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Research Report

Islamic finance in Europe

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GLOSSARY OF ARABIC TERMS

bay' al-'inah	Sale and repurchase agreement
bay 'al-istisna'	Manufacturing contract
bay 'al-mu'ajjal	Instant sale of an asset in return for a payment of money (made in full or by instalments) at a future date
bay 'al-salam	Sale where goods are purchased in advance for delivery on an agreed future date
bay' bithaman 'ajil	Deferred payment sale
fatwa	A legal opinion or pronouncement made by a *Shari'ah* board, a mufti or a *faqih* on any matter pertinent to *Shari'ah*-related issues, i.e. based on the appropriate methodology.
fiqh	Knowledge of the legal rulings pertaining to conduct acquired from specific evidence in the *Shari'ah*
gharar	Describes a risky or hazardous sale, where the details of the sale contract are unknown or uncertain
hadeeth	News, report, narration or tacit approval or disapproval ascribed to the prophet Muhammad
haram	Forbidden
ijarah	Leasing contract
ijarah waiqtina	Islamic hire purchase
ijma'	Consensus or agreement of various schools of thought
ijtihad	Reasoning used by qualified scholars to obtain legal rulings from the sources of Islamic law
illah	Effective cause
istisna'	Refers to an agreement to sell a non-existent asset, which is to be manufactured or built according to the buyer's specifications and is to be delivered on a specified future date at a predetermined selling price.
maysir	Gambling
mudarabah	Profit and loss-sharing
mudarib	Entrepreneur
murabahah	Mark-up sale; a "commodity *murabahah*" involves a purchase and sale transaction related to *Shari'ah*-compliant commodities, whereby the buyer purchases such commodities on a deferred payment basis and subsequently sells them to a third party for a cash payment.
musharakah	Joint partnership
mu'min	Believer
qard hasan	Interest-free financing
qimar	Gambling
qiyas	Analogical reasoning to establish and obtain a decision and a judgement for a case due to a certain cause on the basis of the existence of a similar cause in another particular case
Quran	The word of Allah revealed to the last prophet, Muhammad, by the Angel Gabriel; its precise meaning and wording transmitted to us by numerous persons, both verbally and in writing.
rabb al-mal	Capital provider
Ramadan	A special month of fasting in the Islamic calendar
riba'	Usury

riba al-jahiliyya	Usury in the pre-Islamic period
salam	Future delivery
Shari'ah	Islamic law
sharikat al-'aqd	Contractual partnership
sharika al-milk	Proprietary partnership
sukuk	Islamic bonds
sukuk ijarah	Lease-back Islamic debt instrument
Sunna	Prophetic tradition
tabarru'	Voluntary donation
tahawwut	Hedging
takaful	Islamic insurance
tawarruq	Monetisation
ummah	Muslim community
wadiah	Safe custody
wakala	Investor entrusts an agent to act on his behalf
zanniyyat	probabilistic evidence

ABBREVIATIONS

AAOIFI	Accounting and Auditing Organisation for Islamic Financial Institutions
ABS	Asset-backed securities
BaFin	Federal Financial Supervisory Authority
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
ECB	European Central Bank
EU	European Union
FSA	Financial Services Authority
GIA	general investment account
GII	Government Investment Issue
GCC	Gulf Cooperation Council
GMC	Government *Musharakah* Certificate
IFIS	Islamic Finance Information Service
IFSB	Islamic Financial Services Board
IIFM	International Islamic Financial Market
IIFS	institution offering Islamic financial services
IILM	International Islamic Liquidity Management Corporation
IIMM	Islamic Interbank Money Market
ISDA	International Swaps and Derivatives Association
LIBOR	London Interbank Offered Rate
LMC	Liquidity Management Centre
LME	London Metal Exchange
LOLR	lender of last resort
MENA	Middle East and North Africa
MII	Mudarabah Interbank Investment
MROs	Main refinancing operations
OECD	Organisation for Economic Co-operation and Development
OMO	open market operation
OSFs	operational standing facilities
OTC	over-the-counter
PLS	profit and loss-sharing
REPO	repurchase agreement
RSA	regulatory and supervisory authority
RWA	risk-weighted assets
SIA	specific investment account
SPV	special purpose vehicle
SRI	socially responsible investment
SWOT	strengths, weaknesses, opportunities and threats
UAE	United Arab Emirates
UCITS	Undertakings for Collective Investment in Transferable Securities
UK	United Kingdom
UKIFS	UK Islamic Finance Secretariat
UPSIA	unrestricted profit-sharing and loss-bearing investment accounts
US	United States

ABSTRACT

Islamic finance is based on ethical principles in line with Islamic religious law. Despite its low share of the global financial market, Islamic finance has been one of this sector's fastest growing components over the last decades and has gained further momentum in the wake of the financial crisis.

The paper examines the development of and possible prospects for Islamic finance, with a special focus on Europe. It compares Islamic and conventional finance, particularly as concerns risks associated with the operations of respective institutions, as well as corporate governance. The paper also analyses empirical evidence comparing Islamic and conventional financial institutions with regard to their: (i) efficiency and profitability; and (ii) stability and resilience. Finally, the paper considers the conduct of monetary policy in an Islamic banking context. This is not uncomplicated given the fact that interest rates – normally a cornerstone of monetary policy – are prohibited under Islamic finance. Liquidity management issues are thus discussed here, with particular reference to the euro area.

JEL code: E52, E58, F6, F65, G21, G22, G28, G3, G32, M14

Keywords: Islamic finance, central bank monetary policy and regulations, globalisation, financial institutions, financing policy, corporate governance and culture, social responsibility

NON-TECHNICAL SUMMARY

An Islamic financial system is one that complies with Islamic religious law (i.e. the *Shari'ah*). Islamic finance has become an important part of the international financial system and was, certainly, one of its fastest growing components over the last decades. In the wake of the financial crisis, there has been a renewed debate on the role that Islamic finance can play in the stabilisation of the global financial system, one related to the strong ethical principles on which this type of finance is based. Against this background, this paper aims to contribute to the debate by examining the development of and possible prospects for Islamic finance, with a special focus on Europe.

Section 1 illustrates the main principles underpinning Islamic finance, which can be summarised as follows. The first principle dictates that paying interest is prohibited. As a result, Islamic banks have to use contracts that create exposure to the real sector and must therefore ensure efficient risk management. The second principle involves the profit and loss-sharing concept. Parties to a financial transaction must share both the risks and the rewards that may be attached to it; in this way, excessive losses and profits are minimised. The third principle is the prohibition of uncertainty or speculation. However, risk-taking is allowed when all terms and conditions are clearly stipulated and known to all parties. The fourth principle demands the use of asset-backing. Each financial transaction must relate to a tangible and/or identifiable underlying asset, ensuring that Islamic banks remain connected to the real economy.

As observed in Section 2, Islamic finance has developed significantly over the years to become a noticeable part of the international financial system. The value of Islamic financial assets worldwide increased from USD 150 billion in the mid-1990s to an estimated USD 1.6 trillion by end-2012. Islamic banking continues to dominate the global Islamic finance industry, covering approximately 80% of total Islamic financial assets. Five prominent Gulf States (Iran, Saudi Arabia, the United Arab Emirates, Kuwait and Qatar), as well as countries in South-East Asia (most notably Malaysia) account for most of the Islamic banking market.

As regards the European Union (EU), Islamic finance is still at a fairly embryonic stage, but a number of factors would tend to support its further development:

- government incentives and the measures introduced to create an environment conducive to a growing and thriving Islamic finance industry;
- the increased emphasis on alternative financial solutions following the financial crisis;
- the substantial appetite for attracting liquidity from emerging markets.

While Islamic financial instruments share the merits of conventional ones, they have certain distinct features that differentiate them from their counterparts. Section 3 provides an insight into some of these features, highlighting the issue of risk. It compares the risks associated with Islamic finance with those faced in the conventional financial system. It also provides a comparison between ethical and Islamic investments and notes the proximity of Islamic finance to socially responsible investment. The final part of this section considers the extent to which Islamic instruments and principles can be incorporated into conventional finance. The establishment of "Islamic windows" is particularly important in this context.

The financial crisis has offered an important yardstick by which one can gauge the advantages and disadvantages of Islamic finance. Section 4 provides empirical evidence on how Islamic financial institutions have performed in relation to conventional ones. To this end, it considers the wide body of literature available from two main perspectives: (i) the efficiency and profitability; and (ii) the stability and resilience of Islamic institutions. As regards the former, with a few exceptions, existing studies that predate the crisis indicate that there are no significant differences between Islamic and conventional banks as far as their business orientation and efficiency is concerned. In contrast, most recent studies including data for the crisis period tend to stress that, during the financial crisis, Islamic banks had more difficulties than conventional banks in maintaining their efficiency and profitability. Meanwhile, as concerns the latter issue, empirical evidence based on firm-level data shows that Islamic financing is less than half as risky as conventional financing. Moreover, various studies have documented the high growth of Islamic bank assets during the financial crisis.

Section 5 discusses the conduct of monetary policy operations in an Islamic banking context. The operational framework of monetary policy is normally based on three different channels: a minimum reserve system; open market operations; and standing facilities. Each of these channels deals with slightly different monetary policy objectives, but is always centred on interest rates. Therefore, there is a clear conflict between *riba'* – the prohibition of interest payments – and the normal conduct of monetary policy. Consequently, one needs to develop ad-hoc instruments for a *Shari'ah*-compliant monetary policy. This section also addresses the issue of liquidity management and, in particular, the developments and prospects for creating adequate Islamic interbank markets. Issues related to the collateral framework of the Eurosystem are then considered from an Islamic finance perspective.

Finally, Section 6 provides a brief conclusion.

INTRODUCTION

Islamic finance has become an important part of the international financial system and was, certainly, one of its fastest growing components over the last decades. In the wake of the financial crisis, there has been a renewed debate on the role that Islamic finance can play in the stabilisation of our financial system, given its strong ethical principles and religious foundations.

Islamic finance is based on four main principles, which are all derived from the *Quran and Sunna*. The first dictates that paying interest (i.e. any predetermined payment over and above the principal) is prohibited. As a result, Islamic banks have to use contracts that create exposure to the real sector and must thus ensure efficient risk management. The second principle involves the profit and loss-sharing concept. Parties to a financial transaction must share both the risks and the rewards that may be attached to it; in this way, excessive losses and profits are minimised. The third principle is the prohibition of uncertainty or speculation. Uncertainty in contractual terms and conditions is forbidden. However, risk-taking is allowed when all terms and conditions are clearly stipulated and known to all parties. The fourth principle demands the use of asset-backing. Each financial transaction must relate to a tangible and/or identifiable underlying asset, ensuring that Islamic banks remain connected to the real economy.

Against this background, this paper contributes to the debate by examining the development of and possible prospects for Islamic finance, with a special focus on Europe.

1 ISLAMIC FINANCE – PRINCIPLES AND CHARACTERISTICS (ANGELA DI MARIA)

1.1 DEFINITION AND SOURCES

An Islamic financial system is one that complies with Islamic religious law (*Shari'ah*). It has the distinctive feature that it tries to reconcile a secular financial system with the basic tenets of the Islamic faith. Under Islam, there is no concept of an economy functioning independently of the religious criteria that inform every single aspect of human life: *homo economicus* is not independent and separate from the *mu'min* (believer).

The primary sources of the *Shari'ah* are the *Quran* and the *Sunna*, the sayings and actions of the Prophet Muhammad transmitted orally in the form of the *hadeeth* (the stories of the Prophet's companions). The *Quran* and the *Sunna* leave room for interpretation: they do not cover all of the questions confronting the contemporary Muslim community.[1] Accordingly, there is the need to resort to secondary sources of law.

These secondary sources are Islamic jurisprudence (*fiqh*), based on the interpretations (*ijtihad*) of experts in particular cases (e.g. ones of implicit or unclear rules), on deductive reasoning (*qiyas*)[2] and on the expert consensus of various schools of thought (*ijma'*).[3] However, it is controversial as to whether interpretation is still possible, as some scholars maintain that interpretation was completed centuries ago. This is further complicated by the divide between the *Sunni* and the *Shia* branches of Islam, and the presence of several schools of thought on Islamic jurisprudence within each of these denominations. Orthodox *Sunni* Islam, for example, has four main schools of law.[4]

Differences in the interpretation of the law (*fiqh*) can have significant implications for the development of Islamic finance. The lack of harmonisation of Islamic rules, with different scholars expressing different views, could give rise to uncertainty on one critical issue, namely whether certain financial instruments[5] are compliant with the *Shari'ah*.

1.2 WHY "ISLAMIC" FINANCE?

From a historical point of view, the idea of an Islamic financial system[6] began to emerge during the second-half of the 20th century, when decolonisation and the creation of new states with a majority Muslim population led to the foundation of the Islamic banking industry.

An Islamic financial system was seen as a segment of the overall Islamic economy that would underpin an Islamic social order that could be an alternative to capitalist liberalism and socialist planning. It would offer the faithful the opportunity to reconcile their economic activity with their religious beliefs. Thus, historically, Islamic finance has developed over a long period of a profound

1 The revealed legal evidence is divided into two categories: *qat'iyyat* (unambiguous evidence) and *zanniyyat* (probabilistic evidence), whereby the former is not permitted to be interpreted and the latter leaves some scope for interpretation by qualified Muslim jurists.
2 This means that if a ruling is required on a case not covered by the *Quran* and the *Sunna*, a comparison can be made with a similar situation covered by these.
3 The underlying idea is that the *ummah* (Muslim community) itself becomes a source of law. However, there is no agreement on the consensus; the scope of which varies from the entire community of believers to the agreements of scholars.
4 These are the *Hanafi*, *Maliki*, *Shafi'i* and *Hanbali* schools of law. For *Shi'ites*, the *Jafari* school of law is the largest one.
5 In recent years, for example, there has been a debate on *sukuk* (Islamic bonds) following the announcement by Sheikh Muhammed Taqi Usmani, the Chairman of the *Shari'ah* Board of the AAOIFI, that 85% of the *sukuk* issued are not *Shari'ah*-compliant.
6 The debate on Islamic economics began with the publication in 1941 of "The economic problem of man and its Islamic solution" by Sayyid Abul A'la Maududi. The Egyptian Sayyed Qutb, a Muslim Brotherhood leader, and the Iraqi Muhammad Baqir al-Sadr also contributed to this work.

rethinking of the cultural, religious and social identity of Muslims and with the affirmation of its distinctive characteristics.

The 1970s saw the industry experience its first major development and appear on the global stage, when a huge inflow of liquidity into the Gulf States was used to support the establishment of several institutions offering Islamic financial services (IIFSs). Since then, Islamic financial activity has grown significantly, both in terms of volume and scope, as discussed in Section 2.

The Islamic financial system and the way in which it is perceived by all the major players have changed profoundly since the 1970s: there has been a diversification of products and players and an intensification of the cross-border dimension. Islamic finance is no longer seen as opposed to a "secular", global financial system, but as an integral part of it.

Today, an Islamic financial system exists to provide a variety of religiously acceptable financial services to Muslim communities and also as an alternative for non-Muslim clients seeking ethical investments and greater risk diversification.[7] The on-going expansion of this financial market still tends to be confined to Muslim investors, as well as to the Gulf States and some Asian emerging countries (i.e. Malaysia and Indonesia) (see Aziz 2012). The industry, however, has started targeting non-Muslim clients and, in the 1990s, Islamic financial companies began operating in Western countries (see Section 2).

1.3 THE MAIN REQUIREMENTS

The *Quran* contains explicit rules regulating personal status, contracts, property, civil and criminal law, and the economic system. The main prescriptions relating to financial transactions are: the prohibition of *riba'*[8] (i.e. the payment of a fixed or determinable interest on funds); and the prohibition of economic practices that involve the concept of *gharar* (deceptive uncertainty), *maysir* (speculation) and *harām* (prohibited behaviour).

KEY PROHIBITIONS

THE PROHIBITION OF RIBA'

In the *Quran*, there are several verses that condemn *riba'*, which literally means "increase, addition and surplus". These originate from a pre-Islamic practice whereby the amount due was doubled if the debtor proved unable to repay the debt at maturity.[9]

The scope of *riba'* has been debated since the early days of Islam. The fundamental problem is finding a consensus on the scope of the "interest rate", which is usually considered to be either an unjustified increase or a surplus gain. Some scholars have argued that the prohibition of *riba*' refers

7 El-Gamal (2001) complains that "using pre-modern contract forms, Islamic finance has arguably failed to serve the objectives of Islamic law... Conversely, by focusing on the Islamicity of contract forms rather than substance, Islamic finance has often failed to serve the economic purposes for which certain pre-modern contract structures were codified in classical jurisprudence". He suggested refocusing "Islamic finance on substance rather than form... It would also entail reorienting the brand name of Islamic finance to emphasise issues of community banking, microfinance, socially responsible investment, and the like. In other words, the "Islamic" in "Islamic finance" should relate to the social and economic ends of financial transaction, rather than the contract mechanisms through which financial ends are achieved".

8 Under Islamic law, there are two main categories of *riba'*: (1) *riba al-duyun* or *riba al qurud* (*riba'* arising from financing) and (2) *riba al-buyu'* (*riba'* arising from trade). The latter can take the form of *riba al-fadl* (which arises from a surplus/increase relating to an exchange of unequal qualities or of quantities of the same commodity) or *riba al-nisa* (which arises from the delay relating to a non-simultaneous exchange of equal qualities and of quantities of the same commodity). *Riba al duyun* involves a charge on a financing which is associated with a time delay (*riba al nasi'ah*). See Algaoud, L and Lewis M., 2007.

9 In particular, the prohibition is based on different verses in which *riba'* is contrasted with alms to the poor.

to practices adopted in the pre-Muslim "time of ignorance" (*riba al-jahiliyya*) and that it should not apply to all forms of interest.[10]

Islamic scholars have also tried to provide a theoretical basis for the ban, in terms of ethics and economics. There is no consensus amongst scholars on how to identify the *illah* (effective cause) which constitutes the criterion for acceptability or non-acceptability in accordance with *Shari'ah* rulings on the prohibition of *riba'*. However, the prohibition of interest is based on the assumption that there can be no gain without risk-taking. Divine prohibition of usury, which is a common feature of the three monotheistic religions,[11] does not, in fact, prohibit every return on capital or trade. Its purpose is to protect the weaker contracting party. Some scholars state that, since capital does not have a stable value over time and space, its price cannot be fixed ex ante but must take account the actual economic benefits the debtor has enjoyed upon its usage. Therefore, there must be a link between the results of the usage of capital and the amount paid for it.

Some scholars add secular and economic arguments to the religious motivation for the prohibition: "interest-free" finance could more effectively lead to full employment of resources, while "interest-based" finance would, by its very nature, be more volatile and instable, and therefore detrimental to economic development. In an interest-based system, the major criterion for the allocation of credit is the creditworthiness of the borrower, whereas, in an Islamic financial system, it is the productivity of the project that is more important.[12] This encourages the channelling of credit to productive projects. And this line of reasoning becomes even more compelling with regard to the prohibition of speculation (*maysir*). Speculation is considered to be responsible for many of the most serious financial crises.

However, since classical times, Islamic law has leant itself to reconciling commercial development with religion, making a wide range of financial transactions possible (see Section 1.2).

THE PROHIBITION OF GHARAR AND MAYSIR

Speculative transactions are deemed to involve a type of unjust increase prohibited by the *Quran*. The underlying motivation is to ensure a fair correspondence between the expected benefits and obtained benefits of both parties to a contract. All activities that contain elements of uncertainty, such as commercial transactions in which there is uncertainty about an asset or its price, are covered by the prohibition of *gharar* (uncertainty) and *maysir* (gambling) stipulated in the *Quran*.

Because an element of uncertainty can be found in almost all commercial transactions, it is excessive *gharar*[13] that is prohibited. For example, excessive *gharar* can be identified in the case of insurance contracts. Futures, forwards and other derivatives also fall under *gharar*, as there is no certainty that the object of the sale will exist at the time the trade has to be executed.

These instruments are also subject to the prohibition on *maysir*, which condemns the speculative exploitation of legal uncertainty in order to draw an unjustified (because it is unfair) advantage. In addition, speculation (*maysir*) is seen as diverting resources from productive activities.

10 In Egypt there have been several official pronouncements defending conventional forms of interest, including *fatwa* from the Grand Mufti of Cairo ruling that interest provides security to small investors and is thus permitted, and from the Grand Sheikh of Al-Azhar University affirming that interest paid on some kind of bank deposits (investment accounts) can be considered as profit distributions that are pre-determined by mutual consensus.

