

# ISLAMIC COMMERCIAL LAW REPORT 2016

An Annual Publication Assessing the Key Issues  
and Trends in Islamic Commercial Law for the  
Broader Islamic Finance Industry

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# INTERNATIONAL SHARI'AH RESEARCH ACADEMY FOR ISLAMIC FINANCE | ISRA

**ISRA** الأاديمية العالمية للبحوث الشرعية  
International Shari'ah Research Academy for Islamic Finance

The International Shari'ah Research Academy for Islamic Finance commonly known as ISRA was established in May, 2008 by the Central Bank of Malaysia (BNM) to conduct applied research in pressing issues in Islamic finance and make available to students, scholars and practitioners a repository of Shari'ah and applied research and legal rulings in English and Arabic.

ISRA also aspires to increase both the quantity and quality of human capital in the Islamic finance field. It is, moreover, intended to provide a platform enabling the largest possible number of practitioners, Shari'ah scholars, regulators and academics to participate, both locally and internationally, in pioneering research, serious discussions and creative thinking in order to help Islamic finance realize the objectives for which it was originally established.

## VISION

To be the premier Shari'ah research centre in Islamic finance.

## MISSION

- Integration of Shari'ah experts and industry practitioners.
- Synergizing total human capital development in Islamic Finance.
- Relevant to the market needs.
- Authoritative in research findings.

## OBJECTIVES

- Spearhead and conduct applied Shari'ah research in Islamic Finance.
- Enrich resources of knowledge in Islamic finance.
- Provide avenue for the development of Shari'ah practice in Islamic finance.
- Propagate harmonisation and mutual respect in Islamic finance practices.

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ISRA Consultancy Sdn. Bhd (ICSB) provides a comprehensive advisory related services in Shari'ah related matters in the field of Islamic finance, Islamic capital market and takaful. It also provides a well-researched, high quality Shari'ah focused training courses.

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In the Name of God, the Most Merciful, the Most Beneficent.

# ISRA Foreword



**Prof Dr Mohamad Akram Laldin**

Executive Director

International Shari'ah Research Academy for Islamic Finance

The Islamic finance industry has witnessed exponential growth over the last three decades, with estimates of the current market size ranging from USD1.66 trillion to USD2.1 trillion. The expectation is that it will expand to USD3.4 trillion by the end of 2018. One key factor that has contributed to this progressive development is the flexible nature of Islamic commercial law, which has imbued Islamic finance with the same core characteristic of flexibility.

With the proliferation and outreach of Islamic finance into various jurisdictions, including minority-Muslim countries, disseminating knowledge of Islamic commercial law and effectively implementing it in the day-to-day business of Islamic finance is warranted. To achieve this objective and meet the desired expectations, numerous measures have been introduced by international Islamic standard-setting bodies, regulators, *fatwa* institutions and Shariah advisory councils. These include the issuance of standards, guidelines and resolutions to regulate Islamic financial market practices at the local and global levels.

Despite all these concerns and initiatives, Islamic commercial law remains an under-explored field, a state of affairs which has left a gap in the critical needs of professionals without Shariah background. To address this problem, ISRA, in collaboration with Thomson Reuters, came up with this Report, which highlights key areas, frameworks and approaches that are fundamental in shaping the development of a well-structured Islamic finance industry and thus broadening the Islamic economy's outreach.

The rigour in the output of the Report will be of tremendous benefit to regulators, policymakers, Islamic finance professionals, practising lawyers and barristers, researchers and academicians. The Report is expected to deepen the various stakeholders' understanding of Islamic commercial law and thus help shape the progress of the industry as a whole.

I would like to congratulate the team and the writers for their hard work, ideas and effort in writing the Report. I am also pleased with this strategic collaborative work between ISRA and Thomson Reuters that produced it. I believe our collective efforts and initiatives to disseminate Islamic finance knowledge globally will contribute to the realization of a fair and equitable financial system.

# Thomson Reuters Foreword



**Mustafa Adil**

Acting Head of Islamic Finance  
Thomson Reuters

There is a simple concept at the core of the Islamic finance industry which forms its key differentiator: all activities and transactions must be in compliance with Shariah. Yet in this age of innovative transactions, sophisticated financial systems and complicated capital markets, application of this simple principle is becoming increasingly difficult.

Shariah is one of the world's major legal systems, impacting the public and private lives of over 1.6 billion Muslims. Yet it remains an understudied and under-resourced area of academic inquiry. This is true for all aspects of Islamic law in general, and for Islamic finance law in particular.

Despite being one of the fastest growing segments of the global financial services industry, with assets in excess of \$1.8 trillion, the legal ecosystem around the industry remains underdeveloped. There are no resources for the industry to learn from the activities and innovations that are happening in different parts of the world. And there is little link between the research and activities of academics and practitioners.

To play a small role in addressing this challenge, Thomson Reuters is proud to present the first Islamic Commercial Law Report, in collaboration with our partners, the International Shari'ah Research Academy for Islamic Finance (ISRA).

The Report aims to become a source of current knowledge for practitioners, academics and policy makers in relation to Islamic finance law.

The Report addresses key issues including Shariah governance, standards and recent trend and fatwas; hence providing practitioners with an annual guide to navigate the Islamic legal system and enhance the intellectual discourse of Islamic law in public policy towards actionable and productive outcomes.

The Report also highlights the latest innovations in Islamic finance structuring, the latest interpretations of Shariah law and the latest innovation in Islamic legal thought. This will ensure that stakeholders are up to date with the latest innovation and development in this space, and will help in highlighting the impact of these developments in modern society.

On behalf of Thomson Reuters, I would like to thank all the contributors for sharing their experiences and insights in the Report. This Report would not have been possible without their support.

I hope you find this Report meaningful, and are able to benefit from its key findings and insights. And I hope that together, we can support the development of the legal ecosystem around the Islamic finance industry.



^ Muslim boys read Koran inside a mosque during the holy month of Ramadan in Kolkata July 17, 2013. REUTERS/Rupak De Chowdhuri



# Introduction



he Shariah is what distinguishes Islamic finance. It is the guidance that creates opportunities and responsibilities. The success of Islamic finance depends on endeavouring to understand it, applying it thoughtfully, enabling adherence to it, and understanding the many risks that arise when it is neglected.

ISRA and Thomson Reuters are pleased to present the first annual report on Islamic commercial law. It is our hope that this report and the many more that shall come will serve as a platform for engagement with thoughtful scholarship and committed practitioners. This report will present many of their observations, ideas, and concerns. It will, moreover, serve as an important tool for stakeholders to discuss and dialogue about the challenges and risks facing the industry's continued impressive growth.

In particular, this report will discuss the Islamic legal-ethical issues arising as Islamic financial institutions and investors innovate, as Islamic finance operates within frameworks in which it is a recent entry as well as those in which it has existed for some decades, and seeks to partner with increasingly important sustainable and responsible initiatives. Stakeholders of Islamic banking and finance should find their concerns raised here in these reports and find this report to be a source of important education.

## PART 1

# Trends in Shariah Governance

^  
Palestinians read  
the Koran in a  
mosque in the West  
Bank city of Jenin on  
the first day of the  
Muslim holy fasting  
month of Ramadan  
September 1,  
2008. REUTERS/  
Mohamad Torokman





# SUMMARY

The recent global financial crisis has raised interest in responsible business worldwide. Among the lessons learned has been the importance of strong corporate governance frameworks to promote transparent and efficient organizations and markets. The Organization for Economic Co-operation and Development (OECD) as well as the Basel Committee on Banking Supervision have both emphasized good governance. Hence, this Section focuses on the current trends in Shariah governance for Islamic financial institutions from different perspectives.

The Section begins with the discussion on Shariah foundations of core principles of governance, which include trust, accountability, independence, confidentiality, disclosure and transparency. As Islamic financial institutions consider designing mechanisms to implement these norms, they will be able to identify the parallels between these initiatives and the teachings of the Shariah.

Further, the Section explores the application of corporate governance in Islamic financial institutions (IFIs). As the industry has matured and gained experience, and seen its own corporate governance failures, Shariah scholars as well as other stakeholders have come to understand and appreciate the importance of Shariah governance in the broader framework of corporate and oversight matters, so that the running of IFIs is in line with the Shariah principles. Pursuant to that, AAOIFI and IFSB issued standards and guidelines on Shariah governance in their endeavor to establish a robust Shariah governance system for the Islamic finance industry.

The market has therefore witnessed various models and approaches in implementing Shariah governance, namely (i) two-tier “centralized model” with a Shariah advisory committee (SAC) at the level of the central bank and individual Shariah committees (SC) at the market level in each IFI, (ii) “centralized model” with a Shariah advisory body at the central bank only, and (iii) “non-centralized model” with Shariah committees at the financial institution level only. The relative merits of Shariah governance model of nine countries: Bahrain, Indonesia, Kuwait, Malaysia, Morocco, Oman, Pakistan, Sudan, and United Arab Emirates are reviewed in this Section, with the aims to identify areas of success as well as improvement in light of the importance of unification and harmonization. The assessment and analysis of the Shariah scholars’ network is also presented.

In addition, the Section deliberates on issues related to Shariah governance including qualifications of Shariah scholars, synergies between Shariah scholars and market practitioners, standardization, and research and development (R&D) with some recommendations for improvement. It also highlights major challenges, both micro and macro, in establishing a global Shariah governance framework. The establishment of an International Shariah Convention, which share the same spirit of the New York Convention (i.e. Convention on the Recognition and Enforcement of Foreign Arbitral Awards), might be a viable solution as an arbitrator for all matters pertaining to Islamic finance business worldwide.





# YASSER SAUD DAHLAWI

Chief Executive Officer, Shariyah Review Bureau

**What have been the key developments towards professionalizing the Shariah advisory service to shift from individual scholar as being retained by financial institutions to Shariah advisory firms being retained the same way law firms are for legal advice?**

Professionalizing and institutionalizing Shariah advisory is a requirement for the development and growth of the industry. If these requirements are not met we will have a bottleneck obstructing any advancement.

Key developmental factors include faster review and product approvals, enhanced coverage of scholarly views, enriching dialogues, ease of accessibility, greater transparency, and firewalls to reduce conflict of interests are demanding developments that are challenging the complexities of outsourcing Shariah Advisory functions to experienced bodies. Adding to all of that is the cost element. It's natural that business institutions will continuously look at increasing efficiencies and cost-cutting, which can be achieved through outsourcing Shariah advisory to professional institutions.

Based on our own experience with clients, Shariyah Review Bureau has found that key developments for Islamic financial institutions (apart from cost-cutting) has been a) to bring new products to the market faster for local opportunities b) enable creative product models to drive innovation and c) ensure Shariah

management systems are in place to reduce risk of non-compliance.

**How does the development of Shariah advisory firms benefit from a more centralized Shariah system or does it favor a more decentralized approach?**

Does a single scholar (decentralized) or a committee (centralized) comprising a handful of experts have the capacity to make decisions which can oversee the complete Shariah dynamics of a rapidly growing financial system? In our opinion the stability of any Shariah system in such an environment depends on having a broad "guideline"-based centralized approach with "continuous adjustments" to small changes when a particular mode fails to deliver.

This is important as the modern day success of globalized financial economies depends on constant innovations and too much central planning stifles the expansion of developments. To innovate one cannot rely solely on centralized patterns rather there is a need for a considerable trial and error of unforeseen implementation problems, unexplored dimensions, and performance.

The mechanics of Shariah advisory firms is based on a wide number of individuals, experts and scholars with the ability to coordinate independent initiatives on the ground catering to problems and challenges faced by various markets players.

This allows Advisory organizations to rely on dialogue between scholars and businesses at the "complexity-level" and work out pragmatic solutions at a degree closer to the problem rather than top-down systems, in which a few tell the many what to do from a place where the complexity and its various facets may not be clearly visible.

As a result, the decentralized system of deriving opinions — of course deploying a scientific method with constructive dialogues between scholarly resources — summons forth a considerable variety of innovations within the parameters of Islamic principles. The process also helps reduce favoritism (to one specific school of thought) and aversion to unconventional ideas that a centralized system may entail.

Therefore, we at SRB see the importance of adapting loose-tight polices, with measures that centralize some controls and decentralize other activities.

**Malaysia's Islamic Financial Services Act 2013 imposes a statutory duty on the IFI boards, including a Shariah committee to ensure end-to-end Shariah compliance in its business affairs and activities. Any Shariah non-compliance could result in imprisonment and/or a fine. Does this seem fair or harsh taking into account the existing capacity and capability of Shariah committees?**



In the world of commerce and professional compliance every practitioner required to act prudently and truthfully account for their responsibility — as imposed by local regulation — and whosoever willfully fails to practise the necessary conduct should be liable for the mandated penalties as provided by law. Shariah scholars are no exceptions nor should their ‘limitation in capacity’ be used as an excuse.

When performing their duties as members of Shariah Boards, they are expected to exercise the same level of care — in matters of Shariah compliance — that a Director with similar abilities, skills and experience would exercise in similar (matters of financial and fiduciary) circumstances.

Scholars have a responsibility to act cautiously and to anticipate (to the best of their ability) the consequences of their Shariah supervisory practices before they undertake them. They have an obligation to foresee potential Shariah risks inherent in an environment and to

take reasonable steps to manage those compliance issues.

**There are different models of Shariah governance adopted across jurisdictions. Do you think this poses any challenges to the Islamic finance industry? If yes, what is your recommendation/s to enhance the current practice of Shariah governance?**

We’ve not conducted any exercise on the subtle differences of governance models therefore we cannot state what challenges each one would face.

“

*Scholars have a responsibility to act cautiously and to anticipate (to the best of their ability) the consequences of their Shariah supervisory practices before they undertake them.*

”



**YASSER SAUD DAHLAWI** brings unique experience in counseling enterprises and executive teams as they embark on journeys to Shari’a compliant markets. In his 20 years work experience Yasser has advised clients in a range of industries — including Islamic banking, Takaful, Real Estate and Private Equity. As a co-founder and CEO of Shariyah Review Bureau (SRB) his primary area of work involve assisting the financial sector develop and establish Shari’a compliant businesses.

He has been involved in multiple study/project mandates such as exploring customer’s inputs and managing Shari’a compatible financial products. In his current role as CEO of Shariyah Review Bureau, Yasser spends more than half of his time working with clients directly. He remains passionate in providing “world-changing” service to accelerate the development of Shari’a compliant markets.

# SHARIAH FUNDAMENTALS OF GOVERNANCE

Assoc Prof Dr Said Bouheraoua  
ISRA



Organizing the contractual relationship between partners with regards to the division of responsibilities among different authorities is not a new phenomenon as it has been continuously practised in previous civilizations. However, what is new in the contemporary approach is the extent of its scope as it addresses the concerns of large institutions and conglomerates, the complex representation of parties involved such as the board, management, shareholders, investors, government, and regulatory bodies, and the advanced tools employed to ensure the efficiency of its function. This is in addition to responding to new challenges, especially those related to the implications of recurring crises.

This new complex and comprehensive approach to governance is clearly reflected in the “Principles of Corporate Governance” issued by the Organisation for Economic Co-operation and Development (OECD) in 2004 that says: **“The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities”**.

Similarly, the Basel Committee on Banking Supervision in its Principles for enhancing corporate governance related to financial institutions, issued in 2010, stated that: **“Corporate governance involves the allocation of authority and responsibilities, i.e., the manner in which the business and affairs of a bank are governed by its board and senior management”**. Hence

this resulted in a corporate governance framework setting up some major principles.

With regards to governance in Islamic law, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), Islamic Financial Services Board (IFSB), Bank Negara Malaysia (BNM) and other standard-setting bodies issued standards and guidelines and emphasize the pivotal role of Shariah principles in establishing this governance.

However, not much has been said about its foundations in the texts of the Quran, the Sunnah, and the practice of the companions despite the importance of these foundations in highlighting the epistemological fundamentals of these standards and the role they play in motivating the concerned parties. Hence, the following is a brief highlight of the Shariah foundations of a framework of good governance with the aim of appreciating its fundamentals.

## SHARIAH FOUNDATIONS FOR GOVERNANCE FRAMEWORKS

As stated above, governance in its essence is concerned with the division of responsibilities among different supervisory, regulatory and enforcement authorities by establishing the rights and responsibilities of each. This framework articulated in the guidelines introduced by OECD, Basel, AAOIFI, IFSB and others is well established in the Shariah texts and well articulated in the practices of the Prophet (peace be upon him (pbuh)).

Verses of the Quran such as “help one another in acts of righteousness and piety” (al-Ma’idah: 2)





*Trustworthiness, accountability, responsibility, independence, competency and confidentiality are the core principles of governance promulgated in the guidelines of the OECD, Basel, AAOIFI, IFSB, BNM and others.*



set a strong foundation for a good and constructive collaboration between parties.

The establishment of commands for the community as a whole, which is called, in Islamic jurisprudence, *fardh kifayah* is a clear evidence of the importance of collaborative achievements and a proof for the need of a framework that govern this collaboration.

However, the Madinah Charter is considered by many to be the first formal foundation of a governance framework in Islam. It was the first written constitution, a comprehensive framework that organized the relationship between different stakeholders, ordained equality to its members, protected them against oppression, and extended help to its members in debt or financial difficulties.

The Madinah Charter was exemplified in the practice of the Prophet (pbuh) in organizing the market and setting general rules and regulations to ensure its smooth functioning.

As for the companions of the Prophet, it is known that Umar ibn al-Khattab set a number of market rules to ensure a fair and equitable relationship between different parties. He was also known to check market practices from time to time and impose conditions on traders to ensure compliance to the rules of transactions and partnership. He is the first to impose the recording of transactions and set up a system to ensure accountability. One of his famous sayings is: “No one may buy or sell in our markets unless he has knowledge of the rulings of the Shariah” (al-Tirmidhi).

## SHARIAH FOUNDATIONS FOR GOVERNANCE PRINCIPLES

Trustworthiness, accountability, responsibility, independence, competency and confidentiality are the core principles of governance promulgated in the guidelines of the OECD, Basel, AAOIFI, IFSB, BNM and others. These core principles are highlighted in the Quran and the Sunnah in numerous instances as they are considered as the prerequisites for any relationship, partnership or

deal. The following is a brief highlight of these core principles.

### The Principle of Trust (Amanah)

The principle of trustworthiness is mentioned 31 times in the Quran; for example: "O you who believe! Do not betray Allah and His Messenger, nor knowingly betray your trusts" (al-Anfal: 27) and: "One of the two women said, "O my father! Hire him! For the best (man) that you can hire is the strong, the trustworthy" (al-Qasas: 26).

This principle is highlighted in the *hadith qudsi* that says: Allah the Almighty says: "I am the third of two partners as long as they don't deceive each other. If they deceive each other, I leave them". (Abu Dawud).

Numerous hadiths of the Prophet (pbuh) stressed on this concept among others: "There is no *iman* for the one who is not trustworthy" (Ibn Hibban) and: "The honest and trustworthy traders will be resurrected with the Prophets, the honest men, and the martyrs". These items of evidence characterises the fiduciary duty to act solely in another party's interests.

### The Principle of Responsibility (Mas'uliyah)

Obligations are divided by the Shariah into individual obligations (*fardhu 'ayn*) and communal obligations (*fardhu kifayah*).

The first is manifested in the personal obligation towards people under his direct responsibility. This is clearly stated in the *hadith* of the Prophet (pbuh) that says: "All of you are guardians and are responsible for your wards." (Al-Bukhari and Muslim). Due diligence and care are the core requisites for the discharge of this obligation.

The second is manifested in the responsibility of the individual towards the whole community or entity in light of enjoining good (*amr-bil-ma'roof*) and forbidding evil (*nahi anil munkar*). This is clearly spelled out in the verse that says: "And fear the affliction that will not affect only those of you who do wrong" (al-Anfal: 25). It is also spelled out in the Prophetic parable about people who sit idly by, while the limits of decency are being violated. It compares people to two groups: "They drew lots for their seats in a boat.

Some of them got seats in the lower part, and the others in the upper. When the former needed water, they had to go up to bring water, and that troubled the others, so they said, 'Let us make a hole in our share of the ship to get water; we can avoid troubling those above us.' If the people in the upper part let the others do what they suggested, all the people of the ship would be destroyed, but if they prevented them, both parties would be safe."

### The Principle of Independence

The first step to a true belief in Islam is the rejection of a blind dependence on previous beliefs and practices.

The concept of personal reasoning (*ijtihad*), covering a significant part of Islamic law, is another manifestation of independence in making opinions. The practice of the companions of the Prophet (pbuh) in the Battle of Badr when advising the Prophet to change his proposed camping place, the objection of the women to Caliph Umar ibn al-Khattab's proposal to set a limit on dowries, and the establishment of the schools of law (*madhahib*) are clear examples of the stand of independence when it comes to decision making, which includes Islamic transactions.

These examples of independence are guided by numerous texts of the Quran and Sunnah, among them verse 135 of Surah an-Nisa' is one of the most explicit evidence of independence and integrity in addressing conflict of interest with oneself or people you love and strive not to disappoint. It commands the believers to stand firm in upholding independence in making decisions and judgments, the verse says: "O you who believe! Be you staunch in justice, witnesses for Allah, even though it be against yourselves or [your] parents or [your] kindred, whether [the case be of] a rich man or a poor man, for Allah is nearer to both [than you are]. So follow not whims lest you lapse [from truth] and if you lapse or fall away, then indeed, Allah is ever informed of what you do".

As for Sunnah, the *hadith* that says: "Do not let yourselves be 'yes-men', saying: 'If the people are good then we will be good, and if they are wrong then we will be wrong. Rather, make up your own



minds, if the people are good then you are good, and if they are evil, then do not behave unjustly” (al-Tirmidhi), is a clear promotion of independence and responsibility in making decisions.

### The Principle of Competency

Competency and respect of areas of expertise are crucial for the quest for authority and leadership.

The importance of competency is expounded by verses such as: “How can those who know be equal to those who know not? But only people of understanding will pay heed” (al-Zumar: 9).

The Prophetic guidance promotes competency and establishes this principle by supporting the mastering of one’s discipline. The Prophet (pbuh) said: “The most knowledgeable of my Ummah in matters of *halal* and *haram* is Mu’adh ibn Jabal,” Jabal”. He also said: “The most knowledgeable of my Ummah (nation/community) in judiciary matters is Ali.” Also, the Prophet (pbuh) did not see physical handicaps as an obstacle to taking higher positions if the person is knowledgeable; he appointed Abdullah ibn Umm Maktoum (may Allah be pleased with him), who was blind, as the acting ruler of the Muslim state of Madina on several occasions in his absence.

### The Principle of Confidentiality

Secrets are a kind of trust which must be honoured and a contract or covenant which must be kept. Allah says: “And fulfil (every) covenant. Verily, the covenant will be questioned” (al-Isra’: 34). The Prophet (pbuh) said: “If a man tells you something then looks around, it is a trust” (Abu Dawud and al-Tirmidhi) which means it is entrusted to the one to whom he spoke.

With regards to corporates, confidentiality is paramount to the success of any partnership as

disclosing companies’ secret exposes the company to a huge business and reputational risk. Therefore honoring the secrets of partners is a major religious obligation in Islam and disclosing partners’ secrets is one of the major sins (*kaba’ir*).

Apart from the grave consequences of disclosing secrets on the company, the act is always not in favor of the one who disclosed it, Ali ibn Abi Talib said: “Your secret is your captive, if you disclose it you become its captive” (al-Mawardi).

### The Principle of Disclosure and Transparency

A timely and accurate disclosure of information related to the corporation which includes financial situation, performance, and ownership is crucial to its success.

The principle is one of the major factors of the success of the Prophet’s mission and the successful relationship between him and his companions. It was also one of the major arguments presented before kings and leaders sent by the Prophet (pbuh) as one of the major arguments presented before those kings “we know him”. Umar ibn al-Khatab was among the first to establish the famous rule: “where did you get this”. He was also known to ask his governors to disclose their properties before they are assigned to their position.

## CONCLUSION

In conclusion, the Shariah sets strong foundations for sound corporate governance to ensure equitable and balance division of responsibilities among partners. However, the detailed articulations of these foundations are left to scholars and experts to develop in light of time and space factors.



**ASSOC PROF DR SAID BOUHERAOUA** is a Senior Researcher at the International Shari’ah Research Academy for Islamic Finance (ISRA). He is the editor-in-chief of ISRA International Journal of Islamic Finance (Arabic). Dr Said has published four books, five chapters in books and several articles in refereed journals. He presented several papers in international conferences including the International Islamic Fiqh Academy of the OIC and the Islamic Fiqh Academy of the Muslim World League. He was appointed as consultant for several international projects and conducted training sessions in Islamic banking and finance in Malaysia and abroad.

# INSIGHTS INTO ISLAMIC FINANCE AND CORPORATE GOVERNANCE

**Assoc Prof Dr Rusni Hassan and Assoc Prof Dr Nurdianawati Irwani Abdullah**  
IIUM



Islamic finance is becoming one of the most significant additions to the modern global financial system. As interest piques and growth is seen throughout the Islamic financial system, the subject of corporate governance becomes more important for the obvious reason that Islamic banks or Islamic financial institutions, being corporate entities, need good corporate governance (CG) policies and practices to ensure effective management and compliance with Shariah requirements.

This article examines the concept of CG, its development and also the application of CG in Islamic financial institutions. Due to their Islamic nature, Islamic financial institutions are also governed by Shariah laws, which make up a significant aspect of their governance.

## OVERVIEW OF CORPORATE GOVERNANCE

CG can be described as a system of rules, practices and processes by which a company is directed and controlled. CG essentially involves balancing the interests of the many stakeholders in a company including the shareholders, management, customers, suppliers, financiers, government and the community. CG is a significant imperative to ensure that the operations of the organizations are handled with utmost care and responsibility.

Companies perform well when they adopt good and sound CG practices. Sound CG also strengthens public confidence in corporations and thus enhances their reputation.

CG is also a mechanism to warrant that the transactions or dealings of the institutions do not contravene the laws, regulations and business ethics imposed by a particular country or jurisdiction, thus helping institutions to avoid any scandals, fraud, and potential civil and criminal liability.

## DEVELOPMENT OF CORPORATE GOVERNANCE

The first code on Corporate Governance was introduced in the UK by Sir Adrian Cadbury (the Chairman of the UK Committee on the Financial Aspects of CG) in 1992. It was published in the Report and Code of Best Practice; also known as the Cadbury Report.

The report was released primarily to address the issues of corruption in enterprises in the UK and to ensure a mechanism for the accountability of the Board of Directors. A later initiative emerged in 1999 that was introduced by the the Basel Committee on Banking Supervision, which came up with guidelines on sound CG practices applicable to organizations and other institutions such as companies, firms and banks. These principles were then revised in 2006 based on the principles of the Organisation for Economic Co-Operation and Development (OECD) which were published in 2004. The OECD principles, which are listed below, are currently practised across many jurisdictions.

OECD has laid down principles of CG which have become an international benchmark for policymakers, investors, corporations and other stakeholders. The principles are:

- i. Ensuring the Basis for an Effective CG Framework
- ii. The Rights of Shareholders and Key Ownership Functions
- iii. The Equitable Treatment of Shareholders
- iv. Role of Stakeholders in CG
- v. Disclosure and Transparency
- vi. The Responsibilities of the Board

## CG FOR FINANCIAL INSTITUTIONS AND ISLAMIC FINANCIAL INSTITUTIONS

Financial institutions (FIs) including banks have special characteristics that differentiate them from corporations in general.

They are financial intermediaries responsible for receiving and channeling funds from depositors to creditors. A bank is a public institution that depends on the trust of the people in money/financial arrangements. Therefore, the CG of FIs covers the pools of stakeholders including shareholders, managers and employees and depositors.

In Malaysia, Bank Negara Malaysia (BNM), the country's central bank, issued Guidelines on CG for Licensed Institutions (BNM/GP1). CG in the context of FIs refers to the process and structure used to direct and manage the business and affairs of the institutions towards enhancing business prosperity and corporate accountability with the ultimate objective of realizing long-term shareholder value, whilst taking into account the interests of other stakeholders. The Guidelines promote sound CG by ensuring effective functions of the board in discharging its duties and responsibilities, supported by highly-skilled and knowledgeable management that understand the unique nature of these FIs.

## CONTEMPORARY INITIATIVES IN ESTABLISHING SHARIAH GOVERNANCE IN ISLAMIC FINANCE

The financial industry has witnessed cases on corporate governance failures faced by IFIs such as Faisal Islamic Bank of Egypt, Dubai Islamic Bank, Tadamon Islamic Bank, Qatar Islamic Bank and Bank of Credit and Commerce International (BCCI) that occurred between the 1990s to late 2000s.

The issues on lack of effective internal control, dishonest directors, overgenerous remuneration, weak internal and external checks and poor risk management, which are common corporate governance issues, are what led to some failures of these institutions. In addition to the above, the weakness in due diligence process in the verification of Shariah compliance was also a significant factor that caused the breakdown of CG in these institutions.

At the early development of Islamic finance, Islamic financial institutions (IFIs) were not properly guided in terms of Shariah compliance aspects of corporate governance.

The IFIs were expected to behave not differently from other FIs. However, in addition to the standard criteria for FIs, IFIs are subject to additional responsibility to ensure their conduct and financial transactions are in accordance with Islamic rules and principles.

Unlike the CG for FIs, the CG for IFIs has a more specific objective, in the sense that it has to ensure that the running of the institution is in accordance with the principles of Islamic law. Therefore, IFIs require an additional body in its CG structure, i.e. a Shariah Supervisory Board (SSB), which is a vital function that guides IFIs on Shariah compliance.

Acknowledging the different requirements of CG for IFIs, in 1997, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) took the initiative to issue standards to delineate the Shariah governance structure for IFIs. As at to-date, there are seven Shariah gov-



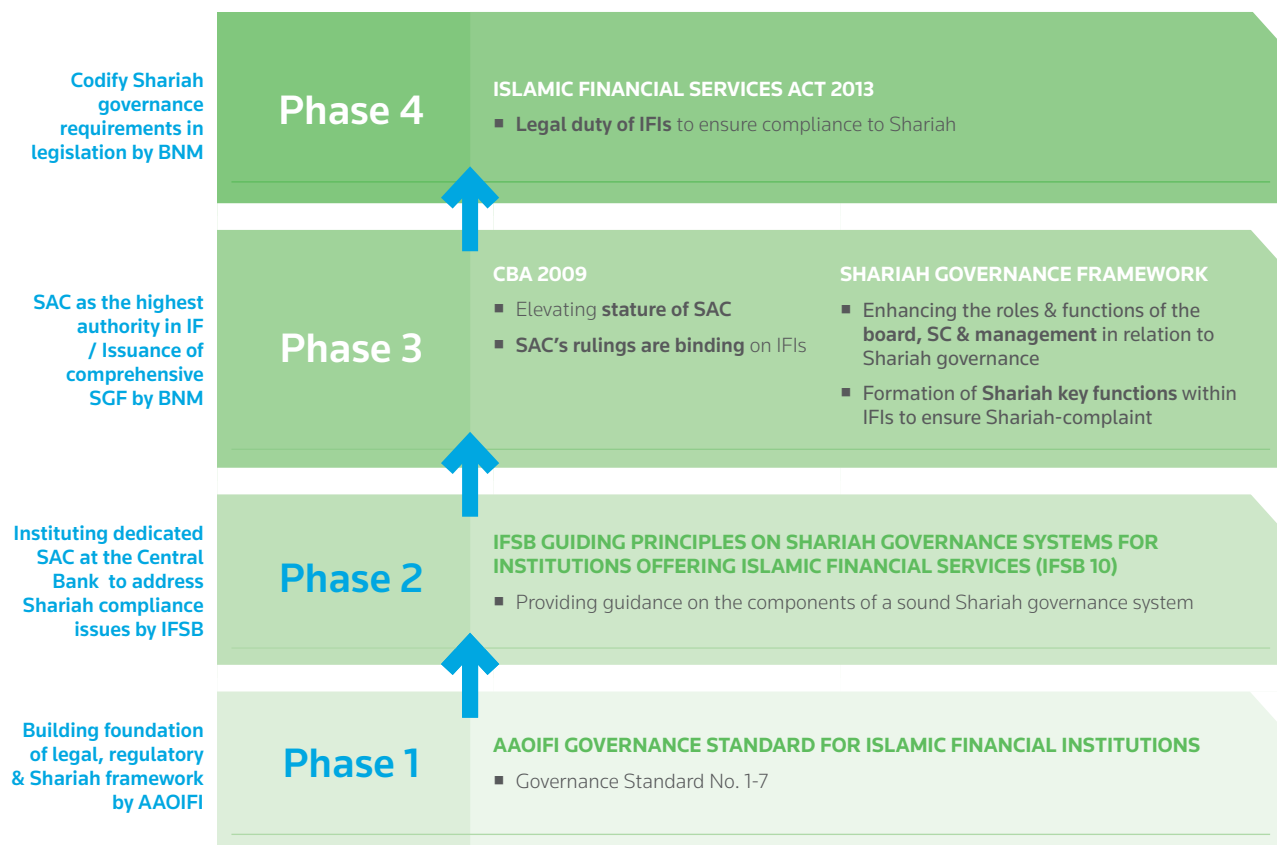
ernance standards developed by AAOIFI, namely Shariah Supervisory Board: Appointment, composition and report; Shariah Review; Internal Shariah review; Audit and governance committee for IFIs; Independence of Shariah Supervisory Board; Statement of governance principles for IFIs; and Corporate social responsibility conduct and disclosure for IFIs.

In support of AAOIFI, the International Financial Services Board (IFSB) then issued the Guiding Principles on Shariah Governance Systems for Institutions Offering Islamic Financial Services (IFSB-10) in 2009. The objectives of the principles are to provide guidance on the components of a sound Shariah governance system, especially with regards to the competence, independence, confidentiality and consistency of Shariah boards.

It is also structured to provide an enhanced degree of transparency in terms of issuance, and the audit/review process for compliance with Shariah rulings, and to provide greater harmonization of the Shariah governance structures and procedures across jurisdictions, especially since there is an increasing number of IFIs with cross-border operations.

The IFSB principles have been emulated by BNM in the Shariah Governance Framework for Islamic Financial Institutions (SGF) 2010, which provides comprehensive guidelines with regards to enhancing the role, responsibility and accountability of the board, the Shariah Committee and the management to implement Shariah compliance process in the IFIs. In particular, the objectives of SGF are as follows:

**Figure 1: Phases of Developing Shariah Governance**



1. To set out the guidelines on the Shari'ah governance structures, processes and arrangements of the Islamic financial institutions in order to ensure that all the operations and business activities are in compliance with Shariah,
2. To provide a comprehensive guidance on the board, Shariah Committee and management of the Islamic financial institution in discharging their duties in matters relating to Shariah; and
3. Outlines the functions in relation to Shariah review, Shariah audit, Shariah risk management and Shariah research.

BNM further enhanced the Shariah governance framework of IFIs with the enactment of the Islamic Financial Services Act 2013 which imposes a legal duty on IFIs to ensure Shariah-compliance. Part IV of IFSA provides the Shariah requirements in respect to three aspects of Shariah governance:

1. IFIs must ensure the compliance with Shariah in their aims and operations, business, affairs and activities.
2. IFI must establish a competent Shariah committee which shall be fully accountable on their decisions, views and opinions related to Shariah matters. IFSA provides requirements

relating to duties, appointment and cessation of the Shariah committee member.

3. The emphasis on the function of Shariah review and Shariah audit in order to provide check and balance in ensuring Shariah-compliance.

A summary of various phases undertaken by AAOIFI, IFSB and BNM to uplift the Shariah governance for IFIs is depicted in Figure1.

## IMPORTANCE OF CORPORATE AND SHARIAH GOVERNANCE FOR IFIS

A firm corporate governance framework is a critical element of business leadership, and is important in any industry. But the CG of Islamic financial institutions is especially important for the simple reason that IFIs generally deal with more stakeholders compared to other corporations. These stakeholders include depositors, investors, borrowers, regulatory bodies, and in some cases entire communities. Therefore, the failure of such an institution would have a big impact on public interest. IFIs also carry the responsibility to ensure that all operations and activities are carried out in a manner that complies with Shariah principles and observe the requirements of the Shariah governance framework.



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# MODELS OF SHARIAH GOVERNANCE ACROSS JURISDICTIONS

Assoc Prof Dr Younes Soualhi  
IIUM



Shariah governance framework (SGF) acts as a yardstick for Islamic financial institutions (IFIs). Over the last few decades, several models of Shariah governance

have been introduced, which capitalize on the best practices of corporate governance set by international standards setters such as the Organization for Economic Co-operation and Development (OECD), Islamic Financial Services Board (IFSB), and Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). The sophistication of these Shariah governance models depends very much on the relative newness of the Islamic finance market and the strategic economic plans across countries. It also depends on the size, complexity and nature of business operations of the IFIs themselves.

In this article, Shariah corporate governance models of nine jurisdictions are briefly investigated: Bahrain, Indonesia, Kuwait, Malaysia, Morocco, Oman, Pakistan, Sudan, and United Arab Emirates (UAE). The article focuses on the general requirements of Shariah governance of IFIs and its specific requirements such as accountability and responsibility, competency and Shariah compliance. The article also examines models of Shariah governance adopted in these countries with regard to the following: i) A “non-centralized model” with Shariah committees at the bank or financial institution level only, ii) A two-tier “centralized model” with a Shariah advisory committee (SAC) at the level of the central bank and individual Shariah committees (SC) at the market level in each IFI, and iii) A “centralized model” with a Shariah advisory body at the central bank only.

## GENERAL REQUIREMENTS

All models have adhered to the general requirements of a Shariah governance framework with its main members being the board of directors (BOD), the management and the SC.

**Sudan** and Malaysia were pioneers in setting up Shariah governance frameworks at the very early stages of the establishment of their respective Islamic finance industries. In 2003, the Sudanese president at the time, Omar Al-Bashir made it his priority to set up a supreme Shariah Advisory Council (SAC), simultaneously issuing guidelines allowing Islamic banks to appoint a Shariah Committee whose roles and responsibilities are based on AAOIFI’s Shariah corporate governance framework.

In **Malaysia**, as early as 2004, the central bank issued Guidelines on the Governance of Shariah Committees of IFIs. In 2010, a Shariah governance framework (SGF) was issued, outlining main requirements such as independence, competency, and Shariah compliance. Recently, the new legislation —Islamic Financial Services Act (IFSA) 2013— devoted considerable sections for the duty of institutions to ensure Shariah compliance via the establishment of Shariah committee.

In **Kuwait**, Article 4 of law 7 of 2010 decreed for the setup of special rules, regulations and procedures to regulate the activity of individuals working in accordance with Islamic law. Special guidelines were issued to address the charter of ethical conduct for the persons authorized to undertake work according to Shariah rulings in 2012. Article 1 in particular, referred to the necessity to standardize *fatwas* (Shariah legal opinions) in financial activities to settle juristic



disputes. Such an objective is not advocated by other Shariah governance legislations, as they tend to regulate rather than standardize *fatwas*.

In 2012, a more comprehensive SGF was introduced in **Oman** outlining the roles and duties of the board of directors and its main members including the Shariah committee and internal Shariah auditors. In 2013, the supreme SAC was established to advise the central bank on Shariah matters pertaining to finance.

Early legislations in the **United Arab Emirates** (Article 5, Islamic banking Act 1985) emphasized the establishment of a supreme SAC at the level of the central bank. The SAC however reports to the Ministry of Awqaf and its decisions are binding on all IFIs. Article 6 of the same law obliges all IFIs to establish a Shariah Committee, whose roles and duties are determined by the IFI itself. To enhance transparency, SC members are to be endorsed by the supreme SAC. Nonetheless, neither a central SAC nor a SGF exists in UAE despite directives and proposals from the central bank.

In a similar vein, **Pakistan** did not develop a comprehensive SGF until 2014. The Islamic banking law, however, did not make it compulsory to have a Shariah Committee as one Shariah advisor is deemed to be sufficient. However, in the SGF 2014, three Shariah advisors are required. The Shariah department of the central bank of Pakistan clearly states that they rely heavily on a suite of international standards such as AAOFI and IFSB and corporate governance standards.

In 2007, **Bahrain** established a supreme SC to advise the central bank. A governance framework was then introduced in 2011, regulating both conventional and Islamic banks. It was not until 2014 that the central bank decreed that all banks should adhere to the Shariah and Accounting standards set by AAOFI, including the Shariah governance framework.

In **Indonesia**, the National Shariah Council was mandated to endorse Islamic financial products as well as the appointment of new Shariah advisors. The year 2008 witnessed the enactment of the Islamic banking Act and the establish-

ment of its Shariah Banking Committee under the purview of the central bank, with the role to assist the central bank to apply the *fatwas* issued by the National Shariah Council. The 2009 Islamic banking corporate governance outlined many aspects of Shariah governance namely the roles and duties of the SC, which is appointed by the shareholders.

In **Morocco**, the newly-gazetted law of participative banks did not outline a comprehensive SGF but upheld an unprecedented practice in the form of establishing only one national Shariah Committee, dubbed the “Shariah committee for participative finance”. The sole authority of this committee aims to standardize *fatwas* to promote consistency. However, actual operations of IFIs have proven that Shariah Committees are very much needed for the IFI’s day-to-day operations, and that the “one committee model” may work at inception but not at expansion.

## ACCOUNTABILITY AND RESPONSIBILITY

The role of the three main organs of the Shariah governance board — the board of BOD, management and SC of an IFI — in the jurisdictions mentioned above reveal that they mainly adopt standard practices of governance, albeit with certain differences.

Malaysia and Sudan are the only countries with comprehensive SGFs. A unique feature of the Malaysian SGF is the option to appoint or invite a Shariah advisor to sit in on the BOD meeting to serve as a bridge between the BOD and the SC.

In all Shariah governance models reviewed, the SC plays a pivotal role in ensuring the Shariah compliance of products, policies and operations. The management is equally central to the Shariah governance practices that have been implemented.

All the nine countries’ regulations oblige the management of IFIs to provide adequate resources to support Shariah governance practices, including the implementation of SC decisions, the provision of necessary information and

adopting a holistic culture of Shariah compliance. However, reputational risks arise when the management's fiduciary duty vacillates between the shareholders and the depositors — a matter that has even impacted the choice of certain Shariah advisors.

## COMPETENCY

The qualifications of the BOD and management in most of the countries studied center around technical knowledge of banking with little emphasis on Shariah knowledge. This has had its repercussion on the business strategy of the IFIs, skewing their fiduciary duty towards the shareholders.

For Shariah advisors, countries such as Bahrain, UAE and Kuwait consider competency as being well-grounded in *fiqh muamalat* with the ability to grasp finance concepts.

Pakistan's "Fit and Proper" guideline states that a Shariah advisor should have a sound Shariah degree with at least three years of experience in giving *fatwa*. In Malaysia, the Shariah advisor should have at least a Bachelor's degree in *fiqh* or *usul al-fiqh* or the equivalent, with sufficient knowledge in finance. No previous experience is required. The three factors of competency, i.e. vast knowledge (with or without a degree), knowledge with experience, and knowledge determined by degree are yet to be tested in terms of preference.

## INDEPENDENCE

A Shariah committee is meant to be an independent body with the aim of satisfying the dictates of Shariah.

In the countries studied for this article, it is a standard practice that a Shariah advisor is appointed by the shareholders (this is true for Bahrain, Indonesia, Kuwait, Oman, Sudan, and UAE) — a practice hailed by many corporate governance experts as being the best so far.

In Malaysia, the SC is nominated and recommended by the BOD, but is officially appointed by the central bank. In another practice, Pakistan SGF 2014 allows the resident Shariah board member (RSBM) to be appointed on a full-time basis with the IFI, and to sit in two other Shariah committees of other IFIs, albeit with permission from SC and the respective IFI. According to Malaysia's SGF, this would create a conflict of interest between the RSBM and the IFIs they advise.

Even though Shariah advisors are answerable to the BODs, this would trigger issues as to whether the SC has a fiduciary duty to the BOD; testing loyalty to different stakeholders. The SC finds itself with a moral fiduciary duty to protect the rights of depositors since they are not being represented on the BOD. This double fiduciary duty is problematic and can affect the independence of the SC.

## SHARIAH COMPLIANCE

In most models reviewed, Shariah compliance of IFIs is mainly vested in the central Shariah Advisory Committee as well as Shariah Council of individual IFIs. In countries adopting AAOIFI standards, a firm cooperation is to be established between the SC and its internal auditor. Shariah compliance is affirmed on an annual basis in Bahrain, Kuwait, Sudan and UAE after reports from the internal auditor and Shariah committee concur. In these countries, Shariah compliance simply means adherence to Shariah rulings and principles, with a special set of decisions made by SCs.

In Malaysia, Shariah compliance is achieved via Shariah audit and Shariah review functions, with the former having a dotted line to SC while the latter has a straight line to SC. Shariah compliance is taken to mean the adherence to both SAC and SC, making it more practical for auditors to audit Shariah compliance. Compliance is further boosted by two main functions: risk management and research.

