Islamic Finance Review

ISFIRE

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Epistemology of finance: mitigating risk

The evolving needs of British Muslims

The Goldman Sachs discord

Global Donors Forum

Interviews with Azmat Rafique and Mohammed Shaheed Khan

Juristic differences in Islamic finance

Evolution of Islamic banking in Pakistan

Islamic Finance Country Index

Revival of the Islamic civilisation

Edbiz-NASDAQ OMX Shari'a Indexes

John L. Jacobs

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EDITORIAL

Sustainability leads to immense reward. An idea or a product that survives through the vicissitudes of time deserves commendation as it has successfully overcome the challenges placed before it. Every business is dependent on a great many factors that go beyond its initial remit.

To be in a constant state of flux, a case of action and reaction is necessary for any business survival. For the world is ever changing, ever growing, and never predictable.

Randomness can therefore alter the perceptions and directions of anyone. It is uncertainty that intrepidities man and makes us feel nervous. Fortune tellers used to be - and in many cases still are- the relief for the uncertain man. Accorded a supernatural status, their portents could comfort or frighten but it led to a degree of clarity. Today, in the financial markets, we have our own fortune tellers. Statisticians have replaced mysterious women at glass balls, producing their predictions through maths and diagrammatic assertions, comforting the investor who wishes to mitigate uncertainty.

How a business responds will determine its longevity; that is why brands such as Coke, Kelloggs, De Beers, etc. are so impressive. These brands have created an idea and ethos which has embedded itself in society. The consumer when he buys a product ultimately buys an idea.

To explain this point, one only needs to look at advertising. We see TV adverts and billboards publicising a product but we have not experienced it. How do we know what a drink tastes like, or how a car drives simply by looking at an advert? Without experience, the advert has to draw you in by appealing to your visceral emotions. It is the idea that is conveyed and it is the idea we buy. Longevity embeds the idea.

Islamic finance has ideas, it has conveyed ideas, but can it last? Will present consumers remain attracted? Will potential customers become impressed with the ideas it seeks to convey?

The unique Edbiz-NASDAQ OMX Shari'a Indexes is one type of product that promotes the idea of Islamic finance and socially responsible investment. NASDAQ OMX, as an international exchange, has been at the forefront of innovation and foreward thinking in the markets. Edbiz Consulting is proud to partner NASDAQ OMX in creating these unique Shari'a indexes. In this edition of ISFIRE, John L. Jacobs, Executive Vice President of NASDAQ OMX, gives us his viewpoints on the indexes and the Islamic finance market in general.

On the topic of social responsibility, the efforts of Dr. Tariq Cheema and the World Congress of Muslim Philanthropists is a step in the right direction for synergising Islamic finance and charitable giving. The Global Islamic Finance Report 2012 recieved an award at their annual Global Donors Forum, a special honour for the Edbiz Consulting Team.

There is still much to do to push Islamic finance forward. The spirit of Islamic finance is still a contentious question. Replication remains a bugbear but for Rizwan Rahman one needs to go deeper to understand the spirit. Looking at Goldman Sachs, he writes upon the potential pervasiveness of greed in banking institutions and argues that a focus on making money can lead to negative consequences. Changes in individual behaviour can have huge changes in culture. Problems of replication and juristiic differences lead to uncertainty. Dr. Inam Ullah Khan explores the latter in a little more detail in this issue of ISFIRE, providing sufficient evidence of the differences between the Gulf and Malaysia on certain products. More harmonisation is required and a rethinking of the way we conduct ijithad. Differences can lead to a weakening of the system especially in today's international connected market. Uncertainty and complexity makes Islamic finance less palatable to a western audience. Maybe, precisiely for these reasons, in the UK, there has not been a sufficient uptake of Islamic financial products. Islamic financial institutions need to understand Muslim financial needs in order to offer the right product mix. Tariq Masood muses over the evolution of Muslim financial needs and what this means for Islamic finance.

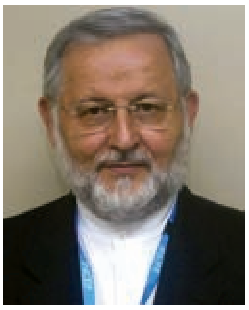
Good ideas and principles can sustain this industry. The question of principles is something Dr. Abbas Mirakhor has been attempting to answer, looking at the epistemology of Islamic and conventional finance. In his final article for ISFIRE, he discusses an approach to risk. While there will always be uncertainty, risk can be mitigated through government action, moral players and efficient markets, particularly stock markets. The way Islamic finance approaches risk is crucial to its success.

Nevertheless, many nations have adopted Islamic finance and it is time that we compare and contrast fortunes. The Global Islamic Finance Report 2012, released in April, contains the groundbreaking Islamic Finance Country Index (IFCI), a composite ranking indicating the performance of Islamic finance in different countries. Rizwan Malik, Associate Editor of the Report, explains the IFCI in a little more detail and gives a breakdown of the ranking. One country in the top 10 was Pakistan. Pakistan has had an interesting relationship with Islamic finance. The State Bank of Pakistan's Usman Ahmad looks at the progress of Islamic finance in Pakistan.

Once upon a time, in the Islamic dynasties of old, the behaviour of its people created a magnificent culture. The Golden Age of Islam was truly a golden age, one that Muslims admire. For Dr. Sofiza Azmi, Islamic finance can be the vanguard of a new, vibrant and dynamic culture. She writes passionately about how Islamic finance can act as the link between the Golden Age of Islam and contemporary society. This is really dependent on the practitioners in the market; and bankers like Azmat Rafique and Muhammad Shaheed Khan are leading the way in promulgating the best that Islamic finance can offer. In this issue of ISFIRE we interview these important figures in the industry.

Professor Humayon Dar
Editor-in-Chief

Epistemology of finance: Mitigating Risk



In this final part, Dr. Abbas Mirakhor explores how Islam views risk and looks into the way the conventional markets tackle risk. He opines that the stock markets, institutional rules of behaviour based on Islamic paradigms and government action can spread risk more effectively and create more robust financial markets.

Achieving the ideal: uncertainty, risk and equity markets

Uncertainty about future outcomes is a fact of human existence. If severe enough, it can lead to anxiety, decision paralysis and inaction. Lack of certainty for an individual about the future is exacerbated by ignorance of how others behave in response to uncertainty. Yet, individuals have to make decisions and take actions that affect their own as well as others' lives. Making decisions is one of the most fundamental capabilities of humans; it is inexorably bound up with uncertainty. Facing an unknown, and generally unknowable future, individuals make decisions by forming expectations about pay offs to alternative courses of action. They can do so using subjective estimates of pay offs to actions based on personal experiences. Alternatively, the person can use known probability techniques to form an expectation of returns to an action. Either way, the expected outcomes will form an expression in terms of probability of occurrence of consequences to an action. In other words, uncertainty is converted into risk. Risk, therefore, is a consequence of choice under uncertainty and exists where more than one outcome is possible. It is uncertainty about the future that makes human lives full of risks.

Risk can arise because the decision maker has little or no information regarding which state of affairs will prevail in the future. The decision maker does not or cannot consider all possible states that may prevail in the future. In this case, even if the decision maker wants to consider all possible future states, there is so much missing information that it is impossible to form expectations about pay offs to various courses of action. This situation is referred to as "ambiguity". If severe enough, this type of uncertainty too leads to reluctance or even paralysis in making decisions. People adopt various strategy of "ambiguity aversion". One strategy is to exercise patience and postpone making decisions until the passage of time makes additional "missing" information available. In a number of verses, the Quran states: "Allah is with those who are patient" and "Allah loves those who are patient".

Dealing with uncertainty is a form of examination from the divine overseer. A number of Quranic verses makes reference to the fact that this temporary existence is a crucible of constant testing, trials and tribulations (see for example verses 2:155 and 2:76). Not even the believers are spared. In verse 29:2 the Quran asks: "Do humans think that they will be left alone when they say: we believe, and they therefore will not be tested?" The fact that this testing is a continuous process is reflected in 9:126: "Do they not see that they are tried every year once or twice? Even then they do to turn repentant to Allah, not do they remember". (See also 2:155). To every test, trial and tribulation in their life-experience, humans respond and in doing so they demonstrate their measure of being self-aware and Allah-conscious. If the response-action is in compliance with the rules of behaviour prescribed by the Supreme Creator, then it is considered the "best action" (11:7). The trial becomes an occasion for self development and strengthened awareness of Allah (swt). Even then, uncertainty remains. Muslims are recommended not to ever assume they are absolutely certain of the consequences of their actions. They are to live in a state of mind and heart suspended between fear (khawf) of the consequences of their actions and thoughts, and the hope (raja') in the Mercy of the All-merciful Lord Creator. All actions are risky because the full spectrum of future consequences of action is not known. The Quran refers to this idea of uncertainty by suggesting that " … at times you may dislike a thing when it is good for you and at times you like a thing and it is bad for you. Allah knows and you do not." (2:216)

Risk sharing

While life and freedom are gifts of the Supreme Creator to humans, and uncertainty and risk are there to test and try humans to facilitate their growth and development, humans are not left unaided to face the uncertainty of life. Books, Prophets and Messengers have brought guidance on how best to make decisions and take actions to mitigate the risks of this life and to improve the chances of a felicitous everlasting life. Islam, in particular, has provided the ways and means by which uncertainties of life can be mitigated. First, it has provided rules of behaviour and a taxonomy of decisions – actions and their commensurate pay offs in the Quran. Complying with these rules reduces uncertainty. Clearly, individuals exercise their freedom in choosing to comply or not with these rules. That rules of behaviour and compliance with them reduce uncertainty is an important insight of the new institutional economics. Rules reduce the burden on human cognitive capacity, particularly in the process of decision making under uncertainty. Rules also promote cooperation and coordination. Second, Islam has provided ways and means by which capable individuals mitigate uncertainty by sharing the risks they face through engaging in economic activities with fellow human beings. Sharing allows risk to be spread and thus lowered for individual participants. However, if a person is unable to use any of the market means of risk sharing because of poverty, Allah (swt) has ordered a solution here as well: the rich are commanded to share the risks of the life of the poor by redeeming their rights derived from the Islamic principles of property rights. Islam's laws of inheritance provide a further mechanism of risk sharing.

Individuals in a society face two types of risks. The first is the result of the exposure of the economy to uncertainty and risk due to external and internal economic circumstances of the society and its vulnerabilities to shocks. How well the economy will absorb shocks depends on its resilience which will in turn depend on the institutional and policy infrastructure of the society. How flexibly these will respond to shocks will determine how much these risks impact individual lives when they materialise. The second type of risk individuals' face relates to personal circumstances. These include risks of injuries, illness, accidents, bankruptcies or even change of tastes and preferences. This kind of risk is referred to as idiosyncratic and when they materialise, they play havoc with people's livelihood. This is because often the level of their consumption that sustains them is directly dependent on their income. If their income becomes volatile so will their livelihood and consumption. Engaging in risk sharing can mitigate idiosyncratic risk and allow consumption smoothing by weakening the correlation between income and consumption such that should these risks materialise, and the shock reduce income, consumption and livelihood of the individual do not suffer correspondingly.

It is important to note a nuanced difference between risk taking and risk sharing. The former is an antecedent of the latter. The decision to take risk to produce a product precedes the decision on what to do with the risk in financing the project. The decision to share the risk in financing does not increase the risks of the project but reduces the risks for individuals involved in financing it as it is spread over larger number of participants. It is also to be noted that the Islamic contract modes that have reached us are all bilateral real sector contracts. The accomplishment of contemporary Islamic finance industry is to:

(i) multilateralise the bilateral contracts as the latter move from the real sector to the finance sector; and

(ii) employ instruments of risk transfer available in the conventional finance but made them Shari'a-compatible.

Instruments of Islamic finance allow risk sharing and risk diversification through which individuals can mitigate their idiosyncratic risks. On the other hand, mandated levies, such as zakat, are means through which the idiosyncratic risks of the poor are shared by the rich as an act of redemption of the former's property rights in the income and wealth of the latter.

Instruments of Islamic finance allow risk sharing and risk diversification through which individuals can mitigate their idiosyncratic risks. On the other hand, mandated levies, such as zakat, are means through which the idiosyncratic risks of the poor are shared by the rich as an act of redemption of the former's property rights in the income and wealth of the latter. Other recommended levies, beyond those mandated, such as sadaqa and qard hasan, too play the same role. They help reduce the poor's income – consumption correlation. In other words, the poor are not forced to rely on their low level income to maintain a decent level of subsistence living for themselves and their families. It is possible that at some point in time even these levies can be instrumentalised to be included in Islamic finance's menu of instruments for risk sharing. Instruments of risk sharing will help blunt the impact of economic shocks, disappointments and suffering on individuals by dispersing their effects among a large number of people. Having a suite of Islamic financial instruments available for all classes of people will assist in reducing their idiosyncratic risks and smooth their consumption. It will ensure that innovators, entrepreneurs, small and medium size firms have access to financial resources without the need to take all risks on themselves or, alternatively, abandon productive projects altogether. Takaful instruments will not only provide protection against health and accident risks but also insure against risks to livelihood and home values to protect people's long-term income and livelihood. Only when such a full-spectrum of financial instruments is available, without transferring risks of any venture to a particular class or to the whole society, can Islamic finance be said to have "democratised finance". This would be in sharp contrast to the results of the "democratisation of finance" project which led to the recent global financial crisis in which the risks and failures of financial innovations were shifted away from financiers to society at large.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Stock markets

The primary instrument of risk sharing is a stock market. Developing an efficient stock market can effectively complement and supplement the existing and to-be-developed array of other Islamic finance instruments. It would provide the means for business and industry to raise long-term capital. A vibrant stock market would allow risk diversification necessary for management of aggregate and idiosyncratic risks. Such an active market would reduce the dominance of banks and debt financing where risks become concentrated creating system fragility.

Idiosyncratic risks impact the liquidity of individuals and firms when they materialise. With an active stock market, individuals can buffer idiosyncratic liquidity shocks by selling equity shares they own on the stock market. Firms too can reduce their own idiosyncratic and liquidity risk through active participation in the stock market. They can reduce risk to the rate of return to their own operation – such as productivity risk – by holding a well-diversified portfolio of shares of stocks. Thus, incentives are created for investment in more long-term, productive projects. Importantly, by actively participating in the stock market, individuals and firms can mitigate the risk of unnecessary and premature liquidation of their assets due to liquidity and productivity shocks. Moreover, an active and vibrant stock market creates strong incentives for higher degree of technological specialisation through which the overall productivity of the economy is increased. This happens because without sufficiently strong risk sharing in the financial system through the stock market, firms avoid deeper specialisation fearing the risk from sectoral demand shocks. The reason stock markets are such an effective tool of risk sharing is because each share represents a contingent residual equity claim.

It can be argued that the actual operation of Islamic finance market differs from its ideal. In essence, there is a market failure: missing markets in equity sharing. Strong government policy action can create an incentive structure for the Islamic finance market to complete the spectrum of its instruments. The market has developed an array of short-term, liquid and reasonably safe instruments which are considered Shari'a compatible. This was not the case some thirty years ago. Then too, there was a missing market for Islamic instruments for which there was substantial demand. It took considerable commitment of resources and credibility on the part of governments, notably Malaysia, to organise this missing market to meet existing demand.