11 According to the Bible, the Christian Church condemned the payment of interest at various times over the 1,400 years before the Reformation.

12 It is also argued that an interest-based financial system has a pro-cyclical effect.

13 There are two types of *gharar* in Islamic commercial jurisprudence: (i) major uncertainty which is unacceptable; and (ii) minor uncertainty which is tolerable.

Gharar and *maysir* render a contract null and void.[14] However, there can be some exceptions to this general principle. Given the important role of derivatives in the management and allocation of risk and in financial innovation, some Islamic economists are making an effort to structure *Shari'ah*-compliant financial contracts that are similar to derivatives. They argue that some Islamic contracts (e.g. *salam* and *istisna'* contracts) have certain features in common with derivatives (e.g. futures or forward contracts).

For insurance products, Islamic jurists have developed a *Shari'ah*-compliant system based on mutual cooperation and assistance (commonly known as *takaful*). They aim to create a structure very similar to that of conventional mutual insurance.[15] Participants in the *takaful* pay a sum of money (*tabarru'*) to a mutual cooperative fund, which is then used for compensation should this be necessary. The *takaful* company acts as the manager of the fund; there is an agency contract and remuneration is seen as a share in any surplus – this being the difference between the *takaful* fund and any payments made. Funds are usually invested on the basis of *Shari'ah*-compliant contracts, particularly those featuring *mudarabah* (see Section 1.2).

Prohibitions under the *Quran* also include *haram* (forbidden) activities, which are primarily related to tobacco, pornography, arms, alcohol, pork and gambling.

PROFIT AND LOSS-SHARING

The Islamic prohibition on paying interest has to be considered in the wider framework of the Islamic economy. This is much more than just a doctrine against usury. Islamic finance fits into the general context of the Islamic economic system; the creation of an economic order in which social solidarity and belonging to the community are core values, in which the principles of equity and inviolability of contractual obligations are ensured, and where there are effective links between financial transactions and real economic activity. Islam recognises the role capital plays in production. Although the *Quran* forbids the creation of money by money, it does allow money to be used for trading tangible assets and for conducting business which may generate profits.

Loans are permitted if the interest is linked to the profit or loss obtained from the investment and the predetermined rate is replaced with a profit commensurate with the result of a real economic activity. For Islam, it is "profit" rather than "interest" that is closer to its sense of ethics and fairness. The concept of profit involves the idea of sharing the risks of both gains and losses, and symbolises entrepreneurship and wealth creation.[16] Although this is the foundation of the profit and loss-sharing system on which Islamic banks should ideally be based, in practice, this kind of contract plays only a secondary role.[17] This risk-sharing principle is implemented through a series of contractual arrangements which are analysed below in Section 1.4.

1.4 THE MAIN FINANCIAL INSTRUMENTS

The Islamic finance industry has developed a wide range of *Shari'ah*-compliant financial products. To ensure that they meet this specification, they make use of contracts acceptable under traditional Islamic legal doctrine and also adapt conventional financial contracts so that they comply with the tenets of the *Shari'ah*.

14 Islamic law, however, does not make a clear distinction between null and void and defective and voidable.
15 The sector only started developing in the late 1970s.
16 This is consistent with the commercial environment in which Islam flourished; Prophet Muhammed himself and his wife Khadija were both involved in commercial activities.
17 A study on Malaysia (Chong and Liu, 2007) shows that only a negligible proportion of Islamic bank financing is strictly PLS-based and that Islamic deposits are not interest-free, but they are closely pegged to conventional deposits.

There are two main types of product: profit and loss sharing instruments (PLS) and mark-up contracts; and financial certificates that are similar to bonds, which are known as *"sukuk"*. For some instruments, there is an open discussion as to whether they are *Shari'ah*-compliant.

1.4.1 PROFIT AND LOSS-SHARING CONTRACTS

Islamic doctrine considers PLS contracts to be closer to the dictates of the *Shari'ah*. Being based on risk participation, they are not only *halal* (*Shari'ah*-compliant), but also preferable to other types of contracts. The most used contracts are those of medieval origin, namely those involving *mudarabah* and *musharakah*.

The *musharakah* contract was used in the Middle Ages to facilitate the joint ownership of property (*sharika al-milk*) or of a commercial enterprise (*sharikat al-'aqd*). It is a contract in which two parties agree on the capital shares that both confer to a project. Both parties are involved in the implementation and management of the project and profits are divided according to the terms agreed in the contract. Meanwhile, losses are allocated in proportion to the capital contributed.

Under a *mudarabah* contract, the owner of capital (*rabb al-mal*; the bank or the customer) gives money to the applicant (*mudarib*; the entrepreneur or the bank in the case of indirect financing), who is committed to managing the amount given with a view towards making a profit. This, in turn, will be divided between the parties on a percentage basis, as specified in the contract: it is a share of total income and, as such, no fixed sum. The same operation can also be used for indirect financing: the agent who has received the capital can conclude a *mudarabah* contract with a third party that will then invest it in productive activities (double-tier *mudarabah*). *Mudarabah* contracts are commonly used for the management of mutual funds and the structuring of *sukuk*.

The difference between the two types of contracts is that, under a *mudarabah* contract, capital is wholly given by the bank, which also pays for losses, whereas, with a *musharakah* contract, both parties participate financially in the project. Moreover, in the former case, the management of the project is in the sole responsibility of the *mudarib*, while it is shared in the latter case. In addition, the assets purchased with the investment remain the property of the bank under a *mudarabah* contract, while their ownership is shared in the case of a *musharakah* contract. In practice, the use of a *musharakah* contract is limited because it is, by nature, a long-term instrument, while most of the deposits collected by Islamic banks have a short-term maturity. Its limited diffusion is also partly due to the lack of support shown by small businesses, which are reluctant to have external interference in their business management. Both of these tools are suitable for financing joint ventures and also for project financing.

1.4.2 INDIRECT PARTICIPATION OR MARK-UP CONTRACTS

There are also forms of non-participatory financing (these do not involve any PLS), which are most often used in practice, particularly for consumer credit and short and medium-term financing: the most popular involve *murabahah* (sale term) and *ijarah* (leasing) contracts. Contracts of this type, which are also known as "trade-based" or "asset-based" contracts, entail a fee or a mark-up on the price of the goods that are bought with the funds supplied. In this case, the remuneration does not explicitly refer to the temporal dimension and is thus considered the compensation for a commercial service (in the case of a *murabahah* contract) or for the use of a good (in the case of an *ijarah* contract). However, the cash flows generated by the contract tend, in fact, to replicate those that are typical of a conventional bank loan.

These operations are also generally associated with indirect forms of collateral, such as the ownership of the goods underlying the transaction. The *murabahah* contract is the one most commonly used. Under this, one party buys an asset and sells it to the other party at a higher price, which is agreed upon conclusion of the contract and is payable at the end. The following contracts are also similar:

- *bay 'al-mu'ajjal* – instant sale of an asset in return for the payment of money (made in full or by instalments) at a future date;
- *bay 'al-salam* – deferred sale of an asset with an immediate payment of the price involved;
- *bay 'al-istisna'* – similar to the *bay 'al-salam* contract, but involving a different object (industrial goods that have not yet been completed);
- *commodity murabahah (or tawarruq)* – the customer enters into a *murabahah* transaction with a bank, requesting it to purchase a particular commodity (e.g. metals).

In the other common type of non-PLS contract, i.e. the *ijarah* (leasing) contract, a party (usually the bank) purchases an item and leases it to the other party (the client). Under Islamic law, the lease is equivalent to the sale of the right to use the good against the payment of a fee, set at the time the contract is concluded and related to the way the good will be used (thus, the gain of the bank takes into account the results achieved by using the leased asset). The seller and the buyer must agree on the mark-up. The object of the contract must have a real usage and the user must be able to benefit from it. Ownership of the underlying asset remains with the bank: this bears the risk associated with lending goods for the duration of the contract. Some types of *ijarah* contract (e.g. the *ijarah waiqtina* contract) include the right of final purchase and allow for the transfer of ownership of the product.

Finally, there is also financing free of charge (*qard hasan*), which is intended for individuals or companies in financial difficulties, and is merely a form of charity.

1.4.3 *SUKUK*

The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) defines "*sukuk*" as certificates of equal value representing undivided shares related to the ownership (and not debt) of tangible assets, usufruct and services or to the ownership of the assets of particular projects or a special investment activity, extending even to contractual rights, which are held in trust for *sukuk*-holders. To be *Shari'ah*-complaint, *sukuk* must be capable of being owned and sold legally, in accordance with the rules of the *Shari'ah*.

In recent years, Islamic investors with a clear preference for investments that use funds consistent with their religious beliefs have increasingly subscribed to *sukuk* issuances. In fact, the growing preference for *Shari'ah*-compliant investments among Muslim populations has been a key growth driver for the global *sukuk* market and for Islamic finance as a whole and has been translated into the development of fully fledged institutions, such as Islamic banks, Islamic insurance operators and Islamic fund managers.

2 ISLAMIC FINANCE IN THE GLOBAL FINANCIAL SYSTEM (BALJEET KAUR GREWAL)

Islamic finance has developed significantly over the years to become a noticeable part of the international financial system (see Chart 1a). The value of Islamic financial assets worldwide increased from USD 150 billion in the mid-1990s to about USD 1.6 trillion by end-2012, led by the Islamic banking sector and the global *sukuk* market (see charts 1b and 1c). And, in 2013, it is estimated to have reached the high figure of USD 1.9 trillion. Despite the formidable growth of the last few years, Islamic finance still accounts for a relatively small share of global finance, and remains mostly localised in selected areas of the world, particularly in the Middle East and Far Eastern Asia (see Chart 1).

The growth of the Islamic finance industry has mainly been driven by the following factors:

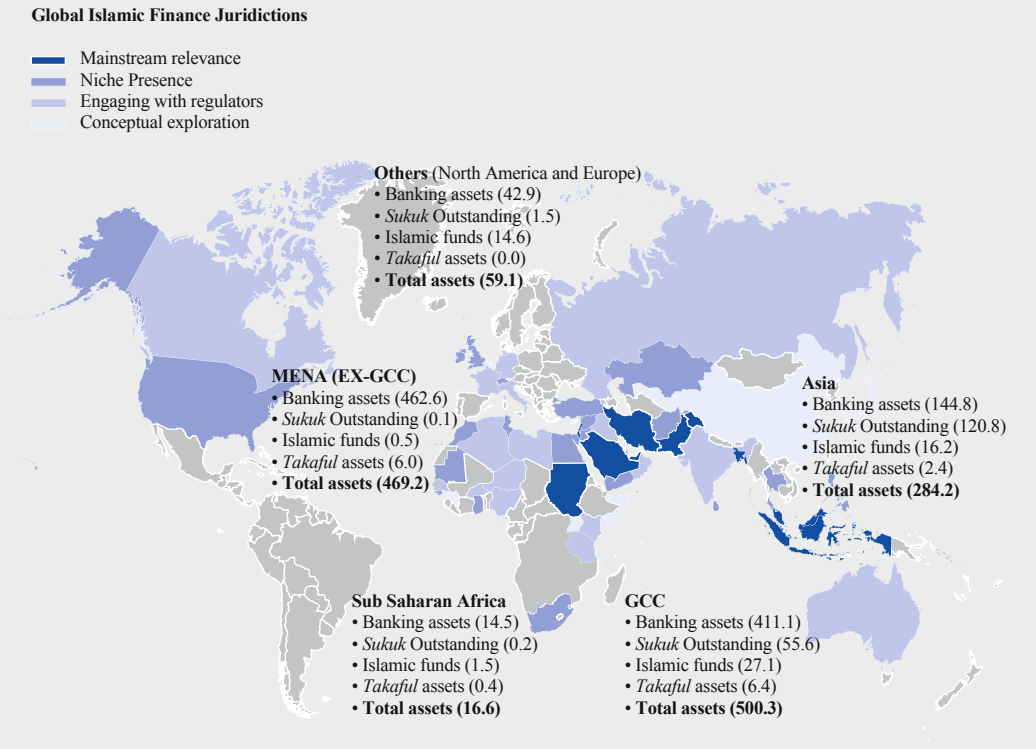
- abundant liquidity flows from the recycling of petrodollars generated by high oil prices over the years;
- the active role played by some jurisdictions around the world to promote the development of Islamic financial markets in their respective countries;
- a growing Muslim population and the related higher demand for *Shari'ah*-compliant products;
- an increased perception that Islamic finance can support efforts to promote global financial stability;
- the fact that multilateral organisations (e.g. the IMF) as well as a number of central banks have embarked on extensive studies/research initiatives to examine prospects for Islamic finance within their respective economic blocs/regions.

Chart 1 Global Islamic financial assets

Sources: Bloomberg and KFH Research.

Chart 2 Geographical Breakdown of Total Global Islamic Financial Assets (2012)

(total global islamic finance assets = USD1,329.4 billion)



Source: KFH Research.

2.1 ISLAMIC BANKING

Islamic finance has only made substantial advances within the last decade. The Islamic banking industry, in particular, has been growing at a sustained rate, despite being at a nascent stage. Islamic banks handled approximately USD 1.3 trillion (estimate) in assets at the end of 2012, and have experienced a growth rate of 15-20% per annum over the last five years. Islamic banking continues to dominate the global Islamic finance industry, representing about 80% of total Islamic financial assets. Iran, four prominent Gulf States (i.e. Saudi Arabia, the United Arab Emirates, Kuwait, and Qatar), as well as countries in South-East Asia account for most of the Islamic banking market (see Chart 3a).

Islamic banking has become the fastest growing segment of the international financial system (see Chart 3b). The internationalisation of Islamic finance makes it a potentially additional means by which intermediation can take place around the globe vis-à-vis cross-border financial flows (see Chart 3c). Turning to Europe, Islamic finance is still at a fairly embryonic stage, but a number of factors would tend to support its further development:

- government incentives and the measures introduced to create an environment conducive to a growing and thriving Islamic finance industry;
- the growing Muslim population within European jurisdictions;

- the increased emphasis on alternative financial solutions in the wake of the European financial crisis;

- the substantial appetite for attracting liquidity from emerging markets.

So far, Islamic banks have profited from a demand-driven niche market that is fast growing. However, with the large number of Islamic banks already present and the growing interest from conventional institutions in this emerging market, the industry is becoming highly competitive (see Chart 4). Conventional financial institutions are increasingly realising the value of Islamic financing techniques and are starting to incorporate these into their existing financing practices or opening up separate "Islamic windows".

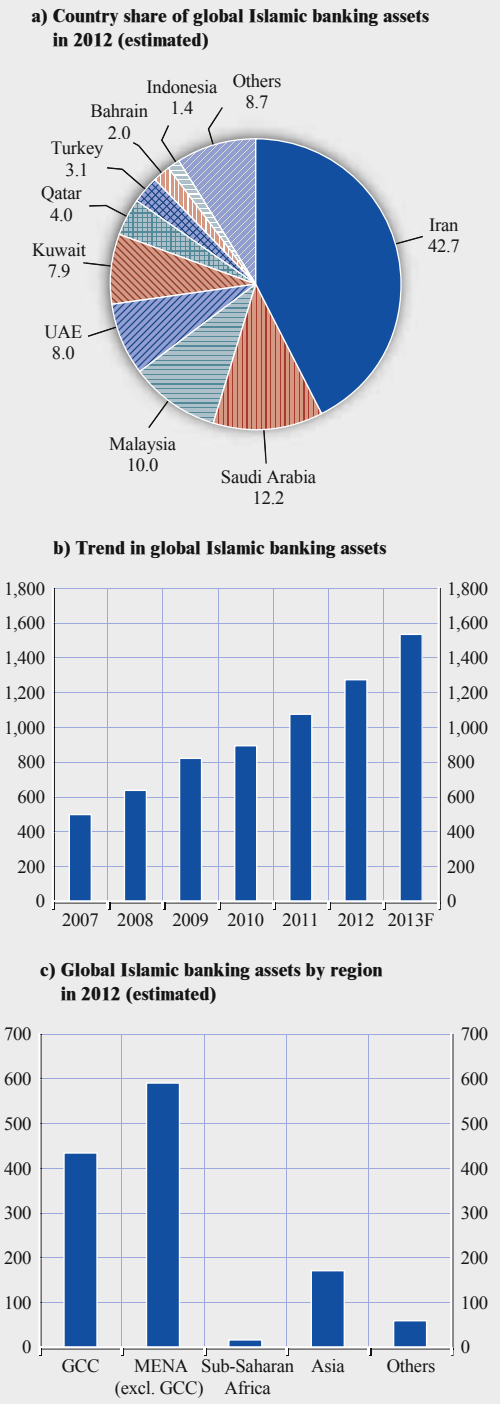
2.2 ISLAMIC CAPITAL MARKETS

Since 1990, the Islamic capital market has developed rapidly across the globe, from South-East Asia to the GCC region and to Europe, becoming a truly international market for fundraising activities. This strong growth has been driven by the increase in the earnings of oil exporting countries resulting from a rise in global oil prices. Participating institutions include multilateral organisations, such as the World Bank and the Islamic Development Bank (IDB), as well as both Islamic and conventional corporate entities.

The Islamic capital market is an integral part of the Islamic financial system. It enables the efficient mobilisation of resources and an optimal allocation thereof, thereby complementing the financial intermediary role of Islamic institutions in the investment process (see Aziz 2012b). Although this market functions similarly to the conventional capital market, any financial arrangement it facilitates has to be in line with the *Shari'ah* principles summarised earlier. At present, Islamic equity, Islamic bonds (*sukuk*), Islamic funds and Islamic real estate investment trusts (REITs) are offered as alternatives to conventional instruments.

Chart 3 Global Islamic banking assets

(percentages; USD billions)



Sources: The Banker and KFH Research.
Notes: "GCC" refers to the Gulf Cooperation Council and "MENA" to the Middle East and North Africa.

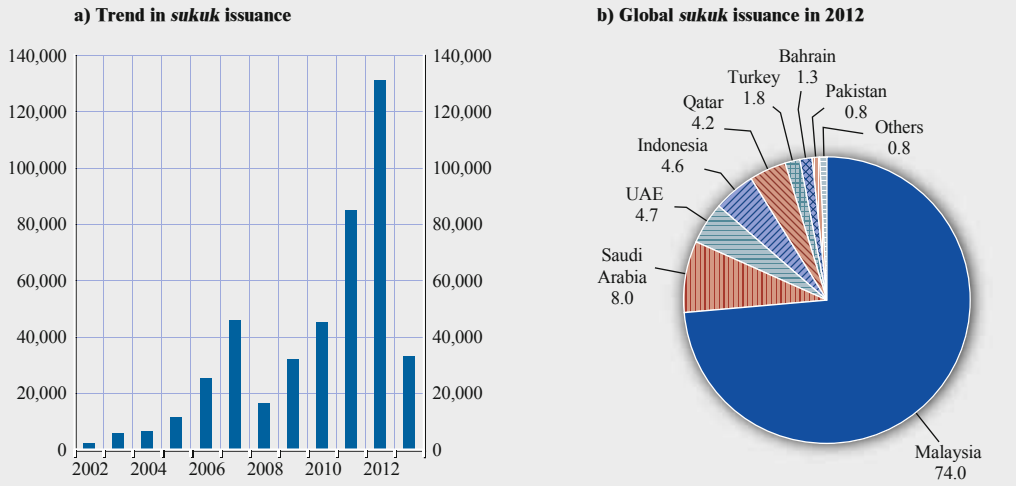
Chart 4 Establishment of Islamic banks and institutions: a brief historical perspective

Source: KFH Research.

Sukuk (see Section 1.4) have been a particularly fast growing segment of the market and, after Islamic banking, represent the second-largest asset class within the Islamic finance industry.

Chart 5 *Sukuk* issuance

(USD millions; percentages)



Sources: IFIS, Bloomberg and KFH Research.

Table 1 European *sukuk* listings

Stock exchange	No. of *sukuk*	Total amount (USD million)
London Stock Exchange	42	35,236.0
Luxembourg Stock Exchange	16	7,280.5
Irish Stock Exchange	9	4,853.1

Sources: Relevant stock exchanges.

The *sukuk* has become an important vehicle for international fundraising and investment activities that generate significant cross-border flows.