## WHICH MODEL WORKS BEST?

Analyzing the Shariah governance models of these nine countries, one would observe that the “non-centralized model” long practised in the Middle East (e.g. UAE, Kuwait), until recently, has ably served Shariah compliance. However this model has been criticized for allowing a Shariah advisor to sit on several Shariah boards at the same time, and potentially triggering a conflict of interest. This model also lacks clear guidelines on how to report Shariah non-compliance events to the central bank, or to verify the relationship of the SC with the bank’s employees. By allowing the SC to conduct external audit, the partiality of the audit report would be at stake.

The other model, the “centralized model” with one central committee as practised in Morocco, concentrates *fatwa* in one institution/body. It remains unclear however, how practical this framework would be in view of the many inquiries an individual IFI may have on a daily basis.

The “two-tier centralized model” with an SAC at the central bank and SC at individual IFIs, which is widely practised in some jurisdictions like Malaysia and the Sudan enhances Shariah compliance at the tier-2 level. However, the Sudanese framework has yet to achieve the levels of Malaysia’s comprehensiveness, structure and applicability in terms of standards.

Malaysia’s SGF is unique in making Shariah compliance overarching over civil courts as judges must refer to the central bank’s Shariah Advisory Committee to decide on Islamic finance cases. The four functions of the Malaysian SGF which are: Review, Audit, Risk management and Research, is exclusive to the country. The obligation

on all IFIs to adhere to the Shariah parameters produced by its central bank, Bank Negara Malaysia, has successfully regulated Shariah compliance through enforcements enshrined in IFSA 2013. Other unique features would include the succession plan of SC to avoid acquaintance (or nepotism) risk, and the right of SC to come up with Shariah opinions more stringent than the national SAC’s. Such detailed governance issues would tighten all the screws as far as Shariah compliance is concerned.

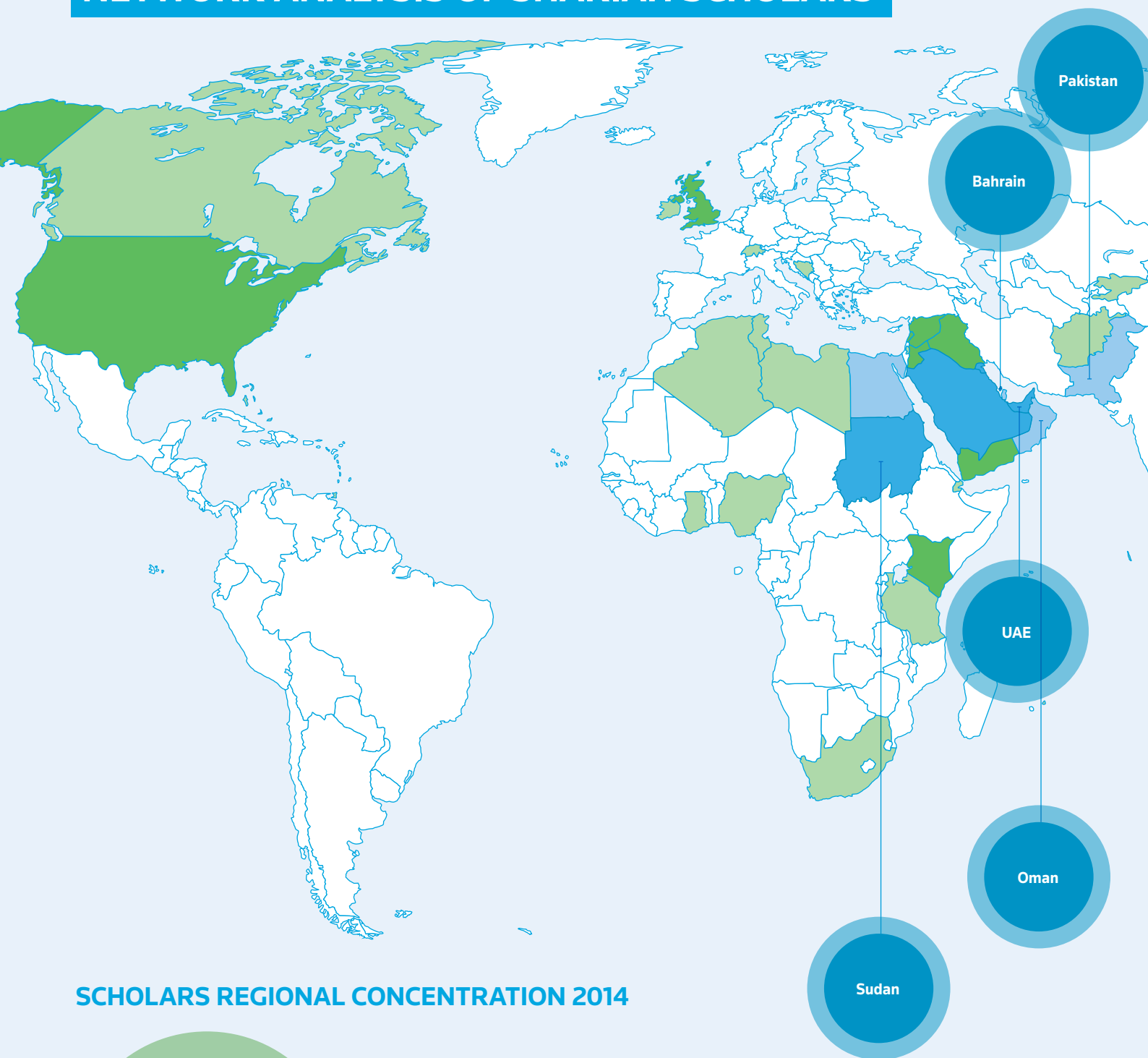
However, lacunae still exist in all Shariah governance frameworks including Malaysia. This would include the lack of representation of investment account holders, unit holders and *takaful* participants in BODs of respective IFIs.



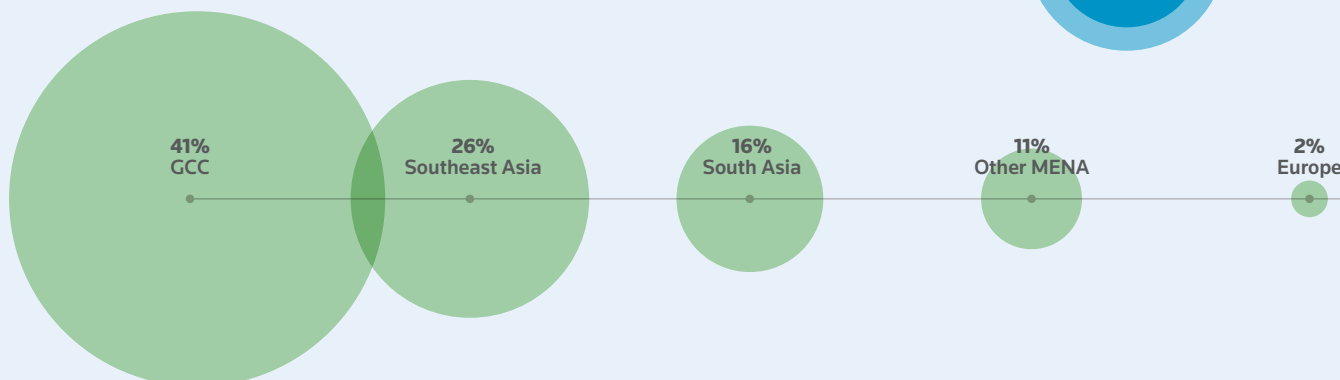
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## NETWORK ANALYSIS OF SHARIAH SCHOLARS



### SCHOLARS REGIONAL CONCENTRATION 2014



## 9 COUNTRIES THAT HAVE CENTRALIZED SHARIAH PRESENCE

Country Name



## NUMBER OF SCHOLARS FROM AROUND THE WORLD

Malaysia	203	> 100 scholars
Bangladesh	173	50 – 100 scholars
Indonesia	131	20 – 49 scholars
Kuwait	70	10 – 19 scholars
Saudi Arabia	68	> 10 scholars
Sudan	60	
Bahrain	60	
UAE	57	
Pakistan	43	
Oman	32	
Qatar	30	
Egypt	26	
Jordan	18	
Yemen	18	
United Kingdom	16	
United States	14	
Syria	13	
Lebanon	13	
Iraq	12	
Sri Lanka	11	
Kenya	11	
Brunei Darussalam	9	
Palestinian Territories	8	
Singapore	8	
Thailand	7	
Canada	7	
Libya	7	
Australia	6	
Maldives	6	
Ireland	6	
Hong Kong	5	
Algeria	5	
Tunisia	5	
Bosnia-Herzegovina	5	
Tanzania	4	
Luxembourg	4	
Djibouti	3	
Bahamas	3	
South Africa	3	
Kazakhstan	3	
Switzerland	3	
Nigeria	2	
Afghanistan	2	
Ghana	2	
Mauritius	1	
Trinidad and Tobago	1	

## ISLAMIC FINANCE DEVELOPMENT INDICATOR (IFDI) — SHARIAH GOVERNANCE

The Shariah Governance sub indicator of Islamic Finance Development indicator (IFDI) assesses the Shariah regulatory ecosystem of a country and Shariah compliance mechanisms. The metrics considered are: Number of scholars with at least one board membership, Number of scholars with more than 5 board memberships (negative score), Number of institutions with more than 3 SSB members, Centralized Shariah committee.

### IN THE LONG RUN, HIGH CONCENTRATION RISK MAY AFFECT SHARIAH DUE DILIGENCE

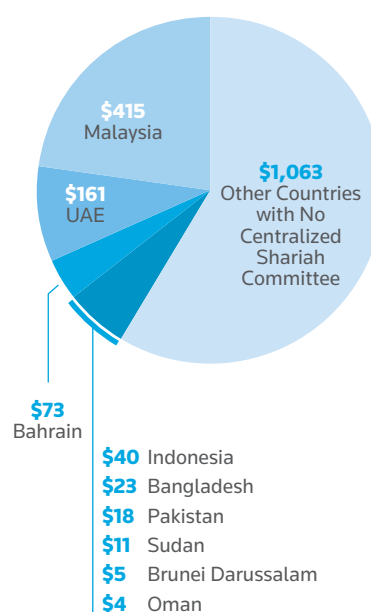
Ten Shariah scholars serve in approximately 497 IFIs where they are responsible for nearly 76 percent of the total IFIs with Shariah boards. Three scholars with the highest number of board memberships serve about 40 percent of IFIs globally.

### CENTRALIZED SHARIAH COMMITTEE REDUCES CONFLICT OF INTEREST AND STRENGTHENS STANDARDIZATION

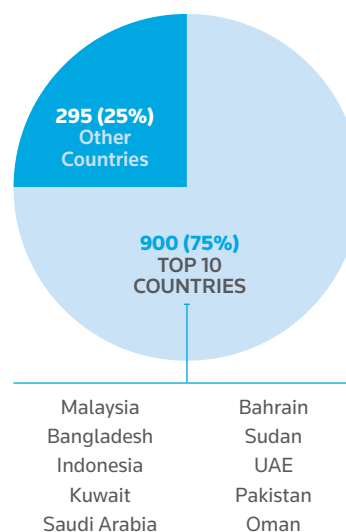
The total number of centralized Shariah committees has increased tremendously recently to cover nine countries: Bahrain, Bangladesh, Brunei, Indonesia, Malaysia, Oman, Pakistan, United Arab Emirates, and Sudan, where approximately \$750 billion of Islamic finance assets are located.

As governments and regulators are becoming more aware of the mechanisms of Shariah governance needed to enhance the Islamic finance ecosystem, some nations have begun establishing centralized Shariah boards in order to govern individual financial institution Shariah due diligence, reduce conflicts of interest and increase standardization.

**Top Countries with Centralized Shariah Committee – Breakdown by Islamic Finance Assets (US\$ Billion) as December 31, 2014**



**Top 10 Countries with Highest Number of Shariah Scholars in 2014**





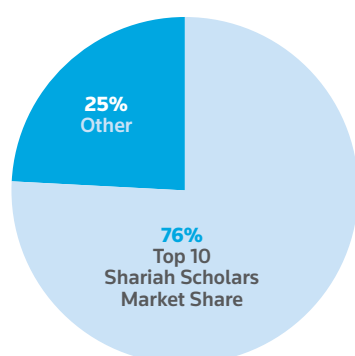
## TOP 10 COUNTRIES HOLD MORE THAN 75 PERCENT OF SHARIAH SCHOLARS

The total number of Shariah scholars reached 952 as of the end of 2014, covering 652 Islamic financial institutions (IFIs) in more than 46 countries. However, 75 percent of these Shariah scholars are located within the top 10 countries by asset size given that most of the Islamic Financial institutions are located there. 41 percent of these scholars are within the GCC region and 26 percent in SEA, while the balance is distributed among other MENA nations, Asia and other regions. Most of the 952 scholars also have multiple board presentation across different countries and companies.

## TOP 10 SHARIAH SCHOLARS BY NUMBER OF BOARD MEMBERSHIPS IN 2014

These numbers show up a high concentration risk to the ability of IFIs to manage the Shariah diligence and review process. As the number of institutions increases and the amount of work increases, this risk becomes more significant. Consequently, institutions may be insufficiently advised and reputation and stakeholder trust may erode. In addition, multiple institutions advised by many of the same scholars increases the potential for a conflict of interest. On the other hand, it could be argued that such a concentration encourages standardization as it transfers knowledge and experience.

### Top 10 Shariah Scholars Board Membership Concentration within a total of 652 Islamic Financial Institutions in 2014



### ICD THOMSON REUTERS ISLAMIC FINANCE DEVELOPMENT INDICATOR BACKGROUND

The ICD Thomson Reuters Islamic Finance Development Indicator is a composite weighted index that measures the overall development of the Islamic Finance industry by providing an aggregate assessment of the performance of all its parts, in line with the objectives of Islamic principles. It is a global level composite indicator with country and unit specific level indicators. The composite indicator is released annually, featuring a full report detailing each country and unit specific level indicator and their raw numbers. Each indicator within the composite indicator's constituents will be equally weighted and aggregated, i.e. all variables are given the same weight. In addition, normalisation is required prior to any data aggregation as the variable indicators in a data set have different measurement units.

For the Country Composite Indicator level, country indicators are normalized to allow for meaningful comparisons over time for a given country and between countries. Various economic indicators (e.g. population size) will be considered while measuring the health of the Islamic finance industry in each country.

For all other insights, visit IFDI Online Model and download the ICD-Thomson Reuters Islamic Finance Development Indicator Report 2015

<https://zawya.com/islamic-finance-development-indicator/>



*As governments and regulators are becoming more aware of the mechanisms of Shariah governance needed to enhance the Islamic finance eco system, some nations have begun establishing centralized Shariah boards in order to govern individual*

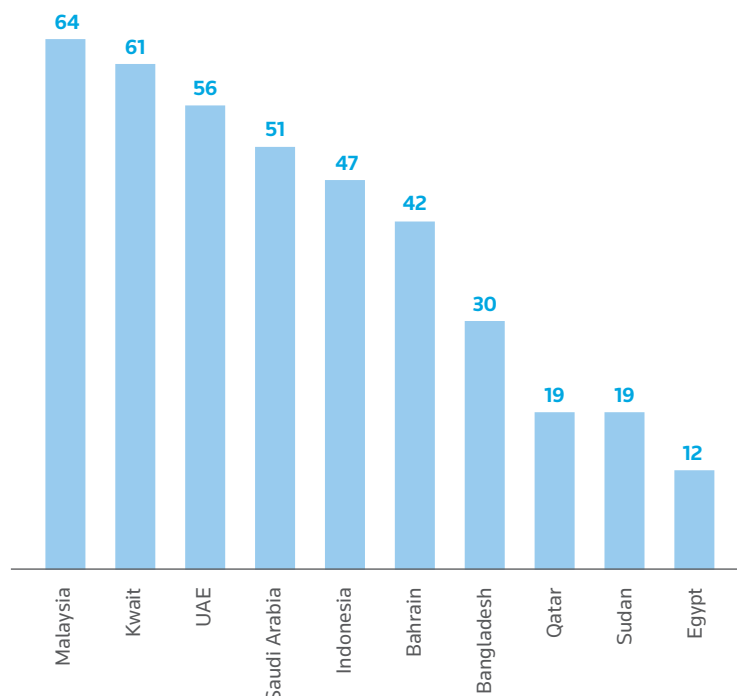


## SHARIAH GOVERNANCE SUB-INDICATOR 2015

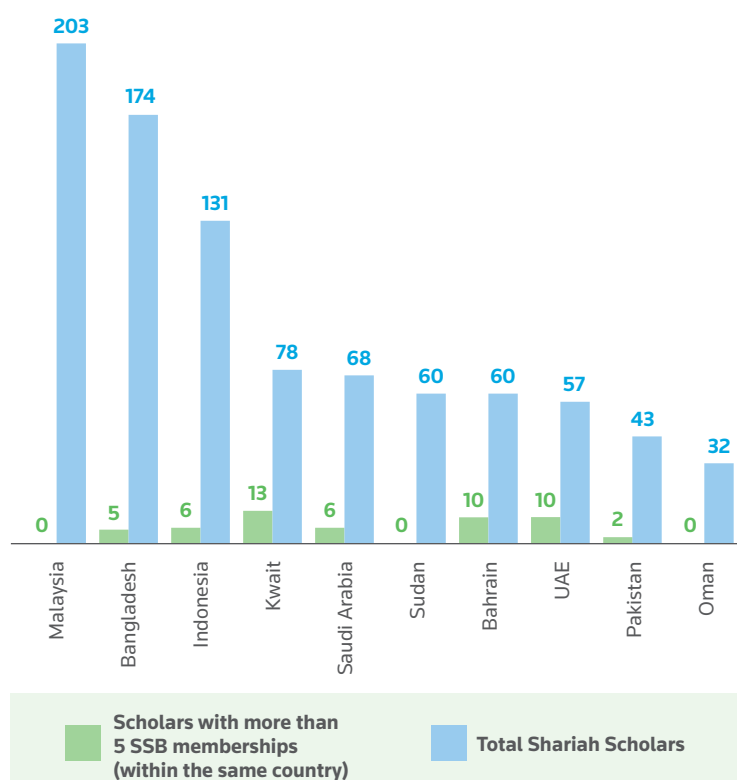
According to the ICD Thomson Reuters Islamic Finance Development Indicator 2015, Bahrain tops the Shariah governance sub-indicator followed by Malaysia and Kuwait. This is based on the assessment of three metrics: (1) the number of IFIs with at least three members in their Shariah board, (2) the number of Shariah scholars with at least one board membership, and (3) the number of scholars with more than five board memberships. Calculations of these metrics are normalized based on country size and macro indicators (including GDP, population, and banking assets).

Malaysia has the highest number of Shariah scholars as well as institutions with more than three Shariah scholars on their boards, followed by Bangladesh, Indonesia, and Kuwait. However, many of the top ten countries have numerous Shariah scholars with multiple board memberships within the same country, creating a high concentration risk and conflict of interest.

### Top Countries with Institutions Consisting of 3 or More Shariah Scholars in 2014



### Top Countries by Number of Shariah Scholars in 2014



### SHARIAH GOVERNANCE SUB-INDICATOR TOP 10 COUNTRIES

#### Country Indicator Value

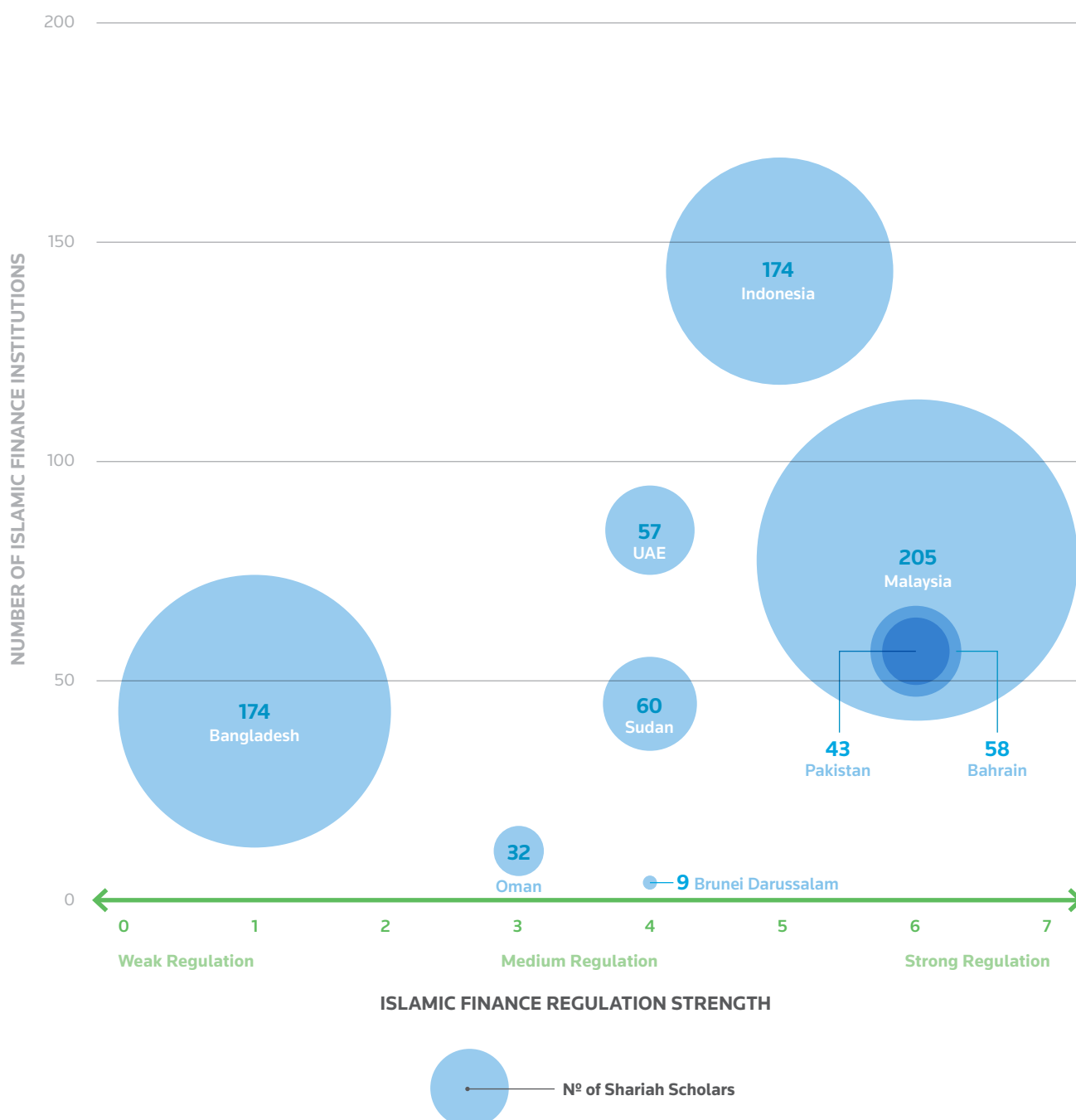
Bahrain	142
Malaysia	116
Kuwait	106
Bangladesh	92
Sudan	89
Oman	70
Indonesia	57
Pakistan	56
Lebanon	53
Egypt	48

## BAHRAIN AND MALAYSIA HAVE THE STRONGEST SHARIAH GOVERNANCE SYSTEMS

Despite Bahrain having some scholars with multiple Shariah board membership, it still possesses the strongest Shariah governance system. It is also worth noting that Malaysia, Pakistan,

and Indonesia have put in place stronger Shariah governance mechanisms than Oman, UAE, Brunei, and Sudan, which in turn are better positioned than Bangladesh.

### Top 10 Countries based on Islamic Finance Shariah Governance at 2014





# STRENGTHENING THE SHARIAH GOVERNANCE OF ISLAMIC FINANCIAL INSTITUTIONS: ISSUES AND RECOMMENDATIONS

**Sheikh Abdelkader Amor**

Al Maali Consulting Group



Shariah scholars have played a central role in designing not only the business models of Islamic financial institutions, banks, takaful companies and capital markets firms since the emergence of the Islamic finance industry, but they have also been responsible for structuring and developing products and services. Shariah scholars strive to implement/observe a Shariah governance framework with the aim to ensure that financial institutions maintain compliance with Shariah, which is the cornerstone of their business models.

This article explores seven pertinent issues related to Shariah governance and recommendations for modifications at both the Shariah Supervisory Board (SSB) and institutional levels to support the Islamic finance industry in reaching its objective of realizing the *maqasid al-Shari'ah*.

## SHARIAH SCHOLARS' QUALIFICATIONS

As a minimum, today's scholars who are well-versed in Shariah, particularly *fiqh* and *usul al-fiqh*, must have a good understanding of the international as well as local financial systems and be well-versed in business administration fundamentals that are used in the day-to-day business of an Islamic bank, such as budgeting, accounting, and financial statement analysis.

In addition, recent developments that are shaking the traditional ways of providing financial services demand that Shariah scholars also attain a good grasp of financial engineering techniques and grounding and master not only Arabic, but other languages such as English and French in order to competently access new challenges in new markets. Today, branchless banking, peer-to-peer financing, crowdfunding, digital currencies, and green finance, to name a few, are gaining more traction in financial markets and Shariah scholars must be able to understand and address their complexities to be able to relate them to and develop them for Islamic financial markets.<sup>1</sup>

Due to shortage of competent Shariah scholars, the top ten scholars serve in approximately 497 IFIs. They advise about 76 percent of the total IFIs with Shariah boards. Also, there is deficiency of about 1700 SSB members, whereby it is expected that the requirement for Shari'ah scholars will rise to 3000 in next 5 years if 5% growth is assumed in the number of IFIs.

Consequently, development of human capital in Shariah requires institutional efforts and necessitates the establishment of specialized institutions to cater to the human capital needs. It also requires introducing specialized degree courses, based on practical aspects of Islamic banking and finance and highly substantiated with credible case studies for developing a pool of competent Shariah scholars, equipped with all the required skills and credentials.

## INCREASING THE SYNERGIES BETWEEN SHARIAH SCHOLARS AND PRACTITIONERS

Some industry practitioners consider Shariah scholars to be extraneous and a hindrance to the smooth process of financial engineering and product development.

A proper Shariah governance framework ensures the independence and neutrality of SSBs. Independence — if understood properly in its true sense — does not contradict cooperation and synergies between SSB and IFIs. Rather, it is quite the opposite. Indeed, both parties

have the same goal — to conduct business in accordance with Shariah principles and precepts. There should be direct regular meetings between SSB and staff, different departments, management and Board of Directors (BODs). This recommendation, if implemented efficiently, has the potential to bridge the existing gulf between SSBs and other professionals in the IFIs.

## TRANSPARENCY AND STANDARDIZATION

The establishment of international institutions such as the Accounting and Auditing Organiza-



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tion for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB) for the sake of codification and standardization of the Islamic financial system is one of the industry's biggest achievements. Despite these important initiatives, the industry still lacks consistency in practices across IFIs globally and sometimes even within the same country.

It is due to the fact that compliance with specific standards is still not compulsory in many countries. In this regard, regulatory bodies should be given the power to enforce standardization according to the international standards while granting IFIs some flexibility and autonomy.

Shariah scholars are also required to play an important role in this standardization process, making the norms comprehensive and adaptable to the different contexts and striving to stick to the standards by improving transparency of the *fatwas* and justifying the instances where *fatwas* are divergent from the standards.

## INSTITUTIONALIZATION OF SHARIAH SUPERVISORY BOARDS (SSB)

International standards for governance have laid down rules, regulations and best practices for the smooth running of boards of directors and their functions. Best practices, for instance, include limiting the number of terms the directors can serve as well as the total number of members that could be appointed onto a board.

Since the role of the SSB in ensuring compliance with Shariah is similar to that of the board of directors, similar practices in regards to the appointment of SSB members is recommended. These include imposing a cap on: the terms Shariah scholars can serve and the number of SSBs they can serve on concurrently. Similarly, the Islamic finance industry needs to move from relying on personalities to institutionalizing Shariah practices and services. Prominent Shariah scholars—instead of representing their person—can play a central role in the emergence of sustainable institutions with new breeds of Shariah scholars flourishing around them.

## SPECIALIZATION OF SHARIAH SCHOLARS

The “one scholar fits all” approach is unlikely to be relevant in the future due to increasing complexity of a growing industry. The Islamic finance industry need only look to the legal profession that started out handling all legal aspects but evolved to specialize in tandem with industry needs.

It is fair to predict the need for specialization of Shariah scholars by the different segments of the industry, i.e. retail banking, investment banking, capital market, asset management, *takaful*, which will enable them to better serve the industry in a more efficient manner.

The industry will benefit from this transformation in two ways. First, specialization will accelerate the preparation of a new generation of Shariah scholars as the supply of existing scholars will not suffice given the projected industry growth ratio and estimated requirements for competent Shariah scholars. Second, it will improve Shariah scholars' involvement and effectiveness with Islamic financial institutions.

## RESEARCH AND DEVELOPMENT (R&D)

Research & development plays an instrumental role in the development of an industry. Coming up with innovative products in order to cater to the changing needs of customers in a complex environment, while giving due consideration to *maqasid al-Shariah* is a challenge that requires constant investment in R&D of Islamic finance products and services.

Shariah scholars are important stakeholders in R&D who should be strongly involved throughout the stages of this lengthy process that can last months or even years. Effective involvement in R&D necessitates having the skills to work with cross-functional teams in a project setting. Furthermore, the R&D involvement upstream will facilitate the operations' supervision when products are implemented and later upgraded.



R&D requires large investment in time and financial resources. Because of the pressure to deliver performance in the short-term, the financial institutions' management may not be eager to invest in such a long-term activity. However, it is in the long-term interest of the industry to invest in R&D and it is hence imperative on Shariah boards to use their influence in order to get sufficient funds allocated for R&D.

## EMPOWERMENT VIA HARMONIZATION AND REGULATORY SUPERVISION

In many cases when a jurisdiction's legal system does not incorporate Shariah in commercial law, court ruling can contradict a *fatwa* issued by a Shariah scholar or board. This weakens the power of *fatwa* and consequently the function of Shariah scholars. The harmonization of local corporate and commercial law with Shariah resolutions and injunctions increases the legitimacy of *fatawa* and work of Shariah scholars in the Islamic finance industry but this requires a substantial buy-in from government and relevant authorities.

Secondly, increased supervision in Shariah matters from central banks as well as capital markets authorities can further support Shariah scholars' work. Increased supervision can be seen as an obstacle, but in reality it serves the Shariah boards interests by affording them more credibility towards the customers and the management of IFIs. Moreover, regulators supervision will lead to more uniformity and standardization in Shariah matters.

## CONCLUSION

Increasing complexity in the role of Shariah scholars and the comprehensiveness of Shariah governance frameworks at IFIs has been transforming the nature of *fatwa*, necessitating higher levels of sophistication and comprehension.

The need for a broader set of skills and competencies across the disciplines for SSB members, dialogue with other expertise and existence of robust Shariah governance mechanism has given *fatwa* a highly professional and comprehensive outlook, which ensures that Shariah opinions are provided on the basis of inclusive Shariah know-how and highly technical expertise, providing assurance of Shariah-compliance to customers and other stakeholders of the Islamic finance industry.

### ENDNOTE

- 1 Thomson Reuters Data.



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Historic Madrasa  
Bou Inania in the  
ancient medina of  
Fes in Morocco



# MAJOR CHALLENGES IN ESTABLISHING A GLOBAL SHARIAH GOVERNANCE FRAMEWORK

**Prof Dr Ashraf Md Hashim and Ziyaat Isaacs**  
ISRA



The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and International Financial Services Board (IFSB) standards on Shariah governance have not been enacted as legislature or institutionalized by the majority of Islamic finance institutions and regulatory authorities in the Islamic finance arena. However, the robust growth and development of the industry has sparked a push from both scholars and policy-makers to include Shariah governance frameworks (SGF) in their respective regions and organisations. As mentioned in previous articles, a few approaches are currently being taken to include SGF in a smaller scale including centralized and decentralized in different jurisdictions.

Despite the various efforts undertaken to establish a robust SGF, there are some issues and challenges that countries face with regards to Shariah governance. This article will articulate those issues from both macro and micro perspectives.

## MACRO CHALLENGES

An SGF promotes adherence to the principles of the “Islam” in Islamic finance. In a sense, it is basically Shariah corporate governance as it aims at aligning the key stakeholders’ objectives to Shariah principles.

As Islamic finance moves into the mainstream, the call for global Shariah governance has become more prominent. Ideally, a regulated centralized approach for global implementation would be the direction for global SGF. This ap-

proach yields several challenges that may in fact distort global implementation, as it requires the establishment of an International Shariah Advisory Council (International SAC) which would, among other things, set off new debates.

At the outset, the following issues will need to be addressed:

1. Deciding the authority empowering this International Shariah Advisory Council
2. Setting the qualifying criterion to be a member of this Council, or for a jurisdiction governed by this Board
3. Deciding whether it will be a public or private initiative and;
4. Deciding on the level of authority of the Board; eg. whether it supersedes National Boards

Alternatively, the National Shariah Advisory Councils of participating countries may charter an agreement to recognize resolutions from respective participating countries. In theory, this may be a viable alternative; however, the practicality of its implementation may require further scrutiny.

This is the spirit of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards, also known as the New York Convention in which 155 countries, who are signatories to the convention, recognize the decision made by an arbitrator, regardless of whether they are on a civil or common law system. Similarly, an International Shariah Convention may be established to serve as an arbitrator in all respects of Islamic finance business worldwide.



In the first approach, the International SAC will have the authority to design a Global SGF to be implemented in all member countries. However, they will require member countries' recognition and this in itself is a major challenge as the variation of resolutions may divert some countries' interest to participate in this endeavour.

Nevertheless, the International SAC and SGF will definitely bring stability and certainty from a Shariah point of view. However, it might distort innovation and create the issue of "one size does not fit all" if not handled smoothly and/or not receive active participation by members.

The second approach suggesting the recognition of "National SGF" through a convention that will serve as an arbiter may face similar challenges as outlined above. Moreover, consideration should be given to Shariah Boards at institutional levels, too. However, this could essentially hinder the process of harmonization. For a start, the convention should be limited to those countries that have a National SAC. These SACs will have regular dialogue to create a common understanding amongst them on selected issues. This initiative will encourage other jurisdictions to set up their own National SACs.

## MICRO CHALLENGES

The implementation of Shariah governance has become increasingly taxing on the industry as policymakers face monumental challenges in adjusting existing statutes to meet the requisites proposed in Shariah governance frameworks.

Firstly, Shariah pronouncements vary across jurisdictions and the preferred verdict according to the ruling school of Islamic thought in a particular jurisdiction may be different to another. These variations are in fact a blessing as the variation rests in the application of its jurisprudence and not the fundamental principles of Islam.

However, the implementation of these varying pronouncements has been ridiculed in the conventional space to the extent of characterizing Islamic principles as inefficient.

Like any other legal infrastructure, Islamic commercial law has been extensively developed to facilitate the immediate circumstances of an individual context. The challenge Shariah governance faces in this regard is to convince policymakers that, like any other legal system, Islamic law is evolutionary, too. Instead of deeming it inefficient, this is a factor that should be considered when different pronouncements are made on a particular issue.

Secondly, with the exception of Malaysia and Pakistan, both the public and private sectors are reluctant to take a leading role in rolling out a complete SGF that should be adhered to by all stakeholders of the Islamic finance industry within a particular jurisdiction.

In Malaysia and Pakistan, regulatory authorities have been successful in achieving this, but many other Muslim-majority countries are still years away from having any form of Shariah governance in their legislature.

There are several reasons that are brought forth to justify this, but are these reasons really justifiable or merely a divergence from fully indulging in the business of Islamic finance?

Whatever the reasons may be, the gap between the public and private sector should be closed, and a common ground needs to be established in order to enable a real platform for the implementation of SGF.

Thirdly, the political will is a key factor in successfully implementing Shariah governance to support a country's Islamic finance industry. At present, some minorities in the respective regions are pushing for the implementation of Shariah governance as a core requirement in the jurisdictional legislature. However, these efforts are often met with strong criticism that Islamic principles are not to be "imposed" in the mainstream as it may lead to impressions of radicalism.

Fourth, in terms of governance, it is the authorities that provide governance policies and guidelines. However, Islamic financial institutions, despite falling under the jurisdiction of the central authorities, are ultimately governed

by the Shariah. The knowledge of the Shariah lies with scholars who have undergone rigorous studies and training in its application. The clash between Shariah scholars and mainstream industry players is another endless source of debate. Both extremes claim to be the authority on matters under their respective purview, and oftentimes end up diverting from the objective at hand and debating on “who knows better”.

On a micro level, Shariah scholars and practitioners should cooperate to facilitate harmonization. In this regard, closer ties between Shariah boards, on both institutional and national levels, should be formed in order to efficiently address concerns on issues at the ground level. Ultimately, harmonization from the grassroots level will provide a sound foundation for global implementation.

## POSSIBLE SOLUTIONS

On a macro level, establishing a convention to regulate National SACs may be a good start for a global Shariah governance framework. National SACs have the potential to be further developed. However, they should be open to change and adjust to global settings.

The matter rests in the hands of both the public and private sectors. The daunting question however remains unanswered: Who will champion this initiative?

If it comes from an existing central authority in Islamic finance, then who will lead? Would it be AAOIFI, IFSB, or an entirely new organisation? Whatever the answer to these questions may be, it should come soon, as we progress into the next phase of growth.



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PART 2

# Shariah Standards





# SUMMARY

One of the most important developments for the nascent Islamic finance industry has been the establishment and the work of industry bodies to address the challenges of regulation, accounting, and Shariah rules. It is well understood that Islamic finance is beset with issues relating to credibility, enforceability, and uniformity. Responding to the call for greater harmonization, standardization, and predictability, various international organizations, standard-setting bodies and authorities have designed numerous approaches and made pervasive efforts to create clarity, consistency, and alleviate concerns. This Section therefore attempts to examine recent trends in the standardization of Shariah rules in the industry. This includes the efforts of the AAOIFI, IFSB, some local regulators such as the Shariah Advisory Council of the Central Bank of Malaysia (SAC-BNM).

This Section begins with establishing the conceptual foundation of standardization in Islamic law, where it traces some of the practices in the history of Islam including the compilation of resolutions during the Moghul emperor, Aurangzeb Alamgir (i.e. *Fatawa Hindiyyah*) and the codification of Islamic law based on the Hanafi school (i.e. the *Mejelle*) during the Ottoman empire; and presents the divergent opinions of scholars with regards to standardization.

Before taking readers through to some recent issuances of Shariah standards by the AAOIFI, which include *wa'd* (promise), different categories of option (*khiyar*) in sales transactions, earnest money transactions (*urboon*), and termination of contracts, this Section elucidates the role of standard-setting bodies like AAOIFI and IFSB and regulators such as Bank Negara Malaysia in relation to Shariah standards and guidelines. While AAOIFI is mandated to look into the substance of Shariah rulings, the IFSB is more concerned with systems and procedures for compliance at the global level. Meanwhile, the BNM and the Shari'ah Advisory Council of the BNM are authorized to oversee both substance of Shariah and procedures of the local Malaysian Islamic finance market.

This Section explores the approach of SAC-BNM in developing and issuing its Shariah and operational standards pursuant to the Islamic Financial Services Act (IFSA) 2013, which recognizes a contract-based regulatory framework to create more transparent and consistent financial contracts. Other efforts by BNM, such as the establishment of the Law Harmonization Committee (LHC) in providing a conducive legal system for the development of the Islamic finance industry in Malaysia are also delineated briefly.

Building on the concern for contract-based governance, this Section takes up the contentious issue of commodity *murabahah* or *tawarruq* financing, arguing for the need to eliminate it gradually based on macro-level policy and moral considerations. Good governance aims to remedy various risks. These financing arrangements create significant reputational and other risks as their proliferation leads to risk transfer rather than risk sharing in the real economy.

The Section also highlights some issues in the implementation of standards issued by various bodies and proposes some solutions pertaining to the standardization of Shariah opinions in Islamic finance.





## JASEEM AHMED

Secretary General, Islamic Financial Services Board (IFSB)

**What is your general assessment of the process and content of the existing Shariah standards/guidelines and parameters issued by various institutions such as AAOIFI, IFSB, IIFM, BNM, etc.? What, in your view, are the areas that require improvements?**

If I may speak on my personal account, I would stress that there is a great wealth of material both historical and modern on issues of Islamic law, and the discipline is both vibrant and rich in content. But there is also great diversity in the Shariah governance frameworks across countries, and these reflect differences in national and institutional histories that are not easy to change rapidly.

At the same time, I think we can point to one essential and common set of factors that perhaps everyone recognises: namely, that a modern financial sector is highly dependent on a legal framework, including for Islamic law, that ensures transparency, consistency and predictability, in the absence of which financial systems are likely to remain small and underdeveloped.

Transparency, consistency and predictability in the legal system was achieved in the UK, for example, through hundreds of years of institutional development in which legal opinions were widely disseminated and in which the legal system itself became subject to the doctrine of

“precedent” — or *stare decisis*. This snapshot indicates the nature of the challenge facing Islamic law and suggests the areas where change would be helpful, for example in transparency.

ISRA is playing an important role here through its collection and dissemination of Islamic legal opinions. This is critical towards achieving progress in “consistency” of decision making, and hence also towards greater predictability.

Malaysia’s adoption of a centralised Shariah governance framework, which values consistency and the use of precedent, is admirable and has been facilitated by its reliance on common law which it shares with the UK, as well as by the strong and sustained public policy drive to develop deep and resilient modern financial markets. There are many lessons there, but not necessarily a blueprint for other countries that may have very different histories and institutional settings.

Turning to the IFSB’s role, the IFSB does not issue Shariah standards per se, which is the mandate of other institutions at both the national and international levels. However, the IFSB takes great care to ensure that its standards for prudential regulation and supervision are rigorously scrutinised by an internationally recognised body of scholars who are

drawn from the leading legal schools of thought under Islamic law.

In terms of its mandate, the IFSB follows a robust due process for the issuance of its standards, which helps to produce high quality and implementable standards in its member jurisdictions.

The key components of the IFSB due process include a) seven working group meetings, members of which include representatives from the IFSB member regulatory and supervisory authorities, international agencies, and occasionally market players, who represent the majority of key Islamic finance jurisdictions globally and b) two reviews by the Shariah Board of the Islamic Development Bank to ensure that the standards comply with Shariah rules and principles.

The Shariah Board reviews the draft documents at two stages of development — before issuance as an Exposure Draft, and before submission to the Technical Committee and Council for issuance. An important part of the due process is the public consultation phase, where the Exposure Draft is sent out to all IFSB members, and made publicly available to other industry stakeholders, for written feedback. The IFSB will organise public hearings or workshops within this public consultation period with the aim of creating public awareness and receiving broader

participation of stakeholders (such as member and non-member supervisors, multilaterals, market players, academics, Shariah scholars, and the public at large).

This due process ensures wider participation and involvement of the industry stakeholders in various stages of the development of the standard – which serves to secure wider appreciation of the recommended guiding principles and other best practices suggested in the IFSB standards, supporting earlier adoption of the standards among jurisdictions.

It has to be noted that the IFSB does address governance frameworks for Shariah advisory institutions. We have issued two standards to assist members in the implementation of the Shariah governance framework.

- IFSB-3, Guiding Principles on Corporate Governance covers broader issues on the governance of institutions offering Islamic financial services (IIFS) such as fiduciary responsibilities to the investment account holders.
- IFSB-10 on Shariah Governance Systems, specifically emphasises the need for an effective and independent oversight of Shariah compliance over operations and processes of an IIFS.

The IFSB standards aim to complement the work of other standard-setting bodies in Islamic finance, who are also playing their role as per their mandates and due processes for issuing the standards and guidelines.

**Can you share with us any standards or guidance notes that IFSB is currently working on to promote more harmonization on the global stage in the different practices of Islamic finance? What will be the focus of the upcoming standards?**

The IFSB through its global standards for the regulation of Islamic finance promotes cross-border comparability, which sets the stage for mutual recognition and/or harmonization of the regulation and supervision of Islamic finance across jurisdictions.

Thus, the wider the take-up and adoption of IFSB standards, the greater the likely progress towards comparable practices in Islamic finance across countries.

In addition, each IFSB standard, since it is benchmarked against existing global standards, also helps to promote a measure of comparability with conventional financial practices. The latter has become especially important in the aftermath of the global financial crisis with the adoption of a new global regulatory architecture in which the Basel III capital and liquidity frameworks feature prominently.

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A key objective of the IFSB in this new environment has been to ensure that the global Islamic financial services industry is not disadvantaged by the new regulatory requirements, and to provide a robust set of guiding principles that are comparable to the Basel III framework while meeting the all-important requirement of being consistent with applicable Islamic law.

Thus, beginning in 2012 in terms of aligning with the global regulatory developments, the IFSB has issued a series of standards on capital adequacy liquidity ratios, the supervisory review process as well as guiding principles on liquidity risk management and stress testing.

To date, 5 new standards and a highly important Guidance Note (on quantitative aspects of liquidity management) have been issued.

