story of a lady in Pasir Puteh, Kelantan. She took a small loan of RM300 with AIM to expand her business of selling chicken. As an AIM borrower, she is known as Sahabat, which means friend in the Malay language. Initially, she would buy 2 chickens from the nearby market and cut them into small pieces to be sold to local villagers. She realised that people in her village do not buy the whole chicken, purchasing what they need for that day only. She set up a small table in front of her house from which she would sell. She has now expanded her business, selling about 1,000 chickens per day and owns a grocery shop as part of her business diversification strategy. She currently employs 8 workers. She took up another loan with AIM for business expansion of RM50,000. Her business has been so successful that she was able to repay the whole loan within 6 months. She is now a successful business woman and has become a mentor to many others. She...
is also a respected leader in her community and was invited to share her story during the inauguration of AIM’s new office building by the Prime Minister. Her 2 children are now in high school and doing well. She took up educational loans with AIM for both of her children.

She is a prime example of how AIM helps to not only economically empower the poor but also uplifts their overall welfare through the provision of a support apparatus, which includes continuous leadership programmes, training to increase financial literacy and vocational courses that improves technical skills. Each year, AIM allocates a budget for training purposes and provides advice to budding entrepreneurs. Borrowers receive both the funds and expert advice that will help them sustain their endeavours.

Most microfinance programmes around the world aim at female empowerment. While this must be appreciated in its own right, many analysts have criticised it for being biased. Given that Amanah Ikhtiar Malaysia has a huge focus on female empowerment, what is your take on it?

Actually, AIM’s initial objective was to simply alleviate poverty. There was no gender bias, neither was there a focus on creating entrepreneurs. This changed in 2001 when the government mandated AIM to create entrepreneurs shifting AIM’s mission. Staff had to be trained in this new area. Our success in creating micro entrepreneurs led to the government issuing a new mandate – develop female entrepreneurs. In fact, under the government’s Economic Transformation Programme (ETP), AIM was tasked to develop 4000 female entrepreneurs. So really, the focus on women has been imposed upon AIM by the government. But that is not to say it should be considered negatively. Quite the opposite. There are social and practical reasons for lending to women: they play an active role within the household; they are reliable with repayments and are more financially responsible; they are more self-sacrificing and they are more likely to invest extra income into the wellbeing of their family. Women are anchors of any family, but far too often women are marginalised, left to domestic concerns and considered impotent in determining economic improvement. Microfinance empowers women, enabling them to set the agenda. It broadens their role as a woman and their outlook, and it often releases the pressure on the men to provide for the family. We forget the hardships for men that have look after a family. It is not easy. Also, studies show that women make better borrowers. They are more focused, more likely to repay the loan and have a higher tendency to capitalise on loans to improve their family’s standard of living.

So AIM is proud to be serving women in poor communities, and for the foreseeable future that will be the focus. In fact, AIM established a strategic partnership with the Ministry of Women, Family and Community Development to produce highly capable women entrepreneurs under the Women Entrepreneurs Development Programme.

Under your leadership, AIM has progressed impressively, meeting some of the targets even before the deadlines. What is the secret of your own personal success and that of AIM?

I remember when I became the managing director in 2006, AIM had about 160,000 clients with 68 branches. Now we have approximately 340,000 borrowers. 20% earning RM3,500 a month. We want to have 500,000 borrowers by 2015. You could say that my banking experience as a banker has helped me in steering AIM to where it is today. But I think this does not sufficiently explain why AIM has grown as it has.

There are many factors for our success and it would be wrong to pinpoint a single cause. We have been immensely fortunate to have the unwavering support and commitment of our stakeholders – the government (being the main supporter), board members and other financial institutions. The activities of AIM complement the government’s own goals and efforts to lift the poorest 40% out of poverty. Government assistance in the form of soft loans to AIM has enabled us to have greater outreach. We now have 123 branches nationwide.

From the outset, the biggest challenge for AIM was always going to be securing funding to sustain as well as expand business. At the end of the day, continued expansion is highly dependent on availability of funds. More liquidity allows AIM to develop better outreach programmes and increase the loan size for...
Interview

Malaysia has the potential to play a leadership role in the ASEAN region to combat poverty.

It is heartening for me to know that with our accumulated experience, we have been able to assist similar organisations throughout the world. AIM has been successful in providing technical advice and on the job training for institutions in Indonesia, Vietnam and Bangladesh. We are exporting our technical expertise, and have sent staff to South Africa to help an organisation set up a Woman Bank.

What other initiatives is AIM working on?

To facilitate activities of Sahabat and serve as another source of income through dividends received as members, AIM established its own cooperative known as Koperasi Amanah Ikhtiar Malaysia in August 2012. The Koperasi currently has 4000 members and the numbers are expected to increase tremendously once the nationwide roadshows are completed. One of the many initiatives introduced by the Koperasi in serving and enhancing the economic interest of its members was the set-up of Pasaraya Sahabat Ikhtiar—a supermarket chain that enables Sahabat to not only buy their groceries from these supermarkets but also market their products, which have the potential to further increase their livelihood. For a start, one was set up in Semporna, Sabah.