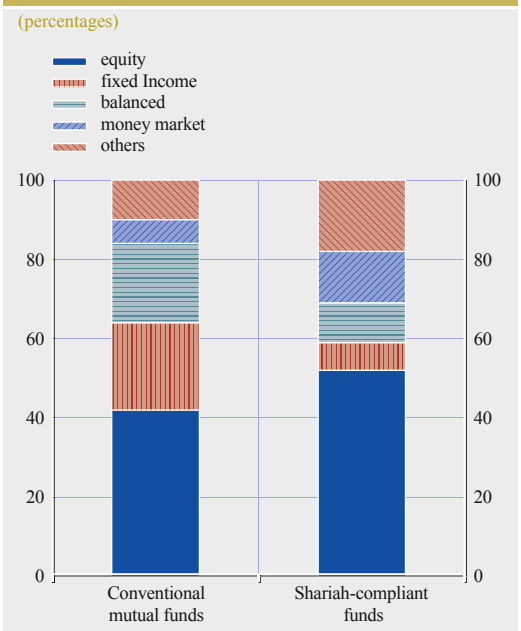
As at end-2012, the value of outstanding global *sukuk* topped USD 229.4 billion – a record high helped by new issuances worth USD 131.2 billion (see Chart 5a). Malaysia, Qatar, the UAE, Saudi Arabia and Indonesia feature among the countries that have been at the forefront of growth in the *sukuk* primary market (see Chart 5b).

At present, there are four major *sukuk*-listing domiciles, namely the London Stock Exchange, the Bursa Malaysia (in Kuala Lumpur), NASDAQ Dubai and the Luxembourg Stock Exchange. The London Stock Exchange is the largest exchange for *sukuk* listings: this offers the benefit of competitive admission and listing costs, being the only major listing venue that does not charge an annual fee to the issuer. During 2012, the exchange attracted two further *sukuk* issuances, bringing the total number of its *sukuk* listings to 42 and the total amount of capital raised to over USD 35.2 billion (see Table 1).

Until a few years ago, the demand for *sukuk* was limited outside of Asia and the GCC region. The new issuances made in 2012 were dominated by government institutions, as well as the construction and financial services industries. Having benefited from a compound annual growth rate of 57% over the past decade, the value of outstanding global *sukuk* reached an estimated USD 225 billion at the end of 2012.

As regards Islamic investment funds, in 2011, the latest year for which data is available, the size of assets under management stood at USD 60 billion, with the number of funds rising to 876 during this year and accounting for approximately 4.6% of global Islamic financial assets. In terms of fund domicile, Saudi Arabia remains the key market for Islamic investors. This country accounted for 42.4% of the industry in 2011, followed by Malaysia at 25.9%, the United States (US) at 7.9%, Kuwait at 4.9% and Ireland at 4.1%.

Chart 6 Composition of investment funds by asset class



Source: KFH Research.

Table 2 Islamic funds by country (2012)

Country	Total assets (USD million)	Number of funds
Ireland	1,887.0	47
Luxembourg	1,353.4	68
Jersey	1,285.0	21
Guernsey	107.4	12
France	147.2	6

Sources: Bloomberg, KFH Research.

While conventional investment funds show a more balanced asset allocation and an orientation towards fixed income assets, *Shari'ah*-compliant funds are focused on equities and money market instruments (see Chart 6).

European Islamic funds currently represent 8.3% of the global Islamic fund industry, with Ireland and Luxembourg accounting for 7% alone. In its endeavour to project Dublin as the European hub for Islamic funds, the Irish government has taken the initiative to educate prospective managers on the benefits of having an Irish domicile for their funds. Ireland's popularity as a domicile for Islamic funds is based on the wealth of expertise across all service channels available, including talented human capital and established financial regulation. In 2012, there were 47 Islamic funds domiciled in Ireland with total assets worth USD 1.9 billion (see Table 2).

Prospects for the Islamic funds industry are expected to continue to improve, supported by sustained economic growth, particularly with regard to oil and commodity-producing economies. Countries with a high savings rate and a surplus are also likely to drive demand for *Shari'ah*-compliant investments. It is estimated that the assets under management of the Islamic funds industry reached USD 63.2 billion by the end of 2012.

2.3 THE ISLAMIC INSURANCE INDUSTRY

Insurance enables households and corporations to live and operate in a stable environment. It facilitates economic transactions by providing risk transfer and indemnification. It also promotes financial stability, enables risks to be managed more efficiently and fosters efficient capital allocation. The Islamic (*takaful*) insurance industry is an important segment of the Islamic financial system. It complements the other segments and acts as a risk-sharing channel to help withstand financial shocks. A robust Islamic insurance industry helps to leverage risks at IIFSs, creates market synergies and provides the base for accelerating the next phase of industry growth.

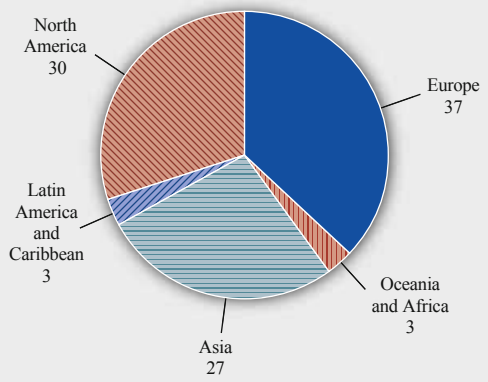
The Islamic insurance industry has developed remarkably over the last four years. Indeed, the number of Islamic insurance companies grew by nearly 73% between 2008 and 2010 (i.e. from 113 to 195), with these being based in more than 30 countries. Their number is expected to increase further in the near future, as the industry's growth gathers momentum. It should be noted that in the five years from 2006 to 2011, the Islamic insurance industry enjoyed a compound annual growth rate of 20%, which was significantly higher than the growth of approximately 6-8% displayed by its conventional counterpart.

Insurers are among the largest institutional investors in Europe. European insurers generate a premium income of almost €1.1 trillion (and thus account for more than one-third of the

global insurance market; see Charts 7 and 8), employ nearly one million people and invest around €7.7 trillion in the economy. Given its depth, the European insurance industry is an established and fully-equipped vehicle for the introduction of Islamic insurance operations. Furthermore, the European market is familiar with the concept of "mutuality and cooperative insurance". which has many similarities with Islamic insurance. In fact, more than two-thirds of all insurers in Europe belong to the mutual and cooperative insurance sector. Mutual and Islamic insurance share the principle of risk-sharing, with risks being spread over members/participants. All of these are key factors that should help Islamic insurance make headway in the European market.

Chart 7 Distribution of insurance premiums (2010)

(percentages)



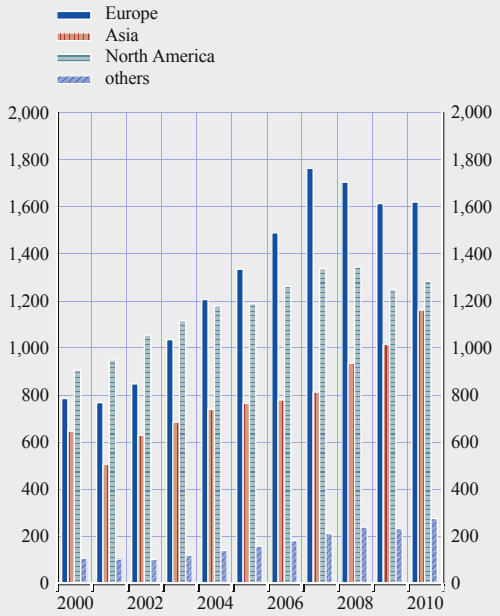
Sources: Swiss Re and KFH Research.

The growth of Islamic finance in Europe has largely been concentrated in the Islamic banking and Islamic capital market segments. But as these segments grow, Islamic insurance could become a key complementary offering for consumers who are seeking Islamic financial solutions. Islamic mortgage insurance, for example, would fit some Islamic financial instruments, particularly Islamic retail banking products and services.

The regulatory reforms across Europe have helped to accelerate the expansion of Islamic insurance products and services in this region. The mandatory "European Single Passport" instituted in December 2002 allows insurance providers registered in an EU Member State to offer their services to the whole European market, and thus promotes the penetration of new markets. This will speed up the introduction of Islamic insurance across Europe. However, the possible adoption of the Solvency II Directive (essentially a capital adequacy regime for insurance firms) by the European Parliament and the Council of the European Union could also challenge the ability of Islamic insurers to meet solvency and risk management guidelines. The regulation's concern about "concentration risks" may require Islamic insurance providers to have a portfolio that is sufficiently diversified across and within different asset classes. This would be difficult to achieve, given the scarcity of *Shari'ah*-compliant solutions in specific jurisdictions. Nonetheless, this scarcity should subside as Islamic finance gains momentum in Europe.

Chart 8 Worldwide insurance premiums (2010)

(USD billions)



Sources: Insurance Europe and KFH Research.

2.4 ISLAMIC FINANCE IN EUROPE

As mentioned in the previous section, the overall magnitude of Islamic finance is still limited in Europe, with there being some notable difference between countries; a point clearly demonstrated by the country reports presented below.

2.4.1 FRANCE

The development of Islamic finance in France is attributed to strong support by the French authorities, who have built an appropriate and friendly environment for such finance in this country. In December 2007, Paris EUROPLACE, the organisation that promotes the city's role as a financial centre, established the Islamic Finance Commission. Since then, the French financial markets regulator, the Autorité des marchés financiers (AMF), has issued two positions allowing *Shari'ah*-compliant investment funds and *sukuk* listings. As such, the Bourse de Paris (Paris stock exchange) has created a *sukuk* segment and four tax regulations (relating to *murabahah*, *sukuk*, *ijarah* and *istisna'*) have been published that confirm a parity of tax treatment with conventional financial products.

In recent years, the French regulatory authorities have taken a number of steps to encourage Islamic finance in the country. The first initiative, which involved significant tax and regulatory changes aimed at boosting Islamic finance in France, was announced in July 2008. More specifically, these changes were related to the admission to listing of *sukuk* on a French regulated market, the tax treatment of Islamic financial transactions and, to a lesser extent, reforms of the fiducie (French trust). Under these changes, compensation paid by *sukuk* issuers is, for tax purposes, treated just like the interest on a traditional bond offering and is deductible from taxable income. In addition, the compensation paid to non-resident *sukuk* investors is exempt from withholding tax in France, regardless of whether an offering is governed by French law or the laws of another country.

In July 2010, the French government made certain amendments to its laws in order to facilitate *sukuk* issuances. The amendments removed double stamp duty, the payment of a capital gains tax on property and streamlined the regulations governing estate agents. In June 2011, France witnessed the introduction of the first Islamic deposit scheme operated via the Islamic window of an existing conventional bank. Following this successful launch, an Islamic home finance product, a 10-year *murabahah* contract, was introduced. This was met with strong demand due to the fact that home financing has been a key expectation of French retail clients. Currently, there are plans to launch a similar *Shari'ah*-compliant deposit scheme aimed at small and medium-sized enterprises. The French tax authorities are also planning to issue additional guidelines dealing with other Islamic finance concepts, including *musharakah* and *mudarabah*, in the near future.

There are presently six *Shari'ah*-compliant funds in France with total assets under management of USD 147.2 million, which are split relatively evenly between money market (47%) and equity (53%) assets.

Going forward, Islamic finance appears to have good potential to develop further in France. Over the years, the country has established favourable trade flows with a number of close neighbours with large Muslim populations, including Morocco, Algeria and Tunisia. A significant proportion of the French population originates from North Africa, and this has been driving domestic demand for Islamic finance.

2.4.2 GERMANY

Germany was the first Western country to tap the Islamic capital market when the federal state of Saxony-Anhalt issued the country's first Islamic bond (*sukuk*) in 2004. The paper attracted strong demand and was fully subscribed, with 60% of the issue going to investors in Bahrain and the UAE and the remaining 40% to investors in Europe, particularly those in France and Germany. The €100 million *ijarah sukuk* (Islamic sale-and-leaseback debt instrument) was fully redeemed in 2009.

In 2009, Germany's Federal Financial Supervisory Authority (BaFin) accepted a request from a foreign institution to conduct banking operations within the country in accordance with Islamic principles. However, without a full banking licence, the range of offerings remained limited. A follow-up conference on Islamic finance was organised by BaFin in May 2012, which had a special focus on *Shari'ah*-compliant capital market products (Islamic funds, *sukuk* and asset-backed securities).

The German market has also witnessed the offering of a new *Shari'ah*-compliant investment product that is benchmarked to the WestLB Islamic Deutschland Index. This is comprised of shares in ten German firms whose business activities are conducted in line with the *Shari'ah*.

German financial institutions also actively participate in the Islamic finance industry via their subsidiaries in London, Dubai and Kuala Lumpur. These institutions could play a key role in attracting *Shari'ah*-compliant funds to Germany through their established networks and expertise.

The prospects for the further development of Islamic finance in Germany are rather solid. First, Germany is the largest economy in Europe and it features the largest Muslim population (4.1 million people, against 3.5 million in France and 2.9 million in the UK). Second, German exporters could use institutions offering Islamic financing solutions as alternative sources of funding and thereby further enhance their funding profiles. Third, Islamic trade finance products offer the potential to strengthen trade ties with countries such as Turkey; a country which is an active trading partner of Germany and that has a budding Islamic finance sector.

2.4.3 ITALY

Italy is one of the most rapidly developing markets in Europe. A number of initiatives have been taken by Italian authorities to study the issues related to an expanded presence of Islamic finance. The Banca d'Italia, for example, has hosted a number of conferences on the subject. ABI, the Italian Banking Association, is currently coordinating a working group related to the issuance of a corporate or sovereign *sukuk*.

Meanwhile, SIMEST (a financial institution supporting the development and promotion of Italian enterprises abroad) is working on the possibility of launching a "Mediterranean Partnership Fund", part of which would be *Shari'ah*-compliant. This initiative, dedicated to promoting small and medium-sized enterprises in the MENA region through equity or semi-equity instruments, may involve the Union of Arab Banks, several Arab governments and Islamic multilateral development banks – hence the proposal to introduce a *Shari'ah*-compliant component to this fund.

According to market estimates, Islamic retail banking deposits among Italy's diverse Muslim community could reach USD 5.8 billion and generate revenues of USD 218.6 million by 2015,

with these figures rising to USD 33.4 billion and USD 1.2 billion respectively by 2050. Meanwhile, efforts have also been made by a local bank to set up a working group on the introduction of a *Shari'ah*-compliant home finance product.

In the wholesale banking area, a number of institutions are active in the Islamic capital market (mostly in terms of trade finance, *murabahah* and participation in syndication facilities) via foreign offices or wholly-owned foreign subsidiaries. Italian banks have also been active in the GCC region, more specifically in private-public partnerships. In addition, there are a number of bilateral trade ties between Italy and GCC-based institutions that have been successful in introducing Islamic insurance products for group employee benefit purposes.

2.4.4 IRELAND

Ireland has developed a strong foundation for the Islamic finance industry, including a comprehensive tax treaty network with Muslim nations and a provision in its tax code specifically for Islamic financial instruments, such as those involving ijarah (leasing), *murabahah* (sale on the basis of cost plus mark-up) and Islamic insurance (*takaful*).

Ireland is home to more than 50 world-class fund service providers, which are all supported by over 11,000 industry professionals, and it offers the widest range of expertise in fund domiciling and servicing. The industry managed assets worth more than €180 trillion in 2010. It is a significant location for Islamic funds, with an estimated 20% of the Islamic funds market outside of the Middle East being located in Ireland.

The Irish Government has supported the development of Islamic finance here. For example, the Irish Financial Regulator has set up a dedicated team to deal with the establishment of Shari'ah-compliant investment funds.

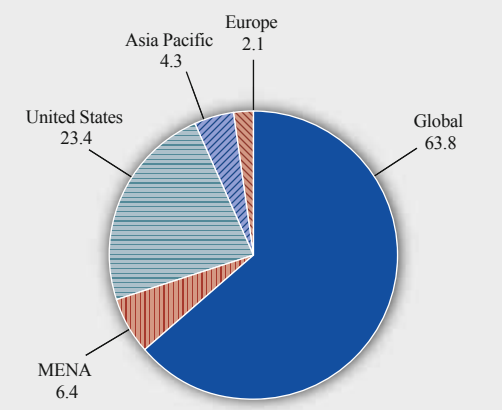
A supportive tax and legal environment,[18] easy access to the European market, a skilled workforce, an investor-friendly transfer pricing regime, supportive infrastructure, business-friendly policies and a stable regulatory environment make Ireland well positioned for further development of *Shari'ah*-compliant business.

Of the total Islamic funds in Ireland, 63.8% have a global geographical focus; 23.4% the United States, 6.4% MENA, 4.3% Asia Pacific and 2.1% Europe (see Chart 9).

As a leading centre for internationally distributed Undertakings for Collective Investment in Transferable Securities (UCITS) funds, Ireland was one of the first countries to introduce the

Chart 9 Geographical focus of Islamic funds in Ireland

(percentages)



Sources: Bloomberg, IFIS and KFH Research.

18 Together with Ireland, other European countries are promoting analogous initiatives. For example, Malta Financial Services Authority (MFSA) issued the Guidance Note on Sharia-compliant funds in Malta.

UCITS IV Directive into national legislation. UCITS established in Ireland can be traded throughout the 27 Member States of the EU.

2.4.5 LUXEMBOURG

Luxembourg is one of the major financial markets in Europe, its popularity is based on competitive pricing, incentives and access to European clients. Since 2002, when Luxembourg became the first European country to list a *sukuk*, there has been a total of 16 *sukuk* listed on the exchange.

Luxembourg is being promoted rather strongly by its government to attract more Islamic funds as well as foreign investments from oil-rich countries and emerging wealthy nations. It became the first EU jurisdiction to adopt UCITS IV at the end of December 2010, and as a major domicile for both conventional and Islamic investment funds it had a first-mover advantage.

In December 1982, the country saw the establishment of a family-owned Islamic insurance operator. Luxembourg has a large traditional life assurance industry, albeit driven by international business. However, given the small domestic Muslim population in Luxembourg, any Islamic insurance operator's strategy was likely to be a cross-border one.

Luxembourg is the second largest investment fund centre in the world after the US. As regards Islamic funds with USD 1 billion Islamic AuM, they are largely equity funds domiciled in Luxembourg, managed and promoted by global investment companies. Today, Luxembourg emerges as the leading non-Muslim domicile for *Shari'ah*-compliant investments funds.

In terms of *sukuk*, the Luxembourg Law of 22 March 2004 on securitisation[19] (the Securitisation Law) created a flexible and efficient regime for securitisation vehicles. Since then, several *Shari'ah*-compliant *sukuk* structures have been implemented in Luxembourg.

In 2009, the country's position in Islamic finance was considerably enhanced with the admission of the Central Bank of Luxembourg as the first EU Central Bank to become a member of the IFSB. Also, that year a major German bank launched a trading platform, *al-Mi'yar*, in Luxembourg to facilitate the issuance of Islamic securities.

Other European countries have been looking to adopt a similar approach to attract foreign funds. The favourable legal framework combined with the UCITS qualification allows Islamic funds domiciled in Luxembourg to be a successful instrument for Gulf investors wishing to tap the European market.

2.4.6 UNITED KINGDOM

The UK has one of the most advanced Islamic financial markets in the western world and is quickly becoming a key destination for foreign *Shari'ah*-compliant institutions. The country is home to the west's first fully fledged *Shari'ah*-compliant retail bank and currently has five true Islamic banks. London in particular is an important financial centre, with major international firms and the Middle East's biggest traditional banks offering Islamic products in this city. Islamic financing activities started in the UK in the 1980s when the London Metal Exchange provided *Shari'ah*-compliant overnight deposit facilities based on the *murabahah* principle.

19 Mém. A - 46 of 29 March 2004, p. 720; doc. parl. 5199.

In 2005, the Sanctuary Building *Sukuk* was launched; the first corporate *sukuk* in Europe and the first from the UK. Based on the same structure, the second corporate *sukuk* was issued by International Innovative Technologies (IIT) Ltd in 2010.

The British government undertook a consultation on the legislative framework for alternative finance investment bonds or *sukuk* that are structured to have similar economic characteristics to conventional debt instruments. Following the consultation, the government introduced measures clarifying the regulatory treatment of corporate *sukuk*, which reduced the legal costs for this type of investment and removed unnecessary obstacles to their issuance. In March 2013, the UK Government established a first Islamic Finance Task Force.[20]

The UK is a major global provider of the specialist legal expertise required for Islamic finance, with around 25 major law firms providing legal services in this area. Specialist services are also available for advice on tax, listings, transactions, regulations, compliance, management, operations and information technology systems.

