

Demystifying Islamic Finance

Correcting Misconceptions, Advancing Value Propositions

Zaid Ibrahim & Co

Trusted Business Advisor

AUSTRALIA | DUBAI | INDONESIA | MALAYSIA | SINGAPORE | THAILAND | VIETNAM

About this Publication

The purpose of this publication is to raise public awareness of Islamic finance and to promote opportunities for Islamic finance generally. It does not constitute a legal opinion and does not seek to examine in detail potential legal, Shariah or tax issues relating to Islamic financial products or Islamic finance business practices. Readers are advised to seek professional advice before entering or subscribing into any financial contracts.

Acknowledgement

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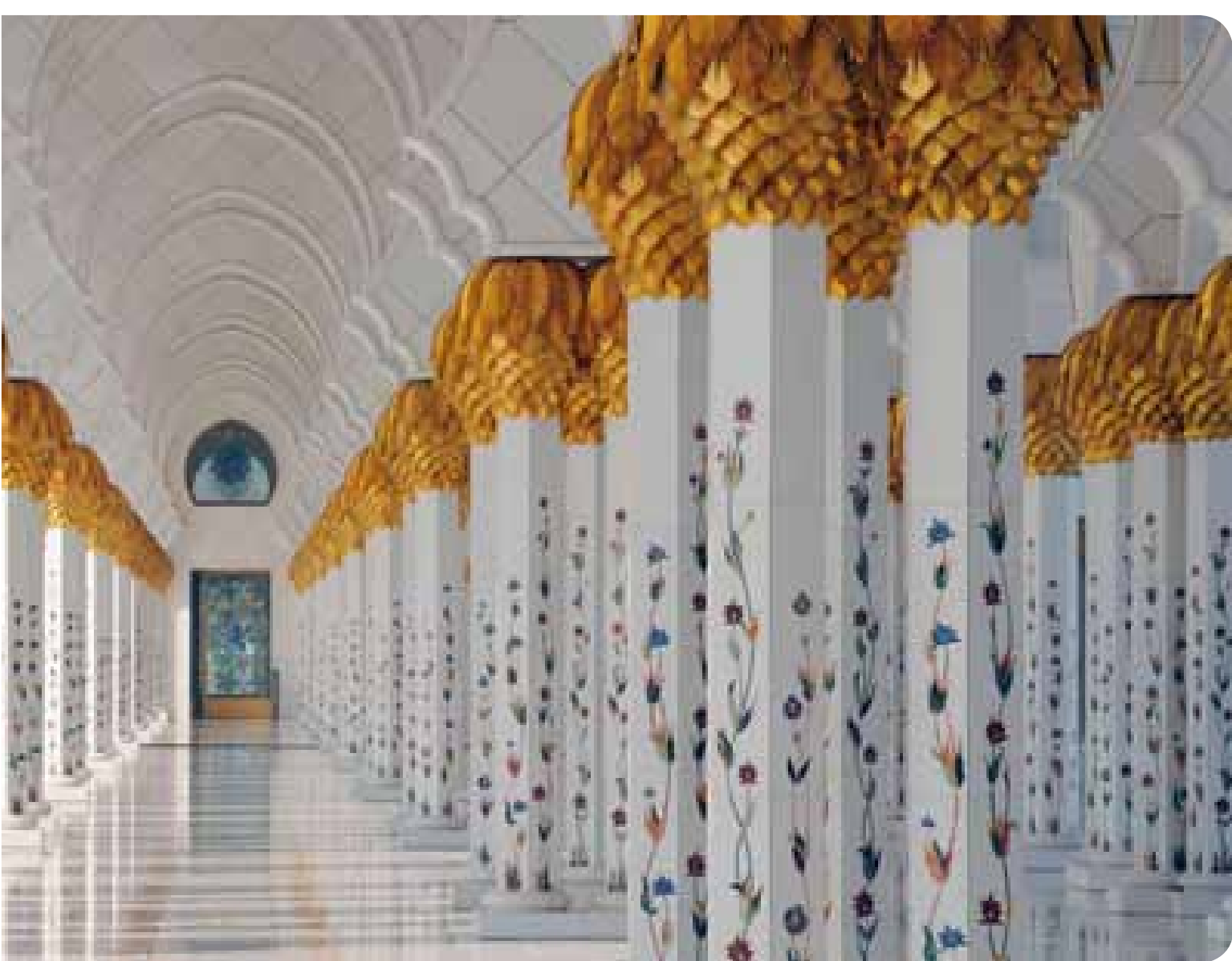
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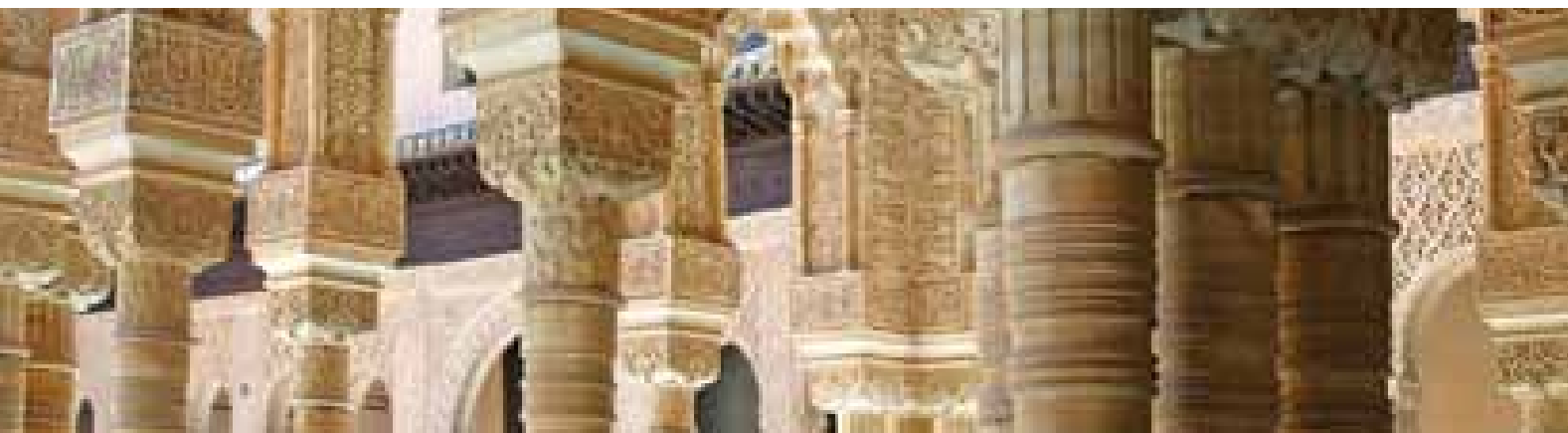
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YOUR LINK TO ISLAMIC FINANCE

1. Zaid Ibrahim & Co Islamic Finance Practice Group **2.** ZI Shariah Advisory Services
3. The Malaysia International Islamic Financial Centre (MIFC) Initiative

GLOSSARY OF ISLAMIC FINANCE TERMINOLOGIES



The recent global financial crisis seems to be a blessing in disguise for Islamic finance. Obviously one of its impacts has been an increasingly enormous interest around the world in the soundness and resilience of the Islamic finance model. This is plainly evidenced by, among others, initiatives undertaken by advanced economies such as France and the Republic of Korea to introduce new laws that accommodate the issuance of Sukuk (Islamic trust certificates). We have also seen how, notwithstanding the liquidity crunch, Indonesia has successfully raised funds through its inaugural sovereign Sukuk. We cannot help but observe that at this time when 216 conventional banks have failed since 2008 up to March 2010 in the US alone (Source: Federal Deposit Insurance Corporation, US), new Islamic banks seems to be mushrooming everywhere including in China, Germany and Kazakhstan.

As a leading law firm in the area of Islamic finance with vast experience in one of the most renowned international Islamic financial centres, Zaid Ibrahim & Co is very well positioned to offer its expertise and share its experience with everyone who is interested in Islamic finance. In line with our recent regional expansion, we are keen to extend our services to governments, market players and other stakeholders along the “New Silk Road” which stretches as far as Dubai in the Middle East down to Sydney and Melbourne in Australia. Beside our specialist lawyers whom are highly regarded within the Islamic finance fraternity, we also have an associate Shariah advisory outfit, ZI Shariah Advisory Services, which has impeccable capabilities in terms of providing Shariah advice and solutions.

As part of our small contribution to the nascent industry, we are proud to bring to you this publication that addresses some of the basic (but often less attended) questions regarding Islamic finance.

Madzlan Hussain, our partner and key person behind this initiative, articulates many of his meticulous observations of the industry within this compact publication. As a thoroughbred Islamic finance practitioner who has served the Islamic finance industry throughout his decade-old professional career, including several years at the Islamic Financial Services Board (the international standard-setting body for prudential framework in Islamic finance), Madzlan is well-travelled and has a deep first-hand experience in many pioneering work for the industry, including at the international level. I am sure readers would find the 15 most frequent misconceptions and 10 main value propositions of Islamic finance as highlighted by Madzlan in this publication to be particularly refreshing and insightful.

I would like to take this opportunity to thank everyone at Zaid Ibrahim & Co who has played their parts in putting together this publication. On behalf of the firm, I would also like to express our heartfelt thanks to the MIFC community who has been very supportive in all of our Islamic finance initiatives.

YBhg Dato’ Dr Nik Norzrul Thani

Chairman
Zaid Ibrahim & Co

When I returned to Zaid Ibrahim & Co (ZICO) recently to join its Islamic Finance Practice Group, it has been indicated to me by the leadership of the firm that my role will be, among others, to add further depths to an already illustrious and magnificent team they have; namely two first-class, Harvard-trained, highly-regarded partners – Megat Hizaini Hassan and Dr Aida Othman. Primarily, I am expected to bring in my modest broad international experience gained during my 6-year stint at the Islamic Financial Services Board (IFSB) to facilitate the firm's ambition as a premier provider of legal services in the area of Islamic finance throughout the jurisdictions where the firm has established a presence. These include Indonesia, Malaysia, Singapore, Thailand, Vietnam, the UAE, and most recently Australia.

I am deeply honoured when I was given the mandate to put together a publication that can be used to profile the firm's credentials in Islamic finance practice, while at the same time providing a useful overview and guidance especially to new markets that are interested to know about this young but fast-expanding industry.

After doing some research on what could potentially be suitable content for such a publication, I noticed that there still remains a vast amount of misconceptions out there about Islamic finance, especially reflected through polemics in websites, blogs, and financial publications. Unfortunately, one can hardly find any reference that puts together a simple, candid, and easy-to-the-eye response to most of the questions frequently asked about Islamic finance.

From my experience, some of the common questions have been raised not only by key stakeholders of the finance industry such as regulatory and supervisory authorities, market players, financial analysts and reporters, but also laypersons – the consumers and members of the public. For me, it is important that these questions be addressed and any misconceptions about Islamic finance be demystified, because the long-term viability and sustainability of the Islamic finance industry will be very much dependent on how far it can convince

everyone (Muslims and non-Muslims alike) that Islamic finance is a genuine ethical business and an authentic value proposition aimed at simply serving the needs and demands of the markets.

While certainly Muslims consider and subscribe to Islamic finance as ordained by their faith in accordance with the rules and principles set out in their law, the Shariah, it should be appreciated by all that the spiritual elements aside, Islamic finance truly has tangible benefits in terms of economics and social values for everyone. If we may suggest a simple analogy, Islamic finance can be viewed just like fasting, or yoga, or even muay-Thai, which has some forms of rituals and religious elements encapsulating it, but notwithstanding those elements and if we look underneath those elements, anyone regardless of his race, faith or cultural background, can actually learn, practice and benefit from the exercises. Indeed, it is only by breaking through such barrier of misunderstanding that we can remove any fear or concern about Islamic finance.

This publication is my humble attempt at sharing with the readers some insights into Islamic finance, in particular on issues and aspects that most often were asked by those who are new to Islamic finance. It does away with text-book references and academic discussion, minimises the uses of technical jargons, and use a language style that shall cater for most people who do not have the technical knowledge of Islamic finance.