A welfare fund known as Tabung Kebajikan dan Kesejahteraan Sahabat (TKKS) was established in 2006 for AIM’s borrowers. The aim of this fund is to provide financial support to members who are sick, hospitalised and whose projects or lives are affected by natural disaster. Members voluntarily contribute RM1 a month while AIM contributes RM500,000 yearly to this fund. Recently, AIM channelled about RM1.5 million of its RM64.4 million welfare fund to borrowers who were affected by the invasion in Lahad Datu, Sabah. Apart from that, AIM is working with local universities and departments of higher education under a programme called Women in Social Enterprise (WISE), where university students will be placed with Sahabat for a month. This is to facilitate knowledge-sharing and to create entrepreneurs out of students. Students will also learn to appreciate the struggles in becoming an entrepreneur as some end up becoming marketing agents for their Sahabat parents by selling their products. On the other hand, Sahabat can pick up skills such as preparing simple accounts from these students. In 2012, over 200 students were involved in this scheme. AIM plans to increase this number to 800 in 2013. To increase market outreach, AIM worked closely with Bank Islam to leverage on the bank’s “Transact at Palm” or TAP Mobile Banking service. This mobile technology allows borrowers to perform banking transactions such as loan repayments, bill payments and prepaid airtime reload anywhere without the need for internet access.

Do you think that AIM would have been equally successful if the government of Malaysia did not support it? Grameen Bank started as a non-government programme and remained so without any significant funding from the government of Bangladesh, while AIM has benefitted from support of the government of Malaysia. What are the differences between philosophy and operations of Grameen Bank and AIM, if there are any?

The model of AIM was originally based on the Grameen Bank model, but this has changed, and AIM has gone beyond microfinance. Our functions have expanded to create entrepreneurs amongst borrowers, to alleviate poverty through entrepreneurship amongst the poor, particularly urban and rural women. AIM is very involved in the development of borrowers, providing training so they have the necessary skills to develop their business. We also assist borrowers in getting subsidies from the government and connect them to relevant government agencies. This gives them added support as well confidence to pursue growth. Additionally, we help them build their business network ensuring that their focus and market is not limited.

Our readership will also be interested in knowing about AIM’s internship programme. Do you have plans to develop it into something like an AIM Academy for Entrepreneurship?

AIM is currently involved in a number of projects beyond our traditional service offerings. We are currently in the process of establishing an Islamic Microfinance Institute that is expected to launch early next year. The Institute aims to provide practical, technical training and sharing of best practices. It will offer programmes in Islamic microfinance and entrepreneurship that will eventually lead to certification. Currently, we are preparing modules for training programmes.

Do you have plans to expand AIM regionally to show that Malaysia has the potential to play a leadership role in the ASEAN region to combat poverty?

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Like other countries, developed and developing alike, there has been huge emphasis on financial inclusion in Pakistan. A number of institutions (including charities and other businesses in the services and utilities sector) are using electronic media to raise and transfer money as part of their payments or credit systems. Many businesses, however, continue to use traditional channels to raise investments from the general public, primarily in an unregulated way. One recent example of the failure of regulation has been in the form of the Mudaraba business scam in Pakistan, which caused investors to lose billions of rupees after being lured into investing in, reportedly, very lucrative businesses that were presented to the financially unsophisticated general public.

Given the improvement in technology, there is a need to look into some traditional forms of savings and loan businesses with a view to regulate them for the benefit of all the stakeholders. Crowd funding is a new phenomenon that emerged from the USA and now becoming a popular way of funding small and medium enterprises in a number of countries. In Pakistan, the “committee” system has existed for a long time where individuals pool funds to save together and help members of the committee to have access to interest-free loans for a variety of purposes, primarily for household consumption but also for businesses and projects. It is interesting to see how this traditional model of savings can be used to develop a powerful financial inclusion tool in Pakistan.

In informal sectors, there are different types of “committees,” one of them being a “lucky committee.” Although there are different variants of lucky committees in practice, all of them have the following common features:

First, a group of people contributes money to a common pool on a frequent basis (daily, weekly, monthly etc.);

Second, a draw takes place at the same frequency as that of monetary contributions. One lucky member of the group, whose name or number is drawn successfully, receives a fixed amount of money, normally equal to or less than the common pool of contributions for the period for which the draw takes place. Once a person wins, they cease to contribute further amounts for the period of the committee. Other members of the group continue until their names are drawn successfully. The committee is wound up when all members of the group have received a fixed amount.