Malaysia's success stems from not only the top-down push by the government but also other ingredients that had to be put in place for the venture's success. The most important of these ingredients were human capital, regulatory structure and financial infrastructure to allow the emergence of Islamic banks. (One of the most important regulatory devises that created an effective impetus to the development of Islamic finance in Malaysia was the "no leakage rule". This rule required that the financial resources mobilised by the Islamic banking window had to be utilised in empowering financially Islamic contracts only). The success of the Malaysia in a relatively short span of three decades indicates it has adopted an appropriate framework for future progress. Specifically, its model would suggest that the same kind of intense dedication and commitment could successfully generate the ways and means of pushing the agenda of Islamic finance forward in terms of developing medium – to – long-term instruments of risk sharing. One strategy would be for governments to develop the long-term, high-return, riskier end of the spectrum of instruments of risk sharing, i.e. stock markets. This would create the needed incentive for the private sector to design and develop instruments in-between the short-term, liquid end of the market on the one hand, and the stock market on the other.

Advantages and disadvantages of stock markets

A large number of theoretical and empirical studies have focussed on the in-

> If the Islamic rules of market behaviour – such as faithfulness to the terms and conditions of contracts, trust and trustworthiness – are in place in a society, the informational problems and transaction costs, governance, and enforcement issues either would not exist or would be at low levels such as not to create deterrence to stock market entry.

vestment-employment-growth benefits of stock markets. When risk is spread among a large number of participants through an efficient stock market, closer coordination between the financial and real sector is promoted as well as better sharing of the benefits of economic growth and financial system stability. Risk transfer through debt instruments, in contrast, along with high leverage, weakens the link between the financial and real sector thus posing a threat to financial sector stability. Especially as the growth of pure financial instruments far out-paces the growth of the real sector activities a phenomenon emerges called decoupling whereby finance is no longer anchored in the real sector. The result is financial instability leading to frequent bouts with crises.

Aside from the fact that, through risk sharing, stock markets become an effective instrument of financing long-term investment, they have an added benefit of being an instrument which individuals and firms can use to insure against liquidity and productivity shocks. While some individual idiosyncratic risks can be mitigated through purchase of insurance policies, such as health, life, and accident, there are potentially a large number of unforeseen, therefore unpredictable, personal or family risks that are not as of yet insurable and for which no insurance policy can be purchased. An individual can buffer against uninsurable risks by buying shares of stocks in good times and selling them when and if a liquidity shock is experienced. Similarly, stock markets can be used to diversify the risk of shock to asset returns. Firms too can use the stock market as a buffer against liquidity and productivity risks. These insurance functions of the stock market create motivation and incentives for investing in projects that have higher returns but lower liquidity.

Empirical studies have demonstrated that countries with robust stock markets rely more on equity and long-term financing and less on banks and short-term debt. Firms place greater reliance on external capital than on internal funds. With a strong stock market, venture capitalists can recoup their capital investment in a project through initial public offerings thus promoting faster roll over of venture capital to make it available more frequently to finance other productive real sector projects. Not only can individuals and firms benefit from existence of a vibrant and robust stock market that provides risk sharing opportunities, countries too can benefit from risk sharing with one another. A large body of empirical research in recent years in the area of international risk sharing has demonstrated that there are gains to be made by countries when they trade in each ther's securities

The question that arises is why is international risk sharing so low? This question is one researchers have been trying to explain in recent years along with another related puzzle called the equity premium puzzle that has been attracting attention since it was first formulated in 1985, It refers to a significant differential existing between stock market returns and the rate of interest paid on a safe bond (US Treasury bonds) over an extended period of time. Economic theory would assert that the differential should not exist. Capital should have left debt instruments and moved into equities until the rates equalised. Hence, the puzzle to be explained is why this high differential continues to persist? The differential cannot be explained by the existing theory of behaviour under risk. Researchers have used varieties of utility functions and risk characteristics, but the puzzle remains largely unexplained. Similarly, there have been attempts to explain the low international risk-sharing puzzle but formal modelling has not been fruitful. It is suspected that reasons which explain low participation in the domestic equity market, hence the emergence of the equity premium puzzle, are the same factors that could explain the low international risk-sharing puzzle. The prime candidate is low trust levels and the high cost of entering the market.

Equity markets that are shallow also have limited participation. Empirical evidence suggests one reason for a low participation of the population in the stock market is that people generally do not trust stock markets. Low level of trust, in turn, is explained by institutional factors and education. Moreover, high transaction costs – especially information and search costs as well as the high cost of contract enforcement – are crucial factors inhibiting stock market participation. These factors too stem from the institutional rules of behaviour in the economy. Possible reasons for limited stock market participation include:

(i) information costs;
(ii) enforcement costs; and
(iii) costs due to weak governance structure of firms and markets.

If these costs are prohibitively high, firms will leave the equity market and resort to debt financing through banks. But banks are highly leveraged institutions that borrow short (deposits) and lend long. This maturity mismatch creates potential for liquidity shocks and instability. Even in the case of banks, there are information problems that lead to market failures such as credit rationing which paralyse the opportunity for risky but potentially highly productive projects because they are rationed out of the market.

Conditions for a vibrant, robust stock market

If the Islamic rules of market behaviour – such as faithfulness to the terms and conditions of contracts, trust and trustworthiness – are in place in a society, the informational problems and transaction costs, governance, and enforcement issues either would not exist or would be at low levels such as not to create deterrence to stock market entry.

There is, however, a paradigm gap between what Islam teaches and the actual behaviour in the market. For this reason, actions governments take and the institutions they create to remedy the deficit in informational, enforcement and governance behaviour to reduce the cost of participation in stock markets have to be stronger and more comprehensive than exist today. These policies, actions and institutions should have the competence, efficiency and enforcement capabilities such that they can elicit the kind of behaviour the results of which replicates or closely approximates those expected if market participants behaved in compliance with Islamic rules. These would include, inter alia:

(i) policies to create a level playing field for equities to compete fairly with debt-based instruments. This means removing all legal, administrative, economic, financial and regulatory biases that favour debt and place equity holding in a disadvantage;

(ii) creating positive incentives for risk sharing via the stock market;

(iii) investing in massive public education campaign to familiarise the population with the benefits of stock market participation; the kind of campaign that the Prime Minister Thatcher's Government ran in the UK which increased stock market participation substantially in a short span of time;

(iv) investing in human capital to produce competent, well-educated and trained reputational intermediaries – lawyers, accountants, financial journalists and Shari'a scholars – which means investing in the creation of world class business and law schools;

(v) limiting short sales and leverage (including margin operations) of non-bank financial institutions and the credit-creation ability of banks through prudential rules that effectively cap the total credit the banking system can create;

(vi) developing strong and dynamic regulatory and supervisory system for the stock exchanges that not only continuously monitor the behaviour of markets and participants but stays a few steps ahead of those with penchant and motivation to use regulatory arbitrage to get around rules and regulations;

(vii) finding ways and means of regulating and supervising reputational intermediaries or, at least, mandating that they become self-regulating to ensure minimisation of false reporting or misreporting under threat of liability to market participants;

(viii) ensuring completely transparent and accurate reporting of the day's trade by all exchanges; and

(ix) instituting legal requirements for the protection of the rights of minority shareholders.

The above policies and actions are not exhaustive by any means, but even this incomplete list will help reduce the cost of market participation, invest the market with credibility and reduce reliance on debt financing.

Lack of good information about firm's true values and the existence of a company self-dealing create the problems of moral hazard and adverse selection. Both problems can be addressed by legal rules and procedures as well as by existence of efficient and credible public and private institutions that monitor the stock market and companies listed on the stock exchange. These laws and institutions can assure investors of the honesty of dealings by firms and of the full transparency and accuracy of reporting and information. Extensive laws regarding financial disclosure; securities laws with strong sanctions of imposing risk of liability (to investors) on accountant, lawyers, firms' insiders, investment bankers in retaliation for false reporting, fraudulent, misleading information or faulty endorsements can be powerful tools of dissuading all concerned from temptation of defrauding investors by false reporting and misleading information. Requiring reputational intermediaries to be licensed by regulators and revoking licenses or imposing heavy fines and initiating criminal proceeding against misbehaviour weakens the incentive structure for abuse of reporting, endorsing, and information processes. Strong listing standards which stock exchanges enforce fully through imposition of heavy fines or even delisting of companies that violate disclosure rules would discourage false information from reaching investors. Existence of an active, dynamic, well-informed financial press can be valuable in creating a culture of disclosure. A strong, independent, and dynamic regulatory agency would be needed to monitor and supervise the stock market and behaviour of its participants and promote aggressively a culture of transparency by requiring prompt and accurate reporting on all trades in the market. Finally, it bears repeating that government must invest considerable resources on development of world class business and law schools to ensure competent source of supply of human capital to reputational intermediaries.

While the above policies and institutions are crucial in reducing the cost of participation in stock markets and thus promoting widespread risk sharing, governments need to do more: they must lead by example. They could become active in markets for risk sharing. Generally, governments do share risks with their people. They share risks with individuals, firms and corporations through tax and spending policies. They are silent partners. They also share risk of life of the poor and disadvantaged through social expenditure policies. They share the risk of the financial system through monetary policy and deposit guarantee. They could choose to finance part of their budget, at least development spending, through risk sharing and direct ownership of development projects with their citizens. This way they would reduce the debt burden on the budget. This reduction in government borrowing reduces the burden on monetary policy as well. Governments undertake public goods projects because the characteristics of these goods – importantly indivisibility and non-exclusivability – prohibit their production by the private sector and therefore are undertaken by governments. However, their social rate of return is substantial and much higher than private rates of return. A recent popular proposal suggests that these projects should be undertaken jointly with the private sector, hence the Public Private Partnership (PPP) label. The proposal has a number of problems: market distortion, informational and governance problems being just three of these.

Government finance and risk sharing

Financing a portion of government's budget though the stock market has advantages some of which are summarised here. First, it can energise a stock market – provided that all preconditions, in terms of human capital, legal, administrative and regulatory framework – are met and helps strengthen the credibility of the market. Second, it deepens and broadens the stock market. Third, it demonstrates that stock markets can be used as a tool of risk and financial management. Fourth, it reduces reliance on borrowing thus imparting greater stability to the budget and mitigate the risk of "sudden stops". Fifth, it has positive distributional effect in that the financial resources that would normally go to service public debt can now be spread wider among the people as returns to the shares of government projects. Sixth, it enhances the potential for financing of larger portfolio of public goods projects without the fear of creating an undue burden on the budget. Seventh, it makes the task of monetary management simpler by limiting the amount of new money creation and limiting the number of objectives of monetary policy. Eighth, it promotes ownership of public goods by citizens; thus have a salutary effect on maintenance of public goods as it creates an ownership concern among the people, and to some extent mitigate "the tragedy of commons". Ninth, it has the potential of strengthening social solidarity. Tenth, it also has the potential to promote better governance by involving citizens as share-holder-owners of public project. Eleventh, it provides an excellent risk-sharing instrument for financing of long-term private sector investment. Twelfth, it is also an effective instrument for firms and individuals to use to mitigate liquidity and productivity risks. Thirteenth, by providing greater depth and breadth to the market and minimising the cost of market participation, governments convert the stock market into an instrument of international risk sharing as other countries and their people can invest in the domestic stock market. Fourteenth, it will change the basis of monetary expansion from credit to equity as economic expansion in the real sector maps onto the financial sector. Finally, it will help demystify Islamic finance and will create an environment of cooperation and coordination with international finance.

The design of risk-sharing instruments to be issued by governments is not difficult. These instruments can be traded in the secondary market if the shareholders experience a liquidity shock. Their rate of return can be structured as an index of return tied to the rate of return to the stock market. If the domestic stock market is not deep, then an index of regional and/or international stock market returns can be included. The argument is that since social rate of return to public goods are much higher than to privately produced goods and services, the investment in public goods should have a rate of return at least as high as the return to the stock market to promote efficient resource allocation. Of course since governments are usually less risky, the rate of return to government-issued shares has to be adjusted downward to take account of governments' risk premium. Depending on the country and the interest rate its government pays on borrowed money, it is not likely that the rate of return it would pay to holders of equity shares it issues – adjusted for the credit rating of the government reflected in lower risk – would be any higher than the rate interest. Even in the unlikely event that a few basis points higher has to be paid, the trade off is worthwhile considering the positive contributions the instrument would make to the economy and the society.

The evolving needs of British Muslims

For there to be a successful and sustainable Islamic finance market in the UK, it is imperative to consider and understand the socio-economic affairs of the Muslim community. In this regard, understanding the evolution of the Muslim psychology since the immigration of the first migrant generation will assist Islamic banks in creating the right services. Veteran banker Tariq Masood explores this further and looks into the implications for the UK Islamic finance market.

From their humble beginnings as mainly shop-floor workers during the UK immigration boom of the 1950's and 60's, the British Muslim community has greatly evolved both economically and socially. According to DataMonitor, in 2002 Britain had well over 5000 Muslim millionaires with liquid assets in excess of £3.6bn. A large portion of Muslims in the UK are of Pakistani origin: the 2001 UK Census recorded 1,591,000 Muslims of which 747,285 residents described their ethnicity as Pakistani, regardless of their birthplace. Using the British Pakistani community as a proxy, this article comments on the economic evolution of British Muslims, how their banking requirements have changed over time and the resulting implications for contemporary Islamic finance.

History of the Pakistani diaspora in the UK

As a result of the industrialisation boom in the UK in the 1950s and 60s, there was a sharp increase in the demand for unskilled and semi-skilled labour. To meet this demand, the UK looked towards former colonies and Pakistanis were among those invited to fill the labour shortages which arose. As Commonwealth citizens, they were eligible for most British civic rights. Almost all of them were males who had left their families behind and relocated solely for economic purposes. The initial mind-set of these workers was one of temporary economic relocation with the aim of returning to their country of birth, while in the interim sending money back in the form of remittances.

They found employment in the textile industries of Lancashire and Yorkshire, manufacturing in the West Midlands, and car production and food processing industries of Luton and Slough. It was common for Pakistani employees to work on night shifts and at other less- desirable hours. In Scotland, some landed jobs in the shipping industry, and a considerable proportion took part in door-to-door sales of household/everyday items, highlighting their unique entrepreneurial and progressive characteristics. These traits have un-


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doubtedly assisted the posterior generation in climbing the social hierarchy. Perhaps it should come as no surprise that the UK's first Muslim councillor and MP were both from Scotland.

The main banking service required by the initial Pakistani immigrants was sending remittances to their families in Pakistan. Pakistani banks were the preferred financial service providers for migrants, as remittances could be easily, and cheaply, sent to remote locations in Pakistan.

From the late 60s onwards, as immigrants started to become more settled and financially stronger, the demographics of UK Muslims also started to change from predominantly men towards a family setup. Their financial needs evolved due to more financial independence and increasing economic aspirations. With respect to personal finance, demand for home financing increased, while commercially, Muslims wanted access to start-up capital in the form of soft loans for small corner shops.

Banks such as Habib Bank Limited (HBL) actively facilitated start-ups by disbursing loans on a 30% to 70% (LTV) basis for small corner shops. Pakistani banks were again preferred as they understood the mechanisms and the mindset of the Asian subcontinent. The initial entrepreneurs were not as organised or professional as was required for local banks to finance them; Pakistani bank managers on the other hand could identify with their clientele and could provide exactly for their needs.

Interestingly, even though the community was growing, from the late 70s and continuing through the 80s, there was a degree of consolidation and branch closure as Pakistani banks started to see a stagnation in their consumer base. Key reasons included:

1) In the case of personal finance, Pakistani banks did not deal in long term house financing i.e. mortgages, and this forced people from the community who wanted to buy houses to go to local banks. These local banks would then require the opening of an account with them to build a credit history, which in turn meant a further flight of money from Pakistani banks to mainstream UK based banks.

