Islamic Financial Markets - A Complementary to the Conventional System: Special Focus on Sultanate of Oman

Dr. P. Kallu Rao, FCSI*
Faculty
Al Sharqiyah University, Ibra – Sultanate of Oman

Abstract
The importance of Islamic method of Financial Services is best known during financial crisis. Not even a single Islamic Bank in the world needed to be bailed out. Islamic Banking is steadily moving into the mainstream of conventional financial system and has remained largely insulated from the global credit crisis. It is expanding not only in the Muslim world, but also in other countries where Muslims are in a minority. The Paper presents the basic concepts and structure of Islamic Financial Markets with a focus on Banking, Securities Markets and Insurance. Further, it covers Institutional Development, Regulatory landscape and Sharia Regulations for Islamic Financial Markets including plan of action for the challenges ahead for Islamic Financial Markets for Internationalization of Islamic Finance. Further, the paper highlights with reference to introduction of Islamic Finance and its regulatory environment in sultanate of Oman.

JEL Classifications: G1

Keywords: Islamic Finance Services, Islamic Insurance, Sharia Regulations, Islamic Institutions, Financial Services, Islamic Financial Institutions.

Corresponding Author’s Email Address: pagarao@yahoo.com

Islamic Financial Markets: Introduction
Global financial industry noticed that the recent financial crisis did not affect the Islamic Financial markets but it certainly did slow its pace and growth. One possible reason for relative lack of activity in Islamic Finance is the decrease in enthusiasm shown by many western Financial Institutions. (1) However, it is important to
acknowledge that the Western Banks have played an important role in the development of Islamic Finance globally as well as in local markets. ABSA
, a subsidiary of Barclays bank for example, has been instrumental in opening up Islamic Financial Services in South Africa. HSBC Amanah and Standard and Chartered Saadiq offer Islamic Financial Services in number of countries and indeed compete with full-fledged Islamic Banks. Let us look at the figures provided by the BMB- Islamic Global Finance Report 2011 (GIFR)
 with reference to global Islamic Financial Services industry. The report stated that the potential global size of the Islamic financial Services industry is at US $4.4 trillion growing at 10% per annum. An observation of the Islamic financial Services data of the various countries during the yester years shows that UK based Banks have shown more interest in Islamic fiancé than US Banks. Increasing number of European Banks, also, is an indication that they are showing interest in this new method.

The importance of Islamic method of Financial Services are best known during the financial crisis. Not even a single Islamic Bank in the world needed to be bailed out. This is, of course was not the case for their conventional counterparts. “The global financial crisis seems to be a blessing in disguise for Islamic Finance” opines, Dato’ Dr. NikNorzul Thani, chairman of the Malaysian Law firm, Zaid Ibrahim & co. According to him, one of the impacts of the crisis has been an increasingly enormous interest around the world with regards to the soundness and resilience of the Islamic Financial Model. Islamic Finance, being a geneiueuly ethical business is yet to be adopted and accepted by most of the countries. “People often forget that the godfather of modern capitalism, and often called the first economist- Adam Smith- was not an economist, but rather a professor of moral philosophy. Smith had a profound understanding of the ethical foundations or markets and was deeply suspicious of the “merchant class” and their tendency to arrange affairs to suit their private interests at public expense….In short, Smith emphasized the ethical content of economics, something that got eroded over the centuries as economics tried to move from being a value based social science to a value free exact science”.

DEVELOPMENT OF ISLAMIC BANKING:

Islamic Banking (or Participative Banking) is Banking or Banking activity that is consistent with the Principles of Sharia and its practical application through the development of Islamic economics. Sharia prohibits the fixed or floating payment or acceptance of specific interest (known as riba,) for loans. Investing in businesses that provide goods or Services considered contrary to Islamic Principles is also haram (“sinful and prohibited”). Although these Principles have been applied in varying degrees by historical Islamic economies due to lack of Islamic practice, only in the late 20th century were a number of Islamic Banks formed to apply these Principles to private or semi-private commercial Institutions within the Muslim Community. As such it is not a totally new concept; however, considering spread of this method of Banking is certainly a fairly recent phenomenon. The term “Islamic Finance” is widely understood to mean commercial financial activity which complies with Islamic law, Principles and jurisprudence including Sharia which is derived from a number of sources, mainly from Qu’ran and Sunna (the living tradition of the Prophet Mohammed (pbuh)). The present structure of Islamic Finance has developed in accordance with these Principles (Sharia) and prohibitions. Some of the basic and key Principles include prohibition of Interest (riba), Speculation (mairis), Uncertainty (gharrar) and Unjust enrichment / unfair exploitation. For effective implementation of Sharia Principles a number of financing techniques have been developed including cost plus financing (Murabaha), leasing (Ijara), construction financing (Istisna’a), Agency (Wakala), Sukuk (negotiable instrument), equity financing (Musharaka) and participation financing (Mudaraba).

The Islamic law or Sharia governs all economic and social activities and undertakings. The Islamic economic model has been developed over time, based on the rulings of Sharia on commercial and financial transactions. The Islamic financial framework, as seen today, stems from the Principles developed within this model which include five key prohibitions viz,

- Interest (riba) – the prohibition on the charging of interest.
- Speculation (mairis) – Speculation or gambling to put differently obtaining wealth without effort.
- Uncertainty (gharrar) – full disclosure requirement for example price of contract
• Unjust Enrichment – the financier should only generate benefit from the project in which it invests and must assume a degree of risk to obtain award

• Unethical Investments – Islam is intolerant of certain products for example alcohol and activities like gambling.

Islamic Banking is steadily complementing into the mainstream of conventional financial systems and has remained largely insulated from the global credit crisis. It is expanding not only in the Muslim world, but also in other countries where Muslims are a minority, notably Britain, France, the US, India and even Japan. The industry has grown at a prodigious rate of 15-20% annually over the past decade; a trend that is likely to continue as the economic and construction boom in the Middle East and Asia regions will boost the value of Sharia assets. Islamic bond sales in the six nations Gulf Cooperation Council (GCC), including Qatar and Saudi Arabia are headed for a record year after borrowing costs reached low. Sukuk sales claimed to $17.7 billion so far this year from $4.8 billion in the year-earlier period. (6)

Islamic Economic Model:

The Islamic Economic Model, mainly, is based on a risk and profit-sharing (and loss-bearing) philosophy and emphasizes fairness. On a macro-economic level, the Islamic model aims at social justice and the economic prosperity of the whole community. It encourages and promotes the right of individuals to pursue personal economic wellbeing, but makes a clear distinction between what commercial activities are allowed and what are forbidden. One of the most important key of Sharia ruling on economic activities is the strict and explicit prohibition of Riba, most usually described as usury or interest. The Islamic Law of Contracts plays a pivotal role within the Islamic Financial System. Islamic commercial jurisprudence consists of Principles and rules that must be observed for transactions to be acceptable in Islam; and the Islamic Law of Contracts is at the heart of this. One important principle is contractual certainty. Under this body of law, uncertainties or ambiguities that can lead to disputes may render a contract void under Sharia (7).

The distinctions between Islamic Banking from its conventional counterparts are………

1. Islamic Banks play multiple roles in assisting individuals and enterprises such as acting as a partner, agent, guarantor etc.
2. Under the partnership contract such as Mudaraba and Musharaka, Islamic Banks jointly share any risk with their clients. However, the risks in Musharaka differ from the risks in Mudaraba. In the Musharaka contract by the bank and the entrepreneur contribute capital and they jointly share the risk on their capital and effort. In case of Mudaraba, the bank may lose its capital and the entrepreneur faces the risk of wasting his efforts.
3. In a few jurisdictions, Islamic Banks participate in true trading activities (Asset Backed Transactions).