This is an interesting arrangement, as no one in the group suffers a total loss of the capital contributed by them. Everyone does receive a fixed amount, although some receive more than what they contribute and others receive less than their contributions. For example, if there are 100 members of the group each contributing Rs100 on a weekly basis, the total
weekly contributions amount to Rs10,000. The total duration of such a committee is 100 weeks. Normally the “lucky pot” is less than the amount collected. For simplicity, we assume that the lucky pot is Rs5,000, which is received by every winning member. Thus the winner in week 1 receives Rs5,000, while they contribute only Rs100. The last winner, on the other hand, receives Rs5,000, while they must have contributed Rs10,000 by that time. This actually means that all those who win in the first half of the duration of the lucky committee receive more than what they contribute while those who win in the second half contribute more than what they receive.

Another committee arrangement, mostly used by business people for their working capital financing, involves bidding for the committee pool. It works like this:

A group of traders and other businessmen agree to contribute a fixed amount on a frequent basis. The pooled money is bid by the individual members on a frequent basis. The frequency of bidding may differ from the frequency of contributions (e.g., the contributions may be made on a daily basis while the bidding may take place on a weekly basis). The member who is willing to receive the lowest amount wins and claims the discounted pool. The successful bidders do not have any further right of bidding (i.e., they can receive money only once). All members, including the successful bidders, continue to contribute to the pool for the duration of the committee. Once all the committee members have claimed the pool money, the committee ceases to exist.

For example, a group of 50 traders and businessmen enters into a “working capital committee” to contribute Rs1,000 on a daily basis to bid at the end of the week for the amount pooled for seven days (which should be Rs350,000). Those members of the group, who are looking for cash for their business bid for the pool. The bidding may start from a slightly discounted figure of say Rs345,000. The member who is most desperate to receive the money will be willing to receive the least amount. Thus, if there were five bids of Rs345,000, Rs343,000, Rs340,000, Rs339,000 and Rs338,500, the one bidding for Rs338,500 will win and receive this much money from the total pool of Rs350,000. The remaining amount (Rs11,500) will go into a surplus pool.

If the terms and conditions of the arrangements are spelled correctly, this arrangement can serve as a great tool for developing working capital financing products and indeed can also be used for crowd funding.

In Pakistan, Mudaraba business regulations already exist and it will be helpful if the Securities and Exchange Commission of Pakistan (SECP) develop a framework allowing integration of features of committees and crowd funding into Mudaraba regulations. This integrated framework will serve the following purposes:

It can be used to develop a comprehensive infrastructure for development of social enterprises in the country. It can also be helpful in expanding the scale and scope of Mudaraba businesses, allowing Mudarabas to have outreach into communities at large, both in the urban centres as well as in rural areas. Needless to say, this will also improve financial inclusion in Pakistan where bank penetration remains very limited. It will also help in promoting Islamic finance in Pakistan.

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Training new leaders in Islamic banking and finance is a must. How can the industry progress without the ideas of passionate individuals looking to drive it forward? We cannot rest on the successes of those who have built the industry, almost from scratch, and expect growth and the realization of an effective alternative to conventional finance. There is a need to develop programmes to train the new crop of individuals, and there are very few institutions involved in Islamic banking and finance that have a well set programme to train individuals to reach the stage required to lead.

Edbiz Consulting aims to develop leaders in Islamic banking and finance by providing them with mentoring sessions in an easy yet professional environment. The manifestation of this idea is the Islamic Finance Leadership Programme (IFLP) that was held in Leicester on 20th-24th September, 2013, and hosted by Markfield Institute of Higher Education (MIHE) in Leicester, UK. The event was a mixture of presentations, interviews, brainstorming sessions, discussions and social events. It was a platform for building long lasting relationships with some of the most influential personalities in Islamic banking and finance. Participants congregated to learn, discuss and formulate strategies for industry growth. Industry leaders guided participants through regaling them of their own experiences, and explained the subtleties of the industry that only a leader would know.

But what are the attributes of a leader? The four day IFLP really explored this in great detail through both lectures and intermingling. One learns a lot from theoretical expositions, but there is nothing compared to sitting with leaders. Their traits shine through their words and their actions. Delegates experienced this first hand though walking with Shahid Malik, Former British Minister for International Development; eating dinner with Professor Mahmood Faruqi, Advisor to Bank of London and Middle East (BLME), sitting in discussion with Mr Sultan Choudhury, Acting Managing Director, Islamic Bank of Britain, and sharing coffee with Dr Tariq Cheema, CEO of the World Congress of Muslim Philanthropists.

The Islamic Finance Leadership Programme, hosted by Markfield Institute of Higher Education, UK, sought to connect budding leaders with current leaders in Islamic banking and finance. The aim was to enhance skills and build networks through collaboration, education and networking.