Islamic banking began in the UK in the 1990s when corporations from the GCC introduced Islamic mortgages (based on the *murabahah* principle) and offered mortgage financing (based on the *ijarah* principle) shortly thereafter. However, these instruments were perceived to be very expensive due to the double stamp duty applicable (i.e. first, when a bank purchases a house, and, second, when a buyer/client purchases this house from the bank concerned). The abolition of the double taxation regime in 2004 paved the way for increased demand for Islamic home financing.

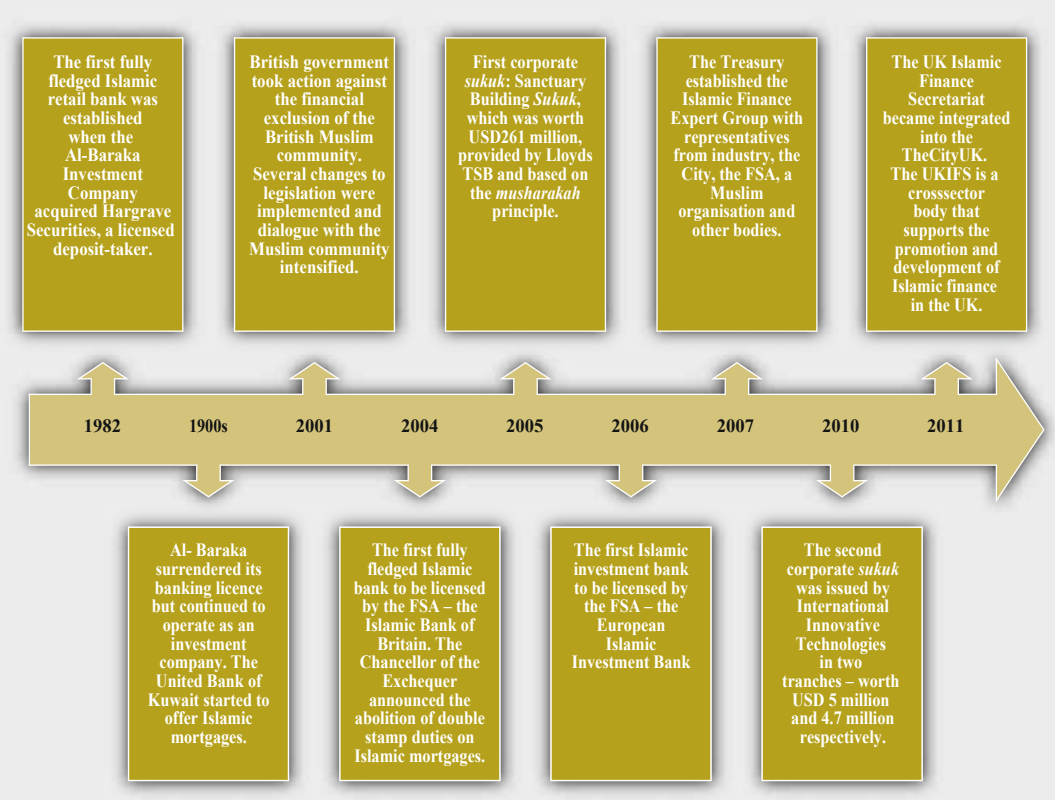
The Bank of England and the Financial Services Authority (FSA), the two banking regulators, have been open to the development of Islamic finance in the UK. The Islamic finance sector operates under a single piece of legislation that applies to all sectors, namely the Financial Services and Markets Act 2000. Hence, there is a level playing field for Islamic and conventional financial products; allowing the market to cater to the needs of ethnic minority consumers.

The UK government's enabling fiscal and regulatory framework for Islamic finance includes the following (see Chart 10):

- the abolishment of capital gains tax and stamp duty (land tax) for *sukuk* issuances and *Shari'ah*-compliant home mortgages;
- the reform of arrangements for bond issues so that returns and income payments are treated in a similar manner to interest;
- FSA initiatives to ensure that the regulatory treatment of Islamic finance is consistent with its statutory objectives and principles.

20 For details see: https://www.gov.uk/government/news/government-launches-first-islamic-finance-task-force--2

Chart 10 The development of Islamic finance in the United Kingdom



Source: KFH Research.

Box 1

ISLAMIC FINANCE TRENDS IN THE UNITED STATES[1]

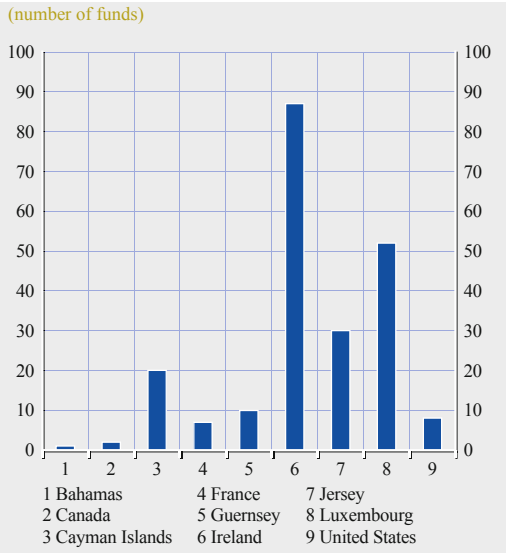
In the US, the Islamic finance sector has traditionally been involved in financing transactions at the consumer level. The first, and most notable, systematic attempt to bring Islamic finance to the US retail consumer market was made in the mid-1990s when the Office of the Comptroller of the Currency (OCC) formally recognised the *ijarah* and the *murabahah* models as being valid for transactions involving residential property purchases.

There are presently a few IIFSs in the US that are able to ensure the proper supervision of the *Shari'ah* advisers required by the national market, and which have established close partnerships with regulators and key financial institutions. These firms are bringing *Shari'ah*-compliant products into the US, and Islamic finance is quickly being recognised by mainstream financial institutions as offering a strong, niche consumer market.

1 Prepared by Baljeet Kaur Grewal.

The year 1999 saw the launch of the Dow Jones Islamic Market Index created for investors seeking equity investments in compliance with the unique principles of the *Shari'ah*. Consequently, this index combines Islamic investment principles with the transparency and rules-based methodology of the traditional Dow Jones Index. It covers thousands of blue chips, fixed income investments and indices arranged along thematic lines. Companies must meet certain requirements related to the acceptability of their products, business activities, debt levels, interest income and expenditure in order to qualify for inclusion in the indices.

Number of Islamic funds in selected countries



Sources: Bloomberg, IFIS and KFH Research.

The interest and involvement of US-based entities in Islamic finance has grown continuously over the past 30 years. To date, seven Islamic funds have been launched with total assets under management of USD 3.6 billion, which represents 7.9% of all Islamic funds managed around the globe. There are about 15 financial institutions that operate on an "usury-free" basis, offering a wide range of *Shari'ah*-compliant products and services, including home financing, personal financing, mutual funds, business financing and investment services. Moreover, five different issuers have tapped the *sukuk* market in various jurisdictions, issuing *sukuk* worth USD 1.1 billion, of which USD 500 million by GE Capital.

Islamic finance has grown differently in the US than in other parts of the world, being largely driven by domestic demand. Home financing products account for most of this demand, with around 10,000 *Shari'ah*-compliant home purchases having been concluded over the past decade.

So far, in the US, Islamic financial institutions have avoided deposit-taking operations due to the regulatory hurdles involved. The relevant regulation on banking is currently similar for all banks wanting to operate in the US, i.e. for both conventional and Islamic banks. In some cases, however, US regulators have raised the concern that banks offering Islamic financial products like *murabahah* may be violating rules prohibiting them from owning real estate other than their own buildings and "other real estate owned" (OREO; mostly foreclosed properties that must be sold within five years). Hence, many Islamic institutions have opted to operate as leasing companies or mortgage brokers, as these are subject to far fewer restrictions.

Overall, the US Islamic finance industry remains a niche segment in the wider North American financial sector.

3 A COMPARISON OF ISLAMIC AND CONVENTIONAL FINANCE (BALJEET KAUR GREWAL)

The unique characteristics of the financial instruments offered by IIFSs have a diverse impact on financial outcomes for stakeholders. Islamic financial products are essentially based on particular principles that are used in varying combinations. While Islamic finance shares the merits of conventional finance, it has some distinct features that differentiate it from its counterpart. This chapter provides an insight into some of these features, focusing in particular on the issue of risk. It compares the risks associated with Islamic finance with those faced in the conventional financial system. It also provides a comparison between ethical and Islamic investments, and highlights the proximity of Islamic finance to socially responsible investment. Other aspects of Islamic finance supporting financial intermediation in today's economic environment are also discussed. The final section underlines the extent to which Islamic instruments and principles can be incorporated into conventional finance.

3.1 RISK-RETURN PROFILE OF ISLAMIC PRODUCTS AND SERVICES

As mentioned in Section 1.4, IIFSs have developed a wide range of instruments based on *Shari'ah* principles. In contrast to a conventional financial institution, an IIFS may extend its scope beyond the traditional role of financial intermediation by acting as a property developer, providing funding via equity injections for customers, or by trading in tangible assets (see Table 3).

The financial intermediation role of an IIFS involves mobilising funds from depositors/investors via *Shari'ah*-compliant contracts and providing these funds to firms or individuals to finance assets or business activities. The key distinguishing characteristic of an IIFS is its underlying contractual relationship with its customers. These contractual relationships underline the risk-return profile of the products and services offered by an IIFS, including its own risk profile (see Table 4).

Generally, the financial risks faced by IIFSs are similar to those of their conventional counterparts. But IIFSs have an additional element that requires consideration when managing their financial risk. Table 5 presents a brief explanation of the relevant risks and the measures that can be used to mitigate them.[21]

21 Further information can be found in the IFSB (2005).

Table 3 Examples of Islamic financial contracts and their underlying characteristics

Contract	Type	Underlying contract type	Inherent risk	Type of product
Ijarah	Debt-based	Lease	Credit risk Market risk Operational risk	Financing
Murabahah	Debt-based	Cost-plus mark up		
Salam	Debt-based	Future contract		
Istisna'	Debt-based	Manufacturing contract		
Musharakah	Equity-based	Profit and loss sharing	Credit risk Operational risk	Deposit
Mudarabah	Equity-based	Profit-sharing and loss-bearing	Displaced commercial risk Operational risk	
Wadiah	Trust Contract	Safe custody of assets	Credit risk	
Qard	Debt-based	Interest free financing	Displaced commercial risk	

Sources: Islamic banks, KFH Research.

- **Credit risk**

Under Islamic finance, credit risk refers to the probability that a third party or counterparty fails to meet its obligations in accordance with the terms agreed, e.g. a customer fails to meet monthly repayments. As a result, loss of revenue and principal due to default on the part of customers may arise from financing, dealing and investment activities. The risk management techniques used by conventional banks can be used to mitigate this risk (for example, by using good-quality data on the past performance of the counterparty to gauge this risk and by determining the probability of default). Collateral and pledges can be used as security against credit risk, as well as personal and institutional guarantees.

Table 4 Types of profit-sharing investment accounts offered by Islamic Banks

General/unrestricted investment	The IIFS has full discretion regarding the use of funds. Investors provide funds specifying any restrictions on where, how or what purpose the funds should be
Specific/restricted investment	The mandate of the IIFS is confined to the activities agreed upon with the holders of profit-sharing investment

Sources: Islamic banks and KFH Research.

- **Market risk**

Market risk for an IIFS arises in the form of unfavourable price movements, such as regarding equity and commodity prices (price risk), benchmark rates (interest rate risk), foreign exchange rates (FX risk), yields (rate of return risk) and volatility in the value of tradable or leasable assets. For example, under an *ijarah* operating lease contract, an IIFS might be exposed to market risk due to a reduction in the residual value of the leased asset at the expiry of the lease term or, in the case of early termination, due to default. Another example would be the price risk involved when the price of a commodity fluctuates during the period between the date of delivery and the date on which it is sold at the prevailing market price. In order to mitigate this risk, an IIFS must have in place an appropriate framework for managing the market risk (and related reporting) of all assets held, including those that do not have a ready market and/or are exposed to high price volatility.

- **Liquidity risk**

Similar to conventional institutions, IIFSs also face the challenge of managing their asset and liability mismatches. Typically, liquidity risk can occur under two scenarios. In the first, due to a lack of

Table 5 A comparison of the financial risks facing conventional and Islamic banks

Type of financial risk	Items of concern	
	Conventional banks	Islamic banks
1. Credit risk	Default value at risk	Default value at risk
		Income expectation for sharing-based assets
2. Market risk	Volatility of market variables	A lower degree of market volatility
3. Liquidity risk	Maturity mismatches and alternative funding sources	Maturity mismatches and alternative funding sources
4. Operational risk	Hardware/system problems and fraud	Hardware/system problems and fraud, Compliance with *Shari'ah* rules, fiduciary risk
5. Legal risk	Compliance with local legal framework	Compliance with local legal framework
		Compliance with *Shari'ah* rules
6. Capital structure	Level of capitalisation	Level of capitalisation
		Composition of capital instruments issued by IIFS

Source: KFH Research.

liquidity, the IIFS is constrained in its ability to meet liabilities and financial obligations by illiquid assets. In the second, the IIFS is unable to borrow or raise funds at a reasonable cost when required. Therefore, it is paramount to ensure that sufficient *Shari'ah*-compatible money market instruments and interbank facilities are available to support IIFSs in their liquidity risk management.

- **Operational risk**

Operational risk is the risk of loss resulting from external risks or from the inadequacy or failure of internal processes related to people or systems. Operational risks also include the risk of failure of technology, systems and analytical models. It is argued that operational risks for IIFSs can be significant due to specific contractual features (e.g. the cancellation risks related to non-binding *murabahah* contracts) and the issue of the enforceability of Islamic contracts in a wider legal context. Therefore, having an end-to-end *Shari'ah*-compliant process is crucial with regard to mitigating operational risk. This would include having systems that recognise the specificities of Islamic contracts, talent that understands and executes Islamic contracts in the correct manner, and internal processes that mitigate the risks associated with any potential non-compliance.

- **Legal risk**

Legal risk (which can also be categorised as part of operational risk) refers to the potential loss that may be incurred by an IIFS as a result of insufficient, improperly applied, or simply unfavourable legal proceedings in the country in which it operates. The lack of a legal framework to support the products and services that IIFSs offer may stunt the growth of the Islamic finance industry and reduce stakeholders' confidence in the viability of Islamic financial solutions. Specific measures that can be undertaken to mitigate this risk would include amending existing laws or guidelines in favour of the industry, appointing *Shari'ah* experts to provide advice on IIFS's operations, preparing legal documentation that is enforceable and which conforms with existing laws and the *Shari'ah*, and ensuring that the talent behind Islamic finance operations is well-versed in Islamic contracts.

- **Capital structure risk**

Both an IIFS and its conventional counterpart face capital structure risk, which refers to how a firm finances its overall operations and growth by using different sources of funds. Both types of institutions use a combination of debt (short and long-term) and equity (common equity and preferred equity) for funding. Nevertheless, the instruments issued by IIFSs, as mentioned in IFSB Exposure Draft 15 that will make up an IIFS's additional capital, would be required to meet the necessary requirements in order to ensure *Shari'ah* compliance. The risks associated with such instruments would therefore be assessed differently than those of conventional instruments.[22]

3.2 INTEREST RATE AND INFLATION RISKS

The portfolios of conventional financial institutions consist mainly of loans, advances, financial leases and other similar credit/term facilities. Exposure to real economic sectors, such as real estate, is not direct, but follows from impairments on bad loans (provided that these have not been securitised and sold on to investors). Such portfolios are also managed with due consideration of the future impact of interest rate changes on operating efficiency and institutional profitability. Credit risk and market risk (more specifically, the rate of return) are therefore two of the most important components of the risk management framework of a conventional financial institution.

22 Further information can be found in the IFSB (2005).

In contrast, Islamic banks mostly purchase real assets and sell these on condition of a deferred payment that includes a stipulated mark-up (profit), thereby creating an asset-based financial transaction. This ensures that Islamic banks assume appropriate risks in order to discourage any malpractice in financing. As for the management of interest rate risk, IIFSs do not deal with interest-based instruments as such, but are not entirely immune from interest rate risks. Exposure to this type of risk occurs indirectly via the price mark-ups used for deferred sale and lease-based transactions, which are determined according to market conditions and risk exposure. To this effect, Islamic banks use a benchmark rate for pricing their financial instruments, for example, the London Interbank Offered Rate (LIBOR). In this case, the LIBOR is representative of the greater scale of financial assets, of which Islamic finance is one part. Therefore, the assets of Islamic banks are equally exposed to the risk of changes in the LIBOR. Consequently, changes in the interest rates paid to depositors in conventional banks will influence the conditions offered to those depositing funds with Islamic banks. If there is a difference between conventional and Islamic banks operating in the same environment, this implies some displaced commercial risk as depositors may flee to the type of institution that is considered more attractive. Hence the need for Islamic banks to pay close attention to interest rate risks.

Through various financing mechanisms and instruments, the balance sheets of Islamic banks hold both financial assets as well as tangible and intangible non-financial assets (see Chart 11). Therefore, it becomes necessary to consider the risk of inflation, both in terms of the risk to the balance sheets of Islamic banks and to the mechanisms by which Islamic transactions are priced.

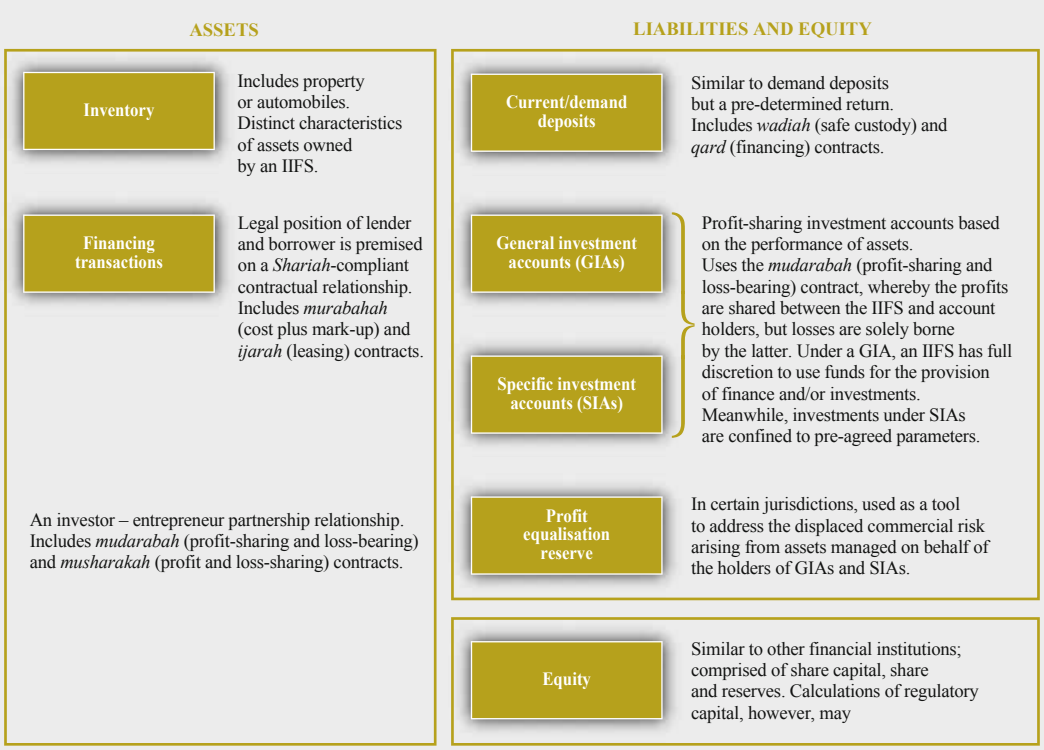
In addition, particular transactions in Islamic banks need to be considered in relation to risk exposure, given their unique characteristics. For example, institutions following the AAOIFI standards on accounting will be engaged in transactions such as operational leases. In cases such as these, tangible assets will have to appear in the balance sheets of Islamic banks as non-current assets together with depreciation and amortisation costs, thereby resulting in direct exposure to inflationary risk. Such accounting requires sufficient risk management to ensure that the risk of inflation is anticipated and reported accordingly.

