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ISLAMIC FINANCE

Opportunity for Long-Term Growth

The continued trend toward risk-averse investments is bringing Islamic finance into the spotlight. In this paper, we explore the industry's emergence, growth and unique investment philosophy, as well as its challenges and limitations.

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Foreword

The growth of modern Islamic finance has been steadily intensifying for more than two decades, but interest in the story of its success accelerated last year as the more conventional financial industry faltered. Though Islamic finance has not been immune to the effects of the global financial crisis, its resiliency is important to note. The sector continues to garner attention because of its unique investment philosophy, which significantly differs from traditional approaches, particularly as it relates to risk. The increased interest has underscored the need for more education, as the distinct moral and legal codes that govern Islamic finance are neither widely known nor well understood.

To help investors better understand the structure of Islamic finance and its strategic investment trends, State Street hosted its first Islamic Finance Congress in October 2008. The event provided an educational overview of Islamic finance on topics that included Shariah law and risk management, as well as current market trends and opportunities.

Organized by State Street's Muslim Professional Employee Network, the meeting highlighted the emergence of Islamic finance and State Street's commitment to this expanding investment market, which the company has been involved in for nearly a decade, providing customers with custody and fund accounting, as well as investment management. As of December 31, 2008, State Street Global Advisors (SSgA) managed a Shariah-compliant portfolio of more than $6 billion. A new office in Doha, Qatar, has strengthened State Street's presence in the Middle East, adding to existing offices in Dubai first established in 1992. Our offices in Southeast Asia are also expanding services to the Islamic finance market.

As Islamic finance attracts an increasingly global group of investors in the years ahead, we believe the industry will respond with new products that will offer greater variety and sophistication for a host of complex, cross-border transactions.

History and Current State of Islamic Finance

The financial crisis has no doubt heightened the appeal of Islamic finance, but its tenets — lower leverage, transparency and no speculation — make it an attractive investment option in any market environment.

Although its roots can be traced back 14 centuries, Islamic finance is still in the early stages of growth, and there are no signs of it slowing. In fact, the industry has only scratched the surface of the world's estimated 1.5 billion Muslims — who represent 20 percent of the

Figure 1: Islamic Investment Product Depth

Sophisticated client investment product depth needs	Emerging	Maturing	Mature
	Private Equity	Structured Products	Equity
	Hedging Products	Cash Management	Real Estate
	Fixed Income		

Source: Aamir A. Rehman, "The Commercial Impact of Islamic Finance: Industry Overview and Implications," October 2008.

world's total population[1] — and it is starting to appeal to non-Muslims as well.

To understand the rise of modern Islamic finance, it's important to examine the principles of Shariah, the moral and legal code that governs the industry's development, impacts the underlying structure of its products and services, and ultimately serves as one of its biggest selling points to investors.

Any discussion of Islamic finance must also consider the socioeconomic and geopolitical drivers that have played an integral role in its growth. Rising oil revenues sparked a transfer of wealth to the Middle East, and that liquidity, in turn, inspired the region to establish new ventures to diversify income sources and build more stable economies that will be less dependent on revenue from hydrocarbon sources. Countries from Southeast Asia to North Africa have used Islamic finance to encourage their populations to broaden the range of available personal finance services. Malaysia's efforts to promote Islamic finance within its borders have given it a unique opportunity to strengthen its presence in global financial markets.

It is also essential to understand the new products that have evolved, as Islamic finance tries to strike a balance between finding solutions that comply with Shariah and meeting the economic and transactional needs of its investors.

Historically, Muslim nations such as Malaysia have used Islamic finance as a vehicle to offer banking services to the often poorer parts of the Muslim population whose religious beliefs may have prevented them from participating in conventional financial activities. Conversely, Sheikh Saleh Kamel of Saudi Arabia founded the first Islamic Bank in that region because he wanted to use Islamic laws to grow his business and wealth. Today, it has evolved into a sophisticated multinational business that is engaged in private equity and project finance, as well as fund, asset and wealth management. As indicated in Figure 1, the evolution of Islamic investment products reflects a concerted effort to accommodate a growing global customer base.

What makes Islamic finance uniquely different — and uniquely global — is the common bond that its Muslim customers share: their religion, whose moral lessons are shared through the teachings of the Koran, but whose legal principles and codes are governed by Shariah, or Islamic law (see call-out on page 4). While Shariah's faith-based principles continue to hold strong appeal for Muslims, the pragmatic benefits arising from its application are becoming increasingly attractive to non-Muslims as well, particularly during the current economic crisis and the intense focus on risk management we are witnessing.

At its core, Shariah specifies that money has no intrinsic value of its own and should be used as a tool for measuring the value of assets. This basic concept has an exceptional impact on Islamic finance's development. Islamic financial institutions aren't able to charge interest, even on basic deposit accounts. They also can't

[1] Gallup Center for Muslim Studies, March 2008.

employ many hedging and derivative instruments commonly used in more conventional finance activities.