Rizwan Malik attended the event and was impressed by the passion and dedication of those involved who are looking to make a real difference in the industry.
Attributes of a Leader

Khalid Hilal Alyahmadi, Chairman, Amjaad Group shared his personal journey of taking a company from 30k Omani Rial capital in 2006 to 13m Omani Rial turnover in 2012. Mr Alyahmadi enumerated 34 attributes of a Muslim leader and stressed the need of a Muslim leader to take guidance from the Holy Quran and the Sunnah of Prophet Muhammad (P.B.U.H). The speakers addressed a number of the attributes in their lectures. This is recounted below.

One thing that was made patently clear is that there is a real need to train individuals in the industry, to build their skills. According to research carried out by Deloitte in 2010, 61% of Islamic finance professionals in the Middle East need training. The lack of high quality Islamic finance talent, professionalism of Islamic finance practitioners and Islamic finance talent development are key strategic issues the Islamic banking and finance industry are facing. To tackle this problem, training providers, regulators and education providers have a very important role to play. But it is not only in the banking and finance sector that skills need to be developed. Religious scholarship needs to be improved as well with greater connections to practical day to day affairs and concerns.

The industry is currently suffering from the lack of talent but leaders can help nurture and build skills required to take the industry forward. The IFLP was created in order to emphasise the importance of training leaders, to give them the tools to go forward and to build lasting networks. The event was a success and it is expected that further programmes will take place in other parts of the world.

Acknowledging the past and learning from mistakes

Professor Khurshid Ahmad, Chairman of Board of Directors, MIHE, took the delegates through the evolution of the industry and how to overcome the challenges at hand especially after the recent financial crisis. To anchor his talk in history, Professor Ahmad keenly highlighted the importance of not ignoring the legacy created, and to rectify the mistakes made. He stressed the importance of training to push forward the industry.

Building community ties and working for the common good

H.E Shahid Malik, Former British Minister for International Development, spoke on building community based leadership. The first Muslim Minister highlighted important traits one has to have to become a community leader and shared his perspective on the importance of Muslims in the UK. He advised Muslims to take an active part in government initiatives. Dr Zahid Parvez elaborated that “a leader is a servant of his followers who seeks their welfare and guides them towards something for the common good of the society”.

Challenging the status quo

Professor Mahmood Faruqi, Advisor to BLME and an experienced lawyer, reminded attendees of individuals that changed the way humanity looked at itself. From the Prophet Muhammad to Nelson Mandela, the actions of these great figures inspired, and continue to inspire, billions. He spoke of contemporary leaders, such as Bill Gates and Steve Jobs, who have contributed significantly to the way we work and socialise. He compared different types of leaders, and concluded that the common attribute among all is challenging the status quo. By doing that, they confront what is already there and try and make things better for the benefit of society at large. Leaders are visionaries, they live for a cause. They are passionate and think beyond death, and in that they struggle and try to make a difference to other people’s lives.

Adapting to Change

Successful leadership is vital for the present world as it requires new visions, new approaches, new skills, new tools and most importantly, an ability to adapt to change. As the world is constantly changing, it is extremely important that Islamic leaders adapt to these changes. Successful leaders have the ability to turn vision into reality by working hard for the cause. They think outside the box and develop plans to achieve the objectives they have a burning desire for. They are strategic in their thinking and are able to build partnerships and networks, take and assess risks and are influential amongst their peers and colleagues.

The next IFLP will be organised on 19th-23rd March in Kuala Lumpur and the event will be hosted by Bank Islam at their offices. Should you wish to attend and be part of it, please email iflp@edbizconsulting.com
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Q: Please tell us about your background in banking and finance and how you became involved in Islamic banking.

I was working as a Research Assistant at a USA based university. During that time I visited my parents in Saudi Arabia where I was introduced to Dallah Al Baraka Group. I decided to pursue Islamic finance with an intention to eventually attain a PhD in Islamic finance. This was back in 1992 when Islamic banking and finance was relatively unknown. Alhamdolillah, I have never looked back on my decision and have always been blessed to be part of leading Islamic financial institutions.

Q: What is the future of Islamic banking in UAE?

Islamic banking and finance has become an integral part of UAE financial markets. The Central Bank of UAE Statistical Bulletin for December 31, 2012 shows that of the total “Loans & Advances”, the share of Islamic banks including Islamic windows of conventional banks have reached 23.4%, which is a very positive indicator. There are a total of 53 licensed banks of which 7 are Islamic and some 12 conventional banks have Islamic Windows. Hence, the market share taken by Islamic financial institutions and Islamic windows is very encouraging and the growth prospects of the Islamic finance industry in UAE is superior to overall growth of the conventional banks.

Q: What inspires you?

My inspiration is my insatiable need to always seek perfection and work towards an ideal model for Islamic financial markets whether it is banking, financing, investments, takaful or any other form where we can apply Islamic principles to improve the social fabric of the society and create true value addition.

Q: What do you do in your spare time?

I divide my spare time between research, publication and quality time spent with family. Since 2010 I have started to contribute and publish my research.

Q: Islamic banking: a profession or passion?

