• Investment Policies Under Shari’ah Principles
• Microfinance in Sudan & Ethiopia
• Empirical Study of the Proximity of Rotating Savings Credit Associations to Islamic Principles of Financing in Ilorin Metropolis
• Revisiting the Design of Interest Free House Finance
• The Comparison between Musharakah Mutanaqishah and Conventional Leasing Structures, Which One is better?
• Islamic Financial Engineering: An overview
• Islamic Finance – Opportunities and Challenges

Journal of Islamic Banking & Finance
Global Perspective on Islamic Finance
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In The Name of Allah,

The most Beneficent, The most Merciful

“O Believers: devour not Riba, doubled and redoubled;

and fear Allah, in the hope that you may get prosperity.”

_Sura Ale-Imran (verse No. 130)_

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# Journal of Islamic Banking and Finance

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"Hamdard", meaning one who shares your grief and misery and provides comfort and relief, is a friend indeed. Truly, for over a century, Hamdard has remained not only a compassionate companion but also a benevolent healer.

Caring for and nurturing mankind with the most comprehensive range of herbal, medicinal and health products known for their efficacy and use in every aspect of healthcare. With the vision of a pro, Hamdard has touched countless lives in countless ways.
Editor’s Note

Approximately, half of global poverty resides in Muslim majority countries even though their share in total global population is roughly one-fourth. Thus, the share of Muslims in total global poverty pool is almost twice as much as their share in total global population. Looking at it in another way, Muslims are most likely to be poor than non-poor as compared to non-Muslims. Most poverty resides in Africa and South Asia and most Muslim majority population resides there.

Islamic finance promises to be not only a Shari’ah compliant alternative to Muslims in meeting their financial needs, but it is also imbued with socio-ethical spirit of Islamic philosophy. Thus, in the view of Islamic scholars, the role of Islamic finance is expected to be more egalitarian as compared to its counterpart. The rapid growth in Islamic banking and finance and its increased penetration and acceptance in various regions is testimony to its commercial potential and resilience. It has successfully catered to the needs of voluntary excluded Muslims who needed Shari’ah compliant interest free financial services. However, after having set foot on the map and making its presence felt, much still needs to be done to deliver on making the Islamic financial products more inclusive and egalitarian. Progress on this front requires efficient expansion of operations so that the commercial competitiveness is retained while the net of services extends in providing more inclusive financial services.

As Islamic finance gains more share of the total financial market, it is expected to tread its own path in providing an inclusive and egalitarian financial system. This will put criticism and scepticism at rest and bring more consensus on its commercial as well as spiritual appeal. The recent inauguration of centres for excellence in Islamic finance in three separate jurisdictions of Pakistan will help in sharing the burden of training the manpower cost of Islamic financial institutions. When Islamic financial institutions provide in-house training to their employees, their costs of recruitment and polishing a ready human force for their service desks becomes high. If this function is performed by established top academic institutions, not only the cost, but the quality of training could also be improved through imparting knowledge on technical aspects of Islamic finance as well as providing broad based training in the areas of accounting, commercial law, project evaluation, security analysis and so on. The cost incurred in such training could be wilfully paid by the candidates given that this training would have academic as well as professional value. Hence, this could strengthen the overall skill base and potential pool of trained human resource for recruitment.

In the years to come, it is expected that Islamic finance would gain more momentum and outreach. Hence, the trained human resource would help in upholding the
most unique selling proposition of Islamic finance, which is Shari’ah compliance nature of each and every product, service and operations. This way, the well trained human resource would also act as the concept ambassadors of Islamic finance.

This issue of Journal of Islamic Banking & Finance documents scholarly contributions from authors around the globe. Contributions in this current issue discuss the theoretical underpinnings of an Islamic economy, contemporary issues in Islamic finance and performance based empirical studies on Islamic banking and finance. Below, we introduce the research contributions with their key findings that are selected for inclusion in this issue.

The paper “Investment Policies under Shari’ah Principles” by Prof. Dr. Mohd Ma’Sum Billah discusses the importance of investments in preserving wealth and how this goal can be achieved in a Shari’ah compliant way. The author discusses how investments can be made in a Shari’ah compliant way in order to achieve returns and cope up with erosion of wealth due to inflation.

The paper “Microfinance in Sudan and Ethiopia” by Professor Badr El Din A. Ibrahim reviews and compares the distinct features and practices of Sudanese and Ethiopian microfinance sector. The author argues that Sudanese experience can offer a lesson from its diversified wholesale market via the government-owned Wholesale Guarantee Agency. The paper also propagates the merits of Islamic microfinance as practiced in Sudan to Ethiopia-Muslim minorities. The author highlights that this can be carried out via new windows or specialized branches within the existing MFIs and hence there is no need for new legislations or a new MFIs structure. The paper recommends that Sudan can learn from the role and functions of AEMFI to establish the Sudanese Association of Microfinance Institutions. Additionally, Sudan can also learn from the Ethiopian social management system to self monitor the social impact of microfinance on their clients.