Shariah also requires that financial transactions be linked to an underlying activity or hard asset, providing a direct connection between financial and productive flows. Furthermore, it demands that risk, as well as profits and losses, be shared between a financier and its customer. This principle aims to encourage both parties to conduct appropriate due diligence before agreeing to a transaction, including the evaluation of whether the agreement will generate sufficient wealth to compensate for any risks.

Proponents of Islamic finance say that these and other Shariah principles provide a built-in system of checks and balances for financial transactions, and are what give the industry resilience and stability — even in today's challenging environment. They also propel the industry to innovate so that it can meet the increasingly sophisticated financial needs of consumers.

So far, it appears that the global financial crisis has had limited direct effects on Islamic finance as investors seek out asset classes and markets they hope will provide stability. In fact, demand for Islamic financial products and services in the global market may be exceeding current availability.

In recognition of this growing market, a number of global financial centers, including London, Tokyo and Hong Kong, have initiated plans to integrate Islamic finance into their financial systems, and some are looking at Islamic finance as a way to enhance their own financial markets. With more than 500 Islamic financial institutions (IFIs) operating around the world, the scope of Islamic financial business is quickly expanding. With it has come product innovation.

With total assets under management by Islamic financial institutions now exceeding $600 billion, the industry has become a viable option for investors and a competitive form of financing for commercial enterprises. It is also allowing for the further diversification of risks and is contributing to an efficient international allocation of resources across borders.

Growth Fueled By Oil

The founding of the first large Islamic banks in the 1970s, including Dubai Islamic Bank and Albaraka Banking Group, is generally considered to mark the birth of modern Islamic finance. The industry's growth, however, really began to accelerate in the early 1990s, bolstered in large part by liquidity in the Gulf from one crucial source: oil.

Some analysts estimate that the rise of the oil industry helped to propel Islamic finance's growth rate to about 10 percent a year, while others say the rate reached as high as 20 percent during the past five years.

The influx of capital generated by rising oil prices has spurred massive investment in infrastructure and real estate development projects in the Gulf Cooperation Council (GCC) states of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates, driving demand for *sukuks* (Islamic bonds) and loans. The liquidity also has led to significant wealth accumulation among individuals, spurring the need for Islamic asset management services. GCC leaders have announced plans to boost domestic investment in the hopes of diversifying the area's economies beyond oil, generating jobs and building new cities.

Already, their vision is impacting investors. An estimated 25 percent of the portfolios of GCC states' wealthy private investors is held in local financial products — an increase from 15 percent in 2002.[2] By the end of this year, the number of Islamic mutual funds may rise to 925, an annualized growth rate of 28 percent since 2000 (see call-out on page 6). The GCC's foreign investment choices will ultimately influence interest rates, liquidity and financial markets worldwide.

Acceptance Grows as Liquidity Crosses Borders

Support differs for Islamic finance among neighbors of the GCC in the Middle East and North Africa. One explanation lies in the varying interpretations of Shariah that exist between different schools of Islamic thought. For the most part, North Africa follows a less conservative interpretation of Islamic doctrine.

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[2] "Investing the Gulf's Oil Profits Windfall," *The McKinsey Quarterly*, May 2008.

Islamic Finance's Shariah Pillars

Islamic finance is based on Shariah, or Islamic law, which is designed to promote social and economic justice, and which provides guidelines for all aspects of Muslim life ranging from religion and politics to economics and business.

There are five pillars of Shariah, as it relates to Islamic finance, which differ from conventional finance. They are:

- Ban on interest (riba)
- Ban on uncertainty (gharar)
- Promotion of risk- and profit-sharing
- Promotion of ethical investments that enhance society
- Promotion of asset-backed transactions in which each financial transaction must be tied to a tangible and identifiable underlying asset

As part of its oversight of business and financial relationships, Shariah promotes risk-sharing, entrepreneurship, transparency and the preservation of property rights, while discouraging speculative behavior. Shariah also outlines a variety of traditional contract agreements that comply with Islam's religious and ethical principals in an effort to ensure that all parties receive fair and just treatment. In addition to provisions commonly found in Western law that safeguard parties from misrepresentation, Shariah contract law includes protections that aim to eliminate forms of exploitation.

Among these protections is the prohibition of riba, or unwarranted gains, and gharar, or levels of ambiguity or uncertainty. It is the prohibition of riba that results in the banning of interest charges under Shariah, since it is considered a cost that is accrued irrespective of the performance of an investment and may not create wealth if there are business losses. Restrictions on gharar are what prevent Islamic financial institutions from employing many derivative-type instruments typically used in conventional finance.

Shariah also places limitations on debt. Under Islamic law, money is used to measure the value of assets and has no value of its own. Based on this definition, Shariah does not permit debt-related contracts, since debt is a form of money. If it's part of a transaction, it should be sold at face value. As a result, instruments used in conventional finance for unsecured corporate debt are forbidden.