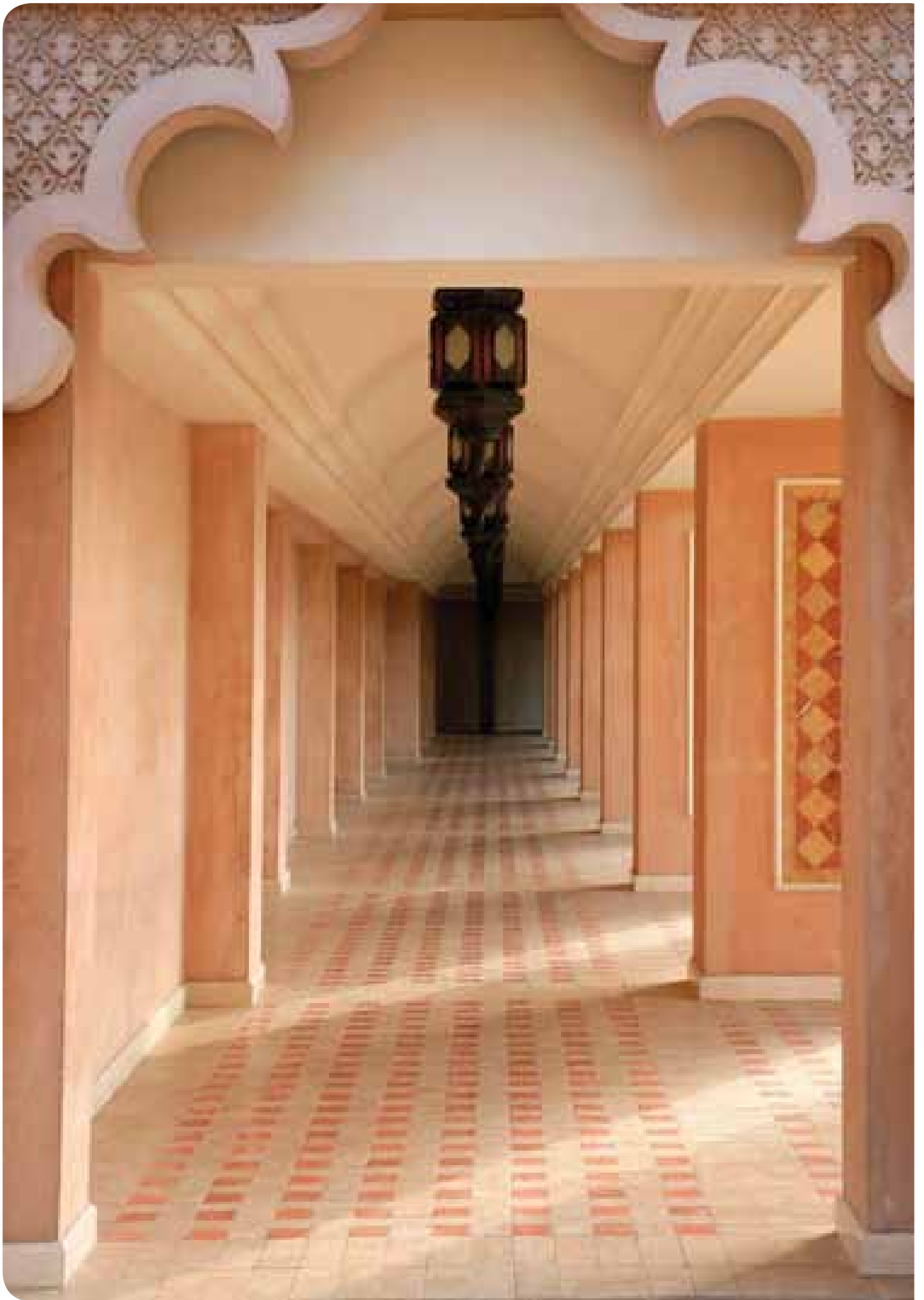
Nevertheless, it may be noticed that a slight emphasis is given to the legal and regulatory aspects in explaining how Islamic finance works, simply because this is the area that we in Zaid Ibrahim & Co know best.

It is our fervent hope that this publication helps to alleviate the general understanding and correct the public perception on Islamic finance.

Madzlan Mohamad Hussain

Partner

Zaid Ibrahim & Co



Islamic finance has been enjoying rapid growth for the past few decades and is now entering a new phase of its development, whereby the business has become more internationalised. The size of the industry has grown quite substantially to reach a trillion dollar threshold, and it has shown remarkable resilience amidst a devastating global financial crisis.

Notwithstanding an increasing worldwide interest, awareness and understanding of Islamic finance, a great deal still needs to be done in order to ensure such interest, awareness and understanding are based on sound and accurate information. Quite often, literatures on Islamic finance tend to be either partial or biased because the author is trying to sell (or debunk) the concept, or they are so scholarly and dense that the layperson cannot understand a word of it. We hope this publication is neither of these two.

Within the limited space of this compact publication, we summarise the various concerns that we know have always arisen amongst stakeholders of the financial services industry vis-à-vis Islamic finance, and share our thoughts over these concerns.

Here, through research and based on our own experience serving the Islamic finance industry, we have identified 15 most frequent misconceptions and 10 main value propositions that we believe everyone should know about Islamic finance. The relevant questions are addressed in a simple, candid manner with the paramount aim of providing a basic understanding of issues and removing any inaccurate or unfounded prejudice against Islamic finance.

For example, this publication highlights that Islamic finance is not terrorism finance, is not a mere replica of conventional finance, and not welfare finance as quite commonly misconceived by some quarters. It also negates the notion that Islamic finance is 'superior' and is inherently immune from unethical practices or from the impact of the

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global financial crisis. Instead, it emphasises that Islamic finance also requires strategic planning, active internal and external regulations, and controls to safeguard its integrity, because it can be exposed to excessive risk-taking, fraud or other misconducts if appropriate risk management and governance frameworks are not adopted.

We also articulate that the value propositions of Islamic finance may vary and can be tailored according to the different needs and objectives of the stakeholders – whether they are regulatory and supervisory authorities that wish to add depth to their financial system, financial institutions that wish to widen their customer base and diversify their product offering and risk profiles, or potential investors or businesses that wish to tap a new avenue for investment and raising capital. It is wrong to assume, for example, that Islamic finance is all about Sukuk and just because there is a shock triggered by Sukuk defaults in the Middle East, then the rest of the Islamic finance world is in limbo. Indeed, Islamic finance is more than what meets the eye.

We pray that this humble publication benefits its readers.



15 Most Frequent Misconceptions about Islamic Finance

It is most unfortunate that sometimes and in some countries, Islamic finance is simply considered **a political hot potato**. It does not deserve to be **underrated and undermined**; Islamic finance should be a tool for the global community to build bridges, not barriers. It ought to be an **instrument of inclusion, not discrimination**. Embracing it can help **promote goodwill and compassion**; neglecting it would only spur further misunderstanding and prejudices.

Notwithstanding its almost four decades of development, the fact remains that compared to its conventional cousin, **Islamic finance is still an infant**. A lot more nurturing needs to be done, plenty more patience and perseverance should be afforded.

Caution and criticism are warranted and welcomed, but should be constructive to contribute positively to the industry's well-being, rather than bludgeoning indiscriminately. Intellectual debates on the direction of the industry should be carried out in a respectful manner, in line with *adabul ikhtilaf* (respecting differences of opinions). **The focus of any debate should be on churning out feasible solutions, rather than finger-pointing and fault-finding.**

While the stakeholders of the Islamic finance industry share the common aim of fostering it to fulfil its true potentials and achieve the higher ideals of a sound financial system, we should also strive to remove the unfortunate misconceptions about the industry.

Misconception 1

TERRORISM FINANCE

The Shariah considers illegal use of violence – especially against innocent victims – as a heinous crime, and hence categorically condemns terrorism.

This means that, as a matter of principle, an Islamic financial institution is strictly prohibited by the Shariah from knowingly assisting, what more actively participating, in terror-related activities.

Unfortunately, since 9/11, international politics have seen prejudice and animosity against Islam to have escalated to new heights. Amidst this climate of fear and suspicion in the West against anything that carries the brand Islam or Shariah, Islamic finance has been unfairly brandished by certain quarters as a front for terrorism finance. Even the sacred obligation of Zakat (alms) has been alleged as funnelled towards terrorist organisations.

While the complex and opaque nature of international finance may expose even Islamic financial institutions to unwarily become a tool for those with criminal intent, it is safe to say that so far, notwithstanding all the conspiracy theories and long-winded connections raised to link Islamic finance with terrorism, there is hardly evidence sufficiently produced to justify such allegations.

Various lawsuits and sanctions have been initiated against some financial institutions and key Islamic finance figures for alleged involvement with terror activities, but most have been struck out. These include, among others and most notably, suits filed in the US against Sheikh Salleh Kamel of Dallah Al-Baraka and Prince Muhammad bin Faisal Al-Saud of Dar al-Maal al-Islami, both of whom are considered pioneers and thought-leaders of modern Islamic finance.

Irrational phobia against Islam in general and Islamic finance in particular continues long after 9/11, with the US Treasury recently also getting entangled in a lawsuit when a Gulf War veteran challenged in court the validity of its action to bail-out AIG during the global financial crisis, simply because AIG has been involved in an Islamic insurance (takaful) business.

The reality is, Islamic financial institutions just like any other financial institutions in any jurisdictions are subject to and bound by strict law and regulations, including anti-terrorism and anti-money laundering

laws. If there is any proof that any Islamic financial institutions are involved in or supporting terror activities, the due process of the law shall be allowed to take its course in order to ensure the respective culprits are brought to justice.

Terrorism and violence – branded upon whatever political, religious or communal cause and agenda – at the end of the day still inflict harm against the life and well being of innocent victims; Muslims and non-Muslims alike. Islamic finance has nothing to do with terrorism financing. It is a genuine legitimate business that has been regulated and supervised in many jurisdictions, simply as a business that offers Shariah compliant financial products as an alternative to existing financial products.

“

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Misconception 2

FOR MUSLIMS ONLY

There is no prohibition against non-Muslims to use Islamic financial products or own institutions offering Islamic financial services. It is easy to observe that

among the largest institutions offering Islamic financial services are conventional banking groups such as Citigroup, HSBC, Standard Chartered, etc. This proves that the values espoused by Islamic finance are not for Muslims only but may be shared by non-Muslims.

Furthermore, it should be noted that prohibition against usury is not only imposed by Islam but also other major world religions such as Christianity, Judaism, Buddhism and Hinduism. The ethical parameters of Islamic investments that forbid certain sectors such as alcohol, gambling, pornography, etc. could similarly be subscribed by some non-Muslim investors as well.

Islamic finance is a value proposition; it offers a way of conducting financial transactions according to certain defined ethical values and parameters different from what is prevalent in conventional finance. If not because of this value proposition and if Islamic finance does not make commercial sense, it would be unlikely for any non-Muslim individuals or entity to participate in it. It is worth noting

that the first corporation to issue an Islamic debt securities or Sukuk is Shell MDS, a multinational company, in 1990.

Since then, other multinationals such as AEON, GE, Nestle, etc. have followed a similar footstep. While the Islamic Development Bank (IDB) is of course well known to have raised funds through Sukuk, other multilateral organisations such as the Asian Development Bank (ADB) and the International Finance Corporation, a member of The World Bank Group have also done the same. The Federal State of Saxony-Anhalt in Germany is the first in Europe to have issued Sukuk.

Even the Vatican's official newspaper Osservatore Romano has some nice words to say about Islamic finance. "The ethical principles on which Islamic finance is based may bring banks closer to their clients and to the true spirit which should mark every financial service," authors Loretta Napoleoni and Abaxbank Spa fixed income strategist, Claudia Segre, said in the article. "Western banks could use tools such as the Islamic bonds, known as Sukuk, as collateral". Sukuk may be used to fund the "car industry or the next Olympic Games in London," they said.



Misconception 3

REPLICA OF CONVENTIONAL FINANCE

Most critics of modern Islamic finance argue that Islamic finance is nothing but a mirror of conventional finance, often due to the similarities between the two, especially in terms of the economic objectives of their users. In fact, quite strangely, the loudest of such criticisms usually come from amongst Muslims themselves.

Arguments that Islamic finance as it is merely emphasises on 'form over substance' is not uncommon. Even amongst Shariah scholars there appear to be heated disagreements over certain products, which have been approved by some scholars while abhorred by some others. As a result, harsh allegations of some Islamic financial institutions practising Shariah arbitrage or fatwa shopping to obtain Shariah approvals have been lashed out, despite a lack of empirical evidence of such practices.

While the critics may have their own basis for their allegations, the fact remains that Islamic finance are governed by some fundamental principles that are contrary to conventional finance, such as prohibitions against riba (usury/interest), maisir (betting/gambling) and gharar (dubious ambiguity). Hence, Islamic finance products are consciously designed to remove these elements, while at the same time retaining some components that may make it easy to understand when compared to conventional financial products, which are their direct competitors.