The paper “Empirical Study of the Proximity of Rotating Savings and Credit Associations to Islamic Principles of Financing in Ilorin Metropolis” by Mufutau Ayinla Abdul-Yakeen, Nasir Mukhtar Gatawa, Chika Umar Aliyu and Mohammed Olanrewaju Ibrahim empirically investigates the level of compliance of members of Rotating Savings and Credit Associations (ROSCAS) in Ilorin Metropolis with Islamic Principles of Financing (IPF). Providing survey based evidence, the study reveals that male, highly-educated, and self-employed respondents have better compliance to IPF than their counterparts. Respondents with higher proximity to IPF must assist and counsel their counterparts in Islamizing ROSCAS. The study also recommends that Muslim dominated nations should also start ROSCAS among themselves.

In his article “Revisiting the Design of Interest Free House Finance”, Salman Ahmed Shaikh, a PhD Scholar in Economics, discusses the difference between conventional and Islamic housing finance products. He explains the structural intricacies and drawbacks of the Diminishing Musharaka. He presents the concept of market based rent setting as opposed to the current practice of Diminishing Musharaka using a benchmark interest rate. Salman Shaikh argues this product more comprehensively complies with Islamic Shariah in that it charges a market based rent by separating tenancy from sale contract.
“The Comparison between Musharakah Mutanaqishah and Conventional Leasing Structures. Which One is Better?” is contributed by Muhammad Iman Sastra Mihajat who is Head of Shariah Audit and Shariah Compliance, Islamic Banking Unit, Oman Arab Bank, Muscat, UAE. In his paper he discusses the Shariah Compliant instrument of Musharakah Mutanaqishah (MMQ). He describes how the MMQ works and what benefit it offers to the borrower.

The paper “Islamic Financial Engineering: An Overview” by Mr. Mahfoud DJEBBAR discusses that the unprecedented growth in Islamic banking which has outpaced conventional banking growth has brought a challenge to the Islamic financial engineering (IFE), which is lagging behind its conventional counterpart. The author emphasizes the innovative strategy over replication strategy, since the former strategy guards the Islamic identity of different financial products and processes, and thereby, improves the creativity in the Islamic financial industry. The author also discusses the challenges facing IFE and the opportunities for its extension in liquidity management and Islamic securitization.

The paper “Islamic Finance – Opportunities and Challenges” by Mufti Ismail Ebrahim Desai notes that Islamic finance has achieved considerable growth and is considered to be the fastest growing segment of the financial system. There however remain various challenges such as lack of human capital, Shari’ah standardization and harmonization, public awareness, regulation and supervision, access to finance, liquidity management and others. The paper recommends adoption of Shari’ah law standards across jurisdictions, creating mass awareness programmes by governments and banks, amendments to tax policies to level the playing field, creation of Islamic financial benchmark and Shari’ah harmonization with existing legal and policy frameworks to sustain this growth and extend the net of Islamic finance.

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The authors themselves are responsible for the views and opinions expressed by them in their articles published in this Journal.

The opinions, suggestions from our worthy readers are welcome, may be communicated on e-mail: ia_ib@yahoo.com / www.facebook link: http://www.facebook.com/JIBFK
Readers Comments

1) Dr. Huud Shittu, Department of Religion & Philosophy, Faculty of Art, University of JOS- Plateau, Nigeria.

“I am delighted to congratulate you, the association, the contributors and members of the advisory board on the progress recorded in the publication of various works free of charge”.
Investment Policies Under Shari’ah Principles

By
Prof. Mohd Ma’Sum Billah, PhD*

Abstract

The state of being wealthy is highly desired by people, regardless of religion, races or nationality. Islam, not being left behind, also encourages its followers to seek for wealth, but in doing so, it is compulsory to ensure that any activities concerning wealth creation must be aligned with Shari’ah principles and guidelines. Beginning from the purpose of wanting to be wealthy, to the way of obtaining and spending one’s wealth, these acts must comply with the teachings of Islam, as depicted in the Qur’an and Hadith of Prophet Muhammad S.A.W. For instance, Allah said: “But seek, with the (wealth) which god has bestowed on thee, the Home of the Hereafter, nor forget thy portion in this world”1 This verse indicates that wealth creation is permitted in Islam and it is a gift from Allah to those whom He wishes to award it to. Nevertheless, wealth should be spent in God’s cause, that is, for charity and good works.2 So, how do we create wealth, the Islamic way? There are many means of obtaining wealth, but the most prominent way is to engage in trade and commerce. Prophet Muhammad S.A.W. said: “Take to trade and commerce, because nine-tenths of the source of earnings is in trade and commerce.”3 Today, trade and commerce are becoming more and more complex, and they require knowledge and expertise in order to ensure the continuation of businesses over a long period of time. Hence, not everyone have the time, opportunity and needed skills to survive in the business world. Then, how are we to take advantage of the huge potential benefits that trade and commerce offer? One way is for Muslims to invest in

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1 Al-Qur’an, Al- Qasas: 77.