In 2014, the IFSB started a new project on stress testing that will complement the earlier standard (IFSB-13) issued in 2012 and provide technical guidance and templates for undertaking the stress testing for both the IIFS and regulators/supervisors. This is a key project as such practical guidance is not commonly provided by standard setters in the conventional space.

We also see the need to update or revise our transparency and market discipline standard (IFSB-4), and we will be proposing this to the IFSB Council for its approval as a part of our new Strategic Performance Plan for 2016-18. This revision would aim to address the changes made by the Basel Committee as a part of Basel III and would have the added dimension of consumer protection for the Islamic banking sector.

In terms of our other standards, in the takaful sector, we are currently preparing a standard on retakaful which is to be submitted for approval to the IFSB Council in 2016. Earlier this area we launched a much awaited Working Group for the preparation of a standard on Islamic Capital Markets. We have recognized the importance of financial inclusion issues, along with our global comparators, and as a part of a joint project with the International Association of Insurance Supervisors (IAIS), we are in the final stages of preparation of a paper on Issues in Regulation and Supervision of Microtakaful Undertakings, which is targeted for issuance before the end of 2015.

Amongst current research, the IFSB is working on a number of working papers in the areas of consumer protection, the comparative experience in standards' implementation, Shariah-compliant deposit insurance and Shariah non-compliance risk in the banking sector. Our research is often the prelude for the formal preparation of standards. We shall see which of these research papers, if any, end up as appropriate subjects for a future standard.

**Some quarters in the Islamic financial fraternity are raising concerns over the adverse effect/disadvantage /uneven playing field of Basel III's LCR, HQLA on the development of Islamic finance. They also contend that Basel III, LCR, HQLA are the temporary panacea for the financial crises that affected conventional finance. Hence should IFIs be subjected to tougher capital and liquidity regime?**

The possibility of an adverse impact was a concern we recognised well before the issuance of the Basel III liquidity framework. Thus the IFSB

saw the need for a dialogue with the Basel Committee to raise the concerns of market players and policymakers who constitute our stakeholders. A level playing field was the objective. There were specific concerns that related to the criteria for HQLA, the need for HQLA to be listed on recognised stock markets, and for the presence of liquid financial markets that had performed under "stressed" conditions, amongst others. These criteria were often not met in many of our members' jurisdictions.

We found the BCBS to be responsive in this dialogue. The channels for raising the concerns of the IIFS were already in place. The IFSB's standards development work in liquidity and capital areas is based on close dialogue with its global partners, including standard setting bodies such as the BCBS, regulatory and supervisory authorities and industry players.

Our dialogue with the Basel Committee resulted in the LCR framework providing room for the use of alternative instruments for meeting the HQLA requirements. Similarly, in the IFSB Guidance Note on Quantitative Measures for Liquidity Risk Management (GN-6), issued in April 2015, a number of changes and adjustments have been made to the definition of operational and fundamental characteristics of HQLA as well as net cash outflow parameters.

GN-6 also highlights the lack of Shariah-compliant Deposit Insurance Schemes and Lender of the Last Resort as important impediments for IIFS to protect their soundness and stability in situations of severe liquidity stress.

In the meantime, our surveys find that many Islamic banks have more than adequate liquidity at present, but



this is often the result of inadequate opportunities for Shariah -compliant investment reflecting an under-developed liquidity management infrastructure of markets, systems and instruments.

This is one of the most important structural features of Islamic financial markets that requires policy action.

In recent years, while a number of governments and supervisory authorities have taken steps to strengthen the liquidity infrastructure in their jurisdictions, and have achieved significant progress, this is far from being satisfactory in most jurisdictions.

For this purpose, governments and central banks have to play a more active role in the issuance and availability of Shariah -compliant HQLA. This emphasis has featured prominently in the IFSB's work on liquidity management over the past decade.

The IFSB Technical Note on Islamic Money Markets (TN-1, 2008) has stressed the importance of a regular issuance programme of Shariah -compliant securities by the governments that will not only increase the supply of liquid instruments to the Islamic finance industry but also support the public debt management and infrastructure development of the jurisdictions.

We can notice that in the short-term, requirements of LCR can be met by the IIFS by holding more cash and central bank reserves; however, it will impact their profitability as these options are mainly non-remunerative. On the other hand, in the medium-to-long term, regular supply of such securities will be instrumental to make the industry more robust. I note that the implementation of LCR (at 60 per-cent) level has started this year, and

the long transition plan provides the opportunity for the governments, regulators and market players to make suitable adjustments in their policies and operations. Similarly, the implementation of NSFR is not targeted to commence immediately, but a few years from now, which will help the industry prepare for its implementation.

Finally, are the LCR and NSFR insufficient responses to the crisis? This remains to be seen. However, they are designed to address the key problem of unstable funding for illiquid assets that was a major factor precipitating the global financial crisis. The contrary views that I have heard focus on whether these measures go far enough, especially in future scenarios in which central banks wind down what is currently a highly accommodating monetary stance in which financial systems are flush with liquidity.

**Has a standard on anti-money laundering and financing of terrorism (AML/CFT) particularly on the risks that are specific to Islamic finance been looked over by IFSB?**

AML/CFT issues are a high priority in the minds of regulators everywhere, and most jurisdictions have already addressed, or are in the process of addressing, this issue — without necessarily distinguishing between Islamic and conventional finance.

One jurisdiction in which separate guidelines have been provided for AML/CFT for the Islamic financial industry is Malaysia. The Malaysian guidelines issued by Bank Negara Malaysia are very detailed and cover the banking and takaful sectors, with additional manuals on electronic banking, and for designated non-financial businesses and professions.

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*A key objective of the IFSB in this new environment has been to ensure that the global Islamic financial services industry is not disadvantaged by the new regulatory requirements, and to provide a robust set of guiding principles that are comparable to the Basel III framework while meeting the all-important requirement of being consistent with applicable Islamic law.*

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I can well see that other jurisdictions may want to follow this approach. Indeed, taking this approach helps to provide assurance to the international community not only that the critical and legitimate issues are being appropriately addressed, but also to reinforce the point that there is perhaps little if anything that makes Islamic finance inherently different from conventional finance, or more risky, in terms of AML/CFT vulnerabilities.

At the same time, it has to be acknowledged that there are organisations outside of the formal regulated financial system, (both Islamic and conventional), that are involved in mobilising and transmitting funds, and these may not always have strong and transparent reporting and monitoring frameworks in place. It is important to keep in mind this distinction, whilst taking the necessary measures that are appropriate and proportional to each kind of institutional setting.

Most recently, the IFSB has taken up the issue of AML/CFT in our most recent standard IFSB-17 – Core Principles for Islamic Finance Regulation (Banking Segment), which was issued in April 2015. One of the Core Principles proposed in IFSB-17 is dedicated to the AML/CFT in which it notes that an additional control in the form of Shariah compliance “in itself demands high ethical standards and conduct, and the absence of activities that would result in fraud and criminal activity”.

Furthermore, IFSB-17 addresses the need for IIFS to have strict customer due diligence rules. This includes a customer acceptance policy that identifies business relationships that the IIFS will not accept based on identified risks, an ongoing customer identification, and verification and due diligence programme that

encompasses verification of beneficial ownership. IFSB-17 has also highlighted, in accordance with international regulations, the requirement for understanding the purpose and nature of the business relationship and the need for risk-based reviews and policies and processes to monitor and recognise unusual or potentially suspicious transactions.

From a broader perspective, in addition to the Financial Action Task Force’s (FATF) 40 Recommendations for AML/CFT, IIFS are subject to another layer of governance – their Shariah governance framework. Shariah governance aims to ensure the IIFS’ compliance with Islamic principles which prohibit its involvement in financial activities that are connected to predicate crimes that may give rise to ML/FT. The IFSB’s existing standards which have been issued for IIFS are consistent with the preventive measures recommended by the FATF and the effective customer due diligence requirements, as highlighted above.

As for our future work plan, we are proposing to study the key issues involved and, indeed, to address the question you have raised – by examining the key risks, if any, to which the Islamic finance industry may be exposed in terms of AML/CFT, and to propose counter measures. We will be discussing this with the IFSB Council in the context of the new strategic performance plan that we are drafting for 2016-2018.

**Protecting depositors is vital in preserving a country’s financial stability. Deposit insurance scheme is one of the security measures that should be put in place in preserving financial stability. For Islamic finance, there are a number of challenges that need to be considered**

**apart from the deposit insurance scheme being Shariah-compliant, i.e. the insurability of Islamic deposits, PSIA, priority of claims, availability and liquidity of Shariah-compliant investments. However there is yet an IFSB standard on this matter, is there any in the pipeline?**

I believe there is a need, in due course, for a standard, perhaps in the form of the Core Principles that exist for conventional deposit insurance.

More broadly, the need for, and indeed, the importance of financial safety net arrangements in the Islamic Financial Services Industry was stressed by the IFSB in April 2010 when in partnership with the Islamic Research and Training Institute (IRTI) and the Islamic Development Bank (IDB), a report was released entitled “Islamic Finance and Global Financial Stability”.

This report was prepared under the guidance of the “Task Force on Islamic Finance and Global Financial Stability” headed by H.E. Dr. Zeti Akhtar Aziz, Governor of Bank Negara Malaysia.

The Report identified eight building blocks aimed at further strengthening the Islamic financial infrastructure at the national and international levels to promote a resilient and efficient Islamic financial system. One of these building blocks relates to the strengthening of the financial safety net mechanism comprising a Shariah -compliant lender of last resort facility (SLCLR) as well as a Shariah -compliant deposit insurance scheme (SCDIS).

Subsequently, the IFSB organised the 4th Islamic Financial Stability Forum (IFSF) on 17 November 2011 on the theme “Strengthening financial safety



nets: Shariah -compliant Lender of Last Resort facilities and emergency financing mechanisms as well as deposit insurance". The IFSF highlighted the need for further studies on SLOLR and SCDIS, and the IFSF proceedings are available on the IFSB website.

The IFSB, in its Strategic Performance Plan 2012-2015 (SPP 2012-2015) identified the roles of SLOLR and SCDIS as a pertinent issue for cross-border study within the IFSI. As such, over the last three years, the subject has been highlighted in various IFSB publications and initiatives, for instance in IFSB's Islamic Financial Services Industry Stability Report, May 2013; Guiding Principles on Liquidity Risk Management IFSB-12, March 2012; and also Revised Supervisory Review Process IFSB-16, March 2014.

In April 2014, the IFSB completed the first half of its financial safety net research mandate (as per the SPP 2012-2015) when it published the Working Paper on Strengthening the Financial Safety Net: The Role of SLOLR Facilities as an Emergency Financing Mechanism, aimed at further strengthening the IFSI infrastructure.

Building on this research, the IFSB Secretariat is in its final stages of completing a second study on SCDIS as a Working Paper which examines the role and significance of SCDIS for the resilience and stability of the

IFSI and the various mechanisms that can be adopted by Regulatory and Supervisory Authorities (RSAs) for operationalising a SCDIS. This Working Paper entitled "Strengthening the Financial Safety Net: The Role and Mechanisms of Shariah-Compliant Deposit Insurance Schemes", intends to cover the second part of the SPP 2012-2015 financial safety net research mandate and aims to serve as initial guidance for RSAs to assist their evaluations and assessments on roles and mechanisms of SCDIS.



**JASEEM AHMED** assumed the position of the Secretary-General of the Islamic Financial Services Board (IFSB) on 1st May 2011. He has 25 years experience in financial sector reform issues, and in the fields of public governance, expenditure management and fiscal decentralization. As Secretary General, Mr. Ahmed contributes to the development of global standards for ethical conduct and regulation of the financial sector through his participation in international bodies. He is a member of the Consultative Group of the Basel Committee for Bank Supervision (BCBS), and also sits on the Consultative Advisory Groups of the International Auditing and Assurance Standards Board (IAASB) and the International Ethics Standards Board for Accountants (IESBA). In addition, Mr. Ahmed is a member of the International Monetary Fund's (IMF) External Advisory Group on Islamic Finance. He is a member of the UK governments Global Islamic Finance Investment Group, an advisory body.

# THE CONCEPT AND PRACTICES OF STANDARDIZATION IN ISLAMIC FINANCE

**Assoc. Prof. Dr Said Bouheraoua**  
ISRA



An ultimate objective of Islamic financial institutions is to achieve the optimum level of standardization. Reaching that level would enable Islamic financial institutions to enhance cross-border transactions, strengthen global connectivity and maximize profitability. However, Islamic financial institutions are faced with two major difficulties in achieving this end: the first is the ambiguity of the term, and the second is the difficulty of identifying the best approaches to realising it. The following is a brief examination of the concept of standardization and the proposed approaches to implementing it.

## THE CONCEPT OF STANDARDIZATION

The concept of standardization is often associated with the concepts of unification and harmonization. The interchangeable use of these concepts with the term “standardization” has created some ambiguity regarding its intended meaning.

An example of this ambiguity is the definition of standardization in the *Business Dictionary* as “formulation, publication, and implementation of guidelines, rules, and specifications for common and repeated use, aimed at achieving an optimum degree of **order or uniformity** in a given context, discipline or field”.

The definition of harmonization is given in some scholarly writings as “the name given to the effort by industry to replace the variety of product standards and other regulatory policies adopted by nations in favor of a **uniform global standard**”<sup>1</sup>.

However, careful examination of these three concepts reveals the difference among them. Standardization is thus concerned with articulating a group of fixed rules and application of a single standard. Depending on how standards are stated, they may not accommodate local differences.<sup>2</sup>

Unification aims to replace two or more legal systems or standards with a single one. Harmonization, on the other hand, seeks to effect an approximation or co-ordination of different legal provisions or systems by eliminating major differences and creating minimum requirements.<sup>3</sup> As such, it provides a degree of flexibility often unfound in uniformity and standardization initiatives.

## PRACTICES RELATED TO STANDARDIZATION IN EARLY ISLAMIC LAW

The concept of standardization was neither specifically mentioned in traditional *fiqh* literature nor was it explicitly supported and practised by the majority. However, its meaning related to determining fixed rules and application of a single rule is supported by some practices in the early stage of Islam. This can be seen in the following:

- The statement of the Prophet (peace be upon him) regarding *salam* transactions, “Whoever makes an advance payment (*salam*) should not make advance payment except for a specified measure and weight and a specified period” (al-Bukhari & Muslim). This directive standardized the use of *salam* to avoid the wide divergence of usage witnessed in its early implementation.



*Though standardization of Islamic finance has gained momentum, clear divergences have emerged among regulators, international standard-setting bodies, international Islamic supporting bodies, and Islamic financial institutions in the means to accomplish it.*



- Umar ibn al-Khattab imposed some standard practices in the market to ensure uniformity and compliance with the rules of transactions such as putting rules for qualified persons to transact in the market. He even selected some of them to ensure a quality start of this rule such as his appointment of Abdullah ibn Utba' ibn Mas'ud to manage the market of Madina.
- Abdullah ibn Muqaffa (d. 145 AH) proposed, in his book titled *"Al-Sahabah (The Companions (referring to the companions of the governors and caliphs))"*, to compile all jurisprudential (*fiqh*) opinions and impose them on judges.<sup>4</sup>
- The Abbassid caliph Al-Mansour suggested to Imam Malik (179 AH) that the jurisprudential reasoning (*ijtihad*) of other scholars be declared void and Malik's *ijtihad*, as recorded in *al-Muwatta'*, be made binding on all. Although Imam Malik advocated the pre-eminence of the legal opinions of the people of Madina, he told him not to do so because companions of the Prophet (peace be upon him) had spread across the world, each of them having preserved some aspect of the Prophet's Sunnah, that would thereby be excluded.<sup>5</sup> It was, furthermore, not his view, that his opinion was absolutely correct in all matters.
- The Moghul emperor Aurangzeb Alamgir embarked on a standardized compilation of Hanafi *fatwas* (*al-Fatawa al-Hindiyyah*) as binding rules. The famous *Majallah* was an Ottoman project that codified the Islamic law of transactions based on the Hanafi School of law.
- Islamic law was codified in many Muslim countries in the 20<sup>th</sup> century with the efforts of great scholars such as al-Sanhuri, Khallaf and others. It started with the codification of family law by the Egyptian authorities and



was followed by similar efforts in Syria, Kuwait, Jordan and other countries.

## OPPONENTS AND PROPONENTS OF STANDARDIZATION OF ISLAMIC LAW

Attitudes in contemporary Islamic finance toward the concept of standardization are influenced by two sides of theoretical *fiqh* views: The first is the minority view that prohibits the codification and standardization of law, including Islamic finance.

Among the modern proponents of this approach are some members of “The Council of Senior Scholars of Saudi Arabia”, the prominent scholar Mohammad al-Amin al-Shinqiti, Bakr Abu Zayd, and others<sup>6</sup>. Among their arguments: (i) codification considers the opinions of individuals even if they are, in the view of the ruler or judge, in violation of clear evidence supported by the majority of scholars; (ii) the prohibition of imitation (*taqlid*) of other *mujtahids* without proof, which leads to the implicit permission of considering very weak opinions; (iii) it has a negative impact on the healthy development of *ijtihad*, which is necessary for the development of *fiqh*;<sup>7</sup> and (iv) many juristic conclusions are probabilistic and codification may exclude views that are possibly correct.

The second is the majority view, which supports codification and standardization of Islamic law and Islamic finance practices. Among its evidences: first, they refute the opposing view on *taqlid* by stressing that this is based on the prohibition of a *mujtahid* following the opinions of another *mujtahid*; however, *ijtihad* is almost absent in our era and therefore standardising and codifying rules is permissible and needed.

Second, the permissibility of restricting multiple opinions to one opinion in practice and even codifying a set of such choices is supported by the general legal maxim that says: the decision of the ruler eliminates dispute. This maxim also applies to authorities delegated by the ruler as long as they adhere to the fundamentals of Shariah. It is also supported by previous practices

related to the concept of Shariah-based policy (*siyasah Shar'iyyah*).

Third, codification does not preclude the revision of the law or the standard, if it is found weak or inappropriate.<sup>8</sup>

## APPROACHES TO THE STANDARDIZATION OF ISLAMIC FINANCE PRACTICES

Though standardization of Islamic finance has gained momentum, clear divergences have emerged among regulators, international standard-setting bodies, international Islamic supporting bodies, and Islamic financial institutions in the means to accomplish it.

As a result, we have witnessed countries, such as Bahrain, Sudan, Pakistan, Syria and Lebanon adopting AAOIFI standards and making them binding upon Islamic financial institutions domiciled there. They have done so on the basis that the institution, AAOIFI, issuing these standards is well-established globally, is represented by the vast majority of scholars around the Muslim world and backed by the OIC Islamic Fiqh Academy, the leading Islamic institution in issuing resolutions related to Islamic finance.

We have, on the other hand, most of the remaining countries, which are not bound by either AAOIFI or IFSB standards and that view their own standards as constituting best practices in Islamic finance (at least for their own countries), granting ultimate decision-making authority to the Shariah committees of their respective local Islamic financial institutions.

Their main argument is that Islamic finance is in its inception and to enrich the Islamic finance practices with innovative propositions and methods, we should not restrict Islamic financial institutions to a single standard for the time being.

Nevertheless, they agree to standardize the practices of their financial institutions to maintain consistency and also aspire to an internationally recognised and binding set of standards as

an ultimate objective. Malaysia added a step to the second approach by issuing locally binding standards as a minimum requirement to ensure consistency and avoid any possible harm to the reputation of the Islamic financial industry in the event of disputes and litigation.

## CONCLUSION

Although the concept of standardization is tinged with some ambiguities in its practical and scholarly usage, we have concluded that its general meaning can be clarified. We have also concluded that standardization, as a general approach, was practised in the early era of Islamic law albeit briefly and in a limited manner, and we have supported its presence with evidence.

A minor issue of controversy was raised with regards to its legality, but the majority has supported its consideration. However, the core issue with the concept of standardization rests with three contemporary approaches that we have identified.

It is premature, in my view, to give preference to any one of these three opinions over the others; however, it is very important to further examine them in order to pave the way for a fruitful and constructive proposition for a comprehensive global standardization of Islamic finance practices.

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## EVOLUTION OF SHARIAH STANDARDS AND GUIDELINES FOR AAOIFI, IFSB AND BANK NEGARA MALAYSIA

**Prof. Simon Archer, Prof Datuk Rifaat Ahmed Abdel Karim  
and Gopala Krishnan Sundaram**



When Islamic banks were established in the 1970s, they were confronted with a major challenge: how to assure users that their services and transactions were in compliance with the cardinal rules and principles of Shariah — which was the *raison d'être* of their establishment.

To fulfill this objective, Islamic banks established a new governance organ, the Shariah Board or Shariah Supervisory Board (SSB). The SSB usually comprises of three members. However, the terms of reference of the SSB in the form of the process of appointment, termination, and composition tend to differ among Islamic banks. The rulings issued by different SSBs with regard to similar transactions may also be inconsistent, resulting in these transactions not being comparable in terms of their basis in Shariah. The resulting proliferation of different variants of such transactions increases transaction costs for Islamic banks and their customers, and this is likely to have hindered the growth of the industry.

These differences in Shariah rulings by SSBs have concerned not only similar transactions across different jurisdictions but also those within the same jurisdiction. In the early years of Islamic banks, their boards of directors were the ones to set the terms of reference of the SSBs; however this has changed in a number of jurisdictions where it is now regulated by the central bank or another central authority, although to varying degrees depending on the legal frameworks that govern the operations of Islamic banks.

### ROLE OF ACCOUNTING & AUDITING ORGANIZATION FOR ISLAMIC FINANCIAL INSTITUTIONS (AAOIFI)

The initial thought behind the establishment of the Shariah Board of AAOIFI was to provide a degree of harmonization to its accounting standards, which was its initial mandate. However, the need to harmonize the differing Shariah rulings of Islamic banks has become more pertinent, becoming the main objective of the AAOIFI Shariah Board.

The AAOIFI Shariah Board therefore adopted a due diligence process similar to that of the AAOIFI Accounting Board for the issuance of Shariah standards. This includes issuing an exposure draft of the standard and holding of a public hearing, allowing the public to inquire about aspects of the standard. This was a major development as almost no Shariah scholars were used to the process. Furthermore, the standards included a section on the “Basis of Standard” to enable users of the standards to ascertain the basis on which the Board had arrived at the content of its standards.

It is worth noting that the standards were issued without any dissent or minority opinion being published, so as not to confuse the public, given the prominence of the Shariah scholars who sat on the inaugural AAOIFI Shariah Board. In addition, the standards were not considered *fatawa* (Islamic legal edicts) so as not to be attributed to any particular member of the Shariah Board, but rather as a collective ruling of the Board.

## ESTABLISHMENT OF THE ISLAMIC FINANCIAL SERVICES BOARD (IFSB)

As Islamic banking and finance found greater acceptance around the world beyond the traditional confines of the Muslim national economies, it became increasingly necessary to develop a regulatory regime to address the specific aspects of Islamic banking and finance and to enable the effective assessment and containment of the risks arising from these institutions' financial transactions. The accounting standards issued by AAOIFI, though necessary, were not adequate for this purpose. There was therefore a need for an international standard setting board for Islamic banking and finance to lend safety and soundness to the Islamic financial industry.

In recognition of this, Malaysia was mandated to lead a Steering Committee for the establishment and inauguration of the IFSB in Kuala Lumpur. Dr. Zeti Akhtar Aziz, Governor of Bank Negara Malaysia, the country's central bank, said in her welcoming address at the launching of the IFSB in Kuala Lumpur on 3 November 2002:

"The Islamic Financial Services Board, IFSB, will serve as an association of central banks, monetary authorities and other institutions, entrusted to develop and promulgate internationally accepted prudential regulatory standards and best practices. In advancing this mission, the Board will examine the extent to which existing international best practices need to be adapted and complemented to be consistent with Shariah principles. The IFSB will liaise and collaborate with other international standard setting bodies to achieve the common goal of international financial stability. In addition, the Board will also focus on the development of risk management instruments, cultivation of sound risk management practices and facilitate the implementation of robust risk control mechanisms in Islamic financial institutions through research, training and technical assistance. This would encompass the adoption of international best practices on risk management standards as well as the development of new risk management techniques in conformity with Shariah injunctions."

As at May 2015, IFSB had issued 17 Standards, six Guidance Notes and one Technical Note.

Noteworthy among these Standards is IFSB-10 Guiding Principles of Shariah Governance Systems (December 2009). This Standard reflects the IFSB's role as an institution concerned with prudential regulation, and, as such, does not seek to issue any specific guidance on the substance of the Shariah. Instead, IFSB-10 is concerned with systems and procedures within Islamic financial institutions designed to avoid breaches of Shariah by these institutions. Such systems and procedures notably include an Internal Shariah Compliance Unit (ISCU) and an Internal Shariah Review Unit (ISRU) — the first of which carries out an ongoing internal scrutiny of transactions as part of the institution's compliance function, while the latter operates in conjunction with the institution's internal audit, but reports to the SSB rather than to the Audit Committee.

Among the benefits provided by the guidance in IFSB-10 is the fact that it can be applied and enforced by industry supervisors in non-Muslim majority jurisdictions, as it does not require the supervisor to possess any knowledge of the Shariah. This can also be an advantage in Muslim-majority jurisdictions where the industry supervisor may not consider that it has the qualifications or responsibilities for making judgments about the substance of Shariah compliance by the institutions it supervises, but is able to observe whether these institutions have the required systems and procedures.

## ROLE OF BANK NEGARA MALAYSIA (BNM)

Prior to the IFSB pronouncements, Bank Negara Malaysia (BNM) had issued standards for prudential requirements and Shariah compliance under the Islamic Banking Act 1983 and the Takaful Act 1984. These prudential requirements were based on the standards widely practised in the conventional financial system but only to the extent that such standards were consistent with the Shariah. Shariah requirements were put in place and implemented under the watchful eyes of the individual Shariah Committees in each financial institution.





*As Islamic banking and finance found greater acceptance around the world beyond the traditional confines of the Muslim national economies, it became increasingly necessary to develop a regulatory regime to address the specific aspects of Islamic banking and finance and to enable the effective assessment and containment of the risks arising from these institutions' financial transactions.*



To streamline Shariah standards for the Malaysian banking and financial industry, and to promote greater uniformity and consistency within the Islamic banking and financial industry, BNM instituted under the Central Bank of Malaysia Act 1958 a National Shariah Advisory Council (SAC). The rulings of the SAC are binding on the Islamic financial institutions in Malaysia and on arbitrators dealing with Islamic banking and financial transactions. Furthermore, these rulings have to be taken into account by the courts of the country.

In 2009 these requirements were further enhanced under the Central Bank of Malaysia Act 2009. The members of the SAC are now appointed by the ruling King of Malaysia. The rulings of

the SAC are binding on the financial institutions, arbitrators as well as the courts of Malaysia.

In a further streamlining exercise, the Islamic Banking Act 1983, the Takaful Act 1984 and the relevant parts of the Payments Systems Act 2003 and the Exchange Control Act 1953 were consolidated into the Islamic Financial Services Act (IFSA) 2013. Under the IFSA 2013, Islamic financial institutions and conventional financial institutions offering Islamic financial services through an "Islamic window" are under a legal obligation to comply with the Shariah rulings issued by the SAC. Any instance of non-compliance with the Shariah has to be reported to the Central Bank with an explanation of the measures taken to redress the breaches of the Shariah. The new IFSA 2013 also provides that

a Shariah audit by an external auditor shall be undertaken by any Islamic financial institution if so required by the Central Bank.

In sum, the roles of the Shariah Board of AAOIFI, the IFSB and the BNM in the development of Shariah standards, frameworks or guidelines for the Islamic finance industry differ as such:

- AAOIFI is concerned with the substance of Shariah rulings at an international level;
- the IFSB is concerned with systems and procedures for compliance, but not the substance, also at an international level;
- BNM and the Malaysian SAC are concerned with both substance and systems and procedures, but on a national or jurisdictional level.

Malaysia is not the only Muslim-majority country to have a national Higher Shariah authority. Such countries include Indonesia, Sudan and, more recently, Oman. For other countries, the AAOIFI and the IFSB provide indispensable

guidance, and such guidance is of great value to all countries.

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**DISCLAIMER: The views expressed in the article are those of the authors and do not necessarily represent the views of their institutions.**



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# STANDARDIZATION AND HARMONIZATION OF ISLAMIC FINANCIAL PRACTICES: THE APPROACH OF THE CENTRAL BANK OF MALAYSIA

**Prof Dr Mohamad Akram Laldin and Dr Hafas Furqani**  
ISRA



Industry practitioners have long believed that the absence of globally accepted standards in Shariah, accounting, legal, regulations and others, are among the factors that impede the realization of the full potential of Islamic finance and hamper the strategic objective of positioning Islamic finance into the mainstream economy.

Efforts towards harmonizing and standardizing the Islamic finance industry is taking place globally and locally. This initiative is seen in the regulations and standards of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), Islamic Financial Services Board (IFSB) and Central Bank of Malaysia (BNM).

This article focuses on the BNM Shariah Standards and the effort for standardization and harmonization of Islamic finance practices in Malaysia.

## BNM STANDARDS

As one of the leading countries in the global Islamic finance industry, Malaysia has attempted to develop solid regulations and standards to guide the development of Islamic finance. The Malaysian approach to Islamic finance is very systematic and integrated, where the Islamic financial system is recognized as part of the country's mainstream system and governed by specific legal structures.

In developing the Islamic finance ecosystem, Shariah compliance and governance have been the utmost priority and consideration since the onset of the industry during the 1980s and 1990s. The establishment of the Shariah Advisory Council (SAC), a centralized Shariah body established in 1997 is a significant preliminary milestone in the structure of overseeing uniform implementation of Shariah rules in Islamic financial transactions in the country.

The SAC has been given the authority for the ascertainment of Islamic law for the purpose of Islamic banking and takaful. Building from these strong foundations and in line with market developments, the ecosystem has evolved in responding to the need for clear guidelines and policies on Shariah aspects in all areas of Islamic finance including legal, operational and prudential frameworks.

In 2013, Malaysia promulgated a statute — Islamic Financial Services Act (IFSA) — that regulates and supervises the Islamic banking and takaful industries. The IFSA provides direction for the shift towards a contract-based regulatory framework by providing legal recognition to the contractual requirements in accordance with the Shariah, thus ensuring alignment in terms of legal and regulatory treatment of Islamic financial transactions with the underlying Shariah contractual principles.

Under the purview of IFSA 2013, the BNM and Islamic finance industry stakeholders in Malaysia are developing an array of Shariah standards



**TABLE 1: CONTRACT-BASED SHARIAH REGULATORY FRAMEWORK IN MALAYSIA IN IFSA 2013****End-to-end Shariah compliance under the Islamic Financial Services Act 2013**

Shariah Standards: Compliance with fundamental requirements of respective Shariah contracts

Operational Standards: Strengthening risk management, governance, transparency and disclosure, market conduct and other operational aspects of applying Shariah standards

**Shariah contracts applied in Islamic financial business**

Assets			Liabilities		
Sale-Based	Equity-Based	Fee-Based	Islamic Deposits	Investment Accounts (Equity)	Investment Accounts (Other)
<i>Murabahah</i> <i>Istisna'</i> <i>Ijarah Tawarruq</i>	<i>Mudarabah</i> <i>Musharakah</i>	<i>Wakalah</i> <i>Kafalah</i> <i>Rahn</i>	<i>Tawarruq</i> <i>Wadiah</i> <i>Qard</i>	<i>Mudarabah</i> <i>Musharakah</i>	<i>Wakalah</i>

and operational standards that are intended to promote transparency and consistency of Shariah contract application to enhance certainty and strengthen Shariah compliance by Islamic financial institutions, as well as to serve as a key reference to catalyze greater mutual respect of Shariah opinions across jurisdictions.

The new enhanced Shariah standards encompass guidelines on mandatory and optional features of the Shariah contracts of which Islamic financial institutions (IFIs) must comply along with guidelines on operational parameters to provide clear guiding principles on effective risk management, governance, legal, disclosure and market conduct.

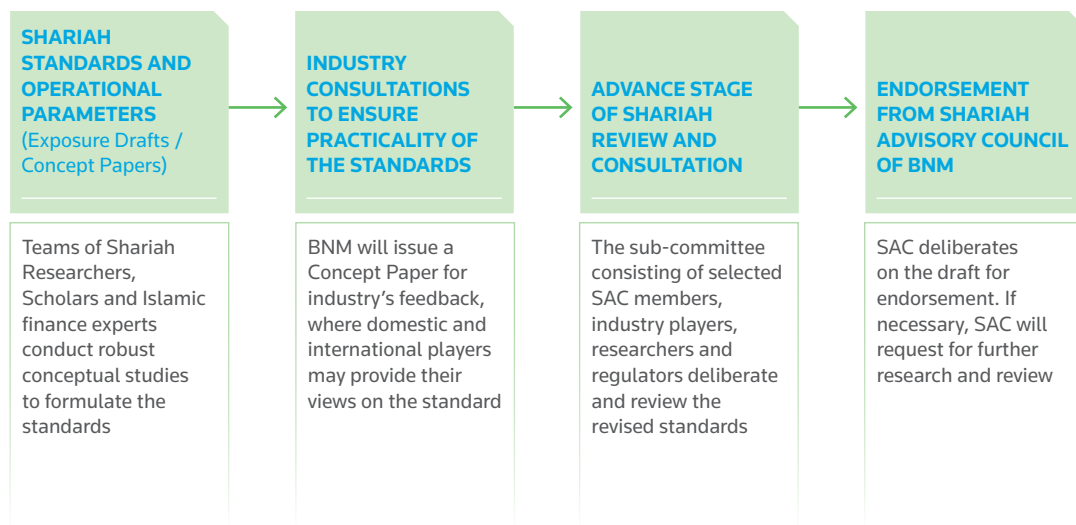
This is vital to better facilitate the operationalization aspects of the Shariah contracts as well as to encourage product innovations and developments. These Shariah standards are expected to enable uniformity of Shariah rulings across institutions while enhancing certainty and public confidence in Islamic financial transactions (MIFC, 2014).

The process of developing Shariah standards is initiated by a robust study to develop a concep-

tual framework of a Shariah standard mainly derived from juristic opinions of the classical *fuqaha'* and contemporary *fatwas* from International Islamic Fiqh Academy of the Organisation of Islamic Cooperation (IFA-OIC), and the relevant global standards setting bodies such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), as well as those of renowned contemporary scholars. The Shariah team would amalgamate the various *fatwas* and then deliberate upon the issue at hand in the light of the primary and secondary sources of Shariah.

Thereafter, the draft concept papers would be tabled to relevant industry stakeholders to get their feedback on their relevance and feasibility to support growth of the Islamic finance industry.

The standards development follows a transparent structured process with the aim of achieving uniform standards that also take into account religious opinions from other *Fiqhs* (Islamic jurisprudence) and hence are comparable to other international standards set by non-Malaysian regulatory bodies.

**Figure 1: Process in Developing BNM Shariah Standards**

Source: MIFC (2014: 6)

In sum, the BNM Shariah standards development process entails the following steps described in Figure 1.

## HARMONIZATION EFFORTS

In line with developing solid Shariah standards for the Islamic finance industry, Malaysia has attempted to harmonize various aspects of national laws and Shariah with the aim of furthering the progress of Islamic finance and making Malaysia the international Islamic finance hub.

It is understood that the Islamic financial industry is beset with issues, including those related to credibility, regulatory framework, enforceability and uniformity (including Shariah matters). Therefore, harmonization in Islamic finance aims to create clarity, consistency and greater integration between Shariah rulings, national laws and global standards and hence bring the industry a step further.

For this purpose, Malaysia set up the Law Harmonization Committee (LHC) in 2010 as a continuous effort to further strengthen the legal system and infrastructure in the country to cater for the growing development of Islamic finance.

The LHC is established with the following objectives:

1. To create a conducive legal system that facilitates and supports the development of the Islamic finance industry;
2. To achieve certainty and enforceability in the Malaysian laws in regard to Islamic finance contracts;
3. To position Malaysia as the reference law for international Islamic finance transactions; and
4. For Malaysian laws to be the law of choice and the forum for settlement of disputes for cross border Islamic financial transactions.

The LHC is mandated to perform the following duties:

1. To review existing laws with the objective of harmonizing the laws to be Shariah compatible, insofar as it is applicable to Islamic finance; and
2. To review new laws that are being made in so far as they affect Islamic finance, to be Shariah compatible.

In a report published in 2013, LHC reported that a total of 9 issues concerning 17 laws in the country were reviewed. After extensive consultation and research, the LHC committee recommended amendments on 4 issues which have since been escalated to the relevant government ministries, department and agencies, namely:

1. Legal recognition to Shariah permissibility of imposing late payment charges on judgment debts in Islamic financial cases;
2. Improving access to financing (especially Islamic financing) involving reserve lands;
3. Recognition of Islamic finance transactions under the National Land Code 1965: Legal recognition of Shariah principles to facilitate provision of Islamic finance under the National Land Code 1965;
4. Facilitating the use of collateralized commodity *murabahah* in short-term Islamic financial market instruments: Clarifying requirements for registration of collateral under Companies Act 1965.

With such efforts it is expected members of the committee are optimistic to achieve a greater level of harmonization between Shariah and law in the issues of concern, hence, further strengthen the position of the Islamic finance industry in Malaysia.

## MOVING FORWARD

The issuance of standards is a reflection of the ultimate effort to attain uniformity in Islamic financial practices in order to elevate the industry in the global financial system. The effort, however, has yet to reach an international consensus as countries introducing Islamic finance still differ on the best standards to be adopted while some have formulated their own standards. Although diversity can be deemed as a form of dynamism in Islamic financial practices, it may have some negative impacts on the industry as it may hinder the goal of harmonization and internationalization of Islamic finance. Therefore, more efforts are needed to create a globally accepted single set of standards.



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## AAOIFI SHARIAH STANDARDS: RECENT ISSUES

**Dr Hamed Meera**  
AAOIFI



The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), established in 1991 and based in Bahrain, is an international not-for-profit organization primarily responsible for the development and issuance of standards for the global Islamic finance industry.

AAOIFI is supported by over 200 institutional members, including central banks and regulatory authorities, financial institutions, accounting and auditing firms, and legal firms, from over 45 countries. To date, AAOIFI has issued a total of 93 standards in the areas of Shariah (54 standards), accounting (25 standards), auditing (5 standards), ethics (2 codes) and governance (7 standards). AAOIFI's standards have introduced a progressive degree of harmonization of international Islamic finance norms and practices.

One of the major strengths of AAOIFI, from which stems its invaluable worth in Islamic financial markets, is its 54 Shariah standards adopted by central banks and financial authorities in a number of countries, on either a mandatory basis or as guidance. These have been developed and issued by the AAOIFI Shariah Board, which aims to be the global authority for the Islamic finance industry. This Shariah Board consists of some of the most prominent Shariah scholars and jurists from approximately 13 countries, representing different schools of thought. They have proven instrumental for Islamic financial institutions (IFIs) in their efforts to promote products and services within and across the countries in which they operate.

The importance and reliability of AAOIFI's Shariah standards are largely attributable to the

extensive technical review process to which they are subject. Each standard is typically developed and issued up to 13 steps in total, commencing with commissioning of experts and consultants for a specific study, which leads to submission and presentation to a specialized committee for discussion, then to preparation of an exposure draft and presentation thereof to the industry stakeholders through a series of public hearings, review by the Shariah Board, then double checking and editing thereof by the formulation committee, and finally issuance and publication of the standard.

With Allah's help, in 2015, six new standards were issued. Below is a summary of these standards:

### SHARIAH STANDARD NO. 49: PROMISE AND PROMISING

Standard no. 49 relates to a unilateral promise (*wa'd*) or a mutual/bilateral promising (*muwa'adah*) for the purpose of entering into a contract or performing a disposition.

It sets out meanings of *wa'd* and *muwa'adah*, and:

- stipulations for permissible and impermissible acts,
- types of *wa'd* and *muwa'adah* and their general rules, and their Shariah basis and nomination under *mua'amalat* jurisprudence,
- way of execution, and cases of bindingness and non-bindingness,

- the parties bound thereby, and cases where fulfillment becomes binding, legally and or under Shariah.

It also sets out consequences of unfulfilled promises on the promisor.

Additionally, the standard presents a number of Shariah-permitted and Shariah-prohibited modern applications of the concept of promise and mutual promising.

## SHARIAH STANDARD NO. 50: MUSAQAH (MUSAQAT)

Standard no. 50 relates to the contract of *musaqah* (*musaqat*) (i.e., irrigation partnership), which constitutes a contract between the owner of an orchard (planted piece of land) and a worker (known as *al-musaqi* or irrigation worker). It sets out a definition of *musaqah* from Islamic jurisprudence, its elements, stipulations, obligations of each of the worker and the owner, the right of the former to seek help from a third party to carry out irrigation, and effects thereof.

It also determines liability for the cost of *musaqah* and sets out the consequences of non-fulfillment by either party, how to divide the output (fruits) of irrigated trees, and the subject matter of division. This standard also handles contingencies relating to the contract of *musaqah* and, furthermore, sets out how the contract of *musaqah* expires and the cases where it can be terminated.

Finally, the standard concludes with a set of modern applications.

## SHARIAH STANDARD NO. 51: OPTIONS OF PROPERNESS (DEFECTS, PARTITIONED OBJECT OF SALE, INCORRECT DESCRIPTION)

Standard no. 51 sets out the cases where a purchaser could have the right to revoke the contract due to defects in the object of sale, or fragmentation of the deal, or incorrect description thereof.

These three options are termed: 1) option of freedom from defects, 2) option of fragmented deal, and 3) option of incorrect description

This standard defines each of the foregoing options and delineates the conditions for validity of the right to revoke the contract. It also sets out the transactions in which such options may be applied. This standard addresses the question of transferability of these options to inheritors and provides a set of modern applications of these options.

## SHARIAH STANDARD NO. 52: OPTIONS OF REFLECTION/ RECONSIDERATION (CONDITION, PAYMENT, SELECTION)

Standard no. 52 relates to options of reflection/reconsideration that may be stipulated by contracting parties in a bid to construct an additional chance to reconsider and refine their terms and conditions.

Specifically, this standard provides definitions of three options: 1) *khiyar al-shart* (option of condition/option by stipulation), a right to stipulate the choice of either confirmation or revocation within a specific period of time. 2) *Khiyar al-naqd* (option of payment) whereby a seller or lessor may revoke the contract upon failure to timely pay the amount due. 3) *Khiyar al-ta'yeen* (option of selection) which gives the right to the purchaser to select one from among a number of subject matters.

This standard sets out the cases in which these options shall be valid and in effect, and the conditions thereof, and entitlement of the party in whose favor an option is established, the effect of these options on the subject matter and on the disposal with the subject matter by two parties during the option's term etc.

It also handles the action to be sought if *khiyar al-ta'yeen* expires without selection by the buyer, and whether the seller shall have the right to revoke the contract.



*To date, AAOIFI has issued a total of 93 standards in the areas of Shariah (54 standards), accounting (25 standards), auditing (5 standards), ethics (2 codes) and governance (7 standards).*



Moreover, the standard sets out the cases where *khiyar al-tarawwi* becomes invalid and whether the above options can be concurrently embedded in a single contract. The standard also addresses the question of tradability of such options and provides a set of modern applications of these options.

### **SHARIAH STANDARD NO. 53: EARNEST MONEY (URBOUN)**

Standard no. 52 covers the *urboun*-based sale and its applications by Islamic financial institutions.

It includes a definition of *urboun*, which constitutes a payment by a purchaser to a seller at the contracting session, with the former having the right to revoke the contract during a contractually specified period of time such that if the contract (1) proceeds, this initial payment composes a part of the total purchase price, and (2) does not proceed or if the purchaser fails to timely pay the balance due, the seller is entitled to retain the initial payment, or *urboun*.

This standard also address the *urboun* that is paid by lessees to lessors; buyers to sellers in *istisna'* contracts; the range of contacts in which *urboun* may be used and those in which it may not be used; whether *urboun* may be paid in kind or in cash or as usufruct (*manfa'ah*); how to determine *urboun* terms; the cases in which option of *urboun* becomes invalid; and whether it is permissible to stipulate reimbursement of *urboun* in specific cases as might be agreed on by the two parties.

The standard also sets out a ruling in the case of attached or separate increase in the subject matter and its yields during the contract term, in addition to the permissibility of tradability of *urboun* contracts. Finally, the standard presents some modern applications of *urboun* by IFIs.

### **SHARIAH STANDARD NO. 54: CONDITIONAL TERMINATION OF CONTRACTS**

Standard no. 54 covers the right to terminate a valid and binding contract on the basis of contractual stipulations whereby a party is given the right to terminate.



This standard does not, however, cover cases of expiration or termination in the absence of such a stipulation. As with the other standards, this standard defines termination, especially by way of stipulation.

It sets this termination apart from similar cases of termination, and provides a form of stipulating conditional termination, the ruling on termination stipulated by the parties to a contract, conditions of validity, and the cases where this right may be used, conditions of validity, and whether it is compulsory on the party with the right to terminate to notify the counterparty with termination.