Shariah is also concerned with promoting ethical investing, and it is this code that helps investors to determine whether an investment is *halal* (acceptable) or *haram* (unacceptable). Industries backed by tangible assets that engage in accepted social behaviors are generally considered halal, which include computers or computer software, energy, telecommunications, textiles, transportation and chemical manufacturing. Haram businesses are seen as those conducting unacceptable activities, such as producing or marketing alcohol, gambling, conventional financial services, pork and pork products, and pornography.

Financial institutions and others who engage in Islamic finance try to ensure compliance with these principles by consulting with a Shariah supervisory board that commonly consists of Shariah scholars with experience in business and financial matters. These boards are viewed as both an auditor for the company offering the financial service or product, and a consumer advocate for the company's clients.

Shariah compliance is what lends a financial product or service its legitimacy in the Islamic marketplace. Proponents of Islamic finance view Shariah principles as mitigating many concerns, especially in light of recent business corruption scandals, the global credit crisis, and fears of economic recession that currently challenge the global environment.

For example, historically the banking clientele of the North African region known as the Maghreb was not particularly opposed to the concept of interest, and tolerated conventional financing and the use of interest rates. In some countries, such as Libya and Morocco, Islamic banks had been considered by some to have ties to Islamic political parties and were therefore denied licenses.

Countries such as Jordan, Tunisia and the Sudan, in contrast, have welcomed Islamic finance as an opportunity to foster economic development.

Gradually those nations with mainly Muslim populations that had hesitated to permit Islamic banks have started to embrace such institutions. For example, in February 2007, Tunisia passed legislation authorizing the creation of the country's first Islamic bank. The following month Morocco's central bank, Bank Al-Maghrib, allowed Moroccan banks to offer Islamic banking services for the first time in the country's history.

The emergence of Islamic finance in North Africa and other countries in the Middle East fulfills two purposes. First, it allows surplus liquidity to be allocated to an area considered culturally similar and in need of foreign direct investment. Second, it guarantees the recycling of liquidity from the Gulf in profitable asset classes that are eligible as Shariah-compliant investments, namely tourism, real estate and infrastructure.

Malaysia: A Pioneer

Oil has not been the only catalyst for growth in Islamic finance. The industry found a powerful ally across the Pacific in Muslim Asia, led by the pioneering country of Malaysia, which has pledged to encourage innovation and development of an international infrastructure.

Islamic finance in Malaysia started as a strategy for greater financial inclusion. It provided a means for the government to reach out to the underserved segment of its society by offering basic banking and insurance products that were compatible with Shariah principles.

The country has made significant strides in liberalizing its market to promote greater financial integration with the global Islamic financial system and to increase foreign entry and participation. As an example, Malaysia has issued new licenses to foreign fund managers and stockbrokers, and has increased the issuance of licenses in Islamic banks and *takaful* (Islamic insurance) companies.

The Ninth Malaysia Plan, for example, which covers 2006 to 2010, seeks to position Malaysia as a global hub for Islamic capital markets, products and services, and, in particular, as a center for origination, distribution, trading, and fund and wealth management.

The growth in Islamic finance in Malaysia has been supported by a significant investment in human capital, culminating in the establishment of the International Centre for Education in Islamic Finance (INCEIF) in 2006. The INCEIF boasts international faculty and students from more than 40 countries, and offers a three-year Chartered Islamic Finance Professional (CIFP) qualification that includes an internship with an Islamic financial institution, as well as master's and Ph.D. programs in Islamic finance.

This year Malaysia established the International Shariah Research Academy (ISRA) to conduct Shariah research on contemporary Islamic finance issues. Specifically, the academy provides a platform to promote engagement and dialogue among global Shariah scholars in the hope that such discussions will assist with the convergence of views from different jurisdictions in the global Islamic financial system.

After three decades of nurturing the Islamic finance industry, Malaysia has succeeded in developing a system that operates in parallel with conventional finance. Islamic banking assets now constitute 16 percent of the Malaysian market, while the takaful sector oversees 7 percent. In the capital markets, Islamic private securities outstanding amount to $79 billion, or 54 percent of total securities in the market.[3] Malaysia's government issued the first sukuk in 2002. The country now accounts for over 62 percent of global Islamic bonds outstanding, representing the

[3] Keynote address by Bank Negara Malaysia Governor Zeti Akhtar Aziz at the State Street Islamic Congress, Boston, October 6, 2008.