ISLAMIC BANKING: INSTITUTIONAL DEVELOPMENT

The Islamic Finance sector has developed into a global phenomenon which is highly dynamic and growing rapidly. While the main centers of Islamic Finance in the world today are traditionally acknowledged to be the Middle East, Malaysia and the U.K., the clientele of Islamic Financial Institutions are not confined to Muslim countries but are spread over Europe, the United States of America and the Far East. (6) Establishing exclusive Institutions for Islamic Banking is relatively a recent creation. One of the first Islamic Banks was set up in Egypt in 1963. The most important institution for the development of Islamic Banking is the Islamic Development Bank (IDB) established in 1975 and given momentum to the movement. It was the first time in modern Muslim history that an international financial institution committed itself to conduct it activities in conformity with Sharia, instead of working on the basis of interest. Later a good number of Islamic Banking Institutions have been established all over the world and some countries have taken the necessary steps to organize their Banking systems along Islamic lines. The first private Islamic Commercial Bank, the Dubai Islamic Bank was founded in 1975.
Since the opening of the first Islamic Bank in Egypt in 1963, Islamic Banking has grown rapidly all over the world. At present there are 500 Financial Institutions operating in more than 75 countries worldwide offering Islamic Banking and Finance products. There are two types of Islamic Financial Institutions (IFIs). The first one is Institutions whose entire businesses are conducted in compliance with Islamic law. The second one is those Institutions who offer Shari’a – compliant products and Services and conventional products. However the need for appropriate segregation between conventional financial activities that are impermissible in the Sharia and Sharia–compliant Products and Services has led to the development of the “Islamic Window” concept.  

**ISLAMIC SECURITIES MARKETS:**

The credit of identifying the significance of Islamic Securities Markets may be attributed to global financial crisis. In fact the crisis established the creditability of Islamic Finance and further contributed for its development. The credit crunch during August 2007 marked the initial, albeit rather drawn-out phase of extensive development for Islamic Finance. This was the period characterized by the gradual emergence of Sharia compliant products in key categories and a rapid growth in numbers of Sharia compliant financial sector Institutions. Before the crisis hit, Islamic system was in place in different countries. However, the crisis has become an important test and ultimately valuable reminder of the need to structure products and strategies to suit the new developments in Islamic Securities Markets.

It is observed that the effect of global financial crisis on Islamic Finance has been dichotomous. The market participants who were criticized Islamic Finance and even government regulators having sizable Sharia–compliant industries become too restrictive and conservative, but now applaud and seek to emulate them. On the other hand, however, Islamic Finance has, obviously, not been immune to the crisis. The growing popularity of Sukuk has coincided with an active recognition of the need to address some of the weaknesses of the still-emerging market. The credit goes to the conventional Banks, who are pioneers to start Islamic Finance across the globe. The first of its kind is Egyptian Bank in Mit Ghamr which started investing funds on profit sharing basis in 1963. Later the Mit Ghamr model was adopted by the Nasr Social Bank of Egypt. By the end of 1976 nine Egyptian Banks had adopted an explicit no interest policy. Then the era of Islamic Development Bank (IDB) established in 1975 and took lead in promoting Islamic Banking globally by providing assistance for economic and social development for the member countries and has become an important catalyst for the Islamic Banking industry. The 1980 saw a steady expansion of Islamic Financial Institutions more specifically in Asian region.

In late 90s the need for distinctive capital market solutions became evident, which led to the introduction of new innovative products such as Sukuk, Islamic equity funds and various structured products. The first private sector Sukuk issues were launched in Malaysia in the 1990s but overtime, governments, also, played a key role in sponsoring these developments. Increasing deregulation and liberalization of Capital Markets in the GCC and other Islamic countries, along with the growing demand for innovative financial products, paved the way for the creation of an Islamic Capital Market infrastructure, complete with Islamic equity indices, asset backed securities, investment Banks and brokers/dealers. In recent years, a growing number of Islamic solutions have emerged for asset management and venture capital Services.

The Capital Markets are an important component of the entire financial system for raising funds for long-term investment. They provide opportunities for diversification of risk through cross-sectional risk sharing. The long term investments are facilitated through a series of short-term contracts in the form of tradable securities enabling the investors an opportunity to exit or enter through trade. Thus they provide an element of liquidity to the otherwise illiquid assets. The secondary market also provides pricing and valuation of assets on a continued basis thus eliminating arbitrage and inefficiencies. Similar environment should be created for the effective implementation of the Islamic securities products more particularly, when they are newly introduced.

The developments of Islamic Financial Markets, has been, particularly, significant in the Securities Market areas which are mainly focusing on tradable securities. Product innovations can add value and increase in risk – return choices for the investors. For this an effective and transparent legal and regulatory structure should be in place.
Besides, the Islamic products have distinct and different characteristics in nature; hence, the legal as well as regulatory structure for these products should match. Capital Markets and interest free financial markets are integral part of Islamic Financial System and also important for the growth of other Islamic Financial Institutions. Globally new products and Islamic Sukuk have been offered both by the public and private corporate sectors in domestic as well as in international markets.

To be specific, the Islamic equity market is composed of equities of companies that do not engage in activities that are considered haram (forbidden) in Islam. The same restriction also applies to the companies having large portion of interest-based debt or net income from interest payments on deposits held in conventional Financial Institutions. Malaysia is the pioneer in developing Islamic equity markets. The first Sukuk was issued by Shell MDS in 1990 for MYR 125 million (USD 33 million). The world’s first sovereign issue (by Malaysian Government) USD 600 million is Sukuk issue in 2002. The world’s first global corporate Sukuk issuance for USD 150 million was made by Kumpulan Guthrie, a Malaysia based company, in 2001. Since then the market for Sukuk has grown both in size and in sophistication.

**Sukuk**

Sukuk is the Arabic name for a financial certificate, Islamic alternative to conventional bonds. Sukuk is a Trust certificate in which investor returns are derived from legal or beneficial ownership of assets. This ownership comes in effect after the completion of subscription and with the investment of received funds. Although the Sukuk is sometimes referred to as the Islamic bond it is better described as an asset based investment as the investor owns an undivided interest in an underlying tangible asset which is proportionate to his investment. The Sukuk certificate evidences this ownership interest. Monies raised by the issue of the Sukuk note are used to invest in an underlying asset, a trust is declared over that asset and thereby the certificate holder will own a beneficial interest in that asset in proportion to its investment and is therefore entitled to all the benefits that entails including a proportion of the return generated by that asset. Prior to the development of the Sukuk product there was a scarcity of Islamic products that could provide a mid to long term investment and which could readily be traded in the secondary market, both from a practical perspective and from a Sharia perspective. The Sukuk is ideal from the perspective of the Islamic investor and, given that it is an ownership interest in a real underlying asset and not just a debt instrument, is a freely tradable instrument.

**Structures of Sukuk:**

Sukuk issue raises the finance / cash. However, for the purpose servicing additional cash flow is required. That is why it must be used in conjunction with another Islamic product. There are two typical structures are used in Islamic debt capital markets are Sukuk–al Ijara and Sukuk –al-Musharaka. Ijara is Sharia compliant lease. It is a hybrid between an operational lease and finance / capital lease with certain ‘ownership risks’, such as the obligation to undertake capital maintenance of the leased asset and the obligation to insure the asset, remaining with the lessor. The lessor may appoint an agent, usually the lessee itself, to carry out these duties on its behalf under servicing agreement. Another Islamic product, Sukuk- al-Musharaka has been developed, mainly, to overcome the inflexibility of Sukuk –al- Ijara. This permits greater flexibility in the asset transfer to cash to be raised ratio as the amount of cash to be raised does not need to correspond to the value of the assets available for transfer into the Musharaka. The examples of these structures have been depicted below.

