

**Bai' Bithamin Ajil Sukuk** *Sukuk* based on *Bai' Bithamin Ajil* (BBA) is an innovation of the Malaysian market. The contract is based on a sale of an asset to investors, with a promise by the issuer to buy the asset back in the future at a predetermined price which also includes a margin of profit. Therefore, the issuer gets immediate cash against the promise to buy back at the purchase price plus a pre-agreed profit, which creates an obligation to be released over an agreed period. The issuer issues securities to the investors to reflect this financing arrangement. Investors expect to earn a return equal to the pre-agreed profit.

This structure is not very popular with Middle Eastern investors because of a debatable *Shari'ah* issue, which does not accept the tradability of debt. In addition, some BBA issuances in Malaysian markets are based on financial assets—which is also an objectionable practice in the eyes of *Shari'ah* scholars in the Middle East.

**Muqaradah Bonds** *Muqaradah* bonds are based on the *mudarabah* contract whereby the capital is provided by a pool of investors against certificates or bonds for a specific project undertaken by an entrepreneur (*mudarib*) with the agreement to share revenues. In this respect, they bear close resemblance to revenue-bond financing in the conventional system, where bonds are generally backed only by the revenue generated by the project funded by the bond issue. These bonds are suitable for undertaking development projects to build networks of roads or other infrastructure projects. Investors have the right to share in the revenues generated by the project. Investors are solely dependent on the revenues generated by the project and they have no recourse to the *mudarib*. On the expiry of the specified time period of the subscription, investors are given the right to transfer the ownership by sale or trade in the securities market at their discretion.

The concept of the *muqaradah* bond was for raising capital for public finance projects, but for several reasons, such as a lack of transparency in the public sector and a lack of liquidity, these bonds did not gain much popularity with investors.

**Musharakah Bonds** As their name implies, *musharakah* bonds are based on the partnership and profit/sharing contract and are similar to *muqaradah* bonds. The major difference is that the intermediary or the entrepreneur is a partner with the investors (the group of subscribers) as well as acting like an agent (*mudarib*). Several *musharakah*-based bonds have been issued by the Islamic Republics of Iran and Sudan. In the case of Iran, *musharakah* certificates were devised and approved by the Money and Credit Council to finance the Tehran Municipality. Sudan has made considerable progress in the development of *musharakah*-based certificates and, with the help of the IMF, designed *musharakah* bonds based on state ownership of key profitable and large public enterprises, which can be traded in the market. A similar arrangement was launched by the central bank for the purposes of Treasury intervention and open-market operations for managing monetary policy. Another example of a successful

launch of *musharakah* bonds was in Turkey in 1984 to finance the construction of a toll bridge in Istanbul.

Being based on profit/loss-sharing principles, both *muqaradah* and *musharakah* bonds are ideal for the promotion of Islamic finance. However, although the issuers of these bonds are public-sector institutions, the low transparency that prevails in the affairs of governments of several Muslim countries keeps investors away from this structure. With enhanced monitoring and transparency, and with a reduction of asymmetrical information, these bonds could make a greater contribution to the development of Islamic capital markets.

Table 9.3 summarizes comparative features of the four most prevalent *sukuk* structures. This demonstrates how different structures provide different risk/return profiles and can be customized to meet the needs of borrowers as well as of investors.

### The *Sukuk* Market

The market for the *sukuk* was originated by government entities and although the market is still dominated by the sovereign issues, corporate issues are gradually emerging. In terms of total amount outstanding, the current ratio between sovereign and corporate *sukuk* is 3.5:1. With a growing *sukuk* market, many conventional rating agencies, including Standard & Poor's (S&P) and Fitch, have started to rate select issues. For example, S&P has now designed a methodology to rate *ijarah*-based *sukuk*. In another positive development, Dow Jones has announced plans for a *Sukuk* Index to monitor the performance of this market. Another particularly encouraging sign in the *sukuk* market is that it is no longer the sole preserve of specialist Islamic issuers or investors. For example, 48 percent of a recent sovereign issue was subscribed for by conventional investors, comprising 24 percent by institutional investors, 11 percent by fund managers and 13 percent by central banks and government institutions.

Table 9.4 lists the top 10 investment banks (lead managers) that were active in underwriting *sukuk* issues during the period 2005–10. The majority of these are based in Malaysia, reflecting the major role played by that country in developing the *sukuk* market. Another notable performance is by the Hong Kong and Shanghai Banking Corporation's (HSBC) Islamic investment entity—*Amanah*—which has also played an important role in the development of this market.

The *sukuk* market has been used by both public (sovereign and quasi-sovereign) and corporate entities. Table 9.5 lists the number of *sukuk* issues by sector and Table 9.6 shows the size of these issues by issuer type. As compared to conventional finance, where government and sovereign sectors dominate, the *sukuk* market shows little activity by sovereigns and this serves to hinder the establishment of a benchmark which can be used to price private sector or corporate issuers. The *sukuk* market suffered during the 2008–09 financial crisis and economic slowdown but rebounded in 2010.

**TABLE 9.3** Comparison of four basic *sukuk* structures

Structure	Asset Type	Description	Benefits	Considerations
<i>Ijarah</i>	<ul style="list-style-type: none"> <li>Existing tangible assets such as plant, machinery, buildings, etc</li> <li>Usufruct rights pertaining to tangible assets can be considered as well</li> </ul>	<ul style="list-style-type: none"> <li>Involves a sale and leaseback of tangible assets (or their usufruct rights)</li> </ul>	<ul style="list-style-type: none"> <li>Most commonly applied and accepted structure</li> <li>Tradable on secondary market</li> <li>Wide <i>Shari'ah</i> acceptability (AAOIFI-compliant)</li> <li>Relatively easy documentation process</li> </ul>	<ul style="list-style-type: none"> <li>Identification of assets</li> <li>100% of assets have to be tangible</li> <li>Assets remain in the ownership of investors till maturity</li> <li>Assets should be unencumbered at time of sale</li> </ul>
Head-lease and sub-lease	<ul style="list-style-type: none"> <li>Existing tangible assets</li> </ul>	<ul style="list-style-type: none"> <li>Involves long- and short-term leases of tangible assets</li> </ul>	<ul style="list-style-type: none"> <li>Tradable on secondary market</li> <li><i>Shari'ah</i> acceptability</li> <li>Template document available</li> <li>Avoid sale of assets which can be sensitive in certain jurisdictions</li> </ul>	<ul style="list-style-type: none"> <li>Tangible assets required; with possibility of using suitable operating rights as underlying assets (subject to <i>Shari'ah</i> approval)</li> <li>Long-term lease has to be for a period of more than 50 years (for <i>Shari'ah</i> structuring purposes)</li> </ul>

(Continued)

TABLE 9.3 Continued

Structure	Asset Type	Description	Benefits
<i>Wakala</i>	<ul style="list-style-type: none"> <li>• <i>Ijarah</i> assets</li> <li>• <i>Shari'ah</i>-compliant equity instruments</li> <li>• <i>Sukuk</i> certificates</li> </ul>	<ul style="list-style-type: none"> <li>• Involves appointing the obligor as investment agent to manage the assets for a fee</li> </ul>	<ul style="list-style-type: none"> <li>• Easily executable if <i>Shari'ah</i>-compliant assets are available</li> <li>• Used by supranationals with <i>Shari'ah</i>-compliant asset portfolios</li> </ul>
<i>Istisna'</i>	<ul style="list-style-type: none"> <li>• Revenue-generating agreements</li> <li>• Linked to business activity</li> </ul>	<ul style="list-style-type: none"> <li>• Transfer of certain rights and obligations to Issuer</li> <li>• Income from agreements are used to service the periodic payments</li> </ul>	<ul style="list-style-type: none"> <li>• Identification of assets and suitability</li> <li>• Size of <i>sukuk</i> limited to size of business and require significant due diligence on business</li> <li>• Non-Middle Eastern investors may require more education on the structure</li> <li>• Introduces "business" risks (performance risk of company) which is not a typical credit risk</li> </ul>

Source: HSBC Amanah, Malaysia.

**TABLE 9.4** League table for *sukuk* issuance

From 2005-01-01 to 2009-12-31			
Ranking	Bookrunner / Lead Manager	Amount (US\$m)	Issues
1	CIMB Islamic	12,179.19	94
2	HSBC Amanah	9,011.77	54
3	Citigroup	3,128.84	19
4	Barclays Capital	2,840.54	8
5	Deutsche Bank	2,588.53	8
6	Standard Chartered Bank	2,438.01	30
7	ABN-Amro Bank Bhd	2,392.20	4
8	Bank Negara Malaysia	2,388.45	2
9	Dubai Islamic Bank	2,344.54	14
10	JP Morgan	2,033.33	3

Source: IFIS

**TABLE 9.5** *Sukuk* issuance by issuer type

Issuance Type	2005	2006	2007	2008	2009	2010
Sovereign	3	32	42	38	66	128
Quasi Sovereign	3	12	21	27	90	39
Corporate	82	164	137	134	600	512
Total	88	208	200	199	756	679

**TABLE 9.6** Total *sukuk* issuance by issuer type (US\$ million)

Issuance Type	2005	2006	2007	2008	2009	2010
Sovereign	706	1,423	5,337	1,839	12,781	24,004
Quasi Sovereign	574	7,021	13,919	5,087	12,463	7,925
Corporate	9,942	17,693	25,671	9,758	6,646	9,634
Total	11,223	26,137	44,927	16,684	31,890	41,564

Table 9.7 provides a breakdown of the *sukuk* market by currency in each sector. Although *sukuk* have been issued in several currencies, two currencies—US dollars and Malaysian Ringgit (MYR)—dominate all the sectors. While the size of *sukuk* issuance is growing, it remains very small by comparison with global conventional securitized and debt markets.

**TABLE 9.7** *Sukuk* issuance by issuer

Sovereign							
Currency	2005	2006	2007	2008	2009	2010	Total
AED				200	680		880.49
BHD	107	318	569	351	712	564	2,619.32
BND		380	188	51	130	127	876.08
GMD				0			0.21
IDR				508	1,052	1,726	3,286.58
MYR		111	2,185	128	6,528	19,253	28,204.22
PKR		134	339	161	362	466	1,462.05
QAR						343	343.29
SDD						200	200.00
USD	600	480	2,023	350	3,045		6,498.36
Total	707	1,423	5,304	1,749	12,510	22,679	44,370.60
Quasi-Sovereign							
Currency	2005	2006	2007	2008	2009	2010	Total
USD	500	4,270	2,350	1,300	3,450	519	12,389.28
AED	–	–	–	1,852	–	–	1,852.19
MYR	45	2,729	10,125	1,873	6,799	4,348	25,918.14
SAR	–	–	1,333	–	1,867	1,900	5,099.66
SGD	–	–	–	–	162	1,094	1,255.83
Others	29	22	111	62	186	64	474.32
Total	574	7,021	13,919	5,087	12,463	7,925	46,989.42
Corporates							
Currency	2005	2006	2007	2008	2009	2010	Total
USD	1,660	6,273	8,425	490	500	2,155	19,503.31
AED	–	–	2,042	3,039	–	–	5,081.35
MYR	7,983	10,592	12,100	3,924	5,299	7,067	46,964.95
SAR	–	800	2,100	1,874	393	187	5,354.04
PKR	–	29	625	189	182	4	1,027.79
Others	299	–	379	242	273	221	1,413.78

Notes: AED (UAE Dirham), BND (Brunei Dollar), BHD (Bahrain Dinar), GMD (Gambian Dalasi), IDR (Indonesian Rupiah), MYR (Malaysian Ringgit), QAR (Qatari Rial), SDD (Sudanese Dinar), SAR (Saudi Riyal), PKR (Pakistan Rupee), SGD (Singapore Dollar), USD (US Dollar)

## CASE STUDY: ISLAMIC DEVELOPMENT BANK

On September 9, 2009, the Islamic Development Bank (IDB) launched the following five-year, US\$850 million *sukuk*. This was the third, and largest, public US dollar-denominated *sukuk* executed by IDB.

Issuer	IDB Trust Services Limited
Obligor	Islamic Development Bank (IDB)
Currency/Format	US\$/Fixed Rate Regulation S
Structure	<i>Sukuk</i> based on <i>wakalah</i> (agency) structure
Obligor/ <i>Sukuk</i> Ratings	Aaa/AAA/AAA
<i>Sukuk</i> Assets	Portfolio of assets owned by IDB comprising <i>ijarah</i> contracts, <i>Shari'ah</i> -compliant equity instruments and/or <i>sukuk</i> certificates
Amount	US\$850 million
Pricing/Settlement Date	9 September 2009/16 September 2009
Maturity Date	16 September 2014
Periodic Distributions	3.172% semi-annual
Price/Re-offer Spread	100.00/MS+40bps
Listing	London Stock Exchange
Governing Law	English Law
Joint Lead Manager and Joint Bookrunner	HSBC Amanah

### Transaction Highlights

- Book-building swiftly gained momentum with the announcement of the price guidance of MS+40–43 bps, resulting in the order book reaching US\$2 billion, at 2.4x oversubscribed with 90 accounts
- The strong bid enabled the transaction to price at the tight end of the price guidance, at a yield of 3.172 per cent
- Distribution was evenly spread geographically and by investor type, thereby achieving IDB's strategic objective of investor diversification into Europe and Asia. Approximately 65 per cent of the issue was placed outside of the Middle East and North Africa region. The issue saw strong distribution to central banks and reserve managers (21 per cent), with the balance taken up by banks (40 per cent), fund managers (34 per cent) and private banks (5 per cent)

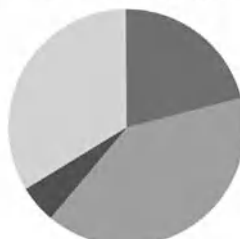
## CASE STUDY: ISLAMIC DEVELOPMENT BANK (CONTINUED)

### Breakdown by Geography



- Middle East (35%)
- Asia (30%)
- Continental Europe (20%)
- United Kingdom (15%)

### Breakdown by Type



- Central Banks (21%)
- Banks & Treasury (40%)
- Private Banks (5%)
- Fund/Asset Managers (34%)

The offering marks a major step for IDB's future, diversifying its investor base into new accounts and establishing a strong benchmark for IDB's future issuances

Source: HSBC Amanah, Malaysia.