Just like one may not be able to fully appreciate the difference between a McDonald's burger that qualifies to be halal with one which does not – because they are still labelled as McDonald's and carry similar taste (if not the same) anyway – sometimes people tend to undermine the difference between an Islamic and a conventional financial product because the distinction is not very obvious.

However, if one look into more details as to the design and economic behaviour of such products, then eventually the distinction will become apparent. For example, if Islamic finance is just a replica of conventional finance, how can it be more resilient than its counterpart during the global

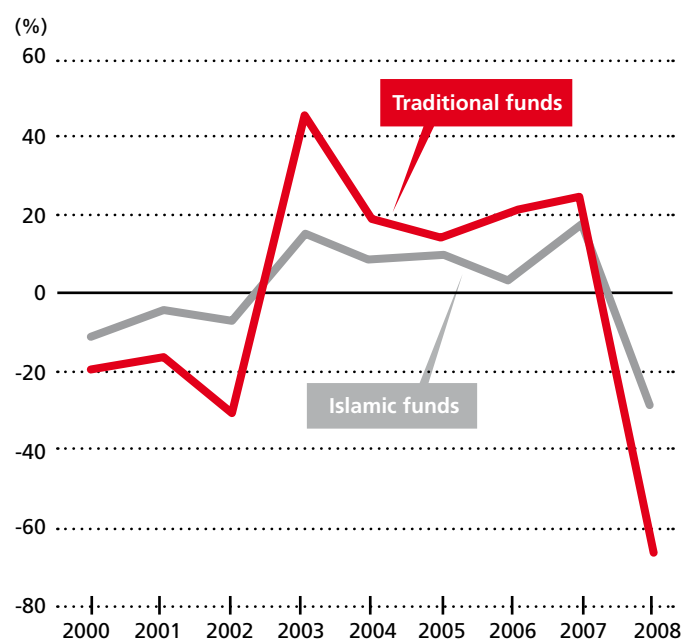
financial crisis? Similarly, even prior to the crisis, Shariah compliant stock indices have performed differently from non-Shariah compliant stock indices. Surely these indicate that there must be differences between the two.

Hence, it is very important to realise that the Islamic sense of "profitable trade" or *tijarat'un rabihah* is a business that brings blessings to those who conduct it.

Obviously, profits are important as ends, but the means by which those profits are earned are even more important. Whether it is obvious to us or not, we should understand that it is this ethos which Islamic financial institutions subscribe to and strive to translate into their business model. Whether their attempts are successful or not, each of us may hold our own opinions – but to be fair, such a noble cause should deserve support and encouragement, rather than scorn and ridicule.

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Annual Investment Return



Source: Korea Capital Market Institute

PRIMITIVE METHODS OF DOING FINANCE

While Sukuk probably is the most well-known Shariah compliant product, it must be emphasised that Islamic finance is more than just Sukuk.

Even when we talk about Sukuk, there appears to be a misunderstanding that Sukuk only comes in one form, although in reality there are more than a dozen ways through which Sukuk can be structured.

Unfortunately, simply because some Sukuk issuers in the Middle East recently defaulted, headlines have been thrown into major newspapers as if all Sukuk are now at risk. Unfair and irresponsible remarks have been spread, questioning the integrity of Sukuk as an investment instrument. The fact is, even conventional finance is not much better when it comes to dealing with defaults of these same debtors. This is because the problem lies fundamentally with the clarity in the judicial process and the insolvency framework in the respective jurisdictions, not the Sukuk structure.

Meanwhile, although the Shariah rules and principles that underlie these financial products may have been developed over the course of 1400 years, this does not mean that no modifications and adaptation have been made in accordance with the advent of technology, knowledge and users' needs. **Islamic finance has developed and currently offers a whole range of financial products to cater for different users, whether in banking, insurance, capital market or wealth management segments of the finance industry.**

Today, Islamic financial institutions, just like their conventional counterparts, are capable of offering e-banking services including mobile banking, using electronic trading platforms, and taking advantage of sophisticated softwares and hi-tech solutions to increase efficiency in their operations.

In fact, Islamic finance has come a long way from being able to offer only some basic safekeeping accounts and financing facilities, to syndicated financing, tradable securities and even money market and hedging instruments. Islamic finance has been used in a broad range of sub-sectors, from micro-financing (to eradicate poverty and support local entrepreneurs) to public infrastructure financing (including dams, ports, airports, railways and highways).

In terms of risks, Islamic finance products form a new asset class and hence add depths to the diversification of risk for the users. Simply because sometimes the existing legal and regulatory framework, as well as existing risk management tools, may have yet to understand and adapt to the specificities of Islamic finance, these should not be used as a reason to make Islamic finance the scapegoat.



Misconception 5

NO STANDARDISATION OF BEST PRACTICES

Concerns over the lack of standardisation, while may be justified in view of the infancy of the Islamic finance industry, is sometimes blown out of proportion and over-exaggerated.

The reality is, a majority of the products and services offered by Islamic financial institutions are already available around the world with pretty much a standard approach of how things are done. To be fair to Islamic finance, conventional banking practices are not entirely standardised across the globe either. Variations and divergence still exist from one country to another.

For example, if one is to go to an Islamic bank whether in Malaysia, the GCC or in the UK and wants to put money into a savings account, he will see that the contract for savings are universal; it is called Wadiah (safekeeping) or Mudarabah (profit sharing) account – so there are actually uniformed sets of contracts accepted around the world. If one is to obtain financing for example, he can get it based on either Mudarabah (profit sharing), Ijarah (sale-and-lease back), or Murabahah (sale-and-buy-back) basis.

Furthermore, there are international mechanisms that are working towards greater cohesion and uniformity in some areas of Islamic finance. For example, in the areas of product standardisation, accounting treatment and financial reporting, there is the Auditing and Accounting Organisation for Islamic Financial Institutions (AAOIFI) that set standards on these. With respect to prudential regulation, such as capital adequacy requirement and risk management, already some initiatives are undertaken by the Islamic Financial Services Board (IFSB). Most recently, the International Islamic Financial Markets (IIFM) and International Swaps & Derivatives Association (ISDA) have collaborated in producing a standard Master Ta'Hawwut (Hedging) Agreement, which further reflect a rapid progress towards standardising best practices in Islamic finance.

Another crucial area which is pretty uniformed is the Shariah interpretation. If one looks at the fatawa or the pronouncements which have been made over the last decade in Islamic finance, more than 95% of them have been in complete accord across all the schools, with only about 5% where there are differences of opinions.

It is also a reality that, the financial contracts aside, many practices in Islamic finance operations are copied from or benchmarked against its conventional counterparts. This is especially quite strongly evidenced by the accounting standards issued by AAOIFI, which aim to complement the International Financial Reporting Standards, and the prudential standards issued by IFSB, which were built mainly from the standards issued by the Basel Committee for Banking Supervision (BCBS), International Organisation of Securities Commissions (IOSCO) and International Association of Insurance Supervisors (IAIS).

Therefore, the perceived lack of standardisation or contrasting variation of practices in Islamic finance is arguably misplaced. On the one hand, it should be viewed as normal for any industry that is still in infancy to fine-tune its best practices, and for innovations to flourish. On the other hand, it should be recognised that the Islamic finance industry (especially though AAOIFI, IFSB and IIFM, as well as through existing international standards that do not contravene the Shariah), is steadily making good progress in this area. Indeed it is very much up to and within the powers of the relevant regulatory and supervisory authorities in every jurisdiction to take a pro-active step in ensuring that their Islamic finance industry adheres to a high standard of international best practices.



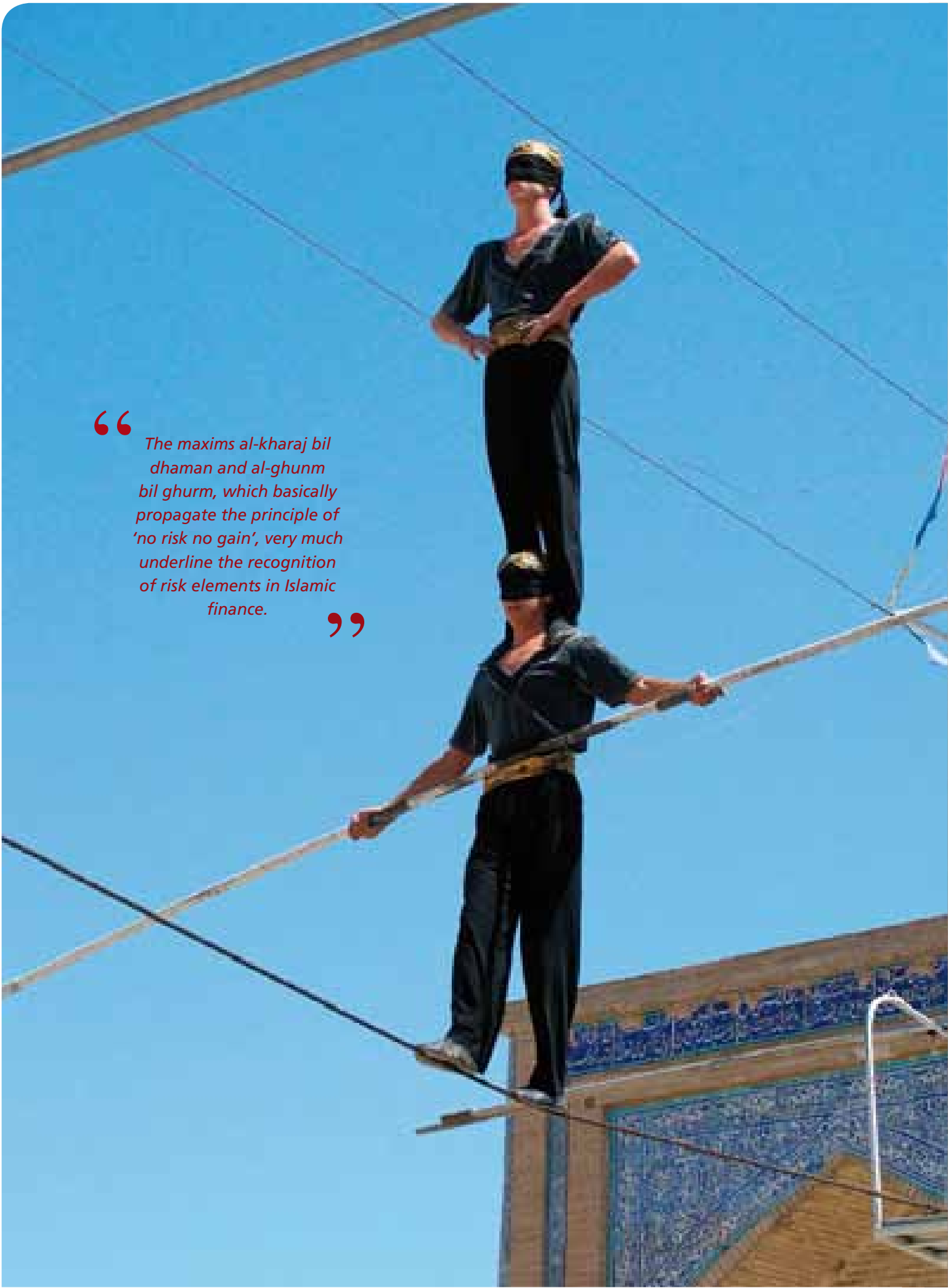
Accounting and Auditing Organization
for Islamic Financial Institutions



هيئة المحاسبة والمراجعة
للؤسسات المالية الإسلامية



“ The maxims *al-kharaj bil dhaman* and *al-ghunm bil ghurm*, which basically propagate the principle of ‘no risk no gain’, very much underline the recognition of risk elements in Islamic finance. ”



Misconception 6

MORE/(LESS) RISKY THAN CONVENTIONAL FINANCE

Islamic finance is usury-free, but not risk-free. As Islamic financial contracts are designed to cater for different risk appetite of the users, the truth is, it is erroneous and would be a blatant generalisation to say that Islamic finance is either more or less risky than conventional finance.

The maxims *al-kharaj bil dhaman* and *al-ghunm bil ghurm*, which basically propagate the principle of 'no risk no gain', very much underline the recognition of risk elements in Islamic finance.

Therefore, different financial contracts, investment strategies and risk management tools will be applicable to accommodate the different risk appetites of users of Islamic finance, very much similar to its conventional counterpart. However, largely due to strict Shariah prohibition against *maisir* (betting/gambling), any excessive speculation based on 'zero-sum game' and 'winner takes all' approach to financial transactions is prohibited. This has the effect of disciplining market players from exposing themselves to risks that are beyond their capacities.

