THE NATIONAL BUREAU *of* ASIAN RESEARCH

NBR PROJECT REPORT | MARCH 2008

ISLAMIC FINANCE IN SOUTHEAST ASIA

Local Practice, Global Impact

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ISLAMIC FINANCE IN SOUTHEAST ASIA
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Local Practice, Global Impact

OCTOBER 18, 2007
COPLEY FORMAL LOUNGE, GEORGETOWN UNIVERSITY

CONFERENCE AGENDA

8:30 WELCOME

Roy Kamphausen
Vice President, Political and Security Affairs and Director, Washington, D.C. office, The National Bureau of Asian Research

Thomas Banchoff
Director, Berkley Center for Religion, Peace, and World Affairs, Georgetown University

8:40 PROJECT OVERVIEW

Emile Nakhleh
Project Research Director, The National Bureau of Asian Research

9:00 INTRODUCTION

Brad Bennett
Chief Executive Officer, American Home Assurance (Malaysia), American International Group, Inc.

OPENING KEYNOTE ADDRESS

Enhancing Interlinkages and Opportunities—the Role of Islamic Finance

Zeti Akhtar Aziz
Governor, Bank Negara Malaysia

9:45 BREAK

10:00 PANEL ONE: Global Trends in Islamic Finance—Islamic Beliefs and Values in Financial Decision-Making

MODERATOR/PANELIST

Rushdi Siddiqui
Global Director, Islamic Market Index Group, Dow Jones Indexes

PANELISTS

Frank Vogel
Independent Consultant and Founding Director, Islamic Legal Studies Program, Harvard Law School

Robert Hefner
Professor of Anthropology and Associate Director, Institute on Culture, Religion, and World Affairs, Boston University

Keith Driver
Chief Executive Officer, HSBC Amanah Takaful (Malaysia) Sdn. Bhd.

11:15 PANEL TWO: The Development and Impact of Islamic Finance on Southeast Asia

MODERATOR

Katherine Marshall
Senior Fellow and Visiting Professor, Berkley Center for Religion, Peace, and World Affairs, Georgetown University

PANELISTS

Angelo Venardos
Executive Director, Heritage Trust Group, Singapore

Nik Norzrul Thani
Partner, Zaid Ibrahim & Co., Malaysia

Mohammad Faiz Azmi
Partner, Global Islamic Finance Leader, PricewaterhouseCoopers

12:15 REGIONAL PERSPECTIVES LUNCHEON ROUNDTABLE: Looking Ahead at Key Trends in Islamic Finance

MODERATOR

Rifaat Ahmed Abdel Karim
Secretary-General, Islamic Financial Services Board

PANELISTS

Zarinah Anwar
Chairman, Securities Commission, Malaysia

Charles H. Bouloux
President, Middle East, Mediterranean, and South Asia, American International Group, Inc.

Tadashi Maeda
Director General, Energy and Natural Resources Finance Department, Japan Bank for International Cooperation

14:00 PANEL THREE: Institutions and Innovations—Integrating Sharia-Compliant Products

MODERATOR

Michael McMillen
Partner, Dechert, LLP and Lecturer, University of Pennsylvania

PANELISTS

Ibrahim Warde
Adjunct Professor, Tufts University

Yusuf Talal DeLorenzo
Chief Shariah Officer, Shariah Capital

Zamir Iqbal
Principal Finance Officer, The World Bank

Agil Natt
President and Chief Executive Officer, International Centre for Education in Islamic Finance

15:00 BREAK

15:15 PANEL FOUR: Policy Outlook—Challenges and Opportunities

MODERATOR

Emile Nakhleh
Project Research Director, The National Bureau of Asian Research

PANELISTS

Mohd Razif bin Abdul Kadir
Deputy Governor, Bank Negara Malaysia

James Bergin
Counsel, Federal Reserve Bank of New York

Etsuaki Yoshida
Deputy Director, Japan Bank of International Cooperation

16:15 INTRODUCTION

Jacob Frenkel
Vice Chairman, American International Group, Inc. and Chairman, Group of Thirty

CLOSING KEYNOTE ADDRESS

Islamic Finance: Challenges and Opportunities

Shamshad Akhtar
Governor, State Bank of Pakistan

17:00 ADJOURN

Mercy Kuo
Senior Project Director, The National Bureau of Asian Research

Mercy Kuo, *Senior Project Director, The National Bureau of Asian Research*
Eric Altbach, *Vice President, Economics and Trade Affairs, The National Bureau of Asian Research*

Just five years ago, Islamic finance was regarded as an "infant industry" struggling to prove its viability and competitiveness. In 2002, not long after the tragic events of September 11, 2001, then-U.S. Treasury Secretary Paul O'Neill was quoted as saying, "It took me six months to realize that Islamic finance was a legitimate way of doing business"—a statement that more or less captured non-Muslim public sentiments about the industry. Since then, Islamic finance has recorded dramatic growth, with a presence now in more than 75 Muslim and non-Muslim countries and total financial assets now estimated to exceed US$1 trillion, about five times the magnitude five years ago. With the integration of Islamic finance into the global economy, its appeal as a market for global capital is increasing. The industry is rapidly maturing from "infancy" to "adolescence"—a growth marked by increases in Islamic financial products and services, progress in developing regulatory frameworks, and enhanced international linkages.

To raise awareness and understanding of Islamic finance among the U.S. policy community and corporate sector, The National Bureau of Asian Research (NBR) convened a conference on "Islamic Finance in Southeast Asia: Local Practice, Global Impact" in October 2007. Representatives from the U.S. and Malaysian governments as well as global institutions such as American International Group, Inc. (AIG), Japan Bank for International Cooperation, Bank Negara Malaysia, HSBC Amanah Takaful, the Dow Jones Islamic Index, the World Bank, Islamic Financial Services Board, Securities Commission (Malaysia), Harvard Law School, Tufts University, and others assembled to discuss the institutions, beliefs, and trends fueling the industry's evolution. The conference offered a venue for constructive interchange between senior finance officials, industry practitioners, and subject-matter experts to consider ways for shaping the context in which these developments are unfolding. Three overarching themes emerged from the proceedings:

Southeast Asia—Global Impact of Local Practice

- The infusion of capital from petrodollar investors from the Gulf Cooperation Council countries into Asia has contributed to the accelerated growth of Southeast Asia's Islamic finance industry over the past two decades. The total Islamic finance market was worth US$1 trillion, of which US$70 billion were Islamic bonds (*sukuk*). Among the countries of Southeast Asia, Malaysia has emerged as a major global force in Islamic finance innovation and expertise, and Singapore is fashioning itself as a sophisticated international provider of Islamic finance wealth and asset management services. With the world's largest Muslim population, Indonesia, often referred to as the industry's "sleeping giant," has the largest market that is slowly being tapped by foreign financial institutions.
- The development of Islamic finance not only strengthens the region's financial system, but also fosters greater pluralism within the region. Financial regulators in Malaysia, Singapore, Indonesia, and Brunei are strengthening their capabilities in nurturing the Islamic finance industry and providing a regulatory environment conducive to product

innovation and expertise-building. The rise in oil prices, demographics, heightened consumer awareness, and a sustained trend toward greater public manifestation of Islam as a way of life have propelled the industry's current growth trajectory. The three legs of Islamic finance—capital markets, Islamic insurance (*takaful*), and banking—all have robust growth potential thanks to increased diversification of investment areas from foreign and local investors and to the region's current rates of economic growth.

Governor Zeti Akhtar Aziz, Governor, Bank Negara Malaysia and Charles Bouloux, President, Middle East, Mediterranean, and South Asia, American International Group, Inc. (AIG).

The "New Silk Road"—Paving the Way for Sustainability

- Islamic finance is a new vehicle promoting financial interdependence within Asia, facilitating the flow of capital in the region and forging linkages with the Middle East. The strengthened economic ties between Asia and the Middle East have created an environment of activity reminiscent of the old Silk Road. Today's "new Silk Road," paved by the locomotive engine of the Islamic bond market, has emerged as a vibrant source of liquidity for Islamic capital markets.
- The sustainability of the new Silk Road will depend on the development of a financial architecture compatible with international norms and practices, as well as collaboration with the international community. Investing in research and development, leveraging information technology, and developing human capital will be critical factors in building that architecture. As the global demand for Islamic financial products surges, an increasing interest from non-Muslim countries to meet consumer demands could drive convergence of international regulatory standards for the industry.

(Left to right) Rushdi Siddiqui, Global Director, Islamic Market Index Group, Dow Jones Indexes; Frank Vogel, Independent Consultant and Founding Director, Islamic Legal Studies Program, Harvard Law School; Robert Hefner, Professor of Anthropology and Associate Director, Institute on Culture, Religion, and World Affairs, Boston University; and Keith Driver, Chief Executive Officer, HSBC Amanah Takaful (Malaysia) Sdn. Bhd.

The Road Ahead—Challenges and Opportunities

- A key challenge for the industry is to develop sharia-compliant products that are acceptable within a conventional regulatory framework. Islamic financial instruments and transactions are structured according to Islamic law (*sharia*). Debates over the interpretation of sharia in a financial context, however, reflect disparate views on a range of issues, such as regulatory challenges and arbitrage, the perception that Islamic finance is purely faith-based, and product innovation.
- Part of the dilemma can be attributed to the limited number of bona fide sharia scholars with expertise and experience in international finance. Divergent views between regions—the Middle East and Asia—coupled with different regulatory standards in country jurisdictions and institutional infrastructure needed to maintain prudential standards also impede attempts toward harmonization. As growing liquidity finds its way into Islamic capital markets, Muslim and non-Muslim countries will require a new generation of practitioners who understand how the modern Islamic legal system, Western common law, and international finance integrally function in a global economic system.

As an integral part of the NBR's business model, key sponsorships and partnerships contribute to NBR's high quality research and analysis. We are thankful to the American International Group (AIG) and Japan Bank for International Cooperation (JBIC) for their leadership as Lead Sponsors in launching NBR's initiative on Islamic finance. As a key player in the Islamic insurance industry, HSBC Amanah Takaful's support underscored the timeliness of understanding the Islamic finance industry's rapid developments. Our partners—Bank Negara Malaysia, the American Chamber of Commerce in Malaysia, and Georgetown University's Berkley Center for Religion, Peace, and World Affairs—provided invaluable contributions in the form of subject-matter expertise and collaborative planning. We also want to express particular appreciation to Governors Zeti Akhtar Aziz of Bank

Negara Malaysia, and Shamshad Akhtar of the State Bank of Pakistan, for providing the opening and closing keynote addresses respectively.

Thanks to our sponsors, partners, and attendees—specialists, practitioners, and analysts representing the private and public sectors in the Washington D.C. area—the October 2007 conference laid the groundwork for NBR's future research efforts to inform U.S. financial institutions and regulators of the challenges and opportunities presented by the Islamic finance industry.

Tadashi Maeda, Director-General, Energy and Natural Resources Finance Department, Japan Bank for International Cooperation.

PROJECT OVERVIEW REMARKS

Emile Nakhleh, *Project Research Director, The National Bureau of Asian Research*

On behalf of The National Bureau of Asian Research, I would like to welcome you to this unique and very important conference. It gives me great satisfaction that only six years after the tragic events of September 11, 2001, we are gathered here, in a spirit of optimism and accomplishment, to examine Muslim contributions to international finance and banking.

It is also encouraging that despite the heinous crimes that a few Muslims, driven by their warped interpretation of the faith, have committed in recent years, we are meeting today to review the phenomenal growth of Islamic finance in the last decade and its ascendancy in the global economy. This conference is an affirmation of the positive contributions that Islam, as a religion and a community of the faithful, has made to business progress and prosperity in a globalized world. Islamic finance has played a key role in at least five areas:

- Bridging the gap between conventional finance and Islamic finance
- Creating linkages among nations and institutions that political conflicts have often kept apart
- Moderating relations between Muslims and non-Muslims
- Empowering average Muslim investors to enter the world of finance on a sure religious footing without fear of violating the teachings of their faith
- Educating non-Muslim financiers on the simple fact that in the final analysis Islam is not inimical to business and to making money

It is highly appropriate that at today's conference we are asked to examine Islamic finance in Southeast Asia because as we know Islam entered that part of the world many centuries ago through commerce and trade. *Da'wa* anchored in business and the entrepreneurial spirit has produced a moderate set of beliefs and practices, a more inclusive approach to human interactions or *muamalat*, and a more tolerant and pluralistic worldview.

- In this regard, it is equally appropriate to ask what roles do Islamic beliefs and social values play in pursuing Islamic finance and whether the rapid growth of Islamic finance in Southeast Asia and elsewhere has been driven by economic considerations or by a changing socio-religious-political landscape.

As Islamic finance and banking have become enduring global enterprises encompassing hundreds of billions of dollars in Southeast Asia, the Middle East, and the Western world, and as these enterprises have been able to marry a faith-based value system with successful business strategies, the timing of this conference is indeed propitious. I commend NBR for taking the lead in organizing this conference and in bringing together such world renowned authorities on the subject—academic and *sharia* experts, high-level practitioners in the world of finance, and senior officials from government and non-government institutions.

The three-fold organizing key objective of the conference is to:

- Examine the growing phenomenon of Islamic finance in Southeast Asia and globally
- Increase our understanding of this phenomenon, the factors that drive it, and its likely future trends

Emile Nakhleh

EMILE NAKHLEH was a Senior Intelligence Service Officer and Director of the Political Islam Strategic Analysis Program in the Directorate of Intelligence at the Central Intelligence Agency (CIA) for fifteen years before retiring in 2006. Dr. Nakhleh was a founding member of the Senior Analytic Service (SAS) and chaired the first SAS Council. He was awarded several senior intelligence commendation medals, including the Intelligence Commendation Medal (1997), the William Langer Award (2004), the Director's Medal (2004), and the Distinguished Career Intelligence Medal (2006). Prior to joining the CIA, Dr. Nakhleh was the John L. Morrison Professor of International Studies, and a Department Chair at Mount St. Mary's College, Maryland, where he taught for 26 years. He has lectured widely both in the United States and overseas, and has written and contributed to many books and journals on Middle East politics, state formation, US policy in the region, and the Arab states of the Persian Gulf. Dr. Nakhleh is a member of the Council on Foreign Relations.

- Explore opportunities for the policy communities, regulators, and financial institutions in the United States and other countries

The sessions and presentations throughout the day are designed to address this objective and offer analytic judgments as to where we see Islamic finance heading over the next decade or so. I look to our speakers to address at least four sets of key questions as we engage in our deliberations:

- What does Islamic finance really mean, how different is it from conventional finance, and who regulates it? How will the role of the Sharia Advisory Boards, as regulators of Islamic banking and finance, change now that Islamic finance is entering, in the words of one of our speakers, a "stage of adolescence"? What is the linkage between political Islam and Islamic economics, and will growing Islamization and increased piety among Muslims drive them to expand their participation in Islamic finance or will they move away from it fearing excessive entanglement in non-sharia compliant operations?
- How will non-Muslim governments and financial institutions adjust to Islamic finance and incorporate it in the global economy without getting entangled in religion or religious supervisory institutions and regulatory bodies of *ulama* or *fuqaha*? Will investment pragmatism trump religious moral and legal teachings should conflict erupt between global banking institutions and Islamic regulatory entities? Or will such a question be rendered irrelevant as financial transactions become more complex?
- What is the long-term strategic impact of Islamic finance on state and non-state actors and how will major financial institutions—government and private—adjust to and incorporate Islamic financial requirements in their transactions? To whom will they turn for advice and authority on what is permissible (*halal*) and what is forbidden (*haram*)?
- As Islamic finance becomes more sophisticated and more entangled in global banking and investment houses, how will it impact the average Muslim investor, and will such an investor be able to decipher the web of transactions or parts of such transactions and decide whether his investment remains sharia-compliant? As cash moves from one bank to another, and as more and more financial institutions get involved in the process, how can the average Muslim, who embarked on a certain investment because of *taqwa* (piety), be sure that a particular transaction along the way that was initiated by halal means did not end up in violation of Islamic injunctions?

Debate is raging within the Islamic finance industry about how to apply traditional Islamic jurisprudence, revealed in 7th century Arabia, to a 21st century highly globalized, fast moving, and business driven world. I trust our deliberations will address the following additional question: What tools or metrics does the industry have to measure whether a specific transaction is sharia-compliant from beginning to end, especially as the transaction races through the pipeline of global banking institutions?

Enhancing Interlinkages and Opportunities— The Role of Islamic Finance

Zeti Akhtar Aziz, *Governor, Bank Negara Malaysia*

OPENING KEYNOTE ADDRESS

Zeti Akhtar Aziz

It is my great pleasure to be here in Washington, D.C. to speak at this important conference which has brought together policymakers, market practitioners, members of academia and the business community to discuss the new opportunities in Islamic finance and its role in enhancing international financial linkages. It is exactly five years ago, when I spoke on this very subject of Islamic finance at the First International Islamic Finance Conference that was held in Washington, D.C. in 2002. The issues discussed at that time were on the challenges faced in developing an efficient and robust Islamic financial system. Five years hence, the Islamic financial system has evolved significantly to become a dynamic and competitive form of financial intermediation in the global financial system. This transformation has been achieved in an increasingly challenging environment.

My remarks today will focus on this transformation that has taken place in these five years in both the national and international Islamic financial system. Most significant has been the development of the Islamic financial markets, the increase in the range of the financial products and services, the increasing significance of the international dimension of Islamic finance, the development of the international Islamic financial architecture, and the enhanced international interlinkages that has been brought about by these developments.

Transformation of the Islamic Financial Landscape

As recent as five years ago, the development of Islamic finance was regarded as an infant industry striving to prove its viability and competitiveness. At that time, the growth of Islamic finance was organic and largely concentrated in countries where the Muslim population was significant. In these five years, Islamic finance has recorded dramatic growth and has a presence in more than 75 countries in Muslim and non-Muslim dominated communities. A growing number of the international financial centers that are beginning to offer Islamic financial products and services such as in London, Singapore and Hong Kong. The number of Islamic banking institutions worldwide including conventional banks that are offering Islamic banking services have doubled to more than 300. The total Islamic financial assets under their management is now estimated to exceed US$1 trillion, about fivefold its magnitude five years ago.

Islamic finance is now among the fastest growing financial segments in the international financial system with an estimated average annual growth of between 15 to 20%. More recently, there has been a growing diversity in the range of products and services being offered and in the markets that have been developed. The *sukuk* market, that is the Islamic bond market denominated in international currencies, has registered a remarkable growth, having doubling in size to amount to US$28 billion compared to a year ago. Including sukuks denominated in domestic currencies, the size of the market is now about US$82 billion. This market is expected to continue to expand significantly given the massive financing requirements for infrastructure investment and other private sector investment by countries that have shown interest in Islamic funding.

ZETI AKHTAR AZIZ has served as Governor of Bank Negara Malaysia since May 2000. She has been with the Central Bank since 1985, in a career spanning several senior positions in monetary and financial policies, and reserve management. She has written extensively in the areas of monetary and financial economics, Islamic finance, capital flows, macroeconomic management, financial reform and restructuring. Dr. Zeti is actively involved in the development of Islamic finance and in regional financial co-operation. Prior to her career in the Bank, Dr. Zeti had served in the SEACEN Centre from 1979–84, where she conducted research in the area of financial policies and reform in the Southeast Asian region.

There has also been significant innovation in Islamic financial products. This has been especially evident in the sukuk products. Following the Malaysian Government issuance of the world's first global sovereign sukuk in 2002, there has been several other sovereign sukuks issued by other countries. This development has also encouraged the issuance of international corporate sukuks by multinational and domestic corporations. Innovative instruments that have been developed include the landmark issuance in 2006 of the exchangeable sukuk by Khazanah Nasional, the Malaysian sovereign wealth management entity. In this arrangement, the sukuk can be exchanged for other shares held by Khazanah. In the same year, a convertible sukuk, in which the sukuk can be converted to the issuer's own shares upon initial public offering, was issued by a Middle Eastern-based corporation. The derivative market has also been developed with the introduction of Islamic currency swaps and profit rate swaps.

There has also been significant growth in Islamic asset and wealth management following the development of diverse and innovative structures of Islamic investment funds, including Islamic hedge funds. There are now more than 250 *sharia*-compliant mutual funds that are managing an estimated US$300 billion in assets. Other developments include the creation of benchmark indices such as the Dow Jones Islamic Market Indexes—covering more than US$10 trillion market capitalization in over 40 countries, the Financial Times Stock Exchange Global Islamic Index Series, and the listing of Islamic financial instruments on international exchanges. These developments have enhanced the depth of the Islamic financial markets as an attractive asset class for investment.

> This new international dimension of Islamic finance has further enhanced the international interlinkages in this more globalized environment.

Another important development in Islamic finance during this period has been the strengthening of the international Islamic financial architecture. In 2002, a major structural enhancement was the establishment of the Islamic Financial Services Board (IFSB), which formulates the international regulatory and prudential standards for Islamic finance. It has since issued the standards for capital adequacy, risk management and corporate governance. Among the standards that are currently being formulated include market conduct and rules for financial disclosure, transparency, the sharia governance framework, and the supervisory review process. This is to ensure best practices and the soundness and stability of the Islamic financial system.

The IFSB now has 137 members that include 35 regulatory and supervisory authorities, five international inter-government organizations including the Bank for International Settlement (BIS), the World Bank and the IMF, and 97 market players and professional firms from 22 jurisdictions. Of significance to note is that the membership of the IFSB comprises several authorities and international institutions from the non-Muslim countries. The IFSB complements the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) which was established earlier in 1991, to set the accounting standards to ensure that the true and fair value are reflected in the financial transactions and to ensure greater accountability and responsibility of the financial institutions.

Finally, these developments have been reinforced by greater liberalization to increase the international dimension of Islamic finance. With increased international participation in Islamic financial markets, it has prompted increased cross-border Islamic financial flows. In addition, Islamic financial institutions that had previously operated only in their own domestic jurisdictions have begun to venture abroad to tap new growth opportunities in other regions. This new international dimension of Islamic finance has further enhanced the international interlinkages in this more globalized environment.

Islamic Finance: Operating in a Challenging and Evolving Environment

The evolution and expansion of Islamic finance has occurred in a fast-changing and dynamic international environment. In the context of a more challenging and competitive environment, the issue of financial stability, viability, and competitiveness are paramount. This is particularly evident in the recent developments experienced in the international financial system. An important element of Islamic finance is the strength and soundness it derives from its sharia principles. Islamic finance has an inbuilt dimension that promotes soundness and stability, underpinned by the sharia injunctions. These sharia injunctions essentially interweave the financial transactions with genuine productive activities.

The soundness and viability of Islamic finance as a form of financial intermediation is premised on the fundamental requirement that Islamic financial transactions need to be supported by an underlying productive activity. There is therefore always a close link between financial and productive flows. The financial transaction has to be accompanied by genuine trade or lease-based and business related transactions where interest is eliminated and profits or rentals are the economic rewards. Alternatively, the Islamic financial institution may enter into a joint venture as a means of financing, in which it becomes a joint partner in the economic activity based on a pre-specified profit-sharing arrangement. In addition, there are also explicit restrictions on unethical and speculative financial activities.