### Limitations of the *Sukuk* Market<sup>6</sup>

*Sukuk* issuance to date has been concentrated in Malaysia and the Middle East, particularly in Bahrain. Outside of those two markets, the *sukuk* occupies only a very small place in the capital markets landscape. We believe the principal limitations on the development of the *sukuk* market are as follows.

First, the *sukuk* market suffers from a lack of frequent sovereign issues. In particular, high-quality sovereign issues, which play an important role in the development of all capital markets and serve the critical purpose of building a benchmark yield curve for the market, are largely absent from this market.<sup>7</sup> Without a benchmark yield curve, it is difficult for other issuers and investors to access the market with confidence.

Second, many investors in this market tend to buy and hold *sukuk* investments until maturity, and, as a result, there is almost no secondary market in most *sukuk* issues. The prevalence of "buy and hold" investors in this market is largely a consequence of an acute lack of supply such that investors know that if they sell the *sukuk* it will be difficult to find another to replace it in their portfolio.

Third, and directly related to the point above, the lack of liquidity of most *sukuk* issues hampers the growth of the market. Investors that place a high value on liquidity may avoid *sukuk* entirely because of the absence



of a secondary market. The illiquidity also harms dedicated *sukuk* investors, because it leads to comparatively large bid-ask spreads and limits their investment strategies and opportunities for portfolio diversification.

The global financial crisis highlighted in stark terms the importance of liquidity. As a result, the lack of liquidity is increasingly detrimental to the market and directly impacts the assessment by both investors and regulators of the overall asset quality of *sukuk*.

Buying and holding and the corresponding lack of liquidity have serious implications for portfolio management. As a fixed-income security ages, it moves from one benchmark to another. For example, a five-year bond may be initially included in a one–five-year benchmark, but as it ages and the remaining maturity comes closer to three years, the bond may be dropped to a one–three-year benchmark. In the conventional markets, periodic “re-balancing” of portfolios to reflect the change in the remaining duration of outstanding holdings is relatively inexpensive to achieve, but in the case of *sukuk*, where the secondary market is very shallow, re-balancing could have a negative impact on portfolio performance in a material way.

Fourth, the complexity of *sukuk* structures is another impediment to the development of this market. *Shari’ah* compliance is often achieved through creating a complex set of cash flows, and the prospectus for even a relatively simple *sukuk* will generally include a cash flow diagram replete with multiple boxes and arrows. Essentially, this is a market where every product is a structured product, even ones that replicate in their credit risk plain vanilla, unsecured bonds.

The global financial crisis also drew attention to the dangers of highly complex structured products. Specifically, such products are difficult to value, as well as to unwind in the event of a default. Because of the similarity of *sukuk* to conventional asset securitization, many of the same banks and professional advisors who dominated the market in complex collateralized debt obligations (“CDOs”) and other complex products that suffered significant downgrades and defaults during the financial crisis are also leaders in the business of structuring *sukuk*. Although the *sukuk* market proved itself to be more resilient than many segments of the CDO market during the financial crisis, the complexity of their structures may continue to discourage participation from many investors and issuers who were burned by structured products.

The lack of uniform interpretations across jurisdictions further hinders the growth of the market. Structures that are deemed acceptable in one market may not be equally accepted in another jurisdiction. The most frequently cited example of this divergence in interpretation is the difference between structures that are considered tradable in Malaysia and those that can be traded in most Gulf countries. Such a lack of uniformity limits the depth of the market for any particular *sukuk* issue.

There are also concerns about the lack of legal certainty in the *sukuk* market. For example, the extent to which courts will consider *Shari’ah* compliance in evaluating the enforceability of an Islamic finance contract remains an open question in most jurisdictions. As a result, there is a risk

that a contractual obligation that would otherwise be found to be enforceable under the governing law of the contract may nonetheless be determined to be unenforceable due to some deficiency in its compliance with *Shari'ah* principles. This risk was highlighted by the 2009 English High Court judgment in *The Investment Dar Company KSCC v. Blom Developments Bank* case, in which the court found reasonable grounds for a claim by an Islamic finance house that its obligations under a contract governed by English law were unenforceable because the contract was not truly compliant with *Shari'ah* law.

There is also a lack of legal certainty with respect to the recourse to assets underlying many *sukuk* issues in the event of the insolvency of an obligor. While the existence of an underlying transaction involving real assets is an essential component of most *sukuk* structures, many issues are “asset-based,” as opposed to “asset-backed” or “asset-linked.” In an asset-based structure, there is rarely a security interest granted in, or recourse to, the assets involved in the transaction. This issue was highlighted in a *Shari'ah* ruling of AAOIFI which criticized existing structures on these grounds. In particular, *Shari'ah* experts have criticized the fact that many agreements underlying asset-based *sukuk* transactions stipulate that the underlying assets are to be bought back at par instead of at prevailing market value.

### **Challenges for the *Sukuk* Market**

The *sukuk* market is in its embryonic phase, but holds great potential for further growth of the Islamic financial industry. The following are some of the issues currently faced by this market:

- The *sukuk* issued so far (with the exception of those by the Islamic Development Bank) have been linked to a particular real asset, rather than to a pool of assets. This model can work for sovereign, supra-national or multilateral borrowers who have large-scale assets to securitize, but poses difficulty for institutions that want to raise capital on a smaller scale. In addition, *sukuk* issued against *salam* or *murabahah* contracts cannot be traded in the secondary markets. The majority of Islamic banks hold a large portion of assets that can be securitized, but so far no Islamic commercial bank has issued *sukuk*, mainly due to the lack of large-scale assets or the holding of short-term *salam* or *murabahah*-based assets. Islamic banks should make serious efforts to utilize the securitization process to take the assets off their balance sheets in order to enhance the liquidity of their existing portfolios. The challenge is to develop *sukuk* based on pools of heterogeneous assets with varying maturities and different credit qualities. The participation of Islamic banks will further develop the market.
- Issuers, investors and intermediaries need to nurture the market patiently. Islamic transactions often face a competitive disadvantage vis-à-vis conventional bond issues in cost-efficiency terms. Each new issue incurs

higher levels of legal and documentation expenses as well as distribution costs; and involves examining structural robustness in addition to evaluating the credit quality of the obligor. Standardization of contracts will reduce this problem.

- Floating-rate *sukuk* are often linked to a conventional interest rate benchmark such as the London Inter Bank Offer Rate (LIBOR). When it comes to pricing, *sukuk* compete directly with the conventional bonds in the level of relative spreads. From the conventional borrowers' point of view, there is no inherent cost advantage to be gained from tapping into *sukuk* markets, since the terms available are mostly derived from competitive pricing levels in the more liquid and cheaper conventional bond market. Borrowers, therefore, need to formulate a comprehensive, long-term and strategic view on how to reduce the overall funding cost by tapping into Islamic markets, rather than focusing on a single transaction.
- In principle, *sukuk*-based funding should be cheaper, since it is based on collateralized cash flows, but in reality this is not the case. It is expected that as the market matures and investors are more comfortable with the instrument, costs will decrease and the market will become more efficient.
- Due to the shortage of good quality bond issues in the *sukuk* market, subscribers, which include institutional investors, central banks, and private-sector Islamic banks, tend to hold the *sukuk* till maturity. As a result, the level of activity in the secondary market is low, which, in turn, reduces liquidity and also increases transaction costs by the way of high bid-ask spreads. This problem can be overcome by increasing the supply of *sukuk* and by developing a market for retail investors.
- There may be intermediation costs involved in issuing *sukuk* when more than one layer of investment banks is involved. Conventional banks often co-lead an issue with the Islamic banks and may be taking a larger share of fees. Also, a conventional investment bank may not be willing to invest time and effort to develop small-scale *sukuk* in the local market. This gap should be filled by a more active involvement of Islamic investment banks.
- It should also be noted that with *sukuk* the need for monitoring costs has not been eliminated entirely. In order to obtain a contract on favorable terms, borrowers may be tempted to exaggerate their competence, ability, or willingness to provide what the principal requires. In such cases, the principal, in order to protect its interests, often requires that borrowers provide evidence that they can indeed perform the task in the manner required. In order to protect themselves from adverse selection, principals (investors) may enter into contracts with entrepreneurs who have the necessary credentials, with the assurance that these agents are competent and trustworthy. Investment banks can play a critical role in reducing the potential for making a wrong choice by conducting due diligence and providing a transparent execution of the deal.

## **CHALLENGES FOR DEVELOPING AN ISLAMIC CAPITAL MARKET**

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Developing capital markets is not an overnight task. Today's conventional capital markets are the result of years of evolution, and this has enabled them to cope with the unprecedented pace of innovation that has been evident in the last couple of decades. Islamic capital markets can learn and benefit from the rich experience of the conventional markets to reduce their own development time.

Today's capital markets do not operate in isolation but, rather, are part of a complex system that comprises several different components: the state of the regulatory system, the quality of supporting institutions, the design of the incentive and corporate-governance systems, and market micro-structure and practices. In addition, other factors like the breadth of the market determined by the product range, the existence of reliable benchmarks for performance evaluation, the culture of market players and the degree of integration with external markets are also critical to the development of an efficient capital market.

The major challenges facing the development of Islamic capital markets are discussed below.

### **Legislative and Regulatory Framework**

The existence of a strong legislative and regulatory framework is essential for capital markets. Laws to protect the rights of investors and mechanisms to resolve disputes in an efficient manner help in establishing the confidence of the investors. This issue has become increasingly relevant given the greater competition to attract cross-border investors.

The majority of Muslim countries in which there is a demand for Islamic products lack a sound legal and regulatory system. In many cases, amendments are made to local laws and regulations on an ad-hoc basis to accommodate the needs of a transaction, but this style of operation is inefficient as well as frustrating for the players in the market. The framework should facilitate the smooth execution of transactions without creating any of the technical, legal or regulatory issues that recent *sukuk* issues have raised. For example, an *ijarah sukuk* transaction requires the owner of the operating assets to enter into a leasing transaction. While the owners are often governments or their related public-sector bodies, the relevant laws and regulations in the host country may not allow these public-sector bodies to pledge or lease assets needed to structure the transaction. This is a fundamental point: the host country's policy actions to promote such Islamic finance will be a key prerequisite for the market to develop further.

The following suggestions are made in this respect:

**Standardization of Legal Framework** One major reason for this inefficiency is that the majority of the markets in Islamic countries operate in a legal system subject to conventional civil and common law, which may not always be compatible with the *Shari'ah*. Different legal environments from country to country make the task of introducing new products very difficult and costly. Countries wishing to develop Islamic capital markets need to review the legal system as a whole and make serious efforts to ensure that the legal framework complies with the *Shari'ah*. Countries should make coordinated efforts to ensure that their legal systems are standardized and harmonized in order to remove any ambiguity regarding the status of Islamic capital market transactions undertaken in a particular jurisdiction.

**Dispute Resolution** In the countries in which Islamic capital markets are being developed alongside conventional markets, the existence of different legal systems for addressing issues with Islamic instruments is not an ideal situation. In order to minimize any confusion, amendments should be made to accommodate Islamic instruments within the framework of existing dispute-resolution procedures, rather than setting up a separate, dedicated system. The approach to dispute resolution should aim to avoid duplication of resources and maintain the confidence in Islamic products.

**Strengthening the Regulatory Framework** While rules exist in a number of markets, the enforcement of them is often weak. The regulatory authorities should play a more active role in the development of capital markets by strengthening the regulatory framework and by establishing the credibility of the regulatory institutions. In many Islamic countries, regulatory institutions either do not exist or are very weak. Having independent regulatory and supporting institutions will serve to further promote and strengthen Islamic capital markets.

### **Market Structure and Practices**

Capital markets in several Muslim countries do not have a good reputation among foreign investors. This low level of confidence stems from a number of practices that leave investors vulnerable to market abuses such as price manipulation, front running, insider trading, and blank selling. Regulators should take steps to restore the credibility of the markets and to ensure that the trading of securities takes place in a transparent fashion.