2) As certain Pakistani businesses grew in the 80s, so did their capital requirements with demands for financing in excess of £100,000. However, due to management policies limiting exposure to risk, Pakistani banks were not willing to provide such facilities which again forced top tier Pakistani businessmen to go to local financial institutions as alternatives.

3) From the 80s onwards, the personality profile and demographic traits of the Muslims in the UK started to evolve as well. British born Muslims who were comparatively more embedded in UK society as a whole than their immigrant forbears began to achieve a critical mass. They could communicate in English comfortably and were more content with opening child/student accounts with local mainstream banks (a service not provided by Pakistani banks), and with the long-term nature of banking relationships, few of these customers have since changed their banking provider.

> The need to learn from previous experiences is critical to future success. The Turner review highlighted one of the reasons for the crisis is the lack of desire to learn from previous mistakes. The UK retail Muslim market represents a dynamic market with a rapidly evolving mixed diaspora. There are a number of nuances and subtleties to consider when dealing in niche markets and the British Muslim communities are no different.

Islamic banking: learning from past experience in the UK

So what can Islamic banks targeting the domestic Muslim market learn from the experiences of the past? And why is it that most traditional Pakistani banks that already have a high number of Muslim clients remain on the margins of the recent Islamic finance boom in the UK.

It is clear that retail Islamic banking in the UK has been an exciting and challenging experience over the past 15 years. The development of the sector effectively from scratch has had significant successes on various fronts (regulatory, taxation parity, increased awareness, etc.

However, UK stand-alone Islamic banks are nascent (less than 6 years old) and have struggled to demonstrate a consistent profitable model. Worse, there has been the closure of the only regulated standalone takaful operator in the UK. Window/subsidiary operators have either pulled their Islamic products from the market or failed to successfully expand their offering which is particularly worrying as retail banking is very much a multi-product portfolio play. Along with the generic challenges faced in any new, fledgling sector, the prevailing financial market uncertainty adds to the challenge for the UK Islamic finance market. Overall, it poses significant concerns for market penetration.

In addressing these challenges towards creating a profitable UK Islamic retail market, it is useful to reflect on prior experiences of servicing the Muslim community by Pakistani banks. Extrapolating from the experiences of Pakistani banks over past 40 years, select insights and lessons are noted below for UK Islamic product providers to consider as they refine their business models:

As the community continues to rapidly evolve, product providers need to demonstrate a dynamic approach and expand and develop their offering in line with market changes to meet the needs of their customers. Key services and products need to be provided competitively and the offering gap reduced. The implications of working in such a dynamic environment put additional emphasis on areas such as:

1) Adaptability – to (re)train staff on

new products;

2) The mindset of senior management - needs to be dynamic and entrepreneurial to reflect the undeveloped and indeed R&D nature of parts of the Islamic market;

3) Education and regular market reassessments - to build a strong insight into consumer perspectives and how this changes with increased education and awareness.

The Muslim community itself has evolved vastly over the past two decades, from being mainly Pakistani and Bangladeshi to having a more diverse ethnicity, including Turkish, Somali, Arabs, etc. The British Muslim community now more than ever in its history represents a real cocktail of various diasporas from UK born Muslims to economic migrants along with British converts to Islam. Detailed market segmentation analysis needs to be undertaken to genuinely understand this mix of ethnicities and the nuances within the behavior trends between each group. The clever utilisation of additional Non-Executive Directors (NEDs) who are from the UK and have lived within and serviced the target customer community will enable product providers to utilise their understanding and unique insights when designing and developing products and the go-to-market strategies deployed.

When serving unproven niche markets, it is imperative to keep tight cost controls and effectively managing the timing of large fixed cost expenditure against utilising relatively lower cost solutions that can be easily changed or retrofitted. In the 80s, HBL and other banks reduced their branches as the fixed cost base for branch operations were proving to be costly and ultimately many Pakistani banks had to merge with other banking entities to remain viable. Consolidation within the Pakistani banks is still occurring to date as evident by the recent acquisition of Habib Sons by HBL. With five standalone Islamic banks in the UK along with various windows operating within the conventional banks in the current difficult economic conditions the market could see a degree of consolidation in the future.

Islamic bank managers require stronger interpersonal relationships with their clients, as the majority of Muslims from the Middle East and the sub-continent historically felt more comfortable doing business with an individual rather than an organisation. The strong relationships and the community cultural element remains evident, particularly as a number of people are migrants coming across as spouses or for work. Examples of the early Pakistani banks that operated in the UK and their initial success can be used as a useful case study.

Conclusion

The need to learn from previous experiences is critical to future success. The Turner review highlighted one of the reasons for the crisis is the lack of desire to learn from previous mistakes. The UK retail Muslim market represents a dynamic market with a rapidly evolving mixed diaspora. There are a number of nuances and subtleties to consider when dealing in niche markets and the British Muslim communities are no different.

Islamic retail product providers can take meaningful lessons from the experience of Pakistani banks in developing a stronger understanding of a large portion of the consumer market they are aiming to capture.

For those who can successfully penetrate the market with a competitive and attractive offering that has a broad market appeal and is based on ethical foundations, there is a significant commercial reward to be won.

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The Goldman Sachs *discord*

In April 2012, Goldman Sachs' employee, Greg Smith, announced his departure from the investment bank by writing a caustic indictment of the bank's culture. The letter was published in broadsheets in the UK and the US, and brought scrutiny and censure to the bank. A profound point was made in the letter about the nature of man. Rizwan Rahman contemplates this further and argues that falling into avarice is more likely in a culture which dehumanises the client.

"I believe I have worked here long enough to understand the trajectory of its culture, its people and its identity. And I can honestly say that the environment now is as toxic and destructive as I have ever seen it"

These words are from Greg Smith's noxious email against his previous employer, Goldman Sachs. It was hardly a death knell to the global megabank. But it did reveal a subtle, worrying psychosis that may pervade the institution. Commentators on Smith's resignation letter published in the New York Times earlier this year were quick to focus on the supposed designation of clients as 'muppets' by Goldman Sach's employees; mere objects from which to extract as much money as possible, even if it meant offering substandard products. Smith's main contention was that the company culture had shifted from meeting client's needs with 'integrity' and 'humility' to encouraging an almost parasitic, money grabbing ethos.

If his letter had been written pre financial crisis, it is unlikely it would have caused a stir. Instead, in the ongoing recessionary environment, the letter provided added ammunition for the congeries of the disconsolate, contemptuous of the "profit maximisation at any cost" culture that triggered the global financial crisis. On the heels of the Occupy movement, the letter served to justify all that is wrong with Wall Street. Money was the goal; money at the expense of civility; money making without conscience.

A public relation headache

Scrutiny fell upon Goldman Sachs. They became the poster child of greed and unconscionable behaviour. There were calls for the resignation of Lloyd Blankfein, the CEO, who many felt was responsible for the shift in culture. Banking was based on trust: the higher echelons had forgotten this. There had to be a rehaul, a change, a revival, a return to first principles, a return to the words of John Pierpont Morgan that commercial credit was primarily based upon character with money and property were secondary considerations.

Many would argue that the letter highlighted a culture which produced vultures, preying on the uninformed. Mr. Smith felt values at the bank had changed. However, the image of the rapacious bank, intent on profiteering is hardly new. Long before 2007, there was 1929, where financial market players were condemned for their profligacy (John Maynard Keynes had called the financial markets a 'casino'). The 80s provided a characterisation of the yuppy, with expensive clothes and an oversized mobile phone, hurrying and scurrying in the traders pit, looking to exploit the differential.

However, for all intents and purpose a bank's purpose is to make money. Maintaining clients comes from generating at least normal profits, but hopefully, supernormal profits. Therefore, the bank will look at possible ways in which this can be accomplished. An esoteric problem of today's financial system is that making money has become easier through the over reliance of computers. Money making can be facilitated through the manipulation of numbers. The focus will be on numbers and not on the 'integrity' of the client. They are rarely in front of you. When numbers on the screen determines the success of both the bank and the client, then from the beginning, the client is dehumanised. . As soon as their ability to make profits is inhibited, the demand will also fade. All clients really need is respect when spoken to and healthy returns but any invective behind closed doors does not necessarily lead to a collapse in fortunes for the company.

Greg Smith's indictment, and similar accusations, is a public relations headache. It is the responsibility of PR departments to ensure that a good image is constantly portrayed of the company. For customer facing institutions, selling tangible goods and services with many store fronts, such as Apple, McDonalds, etc, it is a daily concern. Customer attraction, satisfaction and loyalty will be dependent on many things, from the quality of the product, the level of services, the behaviour of the employees, the interior design, etc Opaque financial institutions such as Goldman Sachs, have to worry about this less. They may need to advertise, ensure they are known, but maintaining client satisfaction is by and large limited to deriving a sufficient level of profits.

Consequently, there is every opportunity of corner cutting and slight exploitation provided the end result is met. Only when the company or clients are losing money will serious questions be asked. The financial crisis in part stemmed from sub-prime mortgages, inherently flawed and consequently exploitative of buyers. CDOs rushed through the system, even though there were obvious structural problems. But users were blindsided by the profits it was generating. When the floor collapsed, questions were asked but one must ask why these questions were not asked before.

> "...greed, for lack of a better word, is good. Greed is right, greed works. Greed clarifies, cuts through, and captures the essence of the evolutionary spirit. Greed, in all of its forms; greed for life, for money, for love, knowledge has marked the upward surge of mankind".

"Greed is good"

To answer that question, it would be expedient to consider the words of the fictional character Gordon Gekko, the antagonist in Oliver Stone's 1987 film "Wall Street". The film is a morality tale depicting the conflict between the working class and the rich, ambition and loyalty, ethics and success, power and corruption. Gekko, respected in the financial markets for his shrewdness and success, delivers an emphatic monologue to an audience of shareholders:

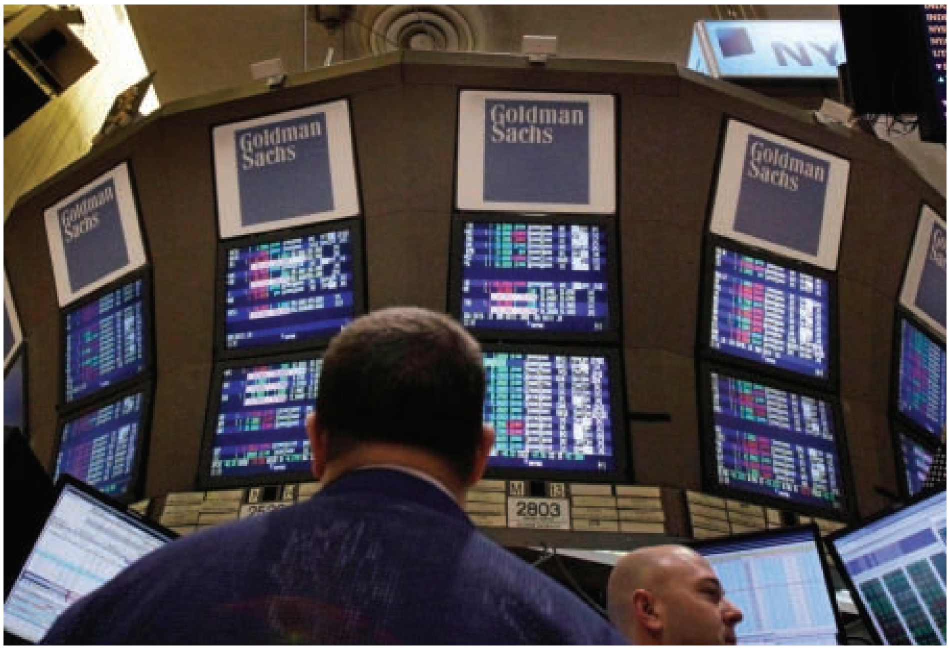
'Well, in my book you either do it right or you get eliminated. In the last seven deals that I've been involved with, there were 2.5 million stockholders who have made a pretax profit of 12 billion dollars...I am not a destroyer of companies. I am a liberator of them! The point is… that greed, for lack of a better word, is good. Greed is right, greed works. Greed clarifies, cuts through, and captures the essence of the evolutionary spirit. Greed, in all of its forms; greed for life, for money, for love, knowledge has marked the upward surge of mankind".

For Gekko, greed is good because it drives mankind forward and thus it 'works'. Progress is achieved by having a desire to have, be it money, love or knowledge. Success is begotten by achieving what you are greedy for. Yet, conventional ethics rails against this concept. In Catholic theology, greed was considered one of the seven deadly sins and a slippery slope to the hellfire. Dante's allegorical poem, "The Divine Comedy", personifies greed as a purveyor of selfishness. He exhorts "O avarice! What canst thou more, who hast subdued our blood so wholly to thyself, they feel no care of their own flesh?

The inference here is that greed consumes the person/s to the point where compassion for kin disappears. As is common with poems and prose with a moral message, exaggeration, metaphors, bathos and other narrative tools are precisely to make the reader ponder as to his own flaws. For moralists, the concern was always the wellbeing of society but the root of any deterioration was flawed individual. Making the flaw consensual and systematic in society, it begins to fester. The moral foundations of society are then weakened and eventually society disintegrates. In a quite remarkable passage in the Quran, it states " God does not change the condition of a people until they change what is in themselves".

Gekko's ultimate philosophy was a single minded focus on the accumulation of money. Having an un-wilting determination to achieve any particular goal is a praiseworthy personality trait but the impact of such ambition on third parties cannot be ignored. A pursuit for money in financial institutions suffers especially as there is little consideration for the asset from which the wealth is being created. Casino like behaviour in the financial markets has effectively created a financial system dependent on numbers building on numbers. Making the number larger then becomes a primary concern.

Thus greed in the financial markets can be thoroughly egregious, self indulgent



What is of greater concern is that only a nominal concern for the Shari'a rules can dilute the spirit of the law. In such a situation, the industry becomes a parody of the complex structuring found in the conventional market. It is a slippery slope.

and domineering. If ones goal is to only build profits, with no real attachment to a tangible product, then the potential to circumvent the rules and exploit the customer increases. The culture of Goldman Sachs is of making money. Why should it come as a surprise that they regard the customer as avenues of exploitation?

Islamic finance is about the real economy?

An inordinate focus on making money can lead to strange outcomes. The credit crisis revealed how complex financial products can be traded but not fully understood. The products still managed to exchange hands as the buyer could only see the potential profits that could be derived. They had failed to see on what tangible asset the product was ultimately based upon. Subprime mortgages rested upon poor buyer looking for housing. A consideration of this would have mitigated if not avoided the crisis.

Would it be correct to say that the ignorance of this boiled down to greed? Was there any real concern as to the affect of the debt on the person? For the bankers involved, was it all about the numbers on the screen? This is a question that is being posed by critics of the Goldman Sachs Sukuk. At first glance, the product is seemingly compliant with Shari'a and a boon for the industry as a leading global megabank will be issuing the product. However, critics have argued that the structure stipulated in the prospectus is a ruse. The returns the sukuk holder receives is not generated by the structure but rather from ribawi transactions, and therefore forbidden activities, undertaken by Goldman Sachs. Moreover, since the sukuk can be listed, the problem of riba is extenuated as certificates begin to be traded not on par.