The intrinsic nature of Islamic finance also encourages risk management and provides confidence through explicit disclosure and transparency of the roles and responsibilities defined in the contract. In Islamic finance, strategies to minimize and manage the risks involve integrating the risks in the real activities. The real activities thus need to generate sufficient wealth to compensate for such risks. In contrast, conventional instruments generally separate the risks from the underlying assets. As a result, risk management and wealth creation may, at times, move in different or even opposite directions. Conventional financial instruments also allow for the commoditization of risks, leading to its proliferation through multiple layers of leveraging and disproportionate distribution. This could result in higher systemic risks, increasing the potential for instability and inequitable concentration of wealth.

The intrinsic principle of governance also contributes toward insulating the Islamic financial system from potential risks from excessive leverage and speculative financial activities. The explicit and transparent nature of Islamic financial contracts and the greater disclosure of information are important in contributing to the stability of the system. The focus of Islamic investment also not only involves *riba* (interest) free activities but also extends to include issues related to ethical values and fair trade. The Islamic investment guidelines thus share a number of similarities with socially responsible investment (SRI) principles.

New Opportunities and Linkages Offered by Islamic Finance

Islamic finance is now at the threshold of a new dimension in which it has an increased potential role to strengthen international financial interlinkages between nations. Islamic finance has the potential to contribute toward the efficient mobilization and allocation of funds across regions. Regions with surplus savings may channel funds to regions with deficit savings and to bring about a more inclusive global financial integration. Financial linkages are now gaining ground as intra-regional financial flows are increasing in significance. In this context, Islamic finance has become a new vehicle contributing to increasing the financial linkages within Asia thereby facilitating cross-border allocation of capital in the region. However, it not only has a potential role in strengthening integration and linkages within Asia, but also more importantly in forging linkages with other dynamic emerging regions such as the Middle East.

Several economies within Asia are now beginning to participate in these trends thus strengthening further economic and financial linkages between these two dynamic growth regions. These enhanced inter-regional linkages between Asia and the Middle East have created an environment of activity reminiscent of the Old Silk Road. This suggests that a New Silk Road has emerged in which financial services providers across continents now operate on this new route. While the New Silk Road reflects the linkages between Asia and the Middle East, the Silk Road has always been extended to the rest of the world. There is thus the potential for greater participation by global investors and the international financial community.

Islamic finance essentially presents value proposition for both investors and issuers in the respective markets, in particular, the sukuk market. For investors, Islamic financial products offer portfolio diversification and new investment opportunities in the form of new asset classes. For issuers, Islamic finance allows access to a new source of funds and liquidity besides providing new risk management options and new mechanisms for price discovery. A number of international financial centers have recognized Islamic finance as an integral part of their financial markets in order to complete the suite of financial products and services available, and are therefore actively developing this segment. This trend is envisaged to stretch the New Silk Road from Asia and Middle East and extend to the West and to other parts of the world.

Further Opportunities: The Sukuk Market

Among the more significant developments in Islamic finance in the recent period has been the development of the sukuk market. Although the size of the sukuk market is modest by global standards, the sukuk market has experienced remarkable growth, increasing at an average annual rate of growth of 40%. This growth is spurred in part by the growing funding requirements in emerging market economies, in particular, in Asia and the Middle East in which there has been increased investment activity. There has also been significant demand for the sukuk spurred by the high levels of surplus savings and reserves in Asia and the Middle East. This strong demand has also been reinforced by the strong financial flows in the international financial system that is in search of higher returns and greater diversification of risks.

It has been estimated however that about 80% of the sukuks issued have been subscribed by conventional international investors. Besides the intrinsic value of the sukuk which are largely asset-backed, convertible for shares or exchangeable with shares, such issuances are attractive as they have a wider investor base that comprise conventional and Islamic investors. With the rising wealth of global investors seeking sharia-compliant investments the market has become highly competitive. More recently, it has prompted corporations worldwide including global multinational companies to consider this as a financing option.

> These enhanced inter-regional linkages between Asia and the Middle East have created an environment of activity reminiscent of the Old Silk Road.

The development of the sukuk market in Malaysia has involved extensive and wide ranging initiatives that include facilitating an efficient issuance process, enhancing the price discovery process, establishing of a benchmark yield, broadening of the investor base, promoting the liquidity in the secondary market, and strengthening further the legal, regulatory, and sharia framework. These initiatives have also been supported by the development of the financial infrastructure including the settlement system and the bond information system.

To position Malaysia as a center for origination, distribution and trading of sukuk, further steps have been taken to liberalize the market to allow foreign corporations including multinational corporations and multilateral agencies to raise funds in the Malaysian bond market. Funds raised by these entities may be used to finance investment activities in other jurisdictions. The inaugural ringgit denominated sukuk issue was in 2004 by the International Finance Corporation, and followed by an issue by the IBRD World bank in 2005. In 2006, the market was further liberalized to allow foreign currency denominated sukuks to be issued from the Malaysian market. These sukuk issues have attracted foreign investors, thereby strengthening our inter-linkages with other international financial markets. Profits or income received by non-residents for investments in ringgit and non-ringgit Islamic securities issued in Malaysia are also exempted from withholding tax. In addition, the Malaysian government has granted tax neutrality measures to accommodate the sukuk issuance.

To further enhance Malaysia's international financial linkages with other parts of the world, the domestic Islamic banking sector was liberalized further in 2004 with the issuance of new licenses to foreign Islamic financial institutions. In addition, the allowed foreign shareholding in Islamic financial institutions was raised to 49% of the total equity in existing Islamic financial institutions. New licenses are also extended to entities to conduct Islamic banking business and *takaful* and re-takaful business in international currencies. These institutions, which may have up to 100% foreign equity ownership, are given operational flexibility to be established as a branch or subsidiary and enjoy a tax holiday for 10 years under the Income Tax Act.

Conclusion

The foundations for the sustainable global development of Islamic finance have now been put in place. Going forward, three key elements will be important in sustaining the current momentum. These include the investment in research and development and hence promote innovation, the development of the pool of talent, and the greater use of technology in Islamic finance.

Islamic finance as an emerging form of financial intermediation requires tremendous investment in research and development to promote innovation. Of importance is to develop a broader range of Islamic financial market instruments that include instruments with equity ownership features, Islamic asset-backed securities, inclusion of permissible forms of credit enhancements as well as sharia-compliant risk mitigating instruments. The development of an Islamic derivatives market for hedging is required for market-making activities to support the development of secondary markets. Malaysia recently established a sharia scholar's fund to fund such research and development efforts. The fund also aims to promote greater engagement among the international sharia scholars and thus provide a platform for deliberation on the sharia compatibility of newly developed Islamic financial instruments and markets.

As Islamic finance continues its robust international expansion, an adequate supply of talent and expertise is vital to support the growth. While shortages in talent are now being felt, this is being addressed on several fronts. To develop the expertise to meet the increasing manpower requirements of Islamic finance, Malaysia has in 2006 established the International Centre for Education in Islamic Finance (INCEIF). It is envisioned that INCEIF acts as a professional certification body and education institute for post-graduates in Islamic Finance. Reinforcing this is the International Centre for Leadership in Finance (ICLIF) in Malaysia that provides for leadership and management programs for the financial services sector including for Islamic finance.

As Islamic finance forges ahead, successful Islamic financial institutions will be those that have the scale and are able to exploit the full potential and opportunities that arise from the advances in information technology (IT). In embracing new leading edge technology, the potential for the Islamic financial industry to provide new products and services will be enhanced. It also represents the potential to increase access through a wider range of new delivery channels, including enhancing efficiency while reducing costs for consumers and businesses. IT needs to be leveraged on in making strategic decisions in the alignment of the business, in elevating the institutional capacity and operational efficiency and strengthening risk management capabilities.

Despite the more challenging and dynamic environment, Islamic finance has continued to emerge as a vibrant and resilient form of financial intermediation that is increasingly being embraced on a global scale to become an integral part of the international financial system. In the process of its development, it has further expanded the set of opportunities for the participation by the international financial community and thus increases the interlinkages both within and between economic regions of the world. In enhancing these new linkages and greater integration, Islamic finance is envisaged to contribute toward unlocking new potentials that would bring mutual benefits, and in doing so, enhance our overall prospects.

Islamic Justification and Authority in Islamic Finance: Current Debates within the Industry

Frank E. Vogel, *Harvard Law School*

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Currently vivid debates are raging within the Islamic finance industry about its religious justifications. Key opinion-makers in Islamic finance—religious-law scholars ("sharia scholars," *fuqaha*) who issue *fatwas* allowing or disallowing transactions, leading theoreticians of Islamic finance and economics ("Islamic economists"), and important industry practitioners ("Islamic bankers")—carry on these debates with the conviction that they are crucial to the future of the industry.[1] From these debates will emerge trends likely to shape the industry for a long time to come.

During the last three years or so Islamic finance seems to have entered a stage of heightened self-examination. It is as if it is an adolescent that has survived its infancy and early childhood and now wants to ask basic questions about who it is, what life is all about, and what it should do in the future. The industry is re-examining decisions made earlier in the push to ensure that the industry gets established and survives. What is the ideal for Islamic finance to work for? Does the industry's current trajectory lead toward that ideal? Are present practices too affected by past practical compromises? For example, economists are returning with new insistence to one of the oldest disagreements within Islamic finance. The original inspiration for Islamic finance was *mudaraba*, a classical partnership form by which capital is rewarded only by a share of the actual profits of a venture, according to a pre-agreed percentage, and, if the enterprise should suffer losses, bears the entire loss. Islamic banks themselves are set up using this model. But when it comes to Islamic bank investments, in practice Islamic finance institutions use mudaraba very little, favoring instead forms of sale on credit or lease, both of which allow much closer analogies to interest-lending. Nowadays the Islamic legal scholars defend sale and lease as equally as Islamic as mudaraba, while much easier to use. The best known of these credit sale transactions is *murabaha* or sale on markup.

In the midst of such soul-searching new developments in transaction design have surfaced which further force the issue. These include *tawarruq*, a transaction by which a customer purchases a commodity from a bank on credit and immediately resells the commodity to a third party for cash, the second sale usually arranged by the bank. The commodity is not sought for its own sake, but only to facilitate the extension of credit; usually a dealer in the commodity stands at both ends of the transaction. Other suspect transactions are swaps of returns between holders of Islamic investments and holders of conventional ones, and ever-cleverer ways of cordoning off Islamically suitable components within larger transactions otherwise non-Islamic. With these flexible, multi-use innovations, critics say, Islamic finance could become virtually identical to conventional finance, except for some added transaction costs. Many consider much of current practice to be mere legal artifices (known as *hiyal* classically), combinations of transactions designed to produce indirectly a result that would be unlawful if done directly. With such stratagems available and so convenient, they fear, any meaningful distinctions from conventional finance will soon be lost.

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[1] For two recent books by representatives of the two most important groups in this debate, see Muhammad Taqi Usmani, *An Introduction to Islamic Finance* (The Hague, Boston: Kluwer Law International, 2002) (sharia scholar) and Mahmoud A. El-Gamal, *Islamic Finance: Law, Economics, and Practice* (Cambridge: Cambridge University Press, 2006) (economist).

For all these reasons we now see vigorous debates among leaders in the industry about what Islamic law compliance means. I have had the opportunity to observe some of these debates first-hand, and am impressed with the significance and sincerity of the questions being asked. Also very much on the table is the issue of authority: who shall answer these questions. The questions asked go to the heart of how Islamic law is to be understood, lived, experienced, applied and enforced today, and not only in the commercial or financial sphere.[2]

Let me give a quick list of some of the questions on the table. I shall raise issues at four levels: 1) basic questions about how religion and law relate within Islamic finance; 2) the religious meaning and purpose of Islamic finance; 3) the methodology of interpretation in sharia, and 4) the persons and institutions that apply sharia in Islamic finance. As will be seen, issues at the various levels often interpenetrate and overlap.

With regard to the relationship between religion and law and how they relate to each other in shaping legitimacy in Islamic finance, the questions are almost theological ones, often age-old. Three key questions are worth examining.

First, in evaluating Islamic finance transactions, should the process of reasoning employed be exclusively that of traditional Islamic jurisprudence (*fiqh*) itself, for which the verbal interpretation of revealed texts is paramount and considerations of contingency, utility and expediency mere makeweights? Should fiqh reasoning be broadened to give greater effect to ordinary human reasoning, such as by attempting to know the divine purpose (*hikma*) behind a divine ruling, and then favoring it even sometimes at the cost of neglecting literal compliance with the ruling itself? How can this divine purpose or hikma be determined without mere human reasoning entering in, distorting revealed truth? If God had intended purposes to guide law, why did He reveal detailed rules? Then, if divine purposes are to be considered, how much should these be understood in worldly, not otherworldly, terms?

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The second question is that of hiyal, legal artifices—a point on which fiqh scholars in the past fundamentally differed, some permitting them, others condemning them. Is it right for law to judge a transaction according to a presumed intention of the parties, its apparent purpose, rather than by simply parsing the legality of its constituent steps, its form? Should tawarruq, for example, be condemned as obviously intended as a loan of money, or allowed because its constituent sales offend no rules? Modern minds often see no value in rote obedience to form when form serves no rational purpose. But still, religiosity often expresses itself through pious adherence to formal dictates, even, sometimes especially,

[2] The debates go on at all fora where the future of Islamic finance is discussed, though usually on the margin of such gatherings. These include the industry's numerous conventions and conferences around the globe, sessions of international industry organizations, and interactions of economists and legal scholars at research institutes and meetings of international doctrine- and standard-setting bodies. The most active participants in these debates are those adhering to Gulf-country sharia standards, wherever these are applied, rather than the standards of Malaysia and other Southeast Asian countries.

when these defy reason, this both in Islam and in other religions. Revered early scholars of fiqh devised hiyal and wrote books collecting them.

A third question is how to weigh the fact that fiqh is after all a law, one that served as the common law of actual legal systems for over a millennium. Its detailed content covers chiefly private or civil law. Is it right to expect that the fiqh of transactions (*fiqh al-muamalat*) alone, preoccupied as it is with concrete, individual exchanges, should serve as the chief guide toward fulfilling the ideals of Islam in commerce, finance and economy? Shouldn't Muslims emphasize as much other streams of interpretation of God's revelation, also often included in sharia, such as theology, ethics, equality, community solidarity, or sound governance?

The second level is that of the religious-legal meanings and purposes of Islamic finance: what makes finance Islamic? Two issues deserve careful consideration:

First, is Islamic finance or economy superior to conventional forms of finance or economy judged under neutral, objective criteria? Some say it is and make this a methodological premise; others say such a question is irrelevant.

Second, does Islamic finance have a social mission? Is it merely a profit-making business that complies with traditional fiqh? Or is it rather expected to serve as the first step, as a crucial catalyst, to inaugurating some broader Islamic ideal socio-economic condition? But if the latter, is it fair to expect so much of a business still devoted chiefly to commercial and investment banking? How much of the burden belongs to other actors within the Muslim community? Particularly, how much of this burden has to be shouldered by individual charity, social institutions, charitable endowments (*awqaf*) and governments?

The third level of debate is that of the fiqh methodology, its method of deriving rules from scripture, as practiced in Islamic finance. Will the age-old prestigious methodology as wielded by ulama be sufficient for the success of Islamic finance? Here there are three points.

First, again, what role should be assigned to other forms of normative reasoning, particularly ordinary utilitarian policy analysis?

Second, how broadly or narrowly is recognition to be given to changes in times and circumstances? Though Islamic legal theory acknowledges that changes in circumstance can affect legal rulings, yet legal opinions rarely refer to the vast changes in circumstances occurring since the original fiqh was developed. There is a near total disinterest in legal and economic history, even though that history would seem essential to appreciate fiqh writings stemming from those eras.

Third, many in the industry now call on Islamic legal scholars to give greater emphasis to *maqasid al-sharia* (objectives of the sharia) and *maslaha mursala* (general utility). These are medieval theories advocating greater use of utilitarian and consequential reasoning in fiqh—theories which, however, remained largely either philosophical or outside the mainstream. The point of such appeals is generally to press legal scholars to give more thought to—and Islamic finance institutions to make greater sacrifices for—general socio-economic ideals sounded in the Quran such as charity to the poor, preventing wealth from circulating only among the wealthy, achieving social justice, or quelling corruption. But as always when maqasid al-sharia and maslaha mursala are invoked, the issue arises whether these tools may be wielded solely by fiqh scholars, on the grounds that deep knowledge of revealed texts is crucial to using them properly and that the utilities and consequences most to be favored are those about religion. Or, to the contrary, should they be entrusted partly or entirely to non-scholars, such as Islamic economists, who know best how to measure this-worldly utilities and consequences?

The fourth and final level is that of the legal system that governs Islamic finance, by which I mean not the formal legal system of any country, but the effective "legal system" governing Islamic finance, the authorities—whether persons, governments, or institutions public or private—that determine and apply law to Islamic finance. Here I consider three such authorities, taking up various issues under each.

The first authority to be considered is that of the Islamic-law scholars, called *ulama* or *fuqaha*. The ideas of these scholars, who hold themselves out as private experts, are an overwhelmingly important influence on the course of Islamic finance, since they exercise, almost exclusively, the authority to decide what is Islamically permitted or not, operating through "sharia boards" within Islamic finance institutions or through various doctrine and standard-setting institutions where they meet to issue joint opinions. As to their authority, three issues are currently in debate.

The first concerns whether fatwas, i.e., the opinions of private scholars on discrete transactions privately solicited, are a sufficient method by which to "legislate" in Islamic finance. Typically Islamic banks establish their own sharia board to vet and approve proposed transactions (several countries, notably Malaysia, have unified, and nationalized, this process using a single government fatwa board). Some argue that sharia board opinions lack regulatory oversight and can fall prey to conflicts of interest, self-dealing, incompetence, lack of uniformity, and so forth. But to make these criticisms is to criticize the way fiqh has always been developed—by ulama whose authority has rested fundamentally on private learning and popular respect, outside the control of governments. Diversity of fatwas has assured flexibility and pluralism in law. Given this, should steps be taken to change the age-old way in which fiqh has been generated? Will this change the essential function of fiqh itself, such as by inviting in the heavy hand of government? If fatwas are kept as the method, how then to prevent abuses which would be acknowledged by fiqh itself (conflicts of interest, etc.)? In the past ulama exercised forms of self-regulation to avoid abuses—will they do so again?

Second, issues arise as the micro-approach of legal scholars, their characteristic focus on individual transactions and their forms. This largely replicates the issue of how much the Islamic finance industry as it now stands—consisting chiefly of commercial banks and defining itself operationally as business conducted in obedience to fiqh contract and property rules—should be charged to work toward the larger socio-economic objectives for Islamic finance identified by other writers.

Third, related issues arise as to narrowness in the expertise of legal scholars. Critics argue that the scholars lack sufficient breadth of knowledge and experience to make decisions governing the whole industry. So the question seems to be whether the process of decision on sharia-compliance—either in regulatory bodies or in individual financial institutions—should be widened somehow to give non-scholars an equal voice.

The second major authority to consider, a second part of the functional legal system of Islamic finance, is government, as well as entities performing functions of government such as the industry's own internationally organized self-regulating institutions. Government and industry bodies are moving away from a pattern where they simply hindered or enabled Islamic finance to a pattern of attempting actively to shape it. Malaysia, United Arab Emirates and Bahrain are competing to offer regulatory and institutional environments supportive of Islamic finance.

Under Islamic legal theory government has authority—under a doctrine called *siyasa shar`iyya*—to act legally, under standards considerably freer and broader than those of fiqh, in support of the general utility. Thus, under Islamic legal theory one would naturally look to the government to fulfill many regulatory and administrative functions, and even law-making in support of them. Of course, now governments do regulate Islamic finance institutions extensively, and no one opposes it. One could also imagine governments and private organizations performing similar roles in establishing new institutions to further the cause of an Islamic economic order, like special markets through which otherwise prohibited trade, such as in various derivatives, could be permitted under controlled conditions. The point here seems to be the need, as Islamic finance matures, for its key players to work collectively and, assuming the same point of view of a hypothetical benign government, to use not only fiqh-doctrinal but also institutional means to further the goals of Islamic finance.

The third and final authority within the functional legal system governing Islamic finance is the public itself. The public's enthusiastic embrace of Islamic finance, even in its present form, has caused it to grow decade after decade at double-digit annual percentage rates. Muslim publics everywhere are becoming more conscious of and informed about Islamic finance, and its practices and players, and sometimes even about the opinions of leading thinkers.

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The Muslim public has always played a central role in the Islamic legal system. Its problems, customs, support, and willingness to accept offered solutions always had a formative role on fiqh's content. The public determined ultimately who among scholars had the most influence and prestige. Here questions arise as to whether the elites in Islamic finance—investors, practitioners, legal scholars, theoreticians, and regulators, each group with its own perspective—will trust the Muslim public to decide the future of Islamic finance, and empower them through increasing education and transparency. But the elites worry: will the popular "market," both commercial and religious, sufficiently protect Islamic legitimacy and prevent abuses, as understood by these elites?

To conclude, debates such as these, in a field where traditional fiqh has been successfully applied in a sphere of life that is sophisticated, modern and globalized, should attract the attention of anyone interested in understanding the future of fiqh applications in any area. For one thing, the experience of Islamic finance indicates that applying sharia in itself need not lead to extremism, rejection of western values, or empowering reactionary social groups, and that those private initiatives under an Islamic banner can usher in improvements in Muslims' lives without engendering social, political and international strife.

Yet current debates in Islamic finance reveal underlying strains that may surface wherever Muslims strive to revive sharia while understanding sharia chiefly as the textbook rules of the fiqh of the past. Will Muslims, seeking to fulfill the manifold ideals of their religion for their worldly lives, continue to depend so exclusively on a largely traditional fiqh and on religious legal scholars for authoritative guidance? Or will they increasingly supplement these from other age-old sources within their religion and evolve new Islamic institutions and authorities? To what extent will fiqh scholars themselves find a largely traditional fiqh and its methods insufficient and adopt new (or revive old) methods, practices, roles, institutions, and partners for themselves?

Global Trends in Islamic Finance: Social Legacies and Institutional Variation

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The global expansion of Islamic banking and investment was one of the most important developments in financial markets during the last two decades of the twentieth century. Although a few years earlier small institutions based on Islamic principles of finance had been established in Malaysia (with its interest-free Pilgrims Savings Fund, founded in 1956) and Egypt (which saw the establishment of interest free-savings/investment houses in 1963), the first broad-service and privately-owned Islamic bank opened in Dubai only in 1975. Islamic financiers in Egypt (1977), Jordan (1978), Bahrain (1979), and Kuwait (1977) soon followed suit. In 1979, the cause of Islamic banking seemed to receive an even bigger boost, as Pakistan became the first country to implement a top-down Islamization of its banking sector. The effort was followed in 1983 by state-imposed bank restructurings in Sudan and Iran.