Further, the operation of markets should be reviewed with a view to complying with *Shari'ah* requirements. For example, the practice of short selling and maintaining margin accounts is not considered acceptable by some *Shari'ah* scholars. A system-wide procedure should be established to standardize these practices. In order to encourage foreign borrowers and to gain access to liquid markets in other Muslim countries, regulators should promote

the listing of Islamic securities issued by foreign member countries on their domestic exchanges.

### **Incentives to Promote Capital Markets**

For the further development of Islamic capital markets, policymakers should provide incentives for businesses and financial institutions to engage in Islamic instruments. These incentives can come in the form of tax breaks for the issuers and underwriters of Islamic securities. These could include, for example, a tax deduction for research and product-development expenses or for payments made on *sukuk* similar to the tax deduction of interest payments in the conventional system.

In the area of equity markets, policymakers should try to attract retail investors to participate in *Shari'ah*-compliant stocks. With the rapid development of Internet banking, policymakers can attract retail investors from different geographical areas, provided that the markets are liberalized and there are no unnecessary restrictions on foreign investors.

### **Developing Supporting Institutions**

Today's capital markets are supported by many institutions that perform critical functions for their smooth operation. These institutions include rating agencies, standard-setting agencies and industry associations. Some progress has been made in this respect with the establishment of institutions such as the International Islamic Financial Market (IIFM) and the International Islamic Rating Agency (IIRA). The IIFM acts as an industry association to promote cooperation among market players and with conventional financial institutions to further enhance the growth of new Islamic products and financial instruments. The IIRA was established to rate, evaluate and provide independent assessments and opinions on the likelihood of future losses by Islamic financial institutions as well as their products and services. Both of these institutions are based in Bahrain and focus on that market. However, similar institutions could and should be established in other Muslim countries to support local markets.

### **Financial Engineering**

Financial engineering has revolutionized the conventional capital markets. *Sukuk* are a good example of financial engineering and the further application of such techniques in the area of development of money and intra-bank markets should be encouraged. Money markets provide liquidity in the short term and support capital markets to focus on long-term capital needs. Another strong candidate for further growth is the development of mortgage-backed and asset-backed securities, where a pool of homogeneous assets is securitized.

### **Role of *Shari'ah* Scholars**

*Shari'ah* scholars can also play an important role. It is essential that multidisciplinary expertise, covering topics ranging from theological interpretation to financial structuring, be developed through knowledge-sharing, cross-training and acquiring an understanding of the functioning of markets. To stimulate cross-border activities in both primary and secondary markets, the acceptance of contracts across regions and across schools of thought and markets will also be helpful.

### **ENDNOTES**

1. Ernst & Young (2009).
2. Askari *et al.* (2009).
3. Marzban (2009).
4. Vogel and Hayes (1998).
5. Usmani (1999).
6. Bennett and Iqbal (2010).
7. Triple-A rated *sukuk* issuance has to date been dominated by only one issuer, the IDB.

## CHAPTER 10

# Non-bank Financial Intermediation

**T**he fundamental tenets of Islamic finance advocate economic development through risk sharing and entrepreneurship, by way of generating linkages between the real and financial sectors. In this respect, the role of non-bank financial institutions (NBFIs) is arguably more critical in an Islamic economy than in a debt-based, conventional financial system. While Islamic NBFIs are experiencing rapid growth, much needs to be done to make this growth sustainable. Policymakers must create a level playing field for Islamic NBFIs by standardizing contracts and creating a regulatory space for them to operate in. For profit/loss-sharing transactions, regulators must ensure vigilant monitoring of business performance. Finally, the growth and development of Islamic NBFIs should be promoted to their full potential, in order to foster equitable economic growth, enhance general access to finance, and expand consumers' options for *Shari'ah*-compliant financing.

A role and scope of non-bank financial intermediation in modern economies is not formally defined in the financial literature. Broadly speaking, NBFIs mediate the transfer of funds between capital-surplus and capital-deficit economic agents, with their delivery channels ranging from informal money lenders to investment banking firms. While NBFIs perform many of the same functions as commercial banks—such as lending, resource mobilization, asset management, and financial advice—their distinguishing characteristic is that they do not accept or maintain deposit accounts. Thus, NBFIs include private-equity and venture-capital firms, leasing and factoring companies, sector-specific financiers, cooperatives, credit unions, microfinance institutions, and development-focused lending institutions.

There is strong evidence that such institutions are vital for an economy's growth and prosperous development. NBFIs complement traditional banking services by offering multiple and diversified services to mobilize capital. The growth of NBFIs such as mutual funds increases product options available for portfolio management, which enhances diversification and ensures efficient risk allocation in the economy. Additionally, these NBFIs provide consumers with longer-term investment opportunities than commercial bank deposits, thereby mobilizing the funds requisite for the development of



equity and corporate capital markets, mortgage-backed securities markets, leasing and factoring, and venture capital. NBFIs such as microfinance institutions expand access to finance for consumers who are either considered non-bankable, or pose risks that traditional banks are unable or unprepared to bear.

In a *Shari'ah*-based financial system, deposit taking on the basis of a predetermined rate of return is prohibited. Rather, bank-based financial intermediation is based on a principal-agent contract whereby the client becomes a partner of the bank, and shares in its profits and losses. If one were to define a non-bank financial institution as one that does not accept deposits, it could be argued that all forms of *Shari'ah*-based financial intermediation are “non-banking.” However, for this discussion, we will consider Islamic commercial and investment banks—although based on profit/loss sharing—as banking institutions, and consider the financial institutions described above as non-bank.

Moreover, for the purposes of this chapter, we will narrow the definition of NBFIs to exclude infrastructure and supporting institutions such as brokerage firms, and include institutions which either accept investors' funds on the liabilities side, or perform investment or lending on the assets side. In adopting this focused definition, it is possible to identify four classes of NBFIs as operating in the Islamic financial industry today. These comprise institutions engaged in (i) asset and fund management (for example, mutual, commodity, and leasing funds—discussed earlier); (ii) specialized sector finance companies (for example, mortgage, leasing, and *mudarabah* companies); (iii) development institutions (for example, multilateral and microfinance institutions); and (iv) *takaful* (Islamic insurance). Although, data on NBFIs is sparse, Table 10.1 shows the number of institutions and estimated assets under management as compiled from several sources.

**TABLE 10.1** Size of NBFi industry as of 2010

Institution Type	No. of Institutions	Assets Under Management (US\$ billion)
Islamic Funds*	698	82.6
<i>Mudarabah</i> Companies (Pakistan)	40	0.4
Mortgage Companies**	10	2.5
Microfinance Institutions***	126	0.197

\*IFIS

\*\*Data based on mortgage companies in the US and UK as of 2008. Size is determined from informal sources.

\*\*\*As of 2008. Karim, Tarazi and Reille (2008)

## **SPECIALIZED SECTOR FINANCE COMPANIES**

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Specialized sector finance companies include those catering to home and consumer financing demands using *ijarah* (leasing) and *murabahah* (cost-plus financing) contracts, or those providing working capital to industrial or agriculture sectors. The most common types are mortgage, *mudarabah*, and leasing companies.

### **Islamic Mortgage Companies**

Islamic mortgages made news in the US in 2001, when government-sponsored home-mortgage giant Freddie Mac agreed to underwrite and securitize Islamic mortgages. In 2007, Freddie Mac bought over US\$250 million in Islamic mortgages.<sup>1</sup> Given the growth and demand for Islamic mortgages and the booming real estate market in the US, several commercial banks such as Devon Bank and University Bank started to offer Islamic mortgages. The chances of success for the Islamic mortgage industry are bright in Western markets, where capital markets are relatively liquid, transparent, and regulated. In particular, there is great potential in North America, where there is a sizeable Muslim community in middle- and upper-class income brackets.

Islamic mortgage companies provide home buyers with *Shari'ah*-compliant options to purchase property. They typically target Muslim communities in Western countries with developed conventional mortgage markets, such as Canada, the United Kingdom and the United States. There are four models of Islamic mortgage currently in practice, as follows:

**Lease to Own** The first model is based on the *ijarah wa "qtinah"* (lease to own) contract, in which the mortgage company purchases the desired property from the builder or existing owner, rents or leases it to the home buyer for a specified period of time, and ultimately sells it to the home buyer for a predetermined residual value. This model is the closest to the structure of a conventional mortgage.

**Cost Plus Mark-up** The second model is based on the *murabahah* contract, in which the bank purchases the desired property from the builder or owner, and immediately sells it to the new home buyer at cost plus a predetermined profit. The buyer and the bank enter into an agreement where the buyer agrees to pay the financed amount over a predetermined period in pre-agreed installments. While, on the surface, this form of Islamic mortgage is similar to a conventional fixed-rate mortgage, there are some differences with respect to insurance obligations and in the way installment payments are treated for tax purposes. *Murabahah* mortgages are commonly practiced in the UK because until 2003 Islamic mortgages based on lease or equity partnerships were subject to double property-transfer tax laws.

The *murabahah* mortgage is often criticized on two grounds. First, a concern is raised that it is financially equivalent to a conventional debt-based mortgage and therefore does not involve risk sharing—the essence of Islamic finance. Second, this model suits well for fixed-rate mortgages but does not offer an option for a variable- or floating-rate mortgage.

**Diminishing Partnership** The third model is based on the diminishing *musharakah* (equity partnership) where the financier (the mortgage company or bank) and the buyer form an equity partnership to jointly own the property and the financier gives the buyer the option/right to buy the financier's share over the life of the mortgage. Over this period, the buyer pays monthly installments comprising the property's monthly rent and an additional contribution to buy out the mortgagee's share. Diminishing partnerships can take various forms and therefore offer flexibility in the design of the product. In a typical diminishing *musharakah* mortgage, the buyer pays the rent on the outstanding share owned by the mortgagee, which diminishes with the age of the mortgage.

For example, if at a given time during the life of the mortgage the ratio of ownership between buyer and mortgagee is 20:80, the buyer will pay monthly installments consisting of rent against 80 percent of the value of the house and the remaining portion will go towards the purchase of mortgagee's share. Suppose, after one installment, the new ownership ratio becomes 22:78, the rental portion of the next installment will decrease and the portion to purchase the mortgagee's share will increase. Thus, over time, the share of the mortgage will "diminish" and the buyer's share accelerates till the buyer owns the property entirely.

While an equity-based mortgage is closer to Islamic principles, it gives rise to concerns as to whether additional protection is needed for the owner. For example, as the market value of the property goes up, this will increase the period over which the owner will have to purchase the mortgagee's share. Ansar Finance in Manchester, UK, offers a variation on the diminishing *musharakah* mortgage whereby the client makes rental payments for the outstanding share without any obligation to purchase. The client is given an option to purchase the property at the market value, which protects the client from negative equity.<sup>2</sup>

**Cooperative Model** The fourth model is similar to a cooperative set-up. Members buy equity membership in a pool of funds used to purchase properties for the members.

### **Mudrabah Companies**

As we have seen, a *mudrabah* is a profit/loss-sharing contract in which one party serves as financier while the other apportions the financier's funds in *Shari'ah*-sanctioned business activities. A *mudrabah* company, therefore, is one which specializes in financing a portfolio of assets in selected economic

sectors, using its own capital and investors' funds, which are mobilized by issuing certificates or shares on a profit and loss basis. A *mudarabah* contract can be used for either multi-purpose or specific-purpose transactions. All *mudarabah* contracts are independent of one another, and no one transaction is liable for the liabilities of, or is entitled to benefit from the assets of, any other *mudarabah* transaction.

In 1980, Pakistan's State Bank issued a law under which financial institutions could register themselves as *mudarabah* companies and mobilize general investors' funds through issuing *mudarabah* certificates. The majority of Pakistan's "Modaraba Companies" (MCos) specialize in leasing, and are therefore also a valuable source of funding for small- and medium-sized enterprises for trade, commerce and fixed assets. By the late 1990s, 49 Pakistani companies had been granted licenses authorizing them to float *mudarabah* certificates.

However, the MCos have acquired a tarnished reputation, with a very small proportion of their funds purportedly being used for profit/loss-sharing transactions.<sup>3</sup> Regulatory mismanagement and a lack of rigorous screening of company listings have also resulted in losses to investors. This outcome has discouraged other countries from experimenting with *mudarabah* companies.

As a profit/loss-sharing commitment, a *mudarabah* gives preference to financially sound business ventures over mediocre ones, therefore facilitating enhanced resource management. If administered appropriately, *mudarabah* companies can serve as catalysts for economic growth in Islamic economies. In order to increase investor confidence, regulatory agencies must perform diligent screening and controls, and require *mudarabah* companies to enhance transparency and operational efficiency.

### **Specialized Leasing Companies**

Leasing is becoming increasingly popular as a form of asset financing. Traditionally, leasing services—whether conventional or Islamic—have been provided by commercial banks. In recent years, the growth and development of specialized Islamic leasing companies has paralleled the rise of their conventional counterparts.

Islamic leasing is more commonly used for real estate and automobiles, but equipment leasing is also growing. Leasing companies typically use an *ijarah* contract, in which the ownership of the asset, associated risk, and responsibility for its maintenance remains strictly with the leasing company. The company is typically not the original owner of the asset, but acquires it at the request of the client. At the end of the leasing term, the institution may sell the asset to the client. For the leasing of equipment, some companies, particularly in the Gulf States, use *murabahah*, where ownership of the asset is immediately transferred to the lessee, and the leasing company does not retain any rights to sell or transfer the asset.