3 Maulana Fazul-ul-Karim, Imam Gazzali’s Ihya Ulum-id-din (Book 2), Sind Sagar Academy, Lahore, at p. 54.
businesses that offer future profits, while ensuring compliance with Shari’ah principles. This paper attempts to analyse the Islamic investment opportunities and some of the issues of investing in Shari’ah approved investments, as practised in Malaysia. Among other types of investments that we will be looking at are: equity and commodity investments, Ijarah, Musharakah and Mudharabah investments. Furthermore, we will also be discussing about Islamic investment criteria and its future.

Keywords: Islam, Shari’ah, Investment, Instruments, Halal Screening

1. Islamic Investment Paradigm

An independent Shari’ah scholar, Shaykh Yusuf Talal DeLorenzo mentioned that, “Investing is one way in which Muslims can be good stewards of their money, as promoted by the teachings of Islam.”

Align with the increasing level of awareness and interest in investing in modern financial markets among Muslims worldwide, for the past few years, investment strategies that honour Islamic beliefs were apparently growing in the financial industry. Hence, it was reported in the year 2000 that there were over $150 billion worth of Islamic Investment market worldwide.

Before we move on, let us first look at the definition and principle of conventional investments, and compare it with the definition and principle of Islamic investments. Kuala Lumpur Stock Exchange (KLSE) defined conventional investment as the act of putting capital, in the form of time, effort or money into a business or venture, with the aim of obtaining a positive return or profit from it; while Islamic investment is defined as the act of putting capital, in the form of time, effort or money into a business or venture, which strictly conforms with the tenets of Shari’ah or Islamic Law, for the purpose of getting an Islamically lawful and positive return or profit from it. Thus, the difference here is that an Islamic investment must comply with the Shari’ah principles, in order to ensure that any gains arising from the investment are from halal sources, and thus can be utilised for personal consumption or for charitable purposes.

The conventional investment follow the rules of maximising profits and usage of available capital, while minimising risk and loss; whereas for Islamic investment, the rules go beyond the conventional investment rules to include divine considerations, meaning that, Islamic investment must be guided by Qur’anic and Prophetic injunctions that will maximise benefits (in the form of profits and social welfare) and minimise harms (including losses and social ills). Hence, we can assert here that in Islamic investment, the aim is not just to collect as much wealth as possible for own personal use, but rather, it specifies that the investments must be aligned with the teachings of Qur’an

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5 Available at http://www.lightbulbpress.com/pr_islamic/pressrelease.html.
and Sunnah, and the investments will give rise to benefits, not only to the investor, but also to the society and ummah as a whole. The Islamic investment thus incorporates within it the sense of brotherhood and wanting to help one another for the benefit of all, as Allah had mentioned in the Qur’an:

“…Help ye one another in righteousness and piety, but help ye not one another in sin and rancour…”

How can Islamic investments benefit the society and reduce social ills? Take for instance, an executive working for Company XYZ. He has a surplus of income because his salary is more than what he actually need to cover his expenses. Hence, rather than leaving his money in a conventional bank that offers low interest rate, he could invest in a project belonging to a friend, who needs capital to pursue his plans. Since the investor has no time to manage the project, both parties could engage in a Mudharabah agreement and share the profits and loss that will arise later on. If gains were realised, part of it will be subject to zakat payment. Thus, we can see here that rather than just keeping his surplus of income in the bank all to himself, the investor could earn more from the profit sharing investment, while at the same time, helping a friend in need to also gain some earnings. If many investors were to engage in this activity, wealth creation, circulation and distribution among the participants of investments could be intensified, and at the same time, the poor could also enjoy the positive outcome of the investments through zakat. Consequently, investment activities can bring about benefits to society.

If then, how does investment minimises social ills? The wise Luqman gave advice to his son, he said: “… shut up poverty by lawful earnings, because he who is poor earns three habits- laxity in religious actions, weakness in intellect and loss of manliness.”

Furthermore, the state of being poor could also lead to theft, robbery and family abuses. Hence, as mentioned earlier, through investment, wealth can be circulated and distributed among the people in a society; so, this will lead to a situation whereby everyone in the society will be in a better position, financially. As a result, social ills due to poverty could then be reduced.