Similar accounting/risk management practices may be necessary for other products offered by Islamic banks. Despite the evolution of products in this area that conform with the existing frameworks used for conventional finance, these modes of finance may naturally give rise to unique, albeit relatively inconsequential, risks. However, the asset-based nature of Islamic finance means that Islamic banks will always be exposed to a certain inflationary pressure when trading in real assets. Nevertheless, Islamic banks have incorporated ways of managing inflation risk by using parallel contracts executed in sequence, which mitigate fluctuations in asset prices and provide fixed cash flows from assets in a similar fashion to conventional loan agreements.

Traditionally, however, Islamic banks have had significant exposure linked to real estate assets, as this asset class provides a natural hedge against inflationary pressure. As such, Islamic banks have had to monitor their inflation risk closely due to the possible consequences for asset price valuation.

In summary, Islamic banks face a unique risk exposure that includes both interest rate and inflation risks. Interest rate risks arise through deferred payment sales, leasing arrangements benchmarked to interest rates and displaced commercial risk. Meanwhile, inflationary pressures may negatively impact the performance of Islamic banks via their investment in real economic sectors and through financial products that involve the buying and selling of real assets.

Chart 11 Extract from an IIFS balance sheet



Sources: The "Islamic Finance and Global Financial Stability" report of the IFSB, the Islamic Development Bank and the Islamic Research and Training Institute (April 2010).

3.3 ETHICAL INVESTMENT VERSUS ISLAMIC INVESTMENT

There is much common ground between ethical and Islamic finance, especially in the investment sphere, where numerous investment products have long used ethics as the key criterion in their investment approach. Ethical or socially responsible investment refers to an approach that integrates social and environmental concerns into the investment decision-making process, whereby companies that meet certain standards of corporate social responsibility are identified and selected for investment. As such, in addition to financial performance, SRI also takes into account non-financial factors when analysing firms from an investment perspective. This includes analysing corporate citizenship, diversity initiatives, environmental management, product safety and other company behaviour; and often excludes firms in industries such as alcohol, tobacco, gambling, defence contracting and nuclear power. All of this is fundamentally in line with the values behind Islamic finance, which seeks to promote activities that are beneficial to the planet and to remove those that may prove harmful.

Both Islamic investment and SRI make use of positive and negative screening, filtering securities by evaluating both qualitative and quantitative factors. There is only a minimal difference between these two investment approaches, i.e. some elements are prohibited by the *Shari'ah* but not by SRI, such as interest-based financial instruments and institutions. Nevertheless, the end objective of both is very similar – to invest in or finance activities that are beneficial to humanity.

3.4 OTHER POSITIVE ASPECTS OF ISLAMIC FINANCE

Islamic finance essentially promotes financial transactions with links to the real economy and abstains from financing activities that are detrimental to society. It supports financial inclusion by offering instruments suited to different socioeconomic groups. Apart from Islamic banking that meets the normal retail needs of consumers (e.g. mortgage and automobile financing, savings accounts), it also serves small and medium-sized enterprises. Moreover, there are institutions that help improve the livelihoods of low-income groups by offering *Shari'ah*-compliant microfinance products based on profit-sharing. Islamic finance is ultimately founded on the principle of partnership and cooperation, which calls for a system of equity participation and risk-sharing. Such a system should promote equal distribution of risk and cooperation between the providers of funds (investors) and the users of funds (entrepreneurs).

Islamic finance is community-oriented and entrepreneur-friendly, emphasising productivity and the physical expansion of economic production and services. Hence, it shifts the overall focus from financial collateral or the financial worth of a borrower (the current predominant practice) to the entrepreneur's trustworthiness and the project's viability and usefulness. This feature has important implications for the distribution of credit risk as well as systemic stability. Islamic finance, therefore, falls under ethical finance. Both are concerned with the impact of financial decisions on society and attract ethically-sensitive investors. And these are growing in size and number (see Tables 6 and 7).

Table 6 A comparison of ethical and Islamic investments

	Key areas	Ethical investment	Islamic investment
1	Main purpose of the investment	The investment seeks a financial return while pursing ethical motives	The investment seeks a financial return while conforming to *Shari'ah* principles
2	Investment policy	Guided by a clearly stated ethically-oriented or socially responsible investment policy	Guided by *Shari'ah* principles
3	Securities selection process	Clearly identified ethical criteria which serve as the filtering mechanism in the securities selection process, and help determine whether a particular asset or stock is suitable for investment or should be avoided altogether	*Shari'ah* guidelines are used as the screening mechanism in the securities selection processes to ensure that only *Shari'ah*-compliant securities are selected and that "non-*Shari'ah*" securities are avoided
4	Asset universe	A limited number of securities that fulfil the pre-determined ethical criteria	Limited to *Shari'ah*-compliant securities only
5	Investment support services	Requires the following: 1. an ethics board that screens, monitors and makes decisions on the admissibility or withdrawal of securities; 2. a research team that identifies potential securities and monitors fund performance.	Requires the following: 1. a *Shari'ah* advisory board that screens, monitors and makes decisions on the admissibility or withdrawal of securities (note that this may also require a *Shari'ah* officer who supervises and monitors *Shari'ah*-compliancy); 2. a research team that identifies potential securities and monitors fund performance.
6	Shareholder activism	Shareholders/investors play an active role in ensuring that company activities remain within ethical boundaries	Shareholders/investors do not always play an active role in advising the company to act according to *Shari'ah* principles
7	Type of investor	Open to all investors, especially those who are ethically-concerned or religious	Open to all, especially investors seeking assets that are compatible with their religious belief and ethical values

Source: KFH Research.

Table 7 An overview of ethical and socially responsible investments

Ethical investments	Socially responsible investments
Ethical investments tend to use negative criteria to avoid companies involved in: • environmentally damaging practices; • trade with oppressive regimes and countries with a poor human rights record; • pornography and offensive advertising; • gambling; • tobacco and alcohol production; • unnecessary exploitation of animals; • unsafe products and services; • genetic engineering, abortion and embryo research; • armaments.	Socially responsible investments adhere to agreed negative criteria and actively seek out firms making a positive contribution to society, for example, those which feature: • products and services that are of long-term benefit to the community; • conservation of energy and natural resources; • environmental improvement and pollution control; • good relations with customers and suppliers; • high employee welfare standards; • organic farming and foods; • strong community involvement; • a good equal opportunities record; • respect for the sanctity and dignity of human life; • openess about their activities.

Sources: The Ethical Partnership Ltd, Horizon and KFH Research.
Notes: This list is by no means exhaustive. Funds may also vary considerably in respect of the negative and positive criteria employed.

3.5 FULLY FLEDGED IMPLEMENTATION OR INSTRUMENT DIFFUSION

At an early stage, fully fledged Islamic finance entities were formed to provide customers with Islamic financial products and services. However, in order to reach a wider customer base, jurisdictions allowed the establishment of "Islamic windows" within conventional financial institutions.

The advantages and disadvantages of establishing a "window" can be gleaned from Chart 12 below, which identifies the possible strengths, weaknesses, opportunities and threats (SWOT) of a fully-fledged Islamic financial institution. While a fully-fledged Islamic bank will have more dedicated staff behind its activities, a window operation can make use of a traditional bank's existing networks and infrastructure for the provision of Islamic products to its customers. A fully fledged Islamic bank will have a wider scope of Islamic banking activities than an Islamic window, which may be restricted to offering a limited range of products and services.

A fully fledged Islamic bank would offer not only *Shari'ah*-compliant products and services, but also an inherent internal *Shari'ah* governance framework. Typically, a fully-fledged IIFS will have its own *Shari'ah* committee/advisers who oversee *Shari'ah*-related issues from product development to execution. In addition, being a fully-fledged entity helps ensure that there is no "leakage" of Islamic funds to non *Shari'ah*-compliant activities and no commingling of Islamic and conventional funds.

Islamic windows have advantages in terms of sharing resources, such as office space and support services, IT systems, legal resources, personnel and marketing infrastructure, and other potential economies of scale. However, a fully-fledged IIFS could have more resources devoted to Islamic products per se, for example, as related to training, research and development and specialised Islamic portfolios. Greater responsibility is vested in the management of a stand-alone IIFS, which will have more accountability than that of an Islamic window.

The Islamic window approach also allows financial institutions to foster strategic partnerships with other IIFSs, such as *takaful* (Islamic insurance) companies, as well as other institutions offering Islamic bank assurance products and *Shari'ah*-compliant investment-linked products. In fact,

Chart 12 SWOT analysis of fully fledged implementation

Source: KFH Research.

instrument diffusion via Islamic windows is a widely used approach in most jurisdictions trying to introduce Islamic finance. It can also be a useful tool for financial institutions to test market-readiness before launching a fully-fledged Islamic entity. A clear advantage of having an Islamic window is that the bank can continue to service its conventional customers while expanding its Islamic financial activities.

European banks are currently being encouraged to provide Islamic investment solutions, not only for their overseas Arab/Muslim clients, but also for domestic populations showing increased demand for *Shari'ah*-compliant products.

While Islamic financial products are meant for everyone, customers receptive to ethical and SRI could be in favour of a fully-fledged IIFS where ethical principles are applied across the board. Fully fledged IIFSs, however, require a large number of trained professionals in order to respond to customer enquiries in an efficient manner, especially when it comes to some of the more intricate *Shari'ah*-compliant products. This may pose a challenge, as the industry is believed to have a scarce supply of qualified talent.

In addition, significantly more capital is required to start a fully-fledged IIFS than an Islamic window. However, as the activities of an Islamic window expand, its parent company may consider opening up a new Islamic subsidiary which is then spun off. While a spin-off may benefit from

being a separate legal entity in terms of its assets and liabilities, this could also unlock its potential to offer and manage a wide range of specialised Islamic products and services (e.g. Islamic wealth management, *Shari'ah*-compliant investments, underwriting of *sukuk* issuances), which would otherwise not be possible under a window operation. As a separate entity, it would have greater leeway and significant resources to expand its operations.

Currently, there are a large number of Islamic windows in the UK and other European markets that are run by conventional banks. At the same time, some large European banks have fully owned Islamic subsidiaries. Furthermore, there are a growing number of stand-alone IIFSs, both foreign and domestic, that have their offices in Europe.

In summary, Islamic windows and fully fledged IIFSs may offer alternative ways of conducting business as Islamic finance continues to grow across different jurisdictions.

4 EMPIRICAL EVIDENCE (STEVEN ONGENA, SAJJAD ZAHEER)

The financial crisis has offered an important yardstick by which one can gauge the advantages and disadvantages of Islamic finance. This section will provide empirical evidence on how IIFSs have performed in relation to conventional ones, particularly during the crisis period, i.e. subject to data availability.

There is a substantial body of literature on comparing Islamic and conventional financial institutions. For the sake of simplicity, this section considers this literature in terms of two main themes:

i) efficiency and profitability;

ii) the stability and resilience of Islamic institutions, including the default of individual financing.

4.1 EFFICIENCY AND PROFITABILITY OF ISLAMIC BANKS

With a few exceptions, existing studies that predate the crisis indicate that there are no significant differences between Islamic and conventional banks as far as their business orientation and efficiency is concerned (both Beck, Demirgüç-Kunt and Merrouche (2013) and Abedifar, Molyneux and Tarazi (2012) are comprehensive studies that also contain excellent literature reviews). Table 8 summarises the evidence presented.

In contrast, most recent studies including data for the crisis period tend to stress that, during the financial crisis, Islamic banks had more difficulties than conventional banks in maintaining their efficiency and profitability. Hasan and Dridi (2010), for example, study the profitability of 120 Islamic and conventional banks across eight countries during the period 2007-09. They find that the

Table 8 Empirical work comparing the efficiency and profitability of Islamic and conventional banks

Paper	Sample				Analysis	
	Countries	Period	No of obs.	Level	Explains	Findings (with regard to differences between conventional and Islamic banks / financing)
Mohamad, Hassan and Bader (2008); Bader, Mohamad, Ariff and Hassan (2008)	21	1990-2005	80	Bank	Efficiency	No differences
Abdul-Majid, Saal and Battisti (2010)	10	1996-2002		Bank – Year	Technical inefficiency	Islamic banks are more technically inefficient
Weill (2011)	17	2000-2007	1,301	Bank – Year	Bank market power	Islamic banks have somewhat less market power
Beck, Demirgüç-Kunt and Merrouche (2013)	141	1995-2007	25,000	Bank – Year	Various bank measures	Few significant differences in business orientation and efficiency
Rashwan (2012)	15	2007-2009	95	Bank	Efficiency and profitability	Listed Islamic banks were more efficient and profitable than similar conventional banks before the crisis, but less so during the crisis
Hasan and Dridi (2010)	8	2007-2009	120	Bank – Year	Profitability	Profits of Islamic banks decreased by more than those of conventional banks in 2009

Note: The table is based on Abedifar, Molyneux and Tarazi (2012) and Baele, Farooq and Ongena (2012).

profits of Islamic banks decreased by more than those of conventional banks in 2009, and attribute this difference to weaker risk management practices at Islamic banks.

Similarly, Rashwan (2012) studies the performance of 46 Islamic banks and 49 regular, listed banks in 15 countries before and during the financial crisis (2007-09). Using a multivariate analysis of variance, he finds that Islamic banks were more efficient and profitable than conventional banks before the crisis, but less so during the crisis.

4.2 STABILITY OF DEPOSITS

Religious people may be more risk-averse than others (Osoba, 2003; Hilary and Hui, 2010).[1] Hence, depositors of Islamic banks may be more watchful of their banks' performance and demonstrate a greater willingness to withdraw their deposits than the depositors of conventional banks. Alternatively, Islamic bank depositors may show greater loyalty (for religious reasons) towards an Islamic bank. The clients of Islamic banks may also be prepared to pay extra for receiving financial services that are compatible with their religious beliefs.

The fact that Islamic banks share profits or losses with their investment account holders may make them more susceptible to deposit withdrawals than conventional banks (Khan and Ahmed, 2001), at least in cases of bank distress when Islamic bank depositors would lose some money while conventional bank depositors would not (e.g. due to bank reserves and partial deposit insurance). But this problem should not be exaggerated, as Islamic banks may, in practice, choose to deviate from traditional *Shari'ah* principles in order to mitigate this increased risk (Obaidullah, 2005). This occurs if they have to pay competitive market returns to investment account holders (regardless of the actual bank performance which, under profit and loss-sharing, would determine the payout).

4.3 DEFAULTS ON ISLAMIC FINANCING

(A) CONJECTURES

In many countries, the most popular Islamic financial products are functionally identical to conventional loan products. Does this necessarily mean that their default rates are similar?[2] Reasonable conjectures can be formed regarding the motivation for preferring one form of credit over another and the expected default rates associated with the choice made (discussion based on Baele, Farooq and Ongena, 2012).

1 But there may also be differences across religions. Kumar, Page and Spalt (2011), for example, show that the propensity to gamble is larger in US regions with a higher ratio of Catholics to Protestants, and that religious beliefs, by shaping overall attitudes towards gambling, impact investors' portfolio choices, corporate decisions, and stock returns. There is a wider body of literature (Barro and McCleary, 2006) that investigates how religion, through its potential impact on investor protection (Stulz and Williamson, 2003), economic attitudes (Guiso, Sapienza and Zingales, 2003), entrepreneurship (Audretsch, Bönte and Tamvada, 2007), human capital formation (Becker and Wößmann, 2009), occupational organisation (Richardson and McBride, 2009), work ethics (Spenkuch, 2011), and risk aversion (Hilary and Hui, 2010), may unidirectionally determine economic development (Barro and McCleary, 2005 and 2006) and explain differences in economic growth across countries (Barro and McCleary, 2003), former colonies (Grier, 1997), regions (Landes, 1999), and in early European cities (Dudley and Blum, 2001).

2 Islamic financing is formally structured differently and is governed by different contracts than conventional loans. Yet, given functional equivalence (i.e. in terms of cash flow), this should not cause the default rate on either type of financing to differ systematically. There can also be different reasons for preferring one form of banking over the other. For example, borrowers may choose Islamic banks over conventional ones because of easy access or specific product needs. If the proximity of bank branch or suitability of product is the overriding reason to choose one type of financing over the other, one would not necessarily expect the default rate on either type of financing to differ systematically.

The existence of Islamic banking per se is based on religion and for borrowers taking out an Islamic financing this is plainly a real economic decision (i.e. so to speak, "putting your money where your mouth is"). An Islamic financing is – after all – a financial product with certain characteristics, one of these being that it is made in accordance with the *Shari'ah*. The text that prohibits interest payments, i.e. the *Quran* and the *hadeeth*, also prohibits the misappropriation of other people's property ("the eating of other people's money in an unlawful way"). Those who choose to abide by one rule (i.e. the avoidance of interest payments) are also expected to have a higher propensity to follow another rule (i.e. "do not default"). Therefore, if borrowers obtain Islamic financing because of their religious motives, one should observe a lower rate of default on Islamic financing.

But borrowers may also base their borrowing and default decisions on a rational comparison of the costs associated with the respective financing contracts. When choosing a financing, they also take into account the expected cost of default. Banks can charge penalties to a borrower defaulting on an Islamic financing, but, unlike with a conventional loan, they have to give that same amount to charity.[3] Because banks (like borrowers) base their financing decisions on a rational comparison of the associated costs and benefits, they may set the penalties on conventional loans lower than those for Islamic financing to attract fees from borrowers that are expected to be only temporarily unable to repay their financing commitments. Islamic financing contracts may further result in a swifter loss of access for the borrower to the financed object (e.g. a car) than a conventional loan contract, particularly when the latter is uncollateralised.[4] In both cases, the probability of default of an Islamic financing may again be lower.

In addition, banks may be more concerned about judicial risk when granting Islamic financing (Jobst, 2007). Not only can Islamic borrowers turn to *Shari'ah* courts, which rule on a case-by-case basis, but they can also seek redress in regular courts. And these may turn to the *Shari'ah* when faced with an Islamic financing (see Hussain (2011) for a primer on the Pakistani court system).[5] To avoid this "double jeopardy", banks may screen Islamic borrowers more strictly or "evergreen" non-performing Islamic financing by rolling them into new Islamic financing or even conventional loans. All these actions will also lower the likelihood of an Islamic financing default or, at the very least, delay it.

Having said this, financing officers at banks granting Islamic financing may target young and riskier borrowers in order to secure future business and higher returns, or they may be less experienced in assessing credit risk and less sensitive about the credit quality of their borrowers in general. Islamic lenders may further be reluctant (for religious reasons) to impose penalties aimed at keeping the borrower in a more solvent state. For a borrower, this makes the expected cost of an Islamic financing default lower than that for a conventional loan default. Therefore, those who have a higher probability of default should prefer Islamic financing over conventional ones. In all of these cases, one will observe a higher rate of default on Islamic financing.

3 If a client does not fully pay on the due date or soon after, and hence is delinquent and "defaults", the price cannot be changed under Islamic rulings nor can penalty fees be charged. In order to deal with the associated moral hazard of the clients (i.e., "the incentives [that] exist for default and abuse" (Iqbal (1987)), it is therefore nevertheless possible under *Shari'ah* to charge penalties, but only if the money is given to charity. If the Islamic bank incurs a real loss (and not simply the opportunity cost of a delayed payment) then an external arbitrator can also allow the bank to actually keep (part of) the penalties.

4 On the other hand, in the case of partnership-type financing, Islamic banks sometimes cannot demand collateral from clients to mitigate credit risk. In addition, banks may not always have enough control over the management of the projects they finance (as in the case of *mudarabah*). Errico and Farrahbaksh (1998) thus argue that Islamic banks should place a greater emphasis on operational risk and information disclosure than conventional banks.

5 But the opposite is also true, and conventional loans may be challenged on the basis of the *Shari'ah*. In general, the *Shari'ah* imposes constraints that imply a more unique credit risk for Islamic financing (Khan and Ahmed, 2001).

In sum, given the aforementioned relevancy of borrower, financing contract and bank characteristics, any analysis that aims to measure differences in the probability of default between Islamic and conventional loans needs to take account of the heterogeneity involved – ideally, this can be seen by the analyst, but, under a worst case scenario, it remains unobserved.

(B) FINDINGS

The following table summarises the empirical evidence comparing Islamic and conventional financial institutions with regard to stability and resiliency.