A study undertaken by the International Monetary Fund (Cihak and Hesse, 2008) provides empirical evidences which verify that Islamic finance is not necessarily more or less risky than conventional finance. The study points out, for example, that by having profit-loss sharing financing, this shifts the direct credit risk from banks to their investment depositors. However, it also increases the overall degree of risk of the asset side of banks' balance sheets, because it makes Islamic banks vulnerable to risks normally borne by equity investors rather than holders of debt.

It was also pointed out that, because of their compliance with the Shariah, Islamic banks can use fewer risk-hedging techniques and instruments (such as derivatives and swaps) than conventional banks. However, it is interesting to note that because of this prohibition against the use of derivative products and short-selling activities in the form used by its conventional

counterparts, Islamic finance were largely shielded from any exposure to 'toxic assets' such as those arising from collateralised debt obligations (CDO) and credit default swaps (CDS).

A lot more studies will need to be done to fully understand the risk profile of Islamic finance products and operations, and develop the appropriate risk management tools to manage those risks. Supervisory authorities especially would need to be wary of the unintended consequences of financial products, which may sometimes take a longer period to be realised. The IFSB Guiding Principles on Risk Management which was issued in 2005 provides a useful framework in identifying and addressing the specific risks in Islamic finance, and should be a primary reference for anyone interested on the subject.



Misconception 7

LOWER/HIGHER COST OF FUNDS

Islamic finance may be interest-free, but certainly not for-free. Simply because no interest can be imposed under an Islamic finance contract, this does not mean that the financier is left without any rights of earning appropriate profit from his funds. Similarly, simply because the Shariah generally prohibits the imposition of penalty for delayed payments, this does not mean that Islamic finance does not recognise time value of money.

Pricing, rate of financing or rate of returns for Islamic finance products, just like its conventional counterpart, is closely associated with the risk exposures involved. While under Basel II conventional banks are deemed to be exposed to credit risk, market risk and operational risk, Islamic financial institutions, due to their business model, have to also take into considerations other risks on top of credit, market and operational risks. These include, for example, Shariah compliance risk; displaced commercial risk; and fiduciary risk arising from profit-sharing investment accounts. Hence, Islamic financial institutions would need to allocate capital to cover for these risks, and may not necessarily find it cheaper to operate compared to their conventional counterparts.

As mentioned earlier, Islamic finance products can be tailored according to the risk-return profile which meets the needs of the users. Accordingly, in products which the financier has to bear more risk, he would expect to obtain a higher rate of return, while in products where the risk exposure is lower, the pricing may fall in favour of the financed party.

Hence, it goes without saying that Islamic finance can be a cheaper source of funds through design and negotiation; but it is not automatic.

It is for example, worth noting that in Malaysia, raising funds through Sukuk can save the issuers between 10–20 basis points, among others due to the attractive tax incentives given by the government to encourage Sukuk issuance and the competitive pricing offered by Islamic financial institutions. The comprehensive legal, regulatory and Shariah framework, as well as the depth and efficiency of its market infrastructure, also makes Malaysia an attractive jurisdiction for Sukuk issuance and brings the cost of raising funds through Sukuk relatively cheaper compared to elsewhere.



Misconception 8

‘WELFARE’ FINANCE

The Qur’an does recommend that one should give forbearance to a debtor that is facing genuine difficulty to meet his obligations. However, this does not mean Islamic finance is ‘welfare’ or charitable finance.

There is also an explicit warning in the *Sunnah* of the Prophet s.a.w. that anyone who deliberately defaults payment of his debt without any genuine cause is a tyrant.

Islamic financial institutions are profit-oriented entities which are answerable to their shareholders, investment account holders and other stakeholders in terms of making sure that they deliver reasonable returns in accordance with the parameters set out under the Shariah. The beauty here is that there is an inherent mechanism to encourage the Islamic financial institutions and their stakeholders to undertake corporate social responsibility, as in Islam there are institutions of mandatory Zakat (alms); voluntary sadaqah (donation) and infaq (gifts); as well as hilm (forbearance); that can be used for the Islamic financial institutions and their stakeholder to contribute to the social well-being of the community.

Islamic financial institutions should not be expected to subsidise the community while giving access to financing. It

is also unfair for customers to take advantage of and abuse the well-meaning gesture of Islamic financial institutions by deliberately defaulting on financial obligations owed to them. A financial institution which is profitable can contribute better to the community; hence Islamic financial institutions should at least be accorded with appropriate moral support and concession for it to become a profitable, socially responsible business.

Most Islamic financial institutions, besides actively performing their corporate social responsibilities, also accommodate customers that have genuine difficulty to repay debts and exercise restraints in undertaking legal recourse for recovering debts. They also afford qard al-hassan (benevolent loans) as part of their service to the society.

In summary, Islamic financial institutions strive to strike a fine balance between earning profits and serving the broader social and economic needs of the community. Such a responsible and ethical corporate culture should be lauded, appreciated and embraced by all.



Misconception 9

NO GUARANTEE

It is true that there is a general rule in Shariah that prohibits the financed party from providing to the financier a guarantee of capital or returns. This is not only to ensure that there is no element of *riba* (usury) that can be oppressive to the financed party. Remember also that the maxims *al-kharaj bil dhaman* and *al-ghunm bil ghurm* which basically ordain that rewards/gains can only be justified by the risks taken, again emphasise the prohibition of pursuing any gain through contractual guarantee.

However, the Shariah does permit for a guarantee to be provided by a third party to the transaction, if given at no consideration. This is the rule under the principle of *kafalah* (guarantee or surety). This is also in line with the principle of *ta'awun* (mutual assistance or solidarity among Muslims) which is very much encouraged by the religion.

Indeed, it is out of the principles of *kafalah* and *ta'awun* that the concept of *takaful* (Islamic insurance) is derived. Hence, it is not uncommon in any financial transaction that the risks are mitigated through the instrument of *takaful*.

It is well recognised in Islamic finance practice that profit-sharing arrangements such as *Mudarabah* and *Musharakah*

requires strong trust among the partners, transparency in disclosures and appropriate governance structure, in order to remove information asymmetry and other moral hazard problems. As a result, a majority of Islamic finance transactions have been arranged as sale or leasing contracts, thus minimising the moral hazards and the high monitoring cost. **Often, a charge or caveat will be registered on the subject matter of the sale or lease, as a collateral to safeguard payments.** To this extent, Islamic finance provides the same protection to the financier just like in conventional finance.

Therefore, simply because Islamic finance applies some different techniques to preserve the rights of the financier compared to conventional finance, this does not mean that Islamic finance is riskier and totally opened to abuse.



Misconception 10

DRIVEN PURELY BY OIL BOOM

While it is true that the petro-dollars have been a catalyst for the growth of Islamic finance especially in recent years, it has to be acknowledged that it is not the only driver of the industry's success. Even before the world petrol price was sky-rocketing, the Islamic financial services industry has been enjoying a steady 15–20% annual growth since its first inception in the 1970s.

Various reports, such as by Standard & Poors, and those commissioned by the government authorities in Australia, France, and the UK, among others identified that the rapid growth of Islamic finance is driven by the following factors:

- an increasing awareness amongst the Muslim population on the availability and feasibility of Islamic financial products that adhere to the Shariah without compromising on efficient wealth generation and risk management
- development of innovative Shariah compliant instruments and licensing of new market players that add depths and choices to cater for different segments of the market
- tax and fiscal incentives from the government, that allows competitive pricing for Shariah compliant financing and investment structures
- intensive restructuring and diversification of the economy, whereby countries started embarking on massive infrastructure projects that are financed through Shariah compliant means
- globalisation contributed to Islamic financial institutions expanding their operations beyond their traditional borders
- resilience of Islamic finance in surviving the financial tsunami, although not entirely unscathed, has attracted new interest in its fundamental principles and business models

By relying less on the oil boom, Islamic finance can focus on tapping other sources of funds and investments, especially in other growing industries such as hospitality and services, commodity and minerals, manufacturing and advanced technology, etc. This diversification would garner better stability into its framework.



“The Islamic financial services industry has been enjoying a steady 15-20% annual growth since its first inception in the 1970s.”

IMMUNE FROM ANY UNETHICAL PRACTICE

Simply because a financial product, a financial institution or a banker wears the label or brand 'Islamic' does not automatically ensure that such product, institution or banker will be pristinely pious and incorruptible. The public must always remember that as much as it has been proven that no financial institution is "too big to fail", similarly there is no institution that is "too pious or too virtuous to fail". The public must always be diligent against deceitful characters and unscrupulous parties whom might be misusing and abusing the label or brand "Islam" just for a quick gain by preying over the gullible public. Such characters do not care if others suffer from their crime or the reputation of the noble industry is damaged by their greed.

Stakeholders of the Islamic finance industry, especially the supervisory authorities and investors, must be vigilant to learn from various cases of frauds, breach of trust and mismanagement that have occurred, most unfortunately, in the name of Islamic finance. Among others:

- 1987 – Al-Rayyan, an "Islamic Investment Company" established in Egypt by brothers Fathi and Tawfik Al-Rayyan, was found to be a pyramid scheme, causing a reported loss of £E 1 billion to more than 400,000 investors. The incident brought down other similar companies

such as al-Sharif, al-Sa'd, Huda Misr, Badr and al-Hilal, and forced the enactment of a new legislation to restrict talaq al-amwal (receiving funds). The case remains infamous among the public in Egypt, to the extent that recent similar frauds have been dubbed Rayyan Al-Qalyubia (2007) and Rayyan Nasr City (2008).

- 1997 – The Bank of Credit & Commerce International (BCCI), which is a conventional bank, accepted funds from some investors through its Islamic Banking Unit based in London. A number of Islamic banks placed funds with BCCI with the understanding that the money will be invested into commodity contracts in accordance with Shariah. When BCCI later collapsed, the auditor's report revealed that BCCI did not make such Shariah compliant investments on behalf of its clients.
- 2001 – Ihlas Finans, then the largest Islamic bank in Turkey with over 40% of the sector deposits, was liquidated by the Turkish Banking Regulation and Supervision Agency because it was found to have illegally appropriated almost \$1 billion, virtually the entire value of the deposit base, through connected lending to shareholders.

Meanwhile, Dubai Islamic Bank has twice suffered from two major embezzlement cases, back in 1997 and then recently in 2008.

The development of various governance standards by both the AAOFI and the IFSB are actually in full recognition that Islamic finance is not inherently immune from unethical practices and governance failures. Besides adhering to the highest standards of governance and risk management best practices, Islamic financial institutions must particularly adopt a stringent recruitment and training requirement to ensure that their staff continue to uphold integrity and observe their fiduciary duties.

“ No financial institution is “too big to fail”, similarly there is no institution that is “too pious or too virtuous to fail.” ”

Misconception 12

IMMUNE FROM THE GLOBAL FINANCIAL CRISIS

A lot has been said about Islamic finance being resilient in the wake of the global financial crisis, but once the dust of the financial crisis has settled, it becomes clear that not necessarily everything is well in Islamic finance.

For example, a number of renowned players in the management of Islamic funds, such as The Investment Dar (TID) and Global Investment House (GIH), both based in Kuwait, have suffered major losses during the crisis and have become technically insolvent. They have to undertake painful restructuring process and the legal battles are still to be fought. The global Sukuk market is seeing smaller issuance and increasing defaults, led by the bankruptcy of the US-based Sukuk issuer East Cameron Gas, followed by the offshore vehicle linked to Al-Saad Group of Saudi Arabia, and later also TID and GIH. As more Islamic financial institutions release their latest financial reports, a number of them proved to suffer huge losses, albeit still lesser compared to those endured by their conventional counterparts.

Islamic financial institutions should therefore ensure that they do not overlook the lessons to be learnt from the financial crisis. Since the global economy is still recovering and growth rate is much slower, they should take this opportunity to clean up the house and tighten up the loose ends, wherever necessary. For example, the tendency by some Islamic financial institutions to blindly replicate and repackage some exotic products of conventional finance through cosmetic changes to make them “Shariah-compliant” should particularly be curbed. It is worrisome to note that initiatives to design some forms of “Shariah-compliant” subprime instrument have been undertaken before the crisis happened – fortunately there were enough wisdom among gatekeepers of the industry that these instruments did not really see the light of the day.