Frankly, when I started my Islamic banking and finance career, it was neither chosen as a profession or a passion. It was my own desire to seek perfection in the field of finance when I was involved in post graduate research work. However, as I developed a better understanding of what Islamic finance is all about, it has become my passion.
**Q: What do you enjoy most when you are with your family?**

I enjoy spending quality time with my family whether it is an evening cup of tea with my wife and son or exchanging views on what is happening around the world in a post dinner conversation. I believe that one needs to spend some quality time every day with their families to assure a healthy environment at the home front as well as maintaining a strong bond.

**Q: What is your all-time favourite movie, if you watch movies?**

I find movies a good escape from the daily pressures of life and work. While I don’t have any one movie which is my all-time favourite, but I generally like to watch science fiction movies or even documentary movies on nature.

**Q: Moin Malim as a CEO or as a father? Which one is a more demanding role?**

Definitely Moin Malim as father is a more demanding role. Obviously as a professional in the field of Islamic finance, I am very clear on my roles and responsibilities. However, as a father, we all want to see our children do better in life whether it is their education, career choice or even normal upbringing as a decent human being and a moderate practicing Muslim.

**Q: Do you think the UAE Islamic banking system, comprising fully-fledged Islamic banks and Islamic subsidiaries or windows of conventional banks is working? Which model would you prefer? Malaysian or the UAE?**

Every market where Islamic finance has taken root it has witnessed different growth patterns; some are driven by the consumers, some by the regulators and some by their leaders. Islamic banking and finance in UAE has evolved purely based on consumer demand and a market niche developed by Haji Saeed Bin Ahmed Al Lootah (the founder of Dubai Islamic Bank) – the first Islamic bank in the world. While the Central Bank of UAE has played a passive role historically in the development of Islamic banking and finance, it has given certain freedom to this industry to naturally grow. However, I foresee a more proactive role of the Central Bank of UAE in working towards bringing more proactive rules and regulations which will help Islamic banking and finance industry to find its own niche. Only time will tell whether UAE adapts the current Malaysian model or not. Nevertheless, if one looks at the Malaysian model of Islamic banking and finance, we will realize that while there was consumer demand, both the regulator and leaders also pushed the development of a policy framework and legal mechanisms which has assisted Islamic finance to grow. I am very positive that with the vision of His Highness Sheikh Mohamed Bin Rashid Al Maktoum to make Dubai the Islamic economic capital of the world, Islamic banking and finance will further grow in the country.

**Q: How important is it for a leader in Islamic banking and finance to be physically fit?**

Physical fitness is the precursor for a healthy work environment in every field whether it is Islamic banking and finance or any other. A physically fit individual who is a leader in his/her discipline always motivates the subordinates and the fellow workers to keep fit. However, with physical fitness, one must also have mental fitness to be really an effective leader. A combination of physical fitness, mental fitness and visionary traits are a few critical ingredients what make a true leader.
The growing, global halal economy cannot be ignored any longer. Once a peculiarity advocated by consciously Muslim countries such as Malaysia and nations in the Gulf, its scope is now reaching the West with aplomb.

The immigrant story

The story of the immigrant to Western nations typically involved a hope for increased salaries and a better standard of living. There were two types of immigrant: the labourer willing to undertake menial jobs in factories or in the service sector. These blue collar workers toiled, confronted with some degree of racism and the responsibility of raising a family imbued within them from their culture back home. Life was tough, and family life was often affected due to long periods of time working. Nevertheless, some outgrew the servitude, guiding their own progeny into schools to prosper.

The second group of immigrants arrived with a silver spoon. Typically born with some degree of wealth, they were educated, and came to the West to increase their qualifications. Ambitious doctors, lawyers, engineers and accountants (the quadrivium of Asian aspiration) saw the opportunities of a better education in the West; some remained, others went back.

Edbiz Consulting attended the first Halal Food Festival at the London ExCel on the 29th September. The festival showcased the diversity of halal food. But it accomplished more than what it had intended to do. It showed that the Muslim story in the West had reached the next stage of its evolution: the creation of conscious, self-confident Muslims proud of their religious identity and keen to promote it in country far from their origins.
Generally, these two groups of immigrants were insular, remaining within the boundaries of their own culture and people. Localized sub-cultures and communities appeared in which whole areas were dominated by a particular group of people. The UK, especially, has been victim of this closed community phenomena. However, the progeny of immigrant fathers were forced to socialize, attending schools in which their peers could be white or black or oriental. Additionally, entertainment modes such as music, sports and television ensured that the cultural vestiges of their parent’s generation were being replaced by the new culture into which they were integrating. The consequence of this was more integration coupled with identity confusion. The colour of the skin and the culture of one’s forefathers dictated they could not be regarded as English, and since they only intermittently returned to their country of origin, they could not be regarded as from that place either. A new identity had to be formed.