For further adoption and expansion of the Islamic equity markets including various innovative products the markets participants and regulators find certain solutions like, comprehensive and integrated regulatory and Sharia –compliant frame work, using the conventional Banks’ network, which are proven capable and efficient for Islamic product sale and distribution, support by the respective governments and policy making bodies, better understanding idiosyncrasies of different geographies and markets, designing efficient domicile and cross border distribution channels, utilizing the Services of conventional insurance and Takaful firms for distribution,
implementation of training programmes for education and awareness of the Investment public etc. which help
the industry to grow parallel to the conventional financial system.

ISLAMIC INSURANCE:

Takaful (means Islamic Insurance or it is also called as halal insurance), as it is called in Islamic terminology is
the Islamic counterpart of conventional insurance which is based on the concepts of mutual solidarity and
financial aid. Under this type of insurance a group of participants mutually agree among themselves to support
one another jointly for the losses arising from the specified risk. It is to be noted that the conventional insurance
is not permitted under Sharia Principles (riba, gharar and maisir). Most of the Islamic scholars agree that
Takaful, which is based on the concept of “taawun” (i.e., mutual assistance), is the fully consistent with Sharia
law. In other words it is form of cooperative insurance. IFSB defined, Takaful as “the participants contribute
a sum of money as a Tabarru (donation) in to a common fund that will be used to mutually assist the members
against defined loss or damage”.  

Takaful – Structures / Models

Takaful models may be classified in to three viz.; ‘Wakala Model’, ‘Mudaraba Model’, and the third one are
Combined or Mixed Model. Under the ‘Wakala Model’ the operator is the agent of the participants, and is
entitled to a fee which is deducted from the contributions made by the participants in to a general Takaful fund
or the investment profits derived from investing the general Takaful fund and which may be performance
related. Whereas in case of ‘Mudaraba Model’ the operator is entitled to a fixed percentage of any investment
profits or surplus, which will be paid into the participants’ Takaful Fund. In ‘Mixed model’ method the Wakala
contract is adopted for underwriting activities, while the Mudaraba contracts are employed for the investment
activities of the Takaful fund.

<table>
<thead>
<tr>
<th>Comparison of Takaful and Conventional Insurance:</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Takaful</strong></td>
</tr>
<tr>
<td>Sharia Board ensures Sharia compliance at the product and operational levels</td>
</tr>
<tr>
<td>Surpluses / deficits shared between participants</td>
</tr>
<tr>
<td>Takaful operator makes available an interest free loan</td>
</tr>
<tr>
<td>Profit from investment of contributions belongs to the participants</td>
</tr>
<tr>
<td>Takaful operator has a fixed capital belonging to the shareholders and variable capital belonging to the participants</td>
</tr>
<tr>
<td>The governing rules relating to the formalities of Takaful contract are mutual guarantee or assurance based on the Principles of contact, which are generally enforceable against both parties as soon as the contract has been accepted by the Takaful operator.</td>
</tr>
<tr>
<td>Contract is bi-lateral in nature and binds both contracting parties.</td>
</tr>
<tr>
<td>The contribution cannot be forfeited. The contribution is ‘tabarru’ and is also treated as capital in the Mudaraba</td>
</tr>
</tbody>
</table>

ReTakaful:
Reinsurance as it is called in conventional insurance. Takaful for Takaful effects, the shift of some portion of the liability from one Takaful Fund to the viz., ReTakaful Fund. Under this method Takaful operators remain obliged to set aside capital to support participants’ funds and support participants (Funds) in case of deficit through interest free loans. However, due to shortage of Retakaful market intermediaries, companies are obtaining Retakaful form the conventional insurance system. It has become a practice in most of the cases both conventional insurance products and Takaful products are offered by the same insurance intermediaries.

Takaful firms by regulatory compulsions are required to have a Sharia Supervisory Board (SSB). The fundamental duty of this Board is to approve the products. Whereas Sharia Advisors or Sharia Audit or Sharia Compliance officers direct, review and supervise the activities of the firm in order to ensure that they are in compliance with the Sharia rules and Principles. Besides this, Corporate Governance also to be satisfied by the firm is added in the newly enacted UAE Takaful law. One of the major regulatory issues relating to Takaful is the potential conflicts of interest arising between the shareholders and participants of the Takaful fund. The Islamic Financial Services Board (IFSB)'s governance paper on this aspect, is suggesting that the creation of a “Governance Committee” to look after the interests of the participants and ensure that they are fairly treated. A big challenge for the Takaful operators particularly where both the systems (conventional and Takaful) are operating in the present competitive environment is to compete with the conventional insurance firm on global basis. New players are attracted by the low entry barriers. This in turn raises standards of insurance and Takaful offerings in the market, but at the same time increases competition among themselves. The advantage of conventional insurance has is the huge resources that they have and their brand strength that provides assurance to potential clients.

In spite of this, the global Takaful industry has been growing exponentially in the last few years and the recent figures from the Earnest & Young world Takaful Report 2012, confirms that global Takaful contributions grew by 19 per cent to $8.3 billion in 2010, out of which, the gulf cooperation Council (GCC) contributed $5.68 billion. The compounded annual growth rate in GCC during 2005 -2009 is stood at 41%. Abdul Rahman Mohammed Al Baker, ED- Financial Institutions Supervision at the Central Bank of Bahrain, said that “the global Takaful market has shown strong growth in the last few years. Driven by increasing awareness and improvements in the quality of products and Services being offered, the Middle East Takaful Industry has seen a significant increase in its market share. With tremendous growth opportunities yet to be fully tapped the Middle-east Takaful industry is poised for major growth in the coming years and therefore it is essential to ensure that strong foundations are in place to support this growth”.

REGULATORY LANDSCAPE: ISLAMIC FINANCIAL MARKETS

The regulatory landscape for Islamic Finance mainly is categorized in to two. The first category – Organizations Responsible for Setting International Standards for the Regulation of the Islamic financial Services Industry- which sets out international standards and norms agreed upon in consultation with the industry leaders having expertise in Islamic Finance. The second category – Domestic Regulatory Bodies and Institutions Implementing Standards and Norms through Rule-Making and Enforcement – relates to the regulatory bodies within each country in which Islamic Finance Standards and Norms of the first category into enforceable laws and regulations within applicable jurisdiction.

Category- I: Islamic Institutions: - Standards and Norms Setters

The Organizations like the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), International Organization of Securities Commissions (IOSCO), the Islamic Financial Services Board (IFSB), and the International Islamic Rating Agency (IIRA) are named under the first category Islamic finance standard setting Organizations. The Standards and Norms set by these organizations / Institutions are adopted and implemented by a number of countries who are implemented Islamic Finance in their respective jurisdictions. The AAOIFI’s Standards and Norms are adopted in the Kingdom of Bahrain, Dubai International Financial Centre (DIFC), Jordan, Lebanon, Qatar, Sudan and Syria. The relevant authorities in Australia, Indonesia, Malaysia, Pakistan, Kingdom of Saudi Arabia and South Africa have issued guidelines that are based
on AAOIFI’s standards and pronouncements. (6) Such standards have proven to be very useful not only for Islamic Banking practitioners but also for professionals in the conventional Banking world who seek a quasi-codified approach to the study of Islamic law as it pertains to their operations. (6) In 2001, AAOIFI and the Bahrain Monetary Authority developed a regulatory framework known as PIRI -- the Prudential Information and Regulatory Framework for Islamic Banks.

The Islamic Financial Services Board (IFSB) established in November 2002 in Kuala Lumpur, serves as an association of central Banks, monetary authorities and other Institutions that are responsible for the regulation and supervision of the Islamic Financial Services Industry. The IFSB is expected to play a significant role in developing international prudential and supervisory standards and best practices for Islamic Financial Institutions. The IFSB has developed two prudential standards for the Islamic Financial Services Industry, namely capital adequacy and risk management standards. These standards were issued in 2005 and addressed the identification, classification measurement and reporting of the risks for Islamic Financial Institutions. The IFSB is planning to develop standards on corporate governance, transparency and market discipline. (6) The IFSB working groups, which include representatives from Central Banks and National Monetary Authorities, work with other international bodies, such as the International Association of Insurance Supervisors (IAIS), to streamline the rules around integration of Islamic products such as Takaful or Islamic insurance, for example.