We should also remember that this is not the first time Islamic financial institutions are tested with a systemic crisis. The experiences of Kuwait Finance House in surviving the Kuwait Souq al-Manakh crisis in 1982, of Bank Islam in navigating through the Asian financial crisis in 1997–1998, and of Turkish participation banks in coming out of the economic crisis (2000–2001), should all convey a clear

message that Islamic finance does have some inherent qualities that contribute to its resilience. Nevertheless, it should also be well acknowledged that these inherent qualities must be supported by sound governance, prudent risk management, effective regulatory framework and strategic leadership. All these features must be inculcated and nurtured over time with full commitment and dedication among key stakeholders of the industry, especially the shareholders and the supervisory authorities.

Indeed, the Prophet s.a.w. has strongly reminded us to “tie up the camel” before we can let our fate be determined by Allah, and the Qur’an also warned us that Allah will not help anyone who does not help himself. Just like natural disasters such as earthquakes, floods and volcano eruption may strike any man regardless of his faith or religion, similarly financial and economic crises do not choose its victims whether Islamic or conventional institutions. Only those who remain prudent, steadfast and well-prepared are more likely to survive any such tests.



GOVERNED ONLY BY SHARIAH

A number of recent court decisions have proven that when it comes to resolving disputes arising from Islamic finance contracts, Shariah rules and principles do not necessarily apply.

This is simply because, most often, the issues in dispute are not of Shariah in nature, but rather specific to the civil and commercial rights and obligations as contracted by the parties. For example, to enforce a charge over the collateralised asset/property, naturally the remedy available and sought is a remedy provided under land laws. Similarly, proceedings such as for interim injunction, Mareva injunction, Anton Piller order, garnishee, etc. are proceedings established under civil law directly related to enforcement of contractual rights and obligations. Sometimes the angle of the disputes may arise from tax, insolvency or inheritance perspectives, in which conflicting parties do not raise any Shariah-related questions.

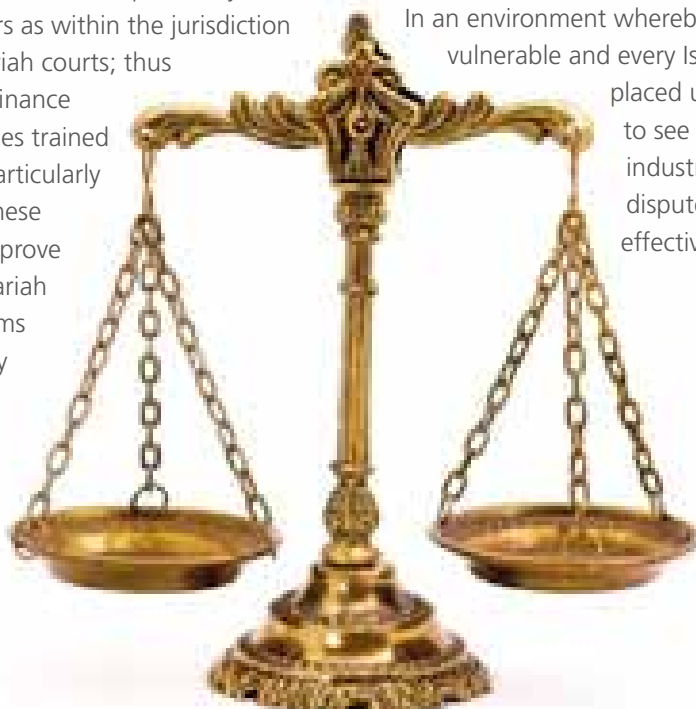
Since English law has widely been chosen as the governing law for many international Islamic finance deals including Sukuk, several cases such as *Shamil Bank v Beximco Pharmaceutical*, *Islamic Investment Company of the Gulf (Bahamas) v Symphony Gem*, and *TID v Blom Development Bank*, have been referred to English courts. Meanwhile the bankruptcy of East Cameron Gas is tried in a US court in Louisiana, bringing all its Sukuk holders to claim for their rights there. In Malaysia, the constitution specifically enlists banking and mercantile matters as within the jurisdiction of the civil courts and not Shariah courts; thus resulting in numerous Islamic finance disputes to be decided by judges trained under common law and not particularly under Islamic jurisprudence. These developments, among others, prove that the interface between Shariah and civil or common law systems are bound to happen especially in international deals, thus requiring intricate legal skills.

An increasing number of Islamic finance defaults and disputes following the recent global financial crisis should present the industry with an opportunity to have a greater clarity and certainty in its dispute resolution process. Judges and lawyers would have a crucial role to play, in order to ensure that the arguments put forward and decisions arrived at would ultimately instil public confidence in the system.

Caution has to be thrown in that assessing the compatibility and enforceability of Islamic finance contracts within a legal system which is not primarily based on Shariah can be a daunting challenge for the court. The court may have to be sensitive, not only to the merits of the case, but also the broader public interests. Among others, the court should be careful to ensure that its decision would not bring about unintended consequences that drive panic in the financial system or raise unfair prejudice against Islamic finance.

Hence, the relevant authorities need to ensure that the court is well supported and equipped with the necessary expertise and legal infrastructure to precede over Islamic finance disputes. Besides adequate training and exposures to develop the relevant skills, the court should have access to expert opinions such as from among Shariah scholars or financial supervisors. Otherwise, the soundness of the decisions, whether in court or other alternative dispute resolution forum, might be deeply questioned.

In an environment whereby the economy is still largely vulnerable and every Islamic finance dispute will be placed under microscopic scrutiny to see which direction it goes, the industry could really benefit from a dispute resolution mechanism that can effectively reinforce public confidence.



Misconception 14

REQUIRES MINIMAL CHANGES TO LEGAL & REGULATORY FRAMEWORK

Islamic finance does not exist in a vacuum; it requires alignment with and support from the whole legal and regulatory framework. This means, while it is important for the banking and financial laws of a country to recognise and accommodate Islamic finance, for example, through a specific legislation, this is far from sufficient in ensuring that the Islamic financial contracts will be effectively enforceable.

At the minimum, other areas of law that may have to be amended to accommodate Islamic finance would include **tax laws** (for neutrality of tax treatment), **property laws** (for ability to undertake transactions involving real estates and create valid collaterals on them), **insolvency laws** (to enable Islamic financial institutions to enforce its claims against debtors and defend itself against creditors as may be needed), and **securities laws** (for the Islamic financial institutions to be able to offer or trade instruments that are Shariah-compliant).

As Islamic finance transactions becomes more internationalised, proper laws would need to be put in place to establish **reciprocal enforcement of foreign judgments** from across different jurisdictions. Clarity in the law would contribute immensely in terms of instilling public confidence in the financial system, and remove uncertainty as to whether an Islamic financial contract will eventually be enforceable in court in case there is a dispute.

Furthermore, it must be duly recognised that the forum for resolving disputes arising from Islamic finance contracts, whether a court of judicature or court of arbitration, must be adequately equipped with competent personnel as well as comprehensive legal infrastructures to enable it to precede over such cases smoothly and efficiently. The judges, arbitrators, attorneys, etc. handling such disputes must be very well-trained in order to ensure adequate competence and professionalism.

It must be borne in mind that the real test of the effectiveness of law is in its enforcement. Therefore, besides enacting and amending laws, authorities shall give adequate attention in **building capacity for law enforcement**.

Hence, it is incorrect to assume that Islamic finance requires only minimal changes to the financial laws and regulations, as indeed this is only the first step in what should be a long journey. At most, an Islamic Banking Act or Islamic Finance Law can be considered as the impetus for a country's Islamic finance industry, but indeed the whole framework can only be feasible if alignment with and support from the rest of the legal system are also stitched together.

In countries where a comprehensive review and reform of the whole legal and regulatory framework is not undertaken, they will find their Islamic finance industry to remain surrounded by legal landmines.

“

It must be borne in mind that the real test of the effectiveness of law is in its enforcement. Therefore, besides enacting and amending laws, authorities shall give adequate attention in building capacity for law enforcement.

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TO REPLACE CONVENTIONAL SYSTEM, AIMED TOWARDS ISLAM'S WORLD DOMINATION

Some Islamophobic websites are so fearful of Islamic finance; it has been described as a "fifth generation warfare" aimed towards replacing the conventional financial system and pursuing world domination by Islam. How would this be possible when the whole Islamic financial system accounts for less than 1% of the global financial system, and Muslim nations remain largely the poorest and under-developed? These arguments are quite mind-boggling. In reality, the 56-member countries of the Organisation of Islamic Conference (OIC) collective gross domestic product is less than 5% of that of the world, and its intra-trade volume (at about US\$800 billion) is only 6–7% of the total global trade. As much as Muslims would very much like to see Islamic finance rise to greater heights, the harsh reality is that the whole ummah is just too weak and divided to even dream of pursuing such an enormous agenda.

Many Islamic countries continue to be largely segregated and suffer from prolonged political unrest, sometimes even to the extent of engaging in civil wars. Under such circumstances, most Muslim nations would be too bogged down by issues which are closer to their hearts and homes, such as national unity, economic survival and family livelihood. Several Muslim nations remain heavily indebted to the international community, and even depend on international aid for food and national security. Indeed, how can one place "world domination" in the vocabulary of a majority of Muslims, while the religion itself teaches that this world is temporary and the Hereafter is what is permanent. In all likelihood, most Muslims would just be grateful and content with what they have, as blessed by Allah.

The small minority of Muslims who have been seen proclaiming that Islam is destined for world domination and Islamic finance shall be the vehicle for financial jihad, honestly, are not in the mainstream. They do not speak for the rest of Muslims.

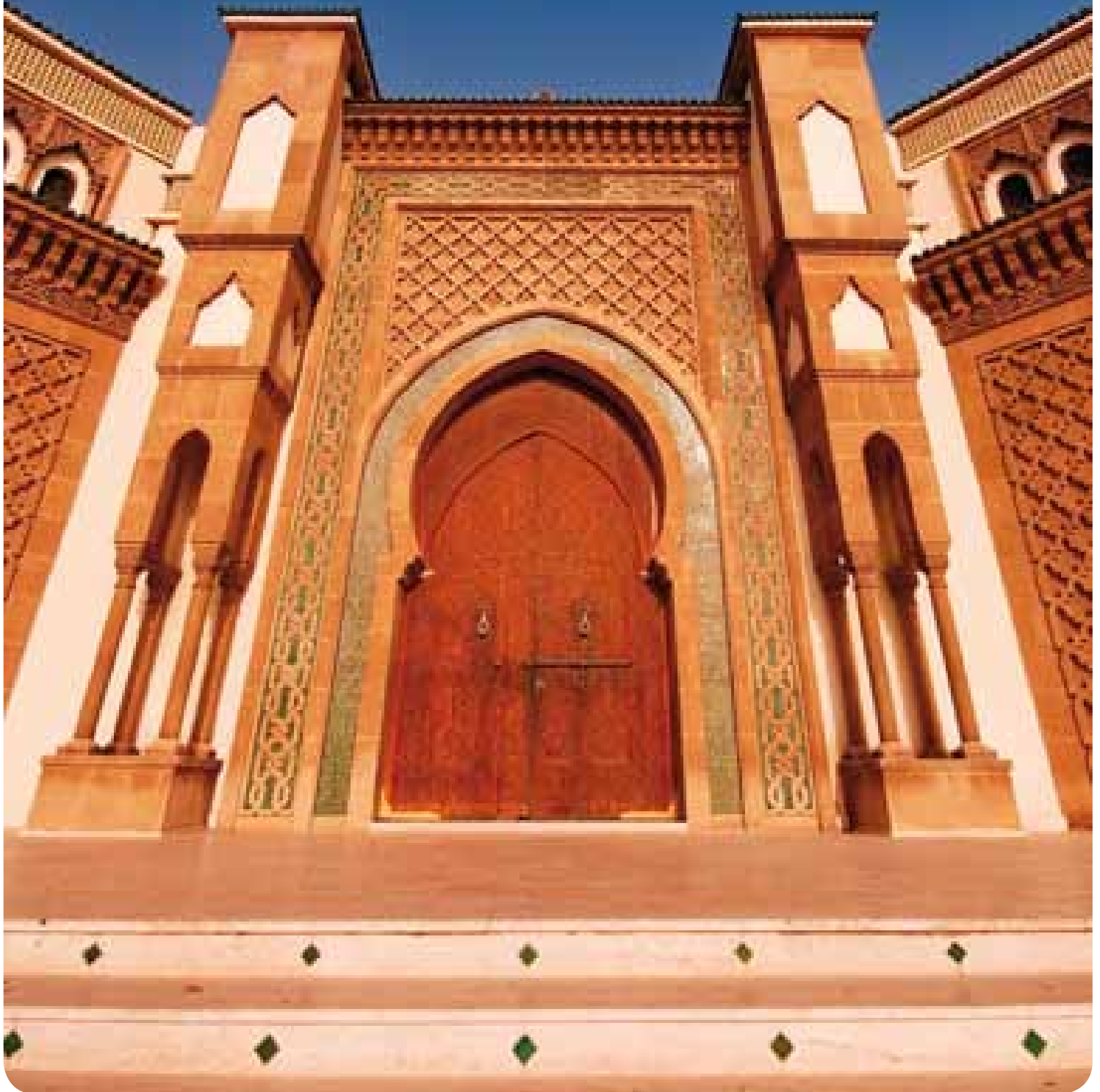
There are more than 1.57 billion Muslims living on this planet, according to a 2009 study undertaken by Forum on Religion and Public Life, a unit of US-based think tank Pew Research Centre. As such they are too heterogeneous to speak in one voice and agree on a common agenda, despite sharing the same faith.