In such a situation, critics are scratching their heads, wondering about the essential nature of the product. A much more pertinent question is what is the intention of the parties? Is it to only make money by attracting Shari'a sensitive investors though purporting to be compliant? These are questions that are not limited to the Goldman Sachs Sukuk. Islamic finance in general has been contending the law vs spirit dichotomy for as long as it has been in existence. There is an inherent tension between the need to comply with the formalistic elements of Islamic law while at the same time being practically relevant. The fundamental paradox for Islamic finance is that irrespective of the diatribes against the ribawi capitalistic system, its framework has been successful both in profitability and minimising risk. Many are asking: has Islamic finance offered a better alternative?

The credit crisis could be considered as evidence of the failure of capitalism but the causes of the crisis was not so much the system, but more so the players within the system. They exploited the flexibility given to them. A desire to exploit then rests upon the choices of the individual. In Islamic finance, many would argue that there is no harm in utitlising commodities to constitute and Islamic finance product. However, if the intention is only on deriving profits, then just as with the CDOs, there is opportunity for an unexpected failure. Those who structure the product according to Shari'a may become less stringent in the application of the law. What is of greater concern is that only a nominal concern for the Shari'a rules can dilute the spirit of the law. In such a situation, the industry becomes a parody of the complex structuring found in the conventional market. It is a slippery slope.

Conclusion

Gordon Gekko was a fictional character but he was a composite of a number of Wall Street traders, looking for that quick buck. Greed for money has always been a vice. It is borne from selfishness and a narrowness in perspective. One aggrandizes his own worth, and the end goal becomes the only goal. Concern for those around him becomes less of a concern. Systemising this view in a culture can lead to devastating consequences. It is difficult to conclude that the culture of Goldman Sachs is as pernicious as Greg Smith alludes. However, the point is in any profit making institution the potential for greed for money is great. Once embedded, it can lead to undesired consequences including creating strange, complicated financial products. Ultimately, the complexity will unravel.

Head of Islamic Banking at Oman Arab Bank

Interview with Azmat Rafique

It has been exactly a year since Oman's leader Sultan Qaboos approved Islamic finance in the Sultanate. Banks have been quick to enter to offer Islamic financial services but there is still a lot to do. We sit with Azmat Rafique, to discuss his own journey and the prospects of Islamic finance in Oman.

You have worked in Pakistan, Bahrain and Qatar before moving to Oman. Tell us what made you leave your previous job in Qatar and move to Oman, which is just starting Islamic banking and is indeed a very new player in the Islamic banking market.

The very fact that Oman is starting Islamic banking was enticing enough. In terms of Islamic banking and finance, Oman is a blank canvass. Entrants into the market have an opportunity to create a unique model, which takes into account any systematic weaknesses of other jurisdictions and tackles them. To mould and manage, create and execute accordingly makes this new position exciting and dynamic. For me, it is undoubtedly a remarkable growth opportunity for my career and one that I would have been foolish to refuse. After working in established Islamic banking markets in Pakistan, Bahrain and Qatar, I gained a comprehensive and valuable understanding of Islamic banking products and systems. Oman Arab Bank has offered me the opportunity to use both my banking and Islamic finance consultancy experience for establishing an Islamic banking window. I am really excited to assist the bank in offering the best Islamic banking products and services to Omani customers.

As Head of Islamic Banking at Oman Arab Bank, which has yet to offer Islamic banking products, what challenges are you facing in terms of product development, IT, accounts, training and marketing?

Product development for a new market is a sensitive and risky business. We are gradually understanding the dynamics of demand of Omani customers and carefully choosing the product structures which can be tailored according to local needs.

Supporting IT solutions is equally important but we have the benefit of choosing from well developed and established IT systems in the market and are confident that this challenge will be met comfortably. Similarly, the Central Bank of Oman's decision to follow AAOIFI Accounting and Auditing Standards has given us a good starting point. Our team is well versed in this area and so we do not see any major difficulty in implementing the Standards.

We have a well structured training program for our Islamic banking team and may use a mix of internal and external resources to implement this. Though we have not started any marketing so far, we have already conceived a structured marketing plan that will enable us to reach out to our customers in Oman.

This is first time that Oman will witness faith based commercial offering and so mindfulness of local sensitivities and religious values is a paramount requirement for success. The majority of Omanis are from the Ibadi sect, founded by Jabir ibn Zaid al-'Azdi, which is different from sects followed in other countries of the GCC. I highlight this point as modern day Islamic finance is very much driven by the Sunnis, though ground-breaking works by Shia thinkers - the most prominent being Baqir Al Sadr – has also played a part in the evolution and continuation of the industry. Nevertheless, by being from a different sect with different legal conceptualisations, it would be irresponsible to ignore their laws, culture and understandings of muamalat. We have to be aware of certain sensitivities of the grassroots in order for us to offer the right product suite.

Why did you choose to do Islamic banking as a career? Do you not think that there still are greater opportunities for building a successful career in conventional banking?

My personal inclination towards Islamic banking is faith based. I left a successful career path in conventional banking when Islamic banking became available in Pakistan. However, I do not think I suffered in terms of my career growth. Islamic banking has given me equally good career growth opportunities.

What are the benefits of having an Islamic window as part of a conventional bank, as compared to having a fully-fledged Islamic bank? Do you think an Islamic window model is more appropriate for the Omani market at this early stage of development of Islamic banking in the country?

There are definite advantages of Islamic window model, especially in a market such as Oman which has only recently introduced Islamic finance. An established bank, from which the window will stem from, has the significant advantage of already knowing and functioning in the market. The bank will have its own customer base with cross sale opportunities. In addition to marketing Islamic banking to new customers, the bank can target its own customer pool, offering and marketing a new range of products. One cannot underestimate customer loyalty and if the bank has developed sizable goodwill, the Islamic window will attract existing customers who have a preference for Islamic finance but previously did not have access to it. In addition, the bank can also leverage on its existing brand image. Even those who are not the banks' customers will know of the bank. To some extent, the bank can rely on their existing setup. The bank understands the regulator, their requirements and their idiosyncracies. They have a greater understanding of what happens behind closed doors and the behaviour of policy makers. It puts them in a better position than someone new in the market.

At the same time, a fully fledged Islamic bank has several advantages over Islamic windows. The do not face any issue of image conflict, no legacy and potential rift within the organisation, and a focus strategy to offer specialised products.

For the Omani market, the window model seems more appropriate due to the factors that I just mentioned. In Oman, Islamic banking windows will also benefit from the Central Bank's decision to maintain transparency and ensure the segregation between Islamic and conventional operations. This will allow Islamic banking windows to enjoy benefits of being a new vehicle and will help them benefit from the profile, tenure and liquidity of the conventional bank.

> Islamic banking in the GCC is ready to ascend to the next level of maturity. Competition and an enabling environment will steer banks towards adopting technologically advanced solutions. I believe the Islamic banking sector in Oman will take 3-4 years before it achieves a respectful size. The country will definitely attract regional investors who are willing to channel funds in Shari'a compliant investments.

Where would you like to see Oman Arab Bank's Islamic banking operations in the next five years?

Oman Arab Bank enjoys a legacy of stability and sound banking practices. We definitely want to grow and enjoy a prominent position in Oman's Islamic banking market; however, we will ensure that we continue our legacy of prudent banking practices. Our vision is to make our Islamic banking offering a leading brand in Oman. There is still a long way to go with regards to Islamic banking and finance in Oman. It was only in the last year that permission was granted, but this did not mean a change in regulations and an analysis of laws which would pose efficiency problems for Islamic banks. The Central Bank is still quite cautious with Islamic banking and is effectively adopting a 'wait and see' approach. Its early days for Islamic finance in the country and just like in Malaysia and UAE, success will ultimately depend on the efforts made by policy makers and regulator in Oman.

Who amongst the contemporary personalities has influenced or impressed you the most?

I cannot point out a single personality but Dr. Mahathir Mohamad, Recep Tayyip Erdoğan, and Dr. Muhammad Yunus are among contemporary personalities I highly regard. Mahathir and Tayyip have been quite remarkable Muslim leaders. They worked off a platform that respected the Islamic identity and tradition and showed that there are ideas and tools in Islamic heritage and law that can meet the challenges of modern life. In many ways, they showed that Islam is not anachronistic and is applicable to the social, political and economical problems of the modern day. Dr. Yunus is an extraordinary individual. His microcredit/Grameen concept has revolutionised approaches to tackle poverty. The poor were no longer considered as those who were incapable of helping themselves, but rather they were humanised as contributors to society. His story is quite inspirational.

What do you see in terms of the future of Islamic banking in the GCC and where would you place Oman on the regional map?

In my view, Islamic banking in the GCC is ready to ascend to the next level of maturity. Competition and an enabling environment will steer banks towards adopting technologically advanced solutions. We may also see new versions of existing products that are tailored to niche markets. Service quality as compared to leading international brands of conventional banks certainly requires attention. Islamic banks are aware of this and we may witness improvement in this area. At a macroeconomic level, the industry will continue its remarkable growth.

I believe the Islamic banking sector in Oman will take 3-4 years before it achieves a respectful size. The country will definitely attract regional investors who are willing to channel funds in Shari'a compliant investments. The Oman economy is quite stable and there are lucrative opportunities in the country. We will also see regional Islamic banking players expanding their operations in Oman.

What in your opinion is the greatest challenge facing the global Islamic financial services industry?

People talk about standardisation, trained human resources, Shari'a compliance, and product innovation. These are essential factors for the growth of industry but in my view, at present, the greatest challenge is to offer a world class service similar to what recognised international brands offer to their customers. It all boils down to customers experience: if they are not happy with what we offer to them, we have not met our ultimate objective.

How is life in Muscat? How would you compare it with Bahrain and Doha?

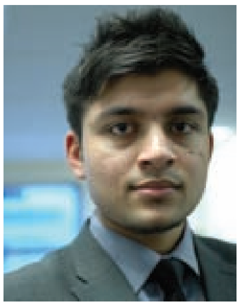
Muscat is an amazingly beautiful place in the monotone landscape of the GCC, populated by friendly and culturally rich people. The place has a significant history that has played a key role in shaping the social psychology of its people. Centuries of cultural and economic interaction has made Muscat a very hospitable place for expats. This is the only place in the GCC where you find many locals fluently speaking Urdu or Hindi. We are really enjoying our stay in Muscat and looking forward to explore the rest of Oman.

Where would you like to see yourself ten years from now?

Inshallah, I see myself leading an Islamic financial institution. I also see myself playing a dynamic role in the further development of Islamic banking industry through new initiatives.

Global Donors Forum

Kuala Lumpur, Malaysia



The Global Donors Forum is an annual gathering of Muslim philanthropists from around the world, hosted by The World Congress of Muslim Philanthropists. Edbiz Consulting were proud to have been invited to the event in Kuala Lumpur, Malaysia. Rizwan Malik describes the proceedings.

The depredations of colonialism, the extrication of Shari'a from governing law and the destruction wrought by the world wars are arguably the progenitors of Islamic finance. Confronted with what appeared to be a dismantling of the social and economic fabric of Muslim society, Islamic finance was envisioned to be the insoluble link between the impoverished and the affluent. The ambition was to appropriate the creative and innovative spirit of capitalism and the unifying paradigm of socialism, while jettisoning the negative aspects of both these ideologies. By this synergy, each member of society would contribute to its health.

The catalyst for this synergy was to be a philanthropic ideal that pervades each member of society. Etymologically, philanthropy means a ' love of humanity' and the core paradigms of Islamic finance were intended to inculcate this most important of moral tenet amongst offers and users. In some respects, Islamic finance is forgetting this essential characteristic but it is not to say it is forgotten. The proportion of Muslims that are affluent and give back to society is growing. Dr. Tariq Cheema saw that by harnessing the desire and the willingness to give amongst Muslims, and creating a global network of like-minded individuals, there is so much possibility for Muslims to contribute extensively to society. Hence, he created the World Congress of Muslim Philanthropists (WCMP)

WCMP is a global network of affluent individuals, foundations and socially responsible corporations, established to advance efficient and accountable giving. It brings together public, private and social sectors, offering information and resources to link donors with social investment opportunities. Each year, the WCMP hosts the Global Donors Forum (GDF) to promote effective giving and build strategic relationships and partnerships for high-impact social investment. Distinguished philanthropists, public and private sector leaders, social investors and experts from across the world congregate to offer pragmatic insight and response to pressing global and regional challenges. To date, there have been five gatherings starting from Istanbul in 2008, Abu Dhabi (UAE) in 2009, Doha

(Qatar) in 2010, Dubai (UAE) in 2011 and the latest held in Kuala Lumpur (Malaysia) in 2012. Previous attendees include Tony Blair, Prime Minister Recep Tayyip Erdogan, Dr Yusuf Al Qardawi and other leading personalities from around the world.

The 5th annual gathering of the WCMP was held in Kuala Lumpur in the last week of April. Over 40 distinguished individuals from around the world participated and spoke at the GDF. Among them were: H. E. Tun Abdullah Badawi, the former Prime Minister of Malaysia; H.E. Prof. Dr. Surakiart Sathirathai, the former Deputy Prime Minister and Foreign Minister of Thailand; Ufuk Gokcen, Ambassador and Permanent Observer of the Organization of Islamic Cooperation (OIC) to the United Nations, New York; HRH Princess Sarah Al-Feisal; President of Generations For Peace; HRH Prince Zain Al-'Abidin ibni Tuanku Muhriz, founding President of the Institute for Democracy and Economic Affairs (IDEAS); HRH Princess Astrid of Belgium, Special Representative to the Roll Back Malaria Partnership; HRH Princess Maha bint Abdulaziz, founder and Chair of Sawa'ed Atheeb, Kingdom of Saudi Arabia; Ms. Farah Kabir, Country Director of ActionAid Bangladesh; Dr. Mohamed Ashmawey, CEO of Islamic Relief Worldwide and Mr. Tariq Al-Gurg, CEO of Dubai Cares.

As part of the GDF, awards for notable achievements in philanthropy and honours for a commitment to social justice are presented at a banquet dinner. This year, the Muslim Philanthropy Award for the year's outstanding grant-making institution was given to the Al-Bukhary Foundation, Malaysia; the award for the most outstanding corporation went to International Humanitarian City, Dubai; and the award for the individual with the most outstanding achievement in giving was presented to Tan Sri Syed Mokhtar Al-Bokhary.

A Special Award for Research and Publications was given to the Global Islamic Finance Report 2012 published by Edbiz Consulting. The central theme of the Report was social responsibility and philanthropy and contained articles which addressed the relationship between Islamic finance and philanthropy. The award was received by the Chairman, President & CEO of Edbiz Consulting, Professor Humayon Dar.

These awards were presented by His Royal Highness Raja Nazrin Shah, Crown Prince of Perak, Malaysia. As the Keynote Speaker, his speech focused on the challenges of global governance. He mentioned that although there has been a lot of improvement in the global governance over the past century, the existing framework is becoming increasingly unsustainable. Poor governance has resulted in instability and insecurity throughout the world.

In addition, two thematic lectures on "Impact Philanthropy and Investing" were delivered by UK's Cass Business School and City University professors, Dr. Paul Palmer and Dr. Jenny Harrow.

Additionally, five innovative philanthropic projects selected from around the world were showcased. These included:

- The Hasanah Trust Fund: A sustainable livelihood fund co-initiated by the World Congress of Muslim Philanthropists and Islamic Development Bank's Islamic Solidarity Fund for Development;
- The Academy of Philanthropy: A

vehicle to develop leaders in philanthropy which introduced its various programs geared towards board members, corporate and foundation executives, as well as young entrepreneurs interested in philanthropy;

• The Al-Salsabil for Empowerment Fund: An attempt to bridge the gap between Islamic finance, social responsibility and philanthropy, which will provide empowerment finance.