Adopting the Islamic identity
Islam, a heritage of their father’s culture, offered a convenient solution. For one thing, being Muslim did not depend on geography. It was spiritual and out-worldly and hardly dependent on migrant patterns. One could be a Muslim in China, just as one could be a Muslim in Timbuktu. This made the Muslim identity far more palatable than being Pakistani, even though one lived in Toronto for most of one’s life. By being Muslim, they had to accept a lot of the rules of Islam: no pork, no gambling, no alcohol, no debauchery, and no interest! Unfortunately, the society they lived in was allowed and conferred all the proscriptions they were taught from a young age to avoid.

At this point, the immigrant child is caught between peer pressure (I will follow what my peer group are doing) and pir pressure (follow the tenets of the religion or risk eternal damnation). Some opt for the former, accepting the western, liberal life and being called coconuts, or worse still, kafirs, by self appointed religion protectors. Others seek to strengthen their Muslim identity.

This has manifested in many forms. The first generation immigrants established the edifice on which to build, creating mosques and halal butchers to satiate spiritual and culinary needs. Upon this foundation, the following generations are building educational institutions, charities, local businesses, cross-border industries, grass-root community organisations and financial institutions. Overall, this has created the so called halal industry.

The Western halal industry is slowly taking shape. Finance, travel, education, and food fall under the umbrella of the halal industry. The USA has been particularly strategic in their promotion of the halal industry. The Islamic Society of North America (ISNA) represents the biggest gathering of Muslims in the US. It gives an opportunity for incumbents of the halal industry to advertise and promote their wares. Other organisations such as IFANCA, the American Halal Association, and DinarStandard are actively involved in the consolidation and promotion of the industry.

The UK has not been as dynamic or grand as the USA. Certainly, Islamic banking got its western home in the UK. Additionally, the concentration of Muslims in specific areas has resulted in the formation of Muslim-owned businesses on high streets. But a full scale promotion of the halal industry has not occurred until quite recently.

The Halal Food Festival
Very few people know Imran Kausar and Noman Khawaja. Imran is a doctor, toyed with investment banking, returned to medicine. Noman is a dentist, toyed with marketing, remained in dentistry. Both Muslims witnessed a gap: there had yet to be a grand promotion of the halal food industry. In the UK, it is estimated that the industry is worth $4 billion. So with this in mind, the doctor and the dentist founded the Halal Food Festival. Its inauguration took place on the 27-29th September at the London ExCel. Simply on the numbers of people that attended, the event was a resounding success.

*The Halal Food Festival is a premium festival to celebrate the best in halal food and showcase the culinary delights that are on offer from all over the world.* So says the official event guide, and entering the cavernous ExCel centre, one is instantly attacked by the smell of food. In the hall, there was intense commotion, with stands littered over the area and droves of people walking and chatting. On the left was a
The ExCel Centre is typically a wide open area for conventions and industry showcases. The combined space of the North and South halls are 888,590m². The Halal Food Festival did not take up the full space. In fact, it was comparatively quite small, portioning out perhaps a quarter of one hall. Within the hall, there was an area termed “Street Food & Restaurants” where a number of food stalls lined up next to each other in a square. Attempting to convey the organised chaos of Egyptian souks or Thai street markets, the attendee would navigate past, picking up the sights, sounds and smells of a variety of foods. Sweets, pastries, waffles and lemonade stalls stood next to stands selling Argentinean steak, American hot dogs, Moroccan vegetarian pitas and Lebanese shawarmas. Attendees could not claim to be spoilt for choice.

The problem, however, was that there were many attendees. After 12pm on each day, flocks of people descended into the hall, and long queues started to form. As stall holders tirelessly cooked, customers stood patiently salivating as they waited. Some stalls were so popular that food ran out leaving disappointed, and hungry, consumers.

They did have the opportunity to learn how to cook. One section of the hall was dedicated to teaching willing participants the art of making cakes, guided by a trained chef. But the Halal Food Festival was not only about food. A number of businesses exhibited their services and goods. There were photography and art exhibits, a book stall, alternative medicines based on Prophetic prescriptions along with charity organisations and hijab boutiques. The vibrancy of the halal industry could be seen past the gastronomic delights that the festival was keenly trying to promote. More than this, the organisers were not limiting to food, but sought to convey the potential of the overall industry.

It appeared, therefore, the purpose of the festival was not to simply promote halal food. It showcased the diversity of the industry and also of the Muslim community. Muslim men and women, whose parents had settled in the UK, gathered to identify themselves as self-consciously Muslim. Religious attire such as the hijab and the thobe adorned the pious minded, but they stood alongside the man with the shirt and trouser, and the woman in the blue dress and high heels. The plurality of clothes and colours reflected a self-conscious Muslim throng who may not have adopted the outward symbols of the religion, but were proud to identify themselves as such. Their presence at the Festival said as much.