Dr. Ralph Braibanti, an Emeritus Professor of Political Science at Duke University eloquently described in *The Nature and Structure of the Islamic World* (2000) that "The one billion people who profess Islam are not concentrated in a single, unbroken landmass. This differs from the one billion Chinese or the near-billion concentration of population on the subcontinent of India. Any imagery of a great green horde, controlled by a single government, capable of raising enormous land armies, is fallacious."

There is a long historical as well as contemporary evidences to support this, thus perhaps it is safe to say that the facts speak for themselves. One should perhaps ponder, albeit halal food has been around throughout the 1400 years history of Islam and is today available everywhere including in non-Muslim countries; no one has ever said that this will mark the demise of non-halal food and the start of Islam's world domination. Hence, similarly halal finance should never be seen as a threat.

10

Main Value Propositions of Islamic Finance





Initially, modern Islamic finance was championed by political Islam as part of the Islamic revivalism that followed the independence of Muslim nations from colonial powers. Gradually, the whole concept became more appealing to some segments of the society especially those who believe that the capitalist and socialist systems are beleaguered with flaws. Many in particular abhor the excessive greed and wide rich-poor divide that are perceived as inherent features of capitalism. At the same time, they dislike the utopian idea of socialism whereby a nation's wealth is nationalised and the government dictates how it should be distributed, with no rights for private ownership. Islamic finance basically offers a middle ground between the two. Private enterprise is allowed and encouraged, but with heavy emphasise on moral and ethical ways of pursuing wealth.

Compulsory zakat (alms) for example, has to be paid by those considered to have met the minimum wealth bracket, which effectively ensures there will be some equitable distribution of wealth, especially to those in need. Business activities deemed to benefit from other people's moral decline and may harm public morality, such as liquor, pornography and gambling are prohibited. Lending at interest, which systematically would encourage over-lending and over-borrowing on the belief that money breeds money infinitely, is forbidden. The core value of Islamic finance demands for genuine and productive economic activities through trades and investments.

Since most would agree that the moral and ethical values espoused by Islamic finance can universally be appreciated by anyone, regardless of his faith, then surely it is worth highlighting the major value propositions in Islamic finance.

“ The Qur'an aptly articulates that one should not deal unjustly if he does not want to be dealt with unjustly (Al-Baqarah:279). By adhering to Shariah rules and principles, the financial system will be harnessed with stronger conscience and integrity, which it does need. ”



ADHERENCE TO SHARIAH, SUBSCRIBING TO HIGHER ETHICAL IDEALS

All moral and ethical value systems would naturally promote higher ideals such as fairness and justice for all mankind. However, it is fascinating to note that the primary source for Shariah rules and principles, namely Qur'an (the Holy Book) and Sunnah (the acts and sayings) of Prophet Muhammad s.a.w, more than 1400 years ago have explicitly ordained in a comprehensive and concise manner certain code of ethics that can be universally applied even in the modern day, undeterred by time, space or race.

For example, there are specific Qur'anic injunctions that calls for honest fulfilment of all contracts (Al-Maidah: 1); prohibits the betrayal of any trust (Al-Anfal: 27); forbids the earning of income from cheating, price manipulation, dishonesty or fraud (An-Nisa'a: 29); shuns the use of bribery to derive undue advantage (Al-Baqarah: 188); as well as promotes clarity in contracts to minimise manipulation from dubious ambiguity (Al-Baqarah: 282).

The Qur'an aptly articulates that one should not deal unjustly if he does not want to be dealt with unjustly (Al-Baqarah:279).

By adhering to Shariah rules and principles, the financial system will be harnessed with stronger conscience and integrity, which it does need.

This does not suggest that the value system in conventional finance is useless and that Islamic finance is outright perfect, but the reality remains that man do need reminders, incentives and motivation, sometimes in the form of a spiritual guidance and aspiration. The Shariah provides exactly that. Since there are 1.57 billion Muslims whom are bound by the Shariah value system, its significance and importance therefore cannot be overemphasised.

In summary, the Shariah provides a framework that can help strengthen the conscience and integrity in the market place. Wherever the governance system, law and regulation, as well as market discipline, may not reach or fail – our first and last line of defence against misconducts has to be self-restraint and human conscience.



PROMOTING CROSS-BORDER TRADE AND FLOW OF FUNDS

H.E. the Governor of Bank Negara Malaysia, Tan Sri Dr Zeti Akhtar Aziz has lucidly expressed that Islamic finance has the potential to become the “New Silk Road” that will enhance economic and financial linkages not only between Asia and the Middle East but also the rest of the world. She first made reference to the New Silk Road at the 2nd World Islamic Economic Forum (WIEF) in November 2006, and has further highlighted this trend in some of her subsequent speeches.

She envisions that Islamic finance can contribute towards the efficient mobilisation and allocation of funds across regions whereby regions with surplus savings may channel funds to regions with deficit savings, to bring about global financial integration. Signs that a New Silk Road is flourishing are abundant – the economic and financial linkages between Asia and the Middle East are growing. While the world trade has on the average expanded by 10% over the period 2001–2005, Asia’s trade with the Middle East has increased on the average by 24%. More than half of the exports from the Gulf states go to Asia, and more than one-fifth of its imports are from Asia. The Gulf is the major supplier of fuel to Asia, while Asia in turn supplies manufactured goods and food to the Gulf.

Recent trends in investment activities have been equally significant. Investment projects amounting to more than USD160 billion to be financed by the Gulf states in Asia have been announced since 2005. In 2006 alone, mega-deals involving corporate acquisitions and real estate purchases from the Gulf to Asia, are estimated to total more than US\$18 billion, including multi-billion dollar IPO purchases in

financial institutions in China, large oil refineries and telecom companies. The value of investments was estimated to have reached around US\$30 billion in 2007.

Islamic finance has demonstrated its viability and competitiveness in a more liberalised and globalised financial environment and has become important in strengthening the linkages between the two regions. While the sizeable Muslim populations in both regions have been attracted to the unique features of Islamic finance, it has also attracted interest and participation from non-Muslims within these regions.

Ben Simpfordorfer describes in *The New Silk Road* (2009) that the recent rise of the Arab world which is matched by an emerging China is not just a coincidence, since the two are historic powers once connected by one of the world’s greatest trade corridors.

The increasing number of countries exploring and introducing laws that accommodate Islamic finance, especially countries which are predominantly non-Muslim such as China, Japan and Korea in the Far East, Australia in the South, as well as France, Luxembourg and the UK in Europe, further proves the value proposition of Islamic finance in promoting cross-border trade and flow of funds.

FINANCIAL INCLUSIONS OF THE UNDERSERVED SEGMENTS OF THE COMMUNITY

In countries where Islamic finance does not have a presence, it is common to observe that a substantial segment of the Muslim population would refrain from using the conventional banking facilities in order to avoid dealing with interest, and as a result they are isolated, albeit by their own choice, from participating in the financial system. The Muslim minorities scattered around Europe for instance, is potentially a vast underserved market waiting to be unlocked, as many of them are professionals and businessmen with reasonable income stream and surely would like an access to financial products and services to meet their needs.

In some parts of the world, the establishment of Islamic banks is part of the peace process in accommodating Muslim minority insurgents, such as in Thailand and the Philippines.

In the UK, the late former Governor of the Bank of England, Sir Edward George, is well remembered for his supportive

“ *It is worth noting that some countries such as China, India, Germany, France, Russia and the United States have a minority Muslim population size which is relatively bigger than many Muslim-majority countries. If each of them adopts a more inclusive financial framework by allowing Islamic finance to be offered in their markets, a huge segment of the community – which currently is most likely to be underserved – can participate in the financial system.* ”

policy of Islamic finance as a means for “financial inclusion”, as he had realised since the early 90s that a large section of the Muslim community there were excluded from the financial system due to their religious principles which prevented them from fully using the financial services, in particular house mortgages. Today the UK has a retail Islamic bank and four Islamic investment banks, positioning itself as a leading hub for Islamic finance in Europe.

Similar to the UK, countries like Singapore, Sri Lanka and South Africa have a legal and regulatory framework that accommodates Islamic finance, allowing their Muslim minority to benefit.

It is worth noting that some countries such as China, India, Germany, France, Russia and the United States have a minority Muslim population size which is relatively bigger than many Muslim-majority countries. If each of them adopts a more inclusive financial framework by allowing Islamic finance to be offered in their markets, a huge segment of the community – which currently is most likely to be underserved – can participate in the financial system.

China and Germany clearly have been more upfront in exploring this opportunity further by the approval of the first Islamic bank to operate in Ningxia and Mannheim respectively. However, it will be most exciting to observe if India, with its 160 million Muslim population being the third largest in the world after Indonesia (202 million) and Pakistan (174 million), is to open up to the idea. This is especially since it is a member of the BRIC (Brazil-Russia-India-China) group predicted to become future world leading economies.

EXPANSION OF A NEW ASSET CLASS

The innovation brought about by Shariah-compliant financial engineering has contributed to the introduction of a new asset class, that is now raising the appetite of investors. Factors that distinguish Islamic financial products as a different asset class from the conventional include, among others, the following:

- as a halal product, it can be offered to and used by anyone, as opposed to conventional products which are haram for Muslims to use – thus arguably, is open to a bigger investor/customer base;
- it often carries a different risk-return profile compared to its conventional counterpart. The IFSB Guiding Principles on Risk Management (2005) explain in detail the differences between the risks in a typical Islamic financial institution and a conventional bank;
- as Islamic finance products usually are underlined by asset, project or business venture, investors will be taking more exposures to portfolios such as real estate, commodity, infrastructures (like dam, port, airport, power plant, etc.), and other alternative investments;
- instruments like Sukuk for instance, can be structured in more than a dozen ways, with pure equity or quasi-equity/quasi-debt risk features. It opens up an opportunity to undertake exposures to strictly Shariah-compliant entities like the Islamic Development Bank and other Islamic financial institutions;
- the pricing mechanism may depart from interest-based benchmarks such as LIBOR.

The expansion of this new asset class would add more depth and width into the financial system, especially as risk diversification becomes increasingly important following the financial crisis.



MORE DIVERSIFICATION OF RISKS

As aforementioned, Islamic finance offers a new asset class, thus allowing more diversification of risks. It is interesting to observe how Islamic finance has come a long way since its early inception, to be able to now offer a wide range of financial products to cater for various needs.

For example, during the early days of Islamic finance, most Islamic financial institutions would only mobilise funds based on Mudarabah, Wadiah or Qard Hassan principles, but today an increasing number of them are able to offer similar products under Murabahah or Wakalah principles. Similarly, the earliest types of Sukuk were mainly structured around Qard, Murabahah or Bay Bithaman Ajil principles, but today we see more of Sukuk Ijarah, Mudarabah, Musharakah, Salam, Istisna', Istithmar, etc. Home-financing products which started off with Murabahah and Bay Bithaman Ajil can now rely on Musharakah Mutanaqisah. All these indicate how the industry is fast developing and maturing with admirable sensitivity to the economic reality and market demands.

In the takaful (Islamic insurance) sector, innovations are also taking place with the movement from Mudarabah model at the early stage to Wakalah and Waqf models in recent years. Re-takaful companies have increased, adding more depths and better capacity for the Islamic finance industry to manage its risks.

In the capital market, besides the innovation in various securities and instruments, more stock exchanges have its own Shariah compliant indexes, injecting further alternatives in terms of investment choices. Investors are able to tap a vast pool of Shariah compliant portfolios from the Dow Jones in the US to the Nikkei in Japan.