During the remainder of the 1980s, however, it seemed as if the movement for the establishment of Islamic financial institutions was faltering. Certainly and significantly, Qatar (1982), Tunisia (1983), Turkey (1985), and Saudi Arabia (1988) joined the ranks of countries legalizing Islamic finance. However, even in countries where interest-free financial institutions were established, operational limits were imposed on the new institutions, sometimes by the very governments that had approved their founding. In the face of these and other events, the movement for Islamic finance hesitated. The reasons for the hesitation after the earlier period of growth were varied, but one issue was government and conventional bankers' concerns regarding two issues:

- Whether the establishment of Islamic banks might boost the fortunes of political radicals opposed to the government. In some countries this concern was amplified by the association of demands for Islamic finance with radical movements and the relatively radical governments in Sudan and Iran.
- Whether the designation of one segment of the financial market as "Islamic" might negatively impact the conventional banking sector. This concern was expressed even in socially conservative countries like Saudi Arabia, where the governing elite and many wealthy business families worried that calling a bank "Islamic" might imply that conventional banks were irreligious. That concerns like these were widespread was understandable inasmuch as, since early independence, national governments had worked hard to operationalize a conventional banking sector. To expose the system to allegations that it was "un-Islamic" might jeopardize this hard-fought achievement.

The hesitations seen in Islamic finance's development during the 1980s, however, soon gave way to a second round of institutional expansion in the 1990s. During that decade, governments in most (but not all[1]) remaining Muslim-majority nations authorized the establishment of Islamic financial institutions in their territories, and globally Islamic finance grew at a rate of more than 10% per annum. Today, there are more than 200 Islamic financial institutions with assets in excess of US$12 billion and capitalization in excess of US$250 billion. Equally important, leading conventional banks like Citibank,

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1 As of this writing, Islamic banks are still absent from Iraq, Libya, Morocco, Oman, and Syria, and their operations are limited in Algeria, Lebanon, and Tunisia. See Clement M. Henry and Rodney Wilson, "Introduction," in Henry and Wilson, eds., *The Politics of Islamic Finance* (Edinburgh: University of Edinburgh Press, 2004), pp. 6–10.

Deutsche Bank, and HSBC have opened Islamic windows in Muslim-majority countries, as well as in Western countries.

Ironically, the integration of interest-free Islamic savings and finance into conventional banks has raised concerns among some Muslim jurists. They worry that the capital raised through *sharia*-based programs may be mixed with funds accumulated through financial instruments that do not otherwise conform to the principles of Islamic economics.

Notwithstanding this concern, the introduction of Islamic financial instruments into conventional banking illustrates the continuing and impressive integration of Islamic finance into the global economy. This development has the potential to draw millions of otherwise hesitant Muslim investors into an economic system about which many once had reservations. By giving those who would otherwise be outside the system a stake in its operations, Islamic finance has the potential to improve popular welfare and, to a significant degree, moderate the aspirations of political groupings that might otherwise oppose their governments' development programs.

Islamic Banking as a Force for Moderation

Having acknowledged Islamic finance's impressive growth, in the remainder of my remarks today I want to talk briefly about variation in the organization and progress of Islamic finance across the Muslim worlds, paying particular attention to the way in which local social and political factors have affected the sector's development in different countries and regions. The hesitant growth experienced in the 1980s was indicative of the more general fact that, as with all entrepreneurial endeavors, the health of Islamic finance depends on the political and social setting in which it is embedded. More than local culture or jurists' judgments on the meanings of Islamic law, the embedding of Islamic financial institutions in state and society has been, and remains, the most important determinant of the financial system's progress.

Before discussing this variation in Islamic finance's development, I think it is important to put to rest the embedding of Islamic banking imagined by some Western observers: namely, that Islamic finance and investment have expanded because they are part of some radical political program, such as financing extremist violence. From both press reports and my own participation in open and unclassified policy meetings in Washington, D.C. since September 2001, it is clear that, in the immediate aftermath of the September 11 events a number of policy analysts with little or no experience with Islamic banking became concerned that one of its aims might be to fund terrorism. In the weeks following September 11, the U.S. government moved to investigate the financial infrastructure that had provided some of the funding for the attacks. The European Union, Saudi Arabia, and more than sixty other countries quickly followed suit.

Investigations soon revealed that wire transfers of funds had indeed taken place prior to the September 11 attacks. As investigations advanced further, evidence also indicated that several private Saudi investors, and allegedly, an Islamic Bank (al Taqwa), had unwittingly developed financial ties with al Qaeda and/or political groups that the United States government had alleged to be terrorist in nature.[2] Whatever the final verdict on these specific allegations, evidence gathered since September 11, as well as the long-established academic literature on Islamic banking and investment, make one thing clear:

> There is no evidence that Islamic finance as a system has ever been involved in providing support to movements of a terrorist nature. Indeed, rather than being an instrument of political radicalism, Islamic banking is a force for moderate social conservatism, of the sort that might be compared in an earlier European setting to Christian democracy.

The main reason Islamic finance is a force for moderation or moderate social conservatism is not just that the institution is concerned with conforming to what is perceived by many (albeit not all) Muslims as a religious injunction prohibiting interest on capital.[3] Rather, it is that, in the controlled political and economic environment of modern states, efforts to establish Islamic financial institutions always have to pass through a host of regulatory and political hurdles, which oblige the proponents of Islamic banking to build broad-based coalitions in support of their cause. Rather than being a force for radicalism, the coalition-building required to promote Islamic finance has led most of its proponents to distance themselves from oppositional politics of any sort, and instead to build support among mainstream actors in state and society.

Economic Dynamism through Coalition-Building

Leaving aside the top-down Islamization of banking seen in countries like Sudan, Iran, and Pakistan, Islamic banking has proved to be most dynamic where it has won the support of three social constituencies well known for their aversion for radical activism. The three groups are the following:

1) The *ulama,* i.e., the classically trained religious scholars who historically have been responsible for the study and transmission of the Islamic sciences, the most important of which is *fiqh* (jurisprudence)

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2 However circumscribed the allegations, they remain highly controversial. For an overview that is itself controversial, see J. Millard Burr and Robert O. Collins, *Alms for Jihad: Charity and Terrorism in the Islamic World* (Cambridge: Cambridge University Press, 2006), pp. 51–76.

3 Although Islamic finance has now moved well beyond its founding preoccupation with the prohibition of interest, for many in the first generation of bank founders, and for many in the Muslim public today, the central principle of Islamic banking is to avoid riba, interpreted as interest on capital in any and all forms. The Quran, verse 2:278 prohibits riba outright. Where things become cloudier, however, is in the translation of the term itself. Today most scholars translate riba translated as "interest" on capital in any form, but other Muslims, including a minority of religious scholars, dispute this translation. They point out that in Islam's first centuries some jurists interpreted riba as referring not to interest on capital per se, but only the usurious forms of interest once widespread in Arabia, default on which could result in one's being condemned to debt-bondage. It is predatory arrangements like these, some jurists still insist, to which the prohibition on riba really applies. By the Middle Ages, however, the majority of jurists adopted the broader position, insisting that the prohibition on riba referred to all forms of interest on capital. Notwithstanding this near consensus, the practice of lending money with interest remained widespread across the medieval Muslim world; it remains so today. In the early twentieth century, Western banks began to play an important role in the economies of Muslim-majority countries. The sudden growth of conventional banking encouraged Muslim jurists to revisit the question of riba's meaning. Although the majority continued to insist that the prohibition on riba applied to all forms of interest, a minority, including several leading jurists in Egypt and Indonesia, argued to the contrary. Interest-bearing instruments are compatible with Islam, the jurists argued, because they bring practical economic benefit to both individuals and the community.

2) Wealthy Muslim financiers who, for reasons of religious piety and economic opportunity, prefer not to invest their surplus wealth in conventional financial or banking institutions
3) Prominent actors in the state, who see it as in the religious and national interest to lend their support to the cause of Islamic finance.

With florid television images of Ayatollah Khomeini and the Iranian revolution in mind, some might doubt that the ulama tend to be a force for a moderating conservatism. However, for a variety of historical reasons, Iran's Shi`i ulama have played a historical role quite distinct from that of their mainstream Sunni counterparts. The latter tend to be socially conservative and, with a few rare exceptions, politically cautious or even quiescent. Indeed, most of the militant Islamic movements that have arisen in the Sunni world over the past few decades, including al Qaeda, have been notable for their deep-seated antipathy for mainstream ulama. The militants regard the latter as too bookish, scholastic, and apolitical for their taste.

However, the bookishness of mainstream Sunni ulama is what makes them so attractive and important for actors wishing to promote institutions of modern Islamic finance. The first generation of proponents of Islamic finance came largely from non-ulama backgrounds, typically from the ranks of what are known in contemporary Islamic studies as the "new Muslim intellectuals," i.e., graduates of secular schools, not fiqh-oriented *madrasas*, who through their own efforts developed an interest in Islamic thought and institutions. However, after the first Islamic financial institutions were established in the 1970s and 1980s, their founders realized that it was prudent to invite well-established religious scholars to rule on the compatibility of various financial instruments and banking practices with Islamic law. Not to do so, or to recruit scholars with little standing in the ulama community, might invite criticism from other religious scholars, putting the entire effort to establish Islamic financial institutions at risk.

> The militants regard the [ulama] as too bookish, scholastic, and apolitical for their taste.

The other two social groups who have played key roles in the establishment of Islamic banking are, first, pious business investors with reservations about investing in projects potentially in conflict with God's law, and government officials. For several reasons, prior to the 1970s, neither of these two constituencies was greatly interested in the cause of Islamic banking. On the contrary, in the post-war period from the 1950s to the 1970s, a significant portion of the political and business elite in many Muslim-majority countries, including Algeria, Egypt, Pakistan, Bangladesh, and Indonesia, was more interested in developing some variant of Arab or Muslim socialism than it was establishing capitalistic financial institutions based on Islamic principles. It was only the gradual dimming of socialism's luster, beginning with the discrediting of its Nasserist variant after the disastrous events of the 1967 war with Israel that interest in an Islamized variant of capitalism began to be broadly appealing. Even at that, the reorientation away from Muslim socialism proceeded at different paces in different societies.

Another influence on the building of the coalitions required to establish Islamic finance in the 1970s and 1980s was the great increase in oil revenues flowing into the petroleum economies of the Muslim world after the oil embargo of late 1973. It was no coincidence that Saudi Arabia and several of the Gulf States led the way in efforts to introduce new Muslim economic institutions. The Saudis and the Gulf kingdoms were flush with oil revenues; they were also convinced that political events in the Israel-Palestine conflict proved that Muslim-majority countries needed to coordinate their economic activities more effectively.

At first Islamic banking ranked low on the list of priorities that the Saudi and Gulf country elites sought to pursue. The primary institution through which these leaders sought to advance their economic aims was the inter-governmental Islamic Development Bank (IDB), which was set up at a meeting of the Organization of the Islamic Conference (OIC) in Lahore in 1974. After its founding in 1970, the OIC had established research institutes dedicated to research on Islamic economics and finance. When OIC representatives established the IDB, some of the scholar-researchers associated with these institutes helped to compose the language of the IDB's charter. The charter specified that the new bank should conduct its activities in conformity with Islamic law. Tellingly, none of the twenty-five signatories to the IDB agreement had an Islamic bank at this time, and in historical retrospect it appears that the representatives who placed their signatures on the charter understood the requirements of the sharia in different ways.[4] Nonetheless, and despite the fact that the IDB did not specifically set out to promote the establishment of Islamic banks, the founding of the IDB helped to set the stage for the first wave of Islamic banking in the 1970s and early 1980s.

A Pluralist Coexistence of Financial Instruments

Notwithstanding the interests of pious private investors and the Islamic Development Bank, governing elites in several Muslim countries continued to harbor reservations about establishing institutions of Islamic finance. As in Saudi Arabia, Morocco, and Indonesia, one of the most widespread causes for concern was that mentioned earlier: that to designate one part of the financial sector as "Islamic" might discredit financial institutions that operated according to conventional, interest-charging principles. Although governments in Malaysia, Saudi Arabia, and Morocco were willing to rein in business activities seen as blatantly un-Islamic, like the production and sale of alcohol, most still felt that the conventional bank sector provided services vital for the public welfare. Inasmuch as this was the case, leaders in most countries felt that the continued operation of conventional

4 On the implications of establishment of the Islamic Development Bank for the cause of Islamic finance, see Ibrahim Warde, *Islamic Finance in the Global Economy* (Edinburgh: Edinburgh University Press, 2000), pp. 75–76, and Monzeer Kahf, "Islamic Banks: The Rise of a New Power Alliance of Wealth and Shari`a Scholarshiip," in Clement M. Henry and Rodney Wilson, *The Politics of Islamic Finance*, pp. 20–21.

banking was justifiable on grounds of the "public interest," a widely accepted principle of action in Islamic jurisprudence, one known by the term, *maslaha*.[5]

The acceptance of conventional banking on grounds of public welfare remains the guiding principle of policy in the great majority of Muslim countries still today. The two broad exceptions to this generalization are; first, countries like Pakistan, Iran, and Sudan that have used the power of the state to do away with conventional finance entirely, and, second, countries like Libya, Morocco, and Syria which proscribe Islamic finance. With the notable exception of these examples at the margins, most governments in Muslim-majority countries have moved over the past two decades toward a pragmatic financial pluralism. The pluralism is characterized by the coexistence of financial institutions based on both Islamic and conventional finance. Interestingly, in moving toward this pluralistic accommodation, most governments have preferred not to try to resolve publicly the question of the jurisprudential grounds for one form of finance as opposed to another. Officials in most countries recognize that the weight of opinion in ulama circles favors the interest-as-*haram* (forbidden) view. Rather than challenging this opinion directly, most governments have preferred that the question of the religious legality of conventional finance not become a matter of public debate. In this regard, governments in most countries appear to enjoy the support of much of the public and large segments of the business community. The latter constituency continues to make more abundant use of conventional banking than it does Islamic finance.

As the field of Islamic finance has grown, scholars and practitioners have had to adapt their ideas and practices to the sobering challenge of market competition and efficiency.

It is important to note, however, that in some countries even well-educated jurists (*fuqaha*) continue to disagree over the legal grounds for or against conventional banking. The central issue remains the meaning of the Quran's prohibition on *riba*. Although I know of no cross-national studies on the subject, in Indonesia, a country in which I have worked over the past thirty years, a significant number of jurists have long challenged what has elsewhere become the dominant view of the meaning of riba. In its thirteenth national congress in 1938, the country's largest association of religious scholars, the Nahdlatul Ulama (NU), affirmed that bank interest was allowed when it brings benefit to the borrower. In 1950 and again in the 1990s, the association, which today has some 40 million followers, and is the largest Muslim social welfare association in the world, went from theory to practice and established its own banks, all of which used interest-bearing loans.[6] Although some scholars have seen actions like these as evidence of

[5] On the concept of maslaha or "public interest" in Islamic jurisprudence, see Sami Zubaida, *Law and Power in the Islamic World* (London: I.B. Tauris, 2003), pp. 15–16, and Wael B. Hallaq, *A History of Islamic Legal Theories* (Cambridge: Cambridge University Press, 1997), pp. 112–13.

[6] On this and other aspects of Islamic banking in 1990s Indonesia, see Robert Hefner, "Islamizing Capitalism: On the Founding of Indonesia's First Islamic Bank," in Mark R. Woodward, ed., *Toward a New Paradigm: Recent Developments in Indonesian Islamic Thought* (Tempe, Arizona: Arizona State University, 1996), pp. 291–322.

Indonesian Islam's alleged "syncretism," such sweeping generalizations seem unwarranted and anachronistic. Surveys today indicate that Indonesian Muslims are rather strict in their observance of religious duties, indeed more so than people in many Middle Eastern countries.[7] Rather than being a reflection of "syncretism," the Indonesian public's caution with regards to Islamic finance is merely one more example of pragmatic attitudes seen in most of the Muslim world, including in Saudi Arabia, which evaluate conventional banking, not just in terms of a unitary legal criteria, but public welfare.

From Equity Investment to Murabaha Mark-Up

Another reason government in most Muslim countries has adopted a more pragmatic and flexible approach to the question of finance has to do with ongoing developments in Islamic finance itself. As the field of Islamic finance has grown, scholars and practitioners have had to adapt their ideas and practices to the sobering challenge of market competition and efficiency. In so doing, they have had to shift from some of their earlier ideas as to how Islamic finance should be conducted and develop instruments that significantly diminish the gap between conventional and Islamic finance. This in turn has led some Muslims to question whether the difference between Islamic and conventional finance is as great as the first generation of proponents of Islamic finance had imagined.

The clearest example of the convergence of Islamic and conventional financial instruments is seen today in the overwhelming reliance of Islamic finance on a type of financial contract known as *murabaha*, and several closely-related financial instruments. Although jurists have sanctioned it, the murabaha is essentially a debt contract, one that uses mark-ups rather than interest to repay a loan. In a typical murabaha transaction, a bank purchases a good desired by a consumer and then sells the item back on an installment-plan basis, with a mark up on the good's price as payment for the bank's service. In all respects other than this use of mark-ups, the murabaha is similar in principle and in operation to the debt-contracts used by conventional banks. Critics of murabaha say that the instrument's mark-up charge is effectively the same as interest on a loan.[8] However, in the opinion of many pious believers, the two forms of finance still differ, and outsiders must respect this judgment.

Whether murabaha is consistent with Islamic economics or merely a disguised form of interest is a matter that Muslims themselves must settle, and many will likely continue to reach different conclusions on the question. Two issues are more immediately relevant for today's discussion: first, that murabaha and similar mark-up instruments today account

[7] On the deepening of Muslim Indonesian religiosity, see Robert Hefner, *Civil Islam: Muslims and Democratization in Indonesia* (Princeton: Princeton University Press, 2000), chapter 3; for a compelling statistical assessment of Indonesian piety, see Saiful Mujani, "Religious Democrats: Democratic culture and Muslim Political Participation in Post-Suharto Indonesia" (Columbus, Ohio: Ph.D. Dissertation, Department of Political Science, Ohio State University, 2003).

[8] For one such critical account, see Timur Kuran, *Islam and Mammon: The Economic Predicaments of Islamism* (Princeton: Princeton University Press, 2004), pp. 10–11.

for some 70 to 85% of total financing provided in Islamic systems[9]; and, second, that prevalence of murabaha contracts is a state of affairs quite different from that imagined by earlier proponents of Islamic finance. Those earlier proponents were adamant in insisting that Islamic finance should be based on profit-and-loss sharing rather than debt contracts with fixed returns. Rather than the fixed return guaranteed in conventional banking, the Islamic financier was to share in both the profits and the losses of the borrower's enterprise.

The two financial instruments most often promoted by early supporters of Islamic finance were known as *mudaraba* and *musharaka*. Under the terms of mudaraba, a bank or group of investors provides capital to a producer or merchant, who uses the capital for some enterprise and then repays the bank with a previously-agreed share of the profits, along with principal. If the enterprise fails, the bank or investors take the loss. Musharaka works in a similar fashion, except that the merchant or producer also risks some of his own capital in the enterprise, thereby earning a higher share of the profits than under mudaraba contracts.

…the spread of murabaha instruments [is] healthy testimony to the level-headed, "un-ideological" pragmatism of Muslim jurists and financiers.

The early proponents of Islamic finance stressed that these contracts' emphasis on risk- and profit-sharing guaranteed that Islamic banks were more likely to be concerned for the well-being of their clients, rather than just wishing to secure repayment of loans. Arguments as to the greater social justice and egalitarianism of Islamic finance were commonplace among the early theorists of Islamic finance, and, as with the banking movement in Indonesia during the early 1990s, the same arguments have been voiced whenever the merits of Islamic banking are debated today.

The fact that today Islamic finance relies rather little on equity contracts like musharaka and mudaraba, and has instead come to rely on murabaha debt contracting, has disappointed many idealistic supporters of Islamic banking, since the reliance on debt contracts suggests to some that Islamic finance is not really all that different from its conventional counterpart. However, in my opinion, the more interesting point has to do with why Islamic banks were not able to fulfill their founders' dreams of building a financial system based on equity contracts. There were several influences on the development, but the most important has to do with simple economic realities.

Whether in the Muslim world or in the West (where venture capitalism operates on principles similar to Islamic equity), equity contracts require that the lender have a detailed knowledge of the operating costs and profits of each enterprise in which the lender invests. This arrangement works well enough where both parties in the contract trust each other and have accounting instruments for keeping track of profits and losses. Yet in most of the

[9] Tarik M. Yousef, "The Murabaha Syndrome in Islamic Finance: Laws, Institutions, and Politics," in Clement M. Henry and Rodney Wilson, *The Politics of Islamic Finance*, pp. 65–66.

Muslim world, most businesses are characterized by relatively casual accounting system, and an even looser (or non-existent) system of reporting to government. The relative lack of economic accountability means that, to protect their investments, Islamic financial institutions intent on using equity instruments have to dedicate significant resources to monitoring their clients. Moreover, even the most effective monitoring will have trouble dealing with an unscrupulous client. In the face of monitoring headaches like these, then, most Islamic financial institutions have concluded that it is in their economic interest to channel most of their investments into mark-up contracts with fixed returns, similar in operation to conventional banks' loans.

Some critics of Islamic finance have seen the sector's reliance on murabaha contracts as a kind of bad-faith cultural fraud. However, I see the matter quite differently. First, if a pious Muslim understands the Quran prohibition on riba as a prohibition on interest on capital in all forms, then observers from outside that tradition have no right but to respect that belief and factor it into their means-ends-analyses of the economy. Having taken the Muslim conviction as regards riba seriously, observers cannot be other than impressed by the speed with which Islamic financiers have responded to marked demand, and developed financial instruments that respected the prohibition on riba while also responding to the opportunities and constraints of financial markets. Rather than ethical fraud, I see the spread of murabaha instruments as a healthy testimony to the level-headed, "un-ideological" pragmatism of Muslim jurists and financiers.

Toward the Future

Although social researchers are supposed to steer clear of social forecasting, let me end my remarks today with a few guesses as to where Islamic finance is likely to go over the next few years. As a preface to these remarks, let me emphasize again this paper's central argument: that the key to Islamic finance's growth is not piety alone but coalition building and entrepreneurial dynamism. I don't believe, then, that the reason that the Saudis and Indonesians were slow to support the establishment of Islamic banks, or that the Moroccans still ban such institutions is that Muslims in these countries are less pious than their brothers and sisters elsewhere. The key lies, and will continue to lie, in the ability of the proponents of Islamic banking to build a broad coalition with other actors in state and society, in such a manner that the growth of Islamic institutions is seen to bring broad social benefit rather than, say, threatening already-established economic institutions.

Against this backdrop, let me venture a few forecasts. First, I believe that Islamic financial institutions are going to continue to grow in market share in those countries where they have been authorized to operate. Their growth will be all the more rapid where Islamic institutions continue what the best are already doing, which is, rather than relying on one set model for finance, developing a diverse array of instruments to provide new opportunities and services. Islamic insurance will almost certainly experience an equally significant expansion in years to come, since the need for such security-providing instruments is enormous.