Leasing enables businesses to employ a range of capital goods without having to purchase them. Therefore, it can both promote economic

stimulation and, at the same time, provide the leasing company with an attractive flow of fixed monthly income. Given this asset-backed *modus operandi*, leasing companies play an important role in strengthening linkages between the financial and real sectors of an economy. Since the workings of Islamic forms of leasing are similar to those of interest-based models, Islamic leasing companies have enormous potential to tap both markets. A key concern which leasing companies must grapple with is developing liquidity for leased assets, or for the financial claims created as a result of leasing. With proper management, lease securitization can play a leading role in enhancing the liquidity status of these companies.

### **Microfinance Institutions<sup>4</sup>**

It is clear that within the present dominant economic system there are a number of serious market failures that cannot be resolved without external intervention. One such failure is the inability of the prevailing credit system to satisfy loan demands from segments of the population that cannot access formal credit channels or do not have sufficient collateral against which they can borrow. These “non-banked” or “non-bankable” groups include not just the poor; would-be entrepreneurs with projects or ideas with potentially high rates of return also fall within this category.

A solution to this market failure came in the form of the Grameen Bank, which has been a phenomenal success since its inception in the mid-1970s. Information economics, developed by Joseph Stiglitz, explains that informational problems underlie many failures of the market system. In particular, the failure of credit markets is due to the fact that the collection and analysis of information is a high-cost activity for financial intermediaries (such as banks), making it expensive to decide whether to extend a loan, and then monitor the behavior of the borrower to ensure compliance with the loan’s terms and conditions as well as its repayment. If information costs are too high, banks extend loans only to those clients with a good credit record and/or high-valued collateral to make defaults costly. Underlying this is the notion of asymmetric information, that the borrower may have information regarding the project’s purpose and chances of success that the lender lacks. This may lead to the lender extending loans to risky borrowers willing to pay high interest rates, or to moral hazard problems where the borrower will use the proceeds for purposes other than those stated or with the intention of defaulting.

Microfinance (MF) gets around these problems by resorting to group lending. In its original conception (Grameen I), no collateral was required and only the poor could borrow, but each client had to be a member of a five-person group which, in turn, belonged to an eight group “center” within a village. While the loans would be granted to individuals within the group for their own independent projects, failure to repay the loan would lead to collective punishment: the entire five-member group would lose its membership in the bank. While there was no explicit requirement for the group to pay off a loan default by one of its members, implicitly there was a strong

incentive for the group to do so if it wanted to regain its membership. The interest rates of MF banks have been in the order of 20 to 30 percent.

This approach to lending to a close-knit group of borrowers resolves both informational problems of adverse selection and moral hazard by shifting the cost of *ex ante* selection of the right borrowers (those with a low probability of default) and the responsibility for monitoring the borrower's behavior to the group. The track record of high repayment rates documents the success of this approach. While Grameen II has modified some of the features of its predecessor, it has retained the basic structure of the earlier version in that reliance is still placed on the reputation of borrowers with group familiarity with each client, interest rates are still as high as 30 percent, and the eventual aim of these institutions is to become successful profit-making banks.

Microfinance and Islamic finance share common ideas and values. Islam's emphasis on economic and social justice through financial inclusion and risk sharing is the foundation for Islamic microfinance. As Islamic finance is establishing itself, attempts have been made to establish *Shari'ah*-compliant microfinance institutions. Modern Islamic microfinance lending has trailed the advance of the conventional microfinance movement. Since the 1970s, a number of institutions have entered the market to service the demand of poor Muslims who refuse financing instruments that contravene *Shari'ah* principles. Islamic microfinance institutions include non-governmental organizations (NGOs), rural cooperatives, credit unions, self-help schemes, and *qard-ul-hassan* funds. In addition, some conventional NGOs operating in Muslim communities have Islamic windows, and offer *Shari'ah*-compliant products among their financing options.

**NGO-based Microfinance** Microfinance NGOs pursue the dual objectives of social and financial returns. They are concerned with providing financial services to those individuals who are too poor to offer sufficient collateral to conventional banks. Many NGOs offer vocational training to their clients, or advise clients on investment decisions. However, loans are not typically disbursed as charity. Most NGOs aim to become sustainable lending institutions, seeking timely payments and high repayment rates, and instilling fiscal discipline in their borrowers. Some NGOs use group-lending methodologies, in which borrowers come together as a group and serve as guarantors for one another in the event of default. An overwhelming majority of Islamic microfinance NGOs use *murabahah* (cost-plus financing) as their primary product. Other contracts include *ijarah* (leasing) and *takaful* (mutual insurance). Deposit-taking restrictions imposed on non-licensed institutions mean that microfinance NGOs are unable to offer savings products such as *musharakah* and *mudarabah*. Today, a majority of NGOs engaged in *Shari'ah*-compliant microfinance remain dependent on donor funds.

**Islamic Microfinance Cooperatives** Islamic cooperatives are community-based organizations designed to mobilize deposits from member clients and use

these funds to provide productive, consumer, and social loans to their members. They are often supported by personalities and organizations that exert a strong religious and social influence on the community. In Indonesia, a network of approximately 4,500 cooperatives offer savings products based on *mudharabah* and *musharakah*, and financing based on *murabahah*, *mudharabah*, and *qard-ul-hassan* contracts. However, a majority of these cooperatives have either gone bankrupt or lie dormant (Seibel 2007).

Syria's Islamic cooperatives or "Village Banks" have been quite successful. They are financed through members' share capital, run by elected members, and offer only *murabahah* financing. Returns are shared among members based on *musharakah* principles, or are retained as capital. Rahman and Ahmad (2010) examine a *Shari'ah*-compliant microfinance scheme in Bangladesh and show that household income increased significantly as a consequence of the program. Islami Bank Bangladesh Limited (IBBL) launched a rural development scheme (RDS) aimed at alleviating rural poverty in 1995. This *Shari'ah*-based microfinance program provides welfare, moral, and ethical services to the rural population in 60 districts. Of the membership of more than half a million, some 94 percent are women. The RDS practices *murabahah* and *bay' al-muajjal* contracts to purchase goods and sell them to the clients at a flat profit rate of 10 percent, with a rebate of 2.5 percent for timely payment. This compares with conventional microcredit, which charges 15–22 percent interest. It is claimed that the investment recovery rate of the RDS is 99.57 percent.

**Credit Union-style Microfinance** Another Islamic microfinance model is based on the concept of mutuality and is similar to a conventional credit union (CU). A CU is a non-profit financial cooperative owned and controlled by its members and engaged in mobilizing savings, offering loans to its members who have a common goal or objective. CUs are quite popular in Asia, notably in Sri Lanka.<sup>5</sup>

***Qard-ul-hassan*-based Microfinance** *Qard-ul-hassan* funds are socially oriented organizations which provide community members with interest-free loans. A *qard-ul-hassan* (benevolent loan) is the only type of loan permitted under the *Shari'ah*. It is often considered a form of charity, because the lender is encouraged to forgive borrowers if they default and repayment is a financial burden on them. According to the Central Bank of Iran's March 2008 estimates, Iran's 6,000 *qard-ul-hassan* funds had a total of US\$5.5 billion in outstanding loans. Since these institutions are heavily reliant on donor funds, they are unsustainable in the long run (Karim *et al.* 2008).

The scope, scale, and product portfolio of each type of institution differs from the next. Nonetheless, there are some discernable trends. A vast majority of Islamic microfinance institutions cater to a higher percentage of women than men, use *murabahah* as the predominant financing instrument, and have far lower outreach than their conventional counterparts operating

in the same regions. Total Islamic microfinance outreach is estimated at 380,000 customers worldwide (Karim *et al.* 2008).

There is a growing realization that Islamic microfinance is essential for those Muslim countries where increasing numbers of the community are suffering from poverty and are in dire need of access to low-cost financing. Much needs to be done and efforts are required to promote *Shari'ah*-compliant microfinance in both public and private sectors. Keeping this in mind, the Islamic Development Bank (IDB) recommends several steps at micro, meso, and macro levels to further promote *Shari'ah*-compliant microfinance (see box).

Banking the non-bankable was the idea behind the establishment of microfinance institutions. However, over the years, conventional microfinance based on the Grameen model has witnessed a paradigm shift. For years, the concept of microfinance was considered a domain for NGOs but, given its success rate, the private sector is now viewing this as purely a commercial proposition and an opportunity to introduce a market-based solution. This should be encouraging for Islamic banks and financial institutions to consider this as an untapped market and to introduce financial products geared specifically for this segment.

## **RECOMMENDED ISDB INTERVENTION IN PROMOTING ISLAMIC MICROFINANCE**

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### **At a micro level**

- Participate in equity of Islamic financial institutions with a view to creating specialized MF Divisions
- Create specific funds to support various *qard-ul-hassan*-based microfinance institutions across the globe
- Create a refinance facility to act as a wholesaler of Islamic microfinance products for a chain of Islamic and conventional microfinance retailers
- Participate in equity of commercial *takaful* companies with a view to developing micro-*takaful* products and services; also of re-*takaful* companies (discussed later)
- Design a credit-guarantee scheme for Islamic microfinance providers
- Promote dialogue among *Shari'ah* scholars for collective resolution of *fiqhi* issues related to microfinance

(Continued)



**At a meso level**

- Develop knowledge base through research in issues pertaining to building
- Islamic inclusive financial systems
- Document, collate and translate best practices from microfinance across the world; undertake training and education programs to impart microfinance-related special skills to bankers
- Undertake training of trainers to impart managerial and accounting skills to users of microfinance
- Encourage formation of apex and regional industry associations whose objective is the development of Islamic microfinance through human resource development, technical assistance, operational standardization and financial product development, facilitation of vertical and horizontal communication among Islamic financial institutions, advocacy and participation in policy dialogue
- Create *zakah* and *awqaf* funds at a global level dedicated exclusively to poverty alleviation and linked to microfinance institutions downstream
- Help create a rating mechanism in member countries for Islamic microfinance institutions.

**At a macro level**

- Assist member countries to develop a regulatory framework for Islamic microfinance
- Support policymakers to ensure that there is an enabling policy framework conducive to the development of Islamic microfinance
- Support and facilitate the integration of *zakah* and *awqaf* in financial-sector reforms
- Build an effective alliance and forum of Islamic microfinance providers and other stakeholders.

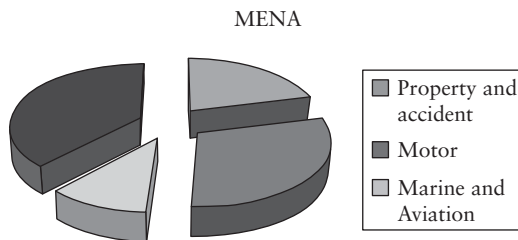
Source: Islamic Microfinance Development: Challenges and Initiatives, 2008, IRTI, IDB

**Takaful (Islamic Insurance)**

The closest Islamic instrument to the contemporary system of insurance is the instrument of *takaful*, which literally means “mutual or joint guarantee.” Historically, demand for insurance products has been much lower in Muslim communities than in conventional markets such as North America

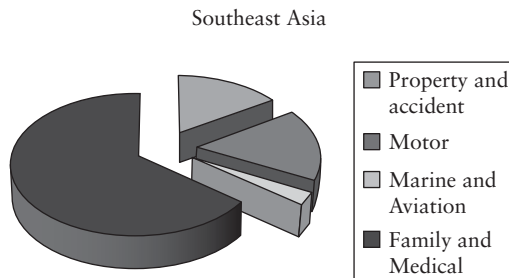
and Western Europe. This can be attributed to the fact that the conventional insurance industry indulges in the prohibited elements of interest and gambling. However, with the introduction of an Islamic mode of insurance, more and more Muslims are open to the idea.

At present, *takaful* has very limited application in Islamic financial markets, with very few institutions offering insurance services on a large scale. Although, the application of *takaful* is for the most part indemnity-based and limited to the loss of physical property, there are products in the market targeting family and medical coverage based on *Shari'ah* principles. According to some estimates, the global *takaful* industry has grown from US\$1.4 billion in 2004 to around US\$5.3 billion in 2008 (2010 forecast US\$8.9 billion), which is considered significantly below its true potential.<sup>6</sup> It is estimated that the market now comprises more than 130 companies in both Muslim and non-Muslim (including Western) countries. In several economies where Islamic finance is practiced, *takaful* is offering price-competitive products and has captured significant proportions of non-Muslim customers.<sup>7</sup> Figures 10.1 and 10.2 show how the coverage was distributed among different sectors in the Middle East and North Africa (MENA) and Southeast Asia regions during 2007. The greater prominence of family and medical insurance in Southeast Asia could be attributed to the popularity of *takaful* in Malaysia.