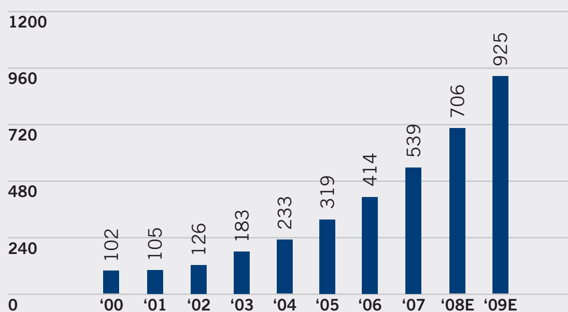
Islamic Mutual Funds

Due to the unique investing approach dictated by Shariah, Islamic mutual funds weathered the credit crisis better than their mainstream peers during 2008. Their conservative investment strategy enabled Islamic funds to avoid the crushing losses associated with the holding of collateralized debt obligations and other high-risk instruments in recent months.

Because Islamic mutual funds must be Shariah compliant, the funds must avoid investing in banks or other firms that earn money by charging interest. This stems from the Prophet Mohammed's teachings that expressed that debts must be repaid only with the amount that was loaned.

Islamic mutual funds (like other faith-based funds) must screen out so-called "sin stocks," which include firms involved with alcohol, tobacco, gambling, pornography and weapons. Additionally, Shariah-compliant funds must also avoid companies involved in pork processing or that are highly leveraged. These rules limit the funds' investable universe to approximately half of all of the publicly traded stocks in the US.

Figure 2: Number of Islamic Mutual Funds



Source: Booz & Company.

Frequent trading of shares is also forbidden under Islamic law because it is viewed as a form of gambling. As a result, the turnover in Islamic portfolios is considerably lower than that of mainstream funds.

The result has been that many Islamic mutual funds have fared better than their more conventional counterparts. The performance and the investment philosophy of Islamic mutual funds in today's economic environment is driving some non-Muslim investors, who are increasingly risk averse and intolerant of leverage, to seek out more Shariah-compliant investments. As evidenced in Figure 2, the number of Islamic mutual funds has increased significantly over the years.

Islamic mutual funds, however, are not immune from the economic downturn. These funds traditionally have high exposure to real estate and thus are vulnerable to declining housing prices.

largest sukuk market in terms of amount outstanding and number of issues.

Expanding into Non-Muslim Nations

Since the 1990s, Islamic banks in the Gulf and Muslim Asia have made significant inroads in attracting retail customers to their products and services. And their efforts are succeeding. In those regions, an estimated 20 percent of banking customers would likely choose an Islamic financial product over a conventional one with a similar risk-return profile.[4]

Islamic financial institutions are now expanding to non-Muslim countries, following a similar development path by focusing first on the retail segment. Their strategy has been effective among parts of the Muslim population in Europe that traditionally avoided using conventional banking facilities because of the practice of charging interest, or *riba*.

Among countries in Europe, the UK has expressed a leading interest in expanding its Islamic financial base. Standard & Poor's estimates that as many as 300,000 retail customers in that country may be interested in Shariah-compliant banking services.

In August 2004, the UK's Financial Services Authority (FSA) approved a banking license for the Islamic Bank of Britain, the country's first Islamic bank to serve the consumer market with Shariah-compliant products. The licensing of the European Islamic Investment Bank, the UK's first independent Shariah-compliant investment bank, followed in March 2006. Its mission is to recycle institutional and private liquidity in the Gulf into Shariah-compliant asset classes with high returns, such as real estate, industrial, infrastructure and tourism in mature, efficient and diversified Western economies.

A rising number of conventional global banking firms have created units dedicated to servicing the Islamic market. Licensing a takaful company or allowing conventional issuers to offer takaful products may be the next step in the UK's strategy to enhance its position in the Islamic finance industry.

London recently became the only non-Muslim competitor to join the major financial hubs to handle Islamic transactions, which had previously been dominated by Dubai, Kuala Lumpur and Bahrain. London offers some distinct competitive advantages: its large size and reach, the liquidity in its secondary market, large human resource capacity and expertise, as well as its already deep and efficient markets where investors can switch from one asset class to another, including sukuk.

London also benefits from a strong legal environment. Notable among initiatives related to Islamic finance was a sukuk-friendly amendment to the country's tax law announced in 2007. The tax regime applied to sukuk coupons makes them deductible, which means they are now equivalent to interest and no longer viewed as rental payments.

The UK itself may consider issuing sukuk notes, which would make it the third sovereign outside of the Middle East to issue Shariah-compliant paper after Malaysia in 2002 and Germany's state of Saxony-Anhalt, which issued a five-year sukuk in 2004. The largest sukuks to date were those issued by Nakheel Group of Dubai for $3.52 billion in the first quarter of 2007, which were listed in both Dubai and London.

Also among non-Muslim countries experiencing growth in Islamic finance is the US, where an estimated 5 to 7 million Muslim residents are calling for more Islamic financial opportunities — particularly in the wake of the subprime lending crisis.[5]

Shariah-compliant financing in the US mainly exists for personal home mortgages by such companies as Guidance Residential, University Islamic Financial, Devon Bank and American Finance House Lariba. The Federal National Mortgage Association (Fannie Mae) and the Federal Home Mortgage Corp. (Freddie Mac) buy Shariah-compliant mortgage contracts from intermediaries, allowing the origination of further mortgages. In 2007, Freddie Mac bought more than $250 million in Islamic home loans.