Second, Malaysia and Qatar's efforts to position themselves as leaders in the world of Islamic finance are likely to continue to make impressive progress, and will likely stimulate a healthy competition between these two financial powerhouses. Although Qatar has the advantage of proximity to and shared ethnicity with wealthy Arab investors, Malaysia perhaps more than any other Muslim-majority country has shown a striking ability to respond to global market opportunities and develop new financial instruments. Reflecting its own unique colonial experience and present multi-ethnic make up, the country is also blessed with a political leadership that has not hesitated to forge business coalitions with, not only fellow Muslims, but with Chinese, Japanese, Westerners, and other non-Muslim Southeast Asians. Finally, although Malaysia has had its share of political turmoil, it has also developed a good part of what most experts on Islamic finance regard as critical to the long-term success of the enterprise: a relatively open and public system of economic accountability.

A small irony of the global economic order now emerging is that Muslim financial institutions will likely do best where the economy and society have experienced a measure of socioeconomic liberalization. By socioeconomic liberalization I refer to the development of institutions that require business and government to develop a more open and transparent system of accountability, so that citizens and investors have accurate instruments with which to gauge the performance of both. Both Qatar and Malaysia are fairly well-positioned in this regard. But Malaysia's long history of inter-ethnic business partnerships, its impressive economic infrastructure, its relatively good school system, and its positioning at the crossroad leading from Asia to the Middle East, may give it an edge in the long-term competition for market share.

Third and more generally, the growth of Islamic finance will continue to vary by country in a manner that reflects the ability of Islamic financiers to integrate with rather than exclude conventional economic institutions. In a recent book on Islamic finance, Tarik M. Yousef at the Center for Contemporary Arab Studies at Georgetown University put the matter rather well: "In the future, the overall institutional environment will be a more important determinant of the evolution of financial structures in Muslim societies than attempts to impose financial systems based on rigid religious interpretations. In fact, the case can be argued on economic grounds that a financial system offering both debt and equity will contribute more to social welfare than one that is restricted to either form."[10] Stating the matter differently, the key to the continuing growth of Islamic financial systems is the recognition that, in the complex world in which we live, the advantage goes to players who show an aptitude for creating positive synergies across systems and civilizations, rather than assuming that social and economic pluralism invites a "clash of civilizations."

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[10] Tarik M. Yousef, "The Murabaha Syndrome," in *The Politics of Islamic Finance*, ed. John Orr, Clement Henry, and Rodney Wilson (Edinburgh University Press, 2004), p. 76.

The Development and Impact of Islamic Finance on Southeast Asia

Nik Norzrul Thani, *Zaid Ibrahim & Co., Malaysia*

Much has been said about the exponential growth of the Islamic finance industry in recent years. It is acknowledged that the nascent industry is emerging as an exciting addition to the global financial system, metamorphosing from an unknown phenomenon barely three decades ago to a bullish current estimate of US$1 trillion in value, and enjoying a yearly growth of between 15 to 20%. Standard & Poor estimates that the world's Muslim community has about US$3.6 trillion of combined wealth, putting the global potential for Islamic financial services reasonably closer to US$4 trillion. While surely the Middle East with its petrodollars and predominantly rich Muslim population may boast to be where the money is, the more sophisticated and heterogeneous Southeast Asia cannot be set aside as the epicenter of development and innovations that contributed enormously to the overall acceptance of Islamic finance into the mainstream of global finance.

It is upon this premise that this paper aims to examine various developments in Islamic finance that have been and are taking place in Southeast Asian countries. Admittedly there have been a number of studies on similar subject by other authors[1], which certainly would offer useful insights. However, I will try to provide, as much as possible, a market player's and practitioner's perspective, based on my own experience and background as a legal counsel/banker advising and participating in many public and private initiatives to nurture and promote Islamic finance within the region.

In this respect, the paper presents my own personal observations and interpretations on questions such as how far Islamic finance has emerged as an increasingly appealing alternative to products and services offered by conventional finance; how does the attraction of Islamic finance reflect the public's changing attitudes and perceptions in Southeast Asia; and whether the rapidly expanding Islamic finance industry denotes a purely economic phenomenon, or whether it reflects a changing socio-political landscape in Southeast Asia. It will also try to identify the key trends in Islamic finance and indicators of its future direction by assessing challenges and opportunities for government and corporate interests in key markets. In conclusion, the paper comments on how multinational corporations can adjust to and benefit from the growing Islamic finance trends in Southeast Asia and elsewhere.

Southeast Asia and Islam

Southeast Asia is the home for slightly more than a third of the 1.5 billion Muslims in the world, and it is easy to notice that there are the Muslim-majority countries of Indonesia (220 million), Malaysia (27 million) and Brunei Darussalam (370,000), and the Muslim-minority countries of Thailand, the Philippines, Cambodia, Singapore, Myanmar, Vietnam and Laos forming this multi-religious region in which Hinduism, Buddhism and

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1 Among others, see Mohamed Ariff, ed., *Islamic Banking & Finance in South-East Asia: Islam and the Economic Development of Southeast Asia* (Singapore: Institute of Southeast Asian Studies, 1988); Mohamed Ariff, ed., *Islam and the Economic Development of Southeast Asia: the Muslim Private Sector in Southeast Asia* (Singapore: Institute of Southeast Asian Studies, 1991); and Angelo Venardos, *Islamic Banking & Finance in South-East Asia: Its Development & Future* (Singapore: World Scientific, 2005).

animism had been the dominant religions or belief systems of the populace prior to the advent of Islam. Muslim communities of this region have lived for centuries with neighbors consisting of Catholics, Protestants, Confucianists, Taoists, Buddhists, Hindus, Sikhs, animists and ancestor worshippers. This multi-religious, multicultural and multiethnic background is an important factor in conditioning the religio-political thought and behavior of the Muslims in different nation states of Southeast Asia. The different political systems and the way each state treats Islam and Muslims constitute another factor, which determines the differing responses of Muslims as a religio-political force.[2]

There has been a long history that transcends several centuries in which international trade flourished in the Malay Archipelago. Southeast Asia contained the important maritime routes for the trade between the East and West, which has resulted in robust economic growth and regional prosperity. Today, Southeast Asia continues to be one of the world's most dynamic regions. Since the turn of this century, its economies have re-emerged to be among the fastest growing in the global economy amidst new challenges and fundamental economic and financial developments. Its steadfast reform and restructuring efforts have rewarded it with strengthened macroeconomic fundamentals and sound and stable financial systems. These efforts continue to be augmented by the strong foundations that the region possesses, namely abundant natural and human resources, high savings rates and the ingrained aptitude to persevere and rise to the challenge.[3]

Trends and Impact of Islamic Finance on Southeast Asian Communities

The 1997 Asian financial crisis, which burnt many investors and wreaked havoc on the lives of millions within the region, have seen Islamic finance emerging as an increasingly appealing alternative to products and services offered by conventional finance. With arguably "fixed profit rates" for most of its financing products, less emphasis on penalties for defaults, and as such "no hidden costs," it has to be said that these features became rationalized attractions for the consumers, Muslims or otherwise, to appreciate the underlying values of Islamic finance. Slowly but surely, there has been a transformation in the public's changing attitudes and perceptions in Southeast Asia whereby Islamic financial products are no longer being seen as an exclusive domain of Muslims alone. Justifiably so, there has been a widespread acceptance that the rapidly expanding Islamic finance industry is a welcomed economic phenomenon that contributes to and strengthens the appreciation of socio-political pluralism in Southeast Asia.

2 Mohamad Kamal Hassan, "Islam in Southeast Asia Today," (paper presented at the Conference on Eastern-Western Dialogue, organized by Casa Asia in Madrid, Spain, October 29, 2003 and in Casa Asia, Barcelona, October 30, 2003).

3 Zeti Akhtar Aziz, "Enhancing Financial Integration in the New Nusantara" (Luncheon Address at the Malaysia–Indonesia Investment & Finance Summit, June 18, 2007).

Muslim-majority countries

Malaysia. Malaysia is fast becoming recognized as the model for the successful development and establishment of an Islamic financial system alongside conventional banking in the Asia-Pacific.[4] A constellation of factors, including a dynamic legal framework and clear policy directives, has intertwined to make Malaysia an illustrious example. One of the simpler indicators to this fact is that by the end of July 2007, from the outstanding s*ukuk* globally totaled US$82.36 billion, close to 62% was denominated in Malaysian ringgit. At present, Malaysia boasted some of the largest Islamic financial instruments globally, besides being the largest sukuk issuer in the world. Malaysia retains the world's largest Islamic bond market, accounting for about US$47 billion (RM157.54 billion), representing two-thirds of total Islamic bonds outstanding worldwide.[5] More than 70% of Malaysian corporate borrowing was Islamic in 2005,[6] attributed to the regulatory framework that has enabled corporate fundraisers to save as much as 10 to 15 basis points when using *sharia*-compliant modes. Various milestones have marked the development of Islamic finance in Malaysia such as the establishment of the first Islamic financial institution in the world in the form of *Tabung Haji* (The Pilgrimage Fund) in 1969, the first Islamic bank in the country in 1983, and the initiatives to become an international Islamic finance hub through the Labuan International Offshore Financial Centre (IOFC) and later Malaysian International Islamic Financial Centre (MIFC).[7] Of the top 40 Islamic banks ranked in Asia, Malaysia dominates with seventeen institutions and 73% of the total assets.[8] It has been noted that Malaysia has a cutting edge above the rest when it comes to an effective Islamic financial market especially because it has an almost complete component of the market, from the banking sector to the debt capital market, as well as from private to public equity markets.[9]

It has been noted that Malaysia has a cutting edge above the rest when it comes to an effective Islamic financial market…

Having the Islamic Financial Services Board (IFSB)—an international standard-setting body for prudential regulations in Islamic finance—to select Kuala Lumpur as its headquarters, further stamps Malaysia's position as a leading jurisdiction for Islamic finance not only regionally, but also globally.

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4 "Malaysia is seen as model for Islamic finance," *Bernama*, August 27, 2007.

5 "Malaysia way ahead in Islamic Finance," *TheEdgeDaily.com*, December 21, 2007.

6 "Asian Sukuk poised for fast growth, not only in Malaysia," *TheEdgeDaily.com*, August 29, 2007.

7 For a more comprehensive picture, see, among others, Nik Norzrul Thani, *Legal Aspects of the Malaysian Financial System* (Petaling Jaya: Sweet & Maxwell Asia, 2002); Nik Norzrul Thani, Mohamed Ridza Abdullah and Megat Hizaini Hassan, *The Law & Practice of Islamic Banking and Finance* (Petaling Jaya: Sweet & Maxwell Asia, 2003); and Nik Norzrul Thani and Madzlan Hussain, "Breaking New Grounds," in *The New Voice of Asia*, vol. 2 issue no. 2 (Third Quarter 2003).

8 Benny Zhang, "Islamic banking on the rise," *The Asian Banker Journal*, Issue 66, January 2006.

9 Soraya Permatasari and Shanty Nambiar, "Malaysia touts Islamic Banking," *Bloomberg News*, March 26, 2007.

Indonesia. Being the country with the largest Muslim population in the ASEAN region (approximately 220 million) would essentially propel the Islamic finance market in Indonesia to significant heights. Having said so, it is noted that, under the current regulatory regime, Islamic banking in Indonesia is suffering from an uncompetitive premise vis-à-vis conventional banks.[10] Islamic banks finance the purchases on behalf of a customer for an agreed fee, but these transactions incur a 10% value-added tax (VAT) because under current taxation laws such a fee is not categorized as interest, which would otherwise exempt it from VAT payments. Despite the regulatory hurdles, the industry is experiencing a mini-boom. Indonesia's first Islamic bank, Bank Muamalat, was founded in 1992 and has forecast that its profits will increase because of surging demand for its innovative, sharia-based Shar-E product. Last year nearly 664,000 customers applied for its Shar-E products, surging from the 132,669 customers it had in 2005. As of the end of 2006, Bank Muamalat had been joined by 23 other Islamic banks and 456 conventional bank branch offices that provided Islamic banking services. According to Bank Indonesia, the central bank, the share of Islamic banking assets of total national banking assets was a mere 1.6%, up slightly from the 1.4% recorded at the end of 2005. Yet Islamic banks reported a 79% year-on-year increase in business volume in 2006, to Rp8.76 trillion (US$1.36 billion). The amount of leasing business, known as *ijara*, grew by a whopping 164.7%, and Islamic mutual funds grew in asset value by 17.6% in 2006, with a total net asset value of about Rp663.7 million.

By the end of 2006, there were about 20 Islamic funds, representing about 5% of Indonesia's total number of mutual funds but only 1.3% of the industry's value. At least 17 companies listed on the Jakarta Stock Exchange have issued sharia-compliant bonds, representing 10.5% of the total number of listed companies that have issued debt instruments, with a total issuance value of Rp2.2 trillion.[11]

Brunei. The oil-rich sultanate is looking at Islamic finance as one of the ways of diversifying its economy. It is contemplating to emulate the Kingdom of Bahrain, which has a similarly small population but has successfully emerged as a leading Islamic finance hub particularly for the Middle East. Brunei established two Islamic banks since the 1990s. The emergence of Islamic finance in Brunei was marked by the inauguration of Tabung Amanah Islam Brunei (TAIB) in 1992 owned by the government, initially being a trust fund for Muslims to make the pilgrimage to Mecca. Subsequently, the concept of Islamic finance developed and Islamic Bank of Brunei (IBB) was established to further meet the demand of majority Muslim population in Brunei. As the initiatives to promote itself as an international finance center is still in an early stage, it remains to be seen how far Brunei can catch up with other leading jurisdictions within the region. However, it is noted that the per capita income in Brunei is one of the highest in the region, and Brunei has already announced the issuance of a sovereign sukuk.

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10 Bill Guerin, "Tapping Indonesia's Islamic potential," *The Asia Time Online*, June 26, 2007.

11 Ibid.

Muslim-minority countries

Singapore. Already with a strong reputation as an international financial center with a full range and plethora of financial services, Singapore is attempting to broaden the menu of its offerings by putting in place a more conducive regulatory infrastructure for Islamic finance. Among others, it has fine-tuned regulations to facilitate banks in Singapore to offer financing based on the *murabaha* concept, waived the imposition of double stamp duty in Islamic transactions involving real estate and accorded the same concessionary tax treatment on income from Islamic bonds that is afforded to conventional bonds. Another significant step was the launch of the FTSE-SGX Asia Sharia 100 Index in February 2007.[12]

Besides Malaysia, Singapore is a classic example where it is proven that Islamic finance attracts more non-Muslim investors and consumers rather than Muslims, who in contrast do not have as much savings and wealth. In Indonesia, where 99% of the population is Muslim, Islamic banking assets total about US$1.7 billion, or just over 1% of total bank assets. On the contrary, Singapore with its predominately ethnic Chinese population that is about 1/50th the size of Indonesia's, already manages around US$2 billion in sharia-compliant funds.[13]

Thailand. The predominantly Buddhist country has a large Muslim minorities especially at its southern provinces bordering Malaysia such as Yala, Pattani, Songklha, Satun and Narathiwat. Statistically speaking, Islam is the second largest religion with over six million followers populated at those provinces. The first institution offering Islamic financial services was a cooperative society, Pattani Islamic Saving Cooperative (1987). By end of 2001, four other Islamic saving cooperatives were established in Southern Thailand, i.e. Ibnu Affan (Pattani), As-Siddiq (Songkhla), Saqaffah Islam (Krabi), and Al-Islamiah (Phuket). Islamic windows was introduced by Government Savings Bank (1998), followed by the Bank for Agriculture and Agricultural Coops (1999) as well as the introduction of 'Islamic Branch' by Krung Thai Bank (2001). The potential for Islamic finance in Thailand could be mirrored by the growth of those Islamic saving cooperatives over the decades. These Islamic cooperative societies have successfully established themselves as viable financial institutions in managing and mobilizing Muslims funds in this region. For example, total assets for Pattani Islamic Saving Cooperative at the end of 2001 were 90 million baht, while total assets for the Ibnu Affan Islamic Saving Cooperative were 60 million baht as at the end of 2002.[14] The first full-fledged IIFS is the Islamic Bank of Thailand (2003), set up under the Islamic Bank of Thailand Act 2002.

As a large proportion of the Muslim population is living below the poverty line, Islamic finance is taking a slow step towards capacity-building and growth of this segment of the community in Thailand.

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12 Zakariya Othman, "Note from the Editor," *Islamicfinancenews.com*, June 16, 2006.

13 Mark Bendeich, "Asian Islamic Finance is a Market for Non-Believers," *Reuters*, February 23, 2006.

14 Sudin Haron & KuMajdi Yamirudeng. "Islamic Banking in Thailand: Prospects and Challenges," *International Journal of Islamic Financial Services*, vol. 5 no. 2.

The Philippines. Like Thailand, the Philippines have a sizable Muslim populace of about five million, mostly concentrated in the southern islands of Mindanao, Sulu and Tawi-tawi. The government-run Al-Amanah Islamic Investment Bank have been operating for more than 30 years to meet demands from Muslim minority, who have long history of hostility against the federal government dominated by the Christian majority. The bank has been bleeding financially due to mismanagement and other problems, causing the government to put it up for sale in an effort to cuts its losses and turn it around. However this has not met much success, as confrontations between the army and armed Muslim rebel groups continue to escalate in the region.[15] However, the Philippines' economy have been enjoying some growth in recent years, and with the participation of Bangko Sentral ng Philippines as an associate member of the IFSB, may give some hope that other international players might be interested to look at the opportunities of Islamic finance in the Philippines once the political environment stabilizes.

Others: Cambodia, Myanmar, Vietnam, Laos and East Timor. The percentage of the Muslim populace in these countries is too small, perhaps less than one million people, even if combined, to rationalize the presence of an alternative finance system such as Islamic finance. In fact, their financial systems have also yet to be developed to accommodate such erudition and complexity. Instead, the proximity of Southeast Asia to other regional economy powers such as China, Japan, India and Australia makes it more sensible for Islamic financial institutions and investors to seek expansion opportunities to these markets where either 1) the market has some depth and developed enough sophistication to understand and appreciate the value proposition brought in by Islamic financial products or 2) there are sizeable demands for such products.

Challenges and Opportunities

Despite all the fascination over the development of Islamic finance around Southeast Asia, one should not forget that this industry is still in a nascent stage and much more needs to be done. From the market player's perspective, the key challenges are:

- Except for Malaysia, which has put in place extensive regulatory framework and infrastructural support for Islamic finance to co-exist with its conventional counterpart, other countries are still at the stage of "arranging the bricks".[16] While Malaysia has gone as far as having a vision for Islamic finance under its 10-year Master Plan for the Financial Sector, set up a Malaysian Deposit Insurance Corporation that is able to cover Islamic finance institutions through sharia-compliant policies, and even set up a RM500 million fund to develop human capital for the industry through its International Centre for Education in Islamic Finance (INCEIF), other countries are still at the stage of ensuring a neutral tax treatment that does not put Islamic finance

15 The government has failed to privatize the bank despite auctioning its stakes for the fourth time recently. See Michelle Remo, "Auction of government's Islamic bank fails," *Inquirer*, May 22, 2007.

16 The author has analyzed the legal framework for Islamic finance in more than 30 jurisdictions in Nik Norzrul Thani and Aida Othman, "Effectiveness of Legal Framework for the Islamic Financial Services Industry," (paper presented at the Third Seminar on Legal Issues in the Islamic Financial Services Industry Board, Kuala Lumpur, March 28–29, 2007).

products at a disadvantage compared to conventional counterparts. On this basis alone, it is reasonable for investors to be extra cautious while evaluating the cost-benefits of Islamic finance for the rest of the region.

- The greater involvement of banks and other financial institutions in investment management, as symbolized by the repeal of the Glass-Steagall Act in the United States, should be advantageous to Islamic finance as its business model as financial intermediaries require the combination of the two. The problem is that investment management in the contemporary context boils down to risk management, which is very underdeveloped in Islamic financial theory and practice. There is a dire need to intensify the development of sharia-compliant risk management techniques, even more so in jurisdictions where the regulatory framework and infrastructural support are not as developed as in Malaysia.
- Despite the generally celebrated pluralism in Southeast Asia, it has not escaped Taliban-style Islamic fundamentalism brought about by pockets of socio-political unease in Muslim-minority regions. Bombing incidents such as in Jakarta and Bali, as well as armed conflicts in southern Thailand and Mindanao, raise a certain degree of Islamophobia to non-Muslims, which indirectly affect the image of Islamic finance as an economic proposition that add values and reasonable returns.

Nevertheless, in many instances, Southeast Asia strives to uphold the sanctity of mutual coexistence and respects among its populace. Despite all the odds, non-Muslims in Southeast Asia especially in Malaysia and Singapore have proven that they can lend generous support to Islamic finance when they see the values that it brings, acknowledging the broad opportunities that came along:

> Despite all the odds, non-Muslims in Southeast Asia… have proven that they can lend generous support to Islamic finance…

- Even more than a decade ago, the dynamism of Islamic investors had already been acknowledged as different from their counterparts in the Middle East in that most are eager to invest in their own region.[17] This is opposite to Middle Eastern investors whom, if not because of September 11, would more often do their banking in places like London, New York or Geneva. In this respect, Southeast Asian investors are not under the same pressure to send their money abroad in case of political upheavals. Also, in contrast to the Middle East, there are certainly ample investment opportunities in the region. Historically, there has always been trading links between the Middle East and the region and it is generally acknowledged that Islam flourished contemporaneously in parallel to the commercial relationships. With the advent of Islamic finance and due to the implications of September 11, it is envisaged that there will be increased investments from Middle East to the region, resulting in a convergence of perspectives on Islam generally and intrinsic harmonization of sharia principles and concepts for Islamic finance.

[17] Aline Sullivan, "Bankers tailoring their products to suit Islamic investors," *International Herald Tribune*, November 24, 1994.

- The relative political stability and sound market economy enables Southeast Asia to continue welcoming increasing number of players in the region. Alongside the various local banks and Middle East banks such as Al-Rajhi from Saudi Arabia, Asia Finance Bank from Qatar, and Kuwait Finance House from Kuwait, there are many Western banks structuring Islamic investments in Southeast Asia including the United States' own Citibank and UBS, Britain's HSBC and Standard Chartered, France's Crédit Lyonnais and BNP Paribas, as well as the Netherlands' ABN Amro and ING. Competition for this market is very keen and strong, reflecting a vibrant and open market economy. Many players also consider it strategic to use their presence in Southeast Asia as a stepping stone to expand into other markets including the Indian sub-continent, Far East and Australasia.
- Southeast Asian ministers are expected to approve the blueprint to speed up plans of the Association of Southeast Asian Nations (ASEAN) to achieve a European-style single market by 2015.[18] It is anticipated that this would be a major development that would further increase the market penetration of Islamic finance from the Muslim-majority countries to Muslim-minority countries in the region, as intra-ASEAN trades expand.