**FIGURE 10.1** *Takaful* market segments in MENA region

Source: E&Y (2010)



**FIGURE 10.2** *Takaful* market segments in Southeast Asia region

Source: E&Y (2010)

## TRENDS IN THE *TAKAFUL* MARKET

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- The Gulf Co-operation Council (GCC) region remains one of the strongholds for *takaful*, with a total volume exceeding US\$3.7 billion in 2008 and accounting for more than half of the global *takaful* market for that year (US\$5.3 billion).
- In Southeast Asia, Malaysia holds the strongest position in volume of *takaful* contributions, which stood at US\$889 million in 2008. Indeed, the country is a glowing example of how *takaful* is part of the financial awareness of customers: some banks report a share of non-Muslim *takaful* customers of over 50 percent and in some cases, over 70 percent, a sign of the successful integration of *takaful* in Malaysia.
- The number of *takaful* operators globally grew from 133 in 2007 to 179 within a year. For such a nascent industry, it has shown no signs of abating and quite a strong resilience demonstrated by a net contributions growth of 18 percent for Malaysia and gross premium growth of 28 percent for Saudi Arabia in 2008, a stark contrast with the conventional sector (with an average of 2.5 percent). In the GCC, Saudi Arabia is a flagship market for *takaful* and witnessed strong growth in 2008. Gross written premiums reached SAR10.9 billion (US\$2.9 billion), up from SAR8.6 billion (US\$2.29 billion) in 2007, representing an increase of 27 percent, compared to 24 percent in 2007. Fifty-one percent of those premiums generated stem from general insurance (a growth of 6.3 percent to SAR5.5 billion (US\$1.46 billion) in 2008 compared to SAR5.2 billion (US\$1.38 billion) in 2007), 44 percent comes from health insurance [a growth of 57 percent to SAR4.8 billion (US\$1.27 billion) in 2008 compared to SAR3.1 billion (US\$826 million) in 2007] and the rest comes from life *takaful*.
- One of the positive trends in this market is that recently there is an increasing number of joint ventures between local and international financial institutions. For example, in November 2008, Zurich Financial Services signed an agreement to establish a joint venture with Abu Dhabi National Takaful. In June 2009, AXA announced its partnership with Salama in the UAE. In Saudi Arabia, FWU Group, the global *takaful* provider, has a stake in Al Ahli Takaful Company and has forged successful distribution partnerships, such as with National Commercial Bank. FWU Group also enjoys a very successful partnership with AMAN, based in Dubai. In November 2009, Allianz Takaful and Standard Chartered Bank announced a five-year sales agreement to promote insurance products from Allianz Takaful in Bahrain. Allianz has received

authorization to operate in Qatar and hopes to launch its first Islamic annuity product in the course of this year, tapping into a growing number of clients in the Middle East keen to add to their state pensions. In December 2009, Generali, the Italian insurance giant, announced it was entering into a strategic partnership with Qatar Islamic Bank in order to access the GCC *takaful* market.

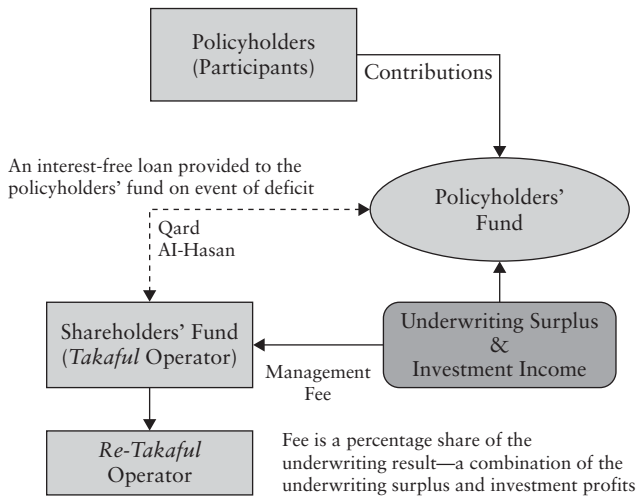
- To raise the awareness of *takaful* and to promote full transparency, consumer education is also extremely important. In Europe, CIMA (Chartered Institute of Management Accountants, based in the UK) as well as the Universités de Dauphine and Strasbourg have added Islamic Finance, including *takaful*, to their curriculum. To achieve this, Bank Negara Malaysia has launched an initiative called “insurance info” which is basically the Consumer Education Program (CEP) on insurance and *takaful*. A joint effort between the banks, the insurance and the *takaful* industry, the program is designed to provide educational information to enable consumers to make well-informed decisions when purchasing.

Source: Jaffer (2010a) and (2010b)

There is no standard operating model for *takaful* companies, as each country may decide on a particular model. Primarily, *takaful* models can be *mudarabah*-based, *wikala*-based or a hybrid of the two.

Typically, implementation of *takaful* is carried out in the form of solidarity *mudarabah*, where the participants agree to share their losses by contributing periodic premiums in the form of investments. They are then entitled to redeem the residual value of profits after fulfilling the claims and premiums.<sup>8</sup> One of the critical differences between contemporary insurance models and *takaful* is the participant’s right to receive surplus profits. While the participants in a given *takaful mudarabah* have the right to share the surplus profits generated, at the same time they are liable for additional amounts if the initial premiums paid during a period are not sufficient to meet all the losses and risks incurred during that period. *Takaful* companies can constitute reserves (like conventional mutual insurance companies), which allow the need for the insured to make supplemental contributions if claims exceed premiums. Figure 10.3 shows a *takaful* set-up based on a *mudarabah* contract, the workings of which can be summarized as follows:

- A principal/agent agreement is established between the insurance operator (agent/manager) and the policyholders (principal) where policyholders are *rabb-al-mal* and insurance operator is *mudarib* to perform both asset management and underwriting.



**FIGURE 10.3** *Mudarabah-based takaful model*

Source: E&Y (2009)

- The operator puts up equity capital and undertakes responsibility to manage the investment fund consisting of policyholders' premiums in accordance with *Shari'ah* principles. The operator also agrees to run the insurance operations of the *takaful* business on behalf of the policyholders.
- The shareholders (the operator) are paid a pre-agreed proportion of any surplus generated by the policyholders' funds. If the fund makes a loss (the claims exceed the premiums), the operator may provide an interest-free loan to cover losses.
- The *takaful* company accepts premiums from the insured. As in conventional insurance, the insured pays premiums to the operator based on the probability of losses and, in exchange, receives the defined protection against future losses.

In the *wikala* model, the policyholders and the *takaful* operator enter into a principal (policyholder) and agent (operator) agreement whereby the operator becomes the representative (*wakil*) of the policyholders. The operator is paid an agreed fee to operate and manage the policyholders' assets. Technically, there is not much difference between the *mudarabah*-based or *wikala*-based models except that the underwriting surplus goes back to the policyholders' funds, rather than being shared with the shareholders or operator.

In the third, hybrid, model the *wikala* agreement is utilized for underwriting activities and to run the operation, while the *mudarabah* contract is

used for asset-management purposes. In this case, the asset management business can be run by an entirely different entity—that is, a professional asset manager—on behalf of the policyholders. Some regulators may prefer this model for transparency reasons. For example, the Central Bank of Bahrain prefers this model.<sup>9</sup>

### **Distinctive Features of *Takaful***

**Cooperative Organization** *Takaful* is based on principles of mutual assistance and therefore is similar to conventional cooperative insurance whereby participants pool their funds together to insure one another. The customers (policyholders) of the *takaful* business agree to pool their contributions and share the liability of each. Claims are paid out of the combined pool of contributions and assets.

**Risk Sharing** In the risk-sharing aspect, the *takaful* is closer to the essence of Islamic finance than the Islamic banks. The policyholders share in the profits and losses of the business through sharing each other's insurance risk as compared to conventional insurance, where there is no sharing of risks across policyholders. For example, in the case of a typical *takaful* model, a surplus or profit made at the end of a financial year after satisfying all claims and reserves is shared between the *takaful* operators and its policyholders. On the other hand, if at the end of the financial year the policyholders' fund suffers a loss, the deficit is funded by an interest-free loan (*qard-ul-hassan*) from the shareholders' fund. Any future surpluses are used to repay the loan. The shareholders' access to the capital from the fund is restricted until the loan is repaid.

**Shari'ah-compliant Investments** One of the most distinguishing features of *takaful* is the requirement that all investments and assets under management are invested in accordance with the principles of Islam and therefore have to be fully compliant with *Shari'ah*. Where conventional insurance companies invest funds in debt-based fixed-income securities, derivatives, government securities, and hedge funds, a *takaful* asset manager cannot invest in these products. Similarly, any investment in stock markets is required to be compliant with *Shari'ah*. With the continued expansion of Islamic financial markets, there are more opportunities of *Shari'ah*-compliant investment products and this requirement is becoming much less of a constraint.

**Mutual Guarantee** *Takaful* is based on cooperative principles which spread the liability amongst the policyholders and all losses are shared. This mutuality results in the policyholders guaranteeing the performance of each other. In other words, policyholders are both the insurer and the insured.

Table 10.2 provides a comparison of different features of *takaful*, conventional, and mutual insurance.

**TABLE 10.2** Comparative features of *takaful*, conventional and mutual insurance

	Conventional insurance	Mutual insurance	<i>Takaful</i>
Responsibility for providing protection	Risk is transferred from the insured to the insurer	Mutual risk sharing among members	Mutual risk sharing amongst participants
Governing law	Secular law and regulation	Secular law and regulation	Secular law and regulation and <i>Shari'ah</i> law
Ownership	Shareholders of insurance company	Members	Participants
Contract forms	Bilateral insurance policy	Bilateral insurance policy	<i>Wikalal-mudarabah</i> agreement and unilateral contracts based on principles of <i>tabarru</i> (donation)
Investment	No restrictions on equity/debt investments	No restrictions on equity/debt investments	All investments to be in accordance with <i>Shari'ah</i> principles—excludes all debt and some equity investments
Liability of the operator	The insurance company (and ultimately its shareholders) are responsible for any claims payments	The members of the mutual are collectively responsible for the payment of claims and may be asked to contribute in the event of shortfall	The participants are collectively responsible for the payment of claims and may be asked to contribute in the event of shortfall if the <i>takaful</i> operator does not provide <i>qard-ul-hassan</i> (interest-free loan)
Surplus in operational income	Ultimately for account of shareholders	For account of members	For account of participants

Source: Hodgins (2009)

## Issues and Challenges for the *Takaful* Industry

The *takaful* industry is growing fast and it is expected to grow even further. Features of *takaful* are attractive not only to those who wish to comply with *Shari'ah* but are equally attractive to conventional customers who are attracted to the cooperative and ethical nature of *takaful*. As with any emerging market, the industry faces several challenges, some of which are common to the Islamic financial industry as a whole. These include a lack of financial engineering, a shortage of human resources, an inadequate risk-management framework, and a lack of liquidity. However, there are several industry-specific challenges, as discussed below.

- Reinsurance plays a critical role in the conventional insurance industry in that it allows insurance companies to protect themselves against excessive risk and to spread risk across the industry. There is no such facility for the *takaful*, which has limited the opportunity to expand the business. *Shari'ah* rules make it difficult for *takaful* operators to utilize conventional reinsurers. While in some cases *Shari'ah* scholars have allowed the use of conventional reinsurers, it is not a preferred option.
- Global brands such as Munich Re, Hannover Re and Swiss Re, together with regional players like Takaful Re and MNRB Retakaful, have contributed to enhancing the Islamic reinsurance capabilities. Today, there are nine fully fledged re-*takaful* operators, mostly in Malaysia, which is widely acknowledged as being at the forefront of regulations for the industry. Indeed, the Southeast Asian model is widely considered to be a blueprint for all insurers—local operators and international players alike—who have the desire to explore *takaful* (Jaffer 2010a).
- The success of the *takaful* business is dependent on its asset-management skills and therefore requires typical financial products and tools to construct and manage efficient portfolios. In this respect, the lack of short-term *Shari'ah*-compliant instruments and the lack of liquidity in the market pose serious challenges for *takaful* operators. The issue of liquidity needs to be addressed for the benefit of the Islamic finance industry as a whole. Without the tools to manage portfolios against market and liquidity risks, operators cannot offer competitive products in the market.
- The *takaful* industry is comparatively new among other Islamic financial services. It faces several challenges in gaining entry to markets in which the regulatory and supervisory environment favors conventional insurance business but is not very well suited for *takaful*. In relation to financial reporting standards, both AAOIFI and IFSB have helped by defining the industry standards necessary to promote this business in countries interested in expanding this sector.
- As mentioned earlier, *takaful* products have been primarily geared towards property insurance, and growth in the area of life insurance has been slow because of continuing suspicions that it may entail an



element of gambling. While *Shari'ah* scholars are still divided on the issue, growing numbers are turning in favor of life insurance. *Takaful* companies need to educate their potential customers well with regard to *Shari'ah*-related issues, taking care not to deliver this education in a way that can be perceived as marketing or advertising. Similarly, they need to educate conventional customers about the benefits of *takaful* to attract their business.

## ENDNOTES

1. Aizenman (2008).
2. Gassner (2009).
3. Dar and Presley (2000).
4. See Iqbal and Karim (2010) and Askari *et al.* (2008).
5. See Obaidullah and Abdul Latiff (2008).
6. Ernst & Young (2010).
7. PriceWaterhouseCoopers (2008).
8. For instance, under the Malaysian *Takaful* Act 1984, the legal definition of a *takaful* scheme is based on the concept of solidarity and brotherhood, which provides mutual financial aid and assistance to the participants in cases of need, whereby the participants agree mutually to contribute for that purpose.
9. Ernst & Young (2009).