With respect to bank lending, Baele, Farooq and Ongena (2012) are the first to have used individual financing data to empirically investigate the differences between Islamic and conventional financing at the contract level, particularly as related to the repayment performance of each financing. They analyse a comprehensive monthly dataset from Pakistan that follows more than 150,000 financing contracts over the period April 2006 to December 2008. A final step in their straightforward identification strategy exploits the concurrent repayment over time of functionally similar conventional and Islamic financing by the same borrower to the same bank. In this way, they decisively account for all observed borrowers and bank heterogeneity.

Baele, Farooq and Ongena (2012) find that the hazard rate (the per period default rate) for Islamic financing is less than half the hazard rate for conventional loans across the many duration models they estimate. During Ramadan and in big cities where religious parties poll well, Islamic financing

Table 9 Empirical work comparing the stability and resilience of Islamic and conventional banks

Paper	Sample			Analysis		
	Countries	Period	No of obs.	Level	Explains	Findings with regard to differences between conventional and Islamic banks/financing
Baele, Farooq and Ongena (2012)	Pakistan	Apr. 2006 – Dec. 2008	603,677	Financing – Month	Financing default	Islamic financing less likely to suffer from default
Čihák and Hesse (2010)	18	1993 – 2004	2,347	Bank – Year	Z-score Bank strength	- Small Islamic > small conventional - Large conventional > large Islamic - Small Islamic > large Islamic
Beck, Demirgüç-Kunt and Merrouche (2013)	141	1995 – 2007	25,000	Bank – Year	Various bank measures	Few significant differences in asset quality or stability
Abedifar, Molyneux and Tarazi (2012)	24	1999 – 2009	3,870	Bank – Year	Credit risk Bank stability	- Islamic < conventional - Small Islamic > small conventional - Crisis: large conventional > large Islamic
Zaheer and Farooq (2011)	Pakistan	Feb. 2002 – Jan. 2010	1,696	Bank – Quarter	Z-Score Various other bank indicators	- Islamic > conventional - Islamic windows < conventional windows
Gamaginta and Rokhim (2011)	Indonesia	2004 – 2009	1,866	Bank – Year	Z-Score	- Islamic < conventional - Crisis: Islamic > conventional
Alam (2011)	Europe	July 2006 – June 2009	-	Weekly Index	Sharp Ratio	- Islamic equities > conventional equities during credit crunch - Islamic equities < conventional equities during boom

Note: The table is based on Abedifar, Molyneux and Tarazi (2012) and Baele, Farooq and Ongena (2012). The symbols < and > represent "less stable/resilient than" and "more stable/resilient than", respectively.

are less likely to suffer from default, further suggesting that religious motivation may partly account for differences in financing default rates.

4.4 RESILIENCE OF ISLAMIC BANKS

(A) PROPOSITION

The advocates of Islamic banking and finance claim that financial intermediation based on Islamic standards increases stability in financial markets and in the domestic and international economy (Dudley, 1998; El-Gamal, 2001; Zaher and Hassan, 2001; Siddiqi, 2006; Chapra, 2008). Moreover, due to financing based on profit and loss-sharing, the entire global system is less susceptible to financial crisis and distress (Zaman and Zaman, 2000; Chapra, 2008).

The origins of the recent financial crisis are perhaps a heavy reliance on interest-based debt financing, high leverage, inadequate market discipline, excessive and imprudent credit growth, investments in risky assets and speculative short selling (Bernanke, 2009; Turner, 2009). Mostly, these causes are either absent from or are partly mitigated in Islamic banking. Chapra (2008), for example, argues that financial instability can be mitigated through "risk-sharing along with the availability of credit for primarily the purchase of real goods and services and restrictions on the sale of debt, short sales, excessive uncertainty (*gharar*), and gambling (*qimar*)". These are the main features of Islamic banking which foster greater market discipline and thus financial stability. For example, the use of asset-backed debt financing ensures a direct link between financial transactions and activities in the real sector and, therefore, a connection to the real business cycle (Mohieldin, 2012).

The investment account holders of Islamic banks may have a greater incentive to monitor bank activities than the creditors of conventional banks, as they share in the profits and losses of their Islamic bank. Increased monitoring of Islamic banks can help impose the market discipline that is required for financial stability.

In addition, conventional banks mainly assess the credibility of the borrower and use collateral to hedge credit risk. Many conventional banks may not appraise the underlying objectives of borrowers and do extend financing for speculative purposes, particularly when the risk of default can be transferred to investors by selling the debt (Chapra, 2008). Islamic banks, however, often specify a stringent project appraisal, particularly in respect of *mudarabah* and *musharakah* financing.

Furthermore, large banks may act imprudently because of the likelihood of a government bailout due to their "too-big-to-fail" position. Since the Islamic banking industry is still in its infancy in most of the countries where it is present, this problem does not apply to Islamic banks.

Having said this, moral hazard problems can also arise in Islamic banking if the management of an Islamic bank believes that losses can easily be passed on to investment account holders. On the other hand, Islamic banks may act more prudently because of the withdrawal risk associated with any unscrupulous action (Beck, Demirgüç-Kunt and Merrouche, 2010). So, ultimately, whether Islamic banks contribute to or help mitigate financial instability remains a somewhat unresolved empirical question.

(B) EMPIRICAL EVIDENCE

There is a general lack of comprehensive empirical research to test hypotheses on the stability and resilience of the Islamic banks, although various report recently document high growth of Islamic

bank assets during the last financial crisis.[6] Employing z-scores to test the relative strength of banks in 18 countries from 1993-2004,[7] Čihák and Hesse (2010) discover that small Islamic banks are financially stronger than small commercial banks, whereas large Islamic banks are financially weaker than large commercial banks and small Islamic banks. They attribute their findings to the problems in credit risk management for large Islamic banks, with respect to the financing based on profit and loss sharing (PLS). However, on their asset side, Islamic banks prefer debt instruments for financing instead of profit-sharing based financing (Aggarwal and Goodell (2009); Beck, Demirgüç-Kunt and Merrouche (2010)).

There may be some other factors that therefore are driving these results that can be disentangled through analysing the individual components of the z-score. So while Baele, Farooq and Ongena (2012) find a substantial difference in credit default at the financing (i.e. bank-firm) level, at the bank level findings are mixed. Beck, Demirgüç-Kunt and Merrouche (2010) for example find that there are few or no significant differences between Islamic and conventional banks in their asset quality and stability. On the other hand, Abedifar, Molyneux and Tarazi (2012) find that small Islamic banks that are leveraged or based in countries with predominantly Muslim populations have lower credit risk than conventional banks. In terms of insolvency risk, small Islamic banks also appear more stable, a finding similar to that of Čihák and Hesse (2010). They find no evidence that Islamic banks charge rents to their customers for offering products suitable to their religious believes. Thus, the higher stability (high z-score) in small Islamic banks is not driven by charging rents to their customers.

Interestingly, Abedifar, Molyneux and Tarazi (2012) further show that the financing quality of Islamic banks is less responsive to domestic interest rates than is the case for conventional banks. This result suggests that the risk-taking channel of monetary policy (Borio and Zhu (2008); Jiménez, Ongena, Peydró and Saurina (2011); Ioannidou, Ongena and Peydró (2009)) could become less potent in case Islamic banks obtain a larger share in the domestic banking sector. Čihák and Hesse (2010) don't find any significant impact of market share of Islamic banks on the financial strength of the other banks. Contrary to this finding, and in a broader study, Beck, Demirgüç-Kunt and Merrouche (2010) discover a significant impact of the market share of Islamic banks on conventional banks, which is negative for stability of conventional banks and positive for their cost efficiency.

Hasan and Dridi (2010) find that Islamic Banks' financing and asset growth performed better than that of conventional banks did in 2008–09, adding in general to financial and economic stability. In a country-specific study, employing the sample data of 27 conventional banks, 6 Islamic banks, and the Islamic banking branches of 13 conventional banks in Pakistan from 2002-2010, Zaheer and Farooq (2011), find that exclusive Islamic banks are more stable than conventional banks but that Islamic banking branches are not. However, a within-bank comparison shows that the Islamic banking branches of conventional banks are more stable than their conventional branches, though this difference decreases with as conventional banks become larger.

6 For example, a 2010 report by *Financial Services London* show that assets of the largest 500 Islamic banks increased by 29 percent during the financial crisis year 2009, when the rest of the world's financial system contracted and many of the financial institutions were deleveraging their positions. The report attributes this strong difference to the fact that Islamic banking tenets do not allow the banks to charge interest and to be involved in the sales of debt instruments, and that Islamic banks generally followed these instructions.

7 The z-score is defined as (Return on Assets plus Capital to Asset Ratio) / the Standard Deviation of Return on Assets. The z-score defines bankruptcy as the situation whereby losses exceeds equity of the bank. The higher z-score corresponds to lower insolvency (see, e.g., Boyd and Gertler (1993)). Similar indicators are also used by Beck, Demirgüç-Kunt and Merrouche (2010) and Abedifar, Molyneux and Tarazi (2012) for stability/insolvency comparison.

Similarly a study for the Indonesian banking sector by Gamaginta and Rokhim (2011) show that Islamic banks in general have a lower degree of stability compared to conventional banks. However, during crisis period of the 2008-2009 Islamic banks and conventional banks had no difference in financial stability, though full-fledged Islamic banks are less stable than Islamic business units of conventional banks.

Regarding capital market, Alam (2011) studies the resilience of Islamic equities, including that of financial firms, and of conventional equities for European market during the credit crunch. He finds that the weekly returns on *Shari'ah*-compliant equities outperform the conventional market portfolios using sharp ratio analysis. However, *Shari'ah*-compliant equities slightly underperform the market portfolio during the earlier expansionary phase in the economy.

Box 2

ISLAMIC CORPORATE GOVERNANCE[1]

The OECD defines corporate governance as "a set of relationships between a company's management, its board, its shareholders and other stakeholders [through which] the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined". According to the OECD, "good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring. The presence of an effective corporate governance system, within an individual company and across an economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy."[2] A sound corporate governance system is particularly important when it comes to financial institutions, due to the sensitivity of their activities and the fiduciary duty that the managers who are responsible for these activities have towards investors, whose assets are used for conducting them. These issues are common to all financial institutions, including IIFSs.

1) Conventional versus Islamic Corporate governance

Conventional and Islamic corporate governance differ in philosophy and, to a certain extent, in their objectives. While the former is definitely "shareholder-centred", the latter is more inclined to deal with the interests of a wider number of subjects (e.g. employees or, more broadly, the "community"), and can thus be described as "stakeholder" or "community-centred". Also, and more importantly, Islamic corporate governance plays a crucial role in ensuring that an IIFS's functioning and its business are compliant with the rules and principles of the *Shari'ah*. Stakeholder protection and *Shari'ah* compliance are frequently mentioned in the preamble of the founding documents of an IIFS, for example, in the articles of association or in a code or charter.

The above-mentioned objectives are reflected in the definition of "corporate governance" provided in the IFSB's Guiding Principles on Corporate Governance for Institutions offering

1 Prepared by Lauren Ho and Pierluigi Caristi.
2 OECD Principles of Corporate Governance, 2004, p. 11. These are also available via the following link: http://www.oecd.org/document/49/0,3343,en_2649_34813_31530865_1_1_1_1,00.html
In the "Glossary of Statistical Terms" published on the OECD website (http://stats.oecd.org/glossary/detail.asp?ID=6778), "corporate governance" is defined using a quote from the ECB's Annual Report for 2004.

only Islamic Financial Services[3] of 2006, which are widely inspired by the OECD's Principles of Corporate Governance. According to the second part of this definition, "in the context of [an] IIFS, good corporate governance should encompass: (i) a set of organisational arrangements whereby the actions of the management of [the] IIFS are aligned, as far as possible, with the interests of its stakeholders; (ii) provision of proper incentives for the organs of governance such as the Board of Directors, [the] *Shari'ah* supervisory board, and management to pursue objectives that are in the interests of the stakeholders and facilitate effective monitoring, thereby encouraging [the] IIFS to use resources more efficiently; and (iii) compliance with Islamic *Shari'ah* rules and principles".

2) *Shari'ah* compliance and the *Shari'ah* Board

Ensuring the *Shari'ah* compliance of a financial institution's activity and of its internal organisation is not only a matter of philosophical importance, but is also quite practical: *Shari'ah*-compliant institutions are in the best position to satisfy the demand of their target stakeholders, who will avoid any financial activities which do not respect the principles of the Islam religion.

The centrality of *Shari'ah* compliance in Islamic corporate governance is reflected in the IFSB's "Guiding Principles on *Shari'ah* Governance Systems for Institutions offering Islamic Financial Services"[4] of 2009; a document which includes among its objectives the achievement of harmonisation of *Shari'ah* governance structures and procedures across jurisdictions. Accordingly, this document defines a "*Shari'ah* governance system" as a set of institutional and organisational arrangements through which an institution offering Islamic financial services ensures that there is effective independent oversight of *Shari'ah* compliance in its activities.

For these reasons, most IIFSs have a specific corporate body, the *Shari'ah* Board (also known as the "*Shari'ah* Committee" or "*Shari'ah* Supervisory Board", depending on the IIFS concerned) which is empowered to oversee the *Shari'ah* compliance of all institutional activity. The presence of this organ within IIFSs is the major difference between conventional and Islamic corporate governance structures. The *Shari'ah* Board usually consists of at least three members, appointed by the Board of Directors, who are scholars with a solid experience in Islamic law and finance, and who satisfy certain reputational and integrity requirements. The scope of the *Shari'ah* Board's oversight activity is twofold: (a) the IIFS's transactions and financial activity in general (whose compliance with the *Shari'ah* is verified ex ante and is the subject of a yearly report); and (b) internal corporate issues, such as the distribution of dividends or expenses among shareholders. The *Shari'ah* Board exercises its powers through the issuance of *fatwas*, i.e. legal opinions or rulings based on the teachings of the *Quran*.

The issues considered by the *Shari'ah* Board would include the identification of appointment criteria that ensure the independence of Board members vis-à-vis the IIFS management, their ability to fulfil their role, the avoidance of possible conflicts of interest and the confidentiality of the Board's work (particularly as regards those *Shari'ah* scholars who serve on several such boards at the same time). Another important issue is the legal value of *fatwas* (considered in more depth below) as well as the related issue of the consistency of *Shari'ah* Board opinions and of its interpretation/application of *Shari'ah* rules; all of which are essential for providing the various stakeholders, notably Islamic finance investors, with clarity and certainty.

3 http://www.ifsb.org/standard/ifsb3.pdf
4 http://www.ifsb.org/standard/IFSB-10%20Shariah%20Governance.pdf

Similar issues are addressed in a consistent manner through the issuance of guidelines and standards by reputable international Islamic finance standard-setting organisations such as the IFSB and the AAOIFI. The achievement of a consistent approach to *Shari'ah* Board-related issues – and, more generally, a certain degree of harmonisation of *Shari'ah* governance systems in the Muslim world – is likely to be beneficial to the governance of an IIFS and to have a positive impact on its fiduciary relationship with Muslim investors.

3) The *Shari'ah* Board in different legal systems: Validity of *fatwa* rulings

The role of the *Shari'ah* Board and the legal value of its *fatwas* can only be properly understood in the context of the regulatory framework in which an IIFS operates. Aside from different schools of Islamic jurisprudence, in the Islamic world, there is no homogeneous model for regulators as far as *Shari'ah* governance systems are concerned. In some Muslim countries *Shari'ah* governance is highly regulated, to the point that a national *Shari'ah* body is established which defines key *Shari'ah* compliance standards. The Malaysian *Shari'ah* Advisory Council would be a case in point. In other Muslim countries, considerable discretion is left to IIFSs and their internal *Shari'ah* compliance bodies. Finally, IIFSs also operate in non-Muslim countries, that is, countries whose legal systems obviously do not regulate any aspect of *Shari'ah* corporate governance.

In Muslim countries where a detailed regulatory system is in place, a *fatwa* issued by the *Shari'ah* Board is usually regarded as binding, and the hierarchical relationship with higher *Shari'ah* bodies and a national tribunal is clearly defined. As far as other Muslim countries are concerned (i.e. those with less comprehensive regulatory systems), the value of rulings will very much depend on the provisions of the corporate documents that define *Shari'ah* Board activities[5] and the validity of its *fatwas*. Finally, a third category of countries can be identified, which includes non-Muslim and Muslim countries with mixed legal systems encompassing both secular law and the *Shari'ah*. In these countries, there is a possibility that Islamic finance cases are subject to the jurisdiction of non-religious courts.

Therefore, disputes could be settled in such a way as to oblige an IIFS to operate in a non-*Shari'ah*-compliant way. For example, the court of an EU Member State could rule that the governing law of a contract for a financial product is the law of that Member State – as opposed to the *Shari'ah* – despite the fact that this is specified in the contract as the governing law. Consequently, the national court could reject the claim that a certain transaction is not valid because it does not comply with Islamic law.[6] That a court of a non-Muslim country can issue non-*Shari'ah*-compliant rulings comes as no surprise. However, as indicated above, similar issues could also arise in Muslim countries with mixed legal systems. In Malaysia, a court ruling that the profit derived from a *bay' bithaman 'ajil* facility is unlawful due to its containing certain interest features has been criticised. It is claimed that the court's analysis of *riba'* was not adequate from a *Shari'ah* perspective,[7] and that a *Shari'ah* expert should have been involved in the evaluation of whether the profit complies with the *Shari'ah*. This is a highly sensitive issue, as *bay' bithaman 'ajil* facilities account for more than 80% of total financing in Malaysia.

5 See the AAOIFI Governance Standards of 2005, according to which the rulings of *Shari'ah* boards should be binding and fully enforceable.
6 See Z. Hasan (2010) on the court case of Shamil Bank of Bahrain versus Beximo Pharmaceuticals Ltd (2004).
7 See Arab-Malaysian Finance Brhad v. Taman Ihsan Jaya Sdn Bhd and Ors, 2008, 5 Malaysian Law Journal, 631; Z. Hasan (2010) provides a critique of this case.

The cases described above, where *Shari'ah* boards or *Shari'ah* courts are not involved in the settlement of Islamic finance cases or where there is a lack of coordination between secular and Islamic courts, show how an IIFS may be prompted to undertake actions that are not *Shari'ah*-compliant or where this is some uncertainty about *Shari'ah* compliance. An IIFS could try to avoid this possibility by adopting comprehensive arbitration clauses investing the *Shari'ah* Board with authority over any disputes among stakeholders on the issue of *Shari'ah* compliance. Of course, such clauses would only have an effect on the contract and would not be binding on third parties. Also, national mandatory rules will obviously prevail over the parties' agreement.

5 MONETARY POLICY AND LIQUIDITY MANAGEMENT (SERGIO MASCIANTONIO, PIERLUIGI CARISTI, STEPHANE COUDERC, STEVEN ONGENA, SAJJAD ZAHEER)

In a conventional financial system, the control of interest rates is the cornerstone of monetary policy. The operational framework of monetary policy is normally based on three different channels: a minimum reserve system; open market operations; and standing facilities. Each of these channels deals with slightly different monetary policy objectives, but is always centred on interest rates. Therefore, there is a clear conflict between *riba'* – the prohibition of interest payments – and the normal conduct of monetary policy. Consequently, one needs to develop ad-hoc instruments for a *Shari'ah*-compliant monetary policy. Furthermore, recent years have seen the growing importance of macro-prudential policy and unconventional monetary policy measures: the compatibility of such measures with Islamic law should also be carefully evaluated.

This section will first discuss the conduct of monetary policy in an Islamic finance context (Section 6.1). Secondly, it will address the issue of liquidity management and, in particular, the developments and prospects for creating adequate Islamic interbank markets (Section 6.2). Finally, issues related to the collateral framework of the Eurosystem are considered from an Islamic finance perspective (Section 6.3).

5.1 ISLAMIC INSTRUMENTS FOR MONETARY POLICY: THEORY AND PRACTICE (SERGIO MASCIANTONIO)

The design of *Shari'ah*-compliant monetary policy instruments has often been quite complex, constraining the development of the Islamic banking industry. The best practices appear to be those adopted in countries where Islamic finance is more prevalent. In what follows, we distinguish between pure Islamic financial systems, which are rarer, and economies where an Islamic finance industry is developing alongside the conventional financial system. As regards the latter, we will treat the Asian and European cases separately.