There are several reasons outlined by the KLSE on why we need Shari’ah compliant investments; the reasons are listed below:

i) Firstly, it says that Islam is a total way of life, whereby the Qur’an and Sunnah embodies the way in which every Muslim should conduct his daily affairs. Therefore, investment activities should also be guided by the Qur’an and Sunnah.

ii) Secondly, the general objective of the Shari’ah, in relation to profit making activities, is to maximise benefits and minimise harms, as opposed to merely maximising profits and minimising losses. Hence, through Islamic investment, this objective can be achieved, as mentioned earlier.

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8 Ibid at slide 4.
9 Al-Qur’an, Al-Maidah: 2.
10 Maulana Fazul-ul-Karim, Imam Gazzali’s Ihya Ulum-id-din (Book 2), Sind Sagar Academy, Lahore, at p. 55.
iii) And finally, there are in excess of 1.9 billion Muslims worldwide and more than $100 billion of Islamic funds in circulation globally (which is growing at the rate of 20 percent annually). Since it is a must for Muslims to earn an income from halal sources, the Islamic investment becomes an avenue for fund channelling.

Furthermore, there are a number of principles governing Islamic investment that makes it different from the conventional investment. The principles, as laid down by the KLSE are:

i) The Islamic investment should conform to the Shari’ah principles, which are based on three sources: the Qur’an, the Sunnah and the consensus of the Islamic scholars.

ii) The invested business must participate in halal venture. Therefore, investment involving elements like riba’, gambling, gharar and manufacturing and/or selling of haram products like liquor and pork are prohibited in Islam.

iii) The investment should be transparent and certain so as to provide investors with full knowledge about the nature and specifications of the investment. This is crucial in order to ensure that the investment is free from non-halal elements mentioned above. However, when the non-halal elements are unavoidable, transparent information will assist investors in purifying their income or dividend earned by giving the non-halal portion to charity.

iv) The investment should involve a tangible commodity. Hence, commodities, which are not tangible or not backed by assets cannot be invested in.

v) And finally, there is clear ownership of the investment on the part of the investor, regardless of whether or not the investor has fulfilled his/her debt obligation, obtained for the purpose of investment.

2. Types of Islamic Investments

There are a number of avenues for channelling funds in Islamic investments. Some are done privately, meaning that investments are between the contracting parties only like Ijarah contracts; while others are pooled or joint investments, which are subject to standardized rules and regulations of authorities in charge like investments in equity. In this section, we will be discussing a few types of Islamic investments that are available in Malaysia.

2.1 Equity

Investment in equity is a very well known type of investment whereby investors purchase shares of companies for either capital gains or dividends distributed by the respective companies. This kind of investment can be done on individual basis, whereby a person purchasing shares of a company like Tenaga Nasional Berhad, or it can be done through an organisation like unit trusts or mutual funds. To invest in equity shares that are acceptable in Shari’ah, the following conditions need to be fulfilled.

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12 Ibid at slide 6.
i) The main business of the company is not in violation of Shari’ah, meaning that the main activity of the company does not involve elements like riba’, gambling, gharar and manufacturing and/or selling of haram products like liquor and pork (as mentioned above).

ii) If the main business is halal, but the company is involved in borrowing money on interest, or depositing its surplus in interest-bearing accounts, thus the Muslim shareholder must express his disapproval by raising his voice against such activities in the annual general meeting.

iii) If some income from interest-bearing accounts is included as part of the whole income of the company, then the percentage of interest related income to the whole income of the company should be obtained. Then, the same percentage out of the dividend paid to the shareholder must be given to charity.

iv) The shares of a company are negotiable only if the company owns some non-liquid assets. Mufti Taqi Usmani reasoned out that if all the assets of a company are in liquid form, i.e. money, hence, the shares represents money only, and the money cannot be traded in except at par. For instance, if one share of a company sells for RM100 and it represents RM100 of money the company owns, without any non-liquid asset, thus, an investor who wishes to purchase or sell the share must be at the price of RM100 only because any disparity in price will lead to riba.