## CHAPTER 11

# Performance of Islamic Financial Services

**W**ith the expansion of the market for Islamic financial services, questions began to be asked about the efficiency and cost-effectiveness of such services vis-à-vis their conventional counterparts. Early comparative studies focused on Islamic and conventional banks within the same country or region. Gradually, these were extended across regions. As capital markets grew, the focus shifted to the financial performance of Islamic funds relative to Islamic indices.

### **THE EFFICIENCY OF ISLAMIC BANKS**

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A typical measure of efficiency is the ability to convert inputs (staff costs, fixed assets and total deposits) into outputs (total loans, liquid assets and other income). Several studies have been undertaken to evaluate the cost and production efficiency of Islamic financial institutions in different countries where Islamic finance is practiced. The majority of such studies have measured efficiency using accounting ratios, comparing them with the ratios of conventional banks of similar size and location.

Metwally (1997) compared the performance of 15 interest-free banks with 15 conventional banks for structural differences between the two groups in respect of liquidity, leverage, credit risk, profit, and efficiency. The study found that although profitability and efficiency differences were not statistically significant, Islamic banks tended to be more conservative in utilizing funds for lending and were disadvantaged in their investment opportunities. Similar findings of constrained investment opportunities were observed by Samad and Hassan (1999), who looked at the interbank performance of Bank Islam Malaysia Berhad (BIMB) in terms of profitability, liquidity, risk, and solvency as well as community involvement for the period 1984–97. They concluded that the average profit of an Islamic bank was significantly lower than that of the conventional banks, mainly because of the limited investment opportunities.

Iqbal (2000) measured the efficiency of 12 Islamic banks by comparing their trends and profitability ratios with a “control group” of 12 conventional banks of similar size from the same countries. The Islamic banks studied accounted for more than 75 percent of the total assets as well as the total capital of the whole Islamic banking industry and were thus reasonably representative of the entire sector. The study found that during the period 1990–97, Islamic banks achieved higher rates of growth in total investments, total assets, total equity, and total deposits than their conventional counterparts. More importantly, it found that Islamic banks also turned out to be more cost effective and made better use of their resources than the banks in the control group, as indicated by their significantly higher deployment ratios.

Hassan and Bashir (2003)<sup>1</sup> analyzed how bank characteristics and the overall financial environment affect the performance of Islamic banks. Utilizing bank-level data, the study examined the performance indicators of Islamic banks worldwide during the period 1994–2001. First, the banks’ profitability measures responded positively to increases in capital and negatively to loan ratios. The results revealed that a larger equity-to-total-asset ratio led to greater profit margins. This finding was intuitive and consistent with previous studies. It indicated that adequate capital ratios play a weak empirical role in explaining the performance of Islamic banks. The Islamic banks’ loan portfolio was heavily biased towards short-term trade financing. As such, their loans were low-risk and only contributed modestly to profits. Bank regulators may use this as evidence for the need for prompt supervisory action. Second, the results also indicated the importance of consumer and short-term funding, non-interest-earning assets and overheads in promoting bank profits. Third, the results suggested that the regulatory tax factors are important in the determination of bank performance.

Based on data from 1993 to 2000, Majid, Nor and Said (2003) concluded that there was no statistically significant difference in the level of efficiency between Islamic and conventional banks operating in Malaysia. This study did, however, find a linkage between inefficiency and size. The size of the bank not only influenced inefficiency, it also did so in a non-linear fashion. Increasing size initially provided some economies of scale; however, diseconomies of scale set in once a critical size was reached, thus suggesting a U-shaped average cost function. Hussein (2003) estimated the operational efficiency of 17 Sudanese Islamic banks from 1990–2000 and found that these did not create inefficiency per se, but that there were wide efficiency differences across domestic Islamic banks. However, foreign banks were found to be more efficient, despite their small size, than the state-owned and joint-ownership banks.

Brown and Skully (2005) examined the efficiency of 36 Islamic banks across 19 countries. They found that average cost-efficiencies based on International Accounting Standards were 46.4 percent, 80.8 percent, and 89.7 percent in Africa, Asia, and the Middle East, respectively. However, based on International Financial Reporting, the results were 45.9 percent, 66.5 percent, and 66.5 percent. Their results also showed that where Iran had the largest

banking market, Saudi Arabia had the highest equity ratio. The highest net interest margin and the highest returns on adjusted assets (ROAA) were in Bahrain and the highest return on adjusted equity (ROAE) was in Gambia. At the regional level, Islamic banks from the Middle East were the most efficient, followed by Asia and Africa.

Yudistira (2004) provided evidence on the performance of 18 Islamic banks over the period 1997–2000. Overall, the results suggested that Islamic banks suffered slight inefficiencies during the Asian crisis of 1998–99. Efficiency differences across the sample data appeared to be mainly determined by country-specific factors. Islamic banks showed considerable overall efficiency across the sample period, with the year 2000 being the most efficient year. However, it is interesting to note that the Islamic banking industry experienced slight inefficiencies in 1998 and 1999 (0.870 and 0.897, respectively) compared to 1997 and 2000 (0.902 and 0.909, respectively). Islamic banks in the Middle East region performed better in overall technical efficiency until 1998 but subsequently recorded sluggish results compared to their counterparts elsewhere. The explanation for this is that Islamic banks outside the Middle East region, especially those in the East Asia region, experienced greater difficulty in the Asian economic crisis in 1997–98. However, when most economies slowly recovered from the crisis (from 1998 onwards), non-Middle East Islamic banks became slightly more efficient than their Middle East counterparts. Previous studies have argued that the explanation lies on the depositors' flight to quality, which was found mainly in the East Asia region. To analyze the size–efficiency relationship, Islamic banks across the sample were grouped by total assets in which banks with more than US\$600 million of assets were categorized as “large” and banks below this level were categorized as “small-to-medium” size. Concentrating on scale efficiency (SCALE), it is clear that the largest degrees of scale inefficiencies came from large Islamic Banks, with the lowest SCALE score being 0.915 in 1998. It is interesting to note that all but one of the large Islamic banks exhibited decreasing returns in 1997–98, whilst in 1999–2000 most showed constant returns to scale.

Bader *et al.* (2007) explored the cost, revenue, and profit efficiencies of 43 Islamic and 37 conventional banks in 21 countries in Africa, Asia, and the Middle East, using financial ratios for the period 1990–2005. Efficiency was measured based on different sizes and ages of banks and their locations. The findings showed no significant differences in efficiency scores between them. On average, the larger the size of total assets, the higher the efficiency and, surprisingly, the revenue and profit efficiency scores for old banks were lower than for new banks.

This research found no significant difference in the mean scores between big and small banks for all efficiency categories. Therefore, any claims that the cost, revenue, and profit efficiency of big banks are significantly better than those of small banks cannot be accepted. This evidence suggests that size does not affect cost, revenue and profit efficiency. The findings also disprove the claims that the mean cost efficiency of new conventional banks

is significantly higher than that of new Islamic banks. In fact, the revenue efficiency in a new conventional bank is significantly higher than that in a new Islamic bank. However, the mean revenue (and profit) efficiency of old conventional banks is not significantly higher than that of old Islamic banks.

The study compares the cost, revenue and profit-efficiency ratios of conventional and Islamic banks in Africa, Asia, and the Middle East and Turkey and does not find any significant differences across regions.

In 2008, IMF staff conducted a first-of-its-kind empirical analysis of the impact of Islamic banks on financial stability.<sup>2</sup> Using z-scores as a measure of stability, Cihák and Hesse (2008) found that small Islamic banks tend to be stronger financially than small conventional commercial banks; large conventional commercial banks tend to be stronger financially than large Islamic banks; and small Islamic banks tend to be stronger financially than large Islamic banks. The study speculates that the reason why Islamic banks, while more stable when operating on a small scale, are less stable when operating on a large scale could be that it is significantly more complex for Islamic banks to adjust their credit-risk monitoring system as they become bigger. The study suggests that monitoring the various profit-loss arrangements becomes rapidly much more complex as the scale of the banking operation grows, resulting in problems relating to adverse selection and moral hazard becoming more prominent.

In general, studies have found Islamic banks to be performing efficiently when compared with similar conventional financial institutions in similar market conditions. By international standards, the average size of an Islamic bank is relatively small but, despite this fact, it is surprising that no study has been able to provide convincing evidence of inefficiencies in Islamic banks. There could be two possible explanations as to why Islamic banks are found to be efficient irrespective of their small size. First, most of the studies have been performed as a comparison with conventional banks in the same geographical region; thus ignoring the impact of systemic inefficiencies. A more realistic analysis should include comparison of efficiencies against international benchmarks, comparison with foreign banks, controlling for any protection against competition, and should take into account the quality of standards, and other macroeconomic variables such as capital movement. Further, most of the studies were conducted during a period of high growth resulting from high demand for Islamic financial services. During the periods of high growth and demand, institutions are often subject to low levels of market pressure and competition. When institutions are entering into a niche market like Islamic finance, some level of inefficiency is compensated by the abnormal initial profit margins. These margins erode fast as more players enter the market and it becomes more competitive.

Another reason could be that undertaking an empirical study to review the performance of Islamic banks or to understand the efficiency of financial services is itself a challenge because of the low degree of transparency and quality of information disclosure. For instance, many Islamic banks do not provide sufficient details as to the division of equity and deposits. Further,

access to transaction-level data is extremely difficult. When it comes to deposits, it is hard to get any reliable and detailed breakdown of the deposit types offered by these institutions because of the common practice of “clubbing” different types of deposits together. Similarly, details on the assets side are often not very transparent. The above factors imply that the results of these efficiency studies are to be taken with caution and one cannot conclude that there is no need to improve efficiency.

## **PERFORMANCE OF ISLAMIC CAPITAL MARKETS**

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In 1998, the FTSE Group launched the first series of Islamic equity indices, the FTSE Global Islamic Index Series (GIIS). The GIIS is a subset of the FTSE All-World Index group, which includes stocks from 29 countries. The FTSE has 15 Islamic indices; classification is based on industry (10 indices) and region (Global, Americas, Europe, Pacific Basin, South Africa). This was followed by the first Dow Jones Islamic Market Index (DJIMI) in 1999, which was created to track the performance of companies whose activities are consistent with *Shari'ah* principles. More recently, Standard & Poor's has also introduced similar indices. The performance of all these indices is regularly monitored and reported.

When the idea of Islamic equity portfolios with special screens was developed, critics objected that by imposing such screens investors would be constrained, and have limited diversification benefits. However, this has been proven wrong, both theoretically and empirically. Lightstone (2006) argued that quantitative methods of stock selection are well suited to the selection of active Islamic strategies that track established equity styles and which can be evaluated against their benchmarks. The paper claimed that using quantitative analysis to develop portfolio strategies using Islamic screening rules strongly outperformed conventional benchmarks in 20 years of back-testing in up and down markets. The paper showed that given the availability of these strategies, there are now opportunities for asset allocation and style rotation.

Several empirical studies have looked at the efficiency and performance of the Islamic indices. Hussein (2005) undertook a comparison of the performance of the Dow Jones Islamic Index and the FTSE Global Islamic Index with those of the Dow Jones World Index and the FTSE All-World Index, respectively. The study reviewed the returns over different periods to control for behavior in different market conditions. The period from December 1993 to December 2004 was further divided into a bull period (December 1993 to December 2000), a bear period (December 2000 to September 2002), and a second bull period (September 2002 to December 2004). It found that the application of *Shari'ah* screens did not have an adverse impact on the performance of the indices. In the short run, a comparison of the raw and risk-adjusted performance showed that the Islamic indices performed as well as their counterparts over the entire period and in the second bull period.

In the long run, there is clear evidence that the Islamic indices performed better than their counterparts in the entire and first bull market periods. On the other hand, the Islamic indices failed to sustain their better performance over the bear and second bull periods since the counterpart indices achieved higher returns.

Hassan and Girard (2005) looked at the Dow Islamic indices for the period of 1992 to 2005 and did not find any noticeable differences in performance between Islamic and non-Islamic indices from January 1996 to December 2005. The Islamic indices outperformed their conventional counterparts from 1996 to 2000 and underperformed them from 2001 to 2005. They suggested that the period-specific performance of Islamic indices was likely to be attributable to style differences between the two types of series because they observed that Islamic indices were growth and small-cap oriented and conventional indices were more value and mid-cap focused. They also concluded that, overall, similar reward to risk and diversification benefits existed for both types of index.

Hassan and Antonios (2006) examined the performance of the Dow Jones Islamic Index against the Data Stream Global Index and confirmed earlier findings that Islamic equity investments are no less profitable than conventional investments given the relatively major differences between Sharpe and Treynor measures and significant positive Alpha over the positive returns period. The study also observed a bias of Islamic indices towards technology stocks, which proved beneficial during bull markets but affected the performance adversely during the bear periods.