Conclusion

The growth in the industry, although to a certain extent initiated by political objectives riding on the religious zeal within Muslim-majority countries, gained momentum due to the free market forces and global economic potentials capitalized by industrialists.[19] The dynamism of Southeast Asian governments and its populace expedited the maturity of the industry to adapt itself into the political-economy landscape to the level of acceptability not only in Muslim-majority but Muslim-minority countries as well. These reinforce some key facts that are worthy of consideration from multinational corporations as well as other governments when strategizing the positioning and preservation of their interests in the Southeast Asian region.

Inevitably, it has to be recognized that Islamic finance is here to stay, and is no longer at the fringe of global finance. It has now been integrated into the mainstream of international finance, and its sojourn as a boutique financial segment is now *passe*. For example, it is illustrative to note that the membership of the IFSB has expanded to include financial regulators from non-Islamic countries including major Asian economic players such as Japan, China, and Singapore. Early this year it was announced to the British Parliament that legislation will be introduced to provide neutral tax treatment to Islamic bonds issue to put it on a similar footing as any conventional securitization.[20] The British public already noticed the bold emergence of the Islamic finance sector when the recent

18 "ASEAN Leaders to launch AEC Blueprint in November in Singapore," *Bernama*, August 27, 2007.

19 Adnan N. Ozair, "Who's on First? What Role do U.S. Policy Makers want to play in the Islamic Financial Services Industry?" *Muslim Public Affairs Journal*, (Debut Issue, Jan 2006): pp. 15–18.

20 Work together to boost Islamic financing, urges Price Andrew," *Bernama*, August 30, 2007.

sale of Aston Martin was financed through a sukuk deal. Also, UK Chancellor of the Exchequer, Gordon Brown (currently UK Prime Minister) pledged at Islamic Finance and Trade Conference in London in 2006 that the government will give its full commitment to make London as a global hub for Islamic Finance.[21] Last year, the Swiss Federal Banking Commission awarded a full banking license to an Islamic private bank.[22] Meanwhile, in addition to the German state of Saxony-Anhalt which had issued a US$100 million sukuk in 2003, another issue is expected from a G7 country when Japan announced it is preparing to launch what would be the first sovereign Islamically compliant bond by a G7 nation, through the Japan Bank for International Cooperation (JBIC), a sovereign trade promotion and international development institution.[23]

Southeast Asia will continue to play a strategic role in the promotion and development of Islamic finance. As articulated by the Governor of Malaysia's Central Bank:

> Hundreds of years ago, the ports of Nusantara were destinations for the spice trade to Europe via India and the Middle East. In the current context, Islamic finance can serve as a bridge that links the Nusantara region to the capital surplus economies. Already, our financial institutions are venturing to have a presence in the Middle East and we welcome their presence in our financial system. This has now in-fact resulted in the cross-pollination of talents and resources, giving rise to innovative products and services, creating depth and breadth to the respective financial markets. Just as the Straits of Malacca served as an important maritime conduit for the Nusantara region, Malaysia and Indonesia has the potential to serve as an important intermediary for mobilizing capital to meet the requirements of the Nusantara region, and to be a distribution center for sharia-compliant securities and to extend the regional Islamic capital markets to other parts of the world.[24]

Islamic finance spurs the social and financial inclusion of a huge part of the Muslim population, whom otherwise has been avoiding the conventional finance products, which they perceive as *haram* (forbidden), into the mainstream of the financial system. Islamic finance products are scrutinized by sharia scholars and affirmed to have met the religious and ethical requirements. This has been helpful in improving the quality of life of Muslims not only in countries where they are the majority, but even more so in countries where they are the minority, such as Thailand and the Philippines. Financial regulators in Malaysia, Singapore, Indonesia, and Brunei have strengthened their capacities and credibility in nurturing their Islamic finance industry and are fast becoming models from which others are willing to learn.

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21 BBCnews.co.uk, September 13, 2006.

22 "The first Islamic private bank is launched in Switzerland," *Halal Journal.com*, October 5, 2006.

23 David Pilling, Guy Dinmore, John Burton and Gillian Tett, "JBIC in talks on Islamic bond issue," *Financial Times*, August 17, 2006.

24 Zeti Akhtar Aziz, "Enhancing Financial Integration in the New Nusantara," at the Governor Luncheon Address at the Malaysia–Indonesia Investment & Finance Summit, June, 18 2007.

The success of Islamic finance not only adds depth to the region's financial system, it also enriches the celebration of pluralism within the Southeast Asian community. It was noted a decade ago that if Malaysia succeeds as a model of modern Muslim state, "then Southeast Asia, historically on the fringe of the Muslim world, could become its modern center. And then the West would have to rethink its own preconceptions and prejudices about 'the Muslim'".[25] This thinking could go a long way in bridging Islam and the West, which has suffered from much of a hostile relationship since the events of September 11.

The United States is home to a significant number of Muslims. It is therefore imperative that the Muslim population in the United States, as with Muslims in other Western countries, would seek to develop Islamic finance within their own jurisdictions. The growing demand for Islamic finance is an opportunity for U.S. financial institutions to tap into a captive market with sharia-compliant products. The issuance of the East Cameron Gas Sukuk—worth US$16 million—by Texas-based East Cameron Partners in 2006 indicates the huge opportunities for Islamic finance in the United States. Regulators and stakeholders in the financial industry have started to implement legislative initiatives to accommodate Islamic finance. Furthermore, by embracing Islamic finance with progressive and dynamic policies, coupled with the leadership of the country in the financial domain, the United States can be a major player in the global Islamic finance arena. Since Islamic finance is viewed as an alternative to conventional finance, financial institutions in the United States, with the right strategies and commitment, can nurture and further enhance Islamic finance to be an effective complement to global finance.

[25] James Kynge, "The very model of a modern Moslem state," *Financial Times*, April 26, 1997.

The Economic Development and Future of Islamic Finance in Southeast Asia

Angelo Venardos, *Heritage Trust Group, Singapore*

Angelo Venardos

To truly understand the current interest in the development of Islamic banking and finance in Southeast Asia and how it is different from the conventional banking system, one must first understand the religious relationship originating from the Quran, and then trace the historical, geographic, and political developments of Islam over recent centuries. Only on this basis can policymakers and market participants, without prejudice or cynicism, begin to appreciate Islamic law (*sharia*) and jurisprudence (*fiqh*). With this appreciation, government bodies and multinational corporations will gain a better understanding of the challenges in the industry's development and benefit from growing Islamic finance trends in Southeast Asia.

Increasing interest in Islamic finance over the past decade can be attributed to various factors, the two most salient being the growing influence of Islam and the surplus of petrodollars. Many Arab Muslim countries, and to a certain extent in Southeast Asia's Muslim-majority countries, are moving toward a "re-Islamization" of society, which has affected these countries' legal and financial systems. This trend is in part a consequence of the Iranian Revolution when the Shah was overthrown and the Ayatollah Khomeini became the highest authority in the country, and in part due to the strength of petrodollars. The excess petrodollars accumulated in the Gulf Cooperation Council (GCC) have been searching for a variety of new investment horizons and high-yield products. With the global reach of fund managers who have become aware of large untapped Islamic wealth, this trend has fuelled their creativity to develop new sharia-compliant products which appeal to the new market of Muslim and non-Muslim investors in the Middle East and Southeast Asia. Currently, the value of the global Islamic financial sector is estimated to range from US$300 to 500 billion and is growing at an annual rate of 12-15%.[1]

A closer examination of Islamic banking and finance developments in Southeast Asian countries will provide insight into the distinct differences of local practices and instruments.

Malaysia: First-to-market Mover

Malaysia is regarded as the leader in Islamic banking in Southeast Asia. Malaysia holds the largest share of the global *sukuk* (Islamic bond) market, with an estimated total of US$29.94 billion (RM 110 billion), and constitutes 44% of the domestic bond market.[2] In May 2006, the Dow Jones Citigroup Sukuk Index was launched as the first index to measure the performance of global Islamic sukuk. It is a benchmark for investors seeking exposure to sharia-compliant instruments.[3] Moreover, in 2001 Bank Negara Malaysia (BNM) implemented the Financial Sector Masterplan, which aims to secure 20% of Malaysia's banking and insurance industry—comprised of Islamic banking and *takaful*

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1 Cheang-hung Kok, "Singapore Exchange—Islamic Finance Prospects," *Islamic Finance News Guide 2007*, pp. 109–11.

2 Yusli Mohamed Yusoff, "Global Acceptance of Malaysian Islamic Products," *Malaysian Islamic Finance Report 2006*, p. 30.

3 Islamic Capital Markets, Aseambankers, "Malaysia—The Center of Islamic Product Innovation and Global Recognition," Malaysian Islamic Finance Report 2006, pp. 42–3.

(insurance)—by 2010.[4] Currently, BNM holds approximately 12% of the country's banking sector.[5] The Malaysian government announced that the country's 2008 budget stipulates substantial tax incentives to boost the Islamic banking and finance industry.[6]

Indonesia: The Sleeping Giant

Despite being the world's largest Muslim country with 190 million Muslims, Islamic banking in Indonesia is lagging behind Malaysia. Islamic banking is only 1.5% of Indonesia's overall banking industry. However, the relatively new industry has experienced some growth. Assets managed by Indonesia's sharia banks have increased from Rp7.85 trillion (US$865 million) in December 2003 to Rp26.72 trillion (US$2.94 billion) in December 2006.[7] To stimulate more growth in Islamic banking, an acceleration program was launched in early 2007. It aims to boost the Islamic banking industry to about 5% of the overall banking industry by the end of 2008.[8] Some of the challenges facing Indonesia in its development of an Islamic financial industry include an undeveloped legal and supervisory framework, absence of institutional players, limitations in human resource, taxation issues, risk management and mitigation, and the lack of a secondary market.[9]

Brunei and Labuan: Offshore Niche Markets

In recent years, Brunei has been moving away from its role as an oil and gas producer toward becoming a financial center. With the establishment of the Brunei International Financial Centre (BIFC), the government has enacted policies and legislation to integrate Islamic banking and finance into Brunei's plans of positioning itself as an international financial center in Southeast Asia. Brunei Darussalam's Shariah Financial Supervisory Board (SFSB) was established in January 2006 to advise regulators and practitioners in ensuring that all transactions, products, and services offered are sharia-compliant. The Islamic banking industry in Brunei has seen a consistent growth of 19% annually since 1993 and a market share of 32%.[10] In March 2006, Brunei's first ever Islamic bond, the

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4 Bank Negara Malaysia, "The Financial Masterplan," 2001, p. 79.

5 Yaroslav Trofimov, "Malaysia Blazes A Trail in Global Islamic Finance," *Zawya*, April 3, 2007, http://www.zawya.com/printstory.cfm?storyid=DN20070403014248.1&&l=213112070403.

6 "Malaysia's Budget 2008 Incentives to Promote Islamic Finance," Islamic Finance Professional, September 8, 2007, http://islamicfinancepro.wordpress.com/2007/09/08/malaysias-budget-2008-incentives-to-promote-islamic-finance/.

7 Bank Indonesia, "Publication of Shariah Banking Data," December 2006.

8 Bank Indonesia, "Indonesian Shariah Banking Outlook for 2007," December 2006.

9 Arlyana Abubakar and Sari Nadia Z. Rizal, "Development of Indonesia's Islamic Capital Market," *Islamic Finance News Guide 2007*, pp. 102–4.

10 Pehin Dato Abdul Rahman Ibrahim, Statement made at the 2006 Annual Meetings of the Board of Governors of the World Bank and the International Monetary Fund, *International Monetary Fund*, Press Release no. 37, September 19-20, 2006, http://www.imf.org/external/am/2006/speeches/pr37e.pdf.

Short Term Government *Sukuk Al-Ijarah* program was launched.[11] This was a definite step toward establishing an Islamic capital market in the country.

Labuan, an island off the coast of Sabah, is recognized as an offshore financial center. In addition to this status, the Malaysian government has included Labuan in its plans of positioning Malaysia at the forefront of Islamic banking in Southeast Asia. The Labuan Financial Services Authority (LOFSA) is one of the participating members of the International Islamic Financial Market (IIFM) which began in April 2002.[12] The IIFM serves to provide a cooperative framework to encourage the growth of an Islamic financial market in accordance with Islamic law. In October 2006, the Labuan International Offshore Financial Centre (IOFC) conducted the primary listing of the world's first exchangeable and equity-linked sukuk issued on the Labuan International Financial Exchange (LFX). The US$750 million sukuk pushed the exchange's Islamic capital market capitalization to US$2.8 billion, representing 18.5% of the total market capitalization of US$15.1 billion.[13]

Singapore: A Complementary International Financial Center

Singapore has emulated the British model of accommodating Islamic banking and finance within the existing banking system by leveling the playing field so that tax inequalities on Islamic transactions are eliminated and allowing banks to offer products and services such as *murabaha* and *mudaraba*. In late 2005, Singapore launched its first murabaha facility, a US$96 million facility offered by the Singapore branch of Standard Chartered Bank for Baitak Asian Real Estate Fund, a joint venture between Singapore-based Pacific Star and Kuwait Finance House.[14] In February 2006, the Singapore Exchange Securities Trading, together with Financial Times Stock Exchange (FTSE) Group and Yassar Research, launched the FTSE SGX Asia Shariah 100 index which tracks 100 sharia-compliant stocks from Japan, Singapore, Taiwan, Korea and Hong Kong. The launch of this index may encourage the establishment and management of Islamic unit trusts and exchange-traded funds in Singapore.[15]

In May 2006, the Singapore Exchange Limited (SGX) launched the SGX AsiaClear™, an over-the-counter (OTC) clearing facility for oil derivatives and dry bulk forward freight agreements (FFA). SGX AsiaClear™ presently clears 21 different OTC trades, and at the end of 2006 it had over 60 country-party accounts.[16] In May 2007, the Development Bank of Singapore (DBS) invested US$250 million (SG$380.2 million) into the first Singapore-

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11 M K Anwar, "Brunei's Capital Market Vision," *BruDirect*, March 15, 2006, http://www.brudirect.com/DailyInfo/News/Archive/Mar06/150306/nite01.htm.

12 Other members include: Islamic Development Bank, Bahrain Monetary Agency, the Central Bank of Indonesia, the Central Bank of Sudan and the Ministry of Finance of Brunei Darussalam.

13 Labuan Offshore Financial Services Authority (LOFSA), "Annual Report of the Members of the Authority for the Year Ended 31 December 2006," 2006, http://www.lofsa.gov.my/lofsa5/PubAnnSpe/ar/ar2006.htm.

14 Arfat Selvam, "Singapore: An International Center for Islamic Financial Services," *Islamic Finance News, Legal Guide 2006*, pp. 30–2.

15 Selvam, "Singapore: An International Center," pp. 30–2.

16 Kok, "Singapore Exchange," pp. 109–11.

based Islamic bank, the Islamic Bank of Asia (IBA). DBS owns 60% of IBA while the remaining 40% lies in the hands of 22 investors from the GCC.[17] In September 2007, the IBA completed its final closing, bringing its paid-up capital to US$500 million. As a result, DBS will retain its majority stake in IB Asia at 50% plus one share.[18]

Product Development

To the uninitiated, the growing appeal of Islamic banking as an alternative to conventional products may seem to be a purely economic phenomenon, particularly where in Malaysia, more than 75% of the customers of OCBC Bank and Maybank consumer banking are non-Muslims. However, the increase in Islamic financial products is not solely a fleeting economic phenomenon. Islamic financial and banking products are developed from an alternative banking and finance structure which is sharia-compliant. Although the socio-political landscapes in both the GCC and Southeast Asia have changed since September 11, investors looking for the same returns and quality as similar conventional banking instruments are increasingly seeking faith-based investments.

The growth of the Islamic finance sector has seen the involvement of global banks, such as Citibank, HSBC, Deutsche Bank, and UBS and the diversification of Islamic structured products, such as real estate, aircraft financing, shipping and trade, as well as project financing.[19] However, it is the capital markets which have attracted much of the attention of the institutional players. Sukuk that are traded and listed will contribute to the eventual liquidity of their trading, hence the aim is to issue more sukuk that are rated and listed. Sukuks are regarded similarly to bonds, and buyers use them for booking and risk management.[20] Sukuks offer an attractive yield because repayments are not dependent on cash flows of the borrowing company but from a future initial public offering (IPO) of strategic government sovereign issues or from corporate sukuk. Therefore, the sukuk's unique structure, with IPO rights, has captured the capital market's attention.[21]

Islamic finance products can be employed rather suitably in real estate as the projects can yield returns equivalent to and even greater than other markets, and the appropriate sharia-compliant financing vehicles can easily be formulated. An increasing number of conventional realtors have been using Islamic financing vehicles for competitive advantage and the greater returns that it yields.[22]

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17 Grace Ng, "Development Bank of Singapore Invests $380 million in Singapore's First Islamic Bank," *The Straits Times*, May 8, 2007, http://app.mfa.gov.sg/pr/read_content.asp?View,7142.

18 DBS Group, "The Islamic Bank of Asia Completes Second and Final Closing," DBS Group News Releases 2007, September 13, 2007, http://dbs.com/newsroom/2007/press070913.html.

19 Bob Charlton and Harnek Shoker, "Islamic Structured Products Diversity," *Islamic Finance News, Legal Guide 2006*, pp. 7–8.

20 Safdar Alam, "The Evolution of Products in Islamic Finance," *Malaysian Islamic Finance Report 2006*, pp. 50–4.

21 Elwaleed M. Ahmed, "Features, Challenges Facing Growth of Islamic Bonds," *Zawya*, July 8, 2007, http://www.zawya.com/story.cfm/sidZAWYA20070708113822.

22 "Islamic Financing Vehicles Increasingly Used in Real Estate Activities across the Region," *Zawya*, July 2007, http://www.zawya.com/printstory.cfm?storyid=ZAWYA20070731120626&l=120600070731.

Islamic financing structures are increasingly used in the project finance domain, particularly for projects in the Middle East. In most Islamic financings incorporated within multi-sourced project financing, the Islamic financing element of the project is provided pari passu with the other senior debt. *Istisna*[23] and *ijara*[24] elements are frequently used. For example, Dolphin Energy signed a US$1 billion Islamic financing agreement with 14 local and international banks in September of 2005, which was the largest sharia-compliant funding to be completed in the oil and gas sector at the time. Banks involved included BNP Paribas, ABN AMRO, Citigroup, Dubai Islamic Bank, and Gulf International Bank. The loan has four-year duration and is structured as an istisna.[25]

The current debate between innovation and imitation in product development concerns the construction of a product from a pure *halah* (permissible) perspective or the alternative method of developing products through "Islamicizing" conventional products. However, conventional products work on principles which may not be sharia-compliant, such as speculation, involving uncertainty and no purchase of the underlying asset. The second method will point to a direction where Islamic finance imitates the conventional banking system. This is a rather short-sighted way of developing products.[26]

There appears to be a future trend and window of opportunity concerning product development as Southeast Asia is the fastest growing economic region in the world. The subsequent relocation of Swiss private banking to Singapore to cater to the growing wealth management industry is now starting to focus on the creation of Islamic products for high net worth individuals (HNWI) from India to China. In particular, fund management and third-party product distribution to HNWI will create a demand for capital, equity, and property product development. These products will originate from Malaysia and Singapore, as both are located between these two large emerging economies of India and China and form the nexus of conventional and Islamic banking in the region for distribution to lucrative markets such as Indonesia and the GCC.

Islamic Finance in the United States

Conducting Islamic finance transactions in the United States can prove to be very difficult due to the limited pool of expertise and experience in Islamic finance. With little exposure, the average investor is unlikely to be motivated to learn the intricacies of Islamic finance, unless he is aware of the huge untapped market potential.[27] As a consequence of September 11, unfavorable perceptions of and attitudes toward Islam-related activities,

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23 A contract of exchange with deferred delivery, applied to specified made-to-order items. Istisna differs from ijara in that the manufacturer must procure his own raw materials. Otherwise, the contract would amount to a hiring of the seller's wage labor as occurs under ijara. www.islamic-finance.com.

24 Leasing.

25 Charlton and Shoker, "Islamic Structured Products," pp. 7–8.

26 Alam, "Evolution of Products."

27 Umar F. Moghul, "The Challenges of Islamic Financial Transactions in the USA," *Islamic Finance News, Legal Guide 2006*, pp. 25–6.

many non-Muslims in the United States may be uncomfortable with Islamic finance. Changing such perceptions will take time.

Some key U.S. banks and financial institutions offering Islamic finance products include the Guidance Financial Group, Devon Bank, and University Bank. La Riba Bank and Guidance were granted permission by U.S. regulatory authorities to offer interest-free financial products in most states. Saturna Capital has been offering Islamic funds since 1989.[28] In 2001, Freddie Mac and the American Finance House (LARIBA) began offering home financing contracts which are in accordance with Islamic law.[29] In New York, HSBC is a prominent bank offering Islamic finance products and services.[30] Citibank is another global bank with a global and domestic presence and offers Islamic capabilities. The establishment of the Dow Jones Islamic Indexes is a promising development of Islamic finance.

At the time of this writing, the U.S.-based HDG Mansur is awaiting approval of its Al Umran Global Property Fund (the world's first public sharia-compliant global real estate fund) to join the Dubai International Finance Exchange (DIFX), while a secondary listing would be made on the London Stock Exchange. The fund is initially targeting institutional and high net worth investors and is staging road show events across the Middle East to attract a minimum of US$400 million in investment. This will be leveraged to acquire up to US$2 billion (Dh7.3 billion) worth of properties within the next 12 months, primarily in the United States, but also in Western Europe.[31]

Key challenges facing the development of Islamic finance in the United States include:[32] superficial understanding of the sharia factor in tailoring products and services, complying with the regulations of the Federal Reserve, Comptroller of Currency Office (OCC) and tax authorities, harmonization of the interpretation of the sharia on permissible products and services, absence of sharia-trained personnel, and increased anti-Islamic sentiments in the United States since September 11.

The economic development and future of Islamic Finance in Southeast Asia is anticipated with excitement as the individual countries attempt to take a stake and be credible participants to Malaysia, the market leader in the region. The growing awareness and competition of this faith-based economic phenomenon will yield ongoing progress in Indonesia, Brunei, Labuan, and Singapore in areas of product and regulatory development to attract global investors, especially those from the GCC.

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28 Stephanie Mumford Brown and Douglas Clark Johnson, "Islamic Finance in the US," *Islamic Finance News Guide 2007*, pp. 112–5.

29 "Freddie Mac Investing in Islamic "Mortgages" From American Finance House –Lariba," *Freddie Mac Press Release*, March 28, 2001, http://www.freddiemac.com/news/archives2001/islam.htm.

30 Ahsan H. Khan, "Free in the USA," *Zawya*, November 2006, http://www.zawya.com/printstory.cfm?storyid=ZAWYA20061206130343&1=130300061121.