However, in the real world, with regard to the last condition mentioned above, most listed companies do have non-liquid assets like computers, factories or office equipments. Hence, differences in prices of shares can be realised and any capital gains arising from trading of shares can be recognized. However, there are questions arising with regard to the exact proportion of non-liquid assets of a company in order to enable its shares to be negotiated. Some Islamic scholars stated that the non-liquid assets must be at least 51% of the total assets because otherwise, if most of the assets (more than 50%) are in liquid form, the majority deserves to be treated as a whole, thus all of the company’s assets should be treated as liquid; some other scholars opined that if 33% or more of a company’s assets are non-liquid, its shares can be treated as negotiable; while the Hanafi school views that shares of a company can be negotiable regardless of the proportion of its liquid assets, provided that the non-liquid part should be in a considerable proportion and the price of the shares should be more than the price of the liquid amount attributed to each share.14

2.2 Commodity fund

In this type of fund, the joint pool of funds is used to purchase commodities for the purpose of reselling them; the profits generated from the sale will then be distributed on pro rata basis among the investors.15 To ensure the alignment of this kind of investment with Shari’ah principles, Mufti Taqi Usmani set out the following rules:16

i) The seller must own the commodity at the time of the sale; hence, short selling of commodities is not permissible.

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14 Ibid.
15 Ibid.
16 Ibid.
ii) Forward sales are not allowed, except in Istisna’ and Bai’ Salam contracts.

iii) The commodities must be *halal*, meaning that dealing with pork or wine is impermissible.

iv) The seller must have the physical or constructive possession of the commodity he wishes to sell; constructive possession, as mentioned by the Mufti, includes any act in which the risk of the commodity is passed on to the purchaser. For instance, if a seller does not have the physical possession of a commodity, but he bears the risk of declination in price that could lead to an unprofitable reselling of the associated commodity, then the seller is allowed to resell the commodity.

v) The price of the commodity must be fixed and known to the contracting parties; this is to ensure total elimination of *gharar* elements in the commodity trading.

### 2.3 Ijarah (leasing)

Under this type of investment, the owner or lessor of an asset (a motor vehicle or house) will lease out his assets to a user or lessee for a certain amount of money or rentals; and at the same time, the ownership of the asset remains with the lessor. The aim of this kind of investment is for the investor or owner of the asset to recover the capital cost of purchasing the asset, plus a profit margin, which are obtained out of the rental payments. There are basically two types of leases: the first is operating lease whereby the ownership of an asset remains with the lessor who puts up the asset for rent every time the lease period expires, and the lessor bears the risk of recession or diminishing demand for the asset; the second type of lease is lease purchase whereby the ownership of an asset will be transferred to the lessee at the end of the lease period. Just like equity and commodity funds, Ijarah contracts must also confirm to the principles of Shari’ah. Some of the principles highlighted by Mufti Taqi Usmani are:

i) The leased assets must have some usufruct and the rentals are charged beginning from the time when the usufruct is handed over to the lessee.

ii) The nature of leased assets enables it to be used for *halal* purposes. Therefore, investing in assets like gambling slot machines is not permissible.

iii) The responsibility of the assets lies with the lessor, as the owner of the leased assets during the lease periods. Hence, when there are any problems associated with the leased assets, it is the responsibility of the lessor to get it fixed. For example, a person rents out his house and later got a complaint from the renter, saying that the water tank is leaking. Thus, it is the responsibility of the owner of the house to make sure that the problem is solved.

iv) The rental charges must be fixed and known to the contracting parties right at the beginning of the contract. Consequently, the owner of an asset cannot simply alter the rental charges as he pleases because this will make the contract between the parties void; and hence, a new contract need to be drafted and signed.

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18 Ibid at 312.
2.4 Musharakah

Musharakah or partnership is a type of investment whereby all partners (investors) share profits of a joint venture according to a mutually agreed ratio, while losses are shared exactly in proportion to capital invested by each partner; at the same time, all partners have the right whether or not to participate in the management of the business. In relation to distribution of profits, the ratio of profit for each partner must be determined in proportion to the actual profit accrued to the business, and not in proportion of capital invested or fixing of a lump sum amount for any of the partners.

For example, if two partners, Y and Z agreed that Z would receive RM3000 every month as his share of profit, while the balance would go to Y; or if Y and Z agreed that Y will get 30% of his investment as his share of profits, then both these arrangements are invalid. An example of a valid agreement is: 30% of actual profits of business will go to Y, while the balance of 70% of actual profits will go to Z. As for sharing of losses, if Y and Z invested 45% and 55% of capital respectively, then the same percentage will be used when losses occurred. Hence, Y will have to only bear 45% of losses, while the balance will be borne by Z.

2.5 Mudharabah

Just like Musharakah, Mudharabah is also a partnership, but the difference is that in Mudharabah, one partner (investor) gives money for investing, while the other partner is responsible in providing labour and skill to manage the money; the profits generated out of the investment are shared in a predetermined ratio. The profit sharing ratio could be 50:50, 40:60, or 30:70, depending on the contracting parties. Mudharabah is one of the most well known Islamic investments and its principles are widely adopted by Islamic banks. Aside from that, Takaful insurance schemes also adopt Mudharabah principles when it comes to distribution of profits and losses between the operator and participants of policyholders. Some of the characteristics of Mudharabah are:

i) The assets of Mudharabah should be easily recognisable and must be realised and liquidated to assist in the distribution of the proceeds between the partners upon termination of operations, completion of deals, or the achievement of the Mudharabah objectives.

ii) The entrepreneur or manager of the Mudharabah funds has no right to mix the funds with his own funds, unless permitted by the investor.

iii) If partners wish to renew the Mudharabah agreement, a new contract must be negotiated. Prior to that, the old contract must be terminated and the rights and liabilities of both parties have to be recognised and settled.