Second most notable organization which contributed for the development of Islamic Finance Regulations is IOSCO through its Task Force. In fact the IOSCO’s Executive Committee9 mandated the formation of an Islamic Capital Market task force to assist relevant regulators in assisting the extent of the development and potential regulatory issues relating to the Islamic Capital Market as well as together information on Islamic financial products and activities30. In the process of development of Islamic Capital Markets there is a greater potential of transfer of financial assets from Islamic Banking Sector to Islamic Capital Markets. The Task Force report identified specific industry issues covering both regulatory issues as well as public and private sector initiatives within IOSCO’s members’ jurisdictions to accelerate the growth of the Islamic Financial Service Industry.

Another important IFI is the International Islamic Rating Agency (IIRA) which is established by the Islamic Development Bank (IDB) in Bahrain in October 2002. The purpose of establishment of this institution is to rate, evaluate and to provide independent assessments and opinions on the likelihood of any future loss by Islamic Financial Institutions as well as their products and Services. IIRA also assesses the Sharia’s compliance aspects of Islamic Financial Institutions and Islamic Financial Products and publishes the data and information relating to rated entities and Financial Instruments to the public. In addition, IIRA has introduced a set of rating products to foster greater Sharia transparency, for both financial products and their issuers. (11)

Category-II: Islamic Financial Regulators in Respective Jurisdictions:

The domestic regulatory bodies in the countries like Malaysia, Bahrain, UAE, Saudi Arabia, UK and USA are the pioneers in implementing Standards and Norms through Rule Making and Enforcement comes under the category II. Malaysia has the distinction of being the World’s first country to have a full-fledged Islamic Financial System operating parallel to the conventional Banking system.21 The Central bank of Bahrain (CBB) was the first to make AAOIFI’s standards mandatory for all Islamic Institutions. The CBB also has rules covering capitalization, risk management, financial crime and disclosure and is pushing to train Sharia’s scholars to aid industry growth. (6)

In Sudan, Pakistan and Iran, where Islamic Banking is the national system, financial products conform to the Sharia as it is defined by local authorities. In countries where Islamic Finance runs in parallel to the conventional system, such as Malaysia and Bahrain, Islamic Banks are regulated separately from conventional Banks. While Gulf and Malaysian models are said to be gradually converging, differences of opinion remain between scholars. Other state regulators have worked with Islamic Financial Institutions to include them in existing regulatory frameworks. In the UK, for example, both the Bank of England and the Financial Services Authority (FSA) were involved in the establishment of the first Sharia-compliant retail bank in Europe or the United States, the Islamic
Bank of Britain, in 2004. The Indian Central bank- Reserve Bank of India- (RBI) has permitted an “Islamic bank” which operates exclusively on the basis of Sharia Principles.

SHARIA REGULATIONS: STRUCTURE AND STRATEGIES

Islamic Financial Institutions (IFIs) have invented sophisticated Sharia compliant products to meet the standards stipulated by growing number of regulatory bodies and country-wide regulatory Institutions. It has to be noted that the Sharia regulations are based, mainly, on Islamic Finance Principles. The basic Principles like prohibition of interest (riba), uncertainty (gharar), and speculation or gambling (maisir) (which are banned under this law), haram (investment banned in certain industries such as those involved in sale of alcohol, pork or pornography) and finally backed by tangible and identifiable assets. These are the main pillars to draw boundaries to the Islamic financial regulations.

1. Riba historically prevented IFI’s involvement in Asset Backed Securitization (ABS) which was popular in the non-Islamic world in various forms, for example interest –bearing credit and receivables are main asset classes Financed through ABS. But under the principle of Riba, the profit / loss under ABS is prohibited. However, experts and IFIs created a number of alternatives to ABS financial Structure viz., leasing contracts, equity interests, Islamic ABS in all of the above cases (Sukuk) assets structured in accordance with Mudaraba and Wakala models and certain forms of sale contracts provided that underlying assets are Sharia compliant. (11)

2. Under the principle of Gharar and Maisir which are banned under Islamic law, no one participant should bear an unequal portion of the risk, profits or losses. This is one of the main features which distinguish from the Islamic financial products from their counterparts, which resulted in that the conventional insurance securitization products are prohibited under Sharia’ particularly in as far as issuers are made no guarantee fixed returns for lenders regardless of the actual performance or value of the underlying assets. (11) Takaful an Islamic insurance concept that has been practiced in various forms for over 1400 years (11) has become increasingly important to Islamic institutional investors wanting to invest Takaful investment proceeds in Sukuk and other Sharia compliant instruments without being accused of exposure of gharar or maisir. Takaful is a system of Islamic insurance based on the principle of mutual assistance and voluntary actions where the risk is shared voluntarily and collectively by a group of participants. IFIs have created analogs to conventional insurance-linked products and securitization structures that incorporate the concept of Takaful and are implemented through either a Mudaraba (profit-sharing) Model or Wakala (agency) Model, or a combination of both. Mudaraba gives the right to the contracting parties to share the profit, while liability for losses is allocated among the participants; and under the Wakala Model, the Takaful operator earns a fee for Services rendered while liability for losses in borne by the participants. Takaful can provide insurance-linked cover against risks to the securitized assets, and Takaful companies can also play an important role as investors in Sukuk offerings. (11)

3. Another important principle is that the Islamic Securities must be backed by tangible and identifiable assets. This increases the collateral cover to IFIs than for conventional Banks. It further increases in disclosure requirements. The Islamic Principles also restrict investments in highly leveraged companies, which proved well for the Islamic investors in the recent global financial crisis.

ISLAMIC FINANCE - DEVELOPMENTS IN SULTANATE OF OMAN

Although Oman is a relatively new entrant to Islamic finance, it has already experienced significant developments for its effective implementation. The Banking regulator, Central bank of Oman (CBO), and Capital Market and Insurance sector regulator Capital Market Authority (CMA) took lead in framing regulations for this ever growing industry. After receiving green signal from the Royal to permit the Islamic financial institutions to operate in the Sultanate and the financial instruments supports the operations of Islamic banking and finance, the CMA with the cooperation of international experts introduced Takaful
insurance. The Authority also granted approval for the establishment of three Takaful insurance companies in the Sultanate.

Doubtlessly, it is a very successful start of Islamic banking in the country. Thomson Reuters, in its 2013 Global Islamic Finance Development Report, ranked Oman number one for its attempts to increase awareness and understanding of Islamic banking in the country. Addressing delegates at the Oman Islamic Economic Forum 2013 in Muscat, Central Bank of Oman chief executive president Hamoud bin Sanjour Al Zadjali said “the local banking industry has recently witnessed many developments, including the promulgation of a decree which provided new horizons for Islamic banking inside Oman by giving licenses for specialized Islamic banks and Islamic windows at licensed traditional commercial banks”

The Forum expressed that, Islamic economics is not a new phenomenon; it is simply adapting to the challenges of modernity. Its history is replete with examples of ideas and products, thinkers and policies that have contributed to the creation of societies with an impressive socio-economic structure. From financial practices, product development, education and innovation, the Islamic Economy undoubtedly created a culture of excellence. This culture of excellence continues through Islamic banking and finance, a sector that has been praised for its resilience during the credit crisis. Al Zadjali said it is expected that Islamic banks would provide the suitable financial support for small and medium enterprises and entrepreneurs and help them with innovative Sharia-compatible solutions that meet their needs.