31 "Islamic Financing Vehicles," *Zawya*.

32 Khan, "Free in the USA".

Certifying Sharia-Compliance in Financial Products: The Role of Islamic Values in Financial Decision-Making

Yusuf Talal DeLorenzo, *Shariah Capital*

Recently, a financial "mechanism" was developed, the purpose of which is to "Wrap a non-sharia-compliant underlying into a sharia-compliant structure."[1] In other words, the objective of the mechanism is to use non-compliant assets and their performance to bring returns into a so-called sharia-compliant investment or investment portfolio. This point is key to the entire transaction, and for that reason it needs repeating. What the product proposes to accomplish is to bring to the Islamic investor returns from investments that are not compliant with sharia principles and precepts. The questions that such a product immediately brings to mind are: How can sharia boards[2] approve such returns? Does the circumstance of direct or indirect delivery to the Islamic investor change the ruling? When the sharia of Islam is understood to differ from other legal systems because it may be characterized as both positive law and morality[3], is it possible to ignore the moral aspect of a financial transaction like this?

The means of delivery, a *wa'd* or promise, is widely seen to comply with sharia norms. Since it is compliant, at least to the letter of the law,[4] some sharia scholars have approved products that use a wa'd to deliver returns from non-compliant investments. By doing so, however, they have failed to consider the purpose of the transaction, they have failed to consider the movement of the cash and, most importantly, they have failed to consider the ramifications for the industry as a whole. At a very fundamental level, the reason for these failings is that they have not discerned the difference between the use of LIBOR as a benchmark for pricing and the use of non-sharia compliant assets as a determinant for returns.

In June 2007, a pioneering Islamic bank in the Gulf launched a principal protected note that was the first product using this "mechanism" to be offered to the public.[5] This was followed by another such product, also offered by a Gulf-based Islamic bank.[6] Prior to this, the mechanism was used in structured products offered by multinational banks to institutional investors and the treasuries of Islamic banks and finance houses. All of these products have been approved and certified by qualified sharia supervisory boards. Not all of these products, however, bring to the Islamic investor returns from investments that are compliant with sharia.

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1 Quoted from a term sheet presented to the author by a multinational bank seeking approval for a structured product based on this mechanism.

2 A Sharia supervisory board, SSB, is a group of Sharia scholars who oversee the operations of Islamic financial institutions. The Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) formally adopted a definitive Standard regulating the composition and functions of such boards, effective from 1 Muharram 1419AH, or January 1999.

3 For a discussion of how the classical jurists of Islam assumed the role of "moralists-cum-jurists" within Muslim society, see Bernard Weiss, *The Spirit of Islamic Law* (Athens and London: The University of Georgia Press, 1998), pp.165–166.

4 "…for the jurists, letter and spirit can never be in genuine conflict if by "letter" one means the clear, unambiguous pronouncements of the authoritative texts and if by "spirit" one means a divinely ordained principle derivable from those same texts." Weiss, op. cit., p.169.

5 DUBAI—Dubai Islamic Bank (DIB) yesterday announced the launch of five-year Capital Protected Notes issued by Deutsche Bank (DB) and linked to 'DB-GSAM ALPS Index' (Deutsche Bank - Goldman Sachs Asset Management). *Khaleej Times*, June 13, 2007.

6 According to a widely-circulated "New Product Launch Fact Sheet," The Emirates Islamic Bank Alternative Fund was launched on 26 June, 2007.

A Few Explanations

Before examining the mechanism from an Islamic legal perspective, however, it may be helpful to make a few preliminary remarks.

1) There should be no reason to object to the use of a wa'd on its own. The use of promises is a matter that the sharia boards of modern Islamic financial institutions have studied in detail.[7] Therefore, it will not be necessary to discuss the definition of a promise, its purpose, or its legal characterization (in terms of *wajib*, *makruh*, etc.).
2) The financial instrument that the wa'd structure seeks to facilitate is called a swap. Swaps are arrangements between counterparties to exchange cash flows over time, and they are very flexible. The most popular forms of swaps are interest-rate swaps and currency swaps because these allow effective management of both balance sheets and risk profiles. In an interest rate swap, for example, no principal is exchanged between the counterparties; only interest is exchanged. The utility of a swap comes from the ease with which it is entered into, as opposed to the numerous steps required to accomplish the same thing by other means.
3) LIBOR (the London Interbank Offered Rate) is the rate at which international banks charge one another for dollar-denominated loans in the London market and is therefore used widely as a reference for any floating-rate loan. Depending on the credit rating of the borrower, that rate may vary from LIBOR to LIBOR plus one or more points over LIBOR.

Before discussing the purpose of the transaction, the movement of the cash and, most importantly, the ramifications for the industry as a whole, it will be well to look at 1) how the wa'd mechanism is actually employed, and then 2) at the difference between the use of LIBOR as a benchmark for pricing and the use of non-sharia-compliant assets as a determinant for returns.

The Wa'd Mechanism

The product developed for the exchange of non-sharia-compliant returns for sharia-compliant returns generally begins with the purchase by the Islamic investor of sharia-compliant assets by means of a *murabaha* contract. In most cases, these will be commodities or base metals. Through a murabaha contract, the bank can offer sharia-compliance and fixed returns of, say, 5%. Then, to give the investor the ability to enhance the returns from the investment, the bank arranges to swap the returns from the murabaha with returns from another investment. The way it does this is by means of a promise, a wa'd. Effectively, what the promise says is that at maturity, or at the end of a certain period of time (generally

[7] The modified form of the classical murabahah sale has been the mainstay of Islamic banking for the past twenty or more years, accounting for as much as 70% of all sharia-compliant transactions (until about five years ago). The modern version of the murabahah includes a promise on the part of the client ordering the purchase, *al-Amir bi'l-Shira',* that it will repurchase the goods acquired by the bank on its behalf. From a modern business perspective, it is essential for the bank that such a promise be considered binding. Thus, while the notion that a promise is binding was a minority opinion in the classical jurisprudence, modern sharia boards have almost unanimously held the promise to be binding. Nicholas Dylan Ray, *Arab Islamic Banking and the Renewal of Islamic Law* (London: Graham & Trotman, 1995), pp. 51–54.

three to five years) the counterparties promise to swap their returns.[8] The bank then takes the further step of protecting the principal invested by the Islamic investor by one means or another.[9]

The benefits to the Islamic investor are obvious; the principal is protected, the returns will almost certainly be at least 5% (from the murabaha), and there is a good possibility that the assets in the other basket will outperform the murabaha. The benefits to the bank may not be quite so obvious, but in fact they are far greater than the benefits to the Islamic investors as we shall see later in this paper when we "follow the money."

Most importantly, however, the Islamic investor is told that the investment is completely sharia-compliant. This is because the money invested has been used for nothing other than the purchase of sharia-compliant commodities. The return on the investment, if it comes from the murabaha, is clearly compliant with sharia principles and precepts. And if the return comes from the other investment, by means of the promise to exchange returns, then those returns may be considered legitimate, halal, even if the investment is non-sharia-compliant. According to the Sharia Boards that have approved such exchanges, the non-sharia-compliant assets have been used to establish a price; and the promised exchange is for the value of the returns established by the performance of the non-sharia-compliant assets. This, they reason, is no different than using LIBOR, an interest rate,[10] to establish the price for a murabaha or an *ijara*. If the use of LIBOR has been nearly universally approved by sharia boards, then the swap achieved by a promise should also be approved.

LIBOR and How Returns are Determined

Let us now consider the difference between the use of LIBOR as a benchmark for returns and the use of non-sharia-compliant assets as a determinant for returns. Sharia boards have approved any number of less than ideal devices if they have been convinced that these will assist in promoting the industry in general. A good example is the use of LIBOR as a benchmark for pricing a murabaha or an ijara when floating rates are to be preferred over fixed rates. In the absence of a viable and widely-published alternative, LIBOR has been used repeatedly; and will likely continue to be used until the industry can develop and then agree upon a benchmark, or a set of benchmarks, based on criteria of its own, i.e., sharia-compliant criteria. In the final analysis, a benchmark is no more than a standard, and therefore non-objectionable from a sharia perspective. If it is used to determine the rate of repayment on a loan, then it is the interest-bearing loan that will

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8 The promise may also include a condition. For example, if the returns from the other basket of assets are greater than the returns from the murabahah, then the parties promise to swap.

9 Such principal protected products are similar in design to conventional capital guaranteed products with the obvious difference that to be sharia-compliant the capital must remain at risk. Using structured products, however, banks can "protect" the capital without actually guaranteeing its return. Such products have been on the market for a number of years and have won the approval of many sharia boards. Generally speaking, principal protection employs either options or dynamic allocations among baskets of assets with varying degrees of risk.

10 LIBOR is the London InterBank Offered Rate or the rate of interest at which banks in London offer to lend funds to other banks in London.

be haram [forbidden]. LIBOR, as a mere benchmark, has no direct effect on the actual transaction or, more specifically, with the creation of revenues.

In modern Islamic financial transactions, LIBOR has been used to facilitate the closing of literally hundreds, if not thousands, of sharia-compliant financings. It should be noted, however, that these do not involve interest. As explained above, LIBOR is merely a convenient and highly transparent measure of the financial markets. Most importantly, the use of LIBOR as a benchmark for pricing in no way means that interest has entered the transaction itself. This is because LIBOR is a notional rate. The bank loans that determine this rate will under no circumstances become a part of the sharia-compliant ijara or murabaha transaction that is benchmarked to LIBOR. Finally, the money paid into an ijara investment using LIBOR will never pass through to the banks whose rates contribute to the setting of LIBOR, and will certainly never finance, directly or indirectly, assets whose performance or credit rating will set that rate.

When a Muslim investor invests in a product that uses a promise to swap returns from a non-sharia-compliant investment, however, the matter is quite different. For, while LIBOR is a benchmark used to set a price by marking value, the wa'd is used to actually deliver that price, even if it does so synthetically. By means of the wa'd, the unwitting Muslim investor actually participates in the non-sharia-compliant investment, however indirectly. This is because, when the investor agrees to exchange murabaha returns for returns from another investment, the investor indicates *qubul* or approval of the other investment. If that investment includes non-compliant assets and instruments, like conventional bonds or treasury bills, then the investor is approving the same and the transaction must be considered unlawful. Finally, and perhaps most significantly, the money paid into the wa'd investment will most certainly be used to finance the other investment(s), however indirectly. Therefore, even if the Muslim investor is not directly financing non-sharia-compliant transactions, if the investment with the swap had not been made, those non-sharia-compliant transactions would not have taken place. This will be clarified later when we consider how the cash in such a transaction actually moves.

In modern Islamic financial transactions, LIBOR has been used to facilitate the closing of literally hundreds, if not thousands, of sharia-compliant financings.

The attempt to draw a legal analogy, *qiyas*, between the use of LIBOR for pricing and the use of the performance of non-sharia-compliant assets for pricing is both inaccurate and misleading. The only similarity is that both are used for pricing. Where LIBOR is used to indicate the return, however, the other is used to deliver the return or, as we shall see, the other is the return. Therefore, it is simply incorrect to justify the swap of returns from non-sharia-compliant assets by comparing the same to LIBOR and then saying that since the one is approved by sharia supervisory boards, the other should also be approved.

The Purpose of the Transaction

The purpose of the transaction was clarified by a spokesperson for the bank offering the product to the public who explained that it was designed to allow Muslim investors access to funds that operate in a non-sharia-compliant manner by "reflecting their performance."[11] The euphemistic description of what the product aims to achieve, like the simplistic explanation of how the money in the investment remains exclusively in compliance with sharia rules, is in my opinion a manipulation and, ultimately, a misrepresentation of the truth. The term sheet for one such product states unequivocally that its purpose is to "wrap a non-sharia-compliant underlying (asset) into a sharia-compliant structure."[12] Nothing could be clearer. When this is the purpose, how can a sharia board possibly approve? Does it matter if the structure and the transactional basis of these schemes are compliant with established sharia rules if the end product is the result of prohibited investments? Does it really matter if that result is direct or indirect if the returns are from investments that do not discriminate between right and wrong, halal and haram, good and harmful? What the public is invited to invest in is a basket that will "reflect" returns from anything from wineries, to pork futures, to casinos, to who knows what else? At the present time, the matter is in the hands of the investors, many of whom are institutional investors with their own sharia supervisory boards; and it is still unclear as to how those boards have decided to view the matter. In my opinion, this particular issue will answer the question of how modern sharia boards will actually deal with matters of morality.

The Movement of the Cash

Before the reader begins to suppose that this discussion is more about taqwa and less about fatwa, or morality rather than law, let us now consider the movement of the cash. The Islamic bank that offers this product insists that the Muslim investor's money is invested in a sharia-compliant product and that the returns are completely halal. Their claim is that the investor's money is used to purchase a principal-protected note, structured by a multinational bank, which invests in simple murabaha contracts. The contract for the note includes an agreement, no more than a promise actually, that if the returns from the murabaha are less than the returns from an internal hedge fund index, then the structuring bank will pay the investor an amount equal to the returns from the index. To be more precise, if the hedge funds outperform the murabaha, the investor will earn returns that are better than murabaha returns. And since the bank will pay investors with its own money[13], the investors will not receive returns directly from the conventional hedge

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11 Dylan Bowman, "Hedge fund market opens to Islamic investors," *ArabianBusiness.com*, June 12, 2007, http://www.arabianbusiness.com/14261-dib-opens-hedge-fund-market-to-islamic-investors?ln=en.

12 Ibid.

13 The Islamic bank's sharia board was careful to point out, quite correctly, that it is generally of no consequence to the Islamic investor where the bank's money comes from. This is not the issue.

funds (which may be using strategies that are non-sharia-compliant, investing in stocks that have never been screened, and selling securities that they borrowed but never owned, to say nothing of investing in interest-bearing bonds, futures, and a host of derivative instruments). In fact, the Islamic bank is happy to point out that it is not investing in any of these prohibited things, and technically, the bank may be right. However, as we shall see, the matter is not this simple.

When the Islamic bank takes in the investor's money, what actually happens? Let's imagine that the investor, say an Islamic pension fund, places US$100 million dollars in this product. The first thing that happens is that the Islamic bank passes the money to the structuring bank. That bank will do two things. Firstly, it will invest US$100 million, after deducting some fees for management, into murabaha contracts. Then, using the murabaha as collateral, it will make a loan to an asset managing bank, one with a prime brokerage of its own that works with hundreds of different hedge funds. The asset managing bank will then allocate that money to a selected group of fund managers. In the absence of any mandate to transact in compliance with sharia, the asset managing bank will choose managers and strategies solely on the basis of performance; and from a risk perspective, this means that the bank will seek to diversify its allocations. Of course, what this means is that some of the money allocated will certainly go to bonds, treasuries, debt instruments, and derivatives like futures, options, and swaps. Also, the loan made by the structuring bank to the asset managing bank will be made for interest at the same rate as the murabaha. In this manner, the asset managing bank suffers no gap between the murabaha swap rate and its borrowing costs.

In the middle of the transaction, the structuring bank is fully secured for its loan because the rates for the murabaha and the loan are matched. This means that the structuring bank, likewise, takes no risk. The structuring bank will also earn fees for the notes it has structured for the Islamic bank.

The money of the client of the Islamic bank, the Islamic investor's money is in a murabaha. By means of the note provided by the structuring bank, the investor's principal is protected as well. The client pays fees for both of these. Some fees go directly to the Islamic bank, others go to the structuring bank, to the asset managing bank, and to the managers of the various hedge funds. In this transaction, the greater part of the returns is shared by the hedge funds, the asset managing bank, and the structuring bank. The Islamic bank's earnings are significantly less than all these. The reason for detailing the money trail here is to point out how the investor's money, even though it remains in murabaha contracts, is actually put to work in ways that are clearly not in compliance with sharia rules.

It may be argued that this will happen anyway—whenever an Islamic bank or institution has dealings with a conventional bank. This may be so. But, ultimately what the conventional bank does with its money, when it becomes the bank's money, is its own business. But the transaction we are considering here has direct, predictable and immediate consequences. In other words, the Islamic client's investment in this product triggers a series of transactions, none of which is sharia-compliant. Moreover, these produce fees and earnings for other than the sharia investor. Can the sharia board of the Islamic bank ignore all of this, and approve the entire transaction because the first link in the series is basically a murabaha? Or is the sharia board compelled to consider the transaction in its entirety?

Consider the parties to this series. There is an investor, an Islamic bank, a structuring bank, an asset managing bank, and a number of hedge fund managers. Then consider how the money passes from one to the other, all the way to the fund managers. And then consider then how it passes all the way back. With each pass, more fees are added to the transaction. Consider also how the Islamic investor's money is the beginning point for the entire transaction. Without this initial investment, none of the rest will take place, no one will earn fees. It is this initial investment which ensures the participation of the structuring bank, the asset managing bank, and the fund managers because it is the initial transaction, the simple murabahah, which effectively creates and guarantees the capital. The irony is that no one, other than perhaps the unwitting Islamic investor, considers this transaction to be only a principal-protected note with a murabaha and a promise. On the contrary, this is a highly complex and profitable transaction involving several different parties at many different levels. In short, it is a golden opportunity for the banks because the money is virtually guaranteed and their risk is next to nothing.

…the investor's money, even though it remains in murabaha contracts, is actually put to work in ways that are clearly not in compliance with sharia rules.

In short, the Muslim investor is assured that the investment product is sharia-compliant because the swap mechanism, which involves a promise, apparently ensures that the Muslim investor's money never goes directly into anything prohibited. So, the Muslim investors' money may not be invested directly into the part of this transactional series that is actually performing and earning returns. Instead, a mechanism is required to bring the returns from that product to the Muslim investor indirectly. It is also clear, however, that an asset managing bank would not be allocating money to managers unless that money came from somewhere. Between the Muslim investor and the fund manager there may be an indirect link, but the cause and effect relationship is nonetheless present. In a very real sense, the promise to exchange the returns from the hedge funds establishes a direct link between those funds and the investor. It also identifies the series as a single transaction. As such, then, it cannot be ignored by the sharia board. The sharia board must consider every step in the transactional series; and when this is done, the sharia board must reject the product.

Ramifications for the Industry

When a sharia board gives consideration only to one part of the transactional series, it is only natural that it should fail to consider the consequences of the product for the industry as a whole. It is an unfortunate shortcoming on the part of the sharia board in this transaction that it has failed to consider the context of the offering. It is an even greater shortcoming when it fails to consider the consequences the product will have for the entire industry. When it is clear that a product cannot be offered in its own form or, in other words, when it cannot be offered directly, but must be offered by means of a derivative like a swap, red warning flags should go up. In such situations, the sharia board must pay careful attention to the circumstances of the offering. If the circumstances can be found to justify such a product, then it may be possible to grant approval. If not, however, approval must be withheld. In the case of promised returns from a referenced basket of assets, the assets must be sharia-compliant in order for the returns to be sharia-compliant. It really cannot be otherwise.

If consideration is not given to the underlying assets, or to the assets referenced by the swap mechanism, it could spell the end of the need for authentic Islamic products, services, and methodologies. Why should a bank bother to spend the extra time and money required to make a securitization into a sukuk? For less money and in less time, it can simply offer conventional bonds and then use the "mechanism" to match performance, appear to sanitize the money, and satisfy the investor that the investment is lawful. If such a mechanism is available at lower costs, then why license an Islamic index for sharia-compliant stocks? Why use mutual funds that follow guidelines laid down by Sharia Supervisory Boards? Why bother with all the complex structuring and documentation that go into sharia-compliant real estate deals? Or infrastructure projects? Or private equity? Or home finance? Why expend the resources required to develop new and innovative Islamic financial products and tools? The swap/wa'd "mechanism" makes all of that unnecessary. At a very fundamental level, however, this mechanism seeks to make the haram halal. This is the nature of the threat to our industry. The fatwa giving blanket approval for this mechanism may well be referred to as the Doomsday fatwa for Islamic finance.

If the product described in this paper is successful, managers of all manner of funds, not just hedge funds, will never be motivated to do what is necessary to manage and invest in ways that comply with sharia. But then why should they, if all they need to do is agree to swap performance? Asset managers can continue as before, buying and selling interest-bearing bonds, debt-based derivatives, pork futures, and bank, casino and brewery stocks. They can trade these however they wish, even by borrowing stocks and then selling them into the market without ever owning them, or by leveraging them and incurring interest on the leverage. In other words, Islamic investors will not know what managers are doing because an Islamic bank and its sharia board have assured them that by means of a special "mechanism" their money will remain separated and pure.

Sadd al-Dhara`i: Blocking Ostensibly Legitimate Means to Illegitimate Ends

When I first became acquainted with the details of the swap "mechanism" (several months ago, when I was invited to approve it by a huge multinational bank), I had thought that the best way to combat it was to have resort to *sadd al-dhara`i,* the legal device from our classical jurisprudence that blocks ostensibly legitimate means when these are employed for illegitimate ends. In other words, in the same way that the digging of a well in the middle of a road may be declared unlawful for the reason that it may lead to great inconveniences and economic losses by those who travel the road, I thought that this mechanism might be declared unlawful by sharia boards for the reason that its use may lead to prohibited investments. So, while a promise to exchange returns may be lawful, if the returns promised have been earned by illegitimate means (by funds that invest in Treasury futures, for example), then that promise may be declared unlawful as it has become a means, an ostensibly legitimate means, for illegitimate ends.

I am now convinced, however, that this transaction is prohibited outright; and that the application of sadd al-dhara`i in this instance is unwarranted. This is because of a subtle point of law regarding the application of when it is possible to resort to sadd al-dhara`i. The classical jurists have stated that whatever leads to involvement in the unlawful will either lead to the unlawful as a certainty or lead to the unlawful as a possibility. This product includes investments, even though they are entered into indirectly, that are clearly unlawful. Moreover, there is no doubt whatsoever that the transactional series leads inevitably, and repeatedly, to what is unlawful. That being the case, that what leads to involvement in the unlawful does so as a certainty and not as a mere possibility, then sadd al-dhara`i is inapplicable. There is no need to resort to sadd al-dhara`i because the transaction is clearly unlawful.

I quote, in what follows, from *al-Bahr al-Muhit, Kitab al-Adillah al-Mukhtalif fiha* by Badr al-Din al-Zarkashi, on the subject of Sadd al-Dhara`i: Blocking Ostensibly Legitimate Means to Illegitimate Ends.