The standard also describes cases in which termination is impermissible and the effect of termination, in addition to the ruling on attached or separate increase in the subject matter of the contract up to termination date.

It provides a general ruling on waivers of termination rights if termination was due to non-recurring damage, a ruling in case termination was due to recurring damage, and whether it is permissible to stipulate compensation for termination. Finally, the standard provides some modern applications of conditional termination by IFIs.

can maintain its support for growth and expansion of the international Islamic finance industry. In carrying out the standards development and revision program, AAOIFI will work with its institutional members and other industry stakeholders from all Islamic finance markets across the world. AAOIFI will also intensify its effort towards achieving wider adoption of its standards.

## MOVING FORWARD

AAOIFI is continuing its standards development and revision program — with development of a number of new standards and revision of existing standards — in order to ensure that the standards



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## COMMODITY MURABAHAH / TAWARRUQ: WHY REGULATORS MUST STOP ITS USE

**Sohaib Umar**

Central Bank of Bahrain



It was in 2013 that I became involved in a financing transaction between a bank in Africa and the Islamic window of a conventional bank in the GCC. A construction project needed financing and was already about 70 percent complete. Given the importance of the project and the urgency to launch, the African bank was willing to provide an attractive rate of profit to the financing bank. Senior managers at the Islamic window were quite enthusiastic at first, saying: “We can complete this transaction within a week”. I asked: “Which mode of financing are you planning to use?” “Commodity *murabahah*, of course,” was his reply. When I told him that the African country did not allow commodity *murabahah* (also called *tawarruq*) and that he would likely have to use *istisna* or some other structure, his disappointment was visible. “In that case it can take up to 6 months to complete the transaction. There will be a lot of work involved including assessing the bank’s risk and exposure, and answering questions from compliance and risk departments. Are you sure they can’t do commodity *murabahah*? It will be so convenient and so quick. We do it here all the time.”

The truth is that bankers everywhere prefer commodity *murabahah* precisely for these reasons — it is quick and convenient. But the most convenient route is not always the correct or the most appropriate. In fact, as this article will further unravel, commodity *murabahah* is an antithesis to everything we claim Islamic banking stands for, which is being linked to the real economy, purpose-based, risk sharing, discouraging unhealthy or excessive level of debt, and so on. Yet it remains the most popular product among Islamic bankers. According to some estimates, commodity *murabahah* assets account for an estimated US\$750 to 800

billion of the US\$1.7 trillion Islamic finance assets globally. It is the most widely-used product in Malaysia and Saudi Arabia, two of the largest Islamic finance markets.

### MURABAHAH AND COMMODITY MURABAHAH — NOT THE SAME

Let me first clarify an important point. *Murabahah* and commodity *murabahah* are not the same. These are two very different transactions with vastly different economic consequences. The confusion is sometimes created by the use of terminology as many Islamic banks call “commodity *murabahah*” transactions “*murabahah*”.

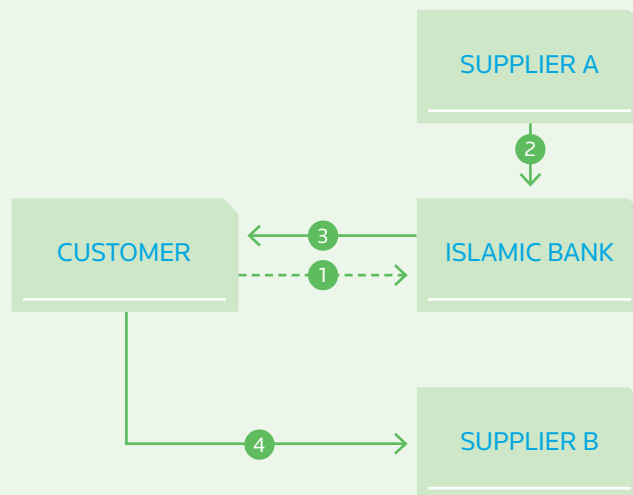
*Murabahah* is a genuine transaction in which a real economic need (e.g. purchase of raw material by a factory) is fulfilled by the Islamic bank by first purchasing the required item and then selling it onwards to the customer for a declared cost and profit, to be repaid over a period of time.

In commodity *murabahah*, another leg of the transaction is introduced whereby the customer sells the commodity onwards to obtain cash. In fact, there is no intention to purchase a commodity for use from the outset; the objective is to get cash, and to this effect, a commodity is used as a means to achieve the monetary objective. The entire transaction is typically “arranged” or “organized” by the Islamic bank.

### EXAMPLE OF A TYPICAL USE OF COMMODITY MURABAHAH

Personal finance is perhaps the most commonly used commodity *murabahah* application that

**Figure 1: Schematic of a commodity *murabahah*-based personal finance transaction**



concerns the average customer. In this account, for example, a customer needs US\$9,000 in cash for consumption purposes (e.g. to spend on marriage or holidays) rather than asset formation. He goes to an Islamic bank seeking the financing (step 1, Figure 1). Since the Islamic bank cannot lend money and charge interest, it has to involve a trade transaction to legitimately profit from it. So, for example, the bank buys diamonds (or whichever commodity) from a designated supplier (let's call him Supplier A) on cash for US\$9,000 (step 2) and sells the diamonds on credit the same day to the customer at a price of US\$10,000 (step 3) to be paid in one year. The customer then sells these diamonds to Supplier B for the market price of US\$9,000 in cash (step 4). The net result is that the customer receives US\$9,000 cash while the bank has a receivable of US\$10,000 from the customer which is to be paid after one year.

The various buy-and-sell contracts are signed almost simultaneously by the customer, the suppliers and the bank in one sitting and the dealings between the customer and the supplier are facilitated by the bank. The diamonds typically do not move an inch from the shop or store room where they were kept. A Shariah-compliant commodity *murabahah* transaction is thus completed.<sup>2</sup>

What is wrong with this transaction? Technically, nothing. After all, if a person needs cash and purchases a commodity from the market on credit and sells it in cash to fulfill his or her liquidity needs, no Shariah rule has been violated. Should Islamic banks then be allowed to facilitate and carry out these transactions? Absolutely not. Let me explain this seemingly paradoxical viewpoint.

## A MAJOR PUBLIC POLICY CONCERN

Allowing commodity *murabahah* is not, strictly speaking, an Islamic jurisprudential issue. It is rather a public policy or prudential issue and should be addressed as such.

The bigger question that regulators and other stakeholders of the Islamic finance industry must ponder upon is: What will be the implications on the system if we allow commodity *murabahah*? Will the overall harm caused by it outweigh its benefits? Shariah, as we know, does not permit whatever that will cause harm to society.

If the overall harm outweighs the benefits, then the mere fact that commodity *murabahah* is permissible by Shariah should not stop regulators from



disallowing it. After all, there are many prudential limits that are imposed by regulators in every country which are permissible in Shariah. For instance, a debt service ratio of 50 percent (based on one's monthly salary) can be imposed for individuals to discourage very high levels of financial leverage. In this case, there are no Shariah issues tied to a higher (or lower) ratio, as long as the financing obtained was Shariah-compliant. Regulators are also well within their right to impose this ratio if it is deemed important for the stability and health of the system.

## NEGATIVE EFFECTS OF COMMODITY MURABAHAH

Commodity *murabahah* has certain negative effects associated with it and poses some major risks to the financial system of a country. These are discussed below<sup>3</sup>:

1. **Disconnect between the real and the financial economy:** Commodity *murabahah* creates a disconnect between the real and the financial economy, unlike other Islamic financial products such as *murabahah* and *ijarah* which are unmistakably linked to asset formation in the real economy. A one-to-one correlation between real and financial economies is a hallmark of Islamic banking but commodity *murabahah* does not have this characteristic as there is no intention of using the commodity — it is simply a conduit for monetization.
2. **Debt accumulation out of line with economic growth:** A related point which is a natural consequence of the abovementioned disconnect is the piling up of debt as a result of commodity *murabahah*, which is out of line with the growth (or lack thereof) in the real economy. If debt is created without commensurate growth in the economy, there will be a negative wealth effect in the long run for the economy as a whole. This means that the average person in the economy will be poorer and the wealth will be redistributed in favor of the creditors (because the debts have to be repaid regardless).

3. **Outcome similar to interest-based system:** As we have seen in the example of commodity *murabahah*-based personal finance, the debt created is larger than the cash obtained. The use of commodity *murabahah* helps one fulfill the immediate cash need but how will he/she repay the debt? If the cash was obtained for consumption purposes then he would either have to draw upon his savings, sell an existing asset, or borrow more in order to repay this debt. None of these options is a happy scenario for the customer and would typically lead to a transfer of wealth to the creditor in the long-term. It is interesting to note that commodity *murabahah* is almost identical to the conventional interest-based system in terms of consequences — unfair, inequitable and eventually leading to instability in the system.<sup>4</sup>

4. **Rise in systemic risk due to unhealthy financial innovation:** In the banking industry, product development is a sensitive issue. Financial innovation, quite unlike scientific innovation, is not always a happy development for the financial system. In fact, each new financial product increases the overall risk of the system as it becomes more complicated. A single-product financial system is easier to regulate than a multi-product one.

We saw the results of unhealthy and irresponsible product innovation in the global financial crisis of 2008. Any new product should be allowed only if there is a strong case for financial value addition and fulfillment of customers' needs without jeopardizing the stability of the system. What financial value add is provided by commodity *murabahah*? Apart from generating liquidity for customers or banks, what economic activity does it generate, or how does it help in new asset formation?

5. **A parasite in the system:** The proliferation of commodity *murabahah* could hinder healthy innovation in Islamic finance as it is cheaper and not dissimilar to existing conventional products. Its parasitic growth, if left unchecked, can lead to commodity *murabahah* replacing

genuine existing Islamic financial products and making them redundant.

Indeed we have already seen it happen to some institutions and some countries, where commodity *murabahah* was initially used by Islamic banks for interbank transactions, then increasingly used for asset-side transactions (e.g. personal finance, auto finance, working capital finance) and eventually used in liability-side products as well (savings and investment accounts based on commodity *murabahah*). Even structured finance products and derivatives have been structured using commodity *murabahah*.

**6. A moral question:** In interbank transactions, commodity *murabahah* can, and does lead to a most unhappy situation whereby Islamic banks end up collecting the liquidity of the system and placing it with conventional banks through a commodity *murabahah* arrangement.

They cannot do so under *musharakah* or *murabahah* due to Shariah considerations that money can only be used for Shariah-compliant purposes.

However, there is no such restriction in a commodity *murabahah* transaction because in a sale purchase mode one cannot control the use of buyer's money by the seller. This has created an ethical and moral issue, which is: "Should Islamic banks be allowed to collect savings from small depositors in the name of Shariah compliance only to place it with conventional banks where it is used to expand the conventional banking business?"

**7. Frequent abuses:** The above negative effects hold true even if the proper commodity *murabahah* structure is followed including involving separate suppliers for the buyer and seller and other such measures recommended by Shariah scholars. We know, however, that abuse is commonplace in such transactions. Constructive or actual possession of the commodity is rarely obtained by the customer. The right sequence of buy/sell transactions is often not adhered to, potentially resulting

in Shariah violations that may or may not be captured due to the volume of transactions.

Some experts are of the opinion that commodity *murabahah* is linked to the real economy as the cash obtained through the transaction is inevitably pumped into the economy, thus generating economic activity. This is an invalid argument as the same can also be said about interest-based conventional banking loans, since the cash obtained in a conventional loan is typically used either for asset formation or for consumption purposes, and in either case it generates economic activity.

Yet it did not stop the creation of a global financial economy which at its height was more than ten times the size of the real economy globally.<sup>5</sup> The key point here is that if there is no one-to-one correlation between a real economy transaction and its corresponding financial economy transaction then the link between the two is broken, which can result in a financial bubble. This one-to-one correlation exists in all Islamic finance products except commodity *murabahah*.

## CAN ISLAMIC BANKING SURVIVE WITHOUT COMMODITY MURABAHAH?

Some question whether it is possible, in today's complex and highly integrated financial world, for Islamic banks to operate without a useful and cost effective instrument like commodity *murabahah*. Their argument is that liquidity management is the key to profit maximization of a modern Islamic bank and commodity *murabahah* is the ideal tool to achieve this.

There is no doubt that banning the use of commodity *murabahah* may result in some loss of profit for Islamic banks in the short- to medium-term but it is not an existential threat to them. We have two examples — Sudan and Oman — where commodity *murabahah* is not allowed. Perhaps the example of Oman is more relevant as it follows a mixed model, like the other GCC countries, where conventional and Islamic banks exist side by side.



Palace of Justice in Putrajaya, Malaysia



When Oman decided to introduce Islamic banking and finance in 2011-12 its regulations effectively prohibited the use of commodity *murabahah*. Today it has two full-fledged Islamic banks and six Islamic windows operating in the country. The rate of growth of Islamic assets has been among the fastest in the world, at approximately 6 percent market share in less than three years, and growing.

Islamic banks and windows in Oman struggled initially to cope in a no commodity *murabahah* environment but soon found an equilibrium and have been operating successfully since<sup>6</sup>. Indeed, closing the door to commodity *murabahah* compelled them to think about other modes, such as interbank *wakalah*, for their short-term liquidity needs.

With the expected issuance of a sovereign *sukuk* in the second half of 2015 the situation should improve even further with a secondary market coming into existence of a high quality liquid instrument. This demonstrates that commodity *murabahah* is not the essential or inevitable tool for liquidity management as some would like to argue, and that a country's Islamic banking system can achieve growth and sustainability without relying on it.

## IS SHARIAH REALLY NEUTRAL ON THE SYSTEMIC PROLIFERATION OF COMMODITY MURABAHAH?

Lastly, a few words on the position of Shariah on the concept of commodity *murabahah*. As mentioned above, purely from a juristic viewpoint there is not enough substance to unequivocally declare it impermissible because no apparent Shariah violation occurs in a typical, or "classical" commodity *murabahah* transaction. This, however, does not mean that there are no Shariah concerns at all. There are many reasons why Shariah scholars have been uneasy about the product, even though they may not have gone as far as to declare it prohibited.<sup>7</sup>

The OIC Islamic Fiqh Academy's landmark Resolution on *tawarruq* in 2009 (1430AH) was perhaps the most prominently published opin-

ions on the prohibition of *tawarruq* — going as far to say that it is haram.

The Resolution reads: "It is not permissible to execute both *tawarruq* (organized and reversed) because simultaneous transactions occur between the financier and the mustawriq, whether it is done explicitly or implicitly or based on common practice, in exchange for a financial obligation. This is considered a deception, i.e. in order to get the additional quick cash from the contract. Hence, the transaction is considered as containing the element of *Riba*."

I would also like to present the following points for the readers' consideration:

### 1. Quran's perspective on substance vs. form:

The Holy Quran repeatedly reminds us that the spirit and the substance of one's deeds is extremely important and cannot be sacrificed or be held inferior to the form or technical correctness.

"And those who avoid the worship of the idols and turn to Allah, for them is good news. So give good news to My servants, who listen to the Word (of Allah), then follow the best of it. Such are they whom Allah has guided, and such are the men of understanding" (39:17 & 18). These verses make it clear that Muslims are duty-bound to follow the right spirit of the law and the purpose for which it is intended. Instead, if the entire emphasis is on following the technical or legal form while carefully avoiding the spirit or substance of the law then this approach cannot be justified as "Islamic" or "Shariah-compliant" in light of the above verses.

**2. Ask your heart:** There is no doubt that at best commodity *murabahah* is a controversial transaction which is not preferred by most classical as well as contemporary Shariah scholars. Prudence demands that such a doubtful transaction is not encouraged on a system-wide level as it may lead to shaking up the very foundations of Islamic finance and/or people may start questioning its basis.

Avoidance of doubt is very much a religious attitude as we find in this Hadith by Wabisah bin Ma'bad: "I went to the Messenger of Allah and

“

*The tremendous growth in the use of commodity murabahah transactions makes it incrementally more difficult to stop its use and roll it back in the markets where it is already established.*

”

he asked me: ‘Have you come to inquire about piety (righteousness)?’ I replied in the affirmative. He said: ‘Ask your heart regarding it. Piety is that which contents the soul and comforts the heart, and sin is that which causes doubts and perturbs the heart, even though people have given their legal opinion [in its favor] again and again.’ (Ahmad and Ad Darmi, and also mentioned in 40 Hadith Nawawi no. 27)

**3. Mafasid / Masalih consideration and Sadd-e-Zari’a:** The consideration of *masalih* (benefits) and avoidance of *mafasid* (harms) of a policy or tool for the overall economy or society has been an integral part of the jurisprudential discussions and debates since the early Muslim era.

As Ibni Qayyim puts it, “Everything that lapses out from justice into injustice, and from mercy to its opposite, and from Maslahah to Mafsadah, and from wisdom into the frivolous, does not belong to Shariah, even if it is inducted into it by interpretation (ta’wil).” (I’lam Al Muwaqqin., Egypt, Matbaa Muniriyah, volume 3, page 1, also see volume 4, pages 309-11).

“Sadd-e-Zari’a” is a widely acknowledged Shariah principle which is used in cases where something, while being halal itself, causes to create something else that is against the higher objectives of Shariah. Also in Shariah, as in public policy, if something is proved to be harmful for society as a whole its benefits for individuals are ignored.

Commodity *murabahah* for individual cases (especially when interest-free loans are not easily available) may find some justification among some quarters but making it into a legitimate banking product and its institutional system-wide promotion can only be allowed if there is enough evidence to suggest that its benefits outweigh its harmful effects. To date, the experience suggests the opposite (as mentioned earlier in this article) — that its harm far outweighs any positive impact it may have in individual cases.

**4. Islamic financial system — real or cosmetic:** Common sense demands that if the Islamic economic and financial system is different from the conventional system then these differences ought to be real and tangible rather than cosmetic and technical. After all, every system is based on certain higher objectives whose fulfillment is the primary goal of that system.

If the difference between the Islamic and the conventional systems is diluted or blurred the very basis of the former will be (rightfully) challenged. Commodity *murabahah*, more than any other product, is diluting this difference<sup>8</sup>. Not only bankers but customers also realize as soon as they engage in a commodity *murabahah* transaction that it is merely a cosmetic exercise they are indulging in while the essence is strikingly similar to a conventional loan transaction.

The tremendous growth in the use of commodity *murabahah* transactions makes it incrementally more difficult to stop its use and roll it back in the markets where it is already established.

Regulators and central banks around the world would do well to act now and restrict any new commodity *murabahah* transactions as a matter of public policy in the interest of the industry's reputation and the public at large. A phased approach can be adopted to let the industry unwind the existing commodity *murabahah* portfolios over a reasonable time period. If, on the other hand, the status quo is allowed to continue, we should all brace ourselves for a systemic shock in the not-too-distant future.

#### ENDNOTES

- 1 The terms commodity *murabahah* and *tawarruq* are used interchangeably in this article.
- 2 When the positions are reversed and the Islamic bank is the one seeking financing the transaction is sometimes referred to as Reverse *Murabahah* or Reverse *Tawarruq*.
- 3 This section draws heavily from the excellent paper written by Dr. Mohammad Nejatullah Siddiqi on "Economic of *Tawarruq*" dated 1 February 2007.
- 4 "The Case Against Interest: Is it Compelling?" by Dr. M. Umar Chapra, Research Advisor, Islamic Research & Training Institute (IRTI), Islamic Development Bank.
- 5 According to Independent Strategy (<http://www.instrategy.com/>), a UK-based independent consulting firm power money and broad money accounted for 115% of the world's GDP in 2007, but after the inclusion of securitized debt and derivatives this figure increases to over 1000%. In other words, securitized debt and derivatives contributed to 90% of global liquidity.
- 6 In a 2014 Thomson-Reuters study of Oman Islamic banking industry Oman's central bank chief Mr. Hamood Sangour was quoted as saying: "To the credit of Islamic banking providers in Oman, they have managed to operate successfully given the constraints they face in the interbank market."
- 7 Amongst the classical scholars we find that Ibne Taimiyya was opposed to *Tawarruq*. His student Ibne Qayyim says the

following about his teacher's attitude towards *Tawarruq*: "...and our teacher (God bless his soul) forbade *Tawarruq*. He was challenged on that opinion repeatedly in my presence, but he never licensed it (even under special circumstances). He said, 'the precise economic substance for which *Riba* was forbidden is present in this contract, and transaction costs are increased through purchase and sale at a loss of some commodity. Shariah would not forbid a smaller harm and permit a greater one!'" (Ibne Taimiyya Al Fatawa Al Kubra — selected scholarly opinions — Sale, *Riba*)

- 8 In principle, other similar products used for the purpose of monetization, for example Share *Murabaha*, also fall in this category but the extent of regulatory concern with each may differ based on the specific product structure and its impact on the financial system.

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## ISSUES IN THE IMPLEMENTATIONS OF STANDARDS ACROSS JURISDICTIONS

**Dr Zulkifli Hassan**  
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Despite tremendous development and achievement, Islamic finance faces difficulties in maintaining growth momentum through its existing framework and practices.

While acknowledging the advantages and viability of Islamic finance, the International Monetary Fund (IMF) has reminded Islamic financial institutions (IFIs) of the need to tighten rules and comply with standards and regulations more consistently<sup>1</sup>.

This strong message from the IMF indicates that Islamic finance must seriously consider the adoption of global standards for the purpose of consistency and to ensure financial stability.

Islamic finance must ensure that operations comply with globally acceptable standards issued by international standard-setting agencies such as the Basel Committee for Banking Supervision (BCBS), the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) to remain competitive and efficient.

### STANDARDS FOR ISLAMIC FINANCE

There are various standards relevant to IFIs. The first category of standards refers to universally accepted global standards, which are applicable to both conventional and IFIs such as the accounting standards set by the International Financial Reporting Standards (IFRS), the International Accounting Standards Board (IASB), and the corporate governance standards issued by the BCBS, the Organisation for Economic Co-operation

and Development (OECD), the World Bank, the Global Corporate Governance Forum, the Commonwealth Association of Corporate Governance.

The second category refers to standards exclusive to IFIs, namely accounting and auditing standards, governance standards, ethics standards and Shariah standards issued by the respective Islamic finance standard-setting agencies such as AAOIFI and the IFSB.

As Islamic finance has proven its potential and evolved into various economic sectors in numerous jurisdictions including in cross-border transactions, the harmonization of these standards is necessary to drive the industry to be more competitive and efficient.

As compared to conventional financial institutions, IFIs bear an additional responsibility to comply not only with global financial standards but also to meet the requirements of the standards set by the specific Islamic finance standard-setting agencies.

In other words, it will be harder for IFIs to compete with conventional financial institutions, as they have to comply with additional necessary standards issued by AAOIFI and IFSB. Another hurdle refers to the several inherent issues on the existing Islamic finance standards such as the weaknesses of the AAOIFI standards, which may stifle future growth and impede innovation in Islamic finance.

### WHY DOES ISLAMIC FINANCE NEED STANDARDS?

While acknowledging the difficulties and constraints to comply with respective Islamic finance-

**TABLE 1: THE RELEVANCE OF ISLAMIC FINANCE STANDARDS ACROSS JURISDICTIONS**

Stakeholders	Objectives
Regulators	<ul style="list-style-type: none"> <li>■ A coherent framework to be used in handling Islamic finance and to limit the divergence in available Islamic finance practices.</li> <li>■ To manage risk relevant to Islamic finance and to promote harmonization and convergence of Shariah principles</li> <li>■ To improve competitiveness <b>through setting best practice standards.</b></li> </ul>
IFIs/ Shareholders/ Investment account holders	<ul style="list-style-type: none"> <li>■ To promote transparency and high fiduciary standards for the safety of all key stakeholders</li> <li>■ To maintain expectations and confidence in the overall financial service system</li> </ul>
Customers/Depositors	<ul style="list-style-type: none"> <li>■ To expect competitive price and return, efficient services and to avoid unnecessary cost through standardization.</li> </ul>

specific as well as other standards, undeniably, those standards bear benefits and advantages. The need to implement certain standards in Islamic finance can be justified from different perspectives.

Table 1.0 summarizes some reasons why Islamic finance needs global standards.

With the current development and potential growth of Islamic finance in the future, if IFIs want to compete with the mainstream global financial industry, they have no option except to improve their practices through the adoption and implementation of necessary standards.

Without standardization, Islamic finance will face difficulties in spreading its products and services across the world considering the diversity of legal systems and different schools of Islamic law.

Such standards will improve transparency and foster credibility of IFIs as well as harmonize Islamic finance practices by mitigating the divergences of Shariah interpretation between regions and institutions. These measures are important in broadening the appeal of Islamic finance across jurisdiction.

## ISSUES IN THE IMPLEMENTATION OF STANDARDS

Despite its positive growth, in reality, Islamic finance across jurisdictions faces numerous challenges. In order to promote uniformity, consistency, transparency and of best practice standards, most countries that implement Islamic finance have required IFIs to comply with the standards issued by standard-setting agencies such as AAOIFI and IFSB.

### The Adoption of the Standards

The primary issue with the implementation of standards refers to the lack of legislative accommodation for the adoption of the required standards. Even with the understanding that standards are necessary for Islamic finance, only a small number of countries have adopted IFSB guidelines and AAOIFI standards and some jurisdictions only use them as references without making them compulsory.

The standards are not binding in many jurisdictions and they are not backed by any legal sanction. As a result, many IFIs still use standards applicable to conventional financial institutions

and some IFIs adopt a combination of Islamic finance and conventional standards.

In jurisdictions where the standards are mandatory, the level of compliance is still questionable. The failure of IFIs to adopt specific Islamic finance standards may raise significant issues, as conventional methods do not address the practical concerns of Islamic finance such as different applications of Islamic financial products and services.

### Interpretational Approach

Different interpretational approaches remain a significant issue in the implementation of Islamic finance standards, particularly Shariah standards. Various *fatwa*-related bodies such as the International Islamic *Fiqh* Academy of the OIC, the *Fiqh* Council of the Muslim World League, *Shariah* board of the AAOIFI and national and state *fatwa* institutions raise an issue as to whether there is any global Shariah standard.

Some *fatwa* bodies in certain countries apply stricter interpretations while other jurisdictions employ more flexible interpretations. This can be seen in the case of rulings on organized *tawarruq* and fees on *kafalah*-based products.

Internationalization and the development of the Islamic finance industry in various jurisdictions with varying legal environments and different schools of Islamic law further contribute interpretational issues in Islamic finance practices. Different interpretations negate interest for standardization in Islamic finance practices.

### Inconsistent and Outdated

As a general rule, the standards must be universal and consistent if they are to be globally accepted. The standards issued by Islamic finance standard-setting agencies such as AAOIFI may differ from the standards issued by more established global bodies which may deflate the confidence of the market.

Additionally, to a certain extent existing AAOIFI and IFSB Islamic finance standards have different applications and are inconsistent to one another.

Another issue refers to outdated Islamic finance standards. Some standards, such as AAOIFI Governance Standards, have not been reviewed or updated after many years.

The issue of conflict of interest and scholars sitting on multiple boards were not addressed appropriately in the existing AAOIFI Governance standards. The objective of harmonizing and standardizing Islamic finance practices will not be realized if the available standards are not updated and reviewed regularly.

### Different Levels of Islamic Finance Practices

Another challenge for the implementation of AAOIFI standards and IFSB guidelines is the different level of Islamic finance practices and maturity of the market.

There are differing standards of Islamic finance practice among countries, including different levels of experience and knowledge of financial regulators and IFIs.

The adoption of standards may be appropriate in certain countries that already have advanced Islamic finance infrastructures but not to newer players, including IFIs in secular legal environment jurisdictions. The adoption of Islamic finance standards may not be suitable in new markets due to certain regulatory environments and frameworks, including tax regimes.

### Governance

Governance issues are also relevant. Scholars on AAOIFI's Shariah board also sit on many IFIs that adopt AAOIFI standards and these same scholars are, at the same time, members of other *fatwa*-issuing bodies such as the OIC Islamic Fiqh Academy. These same Shariah scholars are being paid by IFIs that adopt the standards endorsed by them.

Shariah scholars who sit on the Shari'ah board of the standard-setting agency have been accused of issuing different and conflicting views on certain issues and the same product.

From the governance dimension, this raises the issue of conflict of interest or lack of independence. As the body that sets the standards for

IFIs AAOIFI's Shariah board is expected to be independent. This is important to nurture confidence and ensure transparency in the overall application of the standards.

## THE WAY FORWARD

Many countries have extensively facilitated the implementation of Islamic finance by enhancing their policies to suit domestic and global market behaviors. With the understanding that strong, efficient, consistent and robust Islamic finance practices must balance with a certain degree of flexibility, the respective financial authorities must consistently enhance and improve the Islamic finance framework through the adoption of Islamic finance standards. The implementation of these standards is expected to ensure conformity and consistency across jurisdictions.

The implementation of Islamic finance standards in jurisdictions such as Malaysia is working well and we can clearly witness the industry's development in terms of growth in market share and banking assets, as well as the increase of domestic and global players.

However, the full adoption of standards in some countries may not be appropriate due to several factors, including the interpretational approach, inconsistency with global standards and different levels of Islamic finance practices.

The respective Islamic finance standard-setting agencies, together with IFIs and regulatory authorities, must address the current shortcomings in the available standards through continuous review and updates of these standards.

As the Islamic finance market is still relatively small, Islamic finance players have no other option but to venture into the bigger global market and compete with more attractive and universally accepted products and services. In this regard, the adoption and implementation of universally accepted global Islamic finance standards is therefore no longer an option but an obligation.

### ENDNOTE

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# SHARIAH STANDARDS: FROM CONCEPT TO CONDUCT

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Financial institutions and issuers which offer, or wish to offer, Shariah-compliant financial products and services will generally need to obtain the opinion of Shariah scholars. The importance of standardization of Shariah opinions cannot be overstated.

Leaders and experts around the globe have long called for a standardization of Shariah opinions including rulings and interpretations across various jurisdictions as the benefits are enormous, particularly for supporting the integration of Islamic finance as a mainstream industry within the global financial system. Managing the processes of standardization, however, is by no means a great feat.

Independent Shariah advisors or scholars representing Shariah Supervisory Boards (SSB) are responsible for issuing opinions that financial products, services or securities offered are Shariah-compliant. Rightfully, scholars' opinions are based on their individual understanding and application of *fiqh* (body of Islamic law and jurisprudence), which naturally can lead to differences of opinion, particularly when *fiqh* is applied to complex and sophisticated modern financial products.

Differences in opinion are just one of the many factors as to why standardization in Shariah still remains amongst the key Islamic financial sector infrastructure priorities. Other factors include the lack of clarity on prudential requirements, accounting requirements and consistency in Shariah documentation. Lack of standardization has led to the Islamic finance sector remaining

fragmented with large divergences in processes, procedures and practices.

## INTERNATIONAL EFFORTS

Supranational organizations focused on standardization in Islamic finance are (in no particular order of importance): the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the Islamic Financial Services Board (IFSB), the International Islamic Financial Market (IIFM), and the Organisation of Islamic Cooperation Fiqh Academy (OICFA).

However, despite their commendable efforts, challenges in terms of issuing as well as implementing any new Shariah standards still remain.

Alongside these standards-setters, regulators are also keen on standardization as they want to roll out a predictable regulatory framework that is closely aligned with international best practices to ensure stability of the industry, sustainable growth, and a structure that supports regulatory oversight.

From a market player's perspective, the efficiency of doing business globally, reduction of transaction costs, and greater investor confidence are amongst the benefits they reap if the regulatory framework is predictable.

In addition, convergence in Shariah opinions across jurisdictions also ensures that the Islamic financial sector can keep up with intensifying competition from the conventional financial marketplace.



*To help scholars resolve their differences of opinion or address any sensitivity, regulators and market participants would have to frequently engage with each other to ensure each is provided sufficient information and detailed technical guidance, or be informed of the risks associated with non-convergence.*



## ISSUANCE PROCESS

Standardization of Shariah rulings is a complex process. If there are differences in opinions, dissenting scholars might be expected to work towards a consensual decision even though they are entitled to arrive at their own independent opinion.

This could be perceived as if one school of Islamic jurisprudence prevails over another. This is also challenging for scholars because each school of jurisprudence has established *fiqh* rules through strict and concerted efforts demanded by the *ijtihad* process, which essentially means every rule in *fiqh* on its own must be sound even if some may differ from others on an identical issue.

Thus, the collaboration of scholars is the fundamental and most delicate part of the Shariah standardization process.

To help scholars resolve their differences of opinion or address any sensitivity, regulators and market participants would have to frequently engage with each other to ensure each is provided

sufficient information and detailed technical guidance, or be informed of the risks associated with non-convergence. In turn, this helps the scholars justify and arrive at appropriate solutions acceptable to all so as develop standards that are acceptable internationally.

## TIMING

Timing of the issuance of Shariah standards is also an important factor.

If standards take too long to be agreed or to issue to market, the Islamic finance sector may fail to benefit fully and there would be a smaller appetite to harmonize national-level laws and regulations with Shariah standards.

A good example of this is the development of standards for Islamic derivatives. Not too long ago the development of standards for Islamic derivatives was lagging behind other standards issued for different types of Islamic instruments. This led to the derivative market being fragmented as some jurisdictions were already using their own national solutions to advance the growth of

the Shariah-compliant derivatives market, such as those developed in Malaysia.

Therefore, the various stages of developing standards, such as gathering detailed information on issues, setting the agenda, deliberations by scholars, developing and publishing standards for consultation, publication of standards and technical guidance on implementation issues would have to be managed efficiently, simplified, and reviewed from time to time.

Periodically benchmarking helps with this task, in particular against the well-established methodologies for developing international standards such as those adopted by the International Accounting Standards Board (IASB), Basel Committee on Banking Supervision (BCBS), International Organisation of Securities Commissions (IOSCO), International Association of Insurance Supervisors (IAIS), and others.

## IMPLEMENTATION

While Shariah standards are welcome in the marketplace, they are not always binding. To be binding, the standards must be adopted and for this regulators often take time to harmonize their national laws and regulations to converge with the standards issued. This is because some jurisdictions may have long-established laws and regulations which are complex in nature and the length of time to go through their respective legislative processes to effect any new changes might involve extensive debate and public consultation.

Implementation may be subject to other constraints such as the Shariah framework adopted by the regulators (i.e. centralized Shariah advisory body or otherwise), or the political or economic constraints of jurisdictions.

Malaysia, through the Central Bank of Malaysia Act 2009, for example, strengthened the role and functions of the Shariah Advisory Council of Bank Negara Malaysia (SAC) to accord the SAC the status of the apex authoritative body on Shariah matters pertaining to Islamic banking, takaful and Islamic finance. The role of the SAC

was further reinforced with the introduction of the Islamic Financial Services Act 2013.

In the UAE, the Dubai International Financial Centre adopts a Shariah systems regulator approach. This places the onus of compliance with Shariah matters on the firms by ensuring they have adequate systems and controls to monitor, audit, and disclose Shariah matters.

These differences in approaches can be further compounded by the relative novelty and complexity of the Shariah-compliant products themselves.

Regulators, SSBs, centralized boards and other industry stakeholders would have to be engaged not just at the planning stage but right through implementation. Factors to look into include implementation strategies, plans to raise awareness amongst key stakeholders, providing detailed technical guidance to the stakeholders and identify impediments to implementation such as costs and resources, where necessary. This would help ensure the implementation process is managed smoothly and efficiently.

Another critical factor that regulators would normally consider is whether Shariah standards issued for implementation will properly address issues that cannot adequately be resolved under conventional standards or regulations.

The International Organization of Securities Commissions (IOSCO) core principles, for example, generally apply to Islamic securities as they do to conventional securities. Thus, Shariah standards development would have to be developed on specific risks of securities issuance that are not readily addressed by IOSCO.

An example would be risks arising from the use of one or a combination of Islamic contracts. By confining strictly to the specific Shariah risks, there will not be any inconsistency between Shariah and conventional standards or regulations that apply to all securities or financial products.

Particularly, the effectiveness of implemented standards would be improved if key stakeholders periodically published the results of their post-im-

plementation reviews and take actions where necessary. There may be contentious issues with implementation, which standard-setters would want to know about, particularly vis-à-vis the practical problems from the perspective of each key stakeholder, or if there was any unanticipated cost or resource implications to the stakeholders. Any proposed solutions following such a survey would have to be publicly consulted to allow ample time and room for stakeholders to provide suggestions and feedback for improvement.

If there is certainty that a particular product approved by one SSB will be accepted globally, Islamic banks and financial institutions will be encouraged to develop more standardized products or new products through research and innovation. This would in turn help them foster and embrace innovative business models, including new technologies and delivery channels, and help them grow and foster collaboration among regulators and supervisors of the countries that offer Islamic financial products. These are some of the milestones set out in the World Islamic Banking Competitiveness Report 2014 -2015 to measure the progress of the Islamic finance sector.

There is no doubt that Shariah standardization is the way forward and it is the prerequisite to achieve future milestones for the Islamic finance industry but there are challenges that lie in the standardization processes that would have to be managed delicately, efficiently and comprehensively.

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**PART 3**

# Shariah Trends in Recent *Fatawa*

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# SUMMARY

It is imperative for practitioners and scholars to take note of the historical and theoretical perspectives of standardization if they want to understand reasons behind diverging views and fatwas taken by central banks as well as other regulators in matters pertaining to Islamic financial transactions.

In light of this, this Section briefly delineates two well-known historical occurrences of codification, namely the *al-Fatawa al-Hindiyyah* during the reign of the Muslim Moghul emperor Aurangzeb Alamgir and the *Majallah al-Akham al-Adliyyah* by Hanafi scholars during the Ottoman Empire. Readers will learn that the demand and impetus for standardization as well as views against it are not at all novel in Muslim history. Hence, this Section examines whether the resolutions issued by various *fiqh* academies and standards issued by the standard-setting bodies on Islamic commercial transactions should be codified and made legally binding. To achieve this, however, requires careful scrutiny in light of present-day contextual realities and practices of the industry.

Some recent *fatwas* and resolutions on various Shariah issues in Islamic finance are deliberated in this Section. This Section examines the tradability of “blended” *sukuk*, i.e., trading of asset portfolios comprising a mixture of debt and tangible assets. Readers will learn a useful overview of the Islamic rules regarding the issue along with a detailed discussion of the principles of predominance (*ghalabah*) and subordinacy (*tab’iyyah*), among others.

The Section also discusses the issue of beneficial ownership in the asset based-*sukuk* where *sukuk* holders lack recourse to the assets and depend on credit worthiness of the obligor in order to validate their purchase and participation in the income stream, rather than the use of asset-backed models that depends on asset performance. The concept of beneficial ownership itself has raised many questions. Foremost among these is whether the concept of beneficial ownership exists or maybe recognized under the Shariah, regardless of its basis in common law.

Taking up the subject of preference share, this Section highlights divergent opinions on the issue. While the majority of scholars disallow preference shares due to the elements of fixed dividends and priority in profit distribution upon liquidation, some quarters of scholars argue that non-cumulative preference shares are permissible. Their argument is based on the basis that the holders of ordinary shares willingly waive their rights (*tanazul*) to the holders of preference shares over the profit distribution or capital claim in the event of liquidation.

Finally, this Section takes up the timely subject of spot foreign exchange (FX-i) transactions, where important issues such as ownership and possession of currencies and hand-to-hand delivery requirement of them are discussed. Given the fact that foreign currencies are located in nostro accounts in different jurisdictions with different time zone, infrastructure and settlement facilities, it is argued that the fulfilment of the hand-to-hand delivery requirement would impose significant difficulty.

## THE CODIFICATION OF RESOLUTIONS OF FIQH ACADEMIES AND STANDARD-SETTING ORGANIZATIONS

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An issue that was recently raised asks whether the resolutions of *fiqh* academies and international bodies that issue Shariah standards should be codified and made binding. This has occurred in the context of the development of governance principles for Islamic finance institutions and the movement of Islamic finance to an advanced position in which it can compete with conventional finance on international levels. Shariah scholars have taken diverging positions on whether these resolutions and standards should be codified and made binding. The same holds true for central banks and Shariah organizations in Muslim countries. This article presents a brief explanation of this issue within its theoretical framework.

### THE HISTORICAL DEVELOPMENT OF CODIFICATION OF THE SHARIAH

The earliest attempt to codify *fiqh* — without consideration of [modern] legal forms — was *Al-Fatawa al-Hindiyyah*, when the Muslim Mughul emperor Aurangzeb Alamgir commissioned a dozen scholars to compile the views considered most correct in the Hanafi School — the sanctioned *fatwas*.

This was followed by the *Ma'rudat* of Abu al-Sa'ud al-'Imadi, the chief mufti of the Ottoman State. They were his *fiqh* choices in the form of edicts endorsed by Sultan Sulayman. Judges were obliged to render judgments consistent with them. They were compiled by Ibn 'Abideen.

The original is in Turkish and has been translated into Arabic, but it has not yet been published.

Jurists did not oppose these projects because they considered them an extension of *fiqh*, selecting certain views to be preferred as dictated by conditions of time and place. These were not called laws (*qanun* in Arabic), even though jurists had used the term *qanun* in the field of *usul al-fiqh* (the principles of jurisprudence), and one jurist had named his book *Al-Qawanin al-Fiqhiyyah* (literally, *The Jurisprudential Laws*). No weight need be given to the sensitivity some have expressed about using the term *qanun* and its derivatives and their preference for the term *nizam* (which can also be translated as law or statute).

### MAJALLAT AL-AHKAM AL-'ADLIYYAH

The *Majallah* (also spelled “*Mejelle*”) was the first codification project that was truly comprehensive and systematically organized, presenting issues in a numbered paragraph format.

It starts with a hundred legal maxims having the status of comprehensive laws and then discusses every chapter of financial transactions, and the rules of litigation and evidence, among others. It was prepared by a committee of jurists as per the views of the Hanafi School and was implemented in all the lands of the Ottoman State except Morocco and Egypt. This is mainly because the Maliki School was dominant in Morocco. In Egypt, which enjoyed autonomy under the Ottoman State, its Justice Minister, Muhammad Qadri Pasha, prepared a legal code for financial transactions titled *Murshid al-Hayran ila Ma'rifat Ahwal*

*al-Insan*. While it was not issued officially, it was implemented in practice.

Some of those who participated in the preparation of the *Majallah* wrote commentaries on it, as did others. These include the commentary of al-Attasi and that of Rustam al-Baz. There are also commentaries on its legal maxims such as the commentary of Shaykh Ahmad al-Zarqa, the father of Shaykh Mustafa. The *Majallah* continued to be implemented until it was replaced by civil law (in Syria, Iraq, Jordan) and by the Lebanese legal code (*al-Mujibat wa al-'Uqud*). It remains in effect in Palestine.

The only major criticism to be made of it is that it is derived from the Hanafi School and excludes the views of the other juristic schools. Among its positive features are that it pays considerable attention to definitions, which are placed at the

beginning of each chapter, and it provides numerous practical examples.

## ADOPTION OF THE RESOLUTIONS OF THE FIQH ACADEMIES AND STANDARD-SETTING ORGANIZATIONS

The resolutions of the *fiqh* academies (the International Islamic Fiqh Academy of the Organization of Islamic Cooperation (IFA-OIC), the Islamic Fiqh Academy of the Muslim World League (IFA-MWL), the Islamic Research Academy of Egypt, the Fiqh Academy of Sudan, etc.) are not accompanied by any edicts that make them binding.

However, they are considered authoritative by academics and researchers because they come from groups of qualified jurists who benefit from



*The issue of Shariah resolutions and standards being codified and legally binding is a sensitive one. It requires careful study to bring to light the means of realizing it in the actual practice of Islamic finance.*







> A man wearing an Islamic prayer cap, or "Kufi", looks at Islamic books on display at a bookshop located in the western Sydney suburb of Lakemba October 3, 2014. REUTERS/ David Gray



the input of experts in a variety of technical disciplines. They resemble collective *ijtihad* (the exercise of independent juristic reasoning).

As for the Shariah standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the parameters and standards issued by the Islamic Financial Services Board (IFSB), they have been made binding by certain central banks in their capacity as bank regulators.

This is the case in Bahrain, Lebanon, Pakistan, Sudan, and Syria. Some other jurisdictions, such as Malaysia, Saudi Arabia and the United Arab Emirates, have issued recommendations to observe them or have issued congruent guidelines.

Some Islamic banks have adopted AAOIFI Shariah Standards voluntarily because their Shariah committees endorse them.

These standards have thus become a common reference and a means for synchronizing the products of those banks.

It should be noted that the Shariah Council of AAOIFI takes the resolutions of the IFA-OIC into consideration for the countries to which these resolutions are relevant. The Shariah Standards have been translated into a number of languages (English and Turkish, and they are currently being translated into French). In case a clause mentions implementation of the Shariah in a contract, it means that it should be consistent with the AAOIFI Shariah Standards. This is in order to avoid fractal differences of opinion on *fiqh* issues and to prevent the adoption of anomalous permissive opinions.