Muscat Securities Market took lead in introducing Sharia Index for the Omani Stocks. The MSM director-general Ahmed bin Saleh Al Marhoon said that the launch of the index came at an important time for the national economy as it coincides with the launch of Islamic Banking. He said that the launch of the index would contribute to attracting a new category of investors who prefer to invest in Shariah-Compatible products. This would contribute to the development and growth of the Islamic Capital Market as it provides non-traditional investment options. Al Salmi, the Executive President of Capital Market Authority said, that “the index identifies the companies whose business transactions and activities are compatible with Sharia. This provides a feeling of convenience by a category of investors who were reluctant to trade at the market and also attract new investments to the market,” he said. He pointed out that the MSM continues offering new Islamic investment tools and that the Islamic index would enhance more public issues.

In the recent Global 2014 study Oman ranked as the number one emerging and untapped market. It provides the way and attract for Sukuk investment and issuance. It is reflective of positive perception and sentiment towards Oman's Islamic finance sectors. Sohail Niazi, chief Islamic banking officer of Maisarah Islamic Banking Services stated that, "In the last 12 months, we have introduced 12 corporate, retail and treasury products to serve the Omani market. For our corporate and small and medium enterprises (SME) clients’, we provide range of Islamic Trade Finance solutions through Sharia-Compliant letters of credit, guarantees, and goods Murabaha financing. We offer real estate, construction, and project finance solutions through diminishing Musharaka and other innovative structures. To meet the working capital requirements of our corporate customers, we have developed, in collaboration with our consulting partners, a Mudarabah financing product. This product is an Islamic alternative to a conventional overdraft facility, and was voted the best product and won the innovation challenge award during the Global Economic Summit in Dubai. Many products from across the globe competed in this category,” said Niazi. Several Islamic windows and two banks have been established here, the MSM Sharia Index was created to track Sharia-Compliant stocks.

The first corporate Sukuk was issued, the Takaful Company was launched.

The Central Bank of Oman organized the Annual Bankers meeting on Monday April 28th 2014, wherein CEOs and GMs of the commercial banks operating in the Sultanate converged to discuss pertinent banking matters and issues of common interest. Addressing at the Annual Bankers meeting on April 28th 2014 H.E. Hamood Sangour Al Zadjali, the Executive President of CBO, expressed satisfaction that year 2013 was yet another successful year for our banking sector with positive growth in deposits, advances and profits. Marking the advent of Islamic banks as an important development in the country, H.E. noted that there are two full-fledged Islamic Banks and six Islamic Windows in the country with a total branch
network of 28 Islamic Banking Entities (IBEs) as at the end of the year 2013. H.E. further stated that as at the end of first year of operations, total assets of Islamic Banking sector stood at RO 808 million, deposits at RO 170 million and Islamic financing at RO 425 million. Commenting further, He, further, pointed out that there was a need to create awareness on Islamic banking, its products and services, besides, developing innovative deposit and financing products. He said that nurturing human resources and building human capacities in Islamic banking should be one of the top priorities for the bankers. “Capacity building of Omani staff for offering Shari’a-compliant financial services is going to be a major challenge in the days ahead.

However, for the continuous development of Islamic Industry the OIEF highlighted certain Critical issues to be explored which include:

- Consider how Islamic education needs to adapt to the modern age, and ascertain ways in which collegiate institutions can develop curriculums which create dynamic individuals working from Islamic principles in the commercial world.
- Identify failures in producing a robust human resource pool and look into ways in which to develop employment opportunities and entrepreneurship in the Sultanate and beyond.
- Explore the synthesis of the Halal industry and Islamic finance and what needs to be done to strengthen the relationship between the two sectors.
- Developments in Islamic banking and finance industry in Oman.
- The role of Zakat, Waqf and microfinance in Islamic finance and developing corporate social responsibility, and
- Islamic banking as a tool for economic reform.

Oman's Central Bank took a strict approach to regulating Islamic banking in rules for the sector setting higher standards for the industry than many other countries. The Central Bank's rules cover, besides other areas, banks’ liquidity management, the administration of boards of sharia scholars who oversee Islamic financial institutions, and the operation of conventional banks' Islamic windows - and in many cases, the rules appear considerably stricter and more detailed than regulations in other countries.

A major provision is tight restriction of the use of Tawarruq as a money market instrument for banks; this is expected to limit banks' flexibility in managing their funds overnight, and could thus raise their costs. "Commodity Murabaha or Tawarruq, by whatever name called, is not allowed for the licensees in the Sultanate as a general rule". Interbank transactions which are allowed include Mudaraba, Musharaka and Wakala placements, all common Islamic Finance Structures. The rules state that financial accounting standards from the Accounting and Auditing Organization for Islamic Financial Institutions, a Bahrain-based industry body, will be followed. In the area of vetting and supervising Islamic products, Oman is opting for the decentralized approach which prevails in the Gulf. It will allow each bank to have its own Sharia Board to supervise products, rather than imposing a centralized board for the whole industry.

Salient Features of the Islamic Banking Regulations

- Smaller institutions will be allowed to outsource the sharia board function subject to Central Bank approval.
- Unlike other countries in the region, the central Bank has set out strict requirements for scholars, including criteria for whether they are fit and proper, maximum tenures, and limits on the number of board seats that an individual can hold.
- Each Sharia Board must have a minimum of three scholars; they can only be appointed for three-year terms and serve a maximum of two consecutive terms. Board chairman should preferably serve on a rotation basis, the rules state.
Scholars must demonstrate an understanding of both legal and financial matters and have a minimum of 10 years’ experience, and banks are encouraged to develop local expertise by increasing the membership of Omani’s in Sharia Boards.

The scholars are not allowed to serve in two competing Islamic Financial Institutions within the country, and they can work in a maximum of four non-competing institutions.

They are also required to attend a minimum of 75 percent of board meetings or risk being disqualified; Sharia Boards must meet at least four times a year, and must disclose the number of meetings in the bank’s annual report. Sharia Scholars will face performance assessments, both collectively and individually.

According to the rules, a single branch cannot operate both an Islamic window and conventional banking services, while the windows must disclose the sources and the uses of their funds.

Banks that plan to offer sharia-compliant products through Islamic windows include Bank Sohar, Bank Dhofar, Bank Muscat, Ahli Bank and National Bank of Oman (NBO).

The rules also outline stock market listing requirements, ownership limits, minimum paid-in capital amounts, and a 12 percent minimum capital adequacy ratio for Islamic banks.

Banks may be allowed on a case-by-case basis to issue Sukuk (Islamic bonds) to raise Tier 1 capital and to issue subordinated Sukuk, while the treatment of Sukuk under bankruptcy and insolvency proceedings is outlined in detail. Islamic collective investment schemes will be regulated by the Capital Market Authority.

ISSUES, CHALLENGES AND PLAN OF ACTION

Financial Markets are dynamic in nature. Every system has its own issues and challenges that need to be addressed from time to time. It is more so when both the systems are operating simultaneously in the same jurisdiction. One of the major issues to be addressed is frequent changes in regulations. For example the regulatory changes concerning the structure of Sukuk warrant careful consideration and might tamper some of the recent enthusiasm for Islamic capital market products. In February 2008, the Sharia Committee of the Accounting and Auditing Organization of Islamic Financial Institutions issued recommendations regarding the role of asset ownership, investment guarantees, and the sharia advisory and approval process in Sukuk origination and trading.

The Sukuk market is also still plagued by illiquidity due to high originator concentration, large diversity in deal structures and regional fragmentation (Hesse et al, 2008). In addition, the lack of sufficient information about securitized assets in many Sukuk and the prevalence of “buy-and-hold” investments inhibit efficient price discovery and information dissemination. Secondly the entry of new foreign players in to the domestic markets will heighten competition which necessitated smaller Islamic Banks to consolidate and cascade down into a need for smoother transactions. Further, it is added that the small Islamic Banks will have to strive harder to enhance their efficiency and productivity so as to remain competitive, profitable and most importantly durable.

Profit adequacy is a requirement even for Islamic Banks too but it is supplemented by auxiliary considerations. In case of higher profits for Islamic Banks it is one way good that it meets higher social responsibility by paying more Zakat, also be able to offer more attractive profit / loss sharing ratio on investment accounts and financing.