The GDF was a resounding success and continued WCMP's excellent work in connecting like-minded individuals committed to the development of Muslim philanthropy. It respresented a snapshot of the potential of Muslim endeavour and ingenuity. With the diversity of professional backgrounds and the variety of heritage, the fabric of Muslim society is indeed bight and mulitcoloured. There is a pool of talented individuals searching for a better future. Linking Islamic finance and Muslim philanthropy is imperative and necessary for the success of both fields. Contrary to media negativity, these are exciting times and with such illustrious gatherings, there is much hope and anticipation for Muslims to contribute more to global society.

As part of the GDF, awards for notable achievements in philanthropy and honours for a commitment to social justice are presented at a banquet dinner. This year, the Muslim Philanthropy Award for the year's outstanding grant-making institution was given to the Al-Bukhary Foundation, Malaysia; the award for the most outstanding corporation went to International Humanitarian City, Dubai; and the award for the individual with the most outstanding achievement in giving was presented to Tan Sri Syed Mokhtar Al-Bokhary.

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Inspired Financial Intelligence

Vice President Shariah Banking at Gulf International Bank

Interview with Mohammad Shaheed Khan

The Global Donors Forum in April 2012 was a congregation of altruistic Muslim decisions makers. Bankers rubbed shoulders with politicians; philanthropists with business men. Mohammad Shaheed Khan, spoke at the conference. During the event, he took time out to speak with us on his work and vision.

You have worked in Pakistan, Saudi Arabia, Malaysia and UAE before moving to Bahrain. Tell us what made you move to Bahrain, which has in the recent past almost lost its position as a regional leader in Islamic finance.

I do not think Bahrain has lost its position. Bahrain is still a hub for Islamic finance in the region and it has more of an established infrastructure in Islamic finance than its neighbouring countries. There are 26 Islamic banks and 19 Islamic insurance companies operating in the Kingdom. Bahrain is home to AAOIFI, LMC, IIFM and the IIRA, Islamic financial bodies that are sustaining and promulgating the industry. The industry in Bahrain has remained resilient with its direct contribution to gross domestic product standing at 26%. The Islamic finance industry is strongly supported by the Central Bank, and regulations have been passed which are conducive to the growth and development of Islamic finance.

A central advantage of Bahrain is its location. It is close to Saudi Arabia, which is the Gulf's largest economy. Saudi Arabia is also experiencing a significant boom right now, though this can also be said about Qatar, which is less than an hour's flight way. In fact, I believe the Gulf region is going through a very exciting period. With Bahrain, the unrest had caused uncertainty in the financial markets but this appears to be subsiding. Anxiety remains but I think over the next few years there will be more stability, which will help propel Bahrain forward.

What in your opinion are the greatest challenges facing the global Islamic financial services industry?

Given the impressive growth of Islamic finance, it is easy to forget that the industry is still in its infancy and will take time to reach critical mass. The problem is that we are trying to compete and replicate everything conventional. We flatter their system by imitation. There needs to be a transition from "Shari'a Compliant" to "Shari'a Based". This is changing but there remains a fair level of scepticism. It makes it difficult in terms of marketing to convince potential customers about the value proposition of Islamic finance. A lack of understanding about the products contributes further to this scepticism with many people making presuppositions before actually investigating the nuances of Islamic finance. However, I think the industry shoulders the burden of responsibility to change people's perceptions. At the heart of Islamic finance is a genuine philanthropic spirit which pervades all its business practices. Till the Islamic finance industry is able to meaningfully contribute towards its greater objectives of wealth creation, scepticism will remain. Islamic finance should focus on the dual purposes of personal social responsibility and corporate social responsibility.

Islamic banks need to ensure that not only are contracts for financing halal, but every facet of its business follows Shari'a principles and spirit. Unfortunately, we have seen several Islamic banks in the Middle East that have not lead by example. Practices in western conventional banks are often much better. It is not enough for an Islamic bank to claim Shari'a compliance merely because it has a fatwa from a scholar on a product or service. To date, most institutions have placed additional layers of documentation without looking at maqasid al- Shari'a focusing on the "Form" mostly and ignoring "Substance". I believe all areas of an Islamic bank should be Shari'a based; from its HR policies to remedial management. An Islamic bank should "manage by Islam", following this concept in its entirety. More research is needed in this area linking modern management with Shari'a. We have much to learn about leadership and management practises of the Holy Prophet (PBUH) and his Sahaba.

It is important to educate current customers and potential customers on Islamic finance. The next step is for Islamic banks to understand the needs of its customers; proper customer segmentation exercise is needed for each jurisdiction it operates in. A "one size fits all" approach is no longer usefull. Islamic banks have to deliver products and solutions which are cost effective, creative and adhere strictly to Shari'a principles. Islamic banks are realising that by just pushing products and waiting for a deluge of new customers, it is not going to generate the numbers that will ensure that the industry flourishes. We have to provide solutions, not just simply push and promote products.

Other issues in the market include a lack of trained manpower. There are a number of qualifications and training courses out there that, in the long run, will create a talent pool from which the industry can benefit. It will take time but it is not an insuperable obstacle, and certainly not one that we should be too worried about given the growing interest and desire for Islamic finance. One issue that I do believe needs to be resolved urgently is the lack of uniformity of Shari'a standards. Differences can breed uncertainty and confusion. In the modern world, we pride ourselves in mitigating these factors and having clarity. A lack of uniformity perpetuates ambiguity.

In order to reach the next level, we have to attract non-Muslims. For this to occur, making inroads into the US market is imperative. Islamic finance has entered the US market but unfortunately it is too small and there are far too many negative connotations associated with Islam and Islamic finance in the States. However, there is potential and Islamic financial institutions need to do more to change perceptions.

Why did you choose to do Islamic banking as a career? Do you not think that there still are greater opportunities for building a successful career in conventional banking?

I gave up a career in conventional treasury because I did not want to "wage war against Allah and his Prophet (PBUH)". Since then, I have never looked back. Yes, there have been lucrative opportunities offered to me in the conventional space that I declined. For me, a career in banking has to be only Islamic, InshaAllah. A competent Islamic banker will always have job offers.

I am passionate about Islamic finance and promoting it. Islamic finance has brought a lot of "barakah" (blessings) in my life. When the source of one's income is halal, supplications are answered. I have gained recognition in this industry, Alhamdulillah, from a very young age, I was given opportunities to share my perspective and convey the little that I know globally at various international forums and events. I have been invited to conduct workshops and have had opportunities to teach at universities. From a career perspective, Allah has blessed me with growth within the organisations I served and made my ventures successful. It all begins with having the right "niyah" (intentions) and hard work.

What are the benefits of having an Islamic window as part of a conventional bank, as compared to having a fully-fledged Islamic bank?

Both Islamic banks and conventional windows have their particular roles to play. There is still so much to learn from the conventional banking industry. While Islamic finance is diametrically opposed to the conventional system, we cannot ignore their best practices. Not everything in the conventional banking industry is haram and they have had many more years of experience to ensure best practices and good governance. Windows at conventional banks can leverage off the established brand and working practices and so add value to the Islamic finance industry. We have to concede that Islamic banks are still playing catch up to large sophisticated conventional institutions. Furthermore, within large conventional banks, generally, Islamic businesses contribute very little to the bottom line compared to the conventional business; hence it becomes a challenge at times to make its presence felt.

Who amongst the contemporary personalities has influenced or impressed you the most?

King Abdullah bin Abdulaziz, Mahathir Mohamad and Recep Tayyip Erdogan are extraordinary Muslim leaders, who have done much to for their respective countries and the Muslim ummah at large. One cannot underestimate the importance of a leader in making a country great. Plato spoke of the philosopher king as the desired ruler, one who understands the reality of his people but goes beyond the physical realm and ponders upon profound questions of life. I think these leaders have the right balance of profundity and practicality, making them such excellent leaders. We need these kinds of people for Muslim countries to shake off the negative viewpoints arising due to authoritarianism and poverty that prevails in most Muslim countries. In many respects, these leaders have paved a worthy path for Muslims leaders to follow.

What is it like living in Bahrain?

Bahrain is very different to places where I have lived in the past. Bahrain is a desert island, surrounded by a shallow, warm sea. Barring some recent unrest, life is very peaceful and serene. It is a close knit community and a melting pot of different cultures. Bahrain is an open, tolerant and welcoming society; a place without prejudice. It is the most politically liberal country in the Gulf with long-standing social openness and tolerance and a lot of respect for diversity. Expats and Bahraini nationals are well integrated in both professional and social circles. Bahrain has a very strong, rich heritage and culture in the GCC. Unlike some of its neighbours, Bahrain has retained its authenticity. Bahrain offers very good value for money with its low living costs.

The views expressed here are solely those of the interviewee, and do not necessarily reflect the views of the Gulf International Bank.

JURISTIC DIFFERENCES IN ISLAMIC BANKING AND FINANCE

In this article, Dr. Inam Ulllah Khan discusses the juristic differences in Islamic banking and finance. He highlights several products on which there has been much discussion regarding Shari'a compliancy and emphasises the need for the industry to adopt a maqasid orientated approach in creating products.

Islamic banking is slowly emerging as an important area of applied Islamic law and jurisprudence. The relationship between classical Islamic law and Islamic finance has created a new system of law-making under the Shari'a, one that has evolved remarkably over the last 40 years. The syncretic process of mining the classical texts, considering modern sensibilities and accommodating state-law prescriptions has undoubtedly made Islamic finance a thoroughfare of progression in the Islamic legal derivation process.

Original interpretation and ijtihad is most essential today for the development of Islamic law generally and of Islamic commercial law in particular. Despite the existing weaknesses concerning ijtihad, if there is a success story to be associated with the revival of Islamic jurisprudence in modern times, that story will certainly include Islamic finance. From little more than a concept and an ideal, modern Islamic finance grew rapidly, with the last two decades seeing the establishment of a variety of financial institutions and the creation of a legal and governance framework.

However, a constant concern for Islamic finance is the differences of opinion on product structures. There is a pressing need for harmonisation in the long run especially in today's interlinked global market. If one country prohibits one product, while another permits, then this could have an effect on cross-border transactions, and on the efficiency and efficacy of the industry.

Maqasid Al-Shari'a

Zaki Badawi, former principal of the Muslim College in London, emphasised the importance of the use of maqasid oriented ijtihad for the development of an Islamic financial system. He stated that little attention was paid by most fuqaha to the basic objectives of the Shari'a. He pointed out that Al-Shatibi as well as Al-Ghazali, Ibn Taymiyyah, and Ibn Qayyim advised the fuqaha to take into consideration the purposes of the Shari'a to address the individual and society's needs when issuing a fatwa. Badawi added that the task of identifying the real needs of society, along with their relevance to the purpose of the Shari'a is not easy. It pushes the scholar to consider the literal text on one hand and the abstract purposes of the Shari'a on the other. He concludes that a new ijtihad must begin by adopting the post Al-Shatibi approach to usul al-fiqh.

Hashim Kamali argues that usul al-fiqh has become a theoretical discipline studied as a part of the legal heritage rather than a tool to regulate and encourage ijtihad. He added that usul al-fiqh is not without weaknesses and some of the weaknesses are not new, but existed for almost as long as the usul al-fiqh itself. A legitimate use of human intellect in dealing with emerging circumstances is guided only by the general principles of Shari'a based on justice and benevolence (al-adl wa ihsan).

Al-Shatibi has emphasised the importance of maqasid for ijtihad. He advocated a sound knowledge of the goals and the objectives of the Shari'a as a pre-requisite to reach the rank of a mujtahid. Sano Koutoub argued that the protection and preservation of wealth is one of the essential elements of maqasid al-Shari'a. Therefore, the continuity and growth of wealth in society should be encouraged and maintained. The continuous distribution of wealth in the society should also be enhanced to bring happiness and financial stability. To achieve these objectives, a supportive Islamic jurisprudential framework is required based on the concept of maslaha and the broader objectives of the Shari'a.

There is no doubt Islamic banking and finance has gained greater importance over the last two decades but the soundness and stability of its infrastructure can be secured through the robustness of its regulatory framework supported by the sophistication of its products and services. While it was initially developed to fulfil the needs of the Muslims, Islamic banking and finance has gained universal acceptance as there has always been a demand amongst Muslims for financial products and services that conform to the Shari'a. With the development of workable Islamic alternatives to conventional finance, Muslims are beginning to find Shari'a compliant solutions for their financial needs.

Differences of opinion

Although Islamic banking has made significant headway in a short period of time, juristic disagreements still exist. Debt financing is one of the core areas of concern, where disagreements exist over products such as murabaha, bay bithaman ajil, bay al-dayn and bay al-ina. Generally speaking, the Middle Eastern scholars prohibit debt trading while the Malaysian scholars in official rulings permit it.

Apart from this, there are many issues that have to be addressed by Islamic banks both in terms of documentation and transactional structure. The general legal framework in many countries will need to be modified to promote Islamic banking. The current governor of Bank Negara, Zeti Akhtar Aziz argued that at present Islamic banking and financial institutions have, to a large extent, been governed by the conventional regulatory framework, supplemented and reinforced by the Shari'a framework and Islamic accounting standards. However, Islamic banking is distinct from conventional finance in terms of its philosophy of prohibiting interest, which in turn shapes the nature of its financial transactions and its risk attributes. Therefore, she suggested the development of a separate regulatory framework in view of the unique risks associated with Islamic financial transactions to provide for their effective assessment and management. The focal point that needs to be analysed is the presiding regulatory framework: does it affect the process of fatwa and ijtihad or not?

Sudin Haroon stated that there is no uniformity of laws and procedures in the practice of Islamic banks around the world. Islamic banks have to conform basically to two types of laws: the Shari'a and positive laws. While Shari'a law is based on religious foundations, positive laws are promulgated by sovereign bodies to safeguard public interest. The positive laws, in most cases, are under the supervision of the Central Banks. In Malaysia, for example, the establishment of an Islamic bank is governed by the Companies Act 1965, and its operations are subjected to the Islamic Banking Act 1983 and, to some extent, the Banking and Financial Institutions Act 1989. Islamic banks must conform to all requirements as stipulated in the above stated Acts.

Photography © Jasmin Merdan

Similarly, other governments have passed special laws that govern the operations of Islamic banks in their countries. Islamic banks in Malaysia are subject to the Malaysian's Companies Act 1965; the Islamic banks of Bahrain are subject to the Bahrain Commercial Companies Law 1975 and the Kuwait Finance House (KFH) is subject to the Kuwait Commercial Companies Laws 1960. Whilst Malaysia and Kuwait have recently legislated on Islamic Banks, Bahrain has no special laws on the subject.

Diversity in Fiqh

The social changes in modern times have introduced complexities in the application of Islamic law. The prevailing diversity in the contemporary application of Islamic law as a response to social change on one hand is perhaps a welcome development; but on the other hand, it creates new challenges too. The Islamic banking industry is the most prominent example, where the emerging challenges are significant and need to be addressed urgently.

While the diversity in fiqh opinion is presently contributing to global growth, it may soon become a constraining factor if the challenges arising out of it are not properly addressed. The two distinct mechanisms that operate side by side to carry out business according to the divine revelation are equity financing and debt financing. Equity financing is affected through profit sharing contracts, while debt financing is affected through deferred contracts of exchange. The Quran further elaborates debt financing with the contracts of deferred exchange allowed and interest based lending forbidden. The main disagreement which prevails between the two regions under review, Malaysia and the Gulf, is over debt based financial products such as murabaha, bay al-bithaman ajil, bay al-dayn and bay al-ina.