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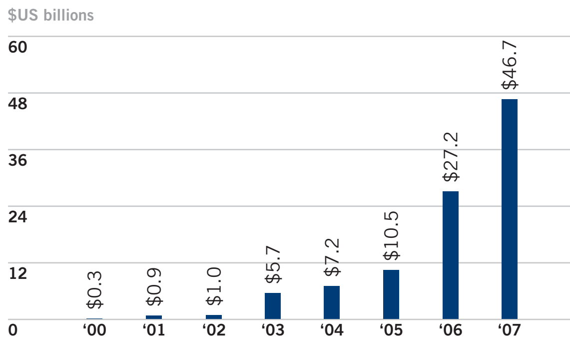
[4] "Chief Drivers Behind Islamic Finance's Global Expansion," Standard & Poor's, Islamic Finance Outlook 2008.

[5] "Islamic Finance: Overview and Policy Concerns," Congressional Research Service, July 29, 2008.

Figure 3: Global Sukuk Issuance



Source: International Islamic Finance Market, August 2008.

Shariah-compliant mutual funds are also offered in the US, as are Shariah-compliant transactions in private equity and real estate.

Sukuk Market

Alongside the global advancement of Islamic finance is the growing international appeal of its fastest-growing product: sukuk. In 2007, new issuance of global sukuks reached a record $47 billion, up 70 percent from the prior year, as evidenced in Figure 3. Although the sukuk market experienced a marked slowdown in 2008, experts predict it will gain ground as global markets recover.

Generally, sukuk refers to bond-like obligations, the majority of which are unsecured. Restrictions within Shariah prohibit the use of conventional debt by Islamic borrowers, mainly because of the definition of money as a means of exchange, or a measure of value, and not an income-generating asset in itself. The funding of existing ventures or assets consistent with Shariah, and the sharing of risks and rewards, are two key principles that differentiate sukuks from conventional debt.

Sukuks can range from equity-like instruments with an outright ownership interest in the issuer to asset-backed and asset-based securities. There are 14 ways to structure sukuks, according to the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), but so far issuers are using mainly seven structures:

- MANFA'A – Assets usufruct selling, which refers to selling the right to use assets but with limitations
- IJARA – A leasing contract that transfers the use of an asset to a lessee in exchange for periodic payments
- MUSHARAKA – A shared equity partnership where two or more partners supply capital to a joint venture
- MUDARABA – An agency partnership where one partner supplies capital and the other provides expertise
- MURABAHA – An installment credit agreement used in the sale of tangible assets at a reasonable markup in which payments can be spread over time
- ISTISNA – A deferred delivery contract used to finance the sale of an asset that is under construction or does not yet exist
- BAY AL-SALAM – A forward-sale contract in which the buyer pays in advance for an asset to be delivered at a specific future time

The sukuk market's tremendous growth has been spurred by the rising funding requirements of emerging market economies in Asia and the Middle East. While the issuance levels are down from a year ago because of deteriorating global market conditions, lower investor interest and the widening of credit spreads, the sukuk market is still expected to remain resilient over the long-term.

The sukuk market's expansion has been fueled mainly by corporate issuances, which accounted for more than 85 percent of sukuks in the first half of 2008. Most sukuks are being issued in markets where liquidity is still abundant and the appetite for Shariah-compliant instruments is high, such as in GCC countries and in Malaysia.

Massive infrastructure projects in the Gulf, estimated in excess of $1.6 trillion, will require huge amounts of funding. Banks in the Gulf also are trying to balance their loans with stable funding through sukuks to accommodate the rapid increase in residential real estate lending. Financial institutions in the Gulf are experiencing widening mismatches between longer-term maturities on the loans they extend and the

shorter-term financing that backs them, creating demand for access to longer-term funding.

The sukuk market could help introduce more standardization and encourage further innovation in structuring Shariah-compliant products, particularly in such areas as real estate, which provide cash flow-generating assets to back the paper.

Most sukuks are over-the-counter instruments, with listed sukuk accounting for only about a quarter of outstanding sukuks issued worldwide. The secondary market is virtually nonexistent, since many Islamic finance scholars stipulate that sukuks may only be resold at face value.

The US dollar has traditionally been the preferred currency for sukuk issuers, but during the past five years has experienced a decline. The percentage of US dollar-denominated sukuks declined to 42 percent in 2007 from 85 percent in 2002,[6] reflecting the US dollar's recent weakness and a rise in issuances in local currency. The other major currencies of issuance in 2007 were the Malaysian ringgit, the UAE dirham and the Saudi Arabian riyal, the latter two reflecting the large amount of liquidity in the Gulf that sukuk issuers are trying to tap. Sukuk issuance in US dollars is expected to pick up again mainly because issuers are financing infrastructure projects in the Gulf, where most costs are dollar-denominated.