Islamic Banks should be in a position to adopt the model which helps to offer more non-traditional Banking products such as Salam and Istisna (sale by order), Mudaraba (partnership of skill and capital), and Musharaka (joint venture) compared to bay’muajjal and Ijara, which are most commonly used modes of financing currently.
These products will prove to be potent for entrepreneurial development, as the products are relatively collateral free.

By carrying an equity flavor and risk sharing values Islamic Banks can play a significant role in developing new entrepreneurial friendly products not readily found in conventional Banking. In the absence of money – lending environment, entrepreneurs should stand for a better chance to flourish and perform even better which leads to, in the long run, growth and development of the micro enterprises.

Most importantly, lack of developed market for money market instruments that are Sharia compliant to address the issue of liquidity risk management, is one of the immediate challenges to be looked into. There is also an immediate need for short-term money market investments and tools for liquidity management, a space that could benefit immensely from the introduction of new instruments. Most of the available Conventional Banking Instruments for liquidity management are interest based and therefore not Sharia compliant. Until new products or solutions are developed, this issue is going to severely hinder development of the Islamic Banking inter-bank money market. It is an important challenge and is constrained due to limited availability of tradable Islamic money market instruments in the various countries and having weak systemic liquidity infrastructure. There is a strong need for widespread and developed Sharia-Compliant short-term Islamic money market, and Islamic repo instruments.

Islamic Finance is still hampered by the need for harmonized financial regulation. The Governance issues, especially for Sharia compliance of products and services constitute a major challenge for the Islamic Finance industry. There is still considerable heterogeneity of scholastic opinions about sharia compliance, which undermines the creation of a consistent regulatory framework and corporate governance principles. Given the rising global integration of the Islamic financial services industry, greater supervisory harmonization across national boundaries is essential.

The problems and unnecessary risks rise due to the differences between the nations in framing the regulations and regulatory objectives. The main reason for this state of affairs is lack of machinery for monitoring, surveillance and governing these markets globally. The significant risks are associated with cross-border Islamic Securities Markets are mainly related to (i) differences among nations and markets in regulations, capital requirements and accounting practices and (ii) financial integrity of market professionals and intermediaries, which are important because they may involve systemic risks to Islamic Financial Institutions that are involved in the markets.

Added to above, Islamic Banks are structured to include a special Sharia Supervision Board made up of Islamic scholars. Analysts say the industry’s more general problem -- a shortage of qualified people -- shows up at this level, with some of the top 20 scholars appearing on Sharia Supervisory Boards (SSBs) for dozens of different Institutions. Forbes magazine estimates that there are only 260 such scholars in the world, of whom only a handful having the requisite grip on complex financial instruments to sit on a bank’s board. Specialized academic centers have been set up to address this, such as the Harvard Law School’s Islamic Finance Project. Conventional Banks which have added new Islamic Services keep Sharia-Compliant products separate from other products.

The Islamic Banks depend upon Profit Sharing Investment Accounts (PSIA) as a major source of funds to Finance their assets, without legal, financial and administrative separation between these asset management activities and the bank’s Commercial Banking activities in many jurisdictions. In addition, contractually the bank shares the profits on their investments (but not losses) with the holders of these accounts, so that the latter face the risk of negative returns, in practice the characteristics of these PSIA vary from being deposit-like products in some Banks and jurisdictions to pure investment products in other Banks and jurisdictions, depending upon the way Banks manage the risk-return characteristics of these accounts. PSIA, in effect, offer a risk-return mix that is linked to a specified pool of Sharia’s Compatible Financial Instruments. Thus, for regulatory purposes, Islamic Banks have to be treated as both Investment Institutions in the Capital Market, as well as Banking Institutions of the Monetary System. (IFSB - October 2006)
The effective management of PSIA by Islamic Banks, and risk management generally in such Banks require that the risk-return preferences of these accounts (and the risk, return and maturity characteristics of other funding and liabilities) be matched by the appropriate asset allocation to back the PSIA (and other funding and liabilities). Such on-balance sheet risk management is needed for Islamic Banks, because of the limited availability of Sharia’s compatible hedging products. This, however, requires a robust Islamic Asset Securitization framework with a well-developed market for Islamic Securities so that assets originated by Banks can be exchanged and traded for suitable assets that match their funding and liability profile. (IFSB - October 2006)

The effective Liquidity Risk Management by Islamic Banks has been constrained by the inadequate development of Islamic Money Markets. It is now increasingly recognized that the development of Islamic Money Markets – markets for Sharia’s Compatible short-term financial instruments suitable for monetary operations of Central Banks and liquidity risk management of Commercial Banks - requires active markets for Islamic Capital Market Instruments as a foundation on which short-term financial instruments can be designed and traded. (IFSB - October 2006) This means that both Banks and Securities Firms will play fundamental role in a new risk intermediation landscape as they become actively involved in the origination, securitization and active management of credit exposures. This shift in risk distribution mechanisms towards capital market and traded products would require closer cooperation between Banking and Securities Regulators in the supervision of Islamic Banks and Securities Firms.

Islamic Banks can borrow funds from the conventional banks based on Sharia Principles. However, it is reverse in case of conventional banks unless these are structured on the basis of Sharia Principle. At the same time Islamic banks cannot lend fund to the conventional banks which is an added disadvantage for the Islamic banks. To overcome this one of the solutions is encouraging conventional banks to adopt Islamic Financial system.

For these reasons, an Islamic Capital Market development program needs to be given emphasis as part of national, regional, and international initiatives toward capital market development. In particular, a Capital Market Development Strategy with an emphasis on asset securitization, including a suitable regulatory and infrastructure support for Islamic asset securitization, is critically needed to foster Islamic Capital Markets. Such a strategy would have two elements on which guidance and standards would need to be developed. Firstly, a suitable regulatory and supervisory framework for Islamic Financial Markets that recognizes the cross-sectoral nature of Islamic Banks, the specific operational and governance arrangements for Islamic Capital Market Institutions and Instruments, and their unique risk characteristics and the another is adaptations in legal, governance, information and liquidity infrastructure (including market microstructure, and clearing and settlement systems) to accommodate the specificities of Islamic Finance.

**Conclusion:**

In spite of above hiccups, the long-term prospects look promising for Islamic Finance. Financial Institutions in countries such as Bahrain, the United Arab Emirates and Malaysia have realized considerable demand for Sharia-Compliant assets and are gearing up for more Sharia-Compliant Financial Instruments and Structured Finance. In addition, financial innovation, driven by both domestic and foreign Banks, will promote alternatives modes of intermediation and contribute to further development and refinement of Sharia Compliant contracts. The regulatory advantages (for example avoidance of double taxation in case real estate registrations) should be given to Islamic Institutions for effective implementation. In fact, it is possible that in the initial stages of the process, some Islamic transactions will fall into legal voids and may be viewed with reticence by the general public. Therefore, the authorities’ should be akin to the British Financial Services Authority’s stated policy of “no obstacles, no special favours” (FSA, 2006) as quoted. As Islamic Finance comes into its own, greater regulatory harmonization will be inevitable. Recent efforts have addressed legal uncertainty imposed by Islamic jurisprudence, discrepancies of national guidelines and under developed uniformity of market practices. The Islamic Financial Services Board has moved ahead with its standardization efforts of the Islamic financial Services industry that will foster the soundness and stability of the system. Globally accepted prudential
standards have been adopted by the Islamic Financial Services Board that smoothly integrate Islamic Finance with the conventional financial system.