Murabaha

Murabaha in fiqh literature is considered as a type of sale. The only feature in murabaha distinguishing it from other kinds of sale is that the seller expressly informs the purchaser of his cost and the profit he intends to make. The main objections to murabaha are that there is a chance for partaking in bay al-ina as practised by some Islamic financial institutions and that it combines two sales in one. There are also differences of views amongst the scholars regarding the binding nature of a promise to purchase.

Ta'widh

The imposition of a compensation rate (ta'widh) is contentious. A consensus has been reached in this regard as contemporary jurists have allowed banks to stipulate late fees on those clients who were able to pay but were nonetheless delinquent. However, this amount shall not become a part of the income of the bank. This opinion is being followed in the Gulf. On the other hand, the Shari'a Advisory Council of Bank Negara Malaysia has permitted the imposition of one percent compensation rate on late payment and unlike the opinion from the Gulf, this money can form part of the income of the bank. This is regarded as ta'widh (compensation) for the bank and cannot be compounded.

Rebate

Another important area is the rebate. The majority of the jurists agree that rebate can neither be stipulated in a murabaha transaction affected by an Islamic bank nor can the client claim it as a right. However, the bank can give the customer a rebate on its own as gratuity. Nonetheless, the Shari'a Advisory Council (SAC) of the Securities Commission in Malaysia has issued a fatwa declaring that a rebate clause and formula to calculate the amount for an early settlement can be stipulated in the primary legal document of Islamic bonds based on the contract of exchange.

Bay al-bithaman ajil

There are controversies amongst Muslim scholars as to whether the price charged by the seller under bay al-bithaman ajil can be higher than the spot price. Even the scholars, who are of the view that charging a higher price than the spot price is permissible under Shari'a, do not recommend a heavy reliance on it. Although, the validity of bay al-bithaman ajil is proven from the Quran and Sunna, certain practices are not accepted internationally, specifically in the Middle East, Pakistan and Europe because of the danger attached to it of opening a back door to riba. The act of deferring the payment of price in a sale is also accepted in the rest of the world and the contract of murabaha is being used predominantly. The main issue in certain types of bay al-bithama ajil as practiced in Malaysia by some Islamic financial institutions is that they use bay al-ina under the guise of bay al-bithaman ajil. In this case, the contract of bay al-bithaman ajil is preceded by a purchase of asset by the bank from the same customer.

Bay al-dayn

Bay al-dayn has always been an issue amongst the past and present Muslim jurists. The jurists who do not allow bay al-dayn have premised their objections mainly on the prohibition of riba, and the increased risk to the buyer in the event of a default. There were differences amongst the classical Muslim jurists regarding the sale of debt from the creditor to the debtor and the sale of debt from the creditor to the third party.

Bay al-ina

The majority of the classical Muslim jurists were of the opinion that it was not permissible because it was a legal excuse to legitimise riba. This opinion is being followed by the jurists of Islamic finance of the Middle East. The Shari'a advisors from the Middle East and Gulf region consider it as a 'back door' to riba. However, bay al-ina is being practiced by Islamic financial institutions in Malaysia. It is considered valid by the Shari'a Advisory Council of Bank Negara Malaysia and the Shari'a Advisory Council of the Securities Commission of Malaysia.

Conclusion

To sum up, the central issue pertaining to existing disagreements between the scholars of Malaysia and those of the Middle East is the interpretation of Shari'a injunctions. Disagreements exist in juristic views and rulings particularly between Malaysia and the Middle East. The issue of disagreement is very important and has a far reaching impact on the Islamic banking and financial industry worldwide. It can be said that disagreement is inevitable, but at the same time, there subsists a reconciliatory mechanism in Islamic law to harmonise different interpretations from either jurisprudential or administrative perspective or both. Nevertheless, harmonisation of the different views amongst the scholars from the different schools of thought is necessary to enhance the global development of Islamic banking and finance. It is recommended that any further move in this direction be made under the purview of siyasah Shari'a. This will create a much more robust system.

Edbiz NASDAQ OMX Shari'a Indexes – a dynamic partnership

In 2010, NASDAQ 100 Shari'a index launched to little fanfare. As the world economy lurched through the global recession, the index failed to replicate the enthusiasm of the Dow Jones Islamic Index. However, two years on as the economy commences its revival, there is an opportunity for the NASDAQ OMX Shari'a index family to have the impact it desires. It's an impact NASDAQ OMX's Executive Vice President and Chief Marketing Officer, John L. Jacobs believes is more than possible. We caught up with Mr. Jacobs to discuss his opinions on the index and its potential to meet the needs of investors.

In 1983, an ambitious young man stepped into the offices of NASDAQ. His ambivalent emotions belied the enthusiastic smile he wore on his face. Inside, he was nervous but excited, worried but hopeful, inexperienced but committed to learn. He had just joined the world's first electronic stock market in an age where computers had yet to be as ubiquitous and essential as it is in contemporary society. NASDAQ was to be a trailblazer and John L. Jacobs had become its newest recruit.

Now approaching two decades, Jacobs sits as the Executive Vice-President and Chief Marketing Officer. He could never have imagined the growth of NASDAQ (now NASDAQ OMX) and the success of his own career were synonymous. He has seen significant changes occur in the company that has been an integral part of his life and has presided over many of the expansive steps that NASDAQ has made. NASDAQ OMX has had to adapt to the constant evolutions of the market and the altering environment. Players enter the market, players leave. To remain in market, a company has to be relevant and adaptable. NASDAQ OMX is undoubtedly a company with its finger on the financial pulse; and so with the emergence of Islamic finance, NASDAQ OMX sees potential. For Jacobs, Islamic finance is a rapidly growing and increasingly important sector of the global economy but he fears that despite the tremendous growth, it remains underserved and still in need of greater global exposure. However, for Jacobs, the company he has served so loyally is uniquely qualified to further develop the Islamic financial sector. It is a bold ambition but very few could doubt Jacobs' accomplished eye.

From NASDAQ to NASDAQ OMX

On February 8th 1971, 12 years before John L. Jacobs began his fateful day, the National Association of Securities Dealers Automated Quotations (NASDAQ) commenced trading of over 2500 securities as part of the NASDAQ composite index. It was set up by the National Association of Security Dealers (NASD), a regulatory authority that had primary responsibility for oversight of brokers and brokerage firms. The NASDAQ exchange granted household names the platform from which to raise capital: Intel, Microsoft and Apple are indebted to the exchange. Recently, Facebook has joined this heady list of illustrious names for its IPO. Over the years, NASDAQ has accomplished many milestones. In 1997, NASDAQ was the first stock market to offer its listed companies a proprietary online service with company, peer and industry trading data called NASDAQ Online. Three years later NASDAQ's membership voted to restructure and turn the exchange from a public company, owned by NASD, into a shareholder-owned, for-profit company. In 2006, NASDAQ completed its separation from the NASD and began to operate as a national securities exchange.

In 2008, the NASDAQ OMX Group, Inc. was formed. It is a holding company created by the business combination of The NASDAQ Stock Market, Inc. and OMX AB. The NASDAQ Stock Market is the holding company's U.S. equities stock exchange.

The transformational combination of the two entities resulted in the expansion of NASDAQ business from a U.S.-based exchange operator to a global exchange company offering technology that powers more than 70 exchanges, clearing organisations and central securities depositories in more than 50 countries.

Why financial institutions need indices

Jacobs is proud of the growth of NASDAQ since he joined. The NASDAQ OMX Group is the world's largest exchange company and owner and operator of 24 markets in the U.S. and Europe. NASDAQ OMX is the parent company of the NASDAQ Stock Market, the world's first electronic exchange and the largest exchange in the U.S. NASDAQ OMX is also home to NASDAQ OMX Global Indexes — a premier full-service global index provider. NASDAQ OMX Global Indexes develops NASDAQ OMX branded indexes and licenses associated derivatives and financial products.

Indices are a barometer of market health, be it reflective of the broader economy or a specific sector – such as technologies. Indexes allow institutional and individual investors to track day-to-day changes as well as long-term trends in the economy and the financial markets. They are used as benchmarks, a standard by which economic sectors and investment portfolios are measured. They bring clarity to market participants and help them with investment decision-making.

NASDAQ OMX's index creation process is driven by demand and developments in the global economy. Jacobs believes objectivity is crucial to the creation of a robust index. The perspective of the investor remains cornerstone to the formulation and an investor has to be positive that the index is truly reflective of the general economy or segment. NASDAQ OMX adopts a methodology that looks at ways to measure segments or sectors of economic models in a fashion that is transparent and based on rules with an emphasis on investing, trading and philosophy.

Due to great demand, NASDAQ OMX Global Indexes is one of the fastest growing indexers in the world. This year alone, they have created 450 new indexes and now have more than 3,000 diverse indexes covering equities, bonds and commodities. Their client base spans the entire spectrum of the financial services industry including big investment banks, portfolio managers pursuing passive investment strategies, commercial banks, and insurance companies located in the Americas, Europe and Asia. During 2011, NASDAQ OMX licensees reported issuing at least 8,500 structured products linked to NASDAQ OMX indexes with the notional value exceeding $1.4 trillion in 24 countries. NASDAQ OMX indexes are widely used as benchmarks by plan sponsors, financial institutions and individual investors. They also license their indexes to asset managers and financial entities that distribute a variety of financial instruments that closely track their indexes with the purpose of achieving investment results that generally correspond to the performance of their indexes, such as exchange-traded funds (ETFs), mutual funds, UITs, annuities and other portfolio-based products. Index options, futures, and other derivatives based on NASDAQ OMX indexes are available to institutional and individual investors to be used for risk management.

Edbiz NASDAQ OMX Shari'a indexes

It has only been recently that Jacobs gained acquaintance with Islamic finance though he must have looked with interest the creation of the Dow Jones Islamic Index in 1999. The launch was significant for the progress of Islamic finance in the western world, announcing quite boldly that Islamic principles have a place in the western based financial system. The creation of the index followed the USA Office of Comptroller of the Currency (OCC) 1997 issuance of directives which permitted murabaha and ijara structures in the USA. HSBC had also entered the USA market to offer their retail products. The horizon was bright for Islamic finance but following 9/11 there has been caution with launching Islamic finance initiatives. 10 years on, Jacobs opines that there are potentially favourable investment opportunities in Islamic finance among US-based investors. However, given his position as a senior representative of a global exchange company, he declines to predict future economic performance: a testament to ensuring NASDAQ OMX remains both objective and transparent. In part, the uncertainty resulting from the global credit crisis precludes any definitive predictions to be made.

Nevertheless, Jacobs feels that there is more demand for tools to accurately measure the performance of the Islamic financial sector. He wants to ensure that NASDAQ continues its position as a premier global index provide by delivering on their commitment to design and license innovative and relevant indexes that meet the evolving needs of investors and other market participants. The introduction of the Edbiz NASDAQ-100 Shari'a Index and the other indexes in NASDAQ OMX's family of Shari'a indexes are examples of their efforts to facilitate investment opportunities in Islamic finance. The Edbiz NASDAQ OMX Shari'a Index family brings a new set of tools to those interested in measuring Islamic economic sectors and maintaining Islamic investment portfolios. They offer Shari'a-compliant solutions beyond the most basic Islamic equity funds. This index family is comprised of securities that meet the Shari'a requirements as prescribed by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) and adopted by NASDAQ OMX with the guidance of the Shari'a advisor, Edbiz Consulting Limited.

Jacobs feels that NASDAQ OMX will be able to benefit Islamic finance by its promotion of the Edbiz NASADQ OMX Shari'a indices. He is quite confident that NASDAQ OMX has the tools to create a Shari'a compliant index which is attractive for its investors. He points out once again that unlike other index providers, the NASDAQ OMX index creation process and methodology is completely objective, transparent and rules-based. This unique approach offers market participants an unbiased perspective of the Islamic financial sector. Additionally, as a global exchange company, Jacobs avers that NASDAQ OMX offers unparalleled market visibility and perspective, key values that most other indexers cannot provide.

The problem for Islamic finance, Jacobs argues, is a lack of awareness. Despite its rapid growth, many market participants are still learning about Islamic finance and Shari'a compliant indexes. This can be mitigated by NASDAQ OMX. The global visibility that NASDAQ OMX offers by being a global exchange and a global brand is a perfect medium for Islamic finance. Leveraging off the NASDAQ OMX brand, as well as their innovative indexes will enable Shari'a sensitive investors to expand the trading and investment landscape with new opportunities in ETFs, structured products, investments and Shari'a compliant derivative securities.

Nevertheless, Jacobs is aware that it is not only awareness that needs to be tackled; competition remains a key consideration in structuring and promoting the Shari'a indexes. Maybe counter-intuitively, competition is not limited to dedicated index providers. NASDAQ OMX faces competition from investment banks, exchanges and developers who create financial products designed to meet investor needs. But such are perennial considerations of a financial market player. The interplay of micro and macro economic factors in the market requires constant monitoring and evaluation. The dynamism of the markets is what Jacobs thrives on. Being the Chief Marketing Officer, he is always looking for those opportunities to create the right profile, build profits and reduce opportunities for loss. The role is challenging but one that Jacobs finds exciting and fulfilling. Entering a new market such as Islamic finance brings its own set of complications and concerns, and embracing a fledgling market requires flushes of optimism.

Components of the Edbiz NASDAQ-100 Shari'a index

The Edbiz NASDAQ-100 Shari'a Index contains securities of the NASDAQ-100 Index which are considered Shari'a-compliant. The NASDAQ-100 Index includes 100 of the largest domestic and international non-financial securities listed on the NASDAQ Stock Market based on market capitalization. Because the Edbiz NASDAQ-100 Shari'a Index is also a market cap-weighted index, the index securities generally enjoy large capital growth. Like the NASDAQ-100 Index, it reflects companies across major industry groups including computer hardware and software, telecommunications, retail/wholesale trade and biotechnology.

The indexes are used by those who are interested in tracking Islamic economic sectors and maintaining Islamic investment portfolios. Institutional and individual investors are interested, as are plan sponsors, asset managers and financial entities that distribute financial products such as exchange-traded funds (ETFs), options and other derivatives.

Target audience is those who are interested in tracking Shari'a-compliant non-financial large-cap growth stocks. Potential clients include professional and individual investors, plan sponsors, asset managers and financial entities that distribute financial products such as exchange-traded funds (ETFs), options and other derivatives.

Comparing the performance of NASDAQ OMX and Dow Jones Islamic Index

The Dow Jones Islamic Market US Index measures the US universe of investable equities that pass Dow Jones' proprietary screens for Shari'a compliance. The selection universe for the DJIM US Index includes the components of the US benchmark index, which covers approximately 95% of the float-adjusted market capitalization of the underlying market.

The correlation between the Edbiz-NASDAQ-100 Shari'a TR Index and the Dow Jones Islamic Market US TR Index is 95.5%. As one would expect with a high correlation, both indexes have moved very much in tandem with one another over the past two years. Returns have been almost identical at 33.65% and 33.62% with NASDAQ edging out Dow Jones.

The future...