> Know that whatever leads to involvement in the unlawful will either lead to the unlawful as a certainty or lead to the unlawful as a possibility.
>
> The first of these two (that it will certainly lead to commission of the unlawful) is not to be discussed under this heading. Instead the proper place for its discussion is under the heading of "That Which there is No Way to Escape the Unlawful Except by Avoiding It" (ما ال خلاص من الحرام الإ باجتنابه). The commission of such an act (whatever will certainly lead to involvement in the unlawful) is unlawful for the reason that whatever is required to ensure the performance of a required act is itself required. (And here the required act is that

one avoid what is unlawful; and what is required to ensure that it is avoided is avoidance of the act that will certainly lead to it.)[14]

To clarify this point, the product we are discussing leads, without a doubt, to the unlawful. Obviously, if fund managers are given no guidelines to follow for sharia-compliance, they will surely make investments that are not sharia-compliant, they will surely manage their cash in ways that are not sharia-compliant, and they will surely transact in ways that are not sharia-compliant. The statements given to the press by the Islamic bank offering this product admit as much. This being the case, that the product leads surely to the unlawful, there is no need to resort to sadd al-dhara`i to prevent the proliferation of the product because the product is already unlawful, owing to its leading directly and without doubt to what is unlawful. If there were some doubt about this, such that the product's leading to the unlawful was only a possibility, whether likely or unlikely, a strong possibility or a slight possibility, then recourse might be had by the jurists to the device known as sadd al-dhara`i. When the assets referenced by the swap mechanism are known to be unlawful, however, the transaction is unlawful and there is no need for recourse to any legal device for its prohibition. This being the case, there is also no need to discuss the opinions of the various classical scholars in regard to sadd al-dhara`i and its use.

It is an established principle of Islamic law that "whatever is required to ensure the performance of a required act is itself required" (ما لا يتم الواجب إلا به فهو واجب). When the avoidance of the unlawful is a requirement, if there is an act that will surely lead to the unlawful, then the avoidance of that act too is a requirement. It is for this reason that it is essential, *wajib*, to avoid or to reject, the "mechanism" in this product. This is because the "mechanism" is what allows the asset manager to deploy money gathered through this transaction, however indirectly, in funds that operate in ways that are non-compliant with sharia, and that invest in businesses that are non-compliant with sharia, ignoring all guidelines for Islamic investing that have been developed at great expense by businesses that respect the Muslim investor's need to transact and to invest only in ways that accord with the principles and precepts of the sharia.

Conclusion

My own feeling, as I considered the problem, was that sharia boards would have difficulty making a decision on the basis of purely moral considerations. As jurists, sharia scholars are trained to look at texts and at classical models, especially in regard to transactions. If a question of law is not answered directly in the texts, jurists are trained to seek indirect answers, often by drawing parallels from the body of accumulated jurisprudence, or through recourse to legal maxims and principles. Then, while Islamic

[14] The author continues, "The second of these two, that it will possibly lead to commission of the unlawful, may be a likely possibility or an unlikely possibility, or a possibility in which both (likely and unlikely) are equal. Such a possibility may be termed "means," or dhara`i."

law may be characterized as both a moral and a legal system, the jurisprudence that has developed around modern trade and commerce relies almost exclusively on derived legal considerations; even if these may be characterized as legal means to moral ends.[15] Thus, it is difficult to suppose that jurists will make decisions on the basis of purely moral considerations.

From a practical perspective, the question may be referred to the Auditing and Accounting Organization of Islamic Financial Institutions (AAOIFI), the standard-setting body for the entire industry. Since the "mechanism" that drives the product is based on a promise, or wa`d, which has applications in many modern instruments including the modern murabahah, AAOIFI should be requested to promulgate a standard dealing with every aspect of the wa`d and its uses.

The product described above presents Muslim jurists with a real challenge. If investor confidence is to be maintained, the industry must demonstrate its ability to regulate itself and insist upon the Islamic authenticity of all that it does or allows to be done in its name. In the past few years, modern Islamic finance has proved itself to be viable, innovative, and profitable. The question it faces now is whether it can prove that it is moral and responsible. والله تعالي الموفق والمعين، وهو الهادي إلى سبيل الرشاد (May God help us and guide us on the path of wisdom).

15 Indeed, while the prohibition of riba may be characterized as a moral prohibition, the prohibition itself is a legal matter. Once the prohibition is incorporated into law, all riba-related issues become subject to legal classification and the element of morality is marginalized.

Islamic Finance After September 11: Toward Arab-Malaysian Integration

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Modern Islamic finance came into the existence in the mid-1970s under the aegis of Saudi Arabia and other Gulf States, with some input, especially in terms of research and manpower, from Egypt and Pakistan. In 1983, Malaysia entered the field, and became a pioneer of financial innovation. Both Arab and Malaysian Islamic finance have over the years experienced high growth rates, though there was little interaction between the two. Malaysian scholars were seen by Arabs as too liberal in their interpretations and most of their innovations were viewed with suspicion. It took the attacks of September 11 to create new partnerships and a growing convergence between the two. This paper discusses the origins of Arab and Malaysian models of Islamic finance, their parallel evolution and the recent trend toward greater integration.

Ibrahim Warde

Arab Islamic Finance

Modern Islamic finance appeared in the early 1970s at the intersection of two important developments in the Islamic world: the rise of pan-Islamism under the aegis of Saudi Arabia, and the oil boom of 1973–74. With the creation in 1970 of the Organization of the Islamic Countries (OIC), the idea of updating traditional Islamic banking principles—an endeavor that had preoccupied a few Islamic scholars, particularly in Pakistan, for a number of years—was soon on the agenda. Research institutes focusing on Islamic economics and finance sprouted throughout the Islamic world. The quadrupling of oil prices turned many Islamic countries into financial powerhouses and favored a mood of experimentation and assertiveness. At the 1974 OIC summit in Lahore, the inter-governmental Islamic Development Bank (IDB), which was to become the cornerstone of a new banking system inspired by religious principles, was created. In 1975, the Dubai Islamic Bank, the first modern, non-governmental, Islamic bank came into existence. Over the next few years, Islamic financial institutions appeared in Egypt, Sudan, Kuwait, Bahrain, and Jordan. By and large Islamic finance was a creature of the Arab world, with Saudi Arabia and other Gulf states providing the bulk of the capital.

A significant geographic broadening occurred when Pakistan became, in 1979, the first country to embark on a full Islamicization of its banking sector. Sudan and Iran did the same, respectively in 1982 and 1983. The first paradigm of modern Islamic banking was established in those years. Islamic jurisprudents reinterpreted a rich legal but pre-capitalist tradition to suit the requirements of the modern era. Islamic banks were to avoid interest and focus instead on partnership finance, or profit-and-loss-sharing (*mudaraba* and *musharaka*). This new approach to finance was to be at once authentic, since it was rooted in the ancient Islamic way of financing trading caravans, and modern, since it resembled venture capitalism. With its focus on cash-poor but promising entrepreneurs, partnership finance held more economic potential than conventional, collateral-based lending, which favors established businesses. Another distinctive feature of Islamic banking was to be its focus on developmental and social goals.

The experience of the first Islamic banks proved quite disappointing. Many suffered heavy losses and a few had to be rescued by governments or central banks. Some of the

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reasons had to do with macro-economic factors such as the decline of oil prices after 1981. But there were also structural flaws that led to questioning the very model of partnership finance. Certainly the focus on the letter of the Islamic law could lead to a violation of its spirit. Thus, the preoccupation with real or physical assets led to a preference for investments in commodity markets and real estate—both quite speculative endeavors that contributed little to economic productivity. This strengthened the hands of those who advocated a "modernist" interpretation of the sharia. Islamic finance was often dismissed as a passing fad associated with the oil boom. In reality, it was on the cusp of a major boom, albeit after adjusting in fundamental fashion to new circumstances. The early disappointments gave rise to a new ijtihad, characterized by greater realism. Deregulation and technological change modified international finance, while political, economic, and demographic forces (the collapse of the Soviet Union and the advent of globalization, a changing oil market, the rise of Asian "tigers," a growing Islamic presence in the West, the emergence of new Islamic middle classes, etc.) had transformed the Islamic world. More pragmatic approaches gained ground. The new world of finance, characterized by the blurring of distinctions between commercial banking and other areas of finance, financial innovation, and the downgrading of interest income, allowed Islamic finance to thrive. The downgrading of interest and the concomitant rise of fees as a major source of revenue for financial institutions allowed Islamic bankers to sidestep the controversial *riba* issue

The ambitious ideal of participatory or partnership finance never really materialized. Most Islamic institutions focused instead on "cost-plus" operations such as *murabaha*, where the bank would purchase the goods needed by the "borrower," and then resell them to him at a profit. Deregulation in the 1980s and 1990s also fostered the creation of tailor-made Islamic products. Until then, financial institutions could only sell a narrow range of financial products. With the lifting of constraints on the products that "financial engineers" could devise to suit every need—religious or otherwise—Islamic products could be created. Arab Islamic banks also became more open to innovation—though as we shall see not nearly as much as Malaysian banks. For all intents and purposes, Islamic banking appeared more and more as an attempt to mimic many aspects of conventional finance, albeit through Islamic contracts and within boundaries imposed by religion. Rapid and sustained growth followed. A few leading international institutions took notice, in 1996, Citibank opened an Islamic subsidiary in Bahrain, in 1998, HSBC created its Islamic HSBC Amana unit in Dubai. That same year, the Dow Jones Company created the Dow Jones Islamic Index. Slowly but surely, Islamic banks entered the mainstream of international finance.

The Malaysian Model

The Malaysian model of Islamic finance can only be understood in relation to the country's political, economic and demographic contexts, Malaysia, a multicultural country of 25 million people, with 30 ethnic groups and subgroups in 13 states, has three distinct ethnic/religious communities: 61% of the population is Malay (mostly Sunni Muslims), 30% Chinese and 9% Indian. For generations, the Malaysian economy had been controlled by minority communities (Chinese and to a lesser extent Indians). Except for a small Westernized elite, the Malays, or bumiputras (literally "sons of the land"), kept to their villages and were excluded from business life. At the time of Malaysia's independence in 1957, a deal was struck whereby in exchange for citizenship for the Indians and Chinese, the bumiputras were given political supremacy. Malay became the official language, and Islam the state religion. Ever since, politics and economics were largely structured along religious and racial lines.

Following riots in 1969, the government adopted in 1970 a New Economic Policy (NEP) which provided a host of preferential policies for bumiputras: quotas in universities, housing, government jobs, government contracts, etc. The main architect of the transformation of Malaysia from agricultural backwater to Asian "tiger" was Mahathir Mohamad, who was Prime Minister between 1982 and 2003. In addition to persevering in the giant "affirmative action" program designed to benefit the Malays, he wanted to turn Malaysia into a rich country by the year 2020. Grandiose projects, such as the Multimedia Super Corridor and the twin towers of the world's tallest building came to symbolize the country's ambitions. Despite setbacks such as the 1997 Asian economic crisis, Malaysia has generally been successful in its developmental drive, with a thriving middle class and annual growth rates consistently approaching the double digits.

> For all intents and purposes, Islamic banking appeared more and more as an attempt to mimic many aspects of conventional finance, albeit through Islamic contracts and within boundaries imposed by religion.

The first experiment in Islamic finance can be traced back to the Muslim Pilgrims Savings Corporation, which was set up in 1963 to help people save for performing hajj. In 1969, it evolved into the Pilgrims Management and Fund Board or the Tabung Haji as it is now popularly known. The real beginnings of Islamic finance in 1983 attracted little notice. Unlike countries such as Sudan and Iran, which were then engaged in the wholesale Islamicization of their banking sectors, Malaysia opted for a dual banking structure whereby an Islamic sector would coexist with the conventional one. The approach was consistent with the view that Islam could be harnessed to the goal of economic growth through the embrace of high technology and finance. Malaysia took a further pioneering step in 1993 when it allowed conventional banks to offer Islamic banking services through dedicated Islamic windows.

The 1983 Islamic Banking Act created Bank Islam Malaysia Berhad (BIMB), a full-fledged commercial bank, controlled by the government and in which the Tabung Haji had 12.5% participation. The bank's memorandum of association stated that "all businesses of the company will be transacted in accordance with Islamic principles, rules and practices." In 1985, the government set up Syarikat Takaful Malaysia, which it touted as the world's first Islamic insurance company. In the following decade, Malaysia issued Islamic corporate bonds, introduced Islamic Acceptance Bills and an Islamic export credit refinancing facility. It also introduced an Islamic Interbank Money Market (IIMM), Islamic Unit Trusts (IUT), Islamic Debt Securities (IDS), Islamic commercial paper, and an inter-bank and check-clearing system. The introduction of indices and benchmarks—such as the RHB Islamic Index which tracks the performance of listed companies that do not contravene Islamic principles or the minimum benchmark for mudaraba interbank investments by which a bank obtains an investment from another on a trustee profit-sharing basis—was another step taken to promote credible capital markets.

Malaysia also encouraged consumer finance by offering encouraged its Islamic home mortgages and a wide array of financial services to consumers. It was the first country to introduce Islamic mortgage bonds based on the profit-sharing principle. Malaysian banks also pioneered the use of Islamic credit cards. More recently, Malaysian banks pioneered the use of certain Islamic derivatives, such as the profit-rate swap, conceived as a sharia-compliant substitute for an interest-rate swap.

Another singular characteristic of the Malaysian system is that Islamic products were geared to Muslims as well as to non-Muslims. Muslims would have the opportunity to invest according to their religious beliefs, while non-Muslims, especially for Chinese minority which controls most of the country's wealth, would have an extension of choice in money-management. A number of privileges, such as tax incentives and greater flexibility with respect to their liquid asset holdings, were extended to Islamic banks

As of this writing, Malaysia has 12 Islamic banks, six Islamic units of conventional banks and three foreign Islamic banks. The Islamic sector controls 12% of banking assets and seems on track to reach the government goal of 20% of assets by 2010. In addition, some 80% of shares traded on Bursa Malaysia, the country's stock exchange, are sharia-compliant.

Mutual Suspicions and Parallel Evolutions

Although both Arab Islamic banks and Malaysian banks experienced rapid and sustained growth, they evolved along separate paths, and had minimal interaction. Scholars in the Arab world considered their Malaysian counterparts were a bit too lax in their religious interpretations, and that Islamic institutions, in their rush to grow, were cutting too many corners. They often referred to the Islamic sector of that country simply as "Malaysian finance." Especially contentious were the issues of *Bay' Dayn* (sale of debt) and *Bay' 'Ina* and, which were essential building blocks to Islamic corporate debt. Outside of Malaysia, most scholars consider the sale of debt to be un-Islamic. As for *'Ina* (under which somebody sells a good for cash and then buys it back from the same person at a higher price in exchange for deferred payment), most schools of Islamic jurisprudence consider it a *hila* or ruse to get around the prohibition of riba, though the Shafii school consider it acceptable.

Behind those differences were fundamental political-economic and religious factors. From a political-economic standpoint, the Arab ijtihad was primarily driven by the surpluses generated by the oil boom of the mid-to-late 1970s whereas the Malaysian effort was driven by the developmental imperative combined with the domestic political factors discussed earlier. In other words, the first was concerned with asset management while the second focused on generating sources of financing for the economy. More broadly, differences in religious traditions and political-economic contexts resulted in divergent interpretations and practices. Another fundamental difference between the two systems is that the Arab model had evolved in somewhat haphazard fashion whereas the Malaysian model was clearly based on a directive, top-down approach. Whereas the sharia guidance Arab model was fragmented and decentralized, Malaysia sought consistency by centralizing the process at its Central Bank.

Although initially influenced by the earlier, mostly Arab and Pakistani, ijtihad on Islamic finance, the Malaysian approach to Islamic finance was to a large extent based on the work of Malay scholars. As part of policies stressing the promotion of Malays, a veritable ijtihad under government prodding had taken place. Islamic research centers and universities engaged in a vast effort to legitimate modern finance, and in particular to create an "Islamic capital market" that would use specially designed interest-free bonds and other securities. The International Islamic University opened a management school. The Malaysian Institute of Islamic Understanding (IKIM) held seminars on all aspects of religion and finance. The message was that industrialization and productivity were fully compatible with piety, and that welfare in this world was fully compatible with salvation in the next.

Scholars in the Arab world considered their Malaysian counterparts were a bit too lax in their religious interpretations, and that Islamic institutions…were cutting too many corners.

In order to avoid bickering among rival schools of Islamic thought, Mahathir established in 1997 a National Syariah [sharia] Board designed to harmonize financial practices and review the compatibility of new financial products with religion. In a statement, Bank Negara Malaysia (BNM), the country's central bank, said that it would be "the sole authoritative body to advise BNM on sharia issues pertaining to Islamic banking and insurance (*takaful*) operations."[1] Such a Board was also to play a key role in establishing Malaysia's credibility as a hub for Islamic products.

The Malaysian brand of Islam has been fused with other influences (nationalism, capitalism, "Asian values") to produce a unique ideology of development.[2] Rather than being an obstacle to change, religion was to be an engine of growth and modernization

1 *Business Times*, July 10, 1997.

2 Khoo Boo Teik, *Paradoxes of Mahathirism: An Intellectual Biography of Mahathir Mohammed* (Oxford: Oxford University Press, 1995).

and a tool to promote financial innovation. An Islamic financial system that could offer a growing array of sophisticated financial services was part and parcel of the effort to turn Kuala Lumpur into a leading regional, if not international, financial center. The Malaysian model also reflected a different balance of power between the political and the religious establishments. In much of the Arab world, the religious establishment had an autonomous power base and could not be easily swayed by political rulers. The contrast with Malaysia is striking. There, on numerous occasions, Mahathir expressed impatience with ulemas arguing over the fine points of religion rather than putting religion at the service of developmental goals. He accused them of being dilatory, inconsistent, or too harsh. According to Mahathir: "Only when Islam is interpreted so as to be relevant in a world which is different from what it was 1,400 years ago can Islam be regarded as a religion for all ages." More specifically, he objected to those who wanted to interpret the Quran too literally. For him, the tolerant, forgiving spirit of religion should be the starting point.[3] Or, in the words of his one-time heir apparent (later disgraced) Anwar Ibrahim, "In implementing Islamic principles in banking and finance, we must address substantive issues rather than be always preoccupied with terminology and semantics."[4] A recurring theme in speeches and publications was that hard work was a form of "jihad."[5] The ulemas were challenged to a new "ijtihad" rather than be content with the imitation of existing models, they were asked to adopt a more innovative approach, exploring the wide array of sharia concepts that had not even been tested. They were also encouraged to look at the state-of-the-art in global finance, and create corresponding Islamic products.[6] The only products to be excluded were those that went explicitly against Islamic beliefs.

Toward Arab-Malaysian Integration

The growing integration of Arab and Malaysian Islamic finance could be traced to the direct and indirect consequences of the September 11 attacks. Until then, Islamic institutions paid lip service to the integration imperative, yet the main players pursued go-it-alone strategies.

Following September 11, Islamic banks and financial institutions provided a logical target to those who were quick to associate anything Islamic with terrorism. In a climate of generalized suspicion, Islamic banks—and more broadly banks from the Islamic world—were considered guilty until proven innocent. Virtually every work in the "secrets of terrorist financing" genre made such allegations.[7] The U.S. Treasury asked foreign bank regulators, including the Saudi Arabian Monetary Authority, to place Islamic banks

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3 *Financial Times*, April 26, 1997.

4 *Financial Times*, November 28, 1995.

5 *The Economist*, August 7, 1993.

6 *Business Times*, July 17, 1997.

7 Richard Labévière, *Dollars for Terror: The United States and Islam* (New York: Algora Publishing, 2000), p. 86–87 and p. 134–140; Jean-Charles Brisard and Guillaume Dasquié, *Forbidden Truth: U.S.-Taliban Secret Oil Diplomacy, Saudi Arabia and the Failed Search for bin Laden* (New York: Nation Books, 2002), p. 81.

under close surveillance.[8] Major lawsuits filed against alleged terrorist financiers on behalf of the families of victims of the September 11 attacks listed Islamic banks among the defendants. Former National Security Adviser Sandy Berger, the top official in charge of the surveillance of Bin Laden's networks during his tenure at the White House (1996-2000) casually stated that it would be difficult to track down Osama Bin Laden's money because it was hidden in "underground banking, Islamic banking facilities."[9] And it took six months for Treasury Secretary Paul O'Neill, the official in charge of the financial war on terror, to "learn," in March 2002 following meetings in Saudi Arabia, Kuwait and Bahrain, that Islamic banking is "a legitimate way of doing business."[10] Even well after it became clear that all those rumors were unfounded, accusations about the connection between Islamic banks and terrorism often resurfaced.[11]

The blow to the industry was considerable since it had been well-integrated into the global economy and widely regarded as a way of countering Islamic extremism.[12] At a November 2001 Islamic Banking Conference in Bahrain, two of the most prominent figures in Islamic finance expressed dismay at the smear campaigns against their institutions. Prince Muhammed Al-Faisal declared: "We all condemn the September 11 attack on the World Trade Center and Pentagon as a heinous crime, which has nothing to do with Islam or Muslims as a whole. The West is raising various questions. But these questions are not raised with us, but with "experts" who do not know anything about this." Asked about the freezing of assets of some Islamic institutions, he said: "If they wanted to do it merely on the basis of suspicion let them do it. Of course, it is fair to freeze anyone's assets if there is proof and there should be remedy if they do so without any proof." As for Sheikh Saleh Kamel, founder of the Al Baraka Group, and chairman of the Council of Islamic Banks, he declared: "The concept of Islamic banking is one of the creative methods of Islam to serve the economic and social welfare of Muslims. But some circles tried to use the September 11 attacks to launch a campaign under the false pretext that these Islamic banks are the source for financing terrorism."[13]

Even well after it became clear that all those rumors were unfounded, accusations about the connection between Islamic banks and terrorism often resurfaced.

In response to perceived hostility, the effort at international coordination and standardization grew more serious and better focused. Throughout the Islamic world, the general rise in Islamic religiosity translated into greater demand for Islamic financial

8 *The Wall Street Journal*, February 5, 2002.

9 Gene J. Koprowski, "Islamic Banking Is Not the Enemy," *The Wall Street Journal Europe*, October 1, 2001.

10 *The Wall Street Journal*, March 12, 2002.

11 Rachel Ehrenfeld and Alyssa A. Lappen, "Financial Jihad," *Human Events Online*, September 22, 2005.

12 Clement M. Henry and Rodney Wilson, eds., *The Politics of Islamic Finance* (Edinburgh: Edinburgh University Press, 2004).

13 *Gulf News*, November 12, 2001.

products. A crucial development was the freezing of the assets of prominent Saudis, and the crackdown on Islamic financial institutions and charities, which led many Muslim investors to take a significant chunk of their assets out of the United States. Home markets could not absorb all those withdrawals (estimated at about US$200 billion) and the quest for a new diversification strategy led more or less naturally to Malaysia, a Muslim country which had achieved an impressive level of economic development. Other forms of political and economic interaction also intensified. The Malaysian Prime Minister's stature grew in the Islamic world as he took a strong stand against those aspects of the global war on terror that he considered as unfairly targeting Muslims. Trade and especially tourism (many Gulf Arabs chose to vacation in Malaysia rather than in the United States or Europe).