Islamic Securities Markets complement the investment role of the Islamic Banking sector. They are more relevant in Islamic economy because prohibition of interest entails a greater reliance of equity and asset based Finance. Obviously, the institutional arrangements of the Islamic financial system may be different with respect to these markets as compared to their conventional counterpart. The important issue before us is how the Islamic Securities Markets will develop and what direction they will take depends on the realization of similarities as well as the differences in the objectives and the means of the Islamic system and based on that, the introduction of new financial products, their characteristics, diversity and the use, the legal and regulatory support provided to functioning of these markets. The regulators should focus, mainly to put effective and transparent legal and regulatory infrastructure in place and amending as per the need time to time. And it is more so in case of adopting the Islamic Securities Markets.

In conclusion I would like to quote from the welcome address by Dr. Zeti ADr Zeti Akhtar Aziz, who stressed that “Islamic finance draws its strength from serving the real economy. An important feature of Islamic finance is that it involves financial transactions that must be accompanied by an underlying economic transaction. And when it is cross border, it will facilitate financial flows that will support international trade and investment flows. It will contribute towards bridging economies and enhancing our economic connectivity with each other”. Further, highlighted three important factors for ensuring sustainability of Islamic finance viz., the wide range of global supply of high-quality Islamic financial products and services that are able to meet the requirements of international businesses, secondly, is having diverse and dynamic intermediaries and market participants that have a global focus including having Islamic banking, Takaful and capital market players that venture beyond domestic boundaries to tap global opportunities and in addition, having the required talent is another imperative in steering the Islamic financial sector towards increased internationalization. Thirdly, effective linkages and connections between global financial markets will be facilitated by business enablers, particularly in the area of legislation, taxation and regulation.

Islamic Finance is an established system decades back and spread to the various countries because of its inherent advantages and ethical satisfaction. However, due to the dynamic financial and changing economic scenarios across the globe, Islamic Financial Markets are still facing challenges, including regulatory changes, illiquidity issues, liquidity risk management concerns, need for harmonized regulation, regulatory disparity amongst supervisors and a potentially non-level playing field which can overcome through regulatory discipline and strong determination. It is obvious that success depends on continuous efforts to curb the deficiencies in the implementation of the new system from time to time.

*********

BOX-1

SHARIA PRINCIPLES AND PROHIBITIONS

<table>
<thead>
<tr>
<th>Principle</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest (Riba)</td>
<td>The payment and receipt of interest (riba) under Islamic law is prohibited and any obligation to pay interest is considered void. Islamic Principles require that any return on funds provided by the financier be earned by way of profit derived from a commercial risk taken by the financier.</td>
</tr>
<tr>
<td>Speculation (Maisir)</td>
<td>Contracts which involve speculation are not permissible (haram) and are considered void. Islamic law does not prohibit general commercial speculation (which is evident in most commercial transactions) but does prohibit speculation which is akin to gambling, more particularly, gaining something by chance rather than by productive effort. However, the distinction between speculation in genuine commercial trading and speculation in gambling arrangements</td>
</tr>
</tbody>
</table>
is not very clear and in each individual case the commercial substance of the transaction must be analyzed to evaluate whether or not it is permissible under Islamic law.

<table>
<thead>
<tr>
<th>Uncertainty (Gharrar)</th>
<th>Contracts which contain uncertainty (gharrar), either as to the fundamental terms of the contract, or the actual subject matter is considered void.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unjust enrichment / unfair exploitation</td>
<td>Contracts where one party gains unjustly at the expense of another are considered void. Again it is not clear exactly what would amount to unjust enrichment and in each contract the commercial substance of the transaction must be analyzed to evaluate whether or not it would amount to unjust enrichment under Islamic law.</td>
</tr>
</tbody>
</table>

BOX-2

ISLAMIC FINANCING STRUCTURES

<table>
<thead>
<tr>
<th>Term</th>
<th>Islamic Name</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost Plus Financing</td>
<td>Murabaha</td>
<td>MURABAHA (cost &quot;Plus&quot; trade financing) is a resale contract (where a bank buys equipment or tangible goods on customer's behalf and then sells them to latter at a &quot;mark-up&quot; (i.e. profit margin). The transaction is deemed legitimate if charges are for Services rendered and not for deferred payments. The mark-up is pegged to the prevailing London Interbank Offered Rates (LIBOR), and/or US short Treasury Bills rates. Pricing depends on credit ratings, transaction size and types of goods being Financed. A bank cannot re-price its receivables if LIBOR rises during the contract's duration. Service charge (Jo'alah) is justified because a bank accepts the risk of unforeseeable damage to goods from the time of purchasing and selling to the buyer. Al Bai Bithaman Ajil is a variant on the concept of Murabaha, whereby the lender permits deferred payments after delivery within an agreed period.</td>
</tr>
<tr>
<td>Leasing</td>
<td>Ijara</td>
<td>SUKOOK or IJARA (sale-leasebacks), where the owner rents equipment or real estate to end-users against fixed-rental for a specific period, but without the option of ownership for the lessee. Thus, responsibility for maintenance and insurance rests with the lessor. IJARA WA-IKTINA (hire-purchase), where the financier acquires a building, factory equipment or an entire project for the sole purpose of renting to clients against agreed rental, together with the latter's agreement to make fixed payments into an &quot;Islamic Investment Account,&quot; which will subsequently lead, as stipulated, to the lessee's purchase (of title) from the lessor. Leased assets must have productive usages, like aircrafts or vessels and cannot be deployed in any un-Islamic ways, e.g. gambling equipment. In retail Banking, Ijara is used for home mortgage schemes and the purchase of cars. Rent is pre-agreed to avoid speculation or deception.</td>
</tr>
<tr>
<td>Constructio n Financing</td>
<td>Istisna’a</td>
<td>ISTISNA (contracts of exchange) is a pre-delivery financing and leasing structured mode. This can be used to Finance the manufacturer of plant/equipment and/or payments to builders during construction stages. A bank funds manufacture of the goods takes the title upon completion and sells to a third party. Istisna forms an important component of large-scale project financing.</td>
</tr>
<tr>
<td>Agency</td>
<td>Wakala</td>
<td>A Wakala is an agency relationship between an investor (muwakkil), typically a financial institution, and the agent (wakil), the entity requiring financing. It is customarily used in interbank arrangements and between group companies. A simple Wakala structure would operate as follows: 1. The Muwakkil agrees to put up capital for a specified period of time which the wakil invests, on behalf of the muwakkil, in certain Sharia compliant investments; and 2. Any profits generated by the investments are structured in a</td>
</tr>
</tbody>
</table>
way that ensures the muwakkil receives its agreed profit, with the wakil entitled to retain any additional profit in excess of the agreed return of the muwakkil.

| Negotiable Instrument | Sukuk | (Islamic tradable bonds) are devised to pay bondholders' rents or profits in accordance with proportional ownership from an underlying business rather than interest. The Accounting and Auditing Organization for Islamic Financial Institutions defines Sukuk as "certificates of equal value representing undivided shares in tangible assets, usufruct and Services... or the assets of particular projects or special investment activity... (and is distinguished from shares and bonds)." Malaysia defines Sukuk as "notes or certificates, which represent the value of a particular asset or assets." The IMF explains a Sukuk is "an asset-based obligation that can be structured so that it is virtually indistinguishable from a non-Islamic bond." Sukuk (like conventional bonds) carry maturity dates, coupons and yields and can be structured on various modes (Murabaha, Ijara, Istsina and Salam). At least 51% of the underpinning assets must be leased-back "real assets" (i.e. not debt instruments).

| Equity Financing | Musharaka | MUSHARAKA (participating financing), whereby both the Financer and borrowing enterprise jointly contribute funds to an existing or future project and either one or both may manage the business. Profits (or losses) are shared according to each party's financial contribution. Musharaka, adhering to principle of profit and loss sharing, is the purest form of Islamic Finance and is usually used to fund long-term investment projects.

| Participation Financing | Mudaraba | MUDARABA (trust-financing) is a contractual agreement whereby an investor (Rab Al Maal) or a bank entrusts capital to an agent (Mudarib) or the entrepreneur for managing a project. The owner of entrusted funds bears 100% financial risk, whilst the agent enjoys autonomy over business decisions. Mudaraba is usually employed in projects with short gestation periods. Profits (or losses) are shared between the two parties on pre-arranged ratios. A bank has the right to receive principal capital at the end of contact period, however, only if surpluses exist. If the books show a net loss, this will not constitute default on the agent-entrepreneur's part. Exclusively an investor sustains losses, but any losses due to the Mudarib's gross negligence are borne by the agent. Islamic portfolio management is based on concept of "Two-tier Mudaraba," whereby the bank mobilizes investors' savings into mutual funds, managed by fund managers. Most operate as either closed or open-ended funds, with tradable units. An Atnel (managing trustee) charges fees for Services.