## SHOULD SHARIAH RESOLUTIONS ON ISLAMIC FINANCIAL MATTERS BE CODIFIED?

In summation, the attempt to codify the Islamic laws of financial transactions is a recurring phenomenon in Islamic *fiqh*.

It began with the attempt to arrange certain Islamic laws in a systematic way, as in works like *Al-Qawanin al-Fiqhiyyah*. It then moved to collecting various *fatwas* and placing them in statutory frameworks that were sometimes made binding. It then took the form of resolutions issued by *fiqh* academies and standard-setting bodies that provided intellectual infrastructure for Islamic financial institutions.

These were made binding in some countries while they were recommended in other countries. Some countries decided to issue local standards that take into account the specific conditions of their own financial systems.

The issue of Shariah resolutions and standards being codified and legally binding is a sensitive one. It requires careful study to bring to light the means of realizing it in the actual practice of Islamic finance.



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# THE CONCEPT OF BENEFICIAL OWNERSHIP: HIGHLIGHTS ON SHARIAH ISSUES IN ITS APPLICATION IN ISLAMIC FINANCE

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The concept of beneficial ownership has long been established in Anglo-American common law through the development of trust law aiming at distinguishing beneficial ownership from legal ownership. Unlike the common law, civil law does not have provisions for trust that forms the basis for the introduction of beneficial ownership in common law. Today, as Islamic banking and finance grows exponentially, the issue of beneficial ownership has become the centre of debate, among many stakeholders particularly Shariah scholars who are points of reference on the Shariah compliance of all activities of Islamic banking and finance. Despite much attention given to this issue gaps remain.

This article examines beneficial ownership focusing on its characteristics and attributes in Shariah. It also examines selected Shariah concepts that share similar attributes of beneficial ownership under English common law.

## CATEGORIES OF OWNERSHIP (MILKIYYAH) IN SHARIAH

There are two types of ownership in Islamic law: absolute ownership that enables one to dispose an asset by sale or by gift, and partial ownership that gives the following: (i) title ownership right only to the asset (*milkiyyah al-raqabah*) [without ability to dispose]<sup>1</sup>; or (ii) the ownership of benefit/usufruct (*milkiyyah al-manfa'ah*); or (iii) the ownership right to personal benefit

(*milkiyyah al-intifa'*) such as the right to use the water in the river.

Ownership in the Shariah has two main subject matters, namely *al-'ayn* or *al-raqabah* (the asset itself) and *al-manfa'ah* (benefit/usufruct). The former can be tangible, intangible, movable or immovable. The latter includes certain benefits of a specified item, such as the usufruct of machinery, a leased building, or returns on *waqf* assets.

## ATTRIBUTES OF OWNERSHIP FROM THE SHARIAH PERSPECTIVE

Both absolute ownership and partial ownership are subject to two main attributes: liability (*al-daman*) and benefit (*al-manfa'ah*). An owner, be they a beneficial or absolute owner, is responsible to manage what they own and bear related risks. They are equally allowed to enjoy the benefit of what they own. The Shariah basis for the two attributes is a *hadith* reported by Ibn Abi Shaybah and Abdul Razzaq: "The *rahn* asset (pledged collateral) should not be taken away from its original owner, to whom its benefits and risks belong."

## SHARIAH CONTRACTS RELATED TO BENEFICIAL OWNERSHIP

*Waqf* is an Islamic endowment in which one donates the corpus of certain property in favour of beneficiaries. *Waqf* entities present the concept



*Although the Shariah recognises the concept of beneficial ownership, as applied in the context of sukuk issuance for example, the issue lies in the restriction placed on disposition of the sukuk asset in the case of default or maturity.*



of dual ownership, namely title ownership and beneficial ownership.

*Waqf* beneficiaries own only a beneficial interest in the *waqf* asset, while the trust manager/administrator (*nazir al-waqf*) holds the assets in the interest of the beneficiaries.

In common law, a trust acts like a *waqf* with ownership bifurcated. The trust owns the assets in question that are administered by a trustee, who has fiduciary duty to administer trust property for the beneficiaries' interest, who in turn, hold beneficial ownership in the trust assets.

Unlike *waqf*, in a common law trust, the beneficial owner is the true owner of the asset, depending however on what is specified in trust documents. For instance, such documents might specify that only income generated by the trust assets is payable to the beneficiaries. On the other hand, it may be specified that the trust property is upon some event to be transferred to the beneficiaries.

Similarly, *ijarah* and *i'arah* contracts provide a lessee and borrower with a beneficial interest, while title to the asset remains with another person as practised in common law. While *ijarah* involves *tamlik al-manafi' bi 'iwaq*, which means transferring the beneficial ownership of the asset in return for commission, *ijarah* involves a transfer of the beneficial ownership without fee.

Apart from *waqf*, *ijarah* and *i'arah*, other contracts related to the question of beneficial ownership are *washiyyah* (bequest of benefit), *hakar* (long-term lease), and *al-'adl* (administrator of collateralized asset).

## APPLICATION OF BENEFICIAL OWNERSHIP IN ISLAMIC FINANCE

### Sukuk Issuance

In the sukuk context, the issue of beneficial ownership arises from the transfer of sukuk assets usually by way of sale or lease and transfer of



contractual interests by way of either assignment or novation or a trust declared over the assets.

For instance, in most asset-based sukuk, for example *sukuk ijarah* structures, the originator holds legal title and transfers the beneficial ownership of the asset to a Special Purpose Vehicle (SPV).

Meanwhile, in asset-backed sukuk where there is a “true sale”, the asset is fully sold to the SPV, hence, sukuk holders have recourse to the asset.

However, in asset-based sukuk, their recourse is not to the assets. In such cases, the originator or the SPV typically undertakes to purchase the beneficial ownership of the asset from sukuk holders in the event of default or upon maturity. The beneficial right of sukuk holders over the asset is subject to Principal Terms and Conditions (PTC). The PTC may restrict the right of sukuk holders to dispose the sukuk asset in the event of default.

Critics question the validity of the transaction given the absence of legal title and the presence of a purchase undertaking, which cause the sale to be quite similar to a *riba*-based financing.

Similarly, if the *waqf* asset is impaired, *nazir waqf* is responsible in the case of mismanagement to ensure that the *waqf* stream stays beneficial to the beneficiaries, even if it is sold and replaced with another asset.

### Asset Financing

The application of beneficial ownership in asset financing depends on the choice of Shariah contracts. For instance, the prevailing Shariah contracts applied in home financing in key Islamic finance jurisdictions i.e. Malaysia, Bahrain, Saudi Arabia, and United Arab Emirates, are *murabahah*, *bay' bi al-thaman ajil* (BBA), *tawarruq*, *musharakah mutanaqisah* (MM), and *ijarah thuma al-bay'* (AITAB).

In *murabahah*, *bay' bi al-thaman ajil* (BBA), and *tawarruq* home financing, there is no issue of beneficial ownership. However, in *musharakah mutanaqisah* home financing, the bank may choose to register the property in the name of

the customer, and retain beneficial ownership with legal charge over the property.

In *ijarah thuma al-bay'* home financing, some banks choose to hold title ownership, and the customer holds beneficial ownership in their capacity as lessee within the leased period.

## SHARIAH ISSUES IN THE APPLICATION OF BENEFICIAL OWNERSHIP

Although the Shariah recognises the concept of beneficial ownership, as applied in the context of sukuk issuance for example, the issue lies in the restriction placed on disposition of the sukuk asset in the case of default or maturity.

Similarly, the lack of due diligence about the sukuk asset and the stipulation of no right to enquiry about the asset on the sukuk holders may pose the question of “true sale” as it is essential in a sale contract for the transacting parties to have full knowledge of the subject matter. Meanwhile, the purchase undertaking is only meant to secure the sukuk holders beneficial interests in the purchased asset.

With regard to the restriction of PTC on the disposal of sukuk asset, al-Shubayli (2013) informs that scholars are of two views: The majority of scholars view that this condition is invalid. The basis for this argument is the *hadith* of the Prophet (pbuh) which “prohibits sale attached to condition.” It is also held that such a condition contradicts the effect of sale, which is to grant the owner the right to freely dispose of the subject matter.

However, the proponents of the second view, among whom are Ibn Taymiyyah and Ibn Qayyim, argue that the condition is valid and does not contravene the effect of the contract. The basis of their argument is the *hadith* “Muslims are bound by their [contractually specified] conditions,” and also the *hadith* of Abdullah ibn Umar the import of which is “Anyone who purchases a palm tree after being pollinated, the fruits of the palm tree belong to the seller, except if the buyer stipulates their inclusion by condition” (Muslim, No. 1543).

The Maliki school also explains that if the seller stipulates a condition which is beneficial to him such as riding [horse] after sale or staying in the house after being sold for a specified period of time, both sale contract and condition are valid (Ibn Juziy, 1397H: 409).

In addition, Imam Shawkani (2004: 505) comments: "Conditions attached to contract do not necessarily invalidate the contract unless such condition is either voidable itself or invalid condition. However, if it is valid but leads to *gharar* that may hamper mutual interest, which is the core element of Shariah transactions, it becomes invalid because it leads to what is prohibited."

It is noteworthy that although the restriction on disposing the asset is resolved based on the second view highlighted above, the issues pertaining to the lack of due diligence, stipulation of no right to enquire the asset and purchase undertaking remain unaddressed.

## RECOMMENDATIONS

To address the issue of the absence of true sale, i.e, restricting disposal of asset, it is suggested that *manfa'ah* (usufruct/benefit) is deemed as the subject matter of the sale contract in asset-based sukuk because there is a lack of proper and due process of transfer of the asset. In other words, sukuk holders only own *manfa'ah* (usufruct/benefit) of the sukuk asset, and not the asset itself.

This *manfa'ah* (usufruct/benefit) can also be referred to as beneficial ownership (*al-milkiyyah al-nafi'iyah*). Such beneficial ownership may only be offered through the following contracts *i'arah* (lending), *ijarah* (leasing), *waqf* (donation) and

*was'iyah* (bequest of benefits) as these contracts only offer *manfa'ah* (al-Zarqā, 1994, 1:375). Therefore, transfer of beneficial ownership implies transfer of subject, which is *manfa'ah* (benefit) of the asset, not the asset in its entirety.

It follows that the beneficial ownership in this regard is not absolute ownership, as these contracts only provide a partial ownership interest in and attaching to the underlying asset. Some contemporary Shariah scholars are of the opinion that restricting disposal of the asset indicates that the originator in sukuk issuance passes only the beneficial ownership to sukuk holders. Hence, they have no claim to the asset except the usufruct/benefit.

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## ISLAMIC INSURANCE: A COOPERATIVE MODEL

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*Takaful* is an alternative term used for 'Islamic insurance'. It is aimed at social help and solidarity to mitigate the impact of losses. The *takaful* concept is aimed at eliminat-

ing *riba* (paying or receiving interest through exchanging money for money with difference in time and amount), *gharar* (inappropriate risk, and excessive uncertainty in exchange contracts), and *maysir* (gambling and other games of chance). Most existing *takaful* business models are based on the concept of *tabarru'*. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in Shari'ah Standard No. 26(2) (hereinafter the Standard) describes Islamic insurance as "an agreement between persons who are exposed to risks to protect themselves against harm arising from risk by paying contributions on the basis of a commitment to donate".

The key issue with existing *takaful* models lies essentially with the legal characterization of the fund entity and its relationship with participants since, in accordance with the Standard, the participants commit themselves to donate to the fund on condition that the fund, in return, undertakes to indemnify them for defined losses.

The key Shariah issue with this arrangement is that although the very intention of establishing *takaful* models was to avoid the effects of *gharar*, its current practice may lead to a commercial contract where two counter values —contributions and claims— are exchanged on the basis of *'aqd mu'awadah*, instead of applying the true essence of *tabarru'*.

As such, the practice of inherent *gharar* therein renders the *takaful* agreement indistinguishable in key respects from conventional insurance. In order to resolve this and other Shariah issues pertaining existing *takaful* model structures, the concept of cooperative Islamic insurance based on *musharakah ta'awuniyyah* model has been proposed by different quarters to be in conformity with the underlying principles of the Shariah, namely the avoidance of transactions commutative in nature in order to avoid the inherent excessive *gharar*, and to be truly reflective of the intention of *takaful* participants.

### WHAT IS MUSHARAKAH TA'AWUNIYYAH?

*Musharakah* refers to a sharing arrangement among members of a group to undertake any joint business for the purpose of earning profit in order to relieve hardship of one another.

Alternatively, we may understand the term as referring to sharing the benefit arising from the joint ownership of an asset, sharing in its appreciation and depreciation, or for common cause of risk mitigation or community welfare. *Musharakah ta'awuniyyah* refers to a proposed contract of mutual help and cooperation based on the agreement and consent of the participants to combine the two elements of safeguarding participants' property and mutual cooperation. Its objective is to ensure that the indemnification is given upon necessity and to eliminate the intention of gaining profit among contractual parties.

## CONCEPT OF ISLAMIC COOPERATIVE INSURANCE MODEL

The Islamic Cooperative Insurance model is quite similar to that of other existing *takaful* business models, except for the use of the doctrine of *tabarru'*.

The key difference of this concept lies in the management structure; otherwise in operations it is akin to the *wakalah* model. In this proposed concept there may be lead contributors who obtain regulatory permission to invite participants to act as partners/primary shareholders as well as *takaful* participants. After payment of claims and reserves as per policy and *retakaful* contribution, they will be entitled for the payment of surplus/profit, if any, and will be liable to fill any shortfall, if needed.

The excess of the management fund (such as *wakalah* fees charged — expenses on management) and the surplus/deficit of the risk fund (which is used to pool the portion of contributions paid by participants in line with the concept of *musharakah ta'awuniyyah* underlying the contract, which is entered into by the participants, which allow them to agree on the events leading to payment of *takaful* benefits) will also belong to *takaful* participants on pro rata basis.

Investment fund (in case of family *takaful*) will belong to the respective *takaful* participants/partners while the *takaful* company, as *mudharib*, will share in the profits earned on investments.

It should be noted here that the proposed model has not yet been practised by any market player because in some jurisdictions the existing regulatory framework does not support such a structure. Before implementing such a structure, Islamic economies and markets should make room to improve the legal and regulatory framework to ensure best and fair practice of the law.

## SHARIAH ISSUES IN EXISTING TAKAFUL BUSINESS MODELS

The key Shariah issue with the arrangements in existing *takaful* models is that although the very intention of establishing these models was to avoid the effects of *gharar*, it is criticized by many scholars as a commercial contract where two counter values — premiums and compensations — are exchanged on the basis of *mu'awadah*, instead of *tabarru'*.

As such, the inherent *gharar* in their view would render the *takaful* agreements invalid from a Shariah perspective. The majority of juristic schools (*madhahib*) hold the opinion that a donor is not entitled to claim back any donation he/she has made so long as it is with the possession of the beneficiary.

In order to resolve this and other related Shariah issues different juristic interpretations of the conditional nature of *tabarru'* in *takaful* have been proposed, which includes *inter alia*: i) a commitment to donate as the view espoused by AAOIFI; ii) a conditional gift; and iii) a kind of endowment (*waqf*). *Hibat al-thawab* (also called *hibah bi shart al-iwad*), i.e., a conditional gift is considered by Hanafi jurists as equivalent to a sale contract because it includes something that is given in exchange.

Some Hanafi jurists, such as al-Sarakhsi, view it as a gift at the beginning but a sale at the end, while others such as Zufar say that it takes the ruling of a sale throughout, from the beginning to the end. The abovementioned key Shariah issue in *takaful* practice may lead to the following issues that need to be resolved.

### 1. Ambiguity in the contractual relationship:

There is not any specific valid contract on the basis of which *tabarru'* is taken. It creates ambiguity in the contractual relationship between the parties, which will tantamount to *riba* and or *gharar*. This ambiguity emanates from the fact that the cooperation among the *takaful* participants are sought based on mutual forgiveness and sympathy and the legalization of each other's rights; but should not be based on commercial exchange, nor



on demand for rights, and the intention of making profit as is the case of commercial structures of *takaful* companies which use *tabarru`* as of now. "The fundamental structure of *takaful* which is premised on the basic concept of *tabarru`* is started to be questioned when many benefits are offered to the participants in the beginning of the *takaful* contract in return for the contributions paid to the *tabarru`* pool managed by *takaful* operators."

2. **Conflict of interests:** Decisions about the amount of contributions and their distribution between the protection and investment parts, etc., are made solely by the *takaful* company's board of directors. This creates a conflict of interest between the operator and the participants.
3. **Elements of excessive gharar:** *Gharar* remains due to the commercial nature of the *takaful* companies, which creates a problem as the end products are practically the same as in the case of commercial insurance. In fact, "many *takaful* products and operations are starting to converge closely with conventional insurance".
4. **Elements of exchange contract:** In most cases, contributions and possible benefits are planned and structured in such a way that the arrangement takes the form of an exchange contract. For example, the top-up policies in family *takaful* arrangements particularly strengthen the impression that the more a policyholder pays the more they will be paid, akin to a commercial contract.

## CONCLUSION

Stakeholders of Islamic finance in general and *takaful* in particular should make the industry truly reflective of Shariah-compliant "Cooperative Insurance" in line with the standards, regulations, suggestions, resolutions, declarations, and guidelines provided by different regulatory bodies, authorities and institutions such as BNM, AAOIFI, IFSB, the OIC Islamic Fiqh Academy, ISRA and Islamic Research and Training Institute (IRTI).

This would resolve all current as well as future Shariah concerns. It is observed that *takaful* operators of current *takaful* business models are not functioning in line with the Islamic principles of *ta'awun*, which advocate mutual help and indemnification, solidarity and cooperative risk sharing.

In addition, operators should not only act as managers, and not bear risks in exchange for contributions. As the participants mutually commit to indemnify one another, they share both underwriting surpluses and losses, and the level of implementation of this principle will determine the level of Shariah compliance of various structures of *takaful* entities.

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## PRINCIPLES OF PREDOMINANCE (GHALABAH) AND SUBORDINACY (TAB'IYYAH): A HIGHLIGHT OF SHARIAH ISSUES IN THE TRADING OF "BLENDED" SUKUK

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With the advent of various Shariah-compliant capital market instruments including *sukuk*, shares and unit trusts — collectively known as financial papers — to match the demand for funds of deficit units with the need for investment opportunities of surplus units, the Islamic finance industry has witnessed unprecedented growth and development in terms of size, innovation and interest to the wider markets in a short span of time.

For instance, new innovative *sukuk* structures, which apply the concept of mixed or blended assets — combination of tangible assets and debt — have been introduced to overcome the problem of issuers having insufficient Shariah-compliant physical assets to back their issuance.

Similarly, scholars have allowed the trading of shares of companies whose activities are mixed, where the primary businesses are lawful while the peripheral activities are impermissible, in order to promote mobilization of the Islamic economy.

These innovations have, however, raised concerns on the tolerable percentage of mixed assets and activities in these financial instruments. This article therefore examines this issue in the light of the predominance (*ghalabah*) and subordinacy (*tab'iyyah*) principles, which have been used as the underlying basis to allow the tradabili-

ty of these financial instruments, particularly "blended" *sukuk*.

### SHARIAH RULES IN TRADING A PORTFOLIO OF MIXED ASSETS

Scholars unanimously agree that if the underlying assets of *sukuk* is purely cash, it can only be traded at par.

If the *sukuk* is represented by pure debt or receivables as in the case of *murabahah sukuk*, *salam sukuk* and *istisna' sukuk*, the majority of scholars view that the certificates cannot be traded except at par. Hence, trading both types of *sukuk* at discount or premium will lead to *riba*.

However, contemporary scholars have allowed the trading of *sukuk* whose underlying assets are a mixture of tangible assets and debt or cash at premium or discount.

The first example of *sukuk* having such an arrangement is the US\$400 million *istithmar sukuk* issued by the Islamic Development Bank (IDB) in 2003, where the asset portfolio comprises 65.8 percent physical assets (i.e. *ijarah* assets), 30.73 percent *murabahah* receivables, and 3.4 percent *istisna'* assets.

In 2011, the government of Malaysia also issued this type of blended *sukuk* worth US\$2 billion. This dual-tranche *wakalah sukuk*, during ongoing and maturity, consist of 51 percent



*The principle of subordination rules that the subordinate (tabi') should not be considered in the formation of any legal rulings. Rather, the rulings should be based on the principal or original (asl) and the subordinate is subservient to the original.*



physical assets and shares and 49 percent *murabahah* receivables.

The International Islamic Fiqh Academy of OIC (IFA-OIC) resolved in its resolution No. 188 (3/20), 2012 – regarding the tradability of financial papers including *sukuk*, shares and investment units – that:

1. If the underlying assets of the securities are cash and debts, dealing in them is subject to the provisions governing exchange and debt selling.
2. If the underlying assets of the securities are property, benefits and rights, dealing in them may be at any agreed rate.
3. When the underlying assets of the security are a mixture of debt, cash, tangible assets, usufruct and rights the matter is subdivided as follows:
  - a) The cash and debt are subordinate to that which can be validly considered to be the principal, and the security includes ownership of that principal. In this case, it is permissible to trade the security without taking into consideration the ratio of cash and debt to the [total] assets.
  - b) The cash and debt are not subordinate, or the security does not include ownership of the principal. In this case, the trading is subject to the rules of predominance.
4. If the company or project that the security represents has not begun actual operation or is in the process of liquidation, the trading of securities is subject to the rules of predominance.

Nonetheless, the question arises on how to determine the subordination of the cash and debt assets to the tangible assets. This will be delineated in the next section.

## THE PRINCIPLE OF SUBORDINACY (TAB'IIYAH)

The principle of subordination rules that the subordinate (*tabi'*) should not be considered in the formation of any legal rulings. Rather, the rulings should be based on the principal or original (*asl*) and the subordinate is subservient to the original. This is based on the following legal maxim:

التابع تابع

*What is auxiliary [to something in fact] is auxiliary [to it in ruling].*

To illustrate the principle of subordination, consider the following illustration:



Contemporary Shariah scholars have allowed the trading of this blended *sukuk* even though the deferred USD is more than one-third (i.e. 49 percent) and despite the fact that Maliki scholars have stipulated one-third as the limit for the permissibility of exchanging a silver-plated sword for silver as the consideration.

This is because the trading of the tangible assets (i.e. *ijarah*) is the original and the trading of the receivables is secondary or subordinate. Hence, the original prevails and the secondary is overlooked.

The basis for the adoption of subordination principle in this case is based on the *hadith* narrated by

Ibn Umar: "When a person buys a slave, who has wealth, then the wealth is for the seller, unless the buyer stipulates that, too." (*Sahih al-Bukhari, hadith no. 2250*).

However, if the principal and subordinate cannot be distinguished, scholars rule that the principle of predominance should be adopted. Yet, what would be the minimum percentage to determine the predominant portion?

## THE PRINCIPLE OF PREDOMINANCE (GHALABAH)

Scholars have different opinions in determining the minimum percentage of the predominant portion: while some view 51 percent; others hold to 33 percent as the limit. The basis for 33 percent is the *hadith* on bequeath where the Prophet (pbuh) mentioned: "... and even one-third is too much..." (*Sahih al-Bukhari, hadith no. 2742*).

When applying this *hadith* on the trading of blended *sukuk*, where the tangible assets constitute 33 percent of the portfolio and the debt or cash represents the remaining 67 percent, the tangible assets is still considered the majority and significant even though the debt or cash is greater so long as the transaction is the exchange of portfolio consisting of tangible assets and debt or cash with cash money, not the sale of debt for cash *per se*.

Although this opinion has been adopted by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in Shariah Standard No. 21 (3/4/2 and 3/4/3) on Financial Papers, particularly in the investment and trading of shares, some contended that the rule of 33 percent or even 51 percent to determine the predominance amount should not be used in trading blended *sukuk*. Rather, the principle of *mudd 'ajwah* (a measure of dates) should be applied. This is because the ratio of debt or cash in *sukuk* does not change when they are traded in the secondary market, unlike in shares which are difficult to determine.



## THE PRINCIPLE OF MUDD 'AJWAH

The principle of *mudd 'ajwah* implies that the cash attached to the tangible asset can be greater than the price of the tangible asset provided that the isolated cash (i.e. payment) is greater than the cash attached to the tangible assets. In contrast, if the isolated cash is equal or less than the combined cash, the scholars unanimously disallow such transaction. For the ease of understanding, the *mudd 'ajwah* principle is depicted as follows:

USD 133 mil ijarah assets (cash)  
+  
USD 267 mil (cash)  
=  
USD 400 mil (cash)  
↓  
Allowed

USD 100 mil ijarah assets (cash)  
+  
USD 300 mil (cash)  
=  
USD 300 mil (cash)  
↓  
Disallowed

USD 100 mil ijarah assets (cash)  
+  
USD 300 mil (cash)  
=  
USD 200 mil (cash)  
↓  
Disallowed

This principle is derived from the following *hadith*:

Fadalah b. Ubaid al-Ansari reported: A necklace having gold and gems in it was brought to Allah's Messenger (pbuh) in Khaibar and it was one of the spoils of war and was put to sale. Allah's Messenger (pbuh) said: The gold used in it should be separated, and then Allah's Messenger (pbuh) further said: (Sell) gold for gold with equal weight (*Sahih Muslim*, *hadith* no. 3863).

Nevertheless, the rule of *mudd 'ajwah* can only be applied if the exchange of mixed assets is made on the spot on both sides (i.e. present tangible asset + cash US\$ = cash US\$). If the exchange involves delay from either of the two sides (i.e. present tangible asset + cash US\$ = deferred US\$; or, present tangible asset + deferred US\$ = cash US\$) – as in the case of IDB's *istithmar sukuk* issued in 2003 and explained above, therefore, the principle of predominance should be relied upon.

## CONCLUSION

Although most collective resolutions issued by international organizations such as OIC-IFA, AAOIFI, Dallah al-Barakah and Kuwait Finance House are in favor of the principles of predominance and subordinacy being the underlying bases for the permissibility of trading blended *sukuk*, the issue remains open for further debate and discussion. OIC-IFA, for instance, had been discussing this issue since 2009, yet in its latest resolution No. 214 (10/22), 2015 the Academy decided to relook all preceding resolutions on the matter and reformulate its recommendations.



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# SHARIAH ISSUES IN PREFERENCE SHARES

**Dr Shamsiah Mohamad**  
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he most common shares issued by companies to its shareholders are ordinary shares, while preference shares are typically issued to investors to protect their interests. Not all of the ways in which preference shares are employed would meet Shariah requirements and certain types of preference shares are subjects of controversy with regards to their rulings. This article highlights those controversies related to these shares.

## DEFINITION OF PREFERENCE SHARES AND THEIR CATEGORIES

Preference shares are shares that carry certain special rights such as the right to receive a fixed dividend before any dividend is paid to ordinary shareholders and the right to claim capital before ordinary shareholders in the event of liquidation.

Preference shares can be divided into several categories, namely cumulative and non-cumulative preference shares, redeemable preference shares and convertible preference shares. Cumulative preference shares give the shareholder the right to carry forward their entitlement to a dividend distribution from one year to the next if no dividend is declared in a particular year. In contrast, the holder of the non-cumulative preference shares is only entitled to a specific rate of dividend out of the profits of a particular year where the dividend is declared and distributed. Therefore, the holder of non-cumulative preference shares will lose their entitlement to the dividend if the company does not declare and distribute the dividend in a particular year.

Redeemable preference shares mean the shares may be redeemed by a company that issues it at a

future fixed date or at the option of the company subject to the terms and conditions of the issue.

Finally, convertible preference shares refer to shares that carry a right to a fixed dividend for a particular term which can then be converted into ordinary shares at the end of the term (Shukri & Karim, 2014).

## SHARIAH ISSUES WITH PREFERENCE SHARES

Based on the above definition and categories of preference shares, it is noted that preference shares are a hybrid instrument bearing the features of equity and debt.

If we consider preference shares as equity based on the *musharakah* contract, there will be some Shariah issues related to fixed dividends and priority in profit distributions and claims upon winding up of the company, among others. These are:

- i. Capital and profit guarantee. The capital is considered guaranteed because the holders of preference shares have priority over ordinary shareholders to receive their capital upon winding up of the company. Ordinary shareholders can only claim their capital, if any, after all preference shareholders are paid out. Profit guarantee refers to the fixed dividend granted to the holders of preference shares. This arrangement breaches a basic Shariah requirement of profit, as fixing profit in a *musharakah* contract leads to profit guarantee.
- ii. No sharing of loss based on capital contribution. This is due to the priority given to the holders of preference shares in claiming their capital and profit (if any) upon winding up of



*Based on IFA-OIC and AAOIFI's views,  
preference shares are prohibited  
if they have an element of  
prioritization upon liquidation  
or distribution of profits.*



the company. Due to this prioritization, the holders of preference shares will receive their capital in full from the assets of the company while the holders of ordinary shares will receive whatever is left over, which may mean only part of their capital or nothing at all. Therefore, the element of prioritization goes against the very fundamental Shariah ruling of *musharakah*, where jurists have unanimously agreed that the partners in a *musharakah* venture shall bear losses proportionate to their respective capital investments.

- iii. Waiving of right before realization of profit. This happens when the priority is given to the holders of preference shares to receive their profit. According to the views of a majority of Shariah scholars, the right can only be waived after the profit is realized. However this issue can be discussed further as there is a view that allows the waiving of profit before its realization.

However, if we assume that preference shares are debt, the Shariah issue is only related to the fixed dividend given to the creditor (preference

shareholders) as it will trigger *riba*, which is prohibited in Shariah.

### KEY ISSUE: DIFFERENCES IN RULING ON PREFERENCE SHARES

The majority of scholars do not agree with the concept of preference shares.

The International Islamic Fiqh Academy of the Organization of Islamic Cooperation (IFA-OIC) in its 14th session held in Doha in 2003 resolved that preference shares are not permissible and in the event a company suffers losses, all holders of the shares have to bear the losses based on their capital contributions.

In addition, according to the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) Shariah Standard No. 21, Article 2/6: "It is not permitted to issue preference shares that have special financial features leading to the granting of priority to these shares at the time of liquidation or the distribution of

profits. It is permitted to grant certain shares features related to procedural or administration matters, in addition to the rights attached to ordinary shares, like voting rights ...”

Based on IFA-OIC and AAOIFI's views, preference shares are prohibited if they have an element of prioritization upon liquidation or distribution of profits.

However, the Shariah Advisory Council of Securities Commission Malaysia (SAC-SC) resolved that non-cumulative preference shares are permissible. This is based on the principle of *tanazul* (waiving of right) which is willingly given by the holders of ordinary shares to the holders of preference shares to receive their profit upon distribution or in claiming their capital upon winding up of the company.

The above Shariah views and *fatwas* have led to two divergent views: permissibility and impermissibility of preference shares. The divergence lies in the different approaches used to analyze the fixed income and prioritization features in the shares. While the SAC-SC's view is based on *tanazul* which can be applied in *musharakah*, IFA-OIC and AAOIFI consider those features contrary to the nature and implication of the *musharakah* contract.

ive. In addition, there is a need to scrutinize the *tanazul* concept as to its appropriate basis in permitting fixed income and prioritization features in preference shares.

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## CONCLUSION

Preference shares are tailor-made instruments issued by a company in different types to protect the interest of investors. Since each type of these shares has its own behavior, further research is needed to identify the behavior of each type to determine their status from the Shariah perspec-



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# ISLAMIC SPOT FOREX (FX-I) OFFERED BY ISLAMIC FINANCIAL INSTITUTIONS: AN ANALYSIS

**Burhanuddin Lukman**  
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Foreign currency exchange (forex) is an important segment of international business activities. The trading of the global forex market is reported to be at an average of US\$5.3 trillion per day in April 2013. According to the Bank for International Settlement 2013 Triennial Central Bank Survey, the turnover was driven primarily by financial institutions.

Being part of the financial system, most Islamic financial institutions (IFIs) are actively involved in Islamic forex (FX-i) spot trading. The operation and process of the FX-i spot trading in an IFI is, however, largely the same as being practised by conventional financial institutions.

Normally, financial institutions, including IFIs, do not stock a large amount of foreign currencies prior to selling them to their customers or counterparties. The FX-i spot trading involves a large transaction amount. An IFI will first sell the currency to its customers and after the sale is complete, the IFI will purchase the currency from an interbank party. The amount purchased from the interbank party will then be credited into the customers' account after two working days (T+2). The common understanding adopted by many scholars as well as Shariah advisory boards is that this flow of transactions raises two main Shariah issues, on which this article will shed light.

## ISSUE 1: OWNERSHIP AND POSSESSION OF THE TRANSACTED CURRENCIES

This first issue of ownership and possession involves a few sub-issues.

Firstly, **selling what one does not own** (بيع ما لا يملك). The reason is because the IFI sells a foreign currency which it has yet to purchase and own. Selling something which is not owned by the seller is a form of uncertainty (*gharar*) which has been prohibited by the Prophet (pbuh). Such a transaction in which an item not owned by the seller could trigger another Shariah issue, namely, **selling something that is not in one's possession** (بيع ما ليس عند الإنسان), as the IFI does not have sufficient currency in its account at the time of contract. The Prophet (pbuh) has prohibited this type of transaction in a *hadith* which states:

«لَا تَبِيعَ مَا لَيْسَ عِنْدَكَ»

**“Do not sell what is not in your possession”.**

Following on from this, the next sub-issue is **effecting a transaction before taking possession** (التصرف قبل القبض). There are a few *hadith* that prohibit reselling what one has purchased before taking possession, amongst others, the Prophet (pbuh) said:

«فَإِذَا اشْتَرَيْتَ بَيْعًا، فَلَا تَبِعْهُ حَتَّى تَقْبِضَهُ»

**“If you make a purchasing deal, do not sell it until you take hold of it (take into your possession)”.**

The IFI in its practices could be contravening this *hadith* as it purchases a foreign currency from an interbank party, delivery of which will be at T+2, but IFIs do not typically wait until T+2 to sell the currency to its customer.<sup>1</sup>

Worse still, the IFI actually sells the currency before purchasing and taking possession.

The above issue is also supported by a ruling from the Islamic Fiqh Academy of OIC and later adopted by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) on currency trading. The ruling prohibits effecting transaction before taking possession, it says: "... the payee is not entitled to dispose of the currency during the transfer period, unless and until the effect of the bank transfer has taken effect so that the payee is able to make an actual delivery of the currency to a third party."<sup>2</sup>

## ISSUE 2: 'HAND-TO-HAND' DELIVERY REQUIREMENT IN A CURRENCY EXCHANGE

Under the Shariah, both exchanged currencies in FX-i trading must be delivered to each of the contracting parties in the contract session before they separate from each other. Thus if the IFI does not have the currency in its possession, how would it be able to deliver the currency immediately in the contract session?

## ANALYSIS OF THE SHARIAH ISSUES

A study has been undertaken by the International Shari'ah Research Academy for Islamic Finance (ISRA) to investigate the aforementioned issues.<sup>3</sup> This study found that the issues pertaining to the ownership and possession of the currency are not relevant in any FX-i spot transaction.

Under the concept of "currency exchange on liability" (*al-sarf 'ala al-dhimmah*), the existence, ownership, possession and physical identification of the currencies being exchanged are not required of the contracting parties when the contract is executed. Hence, the parties are al-

lowed to borrow or purchase the currency from a third party after the execution of the exchange contract so that they can deliver it to the counter party. However, the currencies must be delivered and received by both parties before they separate from each other. This is the view of the majority of Muslim jurists, including the Hanafis, Shafi'is and Hanbalis.

Based on the concept of *al-sarf 'ala al-dhimmah*, the IFI is actually not selling any specific money from any account, but rather bearing the liability to pay. Contractually, there is no interconnection between the IFI's transaction with the interbank party and the transaction between the IFI and its customer. Therefore, the money which is purchased from the interbank party is not conceptually the very money that the IFI is selling to its customer.

The study also found that there are justified reasons why the IFIs do not purchase and stock sufficient amount of foreign currencies before selling them to customers.

Among the main reasons is the market risk due to price fluctuation. The prices of currencies are very volatile and a small movement in the rate will have a significant adverse impact on IFIs because of the large amounts in which they transact.

Practically, the IFIs do not have any need to stock any currencies to meet corporate demand as the chances of getting those currencies from the market are effectively guaranteed. That is to say, the probability of availability is quite high.

Another reason for not stocking currencies in large amounts is if the IFIs were required to obtain a sufficient amount of foreign currencies before they could sell, this would mean that the IFIs must open nostro accounts in those particular currencies in a number commensurate with the currency transactions in which they engage.

IFIs typically participate in transactions involving numerous different currencies. It is not cost-efficient for IFIs to maintain nostro accounts for all such currencies, especially exotic currencies for which there is less demand.



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The Dubai  
International  
Financial Centre  
(DIFC) illuminated at  
night. Philip Lange  
/ Shutterstock.com

Another reason to not maintain large amounts of diverse currencies on hand is to avoid speculation. If the bank purchases a large amount of a certain currency merely for the probability that a customer will buy it, it could be considered speculation that will lead to regulatory issues].<sup>4</sup>

Regarding the second issue, i.e., the “hand-to-hand” delivery requirement in a currency exchange, the study contends that given the nature of foreign currencies that are located in nostro accounts in different jurisdictions with different time zones, different infrastructure and facilities of settlement, it is impossible to deliver the exchanged currencies during the contracting session. This contention is given merit by an overwhelming majority of Shariah scholars who thus justify a relaxation from the original prohibition. In short, a delay for the period that is the standard practice in the market, such as T+2, is allowed.

## IS CURRENT PRACTICE OF SPOT FX-I SHARIAH-COMPLIANT?

Although the basic requirements of any exchange transactions is ownership and possession of the subject matter prior to executing the transaction, the scenario is quite different in FX-i spot trading.

This is because the subject matter in this case are currencies that are normally used as the price or the medium of exchange. In other words, currencies are the price paid in consideration of the subject matter.

In any normal sale transaction, the purchase price is neither required to be present, nor phys-

ically owned and possessed by the purchaser at transaction execution. The delivery of the price is left to the parties to decide whether they want it in cash or deferred. Likewise, in a transaction involving the exchange of two currencies, the Shariah is interpreted to not make compulsory the presence of the currencies during transaction execution; however, Shariah is understood to impose delivery of the currencies before the parties part ways. Immediate delivery during the contracting session is not possible given the different location and time zone of the bank accounts involved. Therefore, the application of the principles of “*al-mashaqqah tajlib al-taysir*” (hardship begets facility), *hajah* (need), *‘umum al-balwa* (widespread problem difficult to avoid) and *‘urf* (custom) create a concession in this regard.

In sum, the current practice of the IFIs is not contradictory to Shariah principles. Rather, it is supported by thoughtful Shariah arguments, valid classical *fiqhi* texts and maxims, as well as the understanding of many classical scholars on currency exchange.

### ENDNOTES

- 1 Burhanuddin Lukman and Noor Suhaida Kasri. (2014). Possession of Currency Prior to Sale: A Fiqhi and Practical Analysis of Spot FX-I in Malaysia. ISRA Research Paper (No. 76/2014).
- 2 AAOIFI Shariah Standard no. 1 on “Trading in Currencies”, Clause 2.6.5 (a)(3).
- 3 Burhanuddin Lukman and Noor Suhaida Kasri. (2014). Possession of Currency Prior to Sale: A Fiqhi and Practical Analysis of Spot FX-I in Malaysia. ISRA Research Paper No. 76/2014.
- 4 In the case of Malaysia, for example under the Foreign Exchange Administration Rules, spot and forward trading of foreign currencies are restricted to current and financial account transactions and settlement of real goods and services.



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**PART 4**

# Latest Innovations in Islamic Finance





# SUMMARY

Appraising the industry's latest innovations in product development and structuring is an important measure in assessing the present state of affairs. This Section begins with examining the innovation trajectory in Islamic banking and finance. It addresses the question as to whether Shariah advisory boards and intellectual infrastructure institutions have prevented Islamic financial institutions from being swept away by the "undertow" of conventional finance. It reaffirms the fundamental nature of Islamic finance that innovative product development and structuring must link finance and business to the ever dynamic real economy.

The Section then examines approaches of innovation in Islamic finance by highlighting two modes of innovations: (i) sustaining innovation that aim at improving existing products to fit the demands of existing customers; and (ii) disruptive innovation that creates a new market for new products. It argues that Islamic finance is a kind of "disruptive innovation" to conventional finance.

The Section points out some constraints to innovation with regards to the product development process. It explicates the regulatory and practical challenges faced by Islamic finance for example home finance and credit card structures. The Section finds that one can readily detect the taint of conventional finance on many Islamic products, but that one must not lose sight of the tremendous effort which is been made to establish and move the industry forward.

The Section puts forth different suggestions to improve product development processes. Proposals include initiatives for simpler, transparent documentation, improving financial literacy, incentivizing sales forces in qualitative fashion, and constructing links between finance, responsibility and sustainability. Rather than force-feeding classical contract forms into present-day demands, innovations should incorporate both the form as well as the substance of Islamic ethics and laws including the broader underlying values of faith.

Among the innovations reviewed by this Section are Islamic derivatives and hedging instruments such as the master collateralized *murabahah* agreement and cross currency templates. Shariah issues in hedging, challenges and present initiatives, such as the upcoming implementation of mandatory margining are also highlighted.

# INNOVATION IN ISLAMIC FINANCE: TRAJECTORY, CONSTRAINTS AND FUTURE PROSPECTS

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Financial innovation as understood in modern financial transactions refers to processes by which new financial products are invented or existing products are further developed in order to increase revenues, or better manage attendant risks, or provide a broader response to customers' demands.

Foremost among the innovations of the last half century is debt securitization. Credit institutions and others use this method to transfer debts by way of special purpose vehicles (SPVs) which issue securities based upon the debt. [By the term securitization, we also refer to] options, futures and swap contracts derived from the extension of credit and related activities.<sup>1</sup>

This article discusses the trajectory of financial innovation in the Islamic finance industry and a Shariah approach which should serve to prevent it from falling into conventional industry pitfalls and to keep financial transactions directed toward serving actual societal benefits. This article also evaluates the extent to which the Islamic finance industry has succeeded in keeping the trajectory of financial innovation aligned with the overall objectives of the Shariah.

## TRAJECTORY OF ISLAMIC FINANCIAL INNOVATION

Anyone who contemplates the comprehensive Shariah principles regarding transactions will see a clear orientation toward firmly establishing justice in the distribution of risks and contractual obligations.

This distribution of risk has been made the essential qualification for entitlement to profit. One can also discern the extent of the Shariah's concern for individuals' actual benefits, which cannot possibly be realized except by giving precedence to the interests of the whole society in cases of conflicting interests.

Finally, serious study of these general principles of the Shariah leads to the unavoidable conclusion that its considerations in dealing with issues of people's livelihoods are broad and far-ranging.

Shariah also gives considerable leeway to people's customs and practices as long as they do not conflict with incontrovertible texts of the Quran and Sunnah or what is derived from them by valid analogy and sound reasoning.

Referral to one of these comprehensive principles, i.e., that the foundational rule for things is permissibility, and its corollary that contracts are to be given the benefit of the doubt when their validity is questioned — when combined with the principle that whatever harms people's interests and individuals' rights should be interdicted — leads us to the conclusion that the Shariah gives people full freedom to design new commercial and financial arrangements as long as they fall within the boundaries of permissible exchange contracts and avoid the prohibitions of *riba* (interest) and *gharar* (ambiguity that engenders risk), among others.

The methodology of Muslim jurists in this regard is corrective and proscriptive rather than prescriptive. It looks at existing or newly invented transactions to see their congruence with the

general Shariah principles and decides whether they are permissible or impermissible, valid or invalid. Juristic method may also determine that a transaction is basically valid but that some of its terms and conditions or constituents are invalid. Such a transaction could, depending on the juristic method involved, be rectified by modifying the problematic terms or conditions. Finally, the ruling of permissibility or impermissibility or validity or invalidity may be decided on the basis of consideration of the consequences and effects of a transaction.

The Shariah in its wisdom has prohibited an increase in the amount of a debt that is solely remuneration for the delay in settlement. This is called *riba al-nasi'ah*, and its prohibition is definitive and unequivocal.

The Shariah has also prohibited increase in the amount as well as delay in exchanges of currency and of fungible commodities within the same genus (*riba al-fadl*). It has allowed an increase in the amount while maintaining the prohibition of delayed exchange when the genus differ from one another (for example, an exchange of gold for silver). This is to shut the door on practices that will eventually lead to *riba al-nasi'ah* (interest in debts), according to the strongest juristic explanation of the effective cause of the rule.

The jurists among the Prophet's companions as well as the next generation followed this methodology when delivering legal opinions on new contractual forms or transactions they found being practised in other cultures. They referred them to the comprehensive principles derived from the Quran and Sunnah. They may have differed in their understanding of the texts, their indications and deduction from them. An example of this is Marwan ibn al-Hakam's issuance of grain vouchers to the inhabitants of Madina. They began trading them among themselves, but Zayd ibn Thabit and Abu Hurayrah objected, considering the practice a form of *riba*. Marwan then prohibited the voucher trading.