They, as consumers, have the potential then to drive the halal industry beyond the boundaries of food. The food festival gave an excuse for people to at least attend, and then see other aspects of the industry. If consciously done by the organisers, it was an excellent marketing strategy. That being said, there were not many small businesses present and the range of goods, besides food, on offer was limited, but this was the first festival of its kind in the UK. Certainly, there were things that could have been improved, and undoubtedly, there would be many complaints. However, the foundations have been laid, and the organisers have to be lauded. The only way is forward.

The Halal Food Festival represented the next step in the evolution of the Muslim community in the West. It exposed the diversity and potential of the community who are becoming more comfortable of their Muslim identity and their position in society. It showed that Islamic prescriptions and promotions can sit comfortably with mainstream thinking and actions. If that is the aim of multiculturalism, then the Festival achieved more than it bargained for.

In the UK, it is estimated that the industry is worth $4 billion. So with this in mind, the doctor and the dentist founded the Halal Food Festival. Its inauguration took place on the 27-29th September at the London ExCel. Simply on the numbers of people that attended, the event was a resounding success.
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NOW AVAILABLE IN 30 MINUTES
When the first degree on Islamic finance was offered, there were no self-declared Islamic financial textbooks. Instead, educators had to rely on monographs, articles, newsfeeds and books of law to educate interested students.

Over the last 15 years, the robust growth of the Islamic banking and finance industry has resulted in a number of universities across the world offering Islamic financial bachelors and masters programmes. The growth of the industry has been so significant that Malaysia opened a university, INCEIF, dedicated to teaching Islamic economics and finance.

Henceforth, to parallel this pedagogical improvement, a number of textbooks have been published over the last three years. The three under review all claim to be addressing the absence of proper information on the subject by providing a comprehensive overview of the industry for academic and professional institutions. TD was published first in 2010, and can reasonably claim to be the first textbook that presents a holistic picture of the Islamic financial industry. ISRA followed thereafter released in 2012, with KH published in 2013.

So with three books in three years, it is perhaps apt to ask whether the three differ significantly with each other. The answer is the differences are subtle.

**Purpose**

As mentioned above, all three claim to be filling the lacuna of information on Islamic banking and finance. In doing so, the books are blunt in their advocacy of the principles of Islamic banking and finance as a cure for the ills of the western financial system. At the same time, there is still disagreement in the industry as to what the industry should look like, and this is clearly reflected in TD and ISRA. To be in support of the industry, or at least the conceptualisation, yet acknowledge the dichotomy of what the industry is and what it should be implies the textbooks are attempting, in some way, to offer a way of reformulating the industry. This is not the purpose of a textbook.

TD is the most brazen with even the subtitle of the book reflecting the dichotomy. The editor is a well-known critic of the industry as it is. The final chapter of the book “A Response to Capitalism” presents a critique of the interest based financial system and offers “A Suggestion for Islamic Monetary Reform” before embarking on a proposition for “Rebuilding the Islamic Economy”. The critique is interesting; the suggestions are contentious and, given that there has been no empirical example of what is being suggested, idealistic. The objective of TD is then to provide an overview of the industry before laying the foundations for its improvement.

ISRA is less presumptive although it too presents suggestions for improvement of the industry. Both textbooks are written with the assistance of contributors from across the industry in different sectors. TD sources the contribution of 11 contributors; for ISRA it is 35 (excluding the Islamic Technical Unit of the Malaysian Account Standards Board) with 29 reviewers. Most of these are from Malaysia.

KH provides no recommendations, and attempts to remain objective but with obvious sympathy for the growth of the industry in its current form. There are only three writers, academicians from America, Palestine and Malaysia. Occasionally, the book strays into opinion; one intriguing example occurring on page 92 on the differences of opinion on Bai
al-Inah. The authors regard the differences of opinion within the industry to be overblown, with a need to down play them. While KH explores differences of opinion on products and the issues that confront the industry, it is less critical and positive about the industry as it is.

Presentation

ISRA is by far the most colourful, with photographs and pictures making it much more of a visually pleasing book. KH adopts a two colour scheme, grey and maroon. TD is in black and white and this gives it a more 19th century scholarly feel. The structure of ISRA and KH reflects that of a textbook. Each chapter begins with learning objectives and a preview. It ends with summary, key terms and concepts, practice questions and further reading. TD does not accommodate any of this besides a self test containing over 30 questions. With a subject that can be dry with legalese, such rigour gives a sense of wanting to challenge the student. In fact, TD uses numbering to separate paragraphs, which can rise up to 5 digits (e.g. 3.1.2.2.2) making the book look like a series of clauses in a legal contract. In addition, TD uses footnotes seen in academic journals giving the impression that the book should be read more as a book with an argument than a text book serving to teach. There are few case studies including three on sukuk (Tabreed, PCFC and one on Hanco Securitisation). ISRA contains a similar case study on Tabreed, and is more comprehensive.