22 Ibid.
24 Ibid at 310.
3. Other Types of Islamic Investments

Besides the five abovementioned Islamic investments, the KLSE also mentioned several other types of Islamic investments, including:25

i) Bai’ Salam, a forward transaction whereby cash is paid before delivery of commodities, while at the same time the quantity, quality and delivery date of goods and services had been specified clearly. In Bai’ Salam, the interest of both contracting parties are taken care of: the seller gets the money he wants in advance for the purpose of covering expenses, in exchange of his commitment to deliver the commodity at a fixed future date; and the purchaser benefits from cheap prices (normally Bai’ Salam sale is cheaper than cash sale) and he is able to hedge his position against fluctuation of commodity prices.26

ii) Istisna’, which is similar to Bai’ Salam, is an investment whereby the investor provide the needed financing for the production of products or services. The price is determined in advance and the investor need not pay the whole amount in advance, payments can be made in instalments or it can be deferred until the time the desired product or services is delivered.27 An example would be the contract between a person and a housing developer: the investor provides the needed capital for the “manufacturing” of his house, which will be completed at a future date.

iii) Murabaha, a mode of financing which is widely used by Islamic banks and financial institutions involves purchasing of commodities for the benefit of clients, and then selling it to them on deferred payment basis at an agreed margin of profits added to the initial cost of purchasing the commodity.28 For example, when a person needs to buy equipment immediately but does not have enough money to purchase it. He then requests the bank to purchase the specific equipment and agrees to buy back the item in the future at a price, which is more than the cost incurred by the bank.

4. Criteria of Islamic Investments

For Malaysian Muslims who wish to invest in companies or projects in Malaysia or internationally, qualitative screening, quantitative screening, and trading and investment practices are looked at in order to determined whether or not an investment qualifies as an Islamic investment.

4.1 Qualitative screening

Under qualitative screening, there are a few questions outlined by the KLSE that need to be answered prior to classifying an investment as an Islamic investment:29

27 Ibid at 311.
I) Firstly, “Is the company involved in an industry or business prohibited in Islam?” For example, Carlsberg involving in alcohol production; Magnum involving in gambling activities, or City Bank involving in interest-based activities. These companies are clear case of companies involving in haram activities, hence making investment in these companies not permissible and non-Islamic.

II) Secondly, “Is the company involved in activities, which are of large benefit to the Muslim community, and the haram element negligible?” For instance, a public utility company like Tenaga Nasional Berhad is involved in interest based loans and it has interest-bearing accounts. This company provides large benefits to Malaysian, including the Muslim community because it generates and distributes electricity to houses, offices and factories. Hence, in this case, the haram element (interest) is negligible, and thus, Muslim investors can invest in this company.

III) Thirdly, “Is there any element of gharar in the business?” For example, investment in conventional insurance activities involves gharar element because in conventional insurance there is no profit sharing agreements between operator and policyholders, and it is uncertain whether a misfortune like motor accidents will or will not happen. If accidents do happen, then the participant will get to claim the benefits, and on the other hand, if accidents did not take place, the insurer gets to keep the premiums received.

IV) Fourthly, “Is the company involved in exploitative and unethical activities?” For instance, if a Malaysian Muslim investor wants to invest in the Coca Cola Company in the United States, among other aspects, he will have to make sure that the company does not provide financial aids to the Israeli troops who wishes to get rid of the Palestinians in Palestine. This is to make sure that Muslim investors are free from the involvement, be it direct or indirect, in any activities that could harm other people, particularly Muslims.

4.2 Quantitative screening

In Malaysia, an Islamic investment should fulfil the criteria of having non-halal elements that are negligible, which are subject to purification from the profits and dividends received by the investor.\(^{30}\) Thus, investing in conventional banks’ shares is impermissible in the eyes of Shari’ah because a significant portion of their earnings is from interest-based sources, which are not negligible. However, in the case of investing in a housing development project for example, where the only non-halal element is associated with borrowings based on interest, which is unavoidable and insignificant in amount, then, Shari’ah wise, Muslim investors are permitted to invest in the project. Nevertheless, as mentioned earlier, the non-halal proportion of the earnings are subject to purification by means of giving it away for charity.