## ISLAMIC FINANCE INDUSTRY: SWIMMING AGAINST THE TIDE

The subsequent eras after the first two generations of Muslims underwent tremendous juristic activity as other peoples and cultures entered the melting pot of Islamic civilization.

Previously unknown transactions spread to the far corners of the Abode of Islam, and jurists capable of independent legal reasoning, particularly the founders of the major schools, were able to understand these newly arising formats and issue rulings for them, each according to his legal methodology.

They referred these new transactions and other arising issues to the comprehensive principles of the Shariah in order to arrive at the rulings for them, and they laid down conditions and rules that must be observed in order for the contract to be valid. All of that proceeded from the starting principle that people have the freedom to invent and develop new contracts and transactions as long as they do not violate these norms.

However, a major schism with the incontrovertible aspects of the Shariah occurred after the Muslim world was invaded by Western civilization, first with colonizing armies and then with hegemonic institutions and systems. The colonial powers found a shaky Islamic intellectual and spiritual order, lacking the vigor to defend itself, and were thus able to successfully remove the Shariah from the public domain. They implanted in our environment models of public administration, politics, culture and economics whose constituents, orientation and effects are often contradictory to Islamic worldviews.

Transactions involving interest (*riba*) and contracts involving ambiguity (*gharar*) became widespread in Muslim countries, and the distinctive features of Islam were on the verge of disappearing had it not been for the efforts of a few jurists, economists and legal experts who had kept alive sparks of the prophetic legacy. They took up the challenge of reviving nearly-extinct Shariah rules regarding wealth and business and succeeded in establishing financial institutions that conduct their activities in a Sha-



Shariah-compliant manner. These institutions were further supported by others that issued Shariah, accounting and technical standards. Examples include the *fiqh* academies that issue Shariah resolutions, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), and the Islamic Financial Services Board (IFSB), which all strive to reconcile the parameters of the Shariah with the economic needs of Muslim countries for financial products and services.

These institutions have adopted a permissive methodology in order to provide practical alternatives that can be implemented in an environment in which the logic of *riba* has achieved near-total dominance.

The theoreticians and practitioners of Islamic finance examined the financial products developed by Western minds and strove to create products that would achieve similar goals with the conventional using the nominate contracts found in the books of Islamic jurisprudence. They made use of *murabahah* (cost-plus-profit sale), *ijarah* (leasing), *salam* (forward sale), *istisna'* (manufacturing on demand), *mudarabah* (silent partnership), *musharakah* (joint partnership), investment *sukuk* (bond-like instruments) and *takaful* (cooperative insurance).

Some even tried to adapt the jurisprudence on options in a sale to create derivative-like products. Throughout such exercises they assiduously tried to prevent the misuse of such products in order to avoid the pitfalls of the legal stratagems engineered to circumvent Shariah prohibitions.

The Shariah standards and resolutions issued by the above institutions were designed to lay parameters that would preserve the essential nature and authenticity of these contracts. They prohibited the securitization of debts and restricted the permissible *sukuk* to those that represent real ownership of tangible assets, usufruct and services. They prohibited the trading of futures, options, swaps and indices on the basis that they are contracts involving massive ambiguity and gambling. They added conditions and restrictions to deferred payment sales in order to preserve them from formal compliance that masks underlying usury and in order to keep

the rights and responsibilities of the contracting parties consistent with the rule that profit entitlement goes hand in hand with liability. From another angle, they also laid down guidelines for corporate oversight and governance to strengthen transparency, disclosure, Shariah and professional compliance, and social responsibility in these institutions.

## TOWARDS AN INNOVATIVE APPROACH TO ISLAMIC FINANCE

Have the Shariah advisory boards and intellectual infrastructure institutions succeeded in preventing Islamic financial institutions from being swept away by the undertow of the zero-sum interest-based conventional finance that dominates the world today?

It would be overly optimistic to answer this question with "yes", as it would be overly pessimistic to answer in the negative. One who closely studies industry practices and the application of the contracts used for bank financing or investment *sukuk* or *takaful* products will inevitably detect the effect of the conventional mindset on them.

It sometimes has an overpowering influence on the design, marketing and implementation of these products, even if the Shariah boards are stringent in their *fatwas* and supervision. However, it would be unfair to ignore the great effort made by those institutions to balance the requirements of the Shariah with the challenges imposed by the struggle to survive in an ocean that has no place for the weak.

Some *sukuk* defaulted in the last financial crisis because they were structured on the pattern of conventional bonds. At the same time, some conventional bonds remained in good standing because they were closely linked to the real economy and far removed from risky and speculative market thinking.

At the same time, we observe tendencies toward responsible or cooperative finance in certain parts of the conventional sector that may very well lead to a convergence with approaches of

the Shariah, even if there are differences regarding interest-based transactions and contracts entailing ambiguity (*gharar*).

Our predecessors taught us to adopt ideas from other cultures when they do not conflict with our religion and to reject the practices invented by our own people when they contradict the Shariah. Learning from this lesson, our financial institutions and Shariah advisors must steer a course toward activities and fund deployment that may generate slightly less short-term profit but are more stable and responsible in the medium- and long-term. We should not forget that one of the factors that caused the recent world financial crisis was the dominance of short-term and unsustainable thinking.

Islamic financial institutions are in need of a review of their operational models and a rethink of the product innovation and marketing methods. That review should consider how, rather than force-fitting contracts and products into narrow frames that are the products of a system, context and philosophy which are alien to the spirit and objectives of the Shariah.

We are certainly in need of returning to the methodology of our classical scholars who seek to comprehend the products of the human intellect after they have been polished and cleansed of anything that conflicts with the real interests of individuals and the society.

We need to move away from pouring through ancient *fiqh* books to extract contracts that were designed for environments and conditions completely different from ours, and then modifying them to make them conform to a financial and

banking system ruled from top to bottom by the logic of *riba* and gambling.

The esteemed Hanbali scholar Ibn al-Qayyim said, “That which is prohibited is either prohibited for its own sake, in which case it cannot be made lawful at any time, or is prohibited because it entails a certain harm in one time but not another, or in one place but not another, or under some circumstances but not others.”<sup>2</sup> Going forward, the criteria for consideration is the realities rather than the names, and objectives and meaning rather than outer forms and wording.

#### ENDNOTES

- 1 Rogério Sobreira, *Innovation financière et investissement, le cas de la titrisation revue*, revue *Innovations: Systèmes d'innovation, Chroniques d'intégration ordinaire*, no 19, 2004/1, De Boeck Supérieur, 115.
- 2 Ibn Qayyim al-Jawziyyah, *Ighathat al-Lahfan min Masa'ib al-Shaytan*, ed. Majdi Fathi al-Sayyid. (Cairo: Dar al-Hadith), 673.



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## APPROACHES OF INNOVATION IN ISLAMIC FINANCE

By Dr Sami Ibrahim Suwailem  
IDB



We live in an ever-changing world where innovation is not a luxury but a must for survival. Virtually all of the economic growth since the 18th century is ultimately attributable to innovation (Baumol, 2002). Developing countries do not so much suffer from a lack of capital and physical inputs but rather from a general lack of innovative ideas. In this ever-changing world, the biggest risk is to stand still; but the stand-still strategy can cost dearly.

Islamic finance by nature is innovative. It links finance to the real world, which is dynamic and ever-changing by nature. Islamic finance therefore helps the financial sector avoid the biggest risk it might face: trying to stand still.

From this perspective, conventional finance is inherently risky. Simply to lend money and collect more money is a repetitive stagnant transaction by nature.

Conventional finance lacks dynamism that characterizes the real world. It is no wonder that conventional banking has been described as “boring banking” (Nocera, 2012).

Conventional finance thus has shifted since the 1990s to more “exciting” activities, involving exotic derivatives such as collateralized debt obligations (CDOs) and credit default swaps (CDSs). Unfortunately, these activities are mainly gambling and high-risk betting that add no value to the economy. Instead, they create toxic assets that set on the balance sheets of banks and financial institutions as time-bombs. The bombs set off the Global Financial Crisis (GFC) in 2007.

Historically, financial crises have been more risky and costly to the global economy than recessions that stem from the real economy (IMF, 2008, 2009). It is now beyond doubt that the financial system, when decoupled from the real economy, is riskier and more volatile than the real economy. Conventional banking therefore is not as safe as it might look.

### WHAT IS INNOVATION?

In his famous *Innovator's Dilemma*, disruptive innovation authority Clayton Christensen classifies innovation into two types:

1. Sustaining innovation
2. Disruptive innovation

Sustaining innovation aims at improving existing products to fit the demands of existing customers.

Disruptive innovation creates a new market for new products; these products appear initially costly and do not meet the demands of mainstream customers. Rather, they meet the needs of a different segment of the market. Moreover, these products have some unique advantages that are lacking from mainstream products. They also have a good potential for the future.

After studying many examples from different sectors, Christensen notes that entrants who bring disruptive innovation succeed through the following steps:

- Focus on the market segment that mostly value the new technology. This segment is

different from the mainstream segment. The new segment is usually small in the beginning, but they are willing to adopt the new technology.

- Create value-network (suppliers, brokers, etc.) that fit the requirements of the new technology.
- Capitalize on the inherent advantages of the new technology to grow and expand the market.

A recipe for failure, according to Christensen, is to try to adapt the new technology to the old one in order to satisfy existing customers. This strategy is usually followed by established firms with a large and established base of clients and value-network. Rather than embracing the new technology wholeheartedly, they try to fit it within the old one. This strategy usually does not succeed.

## INNOVATION IN ISLAMIC FINANCE

From this perspective, it is not difficult to see that Islamic finance is a kind of “disruptive innovation” to conventional finance, at least in some respects. It seems to be more costly, and as such does not fit the expectations of conventional customers.

Many conventional banks are trying to fit the “new technology” i.e. Islamic financial instruments, within the old one, i.e. conventional finance. This takes many forms, but the final result is the same: make the Islamic product as similar and as appealing to conventional customers as possible. But if we think that the *Innovator’s Dilemma* is of any value, we know that this strategy is not a good recipe for success, at least for the long run.

So, how can we capitalize on the “disruptive innovation” offered by Islamic finance?

All we need is simply to do the following:

1. Identify the market segment that wholeheartedly embraces Islamic products. Many

Muslim customers might emotionally embrace Islamic products, but they still think and act in a conventional manner. Their brains are for Islamic finance, but their hearts are still anchored in conventional finance. This segment will not be the best starting point for Islamic products, at least not for the most preferred products like *musharakah*. For such Islamic products to be successful, we have to choose the right segment of customers: those who are willing to pay the additional costs and accept the additional risks. This is not to say that Islamic products can be offered to this segment inefficiently or un-economically. Islamic financial products need to be innovative, efficient and appealing to the new customers, meanwhile serving the main objectives of Islamic finance.

2. For this segment, create the value-network that best serves the objectives and purposes of Islamic finance. For example, *musharakah* is not a credit-based product, and therefore “credit-rating” is meaningless in this context. What we need is a rating of business-worthiness or “fiduciary-capacity rating”.

If we want to issue *musharakah* sukuk, then we need to develop the whole value chain (rating, distributors, lead managers, etc.) that serve the market segment we are targeting, i.e. investors willing to understand and take the calculated business risks. It is pointless to use the same value chain of conventional bonds to market Shariah-compliant sukuk. These sukuk will necessarily be morphed into conventional bonds. No wonder, sukuk are frequently described as “Islamic bonds.”

3. As this segment of investors and customers endorse and adopt the new products, the products will be improved gradually up to a point that will be able to compete with mainstream products.

For example, in the early days of Islamic banking, it was very difficult to imagine how banks could buy and sell goods or services. Banking was only about money for money, and banks were forbidden from trading of any kind. Gradually, the nature of *murabahah* and the



associated risks became clear, and it was possible therefore to address these risks properly.

The same is true for other Islamic products, particularly *musharakah*. Once it is applied properly with the right segment, there will be enough data over time to analyze and assess the associated risks, and thus these products can become mainstream once such risks are properly accounted for.

One important aspect of mainstream finance is its ability to endorse new products once the nature of these products are well understood and properly addressed. The mistake that we repeatedly make is to start with the wrong market segment, and force the Islamic products to adapt to conventional markets. In this manner we will fail to know anything useful about the true nature of Islamic products, because we are applying them in the wrong manner for the wrong market.

The Islamic financial industry needs to re-invent itself in order to meet the expectations of the majority of the population in the developing world, where most Islamic banks operate. The majority of the population in these countries have limited access, if any, to banking services. They are not “bankable.” Hence, Islamic banks are able to serve only a fraction of the larger population. This is not a very good strategy for the long run. With the large youth population in these countries, and with the growing role of social technologies, we are about to witness a “disruptive innovation” that might have a great impact on traditional banking. The Islamic financial industry needs to be truly innovative if it wants to stay on its current trajectory of growth and productivity.

## CONCLUSION

In conclusion, it is helpful to reiterate that the most risky strategy in our ever-changing world is to stand still. We cannot keep doing what we are familiar with and still expect to come out on top. This might happen for a while, but it is the most risky strategy. The following quote might summarize the moral of the story:

When it comes to the future, there are three kinds of people:

- those who make it happen;
- those who let it happen;
- and those who wonder: what happened?!

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## LATEST TRENDS IN ISLAMIC DERIVATIVES

By Habib Motani, Qudeer Lateef & Cheuk-Yin  
Clifford Chance



Islamic derivatives have been a long-standing component of the wider Islamic finance industry, providing risk management solutions to complement other sectors of the industry and offering hedging possibilities to Shariah-compliant market participants.

Those fundamental tenets of Shariah jurisprudence which are particularly relevant to Islamic derivatives are:

- **Prohibition of *Gharar*:** the lack of certainty to a contract is not permitted as this could affect the degree or quality of consent of the parties to a contract;
- **Prohibition of *Maysir*:** games of chance or speculation are forbidden on the basis that they create no additional value to society.

These tenets have safeguarded Islamic hedging from many of the concerns with respect to the conventional derivatives industry throughout the global financial crisis that started in 2007.

Significant developments have occurred in the area of Islamic derivative products and forms of Islamic hedging instruments such as profit rate swaps, Islamic FX forwards, Islamic options and Islamic cross currency swaps, to name a few of the more widely seen examples.

The area of product development continues to be one of product innovation as market participants become increasingly sophisticated. Meanwhile the most commonly used structural building blocks continue to comprise of a combination of *wa'd* and *murabahah*.

### INDUSTRY BODY INITIATIVES

The International Islamic Financial Market (IIFM) and the International Swaps and Derivatives Association (ISDA) remain active in responding to market participant needs.

**Master Collateralized Murabahah Agreement (IIFM):** published in November 2014, this new industry standard document provides a mechanism for access to liquidity on a collateralized basis (based on the Shariah principle of *rahn*) using *sukuk* and other Shariah-compliant securities as collateral.

**ISDA/IIFM Cross Currency Swap templates for the Tahawwut Master Agreement (ISDA and IIFM):** the joint ISDA-IIFM project to develop template documentation for Shariah-compliant Cross Currency Swaps is expected to be published in this 2015.

**ISDA/IIFM FX Forwards templates for the Tahawwut Master Agreement (ISDA and IIFM):** launched in March 2015, the ISDA and IIFM working group has started discussion under the guidance of the Shariah Advisory Panel of the IIFM to develop template documentation for Shariah-compliant FX forwards.

**ISDA Middle East Committee (ISDA):** inaugurated in December 2014 by ISDA, the ISDA Middle East Committee represents a consolidation of the efforts of market participants to drive forward locally-based reforms to provide legislative certainty on derivatives activities.

## INTERNATIONAL BANKS

In addition to the more established financial institutions offering core Islamic derivatives products, the past year has seen unprecedented levels of new interest from global banks that are either building on their other existing Islamic business lines such as arranging *sukuk* or providing *murabahah* financing, or exploring new markets in Muslim countries.

## CHALLENGES

Although the Islamic derivatives industry is at a point of unprecedented volume and sophistication today, there are a number of key challenges for the industry:

**Standardization:** the publication of the ISDA/IIFM Tahawwut Master Agreement in 2010, along with the template documentation for *Mubadalatul Arbaah* (profit rate swaps) and their mandatory adoption by Saudi-based swap counterparties pursuant to a SAMA Decree of 2013 have been major milestones in providing an industry-wide solution to documentation standardization. However, the use of bespoke documentation is still widespread, which increases the workload for swap counterparties comparing like-for-like features across trades for credit and risk evaluation purposes.

**Operations infrastructure:** alongside documentation, standardization of operational processes and technological investment is also required by new market entrants in order to develop an execution infrastructure capable of fully realizing the market potential.

**Netting:** a key component for risk mitigation of derivatives transactions generally (including Islamic derivatives) is the enforceability of the netting provisions under a netting agreement. The ISDA/IIFM Tahawwut Master Agreement is an example of such netting agreement. Although most jurisdictions would recognize pre-insolvency payment netting under their civil codes, post-insolvency netting in order to

enable close-out of covered transactions under a netting agreement has uncertain enforceability in most member states of the Organization of Islamic Cooperation. Notable successes with netting legislation enactment in the past year have been new laws in Malaysia, the Kingdom of Bahrain and the Dubai International Financial Centre (a financial services free-zone within the United Arab Emirates). However, netting enforceability is a key component of providing a sound legal environment for Islamic derivatives to expand.

**Bankruptcy laws:** One of the main challenges to netting enforceability is uncertainty of local bankruptcy laws, which can often require updating to reflect the relevant country's modern economy. As the industry's standardization environment matures, the ability to provide certain treatment of risk sharing upon a counterparty insolvency is necessary to increase confidence — particularly from foreign counterparties — in the derivatives industry.

## REGULATIONS

Although a number of Muslim countries have enacted laws or developed regulations for Islamic banking, the traditional Islamic derivatives markets — particularly with the involvement of global banks — are not immune from the extraterritorial impact of the G20 leaders' commitment in Pittsburgh in September 2009 to increase the financial stability of the over-the-counter ("OTC") derivatives market.

**EMIR/ Dodd-Frank:** global implementation of the G20 commitment reforms are currently nearing their final stages of implementation in the European Union (through the European Market Infrastructure Regulation, "EMIR") as well as the United States (as part of the Dodd-Frank Wall Street Reform Act). The Kingdom of Saudi Arabia is also a G20 member state and thereby has also committed to introduce equivalent reforms. The main concepts under these reforms are:

- mandatory reporting of OTC trades
- timely confirmation, portfolio reconciliation and dispute resolution
- mandatory clearing of eligible OTC trades
- mandatory margining of uncleared OTC trades

Particularly with respect to mandatory margining of uncleared OTC trades, where both parties would potentially be required to post variation margin for relatively “vanilla” profit rate swaps, we expect this “limb” to cause the greatest impact to the Islamic derivatives industry.

Similar reforms are also taking place in the Asia-Pacific region, most notably in Singapore and Hong Kong, with implementation currently at the trade reporting stage.

**Collateralization:** one of the most important reforms to the regulation of financial markets is the impending requirement to collateralize non-centrally cleared derivatives transactions. As it is not expected in the foreseeable future that an authorized central counterparty (known as a “CCP” under EMIR) would be able to centrally clear Islamic derivatives, it is more likely that such transactions would instead be subject to bilateral mandatory margining between the contract counterparties. This requirement for collateralization will soon have a significant impact on the market, from the availability of eligible collateral, to new operations systems which have to be put in place to enable daily variation margining as well as meeting regulatory requirements on the segregation of posted collateral.

#### Capital Requirements Regulations and CRD

**IV:** EU banks are subject to capital requirements for counterparty credit risk arising from the bank’s derivatives, repo and security finance activities, which would also cover the equivalent transactions executed in a Shariah-compliant format. Non-EU counterparties dealing with EU counterparties may see the effect of CRD IV compliance in differential pricing offered between global and regional banks.



*The increasing scope  
of globally driven  
regulations will  
impact the  
compliance require-  
ments applicable  
to Islamic derivatives.*





## GOING FORWARD

The increasing scope of globally-driven regulations will impact the compliance requirements applicable to Islamic derivatives. Whereas market participants may already be familiar with requests from Western-based banks to either adhere to the ISDA EMIR and/ or Dodd Frank Protocols, or to execute supplementary documentation to similar effect, the upcoming implementation of mandatory margining under EMIR is likely to require a widespread operational and re-papering exercise as parties put in place systems to handle variation margining.



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# THE IIFM ISLAMIC HEDGING MASTER AGREEMENT: A SHARIAH PERSPECTIVE

By Ijlal Alvi  
IIFM



The ISDA/IIFM *Tahawwut* Master Agreement was designed to facilitate the risk management function of Islamic financial institutions. It is seen as the backbone for Islamic

hedging products and documentation and has contributed to an increased understanding of Islamic hedging product structuring and its risk mitigation objectives, at the same time boosting product acceptability at the global level.

The Islamic financial services industry has expanded its reach and appeal to many countries across the globe. Islamic financial transactions now take place in a number of currencies, some of which are volatile due to fast-changing global markets. In addition, the rate of return on assets and liabilities is also subject to volatility, as they could be on a fixed or floating basis. Since it is practically not possible to mitigate currency and the rate of return risk through *takaful*, in 2006 the International Islamic Financial Markets (IIFM) in association with the International Swaps and Derivatives Association (ISDA), embarked on the challenging task of developing an Islamic hedging (*tahawwut*) standard master agreement, product confirmations and related credit documentation.

Unlike conventional derivatives where both risk mitigation and speculative activity take place simultaneously Islamic hedging is very much a requirement-based activity. As Islamic finance expands into new markets, the need to mitigate risk, mainly in the areas of rate of return mismatch or currency risk, are crucial. It is worth noting that the primary objectives of the Islamic hedging mechanisms are similar to a conventional hedging mechanism with the exception of adherence to Shariah principles.

## IIFM's role and objective

IIFM has so far played an important role in the development of risk mitigation products and has contributed significantly towards the development of a Shariah-compliant standardized risk mitigation sector. The main objective of this effort is to bring much needed uniformity to financial contracts and product templates and push for Shariah harmonization and the creation of a legal framework for contractual obligations in order to provide a level playing field for all financial institutions, particularly Islamic banks.

## DEVELOPMENT OF THE ISDA/ IIFM TAHAWWUT MASTER AGREEMENT

In line with desired objectives, the first step in compiling a robust hedging documentation was to develop a master agreement under which risk mitigating product confirmations and related credit documentation can be put in place for the creation of a transparent, risk mitigating and efficient Islamic hedging segment.

The ISDA/IIFM *Tahawwut* Master Agreement was published in 2010 to serve as a framework document providing general terms and conditions, such as standardized early termination and close-out mechanisms, as well as other legal and Shariah provisions for privately negotiated and widely accepted Islamic hedging products.

The *Tahawwut* Master Agreement covers all trade transactions between the parties involved. It incorporates the three pillars designed to ensure that in an event of a default or early termination, the exposures of the parties under all outstanding transactions are aggregated and

netted, in order to prevent any possible disputes. These pillars are:

- Single Agreement
- Flawed Asset & Conditionality
- Close-out and netting

The *Tahawwut* Master Agreement is designed for a suite of products globally and is developed to accommodate a range of Islamic hedging products based on *murabahah* and *wa'ad*. It also has several differences when compared to ISDA's 2002 Master Agreement such as:

- No compensation or interest on defaulted or deferred payments and deliveries
- No interest payable
- Additional representations for Shariah compliance
- Governing law and dispute resolution
- Early termination
- Dual close-out mechanism based on indexing, as Net Present Value or Discounted Cash Flow calculation are not allowed in Islamic finance
- Clauses to cover all transactions including the defaulting party's "in the money" profit transactions

There is no doubt that transparency is an important requirement of a sound financial transaction and the key pillar of documentation standardization from the Shariah perspective. Therefore, IIFM standard agreements are generally accompanied by a comprehensive guidance/explanatory memorandum which provides clarity on market practice as well as the legal and Shariah recommendations on the contractual obligations of the financial contract or product confirmation.

## RISK MITIGATION PRODUCT TEMPLATES

Following the successful publication of the *Tahawwut* Master Agreement, IIFM embarked on developing risk mitigating product templates known as DFT (Designated Future Transaction) Terms Confirmation/Agreement which forms part of the *Tahawwut* Master Agreement. The following standard risk mitigating product templates have either been published, or are under development:

- Islamic Profit Rate Swap
- Islamic Cross Currency Swap
- Islamic Foreign Exchange Forward
- Islamic Credit Support Agreement

## ISLAMIC PROFIT RATE SWAP (MUBADALATUL ARBAAH)

In its efforts to accelerate the use of the *Tahawwut* Master Agreement, IIFM in association with ISDA published the first standard product template, the Islamic Profit Rate Swap (IPRS), or *mubadalatul arbaah*.

The IPRS provides the industry access to robust and well-developed product documentation under the master agreement. It provides protection to the Islamic financial institution's balance-sheet from wide swings in fixed and floating profit rates and enables the Islamic financial institutions to manage their cash-flow risk for various Islamic capital market instruments such as sukuk. When dealing with the IPRS mechanism, two important points should be noted:

- *Murahahah* is used in this transaction to generate fixed and floating payments (this includes: cost price and fixed or floating profits).
- It is structured on a *wa'ad* basis where each of the contracting parties undertake the swapping of fixed and floating profit payments at a particular time and date in the future.

Normally a series of reverse *murabahah* is used in this transaction to generate profit payments.



*Out of the available Islamic hedging products, the Foreign Exchange Forward is considered to be the most in-demand product as it is required not only in capital and money markets but also in corporate and trade finance.*



### **ISLAMIC CROSS CURRENCY SWAP (HIMAAYAH MIN TAQALLUB AS'AAR ASSARF)**

The Islamic Cross Currency Swap (ICCS) provides Islamic financial institutions an alternative to efficiently manage currency fluctuation and cashflow management. The use of the ICCS is generally observed in the capital markets, particularly for *sukuk*, where the *sukuk* holders, depending upon their asset and liability profile, may want to manage the cashflow and currency volatility through the ICCS arrangement in order to manage risk. A standard template is currently under development.

### **ISLAMIC FOREIGN EXCHANGE FORWARD (WIQAYAH MIN TAQALLUB AS'AAR ASSARF)**

The objective of the Islamic Foreign Exchange Forward is to minimize the exposure of Islamic financial institutions to currency rate, which fluctuates according to global markets. Out of the

available Islamic hedging products, the Foreign Exchange Forward is considered to be the most in-demand product as it is required not only in capital and money markets but also in corporate and trade finance. This template is currently under development as well.

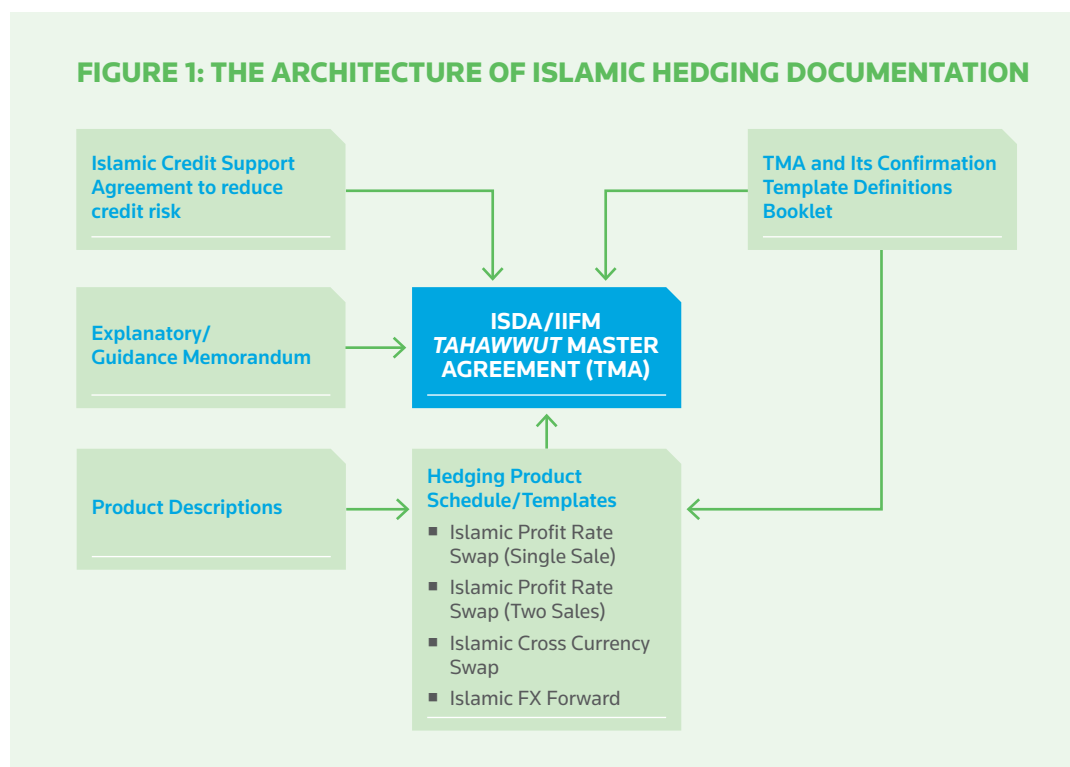
### **ISLAMIC CREDIT SUPPORT AGREEMENT**

Since the 2007/8 global financial crisis, the use of collateral and margin maintenance has become a necessity and in some cases a mandatory requirement by regulators particularly for banks based in G20 countries. IIFM in consultation with the industry has reached a near consensus that credit support arrangement is one related area which needs to be explored. It is required to manage the credit risk of Islamic hedging transactions through collateral and margin maintenance. Market consultation by IIFM is currently underway for this project.



## THE *TAHAWWUT* MASTER AGREEMENT: BUILDING BLOCKS

Once the entire exercise of Islamic hedging documentation and product confirmations is concluded, the documentation architecture will be as depicted in Figure 1.



### SHARIAH PERSPECTIVES ON THE *TAHAWWUT* MASTER AGREEMENT AND ITS DFT TERMS CONFIRMATIONS TEMPLATES

Since the Islamic financial industry is expanding and moving towards sustainable development, it is established beyond any reasonable doubt that protection against a real risk for Islamic financial institutions in their dealings is a must.

There is a consensus amongst industry stakeholders that financial swaps mechanisms are conventional in their origin, and the requirements of Islamic financial institutions for such transactions to mitigate real risks is inevitable. Therefore, to address these conventional mechanisms and their contravention with Shariah principles, Shariah scholars must carefully study and examine the mechanisms of these transactions before passing any ruling on them. As the Islamic maxim goes: "Judgment is to be based on knowledge and understanding".

The result of years of research and study on the part of Shariah scholars has culminated in the following guidelines for Islamic hedging:

- To stick to the purposes and principles of Shariah in these transactions with regard to protection of wealth.
- The purpose of entering into these transactions must be for a real hedge against unexpected risks to both sides of the transaction.
- Entering into these transactions should not be for the purpose of speculation.
- Actual payments and settlement of assets between two parties must actually take place.
- A cash settlement without the actual transaction involving delivery and receipt of assets is not permitted.

- Assets that are exchanged between the contracting parties must be Shariah-compliant.
- No interest should be paid or taken by any party under these transactions/agreements.
- Provisions related to the sale of exchange must be applied throughout the life of the transaction, especially in cross-currency and FX forward transactions, as they fall under a sale exchange. So when there is a delay in receipt and delivery, the validity of the transaction will be affected from a Shariah perspective.

## COMBINATION OF CONTRACTS

Combination of contracts is another aspect of an Islamic hedging transaction which cannot be neglected. As per Shariah ruling, it is permissible to combine more than one contract in one transaction, provided that there is no imposition of one contract as a condition on the other, and that each contract is permissible on its own. The Shariah guidelines are as follows:

- It is not allowed to combine sale and lending (i.e. *bay' wa salaf*) in one contract.

Example: I will sell this asset to you at 100 provided you lend me 100.

- It is not allowed to use a combination of contracts as a trick or excuse for taking or accepting *riba*.
- It is not allowed to combine a lending contract for personal gain, such as:

Stipulating in the contract that the borrower should offer accommodation in his house to the

lender or should grant him a present or imposing excess repayment in terms of quantity or quality on the borrower.

- It is not allowed to combine contracts with different underlying Shariah rulings and ultimate goals, such as: combining *mudarabah* with lending the *mudarabah* capital to the *mudarib*.

## CONTEMPORARY APPLICATIONS FOR COMBINATION OF CONTRACTS

Contractual arrangements which comprise of a number of contracts and pledges are perhaps the most distinguishable forms of contemporary Islamic financial transactions. Therefore, the general Shariah rulings with regard to structure, requirements and conditions should be observed in order to be Shariah-compliant.

Pledges contained in such combined contract sets are binding to their respective parties. A failure to honor contractual commitments from any party to the contract gives the other party right of claiming indemnity for the actual loss encountered. Among these agreements are *murabahah* to the Purchase Orderer (*murabahah lil aamir bi al-shira'*), *ijarah* ending with acquisition of ownership of the asset by the lessee (*al-ijarah al-muntahiyah bi al-tamlik*) and/or diminishing *musharakah* (*al-musharakah al-mutanaqisah*).

IIFM continues to play an important role in the development of a well-structured and risk-prudent hedging market. It is also assessing new regulations being introduced by the European Union (European Market Infrastructure Regulation) and North America (Dodd Frank) to remain relevant in the market and to develop a robust, unified and transparent Islamic finance industry.



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## CHALLENGES IN INNOVATION FOR ISLAMIC FINANCE PRODUCT DEVELOPMENT

By Rafe Haneef  
HSBC Amanah



Over the last three decades, the Islamic finance industry has produced significant product innovation across various business segments. The market has followed the progress of Islamic financial products from simple *murabahah*-based home financing to more complex home financing based on *musharakah mutanaqisah*. We have also seen Islamic cross-border business grow from simple syndicated *murabahah* transactions to complex project finance syndications combining *istisna'* and forward *ijarah*. The *sukuk* market has also undergone exponential growth due to the innovative *sukuk* structures that have been introduced, ranging from simple *ijarah*-based *sukuk* to complex multi-asset *sukuk* combining tangible assets, intangible rights, and *murabahah* receivables. All these innovations have generated a lot of buzz in the Islamic financial markets, and have helped propel the progress of the Islamic finance industry to where it is today.

### CRITICISMS OF FORM OVER SUBSTANCE

Despite the impressive growth story, the Islamic finance industry is at a crossroads. Many have challenged past and current innovations in Islamic finance as mere replications or adaptations of conventional products. According to its critics, Islamic banking and financial products merely comply with the form, and not true principles, or substance of Shariah. These innovations, they say, do not successfully capture the spirit of *maqasid al-Shariah* and only end up mimicking the risk and reward profile of conventional products.

Take for example, a relatively complex home financing product which combines *musharakah mutanaqisah* with *ijarah muntahiyah bittamleek* that at the end of the day has the exact risk and reward profile of a conventional mortgage loan. In reality, the bank as co-owner of the property does not share any of the downside risk of the property. Neither does the bank share in the upside reward of the property (if any). Meanwhile, the purchaser enjoys both the upside and downside risks related to the property.

Similarly for *sukuk*, many complex structures have been introduced, combining many *fiqhi* principles and none of these *sukuk* has been able to capture the true essence of the underlying contract. For example, the sukukholders in the *sukuk ijarah* structure ought to be enjoying the risk and reward of the underlying assets. If the assets' value goes up or down, the sukukholders are meant to enjoy the upside and suffer the downside potential in the asset value. However, the innovation in contemporary *sukuk* structures have been to reflect conventional bonds' profile where the sukukholders only assume the credit risk of the lessee and not the assets being leased.

### BUSINESS REALITIES STIFLE "TRULY INNOVATIVE ISLAMIC PRODUCTS"

To a certain extent, there is perhaps some validity to the critics' arguments. Why aren't the sukukholders sharing in the upside of the value of the *sukuk* assets? Or, why isn't the bank as co-owner of the house under *musharakah mutanaqisah* sharing in the downside risk of the house value?

What the critics fail to realize is that the industry faces huge challenges in creating truly innovative Islamic products.

Innovation is influenced by many external factors which transcend the Islamic finance industry itself. To illustrate this point, let's look at the case of the home financing product. Assume that an Islamic bank is prepared to share the downside risk of the house price at the point of liquidation, which is obviously beneficial to the customer. However, central banking regulations will require Islamic banks allocate more capital for the additional downside risk that the bank is now assuming. This additional capital requirement will result in a higher pricing for the Islamic home financing product compared to a conventional product. It is therefore unlikely that customers will favor an Islamic home financing product that is priced higher than a conventional home mortgage product. This kind of challenge would not prevail in a single system which is entirely based on Islamic finance principles.

As long as Islamic finance runs in parallel with the conventional financial system and is governed by the rule book initially designed for the conventional banking system, any innovation in Islamic finance will find it difficult to comply with the higher objectives of *maqasid al-Shariah*.

Another challenge faced by Islamic banks in developing innovative products is that some products are often not aligned with the *maqasid al-Shariah*. For example, credit card products which are ubiquitous in today's society, has become one of the essential products in the Islamic banking industry. Given that credit cards are tools to facilitate loan-type transactions on a demand basis, it is very challenging to create an alternative credit card based on Islamic principles.

Many banks have experimented with various innovations in replicating a conventional credit card that complies with Shariah. Critics have also argued that these so-called Islamic credit cards have led to customers indulging in impulsive spending beyond their means, to potentially end up in financial difficulties. In reality, what the critics fail to realise is that credit card use and consumerism have become a modern day lifestyle and it is impossible for Islamic banks to attract customers to a bank without providing an essential part of modern day utilities.

These innovations have helped Islamic banking to become a mainstream reality. Proponents and critics both need to realize that an innovation in Islamic banking is influenced by the forces that drive the global economy and financial system. It is unreasonable to expect an Islamic banking system to operate in a vacuum.



*Another challenge faced by Islamic banks in developing innovative products is that some products are often not aligned with the maqasid al-Shariah.*





## FUNDAMENTAL SOLUTIONS

Having said that, it is timely for the Islamic banking industry to take a different path. Whilst their products may be a replication or adaptation of conventional banking products and solutions in a Shariah-compliant format, the approach and manner of offering these products and services have to be materially differentiated from the conventional banking system. For example, Islamic banks have to be more innovative in the following areas:

1. Islamic banking documentation has to be simple, more transparent and written in plain language. The objective is to ensure that the customer is fully aware of the product offering, the true cost of financing and the terms and conditions.
2. Islamic banks have to participate in improving the level of financial literacy of their customers. The objective is to ensure, for example, that whilst the customer is seeking a credit card product which may lead to impulsive spending, the financial literacy programme of the bank educates the customer on how to manage his or her spending and how to fulfill their financial obligations responsibly. The old way of banking which is based on caveat emptor has to stop.
3. Islamic banks can become more innovative in terms of incentivizing their sales force to become more responsible when selling Islamic banking products. Islamic banks today are compensating their sales team based on the amount of financing closed, not dissimilar to conventional banks. This has led to various mischiefs, including mis-selling, predatory lending and other abusive practices. Islamic

banks need to lead the market by compensating the sales team based on the quality of advice given to the customer and customer satisfaction results. This is truly the risk sharing aspect that Shariah aspires Islamic banks to adopt.

4. Finally, Islamic banks should be more innovative in ensuring that the financing afforded to customers are used in a responsible and sustainable manner which will take into account the social, environmental and governance risks inherent in commercial activities.

Innovation in Islamic finance can still be in line with Shariah despite being a replication of conventional banking products and services, if it embraces the principles of ethical, responsible and sustainable financing as highlighted above. These holistic practices will further drive the growth of Islamic banking and hopefully over time, Islamic banking will become the dominant player in the marketplace. With dominance, Islamic banking will hopefully be able to redraw the rule book and define what banking is meant to be in line with the *maqasid al-Shariah*.



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# THE WAY FORWARD FOR INNOVATION IN ISLAMIC FINANCIAL PRODUCTS AND INSTRUMENTS

By Daud Vicary Abdullah  
INCEIF

To put it very simply, the **way forward** is about a back to basics approach. Islamic finance is about Risk Sharing in the context of the Real Economy. The global financial crisis and much post-crisis research have clearly demonstrated that there currently exists a nexus of:



Low interest rates, increase in money supply, increase in credit, increase in debt and increase in leverage created the liquidity that hunted down yield which eventually found its way to subprime mortgages and commodity market speculation. There is an urgent need, therefore, for financial intermediaries to serve the Real Economy rather than the Financial Economy. In that context the following are my observations and suggestions for innovation as the way forward for Islamic finance, in four specific areas: regulation and supervision of IFIs, human capital development, product structuring, and global connectivity.

## THE WAY FORWARD FOR INNOVATION IN REGULATION AND SUPERVISION OF IFIS

Regulation and supervision of the financial markets have always centred on the concept of Risk

Transfer rather than Risk Sharing, putting Islamic financial institutions (IFIs) at a disadvantage.

However, industry-wide standards, guidelines and agreements have emerged as greater internationalization and acceptance of Islamic finance prompted the industry to play an important role in supporting regional and international investment flows as well as intermediating cross-border financial flows.

Today, the industry is well supported by various industry infrastructure bodies, such as the International Islamic Financial Market (IIFM), Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). However, not all the standards issued by these organisations are adopted, or applied consistently across countries.

In the Malaysian context the interbank money market transactions between IFIs is facilitated by several Master Agreements developed by the Association of Islamic Banks in Malaysia (AIBIM). This will need to change to further develop the market.

The biggest challenge for the future will be to garner further acceptance by the conventional standard-setting bodies and regulators to ensure that Islamic finance can play on a level playing field throughout. This will mean redoubling our own efforts to ensure the concept of Risk Sharing is properly understood.

## THE WAY FORWARD FOR INNOVATION IN HUMAN CAPITAL DEVELOPMENT

The crux of this challenge, as indeed it is for any industry, is to ensure a good level of alignment between industry and academia. In more mature industries we have seen the development of professional associations, for example the Accounting and Engineering professions, set professional qualification standards that are independently accredited, which the Education sector uses as a target to develop relevant undergraduate and post-graduate programmes to meet their needs.

The Financial Accreditation Agency (FAA) in Malaysia has a global mandate and is the first such organization that is doing the accreditation work for the finance and Islamic finance industry.

The challenge is to develop strong enough Professional Industry Associations within Islamic finance to set appropriate and effective global professional standards.

Until this is done more thoroughly there will continue to be some disparity between what is produced by the universities and what is required by the industry.

In the meantime, progress is being made through industry and academic collaborations in the fields of research that are relevant to support industry growth. Much of this is funded by industry and this should form the basis of future collaboration and definition of professional standards and requirements for Human Capital.

## THE WAY FORWARD FOR INNOVATION IN PRODUCT STRUCTURING

Product structuring represents a great opportunity for industry, academia and the regulators to work together, to push forward, and to innovate.

Through the creation of organizations such as INCEIF, an academic post-graduate institution that is totally focused on Islamic finance, it is possible

to drive research that is both industry relevant and regulation cognizant. The way forward is to enhance and develop these levels of collaboration so that they become part of the gene pool or second nature, to put it even more simply.

Islamic finance has many challenges ahead, not least of which is steering practitioners, regulators and academics towards the benefits of Risk Sharing and rediscovering the Real Economy. Such an equity-based financial system, where risk sharing takes place, will reduce the over-reliance on debt funding and will therefore avoid the excessive debt and speculation which becomes part of the nexus of the crisis.

Since Shariah principles also discourage excessive debt when carrying out any financial transactions, innovation in both product structuring and providing a coherent and viable “demonstration effect” will be vital. This will require intensive research and collaboration between the three parties highlighted above — industry, academia, and regulators.

The benefits of getting this intense balance right will be enormous. Risk sharing transactions and undertakings greatly enhance the prospects for financial inclusion and bringing the financially unserved and underserved into the economic mainstream by allowing them to build assets. Through a wider application of equity-based structures in financing and investment, the Islamic finance industry would be able to achieve a far broader outreach to small and medium enterprises (SMEs) and microenterprises.

Undoubtedly the way forward is research through focus, collaboration and producing the demonstration effect.

## WHAT'S THE BEST WAY FORWARD FOR INNOVATION IN GLOBAL CONNECTIVITY?

For many years now I have been answering this and similar questions with a very simple answer: Education, Perception, and Liquidity. I see no need to change it for the purposes of closing off this article.

Firstly, it is important to provide educational programmes in Islamic finance that assist all levels of society at their various stages of development, in order to groom and educate people to think and articulate the value propositions of Islamic finance. They will also need to argue the case for Islamic finance and to ensure that they have adequate empirical and anecdotal evidence to support a very compelling argument.

If you are well educated in the subject matter then you have the ability to help change perceptions. You can argue the case, build the demonstration effect and be confident in the validity of your argument and actions. Perceptions must be changed in a non-confrontational way and the best way to arm you to do this effectively is through education.