Jacobs is optimistic about the Shari'a index. He is proud that NASDAQ OMX Global Indexes continuously seeks new opportunities to license indexes to asset managers and financial institutions worldwide. With a range of financial instruments such as ETFs, index mutual funds as well as options and futures contracts, market participants can develop a variety of strategies that help them meet their investment objectives. Jacobs asserts, rightfully, that the NASDAQ-100 Index is one of the most widely watched indexes in the world with almost $400 billion in global assets linked to it. With the Edbiz-NASDAQ-100 Shari'a Index, they are working diligently to replicate the success they have had in making the NASDAQ-100 Index one of the world's most widely watched indexes. Jacobs is confident that this is an achievable aim. After nearly 20 years of success, it would be difficult to argue against him.


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WALL ST
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Morality, Technology and Prices

Professor Humayon Dar

There is a definite relationship between prices and morality. In theory, prices should be low and stable in an environment in which ethics-conscious economic agents interact and trade. Technology further assists in inducing moral behaviour in society, in general, and in the marketplace, in particular, but this has associated costs.

One (economic) definition of morality entails voluntary self-monitoring by economic agents, which represents an important constraint on individual maximising behaviour. To illustrate the relationship between morality and prices, one may consider the example of selling vegetables in the English countryside by offering them from an un-manned table in front of the seller's house. Buyers, who choose to purchase the vegetables, pays by dispensing the precise amount as listed into a box next to the vegetables. A similar practice can be seen in many Malaysian universities, wherein bottles of mineral water are kept on unmanned racks in different departments and the students wishing to purchase the bottled water do so by putting one ringgit (the price of a bottle) in a money box attached to the rack. Such trades work because the buyers do not cheat, i.e., they do not take away the items on sale without having paid for them.

In comparison, within an environment characterised by moral hazard, the sellers have to incur additional costs on monitoring and supervision through manning the stalls. Alternatively, the sellers may use automated vending machines, which also have cost implications. This means that in a marketplace where traders (buyers and sellers) exhibit a lower moral threshold there are additional transaction costs, which must push the prices up.

Let us explore this further. In a trade, it is difficult to ascertain the moral compass of a buyer, which imposes a cost on the seller. Transaction costs - in this particular case – are the costs associated with removing the possibility of loss that one may suffer because of dealing with a transacting party whose moral credentials are unknown or questionable. Sellers, faced by such transaction costs, simply add the morality risk premium to the prices they charge. One may wish to call it morality risk premium.

Such a premium will be difficult to calculate given the abstract nature of morality. However, looking into more tangible manifestations such as corruption, one could hypothesis that in the absence of appropriate, affordable technology, immorality and moral hazard results in even higher transaction costs and prices. Countries who rank high on Transparency International annual corruption index provides appropriate test cases and it would be interesting to find out empirically as to what possible effect corruption and other forms of moral hazard may have on prices in more corrupt countries, especially those countries where corruption is perceived to be on a rise. Intuitively, one may conclude that morality and prices are negatively related, i.e., prices tend to be higher between the economic agents with a lower moral code or standard. Thus, the rampant corruption could at least be partially blamed for higher and rising prices in places like Pakistan. Other demand pull and supply push factors remain relevant to the determination of inflation in the country.

In countries with significant corruption, producers factor in the 'corruption proportion' (bribery, kickbacks and other hidden fees) when pricing the goods and services they produce. Furthermore, higher transaction costs, especially in the absence of technology and other forms of protection like insurance, also play a role in determination of prices.

In such an environment, the higher prices are not only a private sector phenomenon. It also applies to the production of goods and services in the public sector. The governments targeting a reduction of illegal practices are now employing technology to reduce incidences of illegality and, by extension, immoral behaviour. For example, technology has certainly played a role in bringing down a lot of malpractices in the issuance of driving licenses, collection of speeding fines, passports and many more such services. However, this has resulted in the increase of prices of these services. Part of the higher prices is certainly due to higher costs of the technology used in the production of such services.

Religion is a cheaper substitute for inducing morality but in countries where religious authorities are losing their effectiveness and their control, it becomes far more difficult for this to occur. In countries where religious institutions were authority, their transformation into the modern, secular world, has confounded many of the populace. Where does obedience lie, especially when religious authorities still hold a mental grip on many of the denizens of a country? The answer to this question may seem obvious but the paradox that inheres is precisely the problem that needs to be resolved. Religion acts as an anchor for many corrupt countries. It appears that while religious norms prevail, it is not sufficient to stamp out corruption. This is quite unfortunate and thus the focus lies in technology.


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The evolution of the Islamic Banking industry in Pakistan

Pakistan is one of only three countries to have expressly committed themselves to the Islamisation of the economy. This has not been a resounding success, primarily because the objective was overly ambitious and the infrastructure was unable to support it. However, since 2001, Pakistan has adopted a more measured approach to developing a vibrant Islamic financial industry in the country. Usman Ahmad looks at the evolution of Islamic banking in a little more detail.

The global Islamic finance industry has witnessed considerable growth over the last four decades. At present, the Islamic financial industry operates in more than 75 countries across the world and boasts of an asset base of over US$ 1.3 trillion. It is pertinent to note that demand for Islamic finance is not just confined to Muslim states but also exists in non Muslim countries.

Pakistan is one of the few countries to have undertaken the ambitious aim of Islamising the banking system. The process began in the 1960s but made considerable headway in the 1980s (for details of key historical developments of the Islamic finance industry in Pakistan see Table 1). It is important to note that this attempt achieved only limited success. The abrupt conversion of the whole banking system from riba based to Shari'a based without developing an adequate infrastructural framework and improving the human resources capacity weakened long term efficacy and sustainability.

The role of the State Bank of Pakistan

In 2001, policymakers adopted a more phased approach in converting the banking system to interest free. This time the process of conversion was adequately planned providing a comprehensive legal, regulatory and Shari'a compliance framework. The new paradigm was based on a model that allowed four types of Islamic banking institutions:

i) Fully fledged Islamic banks;
ii) Islamic banking subsidiaries of conventional banks;
iii) Islamic banking branches (IBBs) of conventional banks;
iv) Conventional banks having Islamic banking branches were also allowed to have Islamic banking windows in their conventional branches.

It is important to note that in this second phase of transformation, SBP has been spearheading initiatives for the development of the industry. SBP has been playing a dual role of both regulator as well as a facilitator. Some of the initiatives taken by SBP are as follows:

1. SBP issued policies for the formalisation of Islamic banking practices in 2003. These included stipulating eligibility criteria, licensing requirements, and producing guidelines on the physical set up along of the bank, Shari'a compliance procedures and other operational matters of the banks.
2. a comprehensive Shari'a compliance framework was introduced by SBP for Islamic banking institutions that required:
a) Shari'a board at the SBP;
b) a designated Shari'a advisor at

Key historical developments of the Islamic finance industry in Pakistan

Year	Development
1962	The Council of Islamic Ideology was established to provide recommendations to the Federal Government on amending existing laws and changing practices of the country to ensure conformity with the injunctions of Islam.
1973	Article 38 (F) of the constitution of Pakistan stipulated the elimination of riba from the country's economic system.
1980	A regulatory framework for mudaraba companies was introduced.
1981	Murdaraba rules and prudential regulations for murdarabas issued.
1981	Separate interest-free counters started operations in all nationalised commercial banks to mobilise deposits on a profit and loss sharing basis.
1984	The State Bank of Pakistan (SBP) issued BCD Circular No. 13 of 1984 that called for the elimination of riba from the banking system.
1984	Amendment of the Banking Companies Ordinance (BCO) (1962) to allow non-interest based transactions.
1991	The Federal Shari'a Court passed a judgment that declared a number of prevailing financial laws and practices un-Islamic.
2001	The SBP introduced an exclusive Islamic banking policy with detailed criteria for the setting up of Islamic banks.
2002	A new clause was inserted to section 23 of BCO (1962) that allowed scheduled commercial banks to open subsidiaries for Shari'a compliance operations.
2002	Meezan Bank Ltd, the first Islamic bank in Pakistan, received license from SBP to start operations.
2003	SBP issued detailed policies for promotion of Islamic banking containing the criteria for the establishment of fully fledged Islamic banks, Islamic banking subsidiaries; and guidelines for opening standalone Islamic banking branches which was subsequently amended by IBD Circular No. 2 dated 29th April, 2004.
2003	A dedicated department (Islamic Banking Department) introduced in SBP entrusted with the task of promoting & developing Shari'a compliant banking as a parallel and compatible banking system in the country.
2005	A regulatory framework for the operation of Takaful companies in Pakistan is introduced.

individual banks;

c) mandatory internal Shari'a audit;

d) Shari'a inspections by the SBP.

It is important to note that SBP is one of the very few central banks that initiated Shari'a inspections. Before the official endorsement of Shari'a inspections, a comprehensive Shari'a inspection manual was developed and training was imparted to the Shari'a inspectors.

3.For encouraging Islamic microfinance in the country, SBP has allowed the establishment of full-fledged Islamic microfinance banks, Islamic microfinance services by full-fledged Islamic banks and Islamic microfinance divisions in conventional microfinance banks.

4.SBP communicated essentials of major Islamic finance products and instruments along with their model agreements to Islamic Banking Institutions (IBIs). However, SBP has allowed IBIs to develop their own products with the approval of their Shari'a advisor while ensuring adherence to the essentials. SBP has also adopted five Shari'a standards of Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) after customisation in accordance with the local conditions in order to bring harmony and to make local industry at par with the global Islamic finance industry.

5.Risk management guidelines for IBIs based on Islamic Financial Services Board (IFSB) standards were issued. These guidelines cover all major risk categories while providing best practices for establishing and implementing risk management in IBIs.

6.SBP is actively engaged in capacity building through various promotion and training programs. These initiatives are undertaken in collaboration with reputed multilateral institutions such as IFSB, AAOIFI and International Islamic Financial Market (IIFM). These initiatives are helping in enhancing awareness and improving the depth of the talent pool in Pakistan.

7.SBP is currently working on the development of a liquidity management framework for the Islamic banking industry. In collaboration with the local industry, efforts are being made to develop a framework aimed at encouraging Islamic banks to offer participatory mode based financing. It will help to create more musharaka based models.

Industry progress and market share

Since 2001, the Islamic banking industry has shown strong momentum registering a high annual growth rate. In the last few years, the growth rate has been 30 percent. Currently Islamic banking assets constitute around a 7.8 percent market share of the overall banking industry reaching Rs. 641 billion in December 2011 compared to Rs. 477 billion a year earlier. Growth in assets is mainly made up by financing and investment that together grew by 40.4 percent on Year on Year (YoY) basis (Rs. 475 billion in December 2011 compared to Rs. 338 billion in December 2010). Similarly total deposits in the Islamic banking industry in Pakistan have registered substantial growth over the years and reached Rs. 521 billion in December 2011 thereby constituting a market share of 8.4 percent of the overall industry.

As of December 2011, 5 full fledged Islamic banks and 12 conventional banks with Islamic banking branches are operational in the country. There are 886 Islamic branches in more than 70 districts across the country. Growth is likely to gather further momentum with increasing awareness and expansion of Islamic banking network in second and third tier cities.

In terms of profitability, the profit of the Islamic banking industry crossed Rs. 10 billion mark for the first time in December 2011. Despite the successes, there are still some areas in the Islamic banking industry that need to be addressed. For example, concentration of financing in only a few sectors, and the rising non-performing finances (NPFs) to financing ratio, though less than overall banking industry, are some of the key issues faced by the industry.

The domestic sukuk market has shown substantial growth over the years. As of March 2011, sukuk worth more than Rs. 436 billion have been issued in the domestic market. A large portion of this issuance (nearly 76 percent) has come from the Government of Pakistan (GoP) ijara sukuk programme. Since auction of the first GoP ijara sukuk in 2008, a total of 10 ijara sukuk have been issued, amounting to Rs. 333 billion. The issuance of sovereign sukuk has witnessed an upsurge since November 2010 as 6 GoP ijara sukuk have been issued since then amounting to above Rs. 290 billion. The issuance of sovereign sukuk has helped in not only providing a much needed benchmark but also enhanced liquidity management and improved asset quality for IFIs. These high yielding sukuk have provided a good and stable source of funds to governments and

have also encouraged Islamic banks to change their asset structure by shifting their investment from interbank placements (low return investment avenues) to these Islamic bonds particularly since November 2010. There are now regular auctions of GoP sukuk.

Issues and challenges

Despite showing strong growth momentum, the Islamic banking industry is still confronted with several key challenges that need to be overcome in order to sustain the high growth trajectory. Some of these issues are:

1. Despite making a significant contribution to GDP, small and medium enterprises (SME) and agriculture are still underserved sectors in terms of access to finance. By targeting these underserved sectors, Islamic banks can not only increase their depth and breadth but also foster higher financial inclusion levels in the country. SBP has already issued a salam-based product for an agricultural firm and is working with the industry to develop more products. Moreover, Islamic microfinance is another potential area that can be explored for serving the underserved and deprived population of the country.
2. IBIs in Pakistan, like their international counterparts, need to address the limited availability of instruments to manage their liquidity requirements.
3. A large number of unbanked citizens prevails in the country, either due to low penetration of the banking system or due to voluntary exclusion. Such potential clientele of the banking system can be tapped by the Islamic banking industry specifically in the rural areas. In this context, SBP has recently provided a revised definition of rural areas to help the Islamic banking industry increase its outreach.
4. The limited capacity, particularly the scarcity of trained Islamic bankers, is another important challenge that can stagger growth and hinder development of the industry.

Future outlook

Since its re-launch in 2001, the Islamic banking industry in Pakistan has made significant strides forward with both assets and deposits recording a significant increase. A large part of this success has been due to the facilitative role played by the SBP in terms of providing a comprehensive legal, regulatory and Shari'a compliance framework. By adopting a dynamic expansion policy that is inclusive in nature, the Islamic banking and finance industry in the country can significantly increase its outreach while fulfilling the social ethical and moral values embedded in the Islamic economic system. Against this backdrop, it is likely that the Islamic banking industry in Pakistan is going to sustain its growth momentum in the near future. However, a lot will depend upon political will and prudence to fully effectuate a beneficial outcome for Islamic finance.

Islamic Finance Country Index 2012

The Islamic Finance Country Index(IFCI) is an attempt to compare and contrast Islamic financial activity between countries. First introduced in the Global Islamic Financial Report 2011, the IFCI is a testament to the global reach of Islamic finance. Rizwan Malik provides a summary of index and latest changes to the ranking.

The Islamic banking and finance industry is at present valued at USD1.357 trillion according to Global Islamic Finance Report 2012 (GIFR 2012) published by Edbiz Consulting. In GIFR 2011, Edbiz Consulting introduced the Islamic Finance Country Index (IFCI), which ranks countries according to their prominence and involvement in Islamic finance. The index is based on a multivariate analysis of a number of variables that contribute to the growth and development of the Islamic banking industry in the country. This means that the rankings are not based on any individual variable. The latest information available on these 8 variables was collected and weights were ascribed for these variables using a multivariate analysis. The data was tested to see if it contained any meaningful information to draw conclusion from and in making sure it is presented in an objective manner.

The variables introduced in the Islamic Finance Country index are shown to the right. These variables remain the same for IFCI 2012.