Elfakhani, Hassan and Sidani (2007) performed an empirical study of a sample of 46 Islamic mutual funds to investigate the difference in behavior of Islamic and conventional mutual funds. The study concluded that the behavior of Islamic mutual funds does not differ from that of other conventional funds, with some *Shari'ah*-compliant mutual funds outperforming their benchmarks and others under-performing. The total number of over-performing funds ranged between 29 funds (63 percent of the sample) and 11 funds (24 percent), depending on the performance measure used and the market benchmark. This study made two interesting observations: there is no statistically significant risk-adjusted abnormal reward or penalty associated with investing in *Shari'ah*-compliant mutual funds; and Islamic funds can be considered by conventional fund managers, since investing in *Shari'ah*-compliant funds offers some form of diversification and hedging benefits, especially during periods of economic downturn.

## **CORPORATE SOCIAL RESPONSIBILITY**

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Advocates of Islamic finance argue that Islamic financial institutions (IFIs) will follow the principles of Islam in giving high priority to promoting social welfare and justice. If the goal of IFIs is, as they purport, to reconcile the individual pursuit of profit with the good of society as established

in *Shari'ah*, they must serve as active engines of social change rather than indifferent producers of limited and coincidental positive externalities. In this respect, IFIs should pay due attention to corporate social responsibility (CSR) and must constitute social objectives over and above the basic legal and ethical requirements mandated by *Shari'ah*.

Research on the evolution and the performance of Islamic finance has tended to highlight issues of profit and efficiency, while downplaying or ignoring the socio-political goals of the discipline and its practitioners. Sairally (2007) undertook a unique study to evaluate the corporate social performance (CSP) of IFIs in order to determine how socially responsible they are in their objectives, actions, and commitments. This study made the following observations:

- In contrast to their counterparts, IFIs have tended to engage in a strictly “defensive” approach to CSR. While they ranked screening of objectionable products, such as those that engage in *riba* and other impermissible acts, very high on their list of priorities, they ranked the selection of positive products, such as investment in companies that contribute positively to society or invest in environmentally-friendly activities, very low. An analysis of the mission and vision statements of the IFIs revealed that the majority (41 percent) embraced such a defensive approach to CSR, while only 27.8 percent engaged in a more proactive practice.
- The reported practices of IFIs displayed minimal or no commitment towards ethical employment policies and community involvement.
- Most IFIs restricted charitable activities to direct donations (of about 0–2 percent of profits) to charities and community causes. Although, this appears unexpectedly low, one possible reason could be reluctance on the part of IFIs to make such claims public, following a policy that charitable activities should be kept discreet. This is consistent with the results of the survey which showed that 87.5 percent of respondents failed to allocate a percentage of profits to the community activities in which their institutions participated.

Grais and Pellegrini (2006) observed that although there was a noticeable consistency in respecting the social obligations of Islamic finance, the emphasis by IFIs on their social role was not uniform. In a sample of 13 IFIs, the study found that all discharged their almsgiving duties (*zakat*) as required of all responsible corporate citizens by the *Shari'ah*. The majority also provided charitable loans (*qard-ul-hassan*) to help disadvantaged groups meet social obligations. The activities financed included the implementation of development and humanitarian programs, the construction of hospitals and mosques, and the financing of education, house refurbishments and in-kind donations. In general, the study found that IFIs live up to their social goals as claimed in their mission statements.

Any problems regarding a lack of transparency in providing information or with the mediocre standards of community involvement displayed by



IFIs can be alleviated through the creation of an index that tracks the social performance of companies whose activities are consistent with *Shari'ah* principles. Given that the welfare of society is the prime objective of Islamic law, it is essential that the discipline of Islamic finance establishes principles that can gauge whether IFIs are contributing significantly to this objective. Though no such index exists currently, we believe that one can readily be modeled on available ethical-investing indices.<sup>3</sup>

## **PERFORMANCE IN CRISIS PERIOD**

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The financial crisis of 2007–09 offered opportunities for the advocates of Islamic finance to claim that Islamic financial institutions are more resilient to the stresses of financial crises. Several studies were undertaken in support of this claim. Some studies found that the primary reason why Islamic financial institutions and capital markets were not directly affected by the sub-prime financial crisis was that they did not have any direct exposure to toxic assets and, therefore, were immune to the crisis during its early stages. However, as the crisis led to economic recession and global slowdown, Islamic financial institutions also faced deteriorating business and decline in profit margins.

Several IFIs that had exposure to real estate developments in the Middle East experienced an erosion of their asset values. Although this has yet to show up as a liquidity crisis, it is feared that a lack of strict adherence to marking assets to market may be disguising the problem, or at least delaying their being brought to the surface. Similarly, it is too early to tell if Islamic financial institutions will indeed pass through some of the losses to the depositors or if their equity capital will absorb some of the losses, as has been done in the past. In addition, several IFIs have been building reserves from previous years' profits to use during less-profitable periods. The picture should become clearer shortly. Both Islamic and conventional banks are facing problems with asset quality in the post-crisis period. For example, in depressed capital markets, the Islamic banking sector is also facing a decline of revenues derived from brokerage fees and trade finance-related fees.

Hasan and Dridi (2010) conducted a study for the IMF to assess the impact of the crisis using bank-level data covering the period 2007–10 for about 120 Islamic banks and conventional banks in eight countries (Bahrain (including offshore), Jordan, Kuwait, Malaysia, Qatar, Saudi Arabia, Turkey, and the UAE). The study used variables such as the changes in profitability, bank lending, bank assets, and external bank ratings to assess the impact. The study shows that, in profitability terms, Islamic banks fared better than conventional banks in 2008 but this trend had leveled out in 2009 as the crisis hit the real economy. In general, growth in the credit and assets of the Islamic banks continued to be higher in all countries except the UAE. The study concluded that, on average, Islamic banks showed stronger resilience during the global financial crisis. The other findings of the study were:

- Islamic banks' solvency was better, mainly due to low leverage which helped them contain the adverse impact on profitability in 2008, but their weaknesses in risk management practices caused larger declines in profitability than experienced by conventional banks in 2009.
- The weak performance in some countries was associated with sector concentration and, in some cases, was facilitated by exemptions from concentration limits.
- Islamic banks experienced higher profitability during the pre-global crisis period (2005–07), but their average profitability for 2008–09 was not much different from conventional banks, indicating better cumulative (pre- and post-crisis) profitability.
- Larger Islamic banks performed better than small ones because of better diversification, economies of scale, and stronger reputation.

In a World Bank study, Beck, Demirgüç-Kunt and Merrouche (2010) found Islamic banks to be more cost-effective than conventional banks in a broad cross-country sample but this finding was reversed in a sample of countries. Islamic banks had higher capitalization and higher liquidity reserves, which were considered the source of their better performance when compared to conventional banks. Interestingly, the study found that conventional banks that operate in countries with a higher market share of Islamic banks were more cost-effective but less stable.

Whereas analyzing the performance of financial institutions requires extensive data and information, which is not always readily available, it is relatively easy to see the performance of Islamic products in capital markets. We undertook a simple comparison of Dow Jones Islamic Indices with their conventional benchmarks and found that the Islamic indices outperformed the benchmark (whether it be US or World) when performance was measured in risk-adjusted value.

Table 11.1 shows a comparison of the Dow Jones Islamic US Index and the S&P 500 for the five-year period from December 1, 2005 to November 30, 2010. The analysis was performed on weekly index returns, and cumulative returns are reported for the last one-, two-, three-, four- and five-year periods. We computed excess return (ER), tracking error (TE) and information ratio and found that the Islamic index outperformed the S&P 500 in each year in risk-adjusted terms as measured by information ratios.

Figure 11.1 shows the weekly cumulative returns of the two indices. An interesting observation can be made here. Although, on a risk-adjusted basis, the Islamic index had better nominal returns, the S&P 500 outperformed the Islamic index from December 2005 to late 2007 when the Islamic index began to show better nominal returns. One possible explanation for this could be that the S&P 500 included financial stocks, which are not part of the Islamic index. During the boom time, the inclusion of financial stocks created a leverage effect and gave better returns; but before and during the crisis, financial stocks were hit hard.

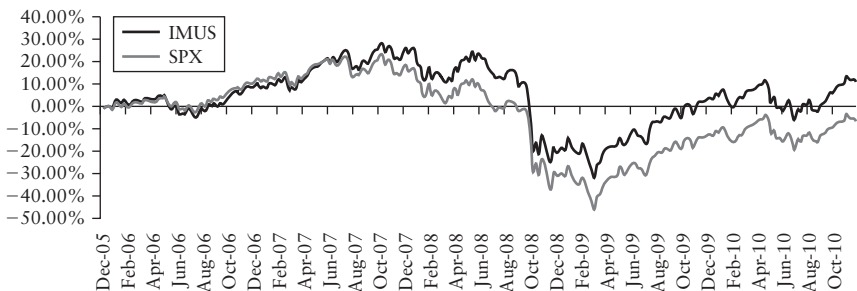
Table 11.2 and Figure 11.2 show the results of a comparison of the performance of the Dow Jones Islamic World Index and the MSCI World Index. The results are identical to those found in the above comparisons of the Dow Jones Islamic US Index and the S&P 500. In both cases, the Islamic and conventional indices had very high correlations.

A similar comparison of the S&P *Shari'ah* 500 and the S&P 500 reveals the same trends shown by the Dow Jones Islamic indices. Table 11.3 confirms that over periods of three and five years, the Islamic index performed

**TABLE 11.1** Performance comparison of Dow Jones Islamic US (IMUS) Index and S&P 500 (SPX), February 2006–February 2011

IMUS	5Y	4Y	3Y	2Y	1Y
Return	0.083%	0.060%	−0.006%	0.337%	0.196%
Sigma	2.84%	3.06%	3.38%	2.80%	2.34%
SPX	5Y	4Y	3Y	2Y	1Y
Return	0.023%	−0.023%	−0.072%	0.319%	0.194%
Sigma	3.04%	3.32%	3.69%	3.07%	2.39%
ER	5Y	4Y	3Y	2Y	1Y
Return	0.060%	0.082%	0.066%	0.018%	0.003%
TE	0.67%	0.70%	0.77%	0.69%	0.36%
IR / Sharpe Ratio	0.09	0.12	0.09	0.03	0.01
Correlations	0.976	0.979	0.980	0.976	0.989

Source: Based on data from Bloomberg



**FIGURE 11.1** Cumulative weekly returns of Dow Jones Islamic US index and S&P 500

Source: Based on data from Bloomberg

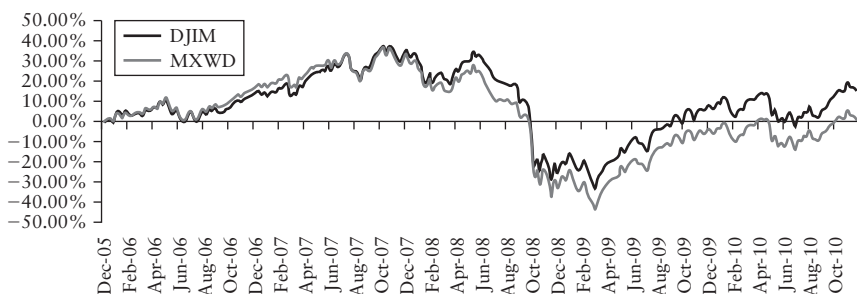
better than its counterpart and had lower volatility, which resulted in a lower Sharpe ratio. This confirms that, irrespective of the index, the performance results of Islamic and conventional indices are the same; that is, better returns, low volatility, and lower Sharpe ratios.

Table 11.4 gives a comparison of the leading ratios of the two indices. The most striking observation is the long-term debt to capital (LTD/capital)

**TABLE 11.2** Performance comparison of Dow Jones Islamic World Index (DJIM) and MSCI World Index (MXWD), February 2006—February 2011

DJIM	5Y	4Y	3Y	2Y	1Y
Return	0.101%	0.065%	-0.026%	0.410%	0.199%
Sigma	3.01%	3.24%	3.59%	2.91%	2.44%
<b>MXWD</b>	<b>5Y</b>	<b>4Y</b>	<b>3Y</b>	<b>2Y</b>	<b>1Y</b>
Return	0.06%	-0.01%	-0.10%	0.39%	0.16%
Sigma	3.16%	3.42%	3.80%	3.13%	2.53%
<b>ER</b>	<b>5Y</b>	<b>4Y</b>	<b>3Y</b>	<b>2Y</b>	<b>1Y</b>
Return	0.04%	0.07%	0.07%	0.02%	0.04%
TE	0.54%	0.56%	0.63%	0.59%	0.33%
<b>IR / Sharpe Ratio</b>	<b>0.08</b>	<b>0.13</b>	<b>0.12</b>	<b>0.04</b>	<b>0.12</b>
Correlations	0.98602	0.98698	0.98718	0.98349	0.99195

Source: Based on data from Bloomberg



**FIGURE 11.2** Performance comparison of Dow Jones Islamic World (DJIM) Index and MSCI World Index (MXWD)

Source: Based on data from Bloomberg

ratio of the S&P *Shari'ah* 500 index, which stands at 25 percent. Theoretically, this ratio, which indicates leverage, should be as close to zero as possible but Islamic indices relax the leverage requirement and select stocks of firms with low (< 33 percent) leverage.