Liquidity is the lifeblood of any industry, be it great or small. Islamic finance is fundamentally about “the efficient and effective distribution of capital for the benefit of the real economy’. As an industry we must develop instruments, mechanisms, and processes that support the mobilization of this capital to get it to where it is needed. The development in recent years of the IILM is an excellent example of where innovation, persistence and vision have overcome the nay-sayers and produced an institution and products that the conventional world has been unable to emulate in 400 or more years of operation.

The spirit of “joining up the dots’ must prevail. To do this we will require vision, foresight and commitment. We have the people and the time is now.

There is much to do and not a moment to lose!



**DAUD VICARY ABDULLAH** has been in the international financial services industry for over 41 years. He has set up and managed two Islamic banks. Currently, he is the President and Chief Executive Officer of INCEIF – The Global University of Islamic Finance. He is a member of the Global Group in Islamic Finance and Investment (Global IFIG); a member of the Steering Committee for The Royal Awards for Islamic Finance (RAIF); a member of the Islamic Finance Committee at the Malaysia Institute of Accountants (MIA); and a Senior Advisor for University of East London’s Islamic Finance and Banking Advisory Board.



## PART 5

# Case Studies on the Interpretation of Islamic Law & Legal Systems



# SUMMARY

This Section provides an overview of the intersection between Islamic commercial law and secular (civil and common) law in various legal frameworks of different jurisdictions namely Malaysia, United Arab Emirates, United Kingdom and the United States of America.

Malaysia has made great strides in integrating or harmonizing the application of Islamic commercial law in cases involving Islamic banking and finance. These cases are dealt with by civil court judges where Islamic commercial law principles are applied and given legal recognition. The Shariah Advisory Council of Bank Negara Malaysia (SAC-BNM) is set up to provide Shariah rulings on any matters pertaining to Shariah compliance of Islamic banking and finance products or transactions. Similar legal recognition is given to Islamic commercial law in Islamic banking and finance disputes that are handled by the Malaysian civil courts and the Kuala Lumpur Regional Centre for Arbitration. This development renders certainty to industry stakeholders and offers level playing field with conventional banking industry.

Nonetheless, in some jurisdictions namely United Arab Emirates and United Kingdom, many Islamic transactions have selected English law as the governing law. Recent court cases including Dubai Islamic Bank PJSC vs PSI Energy Holding Company BSC and Ors are examined in this Section. This case has a number of implications, including that where a debt is governed by English law, the enforcement of any related security is also a matter of English law even if the security documents purport to be governed by local law. Attempts to construct a contract in accordance with the Shariah are unlikely to be given effect by English courts. Remedies are possible but entail contractually excluding events, such as interest awards, deemed contrary to Islam and integrating terms that would mirror local law or Islamic law treatment — no small undertaking.

This Section concludes with a thoughtful analysis of the Arcapita bankruptcy in the U.S. legal territory, the second of its kind after the East Cameron oil and gas *sukuk* bankruptcy. Readers are provided with an overview of the restructuring process of the company. Existing Shariah-compliant debt was restructured and new Shariah-compliant debtor-in-possession financing was used as part of the reorganization plan. The case presents a number of highly relevant implications, namely: (i) U.S. bankruptcy courts appear willing to integrate and honor Shariah principles into their decisions and measures; and (ii) Islamic investors should give careful consideration at the outset of transactions to how a U.S. bankruptcy court will interpret and treat their Islamic financing arrangements. The Court here applied a substance over form approach. This should encourage broader respect and participation in Islamic finance in the U.S. while also highlighting to many of its stakeholders a source of continued criticism.



## THE ADJUDICATION OF ISLAMIC FINANCE CASES: THE UK EXPERIENCE

By Fara Mohammad  
Foot Anstey LLP



he legal system of a country generally consists of the judicial system, the executive, and the legislature. Add to these the legal professions; all are important considerations when it comes to Islamic financial transactions. These components underlie the application and enforceability of the Shariah, with the elements of the legal system varying from jurisdiction to jurisdiction. The United Kingdom has three separate legal systems governing three jurisdictions: England and Wales, Scotland, and Northern Ireland. This article will cover the position in England and Wales.

### ENFORCEABILITY OF ISLAMIC FINANCIAL CONTRACTS UNDER COMMON LAW

In English common law, the general position is that anything can be enforced as long as it is not illegal or contrary to public policy. "The starting point of our domestic law is that every citizen has a right to do what he likes, unless restrained by the common law, including the law of contract, or by statute." Accordingly, an Islamic finance product can be incorporated into an agreement governed by English laws and it will be enforced as it is written by the English courts. This was shown in *Attorney-General v Guardian Newspapers Ltd (no 2)*, an unreported case where the parties argued that the contract was contrary to the Shariah and should not be enforced. The governing law clause provided that: "This Agreement and each Purchase Agreement shall be governed by, and shall be construed in accordance with, English law." The courts rejected the argument and found that the contract was gov-

erned by English law and not Shariah. This was clear and unequivocal.

A subsequent case *Shamil Bank of Bahrain EC v. Beximco Pharmaceuticals Ltd* went to the Court of Appeal. In this case, the defendant *Beximco* and the other borrowers entered into and subsequently defaulted under a *murabahah* agreement. After a series of various termination events under the agreements, the plaintiff applied for summary judgement. The defendants argued that the *murabahah* agreement was invalid and unenforceable because they were disguised as interest-bearing loans. The governing law clause provided that: "Subject to the principles of the Glorious Shariah'a, this Agreement shall be governed by and construed in accordance with the laws of England."

At first instance, *Beximco* counsel argued that the Shariah could be the governing law of the contract. However, the courts relied on Article 1 of the Rome Convention which referred to "any situation involving a choice between *the laws of different countries*" and decided that as Shariah was not the law of a "country", it could not be the governing law. The courts further dismissed the counsel's argument that the Shariah could be incorporated into the contract by reference because the English courts contended that the Shariah was a religion, not law; it was too uncertain and the parties' intention was only to express the Bank's effort to comply with the Shariah.

*Beximco* has become the leading case in this area and the legal industry often refer to this case as it provides the certainty that documents will be enforced as drafted. The Shariah aspect of such transactions became a matter of compliance. However, the law has since changed with the



*Local English law considerations need to be taken into account when entering into an Islamic financial transaction, but at the same time it is equally important to be cautious of generalizing the position of the Shariah from these cases.*



Rome 1 Regulation which provides as follows: “This Regulation does not preclude parties from incorporating by reference into their contract a non-State body of law or an international convention.” In applying this, it can be argued that the decision in *Beximco* is irrelevant for contracts to which the Rome I Regulation applies, i.e. those contracts entered into subsequent to 17 December 2009. Despite this, the predominant stand taken by the Islamic finance industry is that even though the Rome Convention has been replaced by the Rome 1 Regulation, the conflict of law rules applicable in England and Wales remain the same and English law still prevails as the governing law.

Another case which has provoked discussion is *The Investment Dar Company KSCC v Blom Development Bank Sal* which involved TID, a Kuwaiti investment company and Blom Development Bank (Blom), a Lebanese bank. A *wakalah* investment agreement governed by English law was entered into whereupon Blom deposited money with TID and appointed TID as its agent to manage its money as an investment. Blom

sued TID in the English High Court and applied for summary judgment on the grounds of contractual default payment and the deposits held in trust. TID’s argument was based on issues of Shariah non-compliance in that it should not have to pay Blom a fixed return on deposits invested with it as its articles of association prevent it from engaging in forbidden activities, i.e. interest-based activities. However, as the contract was approved by the TID Shariah Board and constituted a binding contract with valid offer and acceptance, in both common law and Shariah, it is argued that TID should have been held to the terms of the contract. As *TID v Blom* is an appeal from a summary judgment, it does not have precedential importance. The main matter of significance i.e. whether the transactions were *ultra vires* was not adjudicated in the English courts.

When English common law is designated as the governing law of an Islamic finance contract, courts tend to sever any association with the Shariah by recognising conflict of laws and asserting that only a national law can govern



the contract. Judges then strictly apply English law to the commercial dispute, and disassociate the Islamic aspects of the transaction from the adjudication process.

Local English law considerations need to be taken into account when entering into an Islamic financial transaction, but at the same time it is equally important to be cautious of generalizing the position of the Shariah from these cases.

The situation may be different in arbitration. Section s. 46 (1) of the Arbitration Act 1996 permits the arbitral tribunal to decide the dispute in accordance with the law chosen by the parties or in accordance with “other considerations” as are agreed by the parties or determined by the tribunal. It is contended that “other considerations” could include the Shariah. Based on this, if a party wishes for a dispute to be subject to arbitration under the Arbitration Act 1996 with the Shariah as its governing law, such party may be able to do so if the parties agree. A factor that may pose a problem with this is obtaining properly qualified arbitrators for such arbitration.

insolvency of a party. The parties then need to refer to a dispute resolution system available in a particular country. It therefore becomes imperative to understand the unique position associated with the operations of an Islamic financial institution and a particular country’s approach when solving Islamic finance disputes.

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*The Investment Dar Company KSCC v Blom Developments Bank Sal* [2009] EWHC 3545 (Ch)

## A DUAL SYSTEM?

The application and enforceability of the Shariah is a significant concern for Islamic financial transactions as it requires simultaneous compliance between the Shariah and national law requirements. As no “Shariah legal system” exists, the activities of the Islamic financial institution, the contracts entered into with customers and local laws must be carefully considered before entering into the transaction. This approach has been embedded within the Islamic finance industry. The difficulty arises when there is a default or any significant issue arises such as liquidation or the



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# ENFORCEABILITY OF ISLAMIC FINANCE CONTRACTS: A MALAYSIAN EXPERIENCE

By Jal Othman and 'Ainin Wan Salleh  
Shook Lin & Bok



Islamic finance is fast becoming part of the mainstream, with Malaysia at the forefront of this development. This growth can be attributed to the dynamic landscape of the Malaysian legal and financial system which has fostered the proliferation of a wide spectrum of Islamic financial instruments. These Islamic financial instruments cannot however exist in a vacuum. First, there must be a legal framework that takes into account the unique principles of Islamic finance. Second, there must be an avenue for dispute resolution that ensures issues in relation to Islamic finance contracts will be effectively adjudicated and subsequently enforced.

As one of the more sophisticated jurisdictions in terms of Islamic finance regulation and oversight, Malaysia sets a fine example for other countries particularly with regards to the enforceability of Islamic finance contracts. Issues such as the application of the corpus of Shariah law as well as the nexus between Shariah and common law come into play when determining the level of enforceability of Islamic finance contracts. In the case of Malaysia, common law and Shariah law both form part and parcel of Malaysian law, allowing for a certain level of enforceability of Islamic finance contracts. However, this is not without its difficulties, and although the Malaysian regulators have shown unwavering support in terms of ensuring Islamic finance contracts are applied and enforced, Malaysian courts still face challenges in dealing with disputes concerning Islamic finance contracts.

## SHARIAH AS PART OF THE LAW OF THE LAND

Applying Shariah law in Malaysia is not akin to adopting a foreign law, as this issue was resolved decades before the emergence of the Malaysian Federal Constitution in the landmark case of *Ramah v Laton* in 1927<sup>1</sup>, where presiding judge Thorne J. stated, “Muslim law is not foreign law, it is the law of the land; and the local law is a matter of which the Court must take judicial notice...”. Although this case was in relation to the issue of Islamic inheritance, that is, a personal matter, the judge used the term “Muslim law”, which can be interpreted widely to cover all aspects of Shariah law, including *muamalat* or financial transactions. Having established that Shariah law is in fact *lex loci*, the question of jurisdiction of the court arises as there must be a forum for the application of Shariah law, particularly in Islamic finance-related cases.

## JURISDICTION OF SHARIAH AND CIVIL COURTS

The jurisdictional separation of the civil courts and the Shariah courts is well entrenched in the Malaysian Federal Constitution (“Federal Constitution”). Article 121(1A) of the Federal Constitution stipulates that the civil courts shall have no jurisdiction with respect to any matter within the jurisdiction of the Shariah courts. Must we then seek the aid of the Shariah courts to enforce Islamic finance contracts? No.

Whilst matters in relation to Islamic personal law are within the purview of the Shariah courts as stipulated in the State List of the Federal Constitution, matters in relation to contracts,



*As one of the more sophisticated jurisdictions in terms of Islamic finance regulation and oversight, Malaysia sets a fine example for other countries particularly with regards to the enforceability of Islamic finance contracts.*



mercantile law, and such fall within the Federal List of the Federal Constitution and hence, under the jurisdiction of civil courts. Therefore, our civil courts have the jurisdiction to hear matters with respect to Islamic finance contracts. There is no issue of overlapping jurisdictions, as Abdul Wahab Patail J. expounded in *Arab-Malaysian Finance Bhd v Taman Ihsan Jaya Sdn Bhd & Ors*<sup>2</sup>, “When dealing with cases involving Islamic financing facilities, the civil court functions strictly as a civil court and does not become a Syariah Court.” The introduction of the Muamalat Bench at the Kuala Lumpur High Court in Court 4 of the Commercial Division, which hears only cases on Islamic finance and banking matters, represents a solemn commitment to recognising Islamic financial matters and adjudicate upon them.<sup>3</sup>

## GOVERNING LAWS

The issue of governing law which arose in the case of *Beximco Pharmaceuticals Ltd. & Ors v. Shamil Bank of Bahrain E.C.*<sup>4</sup> could have probably been decided differently in Malaysia as the coun-

try already has the legal framework committed to uphold and apply Shariah as the cornerstone of Islamic finance contracts, complementing the position of Shariah as the *lex loci*. Not only is Malaysia able to enforce Shariah law, the Malaysian courts have the jurisdiction to do so. Also, Section 27 of the Central Bank of Malaysia Act 2009 contemplates the duality of the financial system in Malaysia, the two systems being the conventional and the Islamic financial system. The provision of such duality paves the way for the recognition of Islamic financial contracts, allowing them to be enforceable.

Nonetheless, the peculiarity of Islamic finance contracts imposes additional challenges on judges in deciding on a case in the civil courts. The judges have to also consider the Shariah principles and concepts that underlie the Islamic financial transactions and their terminologies. Some of these principles are the requirement of a higher level of certainty of terms, prohibition on rights and obligations that are speculative in nature and the overall need to achieve an equitable balance in a traditional financial relationship.

## THE SHARIAH ADVISORY COUNCIL OF BANK NEGARA MALAYSIA

The establishment of the Shariah Advisory Council (SAC) by Bank Negara Malaysia (BNM) shows the Malaysian regulator's commitment to ensure certainty with respect to matters of Islamic finance. The SAC essentially acts as the final arbiter for matters in relation to Islamic finance. Being the *lex loci*, expert evidence cannot be adduced on Shariah law. Guidance is therefore provided via a court or arbitrator's right to refer to the SAC, being the authority for the ascertainment of Islamic law for the purposes of Islamic financial business. A court or arbitrator shall take into consideration any published rulings of the SAC or refer questions in relation to Islamic finance matters to the SAC for its ruling. Such rulings shall consequently be binding on the court or arbitrator.

Having said that, the SAC does not in any way usurp the power of the courts as it only deals with the ascertainment of the Shariah law and leaves the application of such ascertained Shariah law to the court. This position has been decidedly laid down in the case of *Mohd Alias bin Ibrahim v RHB Bank Bhd & Anor*.<sup>5</sup>

## APPLICABILITY OF CIVIL REMEDIES AND PROCEDURE

Once a court pronounces that an Islamic finance contract is valid and thus, enforceable, it must then enforce such judgment to that effect. The courts recognize that when dealing with disputes in relation to Islamic finance, the applicable law is still the law of contract. Hence, if the contract was not vitiated by any vitiating factor recognized in law such as fraud, coercion, undue influence, etc., the court has a duty to defend, protect and uphold the sanctity of the contract entered into between the parties.<sup>6</sup>

Similarly, civil procedure with respect to enforcement of judgment would apply. In *Bank Kerjasama Rakyat Malaysia v Emcee Corporation Sdn Bhd*<sup>7</sup> which concerned the foreclosure of land used as a security for a *bai bithamin ajil* facili-

ty, the Court held that although the facility was an Islamic banking facility, that did not mean that the law applicable in relation to the recovery process was different from the law that was applicable if the facility was given under conventional banking. Hence, in this case, the bank was right to file for an order for sale under Section 256 of the National Land Code and avail itself of all the remedies provided thereunder.

## HARMONY OF SHARIAH AND CIVIL LAW

Whilst common law and Shariah co-exist symbiotically, there may be instances when the two may at times appear to be incongruent. As both Shariah law and common law are recognized, both must be given due regard. For the most part, Shariah law and common law complement one another. For example, the High Court in *Maybank Islamic Bhd v Kamarulzaman bin Mohamed Nordin* held that where parties have read, understood and agreed to be bound by the *bai bithamin ajil* documents, they are bound by such terms as agreed. To support that contention, the judge alluded to the common law concept of parties to be bound by agreement.

Principles of Shariah are taken into consideration in the enforcement of judgment as reflected in the Rules of Court 2012 ("ROC") as compared to its predecessor, the Rules of High Court 1980 ("RHC"). The ROC provides that judgment debts arising from financial transactions in accordance with Shariah shall carry a late payment charge subject to the prescribed conditions, as compared to the imposition of interest on judgment debts. This provision is streamlined with the SAC's resolutions on the matter.

In addition, Order 83 Rule 3 of the ROC accommodates the prohibition of interest in Islamic finance. The previous provision found in the RHC stipulated that in a charge action, the chargee is required to disclose to the court the "*amount of any interest or instalments in arrears*". This resulted in challenges by defaulting customers with respect to the compliance of the said requirement notwithstanding that interest is prohibited under Islamic finance contracts.<sup>8</sup> The new pro-



vision expressed in the ROC did away with this requirement, stating that the chargee is merely required to disclose “*particulars of the amount remaining due under the charge*”<sup>9</sup> without specifically mentioning “interest”. This can be seen as a move to cater to the prohibition of interest in Islamic finance.

## ARBITRATION AS AN ALTERNATIVE

As an alternative to submitting to the courts, parties disputing an Islamic finance contract may wish to settle the dispute privately, via arbitration. The Kuala Lumpur Regional Centre for Arbitration (“KLRC”) had, in 2012, introduced an adapted set of its Arbitration Rules for Islamic arbitration, known as the KLRC i-Arbitration Rules, to cater to the resolution of disputes arising from any contract that contains Shariah issues. These Shariah-compliant rules also provide for an avenue for the arbitral tribunal to make a reference to the SAC for its ruling, in line with the right to refer as aforementioned.

Malaysia’s inclusive legal system could serve as a salient value proposition to issuers and investors alike, as it increases the ease of doing business in the country. Islamic finance contracts are enforceable within the Malaysian legal landscape which not only acknowledges the underlying principles of Shariah in Islamic financial contracts, but also strive to apply the same. The appropriate mechanisms for dispute resolution and recognition

of Shariah law ensure the flourishing of Islamic financing contracts, aided by the co-existence of Shariah law with its common law system.

### ENDNOTES

- 1 (1927) 6 FMSLR (CA).
- 2 [2008] 5 MLJ 631, High Court.
- 3 Pursuant to Practice Direction No. 1/2003, cases filed at the High Court of Kuala Lumpur under code 22A shall be heard by the Muamalat Bench in Court 4 of the Commercial Division.
- 4 [2004] EWCA Civ 19. In this case, the governing law clause in the financing agreement stated “Subject to the principles of the Glorious Sharia’a, this Agreement shall be governed by and construed in accordance with the laws of England.” The issue which arose was in relation to the construction of the said clause, whereby Shariah was not recognised as a law of a country enforceable with respect to requirements as laid out Rome Convention.
- 5 [2011] 3 MLJ 26, High Court.
- 6 *Bank Islam Malaysia Bhd v Lim Kok Hoe & Anor and other appeals* [2009] 6 MLJ 839, Court of Appeal.
- 7 [2003] 2 MLJ 408, Court of Appeal.
- 8 See *Bank Islam Malaysia Berhad v Adnan Omar* [1994] MLJU 221, High Court, applied in *Malayan Banking Bhd v Marilyn Ho Siok Lin* [2006] MLJU 283, High Court.
- 9 *Malayan Banking Bhd v Skycon Development Sdn Bhd* [2015] 7 MLJ 491, High Court.



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# THE ARCAPITA GROUP BANKRUPTCY: A RESTRUCTURING CASE STUDY

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Arcapita Bank (“Arcapita”) and its Debtor and non-Debtor affiliates (the “Group”) suffered an inability to obtain liquidity as a result of the 2007 global economic downturn and debt crisis. This affected the Group’s ability to refinance a US\$1.02 billion syndicated *murabahah* facility that was due on March 28, 2012 (the “Syndicated Facility”). Attempts to arrange an out-of-court restructuring were unsuccessful, as were efforts to dispose of properties and reduce costs. A minority of the Syndicated Facility providers had also declined to approve the restructuring and demanded payoffs at par, threatening precipitous actions in various jurisdictions.

This article summarizes the comprehensive reorganization that was effected pursuant to a plan of reorganization for the Debtors that was approved by the Bankruptcy Court (the “Plan”). The format of this article is issue-oriented. It progresses from the initial issues faced by an insolvent Debtor group through the financial restructuring process. This reorganization case study is illustrative of the issues faced by complex international financial organizations in insolvency situations. It is helpful to identify some of these issues at the outset and to ask how these matters are addressed through the course of the restructuring.

## BANKRUPTCY FILING: A LONG AND COMPLEX PROCESS

After considering several reorganization options in various jurisdictions, the Group’s management determined that a voluntary bankruptcy filing under chapter 11 (“Chapter 11”) of the United

States Bankruptcy Code (the “Bankruptcy Code”) was the most appropriate and efficient vehicle for a comprehensive restructuring for all Debtors. Chapter 11 proceedings were instituted on March 12, 2012, with a voluntary filing in the United States Bankruptcy Court for the Southern District of New York (the “Bankruptcy Court”). That filing involved six debtors; a seventh was added pursuant to an April 12, 2012, voluntary filing. These “Debtors” were:

- a) Arcapita;
- b) Arcapita Investment Holdings Limited (“AIHL”), which owns (i) 100 percent of the equity of LT Holdings, (ii) indirectly, all of the Group portfolio companies, and (iii) special purpose vehicles that provided financing to the Group companies;
- c) Arcapita LT Holdings Limited (“LT Holdings”), which owns 100 percent of the equity of WTHL, AED II Holdings and RailInvest;
- d) WindTurbine Holdings Limited (“WTHL”);
- e) AEID II Holdings Limited (“AEID II Holdings”);
- f) RailInvest Holdings Limited (“RailInvest”);
- g) Falcon Gas Storage Company, Inc. (“Falcon”).

The plan of reorganization for the Debtors approved by the Bankruptcy Court, is described in the related Disclosure Statement. Under the Plan, the Debtors continued to operate their businesses under the Bankruptcy Code as “debtors in possession”. Financing for continued operations was provided pursuant to a new “debtor in possession” financing facility (the “DIP Facility”).

The following are some of the sets of issues that should be kept in mind as one progresses through this case study. These are merely “headline” questions — the list of subsidiary questions is massive. The complexities of addressing these issues in the context of Shariah-compliant Debtors are only just starting to be considered, as the Arcapita bankruptcy is only the second of its kind, after the East Cameron oil and gas sukuk. It is interesting (and gratifying) to note that the Bankruptcy Courts in the United States have striven to adhere to Shariah principles in both of these bankruptcy proceedings, including the financial and corporate restructurings and reorganizations that have been implemented.

- Should the Debtors liquidate or attempt to continue operating?
- If the choice is made to continue operating, what proceedings are available to the Debtors to achieve that goal and in what jurisdictions are the desired proceedings available?
- What are the competing stakeholder claims and interests (debt, equity and other) on the Debtors and how should the claims and interests be grouped?
- How should payments and distributions be allocated among the competing claims and interests? What types of payments and distributions can be structured to address these issues? How much of each type should be allocated to each group, and in what order should allocations be made? To what constraints should each type of payment and distribution be subject?
- How do the Debtors generate the income to allow the desired payments and distributions? Will revenues be generated by operations? Will revenues be generated by asset dispositions? If so, how will operations and dispositions be structured, managed, constrained and implemented? What expenses will be permissible and how will expenses be controlled and managed to generate the necessary distributable income?
- Do the Debtors need to be restructured, from both financial and corporate perspectives, in order to develop an operating model that will maximize the success of the proposed financial plan? If so, how?
- Who will operate the Debtors during the rehabilitation process? And subject to what incentives and constraints?
- Who will be permitted to make the determinations with respect to the foregoing (and many other related) matters?

The purpose of this case study is to highlight how these types of issues arise and how they are addressed in bankruptcy proceedings of this type. The methodology is to consider how they were addressed in the case of the Arcapita group of Debtors. While each bankruptcy will be individually considered, and each restructuring and reorganization will be unique, this case study does identify transferable principles and the thinking of the parties and the courts in a Shariah-compliant bankruptcy scenario.

## CHAPTER 11

Chapter 11 addresses voluntary business reorganization and rehabilitation. It promotes equality of treatment for similarly situated holders of approved claims (“Claims”) and equity interests (“Interests”). A debtor may continue its business and remain in possession of its property as a “debtor in possession” during the proceeding.

Creating and implementing a plan of reorganization is the principal objective of Chapter 11. Bankruptcy court confirmation of a plan binds the debtor, issuers of securities and persons acquiring property under the plan, holders of Claims or Interests and others to the terms of the plan. With limited exceptions, the confirmation order discharges the debtor from its pre-petition obligations.

The reorganization plan must classify the Claims and Interests. Claims and Interests within a particular class must be substantially similar to all

other Claims and Interests within that class. Certain holders of Claims and Interests are permitted to vote to accept or reject the proposed plan; specifically those that are “impaired” by, and entitled to receive a distribution under the plan. The debtor is required to prepare a disclosure statement to enable a hypothetical reasonable investor to make an informed judgment regarding acceptance of the plan. Each reorganization plan is subject to approval by the bankruptcy court to determine satisfaction with the Bankruptcy Code.

## ARCAPITA PRE-PETITION CORPORATE AND CAPITAL STRUCTURE, AND CREDITOR CLASSES

Arcapita (Bahrain) operates a global investment bank under an Islamic wholesale banking license issued by the Central Bank of Bahrain (“CBB”). It is privately owned by approximately 360 shareholders (70 percent third-parties; 30 percent management).

Prior to the bankruptcy petition, the material indebtedness of the Debtors and its Class for Plan purposes were:

### A) Secured Debt to Standard Chartered Bank (“SCB”); two *murabahah* facilities (the “SCB Facility Claims”); Classes 2(a)-2(f):

- i) May 2011; US\$46.6 million; (a) guaranteed by AIHL, LT Holdings and WTHL, and (b) secured by a pledge of (1) AIHL’s shares in LT Holdings, and (2) LT Holding’s shares in WTHL, AEID II Holdings and RailInvest;
- ii) December 2011; US\$50 million; (a) guaranteed by AIHL, LT Holdings, WTHL, AEID II Holdings and RailInvest, and (b) secured by a pledger of (1) AIHL’s shares in LT Holdings, and (2) LT Holding’s shares in WTHL, AEID II Holdings and RailInvest.

### B) Unsecured Debt

- i) “*Syndicated Claims*”: Syndicated Facility with WestLB; March 2007; US\$1.102 billion; Classes 4(a)-4(b);
- ii) “*Arcsukuk Claims*”: *Murabahah* and *wakalah* facility supporting a sukuk issuance; September 2011; US\$100.2 million; guaranteed by AIHL; Classes 4(a)-4(b);
- iii) “*CBB Claims*”: *Murabahah* facility; March 2009; CBB; US\$ 250 million; Class 5(a);
- iv) “*SIF Claims*”: Seven *murabahah* facilities with investors; US\$ 131.4 million; Class 5(a);
- v) “*Interbank Claims*”: Five short-term bank facilities; US\$ 18.4 million; Class 5(a);
- vi) “*Transaction/Syndication Claims*”: Various transactions, syndication and intermediate portfolio companies; US\$ 376 million; Class 5(a);
- vii) “*Investor Claims*”: unrestricted and restricted investment accounts and *murabahah*
- viii) financings; US\$320 million; Class 5(a);
- ix) “*Contested Claims*”: deposits with and by Al Baraka Islamic Bank, Bahrain Islamic Bank and Tadhamon Capital that are contested by the Group; Class 5(a) and Class 3(a);
- x) “*Rights Offering Claims*”: Subordinated Claims of subscribers to Arcapita stock pursuant to 2010 rights offerings, for which Arcapita obtained US\$83.1 million but did not issue shares; Class 8(a); and
- xi) “*Other Claims*”: Unsecured Claims and Intercompany Claims to other Debtors and their affiliates; Classes 5(a)-5(g) and 7(a)-7(g), respectively.



Claims subject to subordination are treated in Classes 8(a), 8(g), 10(a) or 10(g).

## THE ARCAPITA REORGANIZATION PLAN

### Overview

The Plan was designed to structurally and financially reorganize the Debtors into Reorganized Debtors, create new Holding Companies, and combine those entities with non-Debtor affiliates into a Reorganized Group. The “Holding Companies” comprise of (a) a newly-established top-tier Cayman Islands incorporated holding company (“Topco”), and (b) newly-formed intermediate holding company subsidiaries of Topco. The “Reorganized Group” is comprised of the Holding Companies, the Reorganized Debtors and their non-Debtor affiliates.

The Holding Companies own, either directly or indirectly, 100 percent of the Debtors’ assets. The objective of The Plan is to exit from these investments. The Plan transactions will: (i) provide working capital to fund emergence from Chapter 11 and capitalize the Reorganized Debtors and Holding Companies, (ii) allow control of the Debtors’ assets to allow value realization, and (iii) facilitate the wind-down of the Debtors’ investments. Proceeds from asset dispositions are used first to repay the New *Murabahah* Facilities and the Sukuk Facility (each as defined below), and thereafter to make distributions in respect to the equity of the Reorganized Group.

### Financial Instruments and Arrangements

The Plan involves restructuring of the existing debt and equity arrangements of the various entities involved, including the incurrence of new debt to fund the reorganization and allow the Reorganized Group to operate during the disposition process and the issuance of new equity and related warrants.

The primary financing arrangements under the Plan are two new *murabahah* facilities and a *sukuk* issuance. The “New *Murabahah* Facilities” comprise of an “Exit Facility” and a “New SCB Facility”. The Exit Facility is used to pro-

vide working capital, and potentially, take out the existing SCB Facility and has a first lien on the obligors’ assets, junior to first liens on the New SCB Facility. The “New SCB Facility” is a new *murabahah* facility. The “*Sukuk* Facility” is a newly issued unsecured *sukuk* facility that is subordinate to the “New *Murabahah* Facilities”. These are repaid primarily from the proceeds of asset dispositions.

Under the Plan, Topco issues: (a) Class A Shares; (b) Ordinary Shares, (c) Creditor Warrants and (d) Shareholder Warrants.

“*Class A Shares*” are preference shares of two classes. “*AIHL Class A Shares*” (55 percent of the Class A Shares) are issued to holders of Unsecured Claims, Syndicated Claims and Arcsukuk Claims against AIHL. “*Bank Class A Shares*” (45 percent of the Class A Shares) are issued to holders of Unsecured Claims, Syndicated Claims and Arcsukuk Claims against Arcapita.

These two classes are identical except as to voting rights for selection of Topco directors. The Class A Shares have a liquidation preference of US\$810 million, payable through redemption of these shares *after* payment of the New *Murabahah* Facilities and the *Sukuk* Obligations. That liquidation preference is designed to pay in full all holders of Claims against AIHL.

The Ordinary Shares are issued in two separate classes: “*AIHL Ordinary Shares*” (Class A); and “*Bank Ordinary Shares*” (Class B). AIHL Ordinary Shares represent 2.5 percent of the Ordinary Shares and are issued to holders of Unsecured Claims, Syndicated Claims and Arcsukuk Claims against AIHL. Bank Ordinary Shares represent 97.5 percent of the Ordinary Shares and are issued to holders of Unsecured Claims against Arcapita. The two classes have identical terms, other than with respect to selection of Topco directors. No distributions are paid on Ordinary Shares until the Class A Shares have been fully redeemed through payment of the liquidation preference.

Creditor Warrants are distributed to holders of Unsecured Claims, Syndicated Claims and Arc-

sukuk Claims against AIHL. Creditor Warrants entitle holders to purchase up to 47.5 percent of the Ordinary Shares, but only after US\$ 1.425 million has been paid on the Ordinary Shares (the “*Dividend Threshold*”). The “*Dividend Threshold*” is intended to provide for payment in full to holders of Claims against Arcapita.

Upon the exercise of the Creditor Warrants, creditors of Arcapita who are not the beneficiaries of an AIHL guarantee, and creditors of AIHL, will each own 50 percent of Topco equity. This is intended to provide such creditors with future upside potential of the Reorganized Group as compensation for the delay and risk associated with their investments in the Debtors and the reorganization.

Shareholder Warrants (the Subordinated Claim Warrants and the Transferring Shareholder Warrants, and, together with the Creditor Warrants, the “*Warrants*”), if issued, are distributed to holders of Subordinated Claims against Arcapita and Transferring Shareholders. They entitle holders to purchase Class C ordinary shares (the “*Warrant Ordinary Shares*”) constituting approximately 80 percent of the Ordinary Shares on a fully diluted basis. Shareholder Warrants and Creditor Warrants have identical terms. The Warrant Ordinary Shares will have identical terms to the Arcapita AIHL Ordinary Shares and Bank Ordinary Shares, other than with respect to voting for Topco directors.

### Corporate Actions

Under the Plan, four new Topco subsidiaries are formed: (a) “*Holdco 2*” (Delaware); (b) “*Holdco 1*” and “*Holdco 3*” (Cayman); and (c) “*Bank Holdco*” (Delaware), which holds the Arcapita Shares to be transferred to Bank Holdco. Two others may be formed, depending upon the resolution of Bahrain regulatory matters.

All of the Arcapita assets, (other than interests in AIHL and Arcapita (HK) Limited), are transferred to Holdco 3 and holders of Claims against Arcapita receive (i) 15 percent of the Sukuk Obligations, (ii) 45 percent of the Arcapita Class A Shares, and (iii) 97.5 percent of the Ordinary Shares, allocated as described above.

AIHL sells all of its assets to Holdco 2 in exchange for the assumption by Holdco 2 of the DIP Facility Claims and the SCB Claims and the transfer to AIHL of certain other AIHL Consideration. AIHL then distributes the AIHL Consideration to the holders of Claims against AIHL, whereupon AIHL is dissolved.

New boards of directors for Topco, the Reorganized Debtors and the Holding Companies are appointed, and new governing documents adopted for each of these entities. Committee members holding Claims against AIHL (“*AIHL Members*”) designate five of the seven directors, Committee members holding Claims against Arcapita (“*AB Members*”) appoint one, and those six directors appoint one director, who is employed by CBB. This arrangement reflects the relative initial holdings of Class A Shares and the consideration that, until payment of the liquidation preference, a majority of directors should be appointed by AIHL Members. Thereafter, the AIHL Class A Shares remove and replace directors appointed by AIHL Members, and Bank A Shares remove and replace directors appointed by the AB Members. There is a transition from seven directors to five upon payment of the liquidation preference, and the voting arrangements shift to provide greater empowerment to the shares originally relating to the AB Members. Similarly, at the time of satisfaction of the Dividend Threshold, a majority of the board members are appointed by the Warrant Ordinary Shares.

## CONCLUSION

Arcapita and its related Debtor group chose to continue operating through, and in an effort to emerge from, its insolvency and bankruptcy. That led to the choice of a voluntary bankruptcy filing under the United States Bankruptcy Code and the development of a complex financial restructuring and reorganization plan that is still in effect and governs the operations of the entire group of Reorganized Debtors. Existing Shariah-compliant debt was restructured and new Shariah-compliant debtor-in-possession financing was issued, as approved by the debtors, creditors and Bankruptcy Court. To maximize the future potential

of the reorganized Arcapita group, the corporate reorganization was effected, also as approved by the debtors, creditors and Bankruptcy Court. The ability of the Debtors to continue operating, and to effect, a Shariah-compliant restructuring and reorganization was critical to these determinations, and to subsequent restructuring and reorganization determinations that continue to govern the new Arcapita group.

There are numerous lessons to be learned from this case study. Some are systemic, some organizational, and some transactional.

**First,** it is encouraging to note that the United States Bankruptcy Courts continue to support the implementation of restructuring and reorganization under the Bankruptcy Code in compliance with the relevant Shariah principles applicable to both debt and equity elements. This bodes well for the future of the Islamic finance industry. It encourages Shariah-compliant entities that can avail themselves of the jurisdiction of the U.S. Bankruptcy Courts to consider the realistic possibility of the successful continuation of operations, rather than liquidation.

**Second,** the determinations of the United States Bankruptcy Courts support the continuing organizational and transactional use of Shariah-compliant arrangements. The determinations send a clear signal that these arrangements will be honored and implemented.

**Third,** it makes clear that participants in the Islamic finance industry can achieve a desirable long-term result if, at inception, careful consideration is given to how Shariah-compliant debt and equity arrangements will be treated by the United States Bankruptcy Courts as well

as other courts, regulatory authorities and taxation authorities.

Overall, an encouraging picture is emerging to those involved in Islamic finance. The regulators and the courts have adopted, and continue to adopt, an economic substance approach to legal issues of relevance to Islamic finance. The forms of the Shariah-compliant transactions are not disruptive of the analysis and are being adopted and approved by the regulators and courts.

Moreover, these developments enhance certainty and predictability of outcome on a level playing field with interest-based arrangements. That will encourage a broader respect for, and increased participation in, Islamic finance and a broader recognition of Shariah principles – both internationally and within jurisdictions that do not expressly recognize the Shariah as part of the secular law of the land.

#### REFERENCES

Case No. 12-11076 (SHL), Jointly Administered; AHIL was the subject of a separate Cayman Islands winding-up facility that was stayed during the pending of the U.S. bankruptcy proceeding: FSD Cause No. 45 of 2012 AJ. The many filings and orders in this proceeding are available at <http://www.nysb.uscourts.gov> and [www.gcginc.com/cases/arcapita/](http://www.gcginc.com/cases/arcapita/) and are described in the Disclosure Statement.

Case No. 12-11790 (SHL), Jointly Administered, which was the voluntary filing of Falcon.

All transactions involving Class A Share and Ordinary Shares are subject to dilution by issuance of the Warrants.



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## ENFORCEABILITY AT ENGLISH LAW ON ISLAMIC FINANCIAL DOCUMENTATIONS AND SECURITY ENFORCEMENTS: DUBAI ISLAMIC BANK PJSC V PSI ENERGY HOLDING CO BSC AND ORS CASE STUDY

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Finance transactions in the Middle East are governed by a mix of complex domestic and foreign laws. Depending on the location, structure of financing and nature of the parties, the documentation could be governed by a number of different laws with recourse to a number of dispute resolutions available in various jurisdictions.

The choice of English law as the governing law of the principal legal documents in the Middle East is common. Banks and financial institutions take comfort from the legal certainty that English law affords and the English courts are generally viewed as ‘creditor-friendly’. While for security arrangements, they are typically governed by the laws of the jurisdiction in which the secured assets are located.

Drafts of any Islamic documents are also commonly presented to a panel of Shariah scholars, who review the structure and detail of the documents to ensure their compliance with the principles of Shariah. As such, it is not unusual to see principles of English law governing the underlying ‘debt’ obligations, local law governing the security and an overarching precept that the transaction should not contravene Shariah.

Although the interplay and conflict of these different doctrines is not something which is commonly reviewed or considered in detail, the Commercial Court decision in *Dubai Islamic Bank*

*PJSC v PSI Energy Holding Co BSC and Ors* [2013] EWHC 3186 (Comm), although very fact-specific, provides useful guidance for the enforceability of English law on the Islamic financial documentations and security enforcement arrangements.

Dubai Islamic Bank (the ‘Bank’) had provided *murabahah* trade finance facilities to CCH Europe GmbH and its associated company (‘CCH’), the proceeds of which were deposited directly with CCH.

Through time, it became clear that false invoices were being generated in order to maintain a flow of trade financing, with proceeds being diverted in contravention of the permitted purpose and applied in other projects in which the shareholders of CCH had an interest.

When the fraud was uncovered, the Bank and the defendants agreed on full repayment of the debt by entering into an English law-governed restructuring agreement (the ‘RSA’), which placed a primary obligation on all the defendants to repay the debt, and imposed a joint and several guarantee and indemnity obligation in relation to that debt on the defendants.

The defendants also undertook to procure an assignment in favor of the Bank of a lease over certain land in Dubai (the ‘Lease’), which had been acquired using proceeds of the trade financing arrangements. The resultant conditional assignment agreement (the ‘Assignment’) was governed by UAE and Dubai law and subject to



the exclusive jurisdiction of the Dubai Courts. The Assignment further provided that, in the event of a conflict between the RSA and the Assignment, the latter was to prevail.

Following an Event of Default under the RSA, the Bank accelerated amounts due and owing thereunder and enforced its security under the Assignment in November 2008. The Bank did not develop the land or sell the Lease at that time arguing that, due to the economic downturn and the prevailing turmoil in the Dubai property market, the land was essentially valueless or worth a little value. The defendants subsequently contended that the Bank was at fault for failing to dispose of its interest in the Lease and not realising some value.

Expert evidence on behalf of the defendants (and in respect of UAE / Dubai law) contended that the Assignment gave the Bank no right of ownership or possession, such that the Bank's appropriation of the Lease by taking possession was a usurpation under Dubai law, the effect of which was that the value of the Lease at the time of such usurpation must be applied in diminution of the amounts due and owing under the RSA.

English law on the other hand is guided by the principle that where a debt is governed by English law, the question whether or not the debt has been discharged is also a matter for English law. English law would not regard the Bank as having taken possession of the land without having realized its value by sale as discharging the debt and the fact that a foreign law would regard the debt as discharged (and notwithstanding that the Assignment itself was governed by UAE / Dubai law) does not provide the debtor with a defence.

In addition, the RSA provided that the agreement was to be governed by and construed in accordance with English law, "save in so far as inconsistent with the principles of Shariah law". The judge ruled that this proviso was of no effect, as a religious law can never apply as the applicable law and so, in construing the RSA, Shariah law was irrelevant.

This approves the Court of Appeal decision in *Beximco Pharmaceuticals Ltd v Shamil Bank of Bahrain EC* [2004] EWCA Civ 19, which held that, in accordance with the Rome Convention, no provision can be made for the application of a non-national system of law, thereby precluding the choice of Shariah as the governing law of an agreement.

## IMPLICATIONS FOR ISLAMIC AND REGIONAL MIDDLE EASTERN FINANCE TRANSACTIONS

The case therefore has a number of implications for regional finance transactions: Borrowers and banks should be aware that: (i) where a debt is governed by English law, the question of debt enforcement of any related security is also a matter for English law (notwithstanding that the security may be governed by local law); and (ii) any attempt to provide for construction of a contract in accordance with Shariah is unlikely to be given effect by English courts.

Security arrangements commonly contain specific provisions relating to enforcement, including but not limited to taking possession and disposing of the relevant secured assets and the application of any recovered disposal proceeds. Credible borrowers tend to negotiate these provisions to ensure that assets are sold on commercially acceptable terms and that fair value is received in a timely manner. They may also seek to include in the English law-governed financing documents provisions relating to the discharge of the debt following an enforcement event, that (particularly in the case of highly-liquid or price volatile assets) taking possession of a secured asset by the bank would result in the value of that asset (as at that date) being applied to reduce the outstanding amounts under the financing documents *pro tanto*. Of course, banks would be unlikely to accept this, as they would be taking the price risk on the relevant asset from the date of receipt to the date of its actual disposal.

The proviso relating to the application of Shariah principles on the financing arrangements and documentations is of limited comfort to Shariah scholars and investors if such proviso is not given its legal effect by English courts.

Contracting parties may therefore seek to provide more specifically for the exclusion of events or circumstances which would contravene Islamic law. For example, under Shariah principles, the charging and payment of interest, which is deemed to constitute unlawful gain (*riba*), are prohibited. It is therefore not uncommon to exclude judgment interest, whereby the parties waive their right to any interest awarded by any court or competent body in connection with a contractual dispute.

This waiver or exclusion could be extended to include other concepts which are contrary to Shariah and which is reasonable to become an issue at some point in the future. Such approach could not however be exhaustive and some residual risk may still remain.

It is worth noting that the underlying Shariah contract was not called into question. This supports the view that, if drafted correctly and clearly, English law-governed Islamic finance documents are capable of creating an enforceable “debt” obligation at English law.

Although an English court may disregard general principles of foreign or religious law when considering the effect of enforcement on an English law-governed debt, this does not prevent commercial parties from agreeing to specific contractual terms, including, if they so wish, terms which mirror the local law treatment of the jurisdiction in which the assets (or the parties themselves) are located.



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**PART 6**

# Innovation in Islamic Legal Thought





# SUMMARY

As self-assessment and self-accountability take shape, various stakeholders of the Islamic finance industry, from practitioners to end-users, are evaluating the sustainability of continuing adaptive and accommodative measures. Such approaches characterize the progressive development phase of Islamic banking and finance, which witnesses the enactment of legislations granting tax exemptions and other regulatory changes to Islamic financial transactions.