Sukuks present specific credit risks, particularly with regard to delays in scheduled payments, events of default and reporting standards. For example, from an issuer's perspective there is a pricing gap between sukuks and conventional debt instruments. Sukuks require more complex legal structures that result in higher advisory fees. Investors may require higher rates of return from sukuks to compensate for their relatively illiquid nature, smaller market size and lack of proven legal and bankruptcy systems in issuers' jurisdictions.

Issuers are looking to sukuks as an alternative means of tapping cash-rich investors from the Middle East and Muslim Asia, providing them with non-bank alternatives for longer-term funding.

The sukuk market is expected to widen its geographic reach, given that entities located in more than 20 countries, many of which are non-Muslim, have expressed interest in issuing the paper.

In 2007, more than 100 sukuks were issued from 10 countries, and the UK government published a "consultation" seeking views from the public about the potential issue of a wholesale British sterling-denominated sukuk. The state-owned Japan Bank for International Cooperation also voiced its intention to issue sukuks.

During the past two years, sukuk structures have combined different risk-return features, greatly enhancing their appeal for global investors. Examples of innovations include convertible sukuks to IPO shares or issued equity shares, sukuks with put/call options and subordinated sukuks, which are part of tier-2 capital of Islamic banks.

Takaful Market

Takaful is another Islamic financial product gaining a large following, particularly in the GCC where economic growth and a sizable underinsured population are creating an opportunity for the development of the market. The GCC insurance market alone has a potential size of $20 billion[7] as substantial infrastructure investments in the region are generating a need to insure related risks. Currently, the GCC takaful market is growing at about 40 percent a year.

Takaful, which involves the concepts of cooperative risk sharing and community well being, was approved by the Grand Council of Islamic Scholars as a Shariah-compliant alternative to traditional insurance in 1985.

The main challenge for the takaful industry is to increase awareness of the benefits of insurance among retail customers. It suffers a lack of economies of scale and an inability to more effectively diversify risks.

[6] "The Sukuk Market Continues to Soar and Diversify, Held Aloft by Huge Financing Needs," Standard & Poor's, March 11, 2008.

[7] "Takaful: A New and Viable Insurance Business Model or Just a Marketing Opportunity?" Standard & Poor's, Islamic Finance Outlook 2008.

Success will depend on the industry's ability to provide innovative products and high-quality service, as well as an increased awareness of the need for insurance to create demand for it.

The Drive for New Shariah-Compliant Products

While the selection of products at large Islamic financial institutions remains relatively narrow, some newly created Shariah-compliant instruments are beginning to rival those of conventional banks.

On the deposit side, these instruments include profit-sharing investment accounts (PSIAs), which give depositors the right to share in Islamic banks' profits and losses. In addition, several money market, equity, real estate, private equity and infrastructure funds are now being offered.

As capital markets and legal frameworks develop, there are growing prospects for a structured finance market in the Middle East. Originators are examining how it may be possible to securitize assets as confidence in this form of financing increases.

Legal issues, high liquidity in the region and a lack of benchmarks pose challenges. Still, legal developments in some jurisdictions, including new mortgage legislation being introduced in Saudi Arabia and the introduction of foreign ownership laws in Dubai and Saudi Arabia, indicate a willingness to try to facilitate some securitization.

Also, the need to diversify the region's investor base and reduce dependence on the performance of oil markets may be a significant incentive for securitization. Lastly, securitization shares an important feature with Shariah compliance: asset-driven returns.

Financial derivatives and hedging instruments may prove more difficult to develop, mainly because of Shariah's prohibition of interest and activities that have a high risk of uncertainty.

The industry, however, is moving forward to try to find new avenues. The Islamic Development Bank's Shariah Committee approved a Shariah-compliant concept for hedging against risks associated with currency and profit rates structures. The committee also approved a contract to commence hedging operations with one of the counterparties.

It is reviewing other proposals presented by several parties for hedging mechanisms that include the use of diminishing partnerships as a mode of financing in the construction and development of highways, Shariah rules related to liquidity management and rules governing third-party guarantees.

Risks

There are risks involved with any investment, and Islamic finance is no exception. Not surprisingly, some of the more significant risks for the industry lie in its relationship with Shariah.

Compliance with Shariah's code and principles poses the biggest risk in modern Islamic finance because it constitutes the necessary first step toward acceptance of a product and service by Muslim consumers and investors. To prove compliance means that the product and service must first have the approval of a religious authority.

This is why the single most important factor in the management of risk in Islamic finance are the Shariah supervisory boards. These boards generally consist of at least three Shariah scholars who have specialized qualifications in finance or economics. They often participate in a product's research and development before issuing a fatwa, or ruling, on its compliance with Shariah law.