### BOX – III

**THE BASIC FEATURES OF THE SUKUK**

<table>
<thead>
<tr>
<th>Features:</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. An undivided proportionate ownership interest in an asset</td>
</tr>
<tr>
<td>2. The corresponding right to the islamically acceptable income streams generated by the asset.</td>
</tr>
<tr>
<td>3. These current income streams are established and translated into tradable securities</td>
</tr>
<tr>
<td>4. Trust Notes or Certificates similar to Equipment Trust Certificates (ETCs) and Unit Trusts</td>
</tr>
<tr>
<td>5. Issuer creates a trust over the leased Assets</td>
</tr>
<tr>
<td>6. Trustee issues Sukuk to the Primary Subscribers (the beneficiaries under the trust) in the Primary Market</td>
</tr>
<tr>
<td>7. Sukuk Holders have pro-rata undivided beneficial ownership of the leased Assets / Portfolio held in trust -As beneficial owners the Sukuk Holders are entitled to the income</td>
</tr>
</tbody>
</table>
8. The Primary Subscribers can resell the Sukuk in the Secondary Market

9. The Secondary Buyer will be the new pro-rata beneficial owner of the Leased Assets held in trust

Advantages:

- The advantages are Diversification of funding sources, Creating and enhancing profile in international markets, Secondary liquidity, Sizeable financing, Ease of clearing and settlement, Diversification in Investment, Provides Leveraging Capabilities, Secondary Market Liquidity, Ease of clearing and Settlement, Investment available to Institutional and Retail investors and allows for many computation of Risk –Credit /Mkt. /Duration etc.

ENDNOTES

*The views expressed in this article are those of the Author. And should not be attributed to the University. Errors and omissions, if any, are the sole responsibility of the Author.

Paga Kallu Rao* Sources, quoted and unquoted (unknown) are sincerely acknowledged, more, specifically IOSCO and the web resources. My Special thanks to Heiko Hesse Andreas Jobst Juan Solé* Quo vadis Islamic Finance?, and for the contributors of GIFR- 2011.

1 The **Absa Group Limited** (also known as **ABSA** or **Absa**, formerly Amalgamated Banks of South Africa Limited) is the largest consumer **bank** in South Africa. Source: wikipedia

2 GIFR 2011 contains an overview of the Islamic Finance Industry in 55 countries.

3 Please see Box-1

4 Please see Box-2

5 Estimates of the number of Islamic Financial Institutions (IFIs) vary considerably between Institutions. For instance, the IMF estimates that the number of IFIs has increased to more than 300, while the Association of Islamic Banking Institutions Malaysia (AIBIM) estimated that there are 486 IFIs around the world. GIFR 2011 estimated the number to be 500.

6 See Box-3 for Basic features and advantages of Sukuk

7 Adopted from Clifford Chance LLP 2010

8 Generally these risk taking arrangements allow the operator to share in the underwriting results from operations as well as the favorable performance returns on invested premiums. However the operator’s fixed percentage is not guaranteed as there may be no surplus.

9 The model combines the elements of the Wakala and Mudaraba models and is structured so that the Takaful operator retains two Funds: one for the shareholders and the other for participants. The underwriting activities are conducted by reference to the Wakala model, whereby the shareholders manage the Funds as agent on behalf of the participants. In exchange for managing the Funds, each participant is charged a Wakala fee, which is normally a percentage of the contribution paid by each participant. As an incentive for the effective management, the operator is also entitled to earn a fee if there is a surplus in the participants’ Fund. With regard to investment activities, the operator invests the surplus contributions in different Sharia compliant instruments based on the Mudaraba contract. The operator acts as investment manager or Mudarib on behalf of the participants and the ratio of profit is fixed and agreed between the parties at the inception of the contract.

10 Adopted from the Presentation by Clifford Chance

11 Takaful comes from the Arabic root-word ‘kafala’ — guarantee which means mutual protection and joint guarantee. Operationally Takaful refers to participants mutually contributing to a common Fund with the purpose of having mutual indemnity in the case of peril or loss. The basic Elements of Takaful include Mutuality and cooperation, Takaful contract pertains to Tabarru’at as against mu’awadat in case of conventional Insurance, Payments made with the intention of Tabarru (contribution), Eliminates the elements of Gharrar, Maisir and Riba.
Wakala /Modarabah basis of operations, Joint Guarantee / Indemnity amongst participants – shared responsibility, Constitution of separate “Participants’ Takaful Fund”, Constitution of "Sharia Supervisory Board and Investments as per Sharia. The major Objections to Conventional Insurance are Scholars view the Insurance contract as an exchange contract – money is being exchanged for money over time and this brings about the problem of gharrar (which leads to maisir) and in investments aspect, riba.

15 An independent international organization, AAOIFI is supported by institutional members (200 members from 45 countries, so far) including central Banks Islamic Financial Institutions, and other participants from the international Islamic Banking and Finance industry, worldwide. AAOIFI standards are available on AAOIFI’s website, http://www.aaoifi.com.

16 The IOSCO seeks to protect investors address systemic risk, increase investor confidence and otherwise develop the securities market by implementing regulation among other methods.

17 The establishment of IFSB in November 2002 was supported by the International Monetary Fund.

18 Information on the IIRA can be found at http://www.iirating.com. The detailed research report containing analysis, ratios and statistics can be downloaded from the IIRA website under the research reports section.

19 The Executive committee takes all decisions and undertakes all actions necessary to achieve IOSCO’s Objectives.

20 The IOSCO mandated formation of the Islamic Capital market Task Force at the 2002 IOSCO annual conference and meeting held in Istanbul, Turkey.


22 It should be noted that the issuance of conventional Insurance – linked securities (ILS) has shown a gradual, in sometimes uneven, growth that increasingly involves new risk classes. Recent innovations in ILS have provided Insurers and reinsurers with ways to improve capital efficiency through more diverse use of Capital Markets. Further there have been technical advances in new structures and methodologies that express Insurance risk in terms similar to Capital Markets in addition to broadening of the investor base.

23 Omar Fisher and Dawood Y. Tayor, Prospects for Evolution of Takaful in the 21 Century. Copyright and reserved by Fellows and President of Harvard University, April 2000

24 From the PowerPoint slides presented by Dr. Ashraf Usmani on the Islamic Business Resources Centre website.

25 Zakat – means Purification of wealth (2.5% of annual savings go to the poor) Zakah is an Arabic word root “zaka” means to grow, to increase, or to be pure in heart. Zakah money is used to pay off debts but these people are not living in luxury, they are living a normal life. For example, someone who has gone bankrupt because of job loss and is overloaded with debt. Zakat account – Takaful companies are required to establish a zakat Fund into which zakat amounts must be deposited. The zakat Fund is required to be segregated from the shareholders’ Funds and the participants’ Funds:


REFERENCES AND REFERRED SOURCES

1. BMB Islamic. The Global Islamic Financial Services Industry, Chapter 1, p. 34. GIFR 2011.

2. —. GIFR 2011 p. 105.


12. —. The Bahrain Model, Chapter 20, page 172.

13. —. The Bahrain Model, page 173.


19. GIFR 2011, Chapter 6, Islamic Capital Markets, Page 68.


*****