While numerous legal, regulatory, market norms and other contextual constraints remain, such accommodative approaches generally continue. Compromises have had to be made, such as regarding deposit products, which this Section discusses in some detail.

This Section also touches on the factors that influenced the development and evolution of the legal concepts affecting Islamic finance. This includes the development of additional contemporary structures into the classical Shariah contracts such as purchase undertaking (*wa'd*) on to the lease (*ijarah*) contract. Discussion on the innovation in Islamic legal thought is made with reference to the use of trust concept, particularly in the realm of *sukuk*, to create non-charitable special purpose vehicles (SPVs) as intermediaries between originators and investors. These SPVs are formed as trusts quite often under English law to hold assets, raising another area of study for Islamic finance stakeholders, namely the requisite indicia of ownership. A further perspective of innovation is the mechanism of Shariah review, which continues to undergo reform as with the case of *sukuk* transactions where review has deepened in both approving and auditing.

Another noteworthy example is the study of damages under Islamic law upon a breach of *wa'd* (promise) in the context of profit rate swap transactions. Readers in the field will be well served by studying this analysis to understand how breaches may be possible, what types of damages may be validly claimed under the Shariah, and why and how compensation may be calculated. The Section concludes by insightfully pointing out areas requiring further study and reflection as the Islamic law is developed to address newly arisen circumstances.





# DATUK DR MOHD DAUD BAKAR

President/CEO, International Institute of Islamic Finance (IIIF) Inc. (BVI) and Amanie Business Solutions Sdn. Bhd.

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For the young and forthcoming scholars, they are their own main catalysts; they need to prove that they are ready to take a higher level, and more responsibility.

”

**In most risk-sharing sukuk, the issuer would offer mechanisms to ensure that the ultimate risk that investors would take/bear remains with the sponsor (particularly in a total loss event). What is your view on this practice?**

*Sukuk* is a fixed income instrument. In risk sharing *sukuk*, the issuer and *sukuk* investors will share the profit as per agreed ratio but will bear the loss according to capital proportion. Risk transfer to one of them is not allowed. However, a mechanism can be structured and arranged to facilitate the effective risk transfer to the issuer via *takaful* or perhaps risk transfer via the concept of *tanazul*. The notion and practice of *tanazul* as part of the bilateral agreement may have some Shariah basis in some of the juristic discussions and as such, this practice may be allowed from the Shariah viewpoint.

**Many sukuk structures are criticized (by many Shariah scholars) to carry the same characteristics as bonds especially with regards to the guarantee of principle and periodic profit. What is your response to these critics?**

Global investors for *sukuk* are those who have the mandate to invest in fixed income securities. Thus, *sukuk* must have these economic behaviours in one way or another. Otherwise, *sukuk* cannot be invested by these investors.

For *sukuk* to be free from this element of fixed income, we need to have a new set of investors who are taking the risk of the *sukuk* asset i.e. a set of investors with a different mindset and objective. In Shariah, the best *sukuk* structure that can achieve both capital guarantee and periodic payment would be *sukuk ijarah* and *sukuk wakalah* combining both *murabahah* or any financial asset and *wakalah* or *ijarah* asset. This explains why these two structures are popular at the moment.

**As Islamic finance expands into new markets in Central Asia, Africa and in Oman, has the centralized Shariah governance approach become more common?**

The centralized Shariah governance approach is gaining some momentum globally but it is not that visible as yet. The main challenge is not vested with this approach but with the impact from the restriction of disqualifying scholars sitting on Central Shariah boards from participating at the industry level. Unless there is a big enough pool of scholars, this centralized approach may be detrimental.

**Has Islamic finance been able to cultivate a new generation of scholars in senior roles across the Islamic finance industry? What has been the most effective way for them to gain the necessary experience to lead a Shariah board? Is it through government Shariah advisory board,**

**mentorships with senior scholars or through Shariah advisory firm work? What are the advantages and disadvantages of each?**

For the young and forthcoming scholars, they are their own main catalysts; they need to prove that they are ready to take a higher level, and more responsibility. They need to have both good industry knowledge and good emotional intelligence. These skills can be acquired. The senior scholars and also the management at both the regulator and the industry entities can easily pick out these talents if they are there. Indeed, all the scholars

started from the ground-up. Both the industry and the regulator must play certain roles to prepare these young scholars for the next level and to provide new opportunities for those who are qualified and meets the standard. The industry will only take the best. On another note, there should be Shariah advisory firms working on the basis of partnership so the junior partners can be continuously developed under the mentorship of senior partners/scholars.



*Industry Associations within Islamic finance to set appropriate and effective global professional standards.*



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## DEVELOPMENT OF CONCEPTS IN ISLAMIC FINANCE

By Assoc Prof Dr Ahcene Lahsasna  
INCEIF



The rise of Islamic finance proliferated the use of some concepts and practices that were previously unique to the Arabian Peninsula. The flexibility of Shariah principles has enabled the harmonization of Islamic legal thought with new practices in modern contexts and to evolve according to the times. This is not to say, however, that the Shariah principles have been compromised. This article will briefly articulate factors that influence the development of concepts and describe some examples of concepts that have been developed in Islamic finance.

of these two as they may not be directly spelled out in the two sources. In this case, the jurists will refer to *ijma'* (legal consensus) or *qiyas* (analogy). Other secondary sources such as *maslahah* and *istihsan* can also be resorted to. An example of this phenomenon is price fixing (*tas'ir*) which has been clearly prohibited in a *hadith* of the Prophet (pbuh). However, in modern times, the use of subsidies and setting of the price of goods is permitted by the Muslim jurists as it fulfils the tenets of *maqasid al-Shariah* or the preservation of life and the ruling itself is based on *maslahah* which is to provide benefit to the community. Therefore, it could be seen that the evolution of Islamic thought has a significant impact on how Muslims are governed.

### FACTORS DETERMINING THE DEVELOPMENT AND EVOLUTION OF CONCEPTS

There are various factors that have influenced the development and evolution of concepts in Islamic legal thought. They are:

#### The development and evolution of human thought

Concepts used in the Islamic legal thought have emerged as a result of the evolution of human thought, throughout different eras. These concepts are meant to address the changing needs of human society.

#### The development and evolution of Islamic thought

Islamic law has been very consistent since its beginning. The Quran and Sunnah are the primary sources of Islamic law and are the first points of reference for legal matters for Muslims. However, there are matters that may fall outside the ambit

#### The development of society and the evolution of its structure

During the time of the Prophet Muhammad (pbuh), the societal structure was different from societies today. It was small and tribal in nature and every tribe was responsible for the wellbeing of its members only. However, as societies transformed to become a wider interconnected network of tribes, races and nationalities, their structures evolved to accommodate the varied needs of the people. This was evident when the Prophet (pbuh) migrated from Makkah to Madinah where new issues and challenges were encountered. The integration of the migrants into Madinah is a good example of how society grew to accept foreigners and merge various communities together under the rule of a single leader. Thus, the development of societal structures has spurred many innovations in the concepts adopted in Islamic legal thought. They have evolved to include different beliefs and religions and code of ethics existing under a common legal system.



### The development and evolution of the markets and business models

Traditionally, business practices involved simple and direct buying and selling activities between two parties — the buyer and the seller. The market participants were usually known to each other. Therefore, it was possible for the Prophet Muhammad (pbuh) himself, during his time, to keep a check and balance on market practices. Being the head of state, he would visit the market to observe if the practices were fair.

Later, a separate institution (*hisbah*) was introduced to perform this check and balance function. As a result of the evolution of financial and economic activities, the boundaries of business have expanded resulting in the introduction of new terminologies. The business model of this new market was also different from the previous simpler type of business model. An example is the classical *mudarah* business model where the *mudarib* is an individual. But in the modern *mudarah* model, the *mudarib* could be a business entity or (in the case of two-tier *mudarah* model) an Islamic financial institution serving as *mudarib* and *rabb al mal* simultaneously.

### Globalization and the interaction of different civilizations

The phenomenon of globalization and the interaction of different civilizations have had a great impact on the differences in concepts used in different disciplines in Islamic thought. Today, various terminologies are borrowed across cultures. The internationalization of people and institutions has led to the transfer of legal concepts across geographical boundaries. In modern times, the free mobility of both physical assets and human capital has become easier than ever before and almost anything can be transferred from one part of the globe to another in very little time. This process has also facilitated the transfer of ideas and terminologies.

### The development and influence of technology and media

Technology and media have had a significant impact on the propagation of knowledge and information. Intellectual discourse surrounding Islamic legal thought, be it in the form of debates, conferences and roundtables, can be instantly

broadcasted globally without any intermediation. This increased interaction has also contributed to the evolution of Islamic legal thought. Researchers also now have full access to the wide range of information available on the internet, such as databases and journals, contributing significantly to the development and evolution of legal concepts such as corporation, artificial entity, trust, guarantee, bankruptcy and others as these concepts have been consistently imported, exported, and borrowed in legal literature.

### Approaches in Legal Reforms

Legal reform refers to the process where existing laws are examined and changes are made with the aim to improve and enhance the judicial system to improve efficiency in delivering justice, or to respond to certain trends and changes or practice in the community. Changes in legal reforms have had an impact on the concepts in Islamic legal thought, including Islamic finance. One example is Malaysia's Islamic Banking Act 1983 which aimed to provide legal protection to Islamic financial services. Since then, many reforms have been made to the legislation with the Islamic Financial Services Act (IFSA) 2013 being the latest. These legal reforms mean that new concepts will be introduced as more reforms are implemented.

## EXAMPLES OF THE DEVELOPMENT OF SOME POPULAR CONCEPTS IN ISLAMIC FINANCE

To illustrate how the concepts in Islamic legal thought have changed, a lengthy list of terms that were previously used in a different manner but are understood differently today can be provided. However, two examples should suffice to explain this point. However, two examples should suffice to explain this point.

**Murahahah** is a trust-based contract that has two major usages in the classical application: the first one is the sale of the purchased asset to a buyer on spot at cost plus profit; the second one is the sale of a purchased asset to a buyer at cost plus profit on deferred payment. However, *murahahah* in the contemporary practices has new



applications as beside the classical practices, it is used with the addition of purchase request by the customer. It is also used to facilitate *tawarruq* transaction, it is used in *bai' bithaman a'jil* (BBA) for long term contract in Malaysia. It is also used as novation contracts where there is need to replace one of the contracting parties with a new one usually the Islamic bank.

**Ijarah** is also a classical Islamic law contract whereby an asset is leased by one person (the owner or lessor) to another person (the lessee). The ownership of the asset belongs to the lessor while the lessee enjoys the use of asset and its usufructs. At the end of the contract period, the asset is transferred back to the owner. However, the simple *ijarah* contract has evolved today into *al-ijarah thumma al-biy*, or *al-ijarah al-muntahiyah bi al-tamleek*. Under its modern structure, the lease contract is followed by the ownership of the asset by the lessee through a sale contract at the end of the lease period, making the *ijarah* contract a vehicle for financing.

We also have other principles and concepts that are either not used in the classical practices or modified in the contemporary practices, among them:

- **Istisna' muwazi:** as parallel *istisna'* where the bank as manufacturer (*sani'*) appoints the developer to manufacture for his client. This concept has been developed from the normal *istisna'* contracted between two contracting parties to a contract that involve three parties due to the nature of the Islamic financial institutions (IFIs) which assume the intermediary role in the financial deal.
- **Musharakah mutanaqisah:** a form of partnership contract that has been developed

from the normal *musharakah* or partnership with decreasing ownership of the IFI.

- **Sukuk:** an Islamic security/ bond. *Sukuk* have been developed to replace the conventional bonds. *Sukuk* are not a contractual debt relationship but a contractual relationship depending on the nature of the underlying contract of *sukuk* such as *salam*, *istisna'*, *ijarah*, *musharakah*, etc.
- **Takaful:** Shariah-compliant form of insurance. The concept has been developed to provide an alternative to the conventional insurance. *Takaful* has also shifted from its initial social concept to a commercial concept where *takaful* companies become IFIs providing services such as protection, saving and investment.
- **Dhimmah:** liability. The concept of liability has changed to address the liability of the artificial entities such as corporation. Hence, the liability today is no more confined to the liability of the individual but has been extended to cover other entities such as IFIs and corporations which represent a legal and artificial entity.

The amalgamation of Islamic law with modern day finance has resulted in many new innovations in Islamic concepts. Since it is more of an organic process than a standardized procedure, the concepts introduced and even their practices may differ from one jurisdiction to another. As Islamic finance integrates further with the world of conventional finance, it is possible that we will see a move towards standardization in the concepts of Islamic legal thought since they are adaptable and accommodative to the changes in societal practices and needs.



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# APPROACHES IN DEVELOPING ISLAMIC FINANCIAL SERVICES

By Prof Dr Engku Rabiah Adawiyah Engku Ali  
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The Islamic finance industry has grown by leaps and bounds since its introduction in the 1960s and 1970s. The range of Islamic financial services and products has broadened, the volume deepened and the players many times multiplied. The development of Islamic financial products has come largely as a result of the dynamic interaction between the needs of the industry and the ability of the market practitioners, in consultation with Shariah scholars to produce relevant solutions.

This productive interaction between practitioners and scholars in their attempt to respond and provide solutions to market requirements requires a re-examination of the principles of Islamic commercial law in the context of their immediate application to financial market transactions. Diverse approaches can be observed in the exercise and this article attempts to study these approaches as part of the so-called “legal reform” in Islamic financial thought.

## BRAVING UNCHARTERED WATERS WITHIN AN INTEREST-BASED ECO-SYSTEM

The first phase of the development of Islamic financial services, beginning in the 1960s leading to the 1980s, was perhaps the most challenging due to the sheer uncertainty of the road ahead. This phase was characterized by almost zero awareness by the market about Islamic finance and how it was supposed to work. The recurring question posed by many at the time was: “How

can a bank work without interest?” The whole banking business at the time was all about lending and borrowing. Interest was integral and deeply ingrained in the ensuing loan transactions. So entrenched was interest in the banking industry that it was almost unthinkable that any banking business or financial intermediary could ever be conducted sans interest.

Hence, Islamic bankers and scholars had to brave uncharted waters to come out with Islamic financial services and products that could work and survive within the existing eco-system. At that time, numerous literature by Islamic economists suggest that Islamic banking should be based on the principle of sharing where the contracts of *mudarabah* and *musharakah* had been proposed to be the main underlying contracts for both deposit and financing purposes. Yet, the actual products developed and offered by the Islamic banks were not necessarily so. The choices that they had were not that straight forward. They had to accommodate the existing eco-system that had been essentially tailored for interest-based financial intermediation, with almost no precedent to rely on. It was more of a “trial and error” approach.

## ADAPTING AND FITTING IN

The approach adopted by most of the Shariah scholars during the early stage had been “reconciliatory” or “accommodating”. The main concern was: “How to reconcile between strict Shariah requirements and market norms or legal constraints?”

The first line of response was to see whether or not the Islamic financial product could be

allowed to depart from the market norm or a legal requirement. This might require some exemptions or regulatory relief to be granted. If the first line of response was not achievable, the next approach was to find an “opening” or “break-through” via Shariah-compliant transactions that could meet the desired features as dictated by market norms or legal framework.

In the first line of response, we have seen the passage of legislations, granting of tax exemptions and regulatory changes being made to accommodate Islamic banking and financial transactions. These legal and regulatory changes were necessary to accord legal recognition to Islamic banking transactions that necessarily involve trade activities, partnerships and joint ventures that would not otherwise be recognized as banking transactions. The tax exemptions had also allowed Islamic banks to compete on a level playing field with their conventional counterparts.

Unfortunately, not everything could be adjusted to accommodate Islamic finance. For instance, capital adequacy requirements and the high risk weightage assigned to risk sharing contracts such as *mudarabah* and *musharakah* financing rendered the two contracts almost impossible in Islamic banks.

Debt-creating contracts like *murabahah* sale with deferred payment of the price became the contract of choice, simply because they maintain credit risk with similar risk weightage to the conventional loan contracts. Cash financing products would have to resort to very controversial arrangements like *bai` al-`inah* and more recently, *murabahah* with *tawarruq* arrangements because pure *qard hasan* (interest-free loan) would be contrary to the commercial nature of banks.

Even in deposit products, we see constraints. The legal definition necessitates capital guarantee on bank deposits. It follows that most Islamic banks responded by offering either “guaranteed safe keeping” (*wadi`ah yad damanah*) or “interest-free loan” (*qard hasan*) for their deposit products. Both allow guarantee on the deposits, thus fitting well within the legal definition.

Unfortunately, they are commercially “handicapped” because according to Shariah principles, they are necessarily non-profit making contracts and cannot promise any return on the deposits. Since these deposits are guaranteed, depositors take no liability and thus, must not take profit. This adversely affects the competitiveness of Islamic banks that are operating in a dual banking environment where their competitors are able to guarantee deposits as well as give fixed return on them. This led to many Islamic banks’ practice of awarding “*hibah*” to their depositors to remain competitive, despite criticisms by some other scholars.

Islamic banks also offer Islamic investment accounts using *mudarabah* contracts to meet the appetite of depositors who want return on their deposits. These Islamic investment accounts allow for profit payments to the “depositors” based on pre-agreed profit-sharing ratios, with the rate of profit normally indicated as “expected rate” based on previous rates of profits paid in preceding months.

However, these profits are not guaranteed and may change based on actual profits made. In addition, the capital in these *mudarabah* investment accounts must not be guaranteed by the Islamic bank in line with the principle of risk sharing and liability-taking envisaged in the Islamic legal maxim of “gains must accompany liability for loss”.

Yet, the banks’ inability to guarantee the capital may be construed as going against the basic feature of deposits as per the market norm. The inability to guarantee profits also adversely affects the competitiveness of Islamic banks and creates “displaced commercial risk”<sup>71</sup> within these banks.

The above examples illustrate the less than ideal environment within which Islamic banks work. In most instances they have to choose between strict Shariah compliance or conforming to the market norms that are more often than not, dictated by the interest-based financial system. Thus, incongruities are bound to happen, unless certain compromises could be worked out.



*Debt-creating contracts like murabahah sale with deferred payment of the price became the contract of choice, simply because they maintain credit risk with similar risk weightage to the conventional loan contracts.*



In response, compromises had been made, and their examples are plenty.

In the case of *mudarabah* investment accounts, arrangement had been made for third-party guarantee on the *mudarabah* capital by deposit insurance bodies and the like. The need to “fix” the profit rate also led to the practice of “profit equalisation reserve” (PER) to smoothen profit payment. In the case of current and savings accounts (CASA) based on *wadi'ah yad damanah* or *qard hasan*, Islamic banks give “*hibah*” to the depositors based on their own discretion without any pre-condition.

Some of the deposit products use *bai` al-`inah* and later *murabahah* with *tawarruq* arrangement to effectively allow Islamic banks to guarantee the amount deposited, with a fixed amount of profit pre-determined in the *murabahah* price. Some of these arrangements have been criticized as synthetic, organized and not genuine. Yet, they have been approved by the respective Shariah bodies because their approach was to develop the Islamic market by finding solutions that meet both Shariah requirements and market norms.

## AUTHENTICITY AND CREDIBILITY

By mid-2000, the overall growth of Islamic finance had been remarkable, be it in terms of asset size; number of players; range of products; market understanding and awareness; improvement in legal and regulatory flexibility; and consumer acceptance. By this time, Islamic finance had proven to be commercially viable; and in some sectors and markets, had achieved critical mass.

Nonetheless, these developments were received with mixed feelings. There was and still is a growing sentiment that Islamic finance is increasingly similar to the interest-based conventional finance, especially in term of its economic and commercial behavior. Islamic finance was accused of imitation of and convergence with the conventional finance that it was supposed to distinguish from. This led to a feeling of skepticism or disillusionment towards Islamic finance within the Islamic finance fraternity, even among the very scholars who had earlier approved the products.



Discourses were held and calls for self-introspection were made. Serious re-evaluation of the products were made with the aim of verifying Shariah compliance by re-looking the whole chain of transaction. Reassessments of rulings were made to ascertain their alignment with the objectives of Shariah. The approach was to look at the big picture and study the probable implication of any ruling made. This is admittedly a more insightful approach. Such an approach led to some prominent refinements to a number of past rulings, such as: the pronouncement by the Shariah Board of AAOIFI in February 2008 that sought to correct some of the “questionable” practices in *sukuk* transactions; the OIC Islamic Fiqh Academy’s latest resolutions on *tawarruq* to accord “authenticity” to the transaction; and the Central Bank of Malaysia Shariah Advisory Council’s latest resolutions on *bai’ al-’inah* to rectify its flawed implementation in the market.

All of these efforts aim at reforming Islamic finance practices, avoiding the pitfalls and mistakes learned from yesteryears. The desire is go back to the root philosophy of Islamic finance as founded in the Shariah and manifested in its *maqasid*. With strong fundamentals built on principles of accountability, fairness, justice and inclusiveness; supported by clear focus on real transactions that are linked to the real economy; and strengthened by effective regulation and good governance, Islamic finance is bound to create distinction and in the long run, re-gain its authenticity and credibility.

## ENDNOTE

- 1 IFSB (2005) defines the displaced commercial risk as “the risk arising from assets managed on behalf of Investment Account Holders which is effectively transferred to the Islamic Financial Institutions own capital because the Institution forgoes part or all of its *mudarib*’s share (profit) of on such fund, when it considers this necessary as a result of commercial pressure in order to increase the return that would otherwise be payable to Investment Account Holder’s” (Standard 76 ).



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## THE USE OF TRUST IN WAQF AND SUKUK

By Prof Rodney Wilson  
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Islamic financial institutions have attempted to provide as wide a range of products and instruments as their conventional counterparts while ensuring that what is offered is Shariah-compliant. This has proved an enormous challenge, but the successful innovation of new Islamic financial products and instruments demonstrates the flexibility of Islamic commercial law.

While taking account of this wider context the approach here is focused on the Shariah concept of *waqf* of which the English common law equivalent is a trust. Trusts are very versatile contracts recognized both in English common law and Shariah. They are an essential component of many modern Islamic financial instruments, indeed a trust law (or its equivalent alternative as used in certain civil law jurisdictions) is a pre-requisite for *sukuk* issuance. *Waqf* structures can be used for trusts under English common law, but these are applicable to charitable foundations, and not used for commercial transactions.

### USE OF TRUSTS IN SUKUK: SPVS

Trusts have been a useful legal device to underpin Islamic financial instruments, notably *sukuk*, where special purpose vehicles (SPVs) are usually created to hold the asset and administer payments.

Indeed all *sukuk* (or its equivalent alternative as used in certain civil law jurisdictions) now involve the creation of SPVs which are designated as legal entities. These serve as intermediaries between the *sukuk* issuers who are seeking funding and the investors who are providing funding. At

the same time the creation of an intermediate vehicle between the issuer and the investor provides a degree of bankruptcy remoteness. This reassures investors that they will not have additional financial obligations if the issuer becomes bankrupt, or in other words they have limited liability. With some *sukuk* the SPV can issue a guarantee based on the asset held, which effectively means the investors are in the position of senior creditors whose claims will receive priority in the event of the insolvency of the issuer.

SPVs were introduced into *sukuk* structures because they already existed in covered bonds, rather than because of a desire to incorporate the traditional Islamic *waqf* provision. Indeed the SPVs are never designated as *waqf* even though they can be regarded as trusts, with the investors being the beneficial owners. To understand the significance of the SPV designation it is necessary to understand the differences between trusts as an instrument used in English common law and *waqf* as an instrument in Shariah law.

### TRUSTS AND WAQF

Although in the history of English common law trusts were established as charitable endowments, they have become in practice a means of protecting the financial interests of the beneficiaries. They are often established to avoid or minimize inheritance taxes with the wealthy transferring their assets into a trust which will not count as part of their estate.

Trust law can also be used to avoid farm land being broken up into smaller holdings which may be less viable for agricultural output. In jurisdictions where there are no inheritance taxes trusts are largely redundant. They are also of less use in jurisdictions where inheritance taxes are paid

by the beneficiaries rather than being paid out of the estate prior to distribution. This applies in civil law jurisdictions, including most of continental Europe, where trusts are not recognized.

*Waqf* in contrast is still mainly used for charitable purposes, with money being donated to establish a mosque and perhaps associated educational facilities. Often the mosque may be named after the founder. If the endowment is substantial it may generate funds exceeding what is required for the upkeep of the mosque, in which case some of the income may be used for social welfare, with decisions on its allocation made by the board of those with responsibility for running the *waqf*.

apply for charitable status are subject to state inspection and will be responsible for covering the national curriculum.

Therefore in return for benefiting from favorable tax treatment *waqf* endowments are required to be financially transparent with their accounts open for public inspection. Sound standards of corporate governance are also required, the evidence for this being the robustness of the articles of association and the formal minutes of meetings of the boards of trustees.

## TAX TREATMENT OF WAQF CHARITIES

In English common law jurisdictions the *waqf* trustees can apply for recognition as a registered charity. This means the trustees of the endowment will be able to claim back any income tax paid by the donors provided the funds received are not used for commercial purposes. The *waqf* will also benefit from exemptions from corporate taxes and capital gains tax, although the latter exemption is hypothetical as *waqf* endowments cannot be sold. In the case of cash *waqf* any profits must be distributed for charitable purposes and the trustees are not permitted to benefit from any financial gain. To qualify for charitable status *waqf* must have their finances subjected to an independent audit at the end of each financial year, with their accounts deposited with the charity's commission in a timely manner. The commissioners also require an institution applying for charitable status to submit its articles of association and the names and contact details of the trustees. Religious schools which



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# SHARIAH REQUIREMENTS IN SUKUK STRUCTURING

By Nida Raza  
ICD



The *sukuk* market has taken an interesting turn across many aspects in recent years. *Sukuk* structures have advanced from a plain vanilla fixed income instrument to a hybrid structure having both debt and equity features. Similarly, the language used in drafting present *sukuk* offering circulars has changed. The underlying assets have also evolved from pure debt as in the case of *bai bithaman ajil* (BBA) *sukuk*, to lease-based assets as in *ijarah sukuk*, to a mixture of debt and tangible assets as in *istithmar sukuk*. Perhaps the most notable progression has been on the structuring side and obtaining of the *fatwa* for *sukuk* transactions. This article will therefore articulate some of the requirements and processes involved in current *sukuk* structuring.

## SHARIAH APPROVAL

This is typically a two-step process. Once the commercial terms have been agreed upon and assets for a transaction have been identified, the Shariah advisors together with their legal counsel prepare a structure paper with summary details of the transaction including specifics on the assets, Islamic contracts to be used, as well as use of proceeds.

Once the scholars approve the structure paper in principle, the legal documentation is prepared accordingly. Subsequently, when the documentation is in its near final form, the Shariah scholars review and provide comments before the signing of the *fatwa* allowing the transaction to proceed from an Islamic acceptability perspective. There may be times in between these two

stages where Shariah advisors' input is sought to clarify concerns, which may not have been previously discussed.

Recent dealings with scholars and feedback from lawyers and bankers have revealed that it is now taking longer to obtain Shariah approval in principle, even on well-known structures, such as the *ijarah*. It is refreshing to see that scholars are now taking a very keen interest to ensure that not only the assets, structure and contracts are sound but also that its application is suitable to the use for the issuer/beneficiary.

Whilst one can point to previous outstanding or approved *sukuk* structures, the scholars insist on working through each transaction on its own merit without being influenced by precedence. This new level of governance is inspiring for the market and provides more confidence to those who blame scholars and lawyers who drafted *sukuk* contracts without effective communication in place. Of concern now remains the time frame for issuance of a transaction, which points to the benefit of obtaining approval on a *sukuk* programme versus one-time standalone transactions, where the issuance time frame is of grave concern to the issuers and the financial advisors alike especially during volatile economic conditions such as those observed for the best part of this year.

## UNDERLYING ASSETS

Sharia committees have been looking into reviewing the *ijarah sukuk* structure for a real estate asset which is still under construction and required *sukuk* proceeds for completion. In the past, we had seen that as long as the value of the





*Sukuk structures have advanced from a plain vanilla fixed income instrument to a hybrid structure having both debt and equity features*



assets was at least equal to the *sukuk* issuance amount, then for structuring purposes and for Shariah approval, this was sufficient to proceed. In this case, however, the scholars spent time to ensure that the documentation explicitly stated that only the percentage of the asset already constructed together with the land is subject to the *ijarah* contract and the rental payments determination, and that it should be made clear that those floors which are to be built post-*sukuk* issuance are owned outright by the Issuer/Beneficiary and should not form part of the initial *ijarah* contract.

In essence what the scholars have rightfully indicated is that the completed asset on that land will be jointly owned by the *sukuk* holders and the issuer, with the *sukuk* holders owning the land and the asset up to the percentage as stated at the time of the *sukuk* issuance and the balance by the issuer as and when construction of the asset is completed.

Whilst precedence showed that no such conditions were placed on previously issued *sukuk*, it became apparent that the level of scrutiny by Shariah scholars of language used and technical parameters such as the level of completion of an asset or continued use of proceeds is increasing. If one looks at this from a legal lens, since the

structure is, in any case, asset-based and not asset-backed, the *sukuk* holders are in no worse a position than under the scenario where the completed floors of the building would also be under *sukuk* holders' ownership, because in case of bankruptcy or wind up the assets would revert back to the beneficiary.

## SUKUK YIELD

Further, where previously *sukuk* documentation stated that rental yield will be equal to the *ijarah sukuk* distribution payments, the new norm is to state that the rental yield will be in an amount "as agreed" and that to the extent the rental yield is higher than *sukuk* distribution amounts, then it is to be given to the issuer/beneficiary as a performance incentive. *Ijarah sukuk* in the past have neglected to include this explicitly stated feature; we have, however, previously seen such drafting in the case of *wakalah* and *musharakah sukuk* structures where in any case the profit distribution amounts are not guaranteed explicitly. Whilst this is not a significant departure from a risk or return perspective for *sukuk* holders, it is important to note that is a refinement to language used in earlier *ijarah sukuk*.

## THE USE OF SUKUK PROCEEDS

In all circumstances we are seeing an increasing insistence of scholars to have a Shariah advisor/supervisor appointed to the issuer, in order to ensure that proceeds are indeed used as prescribed initially and that no breach of Shariah is seen during the life of the *sukuk*. An example of this is the Dubai-based GEMS Schools *Sukuk* 2013 where scholars insisted that proceeds may only be used in business of the primary school business of GEMS within the GCC. At first glance one may wonder why this condition would be imposed since education is fundamentally a core Shariah-compliant business. The scholars rationalized that within the GCC, the syllabus is known and understood but outside the GCC this is not always the case. Even in the Western education system there are parental concerns on content which is being debated. This new element of governance is a positive change in the market but it does raise the overall cost of issuance of *sukuk* versus conventional bonds.

My view is that this marginal increase in costs should not deter any potential issuers, as the potential investor base which becomes available is far larger than the conventional investor pool. The latter is open to investing in *sukuk* as long as the credit profile fits its criteria. Moreover, the cost mitigates governance risks for the life of the *sukuk*. Only time will tell how successful these new changes will be, but for now the news for lawyers and other advisors is to come prepared with more detailed structure papers in front of their Shariah committees.

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## THE WAY FORWARD

In the longer term, one could argue that the increased scrutiny of *sukuk* and continued periodic review is a positive step to mitigate Shariah non-compliance risk. The question then arises of the increased cost and the fact that this may be a deterrent to some potential issuers who are agnostic and will only issue in Islamic format if there is no difference in price or issuance costs as against conventional bonds.



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## BREACH OF WA'D AND ITS COMPENSATION PAYMENT IN ISLAMIC PROFIT RATE SWAP

By Dr Noor Suhaida Kasri  
ISRA



*wa'd* or unilateral promise has become a prominent tool in structuring Islamic financial products, particularly Islamic hedging instruments.

*Wa'd* is a promise given by one party (promisor) to enter into a Shari'ah-compliant transaction with another party (promisee) in the future. *Wa'd* structure allows parties under Islamic hedging arrangements to be bound by their promise to execute a defined obligation at the time agreed upon in the future.

In the context of Islamic profit rate swap (IPRS), the term *wa'd* refers to the promise given by the promisor to the promisee to purchase specified Shariah-compliant commodities on a certain date for a certain price in the future. This structure has in effect overcome the issue of execution risk in IPRS. It mitigates the uncertainty as to the willingness of the relevant party particularly who is "not in the money", to enter into a *murabahah* or *musawwamah* transaction on each trade date under the IPRS arrangement. The binding effect of *wa'd* is only on the promisor and if the promisor breached its promise to enter into the *murabahah* or *musawwamah* transaction for the purchase of the commodity, the remedy available to the promisee is only compensation.

### SHARIAH RESOLUTIONS ON BREACH OF WA'D AND ITS COMPENSATION PAYMENT

A number of Shariah resolutions, for example the Islamic Fiqh Academy of the Organization of Islamic Cooperation (IFA-OIC), the Accounting and Auditing Organization for Islamic Financial Insti-

tutions (AAOIFI), Dallah Baraka and the Shari'ah Advisory Council of Bank Negara Malaysia (SAC) have issued resolutions on *wa'd* and its breach.

They have resolved that a unilateral promise is binding on the promisor and in the case that the promise is breached, the promisee is entitled to claim compensation for any actual loss suffered. Though these resolutions are unanimous on the granting of compensation for the breach on the condition that the loss suffered must be actual or real, it is not adequate in informing the criteria of actual or real loss except mentioning in general the measurement of actual loss to be based on the difference between the sale price of the commodity and the promised purchase price of the commodity.

In the case of breach of *wa'd* and its payable compensation in IPRS, the SAC, being the only Shariah advisory body that resolves its permissibility, has determined the issue of compensation for breach of *wa'd* under the concept of "close-out amount". The SAC in its 54th meeting dated 27 October 2005 described the close-out amount as an amount that is determined based on the market quotation methodology which refers to the standard formula adopted by market participants to determine the payable compensation amount. In this resolution, the SAC resolved that the methodology used in determining the close-out amount in the conventional interest rate swap is allowed to be adopted into IPRS.

However, the permissibility is subject to the satisfaction of the contracting parties that the close-out amount represents actual loss suffered by a party as a result of a default by the other party (Bank Negara Malaysia, 2010). Nonethe-



*In the context of Islamic profit rate swap (IPRS), the term wa'd refers to the promise given by the promisor to the promisee to purchase specified Shariah-compliant commodities on a certain date for a certain price in the future.*



less, the SAC resolution is still short of describing the constitution of the close-out amount that could be regarded as actual loss suffered by a party as a result of a default by the other party. The following paragraphs explain the mechanics involved in breach of *wa'd* and the composition of close-out amount or alternatively referred to as relevant index value in the IPRS.

### **METHOD OF DETERMINING REPLACEMENT COST UNDER IPRS**

The structure of IPRS involves multiple “legs” throughout the swap period. The parties agreed that at each and every leg the relevant party will exercise its *wa'd* and thereafter a *murabahah* transaction will be entered into by the parties.

However when the party refuses or fails to perform its *wa'd* (promise to purchase the commodity under the *murabahah* transaction), such refusal or failure would trigger an event of default. The effect of an event of default is the early termination of all the future transactions under the respective legs.

In other words, these future transactions are effectively closed-out. Due to this termination, the relevant party will be obliged to pay close-out amount or a relevant index value (RIV) amount (RIV is a term used in the standard document for IPRS, the Tahawwut Master Agreement (TMA)). RIV in principle reflects the net replacement cost of all the early terminated transactions.

As Shariah resolutions that do not clearly stipulate the constitution of real or actual loss, the TMA also does not clearly specify the constitution of the RIV. What is mentioned in the TMA is that in determining the RIV, or the replacement cost, the party determining or calculating the value of the RIV will act in good faith and use commercially reasonable procedures in order to come up with a commercially reasonable result. In ascertaining the RIV, parties would use the market quotation method. The amount determined under this method is based on the quotation from institutions that are called “reference market makers”. The appointment of these reference market makers may be agreed to by the parties in the TMA. In the event that a market quotation cannot be determined or would not in the reasonable belief of the party making the determination to provide



a commercially reasonable result, the calculating party will then be required to calculate its loss.

Loss is referred to in the TMA as an amount that represents the total loss and cost, including gains, calculated in good faith by the calculating party, that are associated with the early termination of all the future transactions. Having said that based on a number of discussions held with few practitioners in the Malaysian Islamic financial institutions, it is learnt that typically the replacement cost claimed by these practitioners could be identified as follows:

1. the commodity price (in the case where the breach of wa'd occurs at the time when the promisee has acquired the commodity);
2. the payment made by the promisee to a third party (in the case where the promisee entered into another say back-to-back hedging arrangement with a third party that cash flow under this back-to-back hedging structure supposedly to match with the cash flow under the IPRS of the promisor and promisee);
3. the cost of fund (the cost incurred by the promisee due to its borrowing from Islamic Interbank Money Market to meet promisee's payment obligation with the third party in the back-to-back hedging); and
4. the penalty for the breach of promise by the promisor.

## COULD THE REPLACEMENT COST BE CLAIMABLE AS ACTUAL OR REAL LOSS?

Applying the Shariah resolutions mentioned earlier, these items are not presently factored in, except for the cost of commodity where parties could cover their losses from the difference between the sale price of the commodity and the promised purchase price of the commodity. While for item (ii) and (iii) Shariah would require that for the loss to be claimable under breach of wa'd it must be real or actual.

Penalty (*gharamah*) under item (iv) on the other hand may not be subjected to the requirement of actual loss though the rightful ability to claim items may raise some questions. Market players contend that whatever being remitted under the reason of breach of wa'd should be claimable as a component of the total loss and cost associated with the early termination of all the future transactions.

Whether the above constitutions of replacement cost are claimable as actual or real loss under the Shariah remains unresolved. Further deliberation is warranted and this brief article could perhaps be an avenue for further discussions.

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The TMA and its other related documents are standard documents issued by the International Islamic Financial Market (IIFM) together with the International Swaps and Derivatives Association Inc. (ISDA). It operates together with other related documents namely the Schedule, the Confirmation, the Designated Future Transaction Terms Agreement (DFT Agreement) and the Designated Future Transaction Terms Confirmation (DFT Confirmation).

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# SPECIAL PURPOSE VEHICLES (SPV): A MANIFESTATION OF ISLAMIC FINANCIAL INNOVATION

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he use of Special Purpose Vehicles (SPV) or special purpose entities (SPE) in project financing has become pervasive in the modern financial system. An SPV is a legal entity established by a parent firm called the originator or sponsor to undertake a specific purpose or certain specified transactions. It carries out such circumscribed activity for which it was created, and it is distinct from its originator. Since an SPV is specially created to be bankruptcy-remote, it is sometimes called a bankruptcy-remote entity.

The United Nations Commission on International Trade Law (UNCITRAL) Legislative Guide on Insolvency Law describes an SPV as a unique entity created to fulfill identifiable business objectives which may be temporary in nature. The advantages of such an informed business decision to create an independent subsidiary company are primarily seen in the areas of bankruptcy remoteness, isolation of financial risk, and tax efficiency. The nature and structure of its asset and liability and unique legal status insulate it from financial risk in the event of the insolvency of its parent company or originator. The rules governing the operations of the SPV are pre-agreed during the contract stage. As a distinct legal entity, SPVs do not have any other purpose except that for which they were established. Generally, an SPV does not have a physical location and its own employees.

## SUKUK AND SPECIAL PURPOSE VEHICLE

As part of the product development process by financial engineers and Shariah scholars in manifesting innovation in Islamic legal thought with specific reference to competitiveness of Shariah-compliant products and instruments, the SPV model was adopted and later adapted to suit the nature of Islamic investment certificates (*sukuk*). The fourteen types of *sukuk* identified by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) can be operationalized for Shariah-compliant project or asset financing through an SPV. Although the general legal form of an SPV could be a limited liability company, a corporation, or even a limited partnership, the most commonly-used SPV model in the *sukuk* market is the trust model.

The common features of an off-balance sheet SPV are:

- Bankruptcy remoteness
- Thin capitalization
- No independent management, employees, and physical location
- Appointed Trustee performs all administrative and managerial functions only based on pre-established rules
- Servicing arrangement for assets held

The origin of the use of SPVs in commercial transactions is often attributed to the English common law of trust. It is however interesting to note some other dimensions of the historical facts that underlie the use of SPVs. The recent history of SPVs can be traced to securitization trends which began in the 1970s. In order to immediately realise the value of liquid assets, a business firm employs the securitization process, which begins with the creation of an SPV. The use of SPV in the *sukuk* market began with the first sovereign *sukuk* in the GCC issued by Bahrain in September 2001. This was later closely followed by the issuance of the first global rated quasi-sovereign *sukuk* in December 2001 by Kumpulan Guthrie, a multinational corporation in Malaysia. Since the Malaysian legal system is based on English law, the concept of trust which was used for structuring the SPV was adopted, further spurring developments of the global *sukuk* market.

### SHARIAH BASIS

The Shariah basis for an SPV might be anchored on the general principle of permissibility (*ibahah*) in *fiqh al-mu'amalat* to the effect that there is no clear-cut prohibition of the SPV arrangement,

where an independent entity is established to manage the investor's proprietary and financial resources. Besides, the concept of *nazir* (or *mu-tawalli*) is recognized as an approved manager of a *waqf* property on behalf of the nominated beneficiaries as contained in the *waqf* deed.

The *nāzir* has fiduciary powers and duties in the management of the *waqf* property. However, ownership of the property is not usually conferred on him, as he is only required to administer the property in accordance with the deed. The position of *nāzir* is so important that if a settlor (*waqif*) fails to nominate a *nāzir*, some Muslim jurists such as Abu Hanifah and Muhammad Al-Shaybani consider such *waqf* as void. It is also permissible for the *wāqif* to appoint himself as *nazir* to manage the *waqf* asset. This justifies the practice of some SPV structures in *sukuk* where the originator also acts as the trustee.

Furthermore, the way and manner a *waqf* is administered on behalf of the nominated beneficiaries provides some semblance to the modern operation of SPVs. It is believed, and it has been argued with convincing evidence, that the Islamic law of *waqf* had significant influence in the evolution of the law of trust in England. What is



*The Shariah basis for an SPV might be anchored on the general principle of permissibility (ibahah) in fiqh al-mu'amalat to the effect that there is no clear-cut prohibition of the SPV arrangement, where an independent entity is established to manage the investor's proprietary and financial resources.*



currently happening in the modern Islamic financial services industry is a cyclical legal transplant or transposition, which saw the adoption of Islamic legal concepts into English law and later evolving into English law of trust.

This was later adopted by the Islamic financial services industry to structure competitive financing products. In addition, the mere fact that joint venture partnerships such as *mudarabah* are permissible as Islamic modes of financing supports the argument that appointing a person or establishing a specific entity to manage a business might not violate any known principles of Islamic law. However, the complexities involved in the management of SPVs in relation to *sukuk* might provide some challenges that the stakeholders in the Islamic financial services industry might need to address.

## HOW IT WORKS

As a separate legal entity distinct from its originator, the SPV is created to finance a specific project. For example, when the government of a country plans for the extension of its airport, it may establish an SPV to issue *sukuk ijarah* (leased-based investment certificates) to prospective investors. This type of *sukuk* is commonly used for project financing, and it is based on the sale and leaseback *sukuk* structure. The government as the originator of the *sukuk* sells part of the airport to the SPV through a Sale and Purchase Contract where the purchase price is paid in cash through the proceeds realised by the latter in its issuance of *sukuk* certificates. Through this arrangement, the funds realised are used to finance the project which is managed by the SPV on behalf of the *sukuk* holders who are the investors.

Through the Declaration of Trust, the SPV acts as a trustee for the *sukuk* holders while the beneficial ownership of the underlying asset is bestowed on the SPV. The SPV leases the land back to the government through an *ijarah* contract and the latter pays its rent periodically. From the funds realised from the lease, the trustee makes a periodic distribution of income to the *sukuk* holders. It is important to note that the *sukuk ijarah* contains a promise (undertaking) to sell the underlying asset and a promise to purchase by the government (the lessee). This will prevent any sale to a third party in case a sovereign asset was used as an underlying asset. The asset is effectively sold back to the government at the maturity date based on the promise to sell.

## THE OWNERSHIP CONUNDRUM

The Declaration of Trust and the general operations of SPVs as trustees is largely regulated by common law principles since such issues do not relate much to core Shariah principles. However, there is increasing debate on the issue of ownership of the underlying asset in a *sukuk* structure. This debate raises the question of whether a true sale required under the Shariah has been made in the transfer of assets from the originator to the SPV, which only holds and manages the asset on behalf of the *sukuk* holders who are presumably the real owners.

In more common *sukuk* structures, the *sukuk* holders only have the beneficial ownership of the asset while the SPV (trustee) is conferred with the legal ownership. The legal conundrum associated with these forms of ownership, originally known to English law, remains a matter to be resolved by both Shariah and legal scholars.



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An Annual Publication Assessing The Key Issues  
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