In recognition of the importance of this religious approval, some areas now require a Shariah supervisory board as well as a fatwa for any company offering Islamic financial services and products. Such certification signifies that a product not only complies with jurisdictional regulations, but has also been scrutinized by an authority on Islamic transactional law.

However, the presence of a fatwa or a Shariah supervisory board does not guarantee market acceptance that a product is Shariah compliant. In fact, there are several reasons for the failure of a product or

service in the Muslim community, including differences of legal philosophy among various jurisdictions, a lack of detailed disclosure in a fatwa, the failure of an investor Shariah board to comprehend the operations or structures described in a fatwa, or simply the rejection by consumers who feel that a fatwa has not adequately addressed their concerns. In some instances, a rejection may come from an independent Shariah authority, such as an imam or community leader, which could lead to general rejection by the public.

The perception of whether a product or service is Shariah compliant, or whether an institution is engaged in activities that are deemed unlawful under Shariah, leads to reputation risk. Again, the Shariah supervisory board plays a crucial role in conducting due diligence and helping to ensure compliance to mitigate this risk.

Companies — particularly those that conduct business globally — are careful about choosing scholars who sit on their boards. These institutions generally establish Shariah supervisory boards with scholars of international repute whose backgrounds cover a broad cultural and linguistic constituency, and who represent the major schools of jurisprudence and the main geographical regions of the Muslim world.

With the rise of Islamic finance, demand for these scholars has intensified, leading to a worldwide shortage of skilled Shariah scholars to serve on these boards. There is also a shortage of workers skilled in marketing and executing the products and services. Subsequently, regulators and industry participants are moving quickly to develop solutions in education and training.

Malaysia's establishment of its INCEIF certification program in 2006 is one example. The Islamic Development Bank also set up a $600,000 Technical Assistance Sub-Account Facility with the International Monetary Fund aimed at helping member countries implement common legal and regulatory standards for Islamic financial institutions.

There is a growing need to address differences in jurisprudence and legal methodology across geographic regions, particularly with regard to financial products and services for which there is no precedent or clear ruling from the classical texts. As Islamic financial products evolve, the law is only beginning to catch up in its interpretation and application. Modern Shariah supervisory boards have had to help companies innovate and be proactive about how to use nominate contracts[8] as building blocks for achieving financial and contractual objectives. For example, the adaptation of contracts helped to bring about interest-free alternatives to conventional mortgages for the financing of homes.

The development of consistent and universally accepted accounting and regulatory standards is also becoming increasingly important for the industry as Islamic financial activity flows across borders. The industry is responding by establishing a global financial architecture that includes the AAOIFI, which was founded in 1990, and the Islamic Financial Services Board (IFSB), established in 2002. These organizations have been essential for the stability of the system, primarily because they have played a key role in reconciling accounting and regulatory standards across different jurisdictions. They have also been instrumental in instituting international best practices.

The importance of setting global standards was highlighted recently when the Shariah board of the AAOIFI in Bahrain declared that many of the innovative sukuk structures failed to comply with religious rules. Buying back the underlying assets of a sukuk at a predetermined price, the board said, represents a guarantee, rendering it in violation of Shariah. The AAOIFI issued new guidelines to address this concern, but the warning temporarily stunted participation in the sukuk market.

Market, credit, funding and liquidity risks also pose unique challenges to Islamic financial institutions because of Shariah compliance.

[8] Nominate contract: A type of contract that occurs so frequently that it has acquired a name and individual characteristics (e.g., purchase and sale).

The management of market risks is often more difficult for Islamic banks than their conventional counterparts because of the limited number of risk management tools and instruments available to them. For example, hedging instruments such as derivatives are generally forbidden. The institutions find some assistance in the prohibition of *gharar* (uncertainty), which can temper their risk profile by limiting the size of their trading operations.

Collateral coverage at Islamic financial institutions is often higher for conventional banks since they have an obligation to back any transaction with a tangible, underlying asset. Still, certain transactions carried out by Islamic banks can bear above-average credit risk, namely *musharaka* (venture capital financing) and *mudaraba* (trust financing), which can increase the risks carried by the banks. In addition, in murabaha (mark-up financing) and *ijara*, the existence of full collateral could lead Islamic banks to be less vigilant when assessing the creditworthiness of their borrowers.

Funding and liquidity risk is one of the most critical issues for Islamic financial institutions since only a small secondary market exists to enable them to manage liquidity. Their assets are generally not sellable on a secondary market, and they aren't able to invest in fixed-income instruments for treasury management purposes.

Liquidity risk is of particular concern with regard to PSIAs, should PSIA holders decide to withdraw their deposits at maturity. Islamic institutions have developed some layers of protection to deal with this, namely profit equalization reserves, mudarib fees and investment risk reserves.

Conclusion

The unprecedented volatility persisting throughout world financial markets today is giving rise to a new world order that is redefining the structure and regulation of the financial services industry. Expressly, there is heightened awareness for greater diversification of risks in the management of funds.