5.1.1 PURE ISLAMIC FINANCIAL SYSTEMS

In pure Islamic financial systems – such as those of Sudan and Iran – difficulties in designing Islamic monetary policy instruments have often hampered an efficient conduct of monetary policy, leading monetary authorities to rely on direct controls on banking activities (Choudry and Mirakhor, 1997). The major difficulties lie in designing financial products that absorb excess liquidity in the banking system without being directly linked to a specific underlying project (see Eslamloueyan and Heidari, 2010). In this peculiar environment, it has been extremely difficult to identify a proper rate of return that could proxy the return on government and central bank securities.

The authorities in Sudan partially overcame these hurdles by using Central Bank *Musharakah* Certificates (equity-type PLS certificates), issued against the participation of the central bank in the equity of private banks (Elhiraika, 2004). This instrument was introduced to regulate the liquidity of the domestic banking sector through open market operations. However, its design, driven by monetary policy objectives rather than profitability, made it too expensive and cumbersome to use. Hence, the Central Bank of Sudan uses other instruments, such as Government *Musharakah* Certificates and Government Investment Certificates (GICs)[43]. These are government-issued securities, but can be used in monetary policy operations.

43 Like CBMCs, GMCs are based on the PLS principle and thus guarantee a participation in state-owned enterprises. GICs are based instead on *mudarabah*-type contracts.

The Iranian authorities developed the National Participation Paper – a monetary instrument based on a *musharakah*-type contract, originally aimed at financing government operations but found to be of use in open market operations (Sundararajan et al., 1998). The rate of return of this instrument is proxied with a subset of shares of companies listed on the Iranian stock market that are involved in activities similar to those of the government projects financed. Another commonly used instrument is the Central Bank Participation Paper, which is also based on *musharakah*-type contracts. This instrument proved to be rather inflexible – as it can only trade at par value – but is appropriate for draining excess liquidity from the banking system. Iran's monetary system also features a reserve requirement ratio, obviously without any corresponding remuneration. The required amount of reserves is managed in a very active way by the Iranian monetary authorities, compared with conventional standards. There are also qualitative and quantitative limits to financing activity that can be classified as macro-prudential measures.

As regards standing facilities, Iran's monetary authorities allow banks to deposit unallocated excess liquidity in central bank accounts that do not provide a return (open deposit accounts). In Sudan, as financing facilities, banks are allowed to rely on a free line of credit with a maturity of up to one week. After the credit line has matured, it is automatically converted into a *mudarabah*-type contract.

5.1.2 ISLAMIC BANKS IN CONVENTIONAL FINANCIAL SYSTEMS – THE CASE OF ASIA AND THE MIDDLE EAST

In countries where both Islamic and conventional banks are present – as in most of the MENA and South-East Asia regions – there is a need to modify existing instruments and monetary policy operations to make them consistent with Islamic law.

As explained in some relevant studies (e.g. IFSB, 2008; IIFM, 2009), such monetary policy framework changes are still under way. Only a few central banks have changed their open market operations to allow for the participation of Islamic banks. There is a distinct lack of tailor-made Islamic financial products suitable for both monetary policy operations and the liquidity management of banks. Lastly, in several countries, a clear standing facilities mechanism does not exist yet. These features impair efficient liquidity management by IIFSs, contributing to their high levels of excess liquidity. Efficient liquidity management has long been recognised as one of the most important issues in Islamic finance; one which is highly controversial (Khan and Ahmed, 1997).

In most of Asia, Islamic banks are required to lodge a reserve account with the central bank. These reserve accounts are *Shari'ah*-compliant, since they are non-interest bearing[44]. However, the penalties associated with an insufficient level of reserves often differ for conventional and Islamic banks, impairing the development of a level playing field for these two types of banks.

With regard to open market operations, the solutions differ, partly reflecting different interpretations of Islamic law. Often, short-term *Shari'ah*-compliant financial instruments are issued by governments and then used by central banks in their monetary policy operations. In fact, since these products need to be asset-backed, direct issuance by a central bank could constrain the amount they contribute to its total assets, limiting the liquidity offered to the banking system.

Given the growing diffusion of *sukuk* in most of these markets, they are increasingly used in monetary policy management operations. The Central Bank of Bahrain issues debt-type securities –

44 As is the case in, for example, Bahrain, the United Arab Emirates and Qatar. In Bahrain, there is a minimum reserve scheme with an averaging provision. The minimum reserve scheme, however, is not considered an effective monetary policy instrument for intra-day liquidity management.

mostly structured as three and six-months *salam sukuk* – on behalf of the Government of Bahrain. These instruments can also be useful for monetary policy objectives, but the ban on their secondary market trading strongly limits their flexibility for liquidity management purposes. The central bank of Bahrain recently issued government *ijarah sukuk* that can be more effectively used in monetary policy operations. The Central Bank of Kuwait is also evaluating the issuance of *salam sukuk*[45]. Meanwhile, in Malaysia, a country which has one of the most developed Islamic banking systems in the world, the central bank relies on a number of different instruments for its open market operations, encompassing several types of Islamic contracts (i.e. *ijarah*, *mudarabah*, *murabahah* and *bay' bithaman ajil* contracts). Many of these instruments were created with the explicit aim of allowing Islamic banks to comply with the liquidity rules set by the central bank and to profitably invest their excess liquidity. Another relevant instrument is the Government Investment Issue[46], which is currently used for financing government operations, but is issued by the country's central bank.

Since the currencies of several GCC countries are pegged to the US dollar, many central banks, like that of the United Arab Emirates, rely on foreign exchange swaps to manage the liquidity of the domestic money market. However, the *Shari'ah* compliance of these instruments is controversial and the majority of *Shari'ah* boards do not approve of their use. In 2010, the UAE central bank announced the launch of a new facility: the Islamic Certificate of Deposit based on commodity *murabahah* contracts (Gavin, 2011). The "Tahawwut (Hedging) Master Agreement" of the IIFM and the International Swaps and Derivatives Association[47] announced in 2010 defines the rules, criteria and procedures for negotiating, clearing and settling Islamic derivative transactions. This development can improve risk management and cross-currency operations.

Standing facilities are not very well developed in most of the Asian countries under review, but central banks have launched a common effort to rapidly improve their frameworks. Instruments usually involve *mudarabah*[48] or commodity *mudarabah* contracts. In Malaysia, banks can obtain an extraordinary line of credit from the central bank through a variety of instruments, i.e. *mudarabah* or *sukuk* (sale-and-buyback agreements) contracts. In Indonesia, banks can access credit lines through a *mudarabah* framework. In Kuwait, as regards deposit facilities, reverse *murabahah* contracts (*tawarruq*) are used to drain excess liquidity. However, financing facilities have yet to be established here. Meanwhile, in other countries, such as Bahrain and the United Arab Emirates, authorities are now studying how to provide suitable standing facilities to Islamic banks to level the playing field with conventional banks. Generally, the design of financing facilities has proven to be more cumbersome than that of deposit facilities.

In conclusion, the creation of proper standing facilities would require some effort towards the development of a *Shari'ah*-compliant repo market[49]. The range of available short-term financial instruments should be broadened to allow for more efficient and dynamic liquidity management. In fact, the lack of a standing facilities' framework across the region, combined with the scarcity of money market instruments, forces many Islamic banks to undertake suboptimal liquidity management: the level of liquid assets is often considerably higher than that stipulated by the monetary authorities, with negative consequences for profitability. Additionally, structuring a proper *Shari'ah*-compliant

45 Other countries relying on *sukuk* for their open market operations are Qatar and Brunei.
46 GIIs are based on *bay' al-'inah* contracts, whose acceptance outside Malaysia is controversial and limited.
47 The ISDA is the main standard setter for OTC derivatives transactions. The IIFM is the main standardisation body for Islamic capital and money markets.
48 Such contracts often involve financing with a rate of return linked to the return of the *mudarabah* contracts of the banks asking for the credit line.
49 The IIFM is evaluating the possibility of establishing an *i'aadat al shira'a* (repurchase) market as an alternative to repo markets.

lender of last resort (LOLR) facility as a backstop for IIFSs experiencing temporary liquidity shortages is important to complete the Islamic monetary framework (see Alamsyah (2011).

5.1.3 ISLAMIC BANKS IN CONVENTIONAL FINANCIAL SYSTEMS – THE EUROPEAN CASE

The United Kingdom is the EU country with the most developed Islamic financial sector. As concerns monetary policy, in the UK the minimum reserves scheme is voluntary. To pursue banking activity, banks are required to lodge a cash ratio deposit with the central bank, which is a negligible fraction of its total assets. Since this deposit is non-interest bearing, it can be considered as *Shari'ah*-compliant. Moreover, the five Islamic banks currently operating in the UK do not meet the minimum threshold to be subject to the cash ratio deposit regime[50].

Until 2009, the minimum reserve scheme was voluntary, had an "averaging regime" under which banks set a monthly target for their reserves, and yielded a return equal to the Bank of England official rate. In 2009 the Bank of England suspended reserves averaging and substituted this with a "floor system", whereby all reserves are remunerated at the Bank rate (Bank of England, 2012). This yield is in direct conflict with Islamic law, which explains why Islamic banks are not able to join the reserve scheme. In fact, the list of banks joining the reserve scheme, which is published periodically by the Bank of England, has never included any of the Islamic banks operating in the UK.

This problem with joining the reserve scheme means that Islamic banks are confronted with a fundamental obstacle to participating in banking activity. Having no relationship with the central bank, these banks are restricted to the periphery of the banking system. Indeed, joining the reserve scheme is one of the requirements for participating in open market operations. Thus, in the UK, Islamic banks are banned from OMOs. Such operations (essentially repo transactions with a fixed or floating yield) would nonetheless conflict strongly with the *Shari'ah*, given the prohibition of *riba'*, and would be precluded to Islamic banks anyway. Since the introduction of the Bank of England's quantitative easing framework in 2009, Islamic banks have not been affected by such non-standard operations, if only indirectly via the general increase in asset prices.

As for operational standing facilities, the Bank of England encourages all banks operating in the UK to join the OSFs scheme, regardless of their association with the reserve scheme, given their financial stability role. Since lending and deposit facility operations, based on a premium and on a discount over the Bank rate respectively, again conflict with Islamic law, none of the Islamic banks in the UK have subscribed to this particular Bank of England scheme. The discount window facility, designed to protect banks from short-term liquidity shocks, has a fee that is not necessarily connected to the Bank rate. However, the liquidity boost granted by this facility would be of no help to Islamic banks due to the scarcity of eligible *Shari'ah*-compliant collateral.

These limitations are less binding for Islamic banks established within a conventional banking group, since access to these operations is granted on a consolidated basis. As explained by the Bank of England (2012), banking groups are allowed to join the reserve scheme and to participate in monetary policy operations only through a single group entity, as liquidity is supposed to be managed on a consolidated basis. In practice, despite the obligation to separate Islamic funds from conventional banking funds, Islamic windows or branches are not totally separated from their groups. The segregation principle and the use of funds in agreement with Islamic law generally follow a restrictive interpretation: they are limited to the Islamic branch itself and its own fund

50 This minimum threshold is set at total liabilities of GBP 500 million in the Bank of England's "Red Book".

management. This is not considered to be in conflict with Islamic law, as long as these funds are invested in *Shari'ah*-compliant projects.

The five stand-alone Islamic banks in the UK face greater limitations in terms of access to central bank facilities. The inability to rely on OSFs makes them intrinsically more fragile from a liquidity and solvency point of view than their conventional counterparts, as they are forced to rely on typical *Shari'ah*-compliant instruments, such as commodity *murabahah*, to manage their liquidity.

As concerns the euro area, stand-alone Islamic banks do not operate in the Eurosystem, as of the end of 2012. However, given the experience of the UK and the sustained growth of the industry, they are likely to become established in the euro area in the coming years. At the moment, only a small number of Islamic windows or representative offices of foreign Islamic banks have established a presence here. The monetary policy framework of the Eurosystem includes a number of obstacles that hinder the establishment of Islamic banks.

The first formidable obstacle to the foundation of an Islamic financial institution is the minimum reserve system. Minimum reserve requirements have to be met within a monthly maintenance period, with the possibility of averaging provisions. Reserves are remunerated by the weighted ECB official rate. However, holding a reserve account with a national central bank is compulsory under the Eurosystem (ECB, 2011). This interest-bearing account would conflict with Islamic law and not holding such an account would prohibit an IIFS from operating in the euro zone.

The ECB – based on criteria listed in Regulation (EC) No 1745/2003 of 12 September 2003 – can exempt single credit institutions from its reserve requirements such as, for example, institutions pursuing special-purpose functions or ones that are not exercising active banking functions in competition with other credit institutions. These tight criteria allow only a very small number of banks to be exempted from reserve requirements. Pursuing exemption from reserve requirements does not appear to be a suitable solution for Islamic banks.

Alternatively banks can hold their reserve accounts indirectly through another intermediary. This possibility is confined to credit institutions that entrust part of their management (e.g. treasury management) to another intermediary, for example, an association of small saving banks or cooperative banks. If it is held that Islamic banks must comply with reserve requirements, they could rely on the indirect management of their reserves by other intermediaries. This is actually the preferred solution of several smaller banks. This reliance could also create room for a *Shari'ah*-compliant management of the reserve account remuneration.[51] Otherwise, the only other possibility left to Islamic banks would be to directly comply with the minimum reserve requirements and to somehow give up the remuneration associated with the reserve account.

The framework for open market operations does not leave more room for the participation of Islamic banks. The ECB's main refinancing operations – MROs, the cornerstone of its open market operations – can be structured as repo contracts or collateralised financing, but they conflict with the prohibition of *riba*. Moreover, the lack of *Shari'ah*-compliant financial instruments in the euro area that can be used as collateral or in repo contracts further restricts the participation of Islamic banks.[52] Islamic banks could operate in the euro area even if they are barred from OMOs. In fact,

51 For example, an Islamic financial institution could transfer this interest-based remuneration to the intermediary that is managing its reserve account, i.e. as part of the remuneration for the services provided.
52 The inclusion of *Shari'ah*-compliant instruments in clearing and settlement systems may be associated with further problems.

not every bank in the euro area is able to take part in OMOs and only a minority of the authorised banks regularly participate in these.

Similarly, Islamic banks would not be allowed to rely on standing facility operations, regardless of their different technical specificities in the national jurisdictions of Eurosystem countries. This obstacle makes IIFSs more fragile and risk-prone from a financial stability point of view.[53]

In conclusion, stand-alone IIFSs established in the euro area would be confined to the periphery of its banking system and thus be clearly disadvantaged in relation to their conventional counterparts. However, since some conventional banks also have no access to ECB monetary policy operations, this disadvantage would not necessarily hamper their establishment. It can be assumed that IIFSs will rely on the same instruments as those used by their UK counterparts to manage their liquidity, and that they will probably hold excess liquidity reserves in order to withstand any sudden liquidity shortage.

5.2 LIQUIDITY MANAGEMENT (SERGIO MASCIANTONIO)

When it comes to managing their liquidity, conventional credit institutions have at their disposal well-developed interbank markets that can be tapped for short-term funding, as well as a plethora of instruments. In contrast, as noted above, IIFSs typically face greater difficulties in managing their liquidity as they do not have access to the same wide range of financial instruments as conventional institutions. This dearth of financial instruments makes for less efficient liquidity management, as IIFSs have to hold more cash than is strictly necessary to meet liquidity thresholds, thereby reducing their profitability; all of which may even impact the financial sector in which they operate. It is clearly in the interest of financial supervisory and regulatory authorities with IIFSs in their respective jurisdictions to encourage the development of a *Shari'ah*-compliant capital market so that these institutions find it easier to manage their liquidity effectively. The question of how this issue has been tackled in various jurisdictions across the globe, particularly in Europe, is considered below.

5.2.1 MAIN DEVELOPMENTS IN ISLAMIC INTERBANK MARKETS

Islamic banking activity has traditionally been conducted via over-the-counter markets, ignoring regulated interbank markets, which are a more recent development. London has played an important role, being one of the main financial hubs for Islamic financial operations. After 1980, several Islamic banks headquartered in the GCC region started relying on financial institutions based in London, which, thanks to the financial expertise found, were able to find suitable instruments for managing their liquidity – given the lack of money markets offering *Shari'ah*-compliant instruments, a not insignificant matter. Today, the London Stock Exchange is a key venue for *sukuk* issuances with over US 34 billion raised up to the end of 2012.[54] In recent years, however, some new important financial hubs for Islamic finance have also emerged, such as Bahrain, the UAE and Malaysia.

One of the most used instruments in these operations is the commodity *murabahah*[55]. This is based on transactions conducted on the London Metal Exchange (LME) and usually has high transaction costs, but is able to provide similar returns to government securities. The depth and breadth of the

53 Note that not all of the banks operating in the Eurosystem are included into the standing facilities scheme.
54 Another relevant venue for *sukuk* listings in Europe is the Luxembourg Stock Exchange.
55 In such a type of contract the bank with excess liquidity buys some metals on the London Metal Exchange only to sell them to counterparty against a deferred payment. The price for this payment is fixed at a price equal to the original purchase price of the metals on the LME plus a mark-up *(murabahah)*. In another formula of this contract, interbank funds are used to finalize a *murabahah*-type transaction in any commodity, with the return paid to the bank that provided the funds. For an in-depth discussion about this instruments, see IFSB (2010).

LME, which limits the market risk embedded in this type of transaction, is one of the major factors counting in favour of London (Wilson, 2007).

Commodity *murabahah* contracts are the instrument of choice in several countries: Bahrain, Saudi Arabia, Qatar, Malaysia, Pakistan, Kuwait and the UAE. GCC countries and the UK are the most active in terms of issuance and trading. However, according to Islamic law, these cannot be actively traded in secondary markets. Moreover, their high fixed costs make shorter-term maturities particularly expensive, and these are the most important ones for liquidity management.

The second most used *Shari'ah*-compliant instrument for liquidity management purposes is the *mudarabah* interbank investment. This instrument is most widespread in South-East Asia (e.g. in Malaysia, Indonesia and Bangladesh). Under the MII, a deficit Islamic bank can obtain liquid funds from a surplus bank via the issuance of a *mudarabah* certificate for a predetermined period of up to one year. However, it is often difficult to calculate overnight pricing of this instrument. Given the PLS principle embedded in *mudarabah* contracts, a bank investing in MII should not have any advance knowledge of the rate of return on its investment. The rate of return should be based on the return gained by the deficit bank (the investee bank) during the tenure of the contract. However, in practice, it is often predetermined and the principal is paid back at maturity. Similar to commodity *murabahah*, MIIs are not easily tradable in secondary markets and are not always suitable for central bank efforts to drain excess liquidity. The majority of these instruments are traded over-the-counter and held until maturity.[56] Also *wakalah* instruments are witnessing a growing role in Islamic interbank markets, even if they are mostly used by Islamic mutual funds and finance companies.

Despite their growing circulation, a reliance on medium and long-term *sukuk* for liquidity management purposes has several drawbacks. They bear a higher market risk, and this problem is exacerbated by the insufficient development of secondary markets. Moreover, only a minority of countries has developed a regular *sukuk* issuance programme; one which foresees *sukuk* issuances that are fully tradable on secondary markets, predictable and of sufficiently high volumes. Having said this, however, instruments based on *sukuk* appear to be more suitable for fostering the creation and development of an efficient money market. These are likely to bear lower transaction costs and could prove a valuable alternative to the existing instruments used by Islamic financial institutions, helping them to improve their liquidity management.

Some countries have tried to develop regulated Islamic interbank markets to improve the transmission of monetary policy and liquidity management in the banking sector. Notable examples are the Liquidity Management Centre (LMC) headquartered in Bahrain, and the Islamic Interbank Money Market (IIMM) headquartered in Malaysia[57].

The LMC[58] was created to improve the allocation of excess liquidity by Islamic banks via short and medium-term *Shari'ah*-compliant financial instruments. Its operations are regulated and supervised by the Central Bank of Bahrain. The LMC provides primary market services through the issuance of a broad variety of *sukuk* (*salam*, *murabahah*, *ijarah*, etc.). However, traded volumes on the secondary market remain thin because certain instruments (e.g. *salam sukuk*) cannot be actively

56 Another commonly used instrument involves an agreement between two Islamic banks to respectively hold non-interest bearing accounts.
57 Since 2010, further attempts have been made to establish an Islamic interbank market (e.g. in Pakistan and Bangladesh).
58 The LMC is a joint stock company. Its shareholders, each with a 25% stake, are the leading Islamic financial institutions in the GCC region, i.e. the Bahrain Islamic Bank, Dubai Islamic Bank, Islamic Development Bank and Kuwait Finance House.

traded, since they are considered pure financial instruments by the Islamic law prevailing in the GCC region[59].