A chapter in KH begins with a professional perspective, interviews with practitioners on the topic of the chapter. To strengthen the practical outlook, chapters typically incorporate real-world examples, diagrams, boxes entitled “Global Islamic Finance” and “Islamic Finance in Practice” which provides a snapshot of a sector in the industry, and occasionally newspaper extracts. Chapters also have definitions of key terms and products on the side which are emboldened in the text. Learning Objectives introduce sections, while subtitles divide themes. Chapters also have “Challenge” boxes that attempt to coax readers to think about issues, along with “Hint” boxes that appear to be author’s notes which could not be incorporated into the text.

As mentioned above, ISRA is by far the most colourful with an assortment of colours being used to define paragraph starts. Typically each chapter has pictures, notepad boxes and, diagrams and tables, case studies and exhibits. The exhibits present a deeper analysis of various issues often going into the intricacies of fiqh or providing hypothetical examples to explain concepts.

Content

There will inevitably be commonalities in information between text books proclaiming to be an introductory text on the subject. This is true for the three textbooks under review. Table 1 shows the breakdown of chapters for each book (only KH is in sequential order). One can see many overlaps between the chapters. KH is the most focused, with one unique chapter on microfinance. The other two do not refer to microfinance: ISRA, on the other hand, contains the same chapters as the other two books. There are no additional chapters. However, it is the longest book.

In terms of content, KH attempts to simplify and generalise many of the technical points. It does not seek to delve too deeply into legal debates and differences of opinion. This is not to say that the book does not tackle the finer points; it does but makes it more palatable to the reader. TD is less judicious preferring to reveal more about technical intricacies and legal debates. It spends 80 pages simply giving the background of Islam and Islamic law, and then explores the various issues pertaining to different contacts. TD espouses the classical viewpoints of the four schools of thought making it interesting for the legal reader. TD also has chapters on Islamic inheritance and wills, and Zakah. While they are not directly related to Islamic banking and finance, it is nevertheless helpful in terms of TD’s project of building a more “authentic” Islamic banking and financial industry. TD also presents transactional information, including constituting documents, of certain sukuk products and investment funds. Therefore, there is a definitive legal angle to the book which is perhaps not surprise given that there are 7 contributors with a legal background both in Shari’ah and English law. ISRA explores the differences between school but like KH, although more so, is not as intricate. At the same time, both KH and ISRA provide enough information for the reader to have a good understanding of the relevant legal issues.

All three books have common sections on classical Islamic contracts, contemporary Islamic banking and finance practices, sukuk, tafaful, and investment funds. The differences between them are the style of presentation and expression. KH and ISRA prefer a lighter tone, less verbosity, which appears to be the tool of TD. Even TD’s diagrams, given that they are in black and white, are archaic, and tables can be significantly more detailed when they contained transactional information. In presenting information, KH prefers to give snapshots giving enough information for introductory readers. ISRA attempts to do the same but goes deeper while at the same time making it readable.

Certain subjects are tackled in KH that are not tackled in ISRA or TD such as rating Islamic bonds and microfinance. KH provides a practical, industrial angle to the industry as compared to TD’s more legalistic approach. ISRA attempts to do both and is successful in giving a good overview of the overall Islamic financial system. While it does not talk about ratings, it does explore the money markets, a contentious and pressing issue in Islamic banking and finance. TD talks of the Islamic Monetary System but from an aspirational and hypothetical point of view. This is ignored in KH. TD tackles sukuk and corporate governance but this is under the umbrella of other chapters.

Picking the right textbook

Each book has its own merits, and reader preference will determine which of the three they would prefer to gather a good insight into the Islamic banking and finance industry. KH and ISRA are very good introductory texts with ISRA containing much of the same information as KH and occasionally expanding on it. TD has more of an agenda, and really wants to explore the relationship between classical
Islamic law and contemporary Islamic financial law. It is also a far more of a difficult read given its archaic presentation and penchant for verbosity. This is not to say that legal issues surrounding Islamic contracts or the application of Islamic investment funds were sufficiently dealt with but then it should not be expected for an introductory text book.

But then this is the problem with TD in that it straddles the line between an introductory and intermediate text book. KH can be regarded as introductory text and for readers it is a very good introduction to the Islamic banking and finance industry. ISRA gives a good balance in both the legal and practical elements. It is also far longer and more comprehensive on certain points. Both KH and ISRA together can be used on syllabuses for first year students of Islamic finance given that certain topics are ignored by one but tackled in another. TD is less palatable and in places quite complex as it misses connective points. Since it broaches on technical points it would require practitioners to clarify. The book cannot be read adequately without a teacher to guide them. KH and ISRA can as its style lends itself to more independent reading. It is also targeted to helping educators. KH has a link for instructors. ISRA does not.

In conclusion, both KH and ISRA target the student. TD is focused on building an understanding of the industry as it currently is before suggesting a replacement. As a text book, the former two are better choices.
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