Against a backdrop of a challenging global environment, Islamic finance is emerging as a competitive form of intermediation in the international financial system. At State Street, we believe its expansion may contribute to a more efficient allocation of capital globally — as well as to greater financial stability — as financial linkages among the East Asian, West Asian and Middle East regions evolve.

For Islamic finance to be fully embraced across the globe, the industry will need to continue to expand business parameters and create new product offerings. Specifically, we believe the industry must increase its investment in research and development to yield new instruments, regulatory structures, best practices and higher standards of risk management to meet the requirements of the international community. These solutions need to combine market requirements with Shariah compliance, as the forces of innovation will expose the divergence of Shariah views that underlie a number of Islamic financial transactions.

Moving forward, one of our highest priorities as a global financial system is to find ways to restore confidence in the markets — and we believe Islamic finance will provide that opportunity. Opening the door to additional alternative forms of investing, particularly ones that emphasize the sharing of risk and reward, will certainly help to facilitate our goal. Despite an impending market recovery, we are likely to see a continued trend toward risk-averse investments and intense scrutiny of investment practices across the board, which will give Islamic finance a boost for years to come.

Glossary

ACCOUNTING AND AUDITING ORGANIZATION FOR ISLAMIC FINANCIAL INSTITUTIONS (AAOIFI): Founded in 1990, the AAOIFI is a non- profit group that prepares accounting, auditing, governance, ethics and Shariah standards for Islamic financial institutions and the industry.

CHARTERED ISLAMIC FINANCE PROFESSIONAL (CIFP) QUALIFICATION: The CIFP is the world's first certification in Islamic finance that aims to provide individuals with expertise in the Islamic banking and financial services industry, including takaful and capital markets. The professional certification program aims to produce high-caliber professionals with the necessary technical skills and knowledge in Islamic finance.

FATWA: A fatwa is an Islamic religious ruling or a scholarly opinion on a matter of Islamic law. It usually is issued by a recognized religious authority in Islam.

FINANCIAL SERVICES AUTHORITY (FSA): The FSA is an independent organization responsible for regulating the financial services industry in the UK.

GHARAR: An Arabic word meaning risk, uncertainty and hazard. It is differentiated from the word *riba* in that the prohibition of riba is absolute, while some degree of *gharar*, or uncertainty, is considered acceptable in Islamic finance.

GULF COOPERATION COUNCIL (GCC): A trade block involving the six Arab states of the Persian Gulf: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.

IJARA: A lease-to-own contract in which a bank buys and then leases an item to a customer for a specified rental over a specific period.

INTERNATIONAL CENTRE FOR EDUCATION IN ISLAMIC FINANCE (INCEIF): Established by the Bank Negara Malaysia, the central bank of Malaysia, in March 2006, the INCEIF offers education and training in Islamic finance, including a professional certificate known as the Chartered Islamic Finance Professional qualification, as well as master's and Ph.D. programs.

INTERNATIONAL SHARIAH RESEARCH ACADEMY (ISRA): Founded by Bank Negara Malaysia (BNM) as part of its effort to establish Malaysia as an Islamic financial hub, the ISRA aims to promote applied research in the area of Shariah and Islamic finance. It also acts as a repository of knowledge for Shariah views or fatwas and undertakes studies on contemporary issues in the Islamic financial industry.

ISLAMIC FINANCIAL SERVICES BOARD (IFSB): Established in 2002, the IFSB is an international organization that aims to set standards and guiding principles for the Islamic financial services industry, which includes the banking, capital markets and insurance sectors. The IFSB also conducts research and coordinates initiatives on industry-related issues, and organizes seminars and conferences for regulators and industry stakeholders.

MAGHREB: A region in North Africa that generally applies to all of Morocco, Algeria and Tunisia.

MUDARABA: A form of trust financing. Under this arrangement, an investment is made on someone's behalf by an individual considered to be more skilled. The contract between the two parties has one side providing the funds, and the other providing the expertise, and both agree in advance to the division of any profits made.

MUDARIB: In a Mudaraba contract, the expert who manages the investment is known as a Mudarib.

MURABAHA: A form of mark-up financing. A contract for purchase and resale that allows the customer to make purchases without having to take out a loan and pay interest.

MUSHARAKA: A word that means "partnership." In Islamic finance the contract involves one party placing capital with another, and both sharing the risk and reward.

PROFIT-SHARING INVESTMENT ACCOUNTS (PSIAS): Offered by many Islamic banks, PSIAs are relatively similar to the time deposits of conventional banks. They are structured so that depositors are entitled to receive a share of a bank's profits, but also must bear all potential losses.

RIBA: An Arabic word meaning interest.

SHARIAH: Islamic law.

SUKUK: An Islamic financial certificate, similar to a bond in conventional finance, that complies with Shariah.

TAKAFUL: Based on Shariah, takaful is a type of Islamic insurance, with members contributing money into a pooling system to guarantee each other against loss or damage.

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