Meanwhile, the IIMM was established in 1994, under the lead of the central bank of Malaysia, as a short-term market providing spot *Shari'ah*-compliant funding instruments. The Malaysian interbank market is more active than its counterpart in Bahrain; also due to the broader range of tradable instruments available. Today, it is the largest regulated secondary market for Islamic products. The MII is one of the most traded instruments on this market. Significant trade volumes are also registered for *ijarah*, *musharakah* and *mudarabah sukuk*, GIIs and other less widespread instruments. Moreover, since 2006, market participants have been allowed to conduct short selling of certain securities without violating the *gharar* prohibition, and to trade certain shares and palm oil futures[60]. In 2009, Bursa Suq Al-Sila', formerly known as Commodity Murabahah House (CMH), was launched. It is intended to facilitate commodity based Islamic financing and investment transactions. Many of these developments are controversial among *Shari'ah* scholars outside Malaysia, but they do represent important advances from a financial innovation and market completion perspective.

5.2.2 POSSIBLE FURTHER DEVELOPMENT OF ISLAMIC INTERBANK MARKETS

Notwithstanding recent developments, Islamic interbank markets are still in their infancy. The development of a repo market would be extremely useful in terms of controlling the supply of money and the liquidity management of IIFSs. A stable repo market also provides additional ways of meeting minimum reserve requirements. There have been some remarkable tests in Bahrain and Malaysia to create structures similar to conventional repo markets. However, bridging the gap between *Shari'ah* compliance and the typical structure of a repo contract has proved to be quite a complex issue. The introduction of collateralised *murabahah* by the UAE central bank and, one year later, by the Central Bank of Malaysia, can reach some repo-like benefits.

In order to support the development of Islamic interbank markets, it is certainly necessary to have money market instruments that can be traded on a secondary market. In this respect, standardising the main features of commodity *murabahah* contracts across different markets could dramatically improve tradability and shorten the time required to complete a transaction. Such an improvement would promote the development of regulated markets rather than over-the-counter negotiations.

Given the growing importance of *sukuk*, a higher issuance of sovereign *sukuk* would improve the overall liquidity of this market segment. However, the debt crisis that emerged in the UAE in 2009 highlighted uncertainties about the regulation of the *sukuk* market and partially slowed down some sovereign programmes for the issuance of Islamic instruments. There are a few countries that regularly issue Islamic sovereign debt, such as Malaysia or Bahrain, with Turkey, South Africa, Kazakhstan and many other countries having made new issuances in recent years.

A primary dealership system and market-making agreements are essential for the further development of an active secondary *sukuk* market. Primary dealers contribute to underwriting the securities issued by central banks or governments on primary markets and to the diffusion of these securities among investors. Market-makers help maintain a smooth and liquid market for securities trading. Market-making agreements could easily be adopted in an Islamic context.

59 Similarly, the Liquidity Management House was established in 2007 in Kuwait and is fully owned by the Kuwait Finance House. It has the objective to become a principal player in the market for *sukuk* and *Sharī`ah*-compliant structured products.

60 Palm oil is a commodity of paramount importance to Malaysia: it is the country's main export product – Malaysia accounts for 50% of total world production. The Malaysian palm oil future is the global benchmark for the price of palm oil and palm oil is the underlying commodity of several Islamic contracts.

In Europe, the UK Treasury evaluated the possibility of issuing a sovereign *sukuk* quite some time ago.[61] This could have greatly helped the liquidity management of Islamic banks, providing them with Sterling-denominated, AAA-rated securities that qualify as domestic government securities under the Basel Capital Accords with a nil capital requirement (BCBS, 2006 and 2011). The *sukuk* issuance would have been a valuable and more flexible alternative to commodity *murabahah* for domestic Islamic banks. Moreover, the issuance programme could have positively contributed to a wider acceptance of *sukuk* as a separate asset class and encouraged other western economies to enter the Islamic securities market. However, after the establishment of the necessary legal framework, the plans for the UK's first sovereign *sukuk* were put on hold in 2010.

Meanwhile, the Bank of England, following a request by the UK Treasury, has started evaluating whether *sukuk* can be accepted as eligible collateral in open market operations. Their use as collateral in monetary policy operations would make them more palatable for conventional intermediaries and would also remove one of the main obstacles hindering Islamic banks from participating in UK central bank operations, thereby easing their integration in the domestic financial system.

In the euro area, France is undertaking steps to promote the development of a domestic Islamic finance industry. The possibility of issuing a sovereign *sukuk* is one of these steps. However, the regulatory and legislative changes required are proving to be slower and more complex than initially expected. In 2010, Luxembourg considered the issuance of a hypothetical sovereign *sukuk*. Given the lack of Islamic banks in the euro area, such efforts can be at least partially explained by the prospect of diversifying the investor base and attracting foreign capital (mainly from countries in the GCC region and South-East Asia)[62]. Another reason would be an attempt to establish continental European financial hubs for Islamic finance in direct competition with the UK. Moreover, a European sovereign *sukuk* could help to internationalise the sector. However, the development of a complete programme of *Shari'ah*-compliant issues would have high fixed costs, making it only profitable for major issuers, such as Germany, Italy and France; these would have the most to gain from the creation of a benchmark for the *sukuk* market.

5.3 ISLAMIC FINANCE AND THE EUROSYSTEM MONETARY POLICY FRAMEWORK (PIERLUIGI CARISTI, STEPHANE COUDERC)

5.3.1 THE *SUKUK*[63] AS LIQUIDITY MANAGEMENT INSTRUMENT

Sukuk are often touted as the answer to the liquidity management problem faced by the Islamic financial world. In a situation where a dearth of *Shari'ah*-compliant instruments is available to IIFSs (and even individuals) for liquidity management purposes, it is no surprise that high-profile *sukuk* issuances, whether of a sovereign or a corporate nature, are frequently oversubscribed[64].

61 The *sukuk* would have had an *ijarah*-type structure and preferred maturities of one and three months.
62 See also Mersch 2009 and 2010.
63 Please refer to chapter 1 for a definition of *sukuk*.
64 As was the case regarding the Dubai Islamic Bank's USD 500 million *sukuk* issuance of 2012, the Central Bank of Bahrain's *ijarah sukuk* issuance of the same year was also oversubscribed.

Box 3

THE INTERNATIONAL ISLAMIC LIQUIDITY MANAGEMENT CORPORATION (IILM)

In 2010 the IILM was established in Malaysia, with the purpose to issue *Shari'ah*-compliant financial instruments and facilitate cross-border Islamic liquidity management.

Membership of IILM is open to central banks or monetary authorities as well as financial regulatory authorities or government ministries or agencies that have regulatory oversight of finance or trade and commerce, and multilateral organisations.

The IILM initiative was facilitated by the Council of the IFSB in line with its mandate to a) enhance and coordinate initiatives to develop instruments and procedures for the efficient operations and risk management and b) encourage cooperation amongst member countries in developing the Islamic finance industry.

Until now, IILM is still to issue its first *sukuk*, highlighting the challenges in (i) ensuring compliance with legal frameworks in all the countries in which its members are present, as well as (ii) designing the instrument to achieve a high credit rating. Agreements with multilateral development banks for the credit enhancement of the IILM are under consideration.

Despite these challenges, there has been progress in preparing the first IILM *sukuk* issuance and the inaugural IILM US dollar-denominated *sukuk* issuance was announced on 6 of April 2013, with an expected size of USD 300 million to USD 500 million.

For the purpose of marketing IILM issuances, each member is allowed to appoint a certain number of credit institutions as primary dealers (PDs) and up to two credit institutions as lead arranger/manager. Primary dealership would involve bidding for a certain minimum amount of IILM instruments at the primary issuance level, provision of bid and offer prices as well as provision of on-going market feedback on development and product innovation to the IILM. Only credit institutions licensed within the jurisdiction of IILM members are eligible as primary dealer.

Beyond the reception of the IILM *sukuk* in the primary market, the development of a liquid secondary market will be important to ensure the usefulness of this new instrument for liquidity management purposes.

Possible institutional relations of the IILM with Eurosystem central banks may be based on Art. 23 of the Statute of the European System of Central Banks and of the European Central Bank ('ESCB Statute'), pursuant to which "the ECB and national central banks may establish relations with central banks and financial institutions in other countries and, where appropriate, with international organisations".[2]

1 Prepared by Stephane Couderc and Pierluigi Caristi.
2 Any possible liquidity arrangements or banking transactions with the Eurosystem would require a specific decision of the Governing Council of the ECB.

STRUCTURING *SUKUK* AS ABS

Paradoxically, having more *sukuk* issuances does not make a market liquid: one needs an exit strategy as well. Most *sukuk*, once bought, are held to maturity by investors for various reasons: some are simply not tradable on the secondary market for structural reasons (the *sukuk* concerned having been structured by their issuers as conventional unsecured bonds with an Islamic label, *i.e.* representing purely receivable or debt); those *sukuk* eligible for secondary market are held to maturity in part because investors are not confident that they can find similar instruments on the market in which they can invest, reflecting supply-side constraints against a backdrop of strong investor demand for *Shari'ah*-compliant securities.

Currently, the dominant form of *sukuk* in terms of global issuance volume[65] is the *ijarah sukuk*. *Ijarah sukuk* involve a sale-and-leaseback arrangement, whereby assets are sold to a Special Purpose Vehicle, which then issues the *sukuk*. It is also the *sukuk* type which, in the course of structuring and in form, potentially raises the least "*Shari'ah* controversy"[66]. Perhaps this is one of the main reasons why it is the most prevalent type of *sukuk* in the market, with global issues in certain jurisdictions *e.g.* Malaysia having huge success with local and international investors.

Ijarah sukuk can be asset-backed or asset-based, although there is some controversy surrounding asset-based *sukuk*[67]. Asset-based *ijarah sukuk*, which make up the bulk of older issuances, are closer in form and substance to conventional unsecured bond. While *sukuk* can be structured to represent debt to the *sukuk* holder, this kind of *sukuk* will not be tradable on the secondary market and instead is held until maturity or sold at par, as the exchange of debt at non-equal amounts would not be deemed acceptable under the *Shari'ah*. *Sukuk,* in order to be tradable from a *Shari'ah* compliance perspective, must be owned by *sukuk* holders, along *with all rights and obligations* of ownership in the underlying assets and must not merely represent monetary flows. Guidelines issued by the AAOIFI[68] in February 2008 on investment *sukuk* state that *sukuk* holders should preferably be the *legal*, rather than nominal ("merely" beneficial owners), owners of *sukuk* assets. While beneficial ownership of *sukuk* assets is allowed under the *Shari'ah*[69], holders of asset-based, "conventional bond"-type *sukuk* falling under this category, such *sukuk* holder owners do not have all ownership rights and liabilities assigned to them (such as *takaful* cost for the underlying asset). For this reason, *asset backed ijarah sukuk* has been argued by some Shari'ah scholars to more closely reflect the objectives of *Shari'ah* law.

Structuring *ijarah sukuk* as *Shari'ah*-compliant ABS instead of *Shari'ah*-compliant covered bonds might be preferable, in particular in view of potential *Shari'ah* compliance issues presented by covered bond structures.

65 IIFM (2011). *Sukuk* Report 2nd Edition, http://www.iifm.net.

66 Sheikh Muhammad Taqi Usmani, prominent Pakistani *Shari'ah* scholar created a sensation when he declared that certain *sukuk* were not *Shari'ah*-compliant mainly because their method for redemption incorporates a purchase undertaking and/or guarantee returns, which violated the principle of risk and profit-sharing on which such *sukuk* should be based. This lead to the 2008 paper from the AAOIFI Board of *Shari'ah* Scholars with guidelines outlining their position on *sukuk*, which included a ruling that purchase undertakings at face value for musharaka and mudarabah *sukuk* structures are no longer permissible The *ijarah* transaction, being lease and buy-back transaction, is not subject to the limitations on purchase undertakings at par to redeem *sukuk*. AAOIFI has also emphasised in its guidelines that tradable *sukuk* must represent ownership (fractional undivided ownership) by *sukuk* holders in actual assets that may be possessed and disposed of legally in accordance with *Shari'ah* principles and precepts.

67 There is some debate within the *Shari'ah* world as to whether asset-based *sukuk* is indeed *Shari'ah*-compliant as such structures tend to be almost indistinguishable from conventional bond structures with no legal transfer of ownership. See in particular pgs. 88-91 of IFSB (2008), Islamic Finance, Survey on Global Legal Issues and Challenges.

68 Ibid.

69 OIC Fiqh Academy, Majallah Majma` al-Fiqh al-Islami, 1990, no. 6, v. 1, p. 771, as also quoted in Bank Negara Malaysia, 2010, Sharia Resolutions in Islamic Finance, Second Edition.

5.3.2 THE *SUKUK*: A POTENTIAL CANDIDATE FOR EUROSYSTEM ELIGIBLITY?

The Eurosystem monetary policy framework is characterised by a very broad range of eligible collateral: at the end of 2012, marketable assets eligible in the Eurosystem monetary policy operations amounted to €14.1 trillion, compared with a total use of collateral of €2.5 trillion. This broad set of collateral reflects the Eurosystem's desire to accommodate the diversity in the euro area financial markets and its counterparties' business models, to avoid central-bank induced distortions between market segments and to diversify risk. As demonstrated by the various adaptations made during the financial crisis, the Eurosystem collateral framework is not "frozen" and, while ensuring stability and predictability, is regularly reviewed to reflect changes in the economic and market environment. From this perspective, the rapid development of Islamic finance is a relevant phenomenon for the Eurosystem, which deserves a close monitoring.

At the same time, the Statute of the ESCB requires all credit operations by the Eurosystem to be based on "adequate" collateral. This requirement is translated by strict criteria and eligibility rules, defined in the Guideline of the ECB of 20 September 2011 on monetary policy instruments and procedures of the Eurosystem (ECB/2011/14), more commonly known as the 'General Documentation'.

So far, no *sukuk are on the list of eligible collateral, maintained by the ECB.* The challenges for a *sukuk* to meet all Eurosystem collateral eligibility requirements are not negligible.

The issuer may be either an entity of the private sector – corporation, credit institution, or an entity of the public sector – international organization, central government, regional or local government. The issuer must be incorporated in the European Economic Area (EEA), US, Canada, Switzerland or Japan. For instance, several euro area Member States, such as France, Ireland or Luxembourg, have contemplated sovereign *sukuk* issuances. Furthermore, international and supranational institutions are eligible issuers irrespective of their place of establishment. In addition to complying with the Eurosystem requirements, such institutions would additionally have to be recognized as international institutions by the Eurosystem. The International Finance Corporation (IFC), which is an issuer of *sukuk,* is in the Eurosystem's list of recognised international and supranational institutions, while the Islamic Development Bank, another important supranational issuer of *sukuk*, is currently not in this list.

The assets must be denominated in Euro. However, since a decision by the Governing Council of the ECB on 6 September 2012, marketable debt instruments denominated in US dollar, pound sterling and Japanese yen, are also eligible as Eurosystem collateral on a temporary basis, providing that they are issued and held in the euro area. Marketable instruments must be issued in the European Economic Area in a central security depository (CSD) which fulfils the ECB standards or in a central bank. They must be held and settled in the euro area, through an account with the Eurosystem or with a security settlement system (SSS) meeting the ECB standards.

As regards its credit assessment, the *sukuk* must meet high credit standards for marketable assets specified in the Eurosystem Credit Assessment Framework (ECAF). If the *sukuk* is structured as an ABS, it would need at least two credit assessments by the recognised external credit assessment institutions (ECAIs) (commonly known as "rating agencies"). Currently, almost all conventional rating agencies use conventional methodologies to rate Islamic instruments. Rating agencies are still polishing, adapting and developing their ratings methodology and tools in relation to assets belonging to the Islamic finance sphere. Furthermore, in order to retain eligibility as Eurosystem

collateral, the Eurosystem must receive rating agency surveillance reports containing up-to-date information relating to the latest coupon payment which must be produced within four weeks in order for the transaction to retain eligibility; such report must contain, amongst others, updated information on the main transaction participants and the composition of the collateral pool. This is another aspect which must be taken into account by the originator when structuring an *ijarah sukuk* as ABS.

With respect to ratings issued by ECAI, it is important to note that IFSB GN-1 *(Guidance Note on Recognition of Ratings by ECAIs on Shari'ah-Compliant Financial Instruments, March 2008)* outlined criteria recommended to national supervisors for consideration when approving *ECAIs* for rating *Shari'ah*-compliant financial instruments (e.g. *sukuk*). Furthermore, GN-1 asserts that rating analysis of *Shari'ah*-compliant assets may differ from analysis of conventional assets, both in terms of the general principles that govern *Shari'ah*-compliant finance (e.g. the concept of default) and of the features of specific financial instruments.

Finally, a delicate balancing act will be necessary to reconcile *Shari'ah* compliance issues and secular, Eurosystem requirements. In this respect, a *Shari'ah* advisory committee with good, knowledgeable *Shari'ah* scholars having a sound financial background is needed to advise the issuer. Reconciling both *Shari'ah* compliance and Eurosystem compliance is not easy: while striving to fulfil Eurosystem requirements, it is essential for an issuer to preserve *Shari'ah* compliance[70]. Indeed, an issuer rarely issues a *sukuk* targeting conventional investors only. Attracting investors from the Islamic finance world, whether national, European or international, to invest in a *sukuk* issuance whose certificates are eligible for Eurosystem collateral is what will create new liquidity flows in the open market. The question of *Shari'ah* compliance of an instrument and thus its *general* acceptance by *Shari'ah* scholars remains an area which can present uncertainties. To play it "safe", an issuer should use a structure which has been generally recognised by the top *Shari'ah* scholars and the standard setting bodies such as the AAOIFI's *Shari'ah* Board as being *Shari'ah*-compliant (such as the asset-backed *ijarah sukuk*, which has generally been recognised as being tradable). Even then the choice, which should also be verified by the issuer's own *Shari'ah* board, can never be a sure one-size-fits-all.

In order to be a seen as an adequate instrument for liquidity management purposes, either in private funding markets or as collateral with central banks, a security should be tradeable and liquid in the secondary market, have a clear and relatively standard structure, and have a favourable regulatory treatment. An additional important criterion in the Islamic finance world is a clear compliance with the *Shari'ah*, which ensures access to a broader investor basis. From these perspectives, the *ijarah sukuk* seems the best placed in the *sukuk* universe, thanks to its tradeability (by contrast, for instance, with the *murabahah sukuk*), its significance in terms of issuance, its relatively simple structure and clear compliance with the *Shari'ah*. Still, further progress is needed in terms of improving standardisation and developing secondary market liquidity. The recent efforts to define and harmonise standards and the establishment of the IILM are important steps in this regard.

CONCLUDING REMARKS

From the perspective of the Eurosystem, a broad collateral framework is an important element of its monetary policy implementation. This framework is regularly adapted to the changing financial and market environment, while maintaining strict consistency with the collateral "adequacy"

70 For example, eligible Eurosystem assets must be traded on a regulated or an acceptable non-regulated market as specified by the ECB. For conventional instruments this requirement is easily resolved, whereas for Islamic liquidity instruments the *Shari'ah* aspect of "tradability" has to be considered as well, meaning the *sukuk* has to be structured, and during its lifetime, conform to *Shari'ah* principles.

requirement. The rapid development of Islamic finance products such as the *sukuk* is therefore relevant for the Eurosystem, although important obstacles remain with regards to insufficient standardisation, a lack of liquidity, the small size of issuances, the insufficient number of high quality issuers and the focus on domestic markets. Initiatives such as the creation of IILM have the potential to address these issues. The Eurosystem monitors closely these developments and is open to an active dialogue and cooperation with the representative institutions of the Islamic finance world.

6 CONCLUSION

The financial crisis and the resulting call for a more stable and secure financial system has renewed an interest in Islamic finance, prompting a debate on its characteristics and potential for further development. This paper has highlighted the main building blocks of Islamic finance, the constraints on its development over the last decades and its possible future prospects, focusing in particular on the EU.

Islamic finance going forward will need to develop in parallel with the distinctive characteristics of different jurisdictions. However, it is conceivable that it will also grow in another way, with conventional institutions providing instruments of a similar nature and incorporating Islamic finance practices into their operations, for example, by establishing "Islamic windows" and perhaps even creating fully fledged IIFSs.

Furthermore, adjustments in the regulatory environment will need to be pursued to ensure a level playing field with conventional financial institutions.

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