According to the rankings of IFCI 2011, Iran ranked number one. This is the same for IFCI 2012. Although Iran is not one of the major global players in Islamic banking and finance industry, the local Iranian banking industry follows the precept of Islamic law. The banks in Iran are thus considered Shari'a compliant by default. Iran currently has $330bn assets under management (AUM) increasing from $160bn in 2006 with an annualized growth of 25 percent. Iran is one of the two countries that converted their economy to conform to the Shari'a. It is also currently home to the world's largest Islamic bank,

VARIABLES	DESCRIPTION
Muslim Population	Represents the absolute number of Muslims living in a country
Institutions involved in Islamic Finance Industry	Represents both banking and non-banking institutions involved in Islamic finance in a country
Number of Islamic Banks	Represents fully fledged Islamic banks in a country of both local and foreign origins
Size of Islamic Financial Assets	Represents all assets relating to the industry in a country
Size of Sukuk	Represents total size of sukuk issued for the reported year
Regulatory and Legal Infrastructure	Represents the presence of regulatory and legal environment enabling IFI to op¬erate in the country on a level playing (e.g., Islamic banking act, Islamic capital markets act, takaful act etc.)
Central Shari'a Supervisory Regime	Represents the presence of a state-representative body to look after the Shari'a-compliancy process across the IFI in a country
Education and Culture	Represents the presence of an educational and cultural environment conducive to operations of the IFI (this could be formal Islamic finance qualifications, degree courses, diplomas, and dedicated training programmes)

Bank Melli, which has over $60bn AUM. The Iranian government is keen to encourage the Sukuk issuance for infrastructure development in the country. Previously, Iran issued musharaka sukuk but they are keen to diversify.

The country ranked second according to IFCI 2012 is Malaysia with over $100bn AUM, approximately 22 percent of total assets of the country. Malaysia is a stalwart for the Islamic banking and finance industry: an innovator, pioneer and promoter. It has been at the forefront of product development, sukuk issuances, regulatory change, building a comprehensive financial infrastructure, and adopting best legal practices. Malaysia has done much in terms of the development of human talent, which is key to capacity building in the industry. The foundation to Malaysia's success has been government support and investment. The government has been proactive in pushing Islamic finance forward. Malaysia is also home to Islamic Financial Services Board (IFSB), one of the two regulators in the global Islamic banking and finance industry. During 2011, Malaysia accounted for 60% of the total sukuk issuance of the world and it appears that this trend is continuing in the first quarter of 2012.

Saudi Arabia was ranked 3rd according to the IFCI. Its Islamic banking and finance assets accounted for approximately $140bn in AUM. Figures from the banking and finance industry show that there is increasing demand for Shari'a compliant products in the Kingdom with 57% of the assets being Shari'a compliant (as reported by Saudi Arabian Monetary Authority (SAMA)). The takaful industry is the fastest growing Islamic financial segment in Saudi Arabia with assets expected to reach $7bn in 2012. The remainder of the top ten includes Kuwait, UAE, Bahrain, Indonesia, Pakistan, Qatar and Sudan.

The IFCI gives a comparative overview of the state of Islamic banking Industry. The ranking is a composite statistic which accounts for the variables listed above. These rankings will change on an annual basis based on the latest information available about the country and the developments in the country for that period. Comparing the ranking of the IFCI 2011 and IFCI 2012, we have seen changes in the ranking. Countries like Kuwait which was ranked as number six has moved number to number four this year while other countries, such as Indonesia, has moved three places down the ranking from number four to number seven. In the last year, Bahrain has experienced much social and political turmoil, but according to the IFCI this has not had an effect on the Islamic banking and finance industry. The overall ranking has improved from number eight to six. Other countries such as Qatar, United Kingdom, Brunei Darussalam, Jordan, and Kenya have also improved in their ranking compared to IFCI 2011. However, countries like Pakistan, Bangladesh have moved down the rankings.

The uniqueness of the IFCI is that it does not rank countries according to one particular variable. It is based on different variables that are assigned weights according to a multivariate analysis. Such information is vital to the growth of the global Islamic banking and finance industry. Through the IFCI, stakeholders and potential investors will be provided an instant summary as to the state of the industry in various countries. However, the IFCI is in its gestation period. For more robust analysis, variables will need to be increased along with a more efficient gathering of data. The IFCI is dependent on the available information and relies upon availability and authenticity of data. If this is missing, there is an effect on the IFCI.

Currently, the IFCI does not reflect how big or small the industry is when compared to conventional finance. However, going forward, IFCI will adopt a more comparative approach.

COUNTRY	IFCI 2011	IFCI 2012	CHANGE
Iran	1	1	-
Malaysia	2	2	-
Saudi Arabia	3	3	-
Kuwait	6	4	+2
United Arab Emirates	5	5	-
Bahrain	8	6	+2
Indonesia	4	7	-3
Pakistan	7	8	-1
Qatar	12	9	+3
Sudan	10	10	-
United Kingdom	15	11	+4
Bangladesh	9	12	-3
Egypt	13	13	-
Turkey	14	14	-
Brunei Darussalam	23	15	+8
Jordan	20	16	+4
Kenya	24	17	+7
Syria	17	18	-1
Yemen	19	19	-
Tunisia	25	20	+5
Oman	N/A	21	N/A
Sri Lanka	26	22	+4
Singapore	33	23	+10
Algeria	16	24	-8
Afghanistan	21	25	-4
South Africa	30	26	+4
Thailand	29	27	+2
Palestine	27	28	-1
Lebanon	22	29	-7
India	11	30	-19
Nigeria	N/A	31	N/A
Senegal	34	32	+2
Gambia	35	33	+2
France	N/A	34	N/A
Kazakhstan	N/A	35	N/A
Switzerland	28	36	-8
Germany	N/A	37	N/A
Tanzania	N/A	38	N/A
Canada	36	39	-3
The Philippines	N/A	40	N/A
United States Of America	18	41	-23
Mauritius	N/A	42	N/A

Islamic Finance as a Means for

The Revival of Islamic Civilisation

There has been much praise for the outstanding growth of Islamic finance in such a short period of time. However, little consideration has been given to how Islamic finance is in fact bringing back to the fore some of the impressive achievements of the Islamic civilisation during its golden age. According to Dr. Sofiza Azmi, Islamic finance is the link that connects the glory of the golden age to contemporary society.

Islamic finance for an increasing number of Muslims is part of a new life style. For others, it is an extension of their Islamic identity. Although it seems like a commercial phenomenon, Islamic finance has wider social implications. Indeed, it can be used for not only reformation of Islamic juristic thinking but also bring about social reformation of Muslim communities around the world. In some countries, like Malaysia, Islamic banking and finance has certainly contributed in terms of widening employment opportunities for the bumiputra, especially those who come from a religious educational background. In other countries, such as certain Middle Eastern countries, it is being used as a tool for enhancing financial management. In the Western world, Islamic banking and finance is being looked into as a possible solution to the volatility in the marketplace. In a nutshell, Islamic banking and finance has become a modality for the renaissance of Islam and an alternative market mechanism. Without doubt, the unparalleled growth in Islamic finance has played a significant role in the revival of the Islamic civilisation that we see today.

The golden age of Islam

At the zenith of its glory, Islamic civilisation was characterised by unrivalled intellectual achievement across all disciplines of knowledge. During this golden age of Islam, the Islamic world was a cauldron of cultures which collected, synthesized and significantly advanced the knowledge gained from other civilisations. Places of worship and educational institutions such as mosque, madrasa, libraries supported this advancement. Cities like Baghdad, Cordoba and Toledo were known as centres of civilisation and knowledge where scholars, both Muslim and non-Muslim, gathered, discussed and investigated. A large number of educational institutions, research centres and great libraries were established in these cities where scientific books were kept with religious ones. In the Western part of the Islamic world, extensive efforts were made to translate many of the Muslim works from Arabic into other languages, especially in the fields of astronomy, mathematics, medicine, chemistry, botany and philosophy. This golden age of Islam was also the golden age of knowledge and education.

The growing international interest in Islamic finance has fuelled a similar growing interest in Islamic studies in the West. The recent two decades have witnessed the explosion of scholarly works and writings related to various aspects of Islamic economics, banking and finance. The development of knowledge in these disciplines has been so impressive that it has become difficult to keep pace with the growing literature produced by an international assortment of scholars and researchers. The global interest in Islamic economics and finance transcends nations, languages and cultures. Many Western scholars have studied and written on Islamic economics, banking and finance. Islamic finance education has also gained significant momentum. Islamic economics and finance courses are now taught as an academic discipline in academic institutions in the Islamic and Western countries. We have also seen top business schools in the West incorporating elements of Islamic finance into their MBA programs. The global growth of Islamic finance has encouraged professional bodies and private entities to offer certificates, diplomas, undergraduate, masters and post-graduate degrees in Islamic finance and economics. The growing interest and advancement of knowledge in Islamic finance attests to the revival of Islamic civilisation.

The second characteristic of Islamic civilisation is its geographical spread. The knowledge gained in science, geography, algebra, medicine, arts, economics and literature in the Islamic world spread through the Middle East and North Africa into Europe and across Asia to the border of China. Trade, commerce, technology, music, arts, philosophy, architecture, law and education flourished and developed across the vast cultural highway created by the Islamic world. San Simon, a French philosopher, wrote in his book The Anthropology: "the one who studies the various structures of human civilisation, he can't deny the big cultural role of Muslims and Arab in building the scientific renaissance of modern Europe." Similarly, growth in Islamic finance has not been confined to the Muslim world, but spans across the West and the Asia Pacific region where the growth is driven by commercial considerations. There are now more than 300 Islamic financial institutions operating worldwide across 75 countries. The broadening geographical base for Islamic financial services has seen Islamic finance moving beyond its historic boundaries into new territories. An increasing number of financial centres in the West, eager to profit from the lucrative Islamic financial businesses, are looking to make appropriate regulatory and legal reforms that would facilitate provision of Islamic financial products. Financial centres such as London, Hong Kong and Singapore have already made Islamic finance as part of their financial and business activities. Following the lead set by these centres, other major economies like Japan and France have also jumped on the wagon of the globally booming Islamic finance industry.

The legacy of trade and finance

At the apex of the great Islamic civilisation, trade was among the most important activity in wealth creation. The Islamic world dominated global trade through its control of land and naval channels from the East to the West. In order to support their trading activities, Muslim traders started the early development of Islamic finance when they engaged in activities such as interest-free deposit taking, money changing, remittance services and the use of cheques. The usage of cheques for trade purposes was a norm in the city of Baghdad. The city of Basra flourished with the activities of money changers. Here, trading and business activities carried out in each market were conducted using cheques issued by money changers which were then used to purchase goods. Hence, Islamic civilisation which was characterised by innovation in financial and business transactions was also the catalyst which unified the different nations and cultures.

Today, Islamic finance involving financial flows between Muslim and non-Muslim world has revived and revitalised economic ties, a trend that will generate mutually reinforcing growth prospects. The emergence of Islamic financial centres in the East and West and their increased financial integration has paved the way for the revival of a vibrant Islamic civilisation in the twenty first century. The phenomenal growth in Islamic finance has led to innovative Shari'a-compliant financial products and services. One of the most striking features of the recent growth in Islamic finance has been the development of sukuk as an investment vehicle and this has been considered as the peak of innovation in Islamic finance. Over the years, the sukuk market has become more diversified with new categories of issuer and more complex structures being used. The Islamic financial product range has now expanded into a broad array of innovative instruments. A number of innovative products have been introduced which include residential backed securities, commodity based financing as well as investment and equity linked products. More recently, the international dimension of Islamic finance has gained prominence as it transitions from being domestic to becoming increasingly more internationalised. This is evident by the increasing international participation in Islamic financial markets in the different jurisdictions and the growing number of Islamic financial institutions that have presence or strategic interests in foreign jurisdictions. This trend has resulted in increased cross border financial flows.

Islamic civilisation had many great achievements and accomplishments that have contributed to world culture. Today, Islamic finance as a new financial culture has emerged in many parts of the world now that Muslims have regained their political and economic independence. Islamic banking came as a market response to the needs of Muslims who were looking for Islamic financial solutions and services that not only fulfil their financial needs but also their religious obligation. However, it would be wrong to pigeonhole Islamic finance as Muslim-only. The industry began to fulfil the needs of only Muslims but it can be safely said that Islamic finance is no longer just an all-Muslim affair.

Creating the new lifestyle

The industry's appeal has grown to attract the non-Muslim markets. We find that this new Islamic financial culture transcends religions and nations. Consumer interest is not merely driven by religious beliefs, but stems from transparency of the terms and conditions, the ethical nature of socially responsible investing, fairness to the consumer and competitive pricing. In many respects, Islamic banking and finance has also emerged as an elitist phenomenon, especially in the Gulf region. The finance offered by Islamic banks is for a new and modern life style. Luxury items like yachts, personal jets, expensive cars and high-end living are being financed by Islamic banks. Other financial products like Islamic credit cards, Shari'a compliant mortgages, takaful and similar services are giving rise to a new financial brand - an Islamic brand to which an increasing number of young Muslims are subscribing. In the past, an Islamic life style was primarily associated with rituals – 'ibadat – but this new brand associates Islam with other aspects of social interaction – mu'amalaat - as well.

At the apex of the great Islamic civilisation, trade was among the most important activity in wealth creation. The Islamic world dominated global trade through its control of land and naval channels from the East to the West.

This new Islamic financial life style is developing a new identity for contemporary Muslims. A 21st century Muslim wishes to be identified with the new trends in all aspects of life, including banking and finance. This trend as an individual choice offers an opportunity for the Islamic states as well. Given that economic power plays an important role in determining the contribution of a particular country or nation in world affairs, the global movement of Islamic banking and finance provides an opportunity to the OIC countries to develop a new financial civilisation based on an Islamic heritage in business and trade.

Malaysia has indeed found an opportunity in Islamic banking and finance to play a role in the peaceful restoration of Islamic ideals and its once vibrant culture. A pioneer in Islamic finance for more than 30 years, Malaysia has paved the way and designed the building blocks for the development of the global Islamic finance industry. Today, Malaysia's contribution to Islamic finance has received global recognition. The key to their success lies in the development of the regulatory infrastructure encompassing liberalisation and incentivisation to promote the Islamic financial industry. Regulation has been passed on key structural components namely the Islamic banking sector, Islamic capital market, takaful and many other peripheral Islamic institutions. Malaysia is also at the forefront of disseminating Islamic finance education.. Malaysia, as a multicultural nation, understood the pervasive influence of cultural and religious paradigms on modern life and proactively sought to enact a vision. This transformed the nation into a model for the revival of Islamic civilisation in the modern world.

The challenges today

The glory of Islamic civilisation emerged as a consequence of the enormous flow of ideas from Muslim thinkers. From these streams of ideas emerged Islamic philosophy which later became the handmaiden that developed Islamic sciences that included mathematics, physics, geology, chemistry, astronomy and sociology. This new knowledge continued to flow and enrich not only the Islamic world but also the entire human civilisation at that time. More importantly, every discovery added a newer, deeper and richer dimension to the Islamic world. It is disheartening to note that such a glorious era of knowledge promotion and advancement is very much lacking in the Muslim world today. I believe the singular reason for this state of affairs is the transformation of a people from processors of ideas to recyclers of ideas. On the moral and spiritual front we are trying to recycle the ideas of our forefathers and on the material front we are just consumers of western ideas.

As we progress in this millennium, Islamic civilisation will be able to emulate some of its past successes highlighted earlier. We are already witnessing a gradual increase in the share of Islamic financial activities as a proportion of the global financial system. Increased wealth and assets placed and managed by Muslims financial professionals can be utilised through refinancing to reduce the debt burden of Islamic countries and enhance the prosperity of the ummah. Indeed Islamic finance has come a long way as a new financial culture and global civilisation. But the road ahead remains long. The Muslim world must learn to cooperate better and strive to unleash its potential by focusing on economic development and building stronger trade links. The promotion of economic integration through enhancing the breadth and depth of Islamic finance should remain the agenda of the day for Muslim nations.