Earlier misgivings about diverging interpretations of the sharia gave way to a quest for common ground. The most dramatic example was the 2002 sovereign Malaysian sukuk, which explicitly targeted Gulf investors (for that issue, Malaysian as well as Arab sharia scholars gave their endorsement). Soon afterwards, those ijara sukuk formed the template for a number of Arab sukuk issues.[14] The Malaysian Central Bank alongside with its Arab counterparts played a key role in finding common ground. As a way of promoting its own viewpoint, Bank Negara Malaysia is spending US$57 million to invite Islamic scholars from around the world to Kuala Lumpur for a "shariah dialogue" program.[15]

The Arab-Malaysian integration is part of a broader phenomenon of regionalization of Islamic finance.

Malaysia started working closely with Arab regulators, especially those of Bahrain and the United Arab Emirates on matters of Islamic finance. The Dubai Financial Services Authority (DFSA) recently entered into a memorandum of understanding with Bank Negara Malaysia, committing both parties to the further development of international Islamic finance markets. As a result of the joint initiative, DIFC (Dubai International Financial Centre) domestic funds will be the first foreign funds permitted to be sold into Malaysia.

Especially worthy of mention is the creation of the Islamic Financial Services Board (IFSB) in Malaysia in 2002. This organization sought to coordinate bank supervision, promote Islamic finance and facilitate the integration of the Islamic sector in mainstream finance. Working closely with the International Monetary Fund, the Islamic Development Bank and the Basle Committee, the IFSB issued in 2005 a draft on the Basle 2 rules for Islamic institutions. Although in existence since 1991, the Bahrain-based Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was reenergized in its effort to harmonize accounting and auditing rules and create standard contracts.

The relatively closed Malaysian market has also progressively opened its doors to Arab Islamic banks. At the end of 2001, the Malaysian government established the

14 Ibrahim Warde, *Islamic Finance in the Global Economy*, (Edinburgh: Edinburgh University Press), second edition (forthcoming).

15 Yaroslav Trofimov, "Borrowed Ideas: Malaysia Transforms Rules For Finance Under Islam; In a Lesson to Arabs, Asian Bankers Mix Religion, Modernity," *The Wall Street Journal*, April 4, 2007.

first International Islamic Financial Market (IIFM) at its Labuan international offshore financial center (IOFC), where foreign Islamic institutions were encouraged to establish branches. The Malaysian Central Bank introduced tax incentives to encourage overseas institutions to enter or expand in Islamic banking, insurance and fund management.[16] Foreign institutions can now hold up to 49% of the Islamic banking units of Malaysian banks.

Most significantly, since 2006, three Arab Islamic banks have been authorized to operate in Malaysia: Kuwait Finance House, Saudi Arabia's Al-Rajhi and the Asian Finance House. The first two powerhouses of Islamic finance had initially been major players confined to their home markets, while the third is a joint venture of Qatar Islamic Bank and other Middle Eastern investors. Saudi-based Al-Rajhi, whose Malaysian operations have a Sharia Board consisting of two Saudis and two Malays, has experimented with products inspired by Malaysian practices before trying to re-export them to its home market. One example is a profit-and-loss sharing account whose remuneration, like those of a conventional savings account, is fixed and predetermined (thanks to a profit reserve account which allows the bank to cover fluctuations in its profits and losses).[17] Another interesting development is the broadening of sharia boards of Malaysian banks to Arab scholars.[18]

The Arab-Malaysian integration is part of a broader phenomenon of regionalization of Islamic finance. Dubai Islamic Bank, the first Islamic bank, has also recently expanded its operations to Pakistan. As for Singapore, it has announced its intention to become a hub of Islamic finance. The Development Bank of Singapore (DBS) has recently established, in association with Arab investors, the Islamic Bank of Asia, to focus on wealth management and capital market instruments for corporate and private banking clients in the Middle East and Asia.

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16 Roula Khalaf, Gillian Tett and David Oakley, "Eastern promise turns to western delight," *Financial Times*, January 18, 2007.

17 Yaroslav Trofimov, "Borrowed Ideas: Malaysia Transforms Rules For Finance Under Islam; In a Lesson to Arabs, Asian Bankers Mix Religion, Modernity," *The Wall Street Journal*, April 4, 2007.

18 "CIMB appoints Sheikh Nizam Yaqubi to Syariah body," *The Edge*, July 11, 2006.

Islamic Finance: Its Sustainability and Challenges

Shamshad Akhtar, *Governor, State Bank of Pakistan*

CLOSING KEYNOTE ADDRESS

Shamshad Akhtar

In the closing session for this event on Islamic finance, I propose to reflect on the growth and trends in Islamic finance, its size and dimensions, and prospects which are now evolving from a regional to global scale and impacting private capital flows. The renewed interest and hype in Islamic finance is unprecedented. Since it coincides with commercial interest of Western financial institutions to attract flows generated from oil revenues and other savings, there is a degree of skepticism regarding sustainability of interest and trends in Islamic finance industry within and outside Muslim jurisdictions. Also there are concerns echoed on whether the industry will persevere the competition from the global financial world nurtured by the conventional system backed by strong legal, policy, regulatory, and institutional frameworks.

In my assessment, Islamic finance now seems to be a reality and is on its way to being institutionalized, albeit at different levels in different countries, and the Western world is also now selectively and cautiously positioning itself to invest in this system. There are promising signs that Islamic finance trends are sustainable. It is entrenched in a well conceptualized Islamic economic system whose mysteries are being unfolded with renewed academic interest in the subject. While undeniably faith driven, the Islamic finance system has great potential to meet the financial gaps and requirements of development and society at large and as such its demand would be robust going beyond religious grounds.

Islamic finance has to be recognized as a parallel system which will augment and be augmented by the deeper knowledge and experience of the conventional financial system. As such, the key challenge to its growth and sustainability lies in how it interfaces with and benefits from complementing and supplementing the conventional system and how it adapts and conforms to the international regulations and supervision adequately refined in line with the technicalities and nuances of Islamic financial instruments and their associated risks. Exploiting properly the unique features of Islamic finance with appropriate adaptability, without compromising *sharia* principles, will be critical to the growth and promising future of the Islamic finance industry.

Touching on some of these debates, I propose first to discuss the trends in Islamic finance, lay the case for sustainability of Islamic finance, and finally discuss some of the key challenges facing the industry which the Islamic financial community is now trying to address.

Global and Regional Growth and Trends

Spread across 70 countries, Islamic finance has grown to almost a US$1 trillion industry. Despite its growth, given its current size and composition it is still a niche market in the overall global financial industry. Prospects for the industry are quite bright given strong demand for financial services from a large segment of the world's 1.4 billion Muslim population and need to channel effectively rising foreign savings and high net worth individuals.

The growth, level, interest, and motivation to promote this industry varies across the globe. The growth in the Gulf Cooperation Council (GCC) has been exceptional with

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Bahrain emerging as a main center adopting and implementing Islamic banking regulation, with the Central Bank of Bahrain having the distinction of being the first central bank to issue *sukuk* and establishing center for Islamic finance education, etc. Moreover, Iran and Sudan declared 100% conversion to Islamic banking. Within Southeast Asia, Malaysia stands out with US$31 billion Islamic banking assets, a US$1.7 billion Takaful industry and has the largest Islamic private debt market which constitutes 45.5% of its total debt market.[1] Other countries in Southeast Asia have smaller Islamic financial markets and Singapore has positioned itself to offer strong wealth management potential. Within South Asia, Pakistan stands out for its proactive and systematic stance to develop the Islamic finance industry. In all these countries, assets of Islamic banking have grown faster than the overall banking assets, and the scope and coverage of financial services have been extended to retail and consumer finance, private equity, structured products, insurance and project finance, etc.

Distinct from Islamic countries is the interest of a few global financial centers such as London that now provides policy and tax incentives to promote Islamic finance industry to attract funds from high net worth clients. The same motivation seems to have driven global banks such as HSBC, Standard Chartered, Deutsche Bank, Citibank, etc. to set up special hubs to structure Islamic finance products.

In reality, while the current hype in industry may be partially driven by availability of surpluses generated by oil revenues, Islamic banking is also emerging as an alternate financing option that coexists alongside the conventional financial industry. Moving from traditional Islamic products, now the industry is offering consumer financing for residential purposes and structuring financing vehicles for supporting infrastructure and housing finance projects, among others. Product innovation is emerging with several different types of hybrid sukuks and other combinations of structures which involve different forms of *musharaka* with other products. Notwithstanding these developments, an increasing share of equity-based credit products, such as *murabaha* and *ijara*, remain the dominant form of Islamic financing across Islamic finance institutions.

These trends are expected to persist and the industry is set to grow. Standard & Poor's Services Rating Agency estimates that the industry has a potential to grow to US$4 trillion over the medium term.[2] As highlighted above, the exceptional growth in Islamic finance, particularly since 2000, which has coincided with growth in oil revenues, has raised questions as to whether interest in Islamic finance is a one time phenomenon and what the future prospects and sustainability of the industry are.

While motivations and driving factors for this industry vary across the world, this round of wave in Islamic finance industry is here to stay. What lends one confidence are the large investments by financial industry across main hubs in the GCC, Middle East, Southeast Asia, and South Asia, within the countries and growing foreign ownership and

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1 See PricewaterhouseCoopers, http://www.pwc.com/extweb/indissue.nsf/docid/1d681d874f24fda7ca25720a00158bfd (Malaysia: Leading Islamic Finance).

2 See Standard and Poor, http://www2.standardandpoors.com/spf/pdf/media/Islamic_Brochure_2006.pdf (Islamic Finance Outlook 2006).

joint ventures across borders, in infrastructure development in this industry through 1) issuance of holistic banking licenses or opening of special windows or creation of hubs, dedicated to Islamic asset management funds, private equity funds, and hedge funds accompanied by the Dow Jones Islamic Index to which all such transactions subscribe are large; 2) development of sharia knowledge and understanding and engagement of sharia advisors and scholars which together are providing required consensus, guidance, and legitimacy to Islamic industry, products, and structures; and 3) development of Islamic standard setters such as the Islamic Financial Supervisory Board and Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), International Islamic Financial Market (IIFM), etc. by the central banks as well as a range of multilateral development agencies including the Islamic Bank Development. The combined efforts have helped develop and initiate implementation of Islamic prudential regulatory, accounting and auditing frameworks, and inspection and supervision of financial institutions

All these regional and global efforts are serious long-term initiatives which are irreversible, though maintaining and building momentum on these fronts would be critical to address the questions of sustainability and challenges facing this industry.

Sustainability and Challenges of Islamic Finance

Prospects for sustainability of Islamic finance appear promising, but there are associated challenges which need to be concurrently addressed, while one exploits and maximizes the opportunities created by this discipline.

1) The sustainability of Islamic finance stems from recognition that Islamic economic and financial architectures have a lot of appeal and depth going beyond Muslim countries. While initially conceived to be solely anchored on a *riba* free interest rate regime, there is now appreciation that advocacy to move to Islamic business and finance structures, whether on religious or social grounds, is not a "slogan" or mere religious pronunciation or condemnation of riba, but is supported by a complete and deep Islamic ideology. When studied carefully, it has its logic and basis in a comprehensive Islamic economic system which deals with allocation of resources, production and exchange of goods and services, and distribution of wealth—all too familiar debates in conventional economic textbooks.
2) The confidence in sustainability of Islamic economic system emerges from the better understanding that this economic system is a wel-conceptualized, consistent, and integrated framework. More interestingly, it is accompanied by a rich and an elaborate set of tenets which, among others, recognize the right to property supported by elaborate obligations for stakeholders, principles and rules of conduct, a contract system and institutional framework and procedures for enforcement of rules which all together lay the foundation for Islamic business and financial architectures. It is this substantive Islamic ideological and legal framework, governed by sharia injunctions and principles, that have translated into defining the public and private economic and social affairs that eventually help frame business and financial relations. The core of

these relationships is backed by solid principles of contracts, rights, and obligations of parties to the contractual arrangements.

3) The sustainability of this system is reinforced by the business and financial relations that are guided by the logically defined emphasis on the preferred modes of transaction which advocate profit-sharing and as such rely on "ex-post" variability rather "than ex ante" fixity in returns and consequently have built in risk sharing as a central element of transactions. Relevance of contracts is at the core of Islamic transactions which defines the rules of game for sale and purchase, trade, exchange of goods and services. Financing contracts are then structured around the nature of transaction which could be either in the form of trade financing, asset based financing or different forms of partnerships. Under Islamic finance preference is given to trading of physical assets as well as trading of rights.

4) The confidence in sustainability emerges from the framework of enforcement implicit in Islamic system. The main driver of enforcement of contracts and rules-compliance in Islamic system is ideology and faith which is in turn influenced by Islam's emphasis on establishing an equitable, ethical, just, and fair socio-economic system. It is this feature which shapes up Islamic finance and also distinguishes it from the conventional finance. Although one can argue that sustainability of interest in Islamic finance is tied solely to the response of Muslim population to their religious values and beliefs, but it has to be recognized that attraction in this discipline is now widely emerging as better understanding of Islamic economics, finance, and mechanisms are being found to juxtapose the knowledge of conventional economics and financial engineering.

5) Flexibility and innovation to structure different types of financial products augur well for Islamic finance's sustainability. What distinguishes Islamic finance is its emphasis on trading of goods and services and its advocacy for profit- and risk-sharing in businesses supported by a variety of partnership arrangements—this is in sharp contrast to loan based financing in conventional banks. By virtue of these characteristics, Islamic finance offers prudent financing options being asset-backed or equity-based, particularly linkage of assets with financing ensures that transaction is less prone to debt crisis and funds are used for their prescribed purpose minimizing defaults resulting from improper use of borrowed funds. Concurrently, it offers promising potential for offering alternate avenues for saving and investment for all segments of population.

6) Market surveys confirm that the potential for retail, housing and project finance[3] and innovation emerging in these markets is significant and augurs well for economic and financial services development. Islamic banks have registered double digit growth in retail markets. Penetration has occurred faster where personal banking solutions have been well structured and where information technology is used to offer online, ATMs and telephone banking services. By and large products are structured on murabaha principles where funds are allocated for particular projects or finance an asset (such as home ownership and automobiles) in which depositor shares in the project rather than

[3] "Islamic Finance: The Way Ahead," Harvard International Review web log, February 10, 2007, http://hir.harvard.edu/blog/?p=200.

bank profits and to structure ijara (leasing) with appropriate asset backing and legal structures.

Islamic housing finance for acquisition and other purposes has evolved to be a natural and promising market to cater for huge home financing demand in Muslim countries. This market is gaining momentum following some interesting facilitation and incentives offered by some countries: for instance the United States has facilitated Islamic lease-to-own relationship by allowing a bank to take title to property, and in the United Kingdom the Bank of England has abolished double stamp duty on Islamic mortgages, ijara and murabaha transactions, and rationalized legal service fees and risk weightage, etc. Likewise Australia and Canada allowed adoption of declining balance partnership concepts to facilitate structuring diminishing musharaka contract, etc.

In some jurisdictions momentum for tapping retail market has been accelerated by partial or full conversion of conventional to Islamic banks such as Saudi Arabia, challenges of which cannot be underestimated as it involves converting the loan book to sharia-compliant modes of product. Stand alone Islamic banks have a challenging task of competing with the conventional players who have an edge on longevity, customer loyalty, and economies of scale. A high level of customer service, offering full product range, introducing a level of transparency in transactions, devising unsecured personal loan products (a wave emerging with adoption of *tawarruq* product), introducing sharia-compliant credit cards, handling properly the unfunded businesses, and improving efficiencies are some of the responses to the challenges of competition.

Large scale business opportunities, however, lie in exploiting project finance. Successful application and integration of Islamic instruments with the conventional financing has helped in this area while facilitating closure of large and complex multisource financing deals. Project financing—backed by asset and equity and structured using combination of ijara, istisna, sukuk, and musharaka, etc.—has offered opportunities for risk diversification, avenues for resource mobilization and revenue sharing, and performance of services between contractual parties. These deals have illustrated how conventional and Islamic financing can blend and coexist under common legal and regulatory arrangements.

Finally, more than conventional finance, Islamic finance emphasizes a just and equitable financial system. Among others, Islamic finance offers a financial inclusive option to Muslims who have excluded themselves from financial services in absence of riba free services.[4] Since a number of Muslim countries suffer from low financial services penetration, bringing in the appeal of sharia-compliant financing mechanisms could turn out to be a powerful tool for enhancing access to development finance and empowering the poor and vulnerable groups.

It is important to recognize that Islamic finance confines itself to largely socially and development projects and institutions are not permitted to invest in prohibited or socially undesirable investments. Emphasis on ethical issues and rigorous self-regulation

[4] Shamshad Akhtar, "Building an Effective Islamic Financial System" (presentation presented at the Global Islamic Financial Governor's: Financial Regulators Forum in Islamic Finance, Kuala Lumpur, March 27, 2007).

in terms of sharia supervision ensures fair play and justice and offers a superior consumer protection model. Furthermore, it induces higher financial discipline and places stringent ethical standards for all stakeholders that offer a strong and unique model of governance.

Conclusion

In conclusion, encouraging developments and trends in Islamic finance lend confidence that this industry has taken off. There are varying motivation and driving factors for the development of this industry ranging from religious fervor to the opportunities that exist in Islamic finance for broadening and deepening the process of financial intermediation which augur well for financial innovation and engineering, enhancing the financial services penetration in national jurisdictions, and for cross border capital flows. While the size of Islamic financial industry is still quite small as a proportion of the total world's financial assets, the current growth trends and the investments in infrastructure in development of its networks and regulatory and supervisory systems, lend confidence that this industry has promising potential.

Prospects for this industry appear comforting because of variety of factors, most significant being the strengths of Islamic ideology and economic system which offer a complete framework for the Islamic finance industry. An Islamic financial system lays down rules of conduct and contractual arrangements, and offers a feasible financing structure which emphasizes trade and equity financing that together will foster much needed financial diversification in Islamic countries.

Islamic finance also has potential to blend economic and social objectives and address the ethical aspects of effective financing. As such, it is generally more acceptable in populations with moderate to strong inclinations toward managing their financial relationships in line with their beliefs. This can help in poverty alleviation through inclusion of a larger proportion of population into the banking system giving them access to credit and mobilizing their savings effectively.

The emerging solutions and application to structure Islamic finance innovatively have helped cater to all types of markets and financing requirements, ranging from retail to project and home financing to equity funds, products, and insurance. Industry efforts to benchmark pricing and apply legal, regulatory service standards on par with conventional products and standards have also helped encourage confidence in the system.

Going forward, the sustainability of Islamic finance will rest in how the international community builds on the momentum achieved thus far. This would require:

- Further deepening the efforts to enhance the legal and regulatory framework of Islamic finance consistent with the international practices.
- Continued efforts to conform and align the structures and products in line with sharia principles to motivate Muslim populations to turn to this alternative mechanism of financing, while attracting others to product and risk management, mitigation innovation, and additional options that this window offers.

- Recognizing that Islamic finance has perpetuated and changed the dynamics of cross border private capital flows, this industry has great potential to augment the process of globalization and financial integration, but this requires more cooperation and vigilance on the part of home and host regulators.
- Launching aggressive efforts to implement the evolving Islamic financial regulatory and supervisory standards and capturing the different types of risks associated with Islamic finance, while launching consumer protection frameworks.
- Promoting more financial diversification by encouraging financial innovation and Islamic capital market development.

Glossary

alim (plural: *ulama*): a qualified religious scholar or learned person in Islam

awqaf (singular: *waqf*): An endowment or a charitable trust set up for Islamic purposes (usually for education, mosques, or for the poor). It involves tying up a property in perpetuity so that it cannot be sold, inherited, or donated to anyone; plural form for *wqaf*

Bay' Dayn: sale of debt; debt trading

Bay' 'Ina ('Ina): sale repurchase (someone sells a good for cash and then buys it back from the same person at a higher price in exchange for deferred payment)

Da'wa: to invite or invitation; proselytization

fatwa (fatwas): authoritative guidance, legal opinions from a qualified *fuqaha*

fiqh: Islamic jurisprudence; knowledge of Sharia norms and rulings achieved through the cumulative interpretative effort of *fuquha*

fuqaha (singular: *faqih*): chiefly religious-law scholars; scholars of *fiqh*

halal (halah): permissible by Islamic law

haram: forbidden, unlawful

hikma: wisdom; the divine purpose

hiyal (singular: *hila*):legal artifices

ijara: Islamic lease agreement

ijtihad: reasoning and interpretation of the sources of law, based on the Quran and Sunna

istisna': Advance purchase of goods or buildings where a commodity is transacted before it comes into existence

madrasa: Islamic religious school

makruh: disliked or offensive act

maqasid al-sharia: objectives of the Sharia

maslaha: general interest; used by some jurists to justify adjustments or innovations in jurisprudence where a pressing public interests seems to require change.

maslaha mursala: general utility

muamalat: commercial/economic transactions

mudaraba: trust financing, profit sharing; an investment partnership, whereby the investor provides capital to the entrepreneur (the *mudarib*) in order to undertake a business or investment activity. While profits are shared on a pre-agreed ratio, loss of investment is born by the investor only. The entrepreneur loses his share of the expected income.

mudarib: trustee, agent, entrepreneur

murabaha: Purchase and resale. Instead of lending out money, the capital provider purchases the desired commodity (for which the loan would have been taken out) from a third party and resells it at a predetermined higher price to the capital user. By paying this higher price over installments, the capital user has effectively obtained credit without paying interest.

musharaka: profit and loss sharing. It is a partnership where profits are shared as per an agreed ratio whereas the losses are shared in proportion to the capital/investment of each partner. In a musharaka, all partners to a business undertaking contribute funds and have the right, but not the obligation, to exercise executive powers in that project, which is similar to a conventional partnership structure and the holding of voting stock in a limited company. This equity financing arrangement is widely regarded as the purest form of Islamic financing.

qiyas: analogical deduction, legal reasoning *qubul*: approval or acceptance of the other investment

riba: excessive interest; the legal notion extends beyond just interest, but in simple terms *riba* covers any return of money on money—whether the interest is fixed or floating, simple or compounded, and at whatever the rate. *Riba* is strictly prohibited in the Islamic tradition.

sadd al-dhara'i: blocking ostensibly legitimate means to illegitimate ends

Sharia: Islamic Law

sukuk: Islamic bond; similar characteristics to that of a conventional bond with the difference being that they are asset backed, a *sukuk* represents proportionate beneficial ownership in the underlying asset. The asset will be leased to the client to yield the return on the *sukuk*

Sunna: practices and traditions of the Prophet Muhammad and the first four "rightly guided" Caliphs after the prophet

takaful: Islamic insurance; structured as charitable collective pool of funds based on the idea of mutual assistance, *takaful* provides mutual protection of assets and property and offers joint risk-sharing in the event of a loss by one of the participants. *Takaful* is similar to mutual insurance in that members are the insurers as well as the insured

taqwa: one's being heedful of the Almighty; piety

tawarruq: reverse *murabaha*; a transaction by which a customer purchases a commodity from a bank on credit and immediately resells the commodity to a third party for cash, the second sale usually arranged by the bank. In this way, the customer can obtain cash without taking an interest-based loan.

ulama (singular: *alim*): qualified religious scholars

wa'd: promise

wajib: necessary, obligatory, a legal characterization that performance of an act is necessary