Furthermore, the international criteria for Islamic investment, as stated by the KLSE, revealed four types of quantitative screening that must be fulfilled:\(^{31}\)

\(^{30}\) \textit{Ibid} at slide 16.

\(^{31}\) \textit{Ibid} at slide 17.
i) Interest related income must not be more than 5% of total income and it must be purified from earnings and dividend obtained. However, there are also some other scholars who perceive that up to 10% of a company’s total income can be realised from interest-based sources.\footnote{Available at http://ihilal.com.}

ii) The debt to asset ratio of a company must not be more than 30% to 33%. The rationale is that nowadays debts are incurred from interest-based borrowings, which are not supported by Shari’ah rulings. But, since interest is unavoidable, a certain level of debt to asset ratio is specified and permitted by Islamic scholars to be in existence in a company. In addition, if the debt level is too high, it could also lead to a financial distress situation, and hence, the future survival of a company could be uncertain in the sense that the future total income might not be sufficient to cover the interest payable on the amount borrowed. This situation, which imposes an increment in the level of uncertainty relating to the future of the company, will result in investment in the company to be impermissible under Shari’ah principles. Therefore, it is a must for companies to maintain the stated debt to asset ratio in order to qualify as an avenue for Islamic investments.

iii) Liquid assets must not be more than 33% to 45% of total assets. This type of quantitative screening is essential to enable the shares of the company to be negotiated at a price different from par value, as mentioned in the equity investment section above.

iv) The ratio of accounts receivables to total assets must not be more than 45%. A high level of accounts receivables could indicate that a company is inefficient in its collection, and it could also lead to a high level of bad debt if the receivables are not collectable in the future. Too high a level of accounts receivables could then result in cash flow and financial problems, thus, it is necessary for Islamic investments to adhere to the stated accounts receivables to total assets ratio in order to ensure that Muslim investors will be protected from unfavourable situations, and to make sure that companies are well disciplined and efficient in their day to day operations.

5. Trading and Investment Practices

In the process of selecting securities to invest in, an individual investor and Islamic mutual fund operator must comply with the Shari’ah rulings applicable to trading and investing practises, which are:\footnote{Ibid.}

I) The fund or money used to invest must be free of interest-based debt; therefore, a Muslim investor is not permitted to borrow on interest in order to finance his investments. For instance, a potential Muslim investor is certain that company ABC’s shares will appreciate in the future because the company had won in the bidding of a profitable project. In order to take advantage of the future appreciation of share prices, the person wishes to purchase the shares of ABC now, so that he can sell it in the future at a higher price and thus realise capital gains; however, he
does not have enough money to purchase the shares. Therefore, according to Shari’ah rulings, the potential Muslim investor cannot borrow from conventional banks or any other sources that imposes interest on borrowings, for the purpose of financing his investment. On the other hand, he could borrow from Islamic banks or any other institutions or persons who do not require interest on borrowings; or he could engage in a Mudharabah contract with a relative for example, and share the profits at a predetermined ratio.

II) Muslim investors are prohibited from basing investment decisions on short-term speculation without prior knowledge about the fundamental values of the invested companies. Therefore, sound fundamental analyses need to be carried out before making an investment decision. Muhamad Obaidullah, said that all business decisions involve speculation because businesspersons are required to assume some level of risk, after making proper assessment of risk with the help of knowledge. Therefore, any investment activity is also a form of speculation; however, the kind of speculation that is impermissible under Shari’ah are speculation without prior knowledge and speculation which involves manipulation and could give rise to one party gaining at the expense of the other party. Prophet Muhammad S.A.W. said:

"Whoever interferes with the prices of Muslims’ goods in order to raise them deserves that Allah should make him sit in the Fire on the Day of Resurrection."

In relation to the above hadith, Islamic scholars have deduced that manipulation is prohibited when two conditions exist: firstly, manipulation that could harm the people of a country, and secondly, the manipulator’s aim is to make profit. If these elements are present and known to the Muslim investor, then he should refrain himself from going on with the investment.

6. Misconceptions and the Truth about Islamic Investments

Some critiques of Islamic investments said that Islamic investment products are rigid and the investment opportunities are limited; Islamic investments give low returns or they are underperform; Islamic investments are not innovative and stagnant; and Islamic investments are merely an alternative to the current conventional investments. These criticisms might be true in the early days of Islamic investments, but now thing have changed and the misconceptions need to be corrected.

First of all, the choices of Islamic investments are abound and they are able to fulfil the needs of investors, risk profiles and investment appetites- there are hundreds of Islamic investment products and services available in the market; there are in excess of 200 Islamic banks and financial institutions globally; and there are more than 150 Islamic funds available globally in Malaysia, the Middle East, US and Europe.\(^{39}\) The many products and avenues of Islamic investments available in the market today clearly remove the first criticism that Islamic investment products are rigid and have limited opportunities. Now, Muslims can invest in Shari’ah approved investments not only in their respective countries, but they can also do so in other countries, including non-Muslim countries like the United States or United Kingdom.