Without a doubt, Islamic finance truly offers a value proposition in the form of more risk diversification in the market.



UNLOCKING THE VALUES OF IDLE ASSETS

The Shariah prohibition against interest means that Islamic financial institutions cannot make money out of money, but rather embark on trades (i.e. through sales and/or leasing contracts) or participatory financing (i.e. through joint venture or profit-sharing arrangements) to expand wealth. Both types of ventures would often require some underlying assets to be attached to the transaction.

For example, it is easily observed that Sukuk issuance, particularly in the GCC, had been dominated by real estate developers before a regional construction boom came to an end in 2008 as the crisis shocked market confidence and oil prices slumped. This is because the Sukuk rely on returns from tangible assets such as rents from properties to produce cash flows - not interest - to pay investors.

The rise of Islamic finance in general and the Sukuk market in particular, provides an avenue for unlocking the values of some idle assets simply because (i) they may comply as Shariah compliant assets; and (ii) real estate was an easy asset class to structure around because of its availability and the appetite for it.

The use of real estate as an underlying asset will continue to play a role in the sector, although at the moment that may have to take a short break, due to the burst of real estate bubbles in the US, Europe and the GCC.

In the meantime, the industry could find alternatives including ship financing, and ship and aircraft leases, as these assets are all available and there are Islamic products out there that are based on such leases. There could be a focus on those underlying assets going forward. Other options could include the securitisation of receivables by companies in the telecom, energy and services sectors.

Commodities are another type of asset that broadly underlies transactions carried out in Islamic finance. Therefore commodity suppliers and commodity markets can find another source of demand, i.e. amongst Islamic financial institutions that have the appetite for commodity to underlie their financial contracts.

There could be other types of idle assets that can qualify as Shariah compliant and thus can benefit from Islamic finance requirements of underlying assets. It is up to the market to identify and leverage on these assets, as Islamic financial institutions would welcome alternatives that can add depths and widths into the product menu and selections.



It has been widely reported that the Islamic financial services industry suffers from a dire shortage of professionals specifically trained and qualified for this industry. While it is obvious that Shariah advisory and supervisory skills are the areas that would have the highest demand within the industry, there is still a vast scope of opportunities for other jobs. Albeit surely far from exhaustive, the following are amongst the types of services required as the industry continues to grow:

Trust administration services

Trust administration establishes various types of trusts with confidence, as trusts can be used for a variety of purposes, such as passing wealth onto successive generations or establishing charitable foundations. Trusts can represent one of the most tax-efficient ways to preserve the value of assets. Effective trust planning, management and administration can be an extremely complex matter, so a specialised advisor is required to plan, implement and manage high-value trust funds for years to come. The independent advisor is also a significant philanthropic trustee in administration through the global foundations designed to address major social and cultural issues.

Business succession and corporate wealth management

Families of considerable net worth often maintain an array of holdings – from real estate and business assets to trust funds and other investments in many different countries. Supervision of these assets has often been delegated to portfolio managers and is sometimes almost as diverse as the assets themselves.

Inheritance and estate planning

Islamic estate, inheritance and gift planning aims to see that all individual and charitable beneficiaries receive an optimum legacy, according to Shariah inheritance law. It requires careful planning vis-à-vis tax, corporation and financial laws applicable in each country.

Philanthropy and wealth with responsibility

The Islamic financial institutions and wealthy investors often wish to have programmes to contribute for the greater good, and to establish a culture of responsibility among the client's heirs and successors. Specialists trained with knowledge of Zakat, hibah, sadaqah and infaq and other charitable instruments would be required.

Independent Financial Advisers (IFAs)

IFAs may be needed to help address client needs over a variety of functions, including:

- Select investments
- Mutual funds
- Foreign exchange and commodities
- Hedging instruments
- Private equity
- Real estate
- Financing facilities

It is interesting to note that in the area of Shariah advice and supervision in particular, the Islamic financial services industry has contributed in creating a wholly new niche profession called 'Shariah advisors'. It helps to change the paradigm of Shariah education and training from producing imam and muftis that lead prayers and conduct marriage ceremonies, to highly skillful Shariah experts that are familiar with financial engineering and sophisticated economic analysis, thus commanding respect just like their counterparts in other professions such as lawyers, accountants and bankers.

The International Islamic University Malaysia estimates that the number of professionals required by the Islamic finance industry would reach 2 million people by 2020. Even if we conservatively reduce that by 50%, there is still a lot of jobs to be anticipated.

SOUND RISK MANAGEMENT

A quick reference to the IFSB Guiding Principles on Risk Management (2005) will highlight that Islamic finance has some specific risk components that differ from conventional finance, and additional risk management structure and framework would be needed to manage these risks. The additional layers of risk management structure and framework would establish a more sound risk management culture in Islamic financial institutions.

For example, to deal with Shariah compliance risks, which is part of the operational and reputational risks of Islamic financial institutions, appropriate Shariah governance framework will have to be put in place.

In another example, in order to address the displaced commercial risk (DCR) arising from competitive pressure to distribute a rate of dividends that is comparable to what is paid in the market for its investment account holders (IAH), Islamic financial institutions usually establish a profit equalisation reserve (PER) and an investment risk reserves (IRR). The PER and IRR basically are built from the gross profits earned from the investments made on behalf of the

IAH, and will be used to smoothen the periodical dividend distributions to the IAH, so that they match the returns given by the market.

As have been well acknowledged, the Islamic finance resistance to conventional derivatives and other similar toxic assets have been a major saviour in minimising the impact of the financial crisis on Islamic financial institutions. Before the crisis, often this has been described as the Islamic finance's Achilles heel, because it cannot freely hedge its risks using derivatives instruments. Today, this feature has been proven to be truly a blessing in disguise.

Even in terms of stock index performances, Islamic stock indexes have been performing better between 3–4% compared to other stock indexes, simply by avoiding all the interest-based financial institutions that suffered huge losses during the crisis and saw their stock prices plummeted.

Hence, Islamic finance offers a genuine value proposition in terms of sound risk management.



CLOSER SUPPORT TO REAL ECONOMY

Shariah rules and principles require that an Islamic financial transaction be supported by an underlying economic activity, thus ensuring that there is a close link between financial and productive flows. This principle fundamentally reflects the basic banking function of providing financial services that adds value to the real economy. Financial flows in Islamic finance are therefore accompanied by the expansion of genuine productive activity. Under this arrangement it also avoids over-exposure to risks associated with excessive leverage.

While the application of asset-backed and asset-based sale and lease contracts provide a better comfort level for those who may have moderate risk appetite, as their risk exposures are cushioned by the underlying asset, the profit-sharing and joint-venture arrangements can be used by those with higher risk-tolerance. This should very much serve the needs of those with innovative and enterprising ideas, as they can still have access to capital funding despite a lack of assets to be pledged as collaterals.

The general prohibition imposed by Shariah against highly speculative activities such as selling of debt at discounts, short-selling, hoarding, etc., besides channelling funds/resources to be utilised for productive ventures, also help to protect the economy from abuses and distortions. Overleveraging, that have seen some financial systems outgrowing the real economy by several hundred percent, would not be allowed to happen in Islamic finance.

Efficient allocation of capital and resources would spur innovation and entrepreneurship, and narrow the disparity between the rich and the poor. This is mainly because competition for capital and resources will be based on viability of the business/project undertaken and not much based on assets available as collaterals.

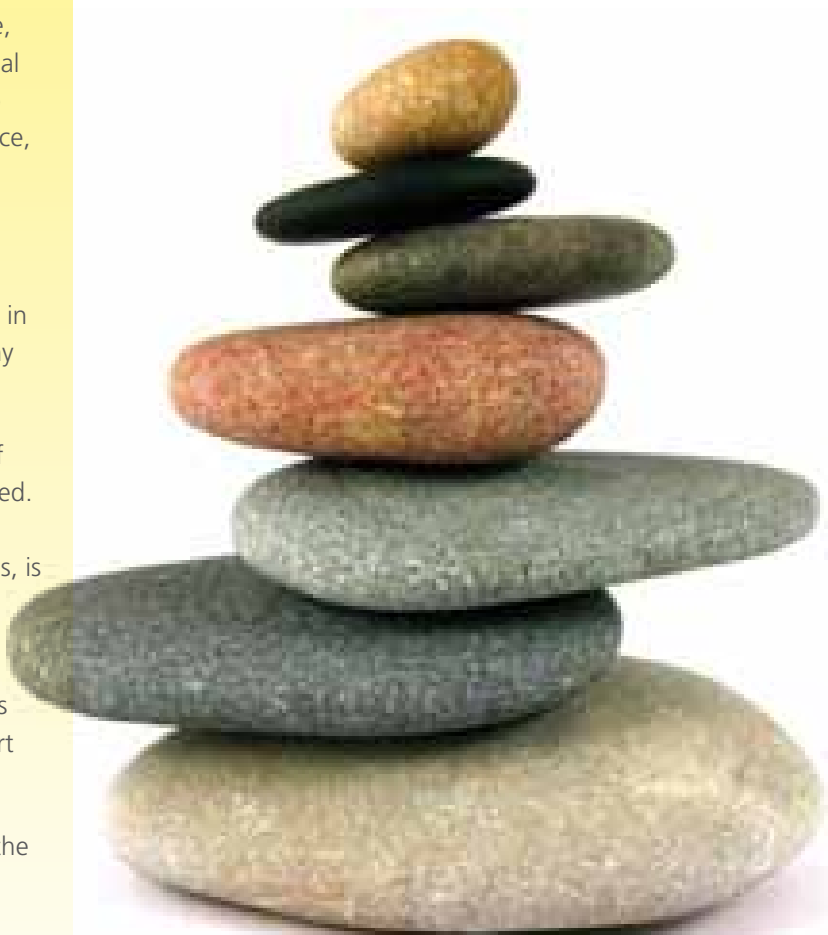
The IDB-IFSB Task Force on Islamic Finance and Global Financial Stability, chaired by H.E. Governor of Bank Negara Malaysia, Tan Sri Zeti Akhtar Aziz, in its report confirms that Islamic finance can contribute to global financial stability.

The Task Force identified the following inherent features of the Islamic financial model, which is based on compliance with Shariah rules and principles, as key to its potentials in contributing to global financial and economic stability:

- ✓ Finance can only be extended to projects, trade, economic and commercial transactions. Financial assets can therefore only grow in proportion to the growth in real economic activities and, hence, the possibility of excessive leverage tends to be remote.
- ✓ “Don’t sell what you don’t have” is one of the fundamental principles of wealth management in Islam, which restricts the possibility of unhealthy and excessive speculation.
- ✓ Sale of debt is discouraged and rescheduling of debt on the basis of earning interest is prohibited. Hence, the creation of an inverted pyramid of debts, which is a major source of financial crises, is avoided.
- ✓ Investments in public and private equities have to pass a set of screening processes. This makes social and ethical responsibilities an integral part of investment decisions.
- ✓ Preserving genuine liquidity, further adding to the stability of the IIFS.
- ✓ Providing strong incentives for Islamic financial institutions to ensure the success of the projects and activities that they finance.
- ✓ Emphasising transparency, disclosure and documentation of contracts.

The Task Force recommends the establishment of an Islamic Financial Stability Forum, which aims to complement the G-20 initiated Financial Stability Board, in promoting global financial stability.

In view of the 9 major value propositions highlighted earlier in this document, and the findings of the Task Force, it is inevitable to conclude that Islamic finance is a vital and useful component within any financial system.



A low-angle, upward-looking shot of a modern building's exterior. The image is dominated by a complex grid of dark blue or black metal beams that support a glass facade. The perspective creates a sense of height and architectural scale. The sky visible through the glass is a clear, pale blue. In the lower portion of the image, there is a solid orange rectangular banner with white text.

Your Link to Islamic Finance



ZICO Islamic Finance Practice Group

Zaid Ibrahim & Co
Trusted Business Advisor

ZICO has garnered a reputation for being a leading regional legal firm in Islamic financial services, with its highly regarded credentials and depth of expertise.

As one of the legal firms involved in pioneering the industry in Malaysia, a premier international Islamic finance hub, we are familiar with a broad range of domestic and regional Islamic finance transactions. We also have extensive experience across all aspects of Islamic

finance, including the legal and regulatory framework, compliance, product design and structuring as well as documentation and operation. We are therefore very well positioned to advise you in exploring new frontiers and negotiating the complex legal, cultural and practical landscapes of Islamic finance across Asia, whether you are a government authority, financial institution, investor or customer contemplating to participate in this thriving industry.