**TABLE 11.3** Performance comparison of S&P *Shari'ah* 500 and S&P 500

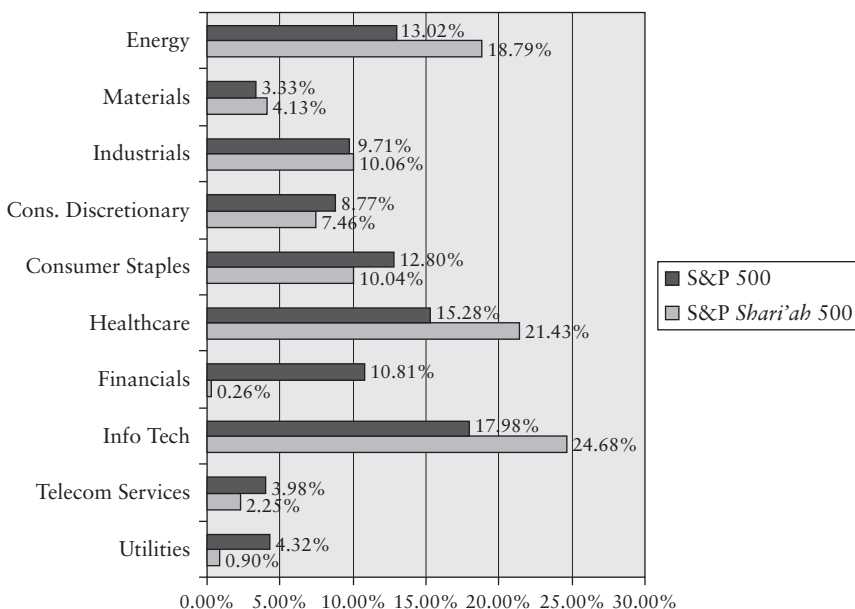
Index Performance	Quarter	YTD	12M	3 Year	5 Year
S&P <i>Shari'ah</i> 500	-7.23%	-7.23%	-30.22%	-7.31%	-0.67%
S&P 500	-11.01%	-11.01%	-38.09%	-13.06%	-4.76%
Standard Deviation	3 Year	5 Year			
S&P <i>Shari'ah</i> 500	16.35%	13.92%			
S&P 500	17.67%	14.69%			
Sharpe Ratio	3 Year	5 Year			
S&P <i>Shari'ah</i> 500	-0.17	-0.06			
S&P 500	-0.26	-0.13			

Source: S&P (2009)

**TABLE 11.4** Ratio comparison of S&P *Shari'ah* 500 and S&P 500

	S&P 500 <i>Shari'ah</i>	S&P 500
Market Cap (US\$ million)	80,578.20	66,828.54
P/E	12.5	11.8
P/CF	7.9	6.2
P/Sales	1.4	0.8
P/BV	2.3	1.6
3-year EPS Growth	17.1	12.9
3-year Sales Growth	12.8	12.6
ROE	25.8	21
ROA	12.8	9.6
LTD/Capital	24.9	32.9
Operating Margin	21.2	18.6
Net Margin	13.6	11
Dividend Yield	2.54	3.42

Source: S&P (2009)



**FIGURE 11.3** Comparison of sector allocation of S&P 500 and S&P Shari'ah 500  
Source: S&P (2009)

Figure 11.3 shows the sector allocation of two indices and reveals that the Islamic index has almost no allocation to the financial sector, which confirms our earlier assessment that Islamic indices have done better in the crisis period when investors suffered losses due to problems in the financial sector whereas Islamic investors had no exposure to that sector.

An S&P study found that, in the first nine months of 2008, commercial Islamic banks continued to exhibit strong profitability, reporting an average return on assets (ROA) of 3.1 percent. These banks appear to have benefited from the supportive economic environment that prevailed in the first half of 2008, from their good efficiency and from the low cost of risk. In line with the Islamic principle that all transactions must be backed by a real asset, one of the preferred asset classes of Islamic banks is real estate. Studies show that the total direct exposure to the real estate sector for IFIs is equivalent to about 20 percent of total lending, which is high and increases the IFIs' exposure.<sup>4</sup> With deteriorating market values, IFIs can face problems in passing the losses to investors/depositors unprepared to face this reality. IFIs will have to wait and hope for a rebound in these values to achieve modest returns for their investors/depositors.

In 2009, the Islamic International Rating Agency (IIRA) conducted a survey of key Islamic banks to assess their liquidity position and concluded that although they were not entirely immune from the impact of declining real estate values and restricted real estate lending, these banks were less

likely than conventional institutions to suffer negative outcomes beyond their capacity to sustain core profitability and capital.<sup>5</sup> The report showed that, on average, during 2008 the impact of the global crisis on liquid assets remained limited, as reflected in a modest downward adjustment of the liquidity ratio. Liquid assets as a percentage of total liabilities declined during 2008, which indicates the banks' use of internal resources to manage the funding shortfall. From being net providers of funds in 2007, many Islamic banks became net borrowers from the interbank market during 2008—an indication of their increased liquidity needs. A few banks have large maturing liabilities, which has resulted in a significant negative gap; while some have sufficient maturing assets to support their maturing liabilities.

The performance of Islamic financial institutions can be considered good, especially in light of the fact that Islamic institutions are part of an emerging and developing market that is trying to overcome many challenges and obstacles. The returns to Islamic banks have been comparable to those of conventional banks. No Islamic bank has failed as a result of the sub-prime crisis. The risk-adjusted returns of some Islamic capital-market products are higher than comparable ones in conventional markets. These are, however, preliminary results and may change with time.

## **BANK FAILURES**

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Although there has not been a major failure in more than 30 years of the Islamic banking industry's history, there have been instances of failures of financial institutions claiming to offer Islamic financial products. A review of the causes leading to their failure can shed light on how it could have been avoided, how other institutions offering similar products and services were affected and how they can learn from these experiences.

### **Ihlas Finans<sup>6</sup>**

Ihlas Finans was a Turkish institution that behaved similarly to a deposit-taking bank offering *Shariah*-compliant financial services. These financial houses were not recognized as part of the regular banking sector but were given the status of Special Finance Houses (SFHs), as they were considered to be offering non-conventional and specialized services. SFHs constituted only 3.1 percent of the total banking-sector deposits, and their investment allocations represented only 4.7 percent of the total. As SFHs, these institutions were not subject to the same regulations as other institutions in the banking sector. For example, SFHs were considered an uninsured sub-sector of Islamic banks.

In early 2000, the Turkish financial sector went through a macroeconomic and financial crisis which affected the entire banking sector and led to the failure of some conventional banks. Of the five SFHs engaged in Islamic finance, however, Ihlas Finans was the only one that did not survive.

Ihlas Finans was a subsidiary of Ihlas Holdings, a social-oriented business organization established in the 1970s that eventually grew into a large holding company. While its core business was in the fields of construction, healthcare, and education, it had a number of subsidiary businesses ranging from manufacturing of household appliances, to news media, to providing financial services and insurance of various kinds. Ihlas Finans was one such subsidiary, established in 1995 with the objective of providing interest-free investment opportunities to investors and small savers. Registered as a Special Finance House with the Central Bank of Turkey, it grew into the largest of its class. The balance-sheet assets had grown from US\$17 million in 1995 to US\$1,173 million by 1999,<sup>7</sup> with a majority market share of 40 percent.

However, in the wake of the banking crisis that developed in Turkey in the last quarter of 2000 and early 2001, the company faced a run on its deposits. On February 10, 2001, the Banking Regulation and Supervision Agency (BRSA) intervened and cancelled its license, leaving the company's 200,000 depositors around the country unsure as to what had become of their deposits. The BRSA cited several reasons for this action. First, it announced that Ihlas Finans had irregularly appropriated almost US\$1 billion (practically the entire value of deposits) through connected lending to shareholders.<sup>8</sup> Second, it considered that the company was unable to fulfill its obligations to the public and therefore to be in violation of banking rules. Third, there were irregularities, as Ihlas had made substantial investments in its subsidiaries and with the agents of its subsidiaries.

The detailed analysis of the case conducted by Ali (2007), highlights several factors for the failure of the institution and holds several stakeholders and deteriorating market conditions responsible for this failure. While there was clear evidence of carelessness on the part of the regulators and supervisors, who were unable to detect the warning signs in time, here we focus primarily on those factors where the management of Ihlas Finans was directly responsible for the negligence and where the *trust* of the stakeholders was breached through misrepresentation. It is important to understand the implications of these factors since they were the source of considerable concern for the depositors of other SFHs and to the reputation of the industry in the country. These factors are summarized below.<sup>9</sup>

**Weak Governance Structure** It appears that Ihlas Finans was not following the best practices in corporate governance. For example, it is reported that the members of the Board of Directors showed a lax attitude towards governance and some members appointed to the board did not have the requisite experience. Since Ihlas Finans was a subsidiary of a large holding company, some of its board members represented multiple boards, which resulted in a conflict of interests.

**Fraudulent Practices** It appears that Ihlas Finans tried to conceal its financial and managerial failures by indulging in fraudulent practices. For example,



it was discovered that some of the agency (*mudharabah*) financing was done in the name of fictitious parties, while the funds were in fact used for concealing internal financial problems.

**Lack of a Risk-management Culture** There were serious flaws in the company's risk management framework. Credit was extended to finance other businesses in sibling holding companies and some of the clients became heavily dependent on Ihlas as a source of funding, thus increasing exposure to credit risk. The depositors' funds were used to finance several businesses of Ihlas Holdings which in turn placed the funds in highly illiquid projects such as construction. Even though these projects were profitable ventures, they led to increased liquidity risk for Ihlas Finans and were cited as one of the primary reasons for its failure. It is evident that Ihlas Finans lacked a crisis-management plan, and decision-making during the crisis was ad hoc and uncoordinated, internally and externally.

**Management Failure** It appears that Ihlas Finans did not follow the best practices in management and did not act in good faith. Its hiring and selection process was called into question when it was shown to have hired a senior executive who was the subject of a BRSA investigation of a failed bank—adding further fuel to customers' concerns and damaged their confidence. Furthermore, the management was slow in responding to the changing legal and regulatory environment and demonstrated poor judgment by ignoring the severity of the problem during the early phases of the crisis. For example, while other SFHs were able to convince depositors to hold off on their withdrawal requests to avoid a liquidity crunch, Ihlas Finans lost more than US\$200 million-worth of its most liquid assets by paying out on depositors' demands even before the liquidity crunch hit. As a result, withdrawal requests increased, which ultimately placed pressure on the BSRA to close down the institution.

### **The Islamic Bank of South Africa**

The Islamic Bank of South Africa (IBSA) failed in November 1997 with debts of between R50 million and R70 million. The primary depositor base of the IBSA consisted of small depositors, mostly Muslims, who saw it as a community bank and deposited their money to make the Hajj pilgrimage to Mecca. Okeahalam (1998) conducted an analysis of its failure and the role of the supervisors, and concluded that bad management and improper accounting and management systems caused the bank to fail. Allegedly, a large amount of insider unsecured lending took place, which resulted in a large proportion of non-performing assets in the balance sheet. The study found that the bank's management hid behind the self-regulatory position accorded to true Islamic banks but that IBSA abused this special trust. The regulators should have been more cautious.<sup>10</sup>

Further details of the causes of failure are found in van Greuning (2005), who makes the following observations:

- IBSA claimed to share profits and losses with ratios of 66 percent for the investor and 33 percent for the bank. However, in fact, the bank paid 11–13 percent return regardless of actual profits or losses, which created a false image of the health of the institution to potential investors. The bank was to provide a monthly P&L statement, something that was never done. Profits and losses were distributed at the discretion of the CEO, with no records to back them up.
- It was discovered that numerous loans were made to the directors. There was evidence of connected lending, self-dealing and insider lending through an over-extension of credit to directors and large shareholders, or to their interests. Forty percent of non-performing loans had never paid anything since they were set up. Twenty-seven percent of loans were to insiders.
- Shareholders did not pay in their capital (capital was immediately lent back to the shareholders), so the “cash” received was converted into a loan. Accordingly, there was a negative impact for depositors since they had no “buffer” against their losses. One shareholder had more than 15 percent control and hid his stake through front companies.
- There were no risk committees to assist the board; thus, management and decision-making were performed within an extremely informal framework. Banking law was also breached because audit committees and internal audits did not exist. Banking law also required directors to be “fit and proper” and understand the “business of banking and banking risks”; however, the liquidator did not find this to be true as there were no risk-management systems in place. Furthermore, credit information was incomplete, since the purpose of borrowing and the intended plan and source of repayment were not specified.

The IBSA case clearly shows that the bank was not following basic banking practices. The management was guilty of misrepresentation and indulging in unethical practices, which resulted in the distortion of information and a lack of transparency. The regulators had assumed that the bank would impose the discipline of self-regulation and did not supervise this prudently. Consequently, this trust was breached when detailed investigation revealed the wrongdoing of the institution.

### **Islamic Investment Companies in Egypt<sup>11</sup>**

In Egypt in the 1980s, the activities of certain investment companies came to the attention of regulators and the media in Egypt in the years 1985 to 1988. These companies were based on a profit-sharing principle (*sharikat tawzif al-amwal*), accepting deposits from the public and investing funds in *Shariah*-compatible modes. During 1985 and 1986 they attracted the attention of investors by offering high rates of return (20–30 percent), claimed as profits. By the end of 1986, there were 190 registered companies engaged with private investment and operations, and 90 non-registered companies. According