Our core strength lies in our intellectual capital and profound insight into the industry, as our lawyers have been involved in proposing law and regulatory reforms, complex transactions, product innovation and Shariah-compliant solutions for many jurisdictions and institutions. We consider ourselves as a genuine servant and partner of the industry, committed to not

only benefit from its expansion but more importantly to contribute to its development through high quality legal services and legal scholarship.

The financial service sector must be underlined by ethical principles and serve to promote productivity and values in the economy, not destroy them. The global financial crisis proves, among others, the devastation that can happen if these fundamentals are undermined.

In Islamic finance, this is well embedded as part of the objectives (maqasid) of the Shariah. Zaid Ibrahim & Co takes pride in serving the industry with ethics and integrity, not only by advising and helping to bring into the market billions of ringgit worth of financial products, but observing that diverse and productive sectors of the economy including energy, infrastructure, plantation and manufacturing benefit from Islamic finance. Our work has helped clients in protecting themselves from a complex

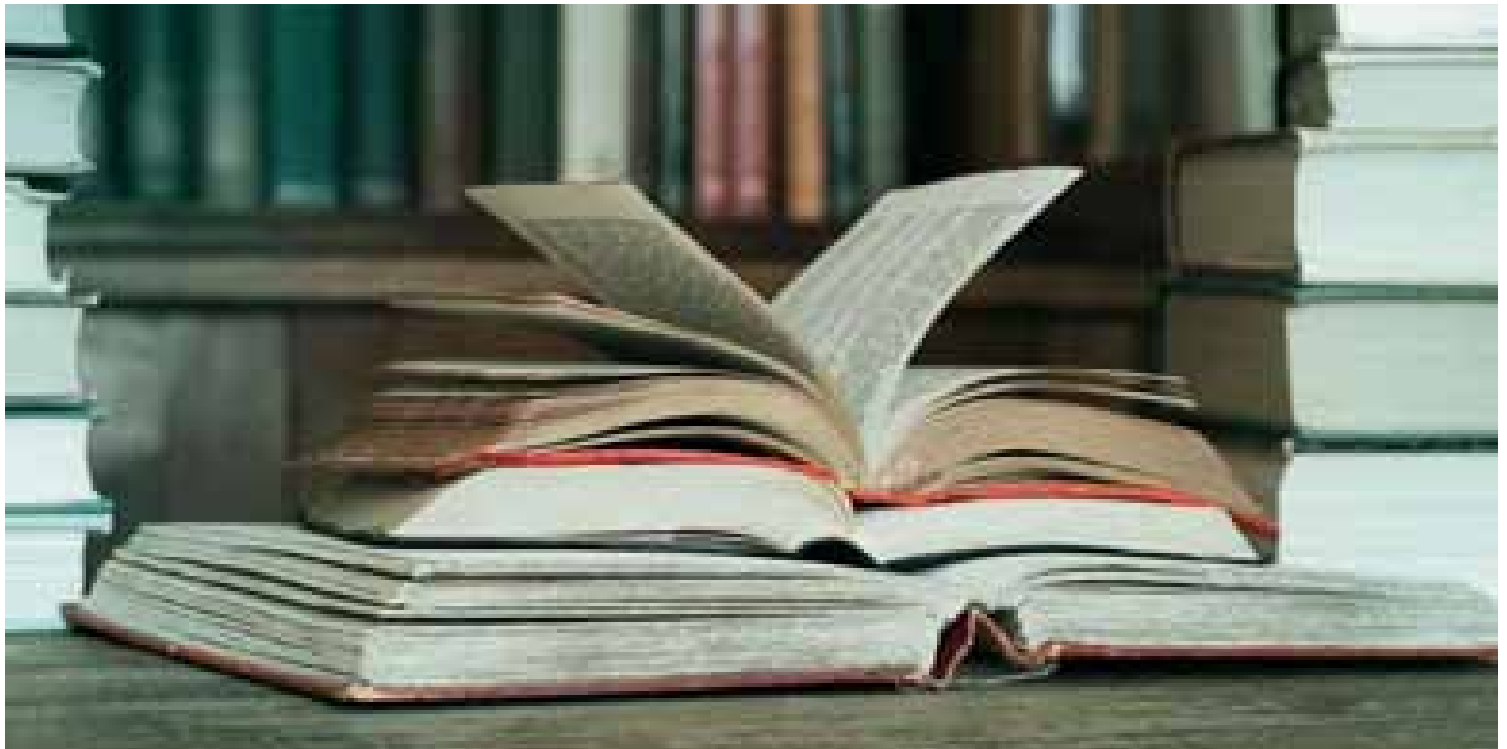
web of risks, including legal and Shariah non-compliance risks, and assisted authorities in safeguarding the industry's soundness and resilience.

We are devoted to playing our part in assisting economies in benefiting from Islamic finance and the industry itself to realise its true potentials. Our specialised team of lawyers is acknowledged as prominent practitioners in the field of Islamic financial services, with a wealth of experience that is respected by peers and clients alike. With our expertise in the legal and regulatory framework, Islamic structures, transactions and products and the setting-up of Islamic financial institutions, our team is well equipped to address queries and interests from and regarding any segment of the industry.





ZI Shariah Advisory Services



ZI Shariah Advisory Sdn Bhd is a provider of Shariah advisory services in Islamic banking and finance, takaful, Islamic funds, wealth management and Islamic law in general.

We guide regulatory authorities, financial institutions and also individuals from various jurisdictions around the globe on conducting business in accordance with Shariah principles. We provide advice based on authoritative standards, certifications and regulations, and have assisted clients in grasping complex Shariah issues in tandem with the rapid evolution of the Islamic finance industry.

Building on our team members' qualifications in Islamic law and a decade of legal experience in Islamic finance, we are uniquely equipped to appreciate the nuances of the Shariah advisory landscape. Our access to the most erudite and accomplished Shariah scholars working in the field today together with our strong commitment to research and scholarship enable us to expand our knowledge base and hone our skills in both theory and practice. Being

first-in-market with specialised Shariah-related services, we have proven our capabilities for informed Shariah advice to discerning clients. This has earned us the recognition from the Securities Commission of Malaysia as an approved Shariah advisor for Sukuk issuances, Islamic funds and other approved Islamic capital market products.

Our team members have acquired practical legal knowledge and insight gained from working on complex Shariah issues and major cross border transactions. We also have access to distinguished Shariah consultants from the academic and business worlds. We are thus able to give clients invaluable input from the finest minds in the industry.



The Malaysia International Islamic Financial Centre (MIFC) Initiative

In support of the MIFC initiative:



In August 2006, the Malaysia International Islamic Financial Centre (MIFC) initiative was launched to position Malaysia as a hub for international Islamic finance.

The MIFC initiative comprises a community network of the country's financial and market regulators, Government ministries and agencies together with industry participation from the banking, takaful, capital market institutions, human capital development institutions and professional services companies which are participating and working collaboratively in the field of Islamic finance.

The MIFC initiative is supported by global legal, regulatory and Shariah best practices that enables industry practitioners to conduct international business in Islamic finance activities anywhere in Malaysia in the areas of sukuk origination, Islamic fund and wealth management, international Islamic banking, international takaful and human capital development, while enjoying attractive incentives.

Malaysia welcomes global talents, leading players, issuers and investors to shape the future of Islamic finance together through the MIFC initiative, leveraging on and benefiting from Malaysia's more than 30 years of experience in Islamic finance in an environment of innovation and thought leadership.

For more information, log on to www.mifc.com

Glossary of Islamic Finance Terminologies

Bay' Bithaman Ajil (BBA) : A contract which refers to the sale and purchase transaction for the financing of assets on a deferred and instalment basis with a pre-agreed payment period. The sale price will include a profit margin.

Bay' al-Salam : A contract whereby payment is made in cash at point of contract but delivery of asset purchased is deferred to a pre-determined date.

Dhaman : A contract of guarantee whereby a guarantor underwrites any claim and obligation that should be fulfilled by the owner of an asset. This concept is also applicable to a guarantee provided on a debt transaction in the event a debtor fails to fulfil his debt obligation.

Gharar : *Gharar* is an element of deception either through ignorance of an essential element of the goods, the price, or through faulty description of the goods, in which one or both parties stand to be deceived. E.g. gambling is a form of *gharar* because the gambler is ignorant of the result of the gamble.

Gharar is divided into three types, namely *gharar fahish* (excessive), which vitiates the transaction, *gharar yasir* (minor) which is tolerated and *gharar mutawassit* (moderate) which falls between the other two categories. Any transaction can be classified as a forbidden activity because of excessive *gharar*.

Hibah : A gift awarded to a person.

Hilm : Forbearance or waiver.

Ijarah : A *manfaah* (usufruct) type of contract whereby a lessor (owner) leases out an asset or equipment to a client at an agreed rental fee and pre-determined lease period upon the '*aqd*' (contract). The ownership of the leased equipment remains in the hands of a lessor.

Ijarah Thumma Bay' : A contract which begins with an *ijarah* contract for the purpose of leasing the lessor's asset to the lessee. Consequently, at the end of the lease period, the lessee will purchase the asset at an agreed price from the lessor by executing a purchase (bay') contract.

Infah : It has the same meaning as *hibah*.

Istisna' : A purchase order contract of assets whereby a buyer places an order to purchase an asset to be delivered in the future. The buyer requires the seller or a contractor to construct the asset and deliver in the future according to the specifications given in the sale and purchase contract. Both parties decide on the sale and purchase prices and the settlement can be delayed or arranged based on a schedule of work completed.

Kafalah : It has the same meaning as *dhaman*.

Maisir : Any activity that involves betting whereby the winner takes the bet and the loser loses his bet. This is prohibited according to the Shariah.

Mudarabah : A contract made between two parties to finance a business venture. The parties are a *rabb al-mal* or an investor who solely provides the capital and a *mudarib* or an entrepreneur who solely manages the project. If the venture is profitable, the profit will be distributed based on a pre-agreed ratio. If the business is a loss, it will be borne solely by the provider of the capital.

Murabahah : A contract referring to a sale and purchase transaction for the financing of an asset whereby the cost and profit margin (mark-up) are made known and agreed to by all parties involved. The payment of the purchase price can be settled either on a deferred lump sum basis or on an instalment basis, and is specified in the agreement.

Musharakah : A partnership arrangement between two parties or more to finance a business venture whereby all parties contribute capital either in the form of cash or in kind. Any profit derived from the venture is distributed based on a pre-agreed profit sharing ratio and a loss is shared on the basis of capital contribution.

Qard Hasan : A contract of loan between two parties on the basis of social welfare or to fulfil a short-term financial need of the borrower. The amount of repayment must be equivalent to the amount borrowed. It is, however legitimate for a borrower to pay more than the amount borrowed as long as it is not stated or agreed at the point of contract.

Riba : An increase, in a loan transaction or in exchange of a commodity, accrued to the owner (lender) without giving an equivalent counter value or recompensation in return to the other party. It covers interest both on commercial and consumer loans, and is prohibited according to the Shariah.

Sadaqah : Donation.

Sukuk : A document or certificate, documenting the undivided pro-rated ownership of underlying assets. The *sak* (singular of *sukuk*) is freely traded at par, premium or discount.

Shariah : Islamic law, originating from the *Qur'an* (the holy book of Islam), and its practices and explanations rendered by the prophet Muhammad (*peace be upon him*) and *ijtihad* of *ulamak* (personal effort by qualified Shariah scholars to determine the true ruling of the divine law on matters which revelations are not explicit).

Takaful : A form of Islamic insurance based on the principle of *ta'awun* or mutual assistance. It provides mutual protection of assets and property and offers joint risk sharing in the event of loss incurred by one of its members. Takaful is similar to mutual insurance in that members are the insurers as well as the insured.

Wakalah : A contract which gives a person the power to nominate someone to act on his behalf, as long as he is alive, based on the agreed terms and conditions.

Wadiah Yad Dhamanah : Goods or deposits kept for safekeeping with another person, who is not the owner. As *wadiah* is a trust, the depository becomes the guarantor and guarantees repayment of the whole amount of the deposits, or any part thereof outstanding in the accounts of the depositors, when demanded. The depositors are not entitled to any share of the profits but the depository may provide returns to the depositors as a token of appreciation.

Zakat : A tax, which is prescribed by Islam on all persons having wealth above a certain amount at a rate fixed by the Shariah. According to the Islamic belief zakat purifies wealth and souls. The objective is to take away a part of the wealth of the well-to-do to distribute among eight categories of people stated in the Quran.

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