Secondly, over the past few years, Islamic investments had actually outperformed conventional investments in terms of yielding higher returns- the average returns on investments on Islamic funds in Malaysia were 20% to 35% on average for the year 1998; 45% to 55% on average, with the highest return being 102.7% in the year 1999; and 81% average, with the highest figure of 116% as at year end March 31st, 2000.\(^{40}\) These are clear evidences that Islamic investments are much better off than conventional investments. By complying with the teachings of Islam, as written in the Qur’an and Sunnah, greater benefits can be realised, compared to following human made policies and regulations, which are subject to injustice and defects. Furthermore, the higher rate of returns offered by Islamic investments serve as the biggest attraction for investing in Shari’ah approved investments.

Thirdly, Islamic investments are open to non-Muslims and they are also available in non-Islamic nations; for instance, in the US and Europe, investors from all ideologies and religion invest in Islamic funds, and in the US the Dow Jones Islamic Market Index (DJIM) was established.\(^{41}\) The establishment of DJIM in the US points out that Islamic investments are widely accepted, even in non-Muslim countries. Moreover, there is no Shari’ah rulings or clauses in the Qur’an and Sunnah, which disallow the non-Muslims to invest in Islamic investments. Hence, everyone is free to participate and become an investor in Islamic investments.

Fourthly, constant Research and Development (R & D) are conducted to develop new and innovative Islamic products and services- in the year 2001, there are over 150 Islamic funds worldwide, which were growing at the rate of 100% per year; Islamic investment principles are being taught in universities in Malaysia, Middle East, Europe and US; and there are numerous training centres worldwide like the BIMB Institute of Research and Training (BIRT) in Malaysia, which aims to train professionals in the field of Islamic finance.\(^{42}\) With the existence of universities and training centres worldwide, more skilled and knowledgeable persons in the area of Islamic finance and investments can be produced. Thus, further development of Islamic products and services can be offered (to the Muslims in particular), which are capable of competing and outnumbering the quantity of the conventional investment products and services offered in the global market today. With the current level of growth in Islamic products and services, it is foreseeable that in the future, Islamic products and services are able to capture more market share, be it in Islamic or non-Islamic nations.

\(^{39}\) Ibid at slide 11.
\(^{40}\) Ibid at slide 12.
\(^{41}\) Ibid at slide 13.
\(^{42}\) Ibid at slide 14.
And finally, it is argued that Islamic investments are not merely an alternative to conventional investments, instead they can “hold their own”, meaning that Islamic investments can survive without the “help” from conventional investments- Islamic financial opportunities are currently growing at a high rate, and it is estimated that by 2010, 50% to 60% of the world’s savings will be in Islamic institutions. Thus, it is evidenced here that Islamic investments are indeed getting more popular, and in a few years time, at least half of the world’s savings will be channelled into Islamic investments, as more people gain confidence in Islamic products and services.

7. Future of Islamic Investments

With the ever-growing number of new Islamic investment products and services being offered and accepted in the market, there remains a potential danger that when people are too engross in innovation of new products and services, they might neglect or abandon some Shari’ah rulings just to suit their innovative minds. Therefore, it is necessary to have a global Shari’ah Advisory Council to standardise the rulings relating to Islamic investment products and services innovated, to ensure their alignment with Shari’ah principles.

As it is, in Malaysia and other countries, there are several Shari’ah Advisory Councils (SACs) established to monitor and ensure that Islamic products and services developed are Shari’ah compliant. However, since there are several SACs present, there are issues that do not get unanimous consensus from Islamic scholars. For instance, some scholars in Malaysia allowed Bai’ al-dain investments, while other scholars outside of Malaysia prohibited it. Therefore, establishing a global Shari’ah Advisory Council is needed to solve these kinds of issues. In addition, it is possible that in the future, when Islamic investments are highly preferred to conventional investments, there might be people who are illiterate in Shari’ah rulings, who creates new kind of investments and labels them as Islamic investments just to market them. Hence, if a Shari’ah Advisory Council is set up at the national level, a list of Shari’ah approved Islamic investments can then be produced and publicized so as to protect Muslims from mistakenly investing in investments that use Islamic labels, but are actually non-compliant with Shari’ah rulings.

Concluding Remarks

Gaining enormous wealth is the basis of all sins; when we are wealthy, we become arrogant, we tend to forget to fulfil our obligations to god and we forget about our responsibilities because all we care about is to enjoy the money that we have. To a certain extent, some wealthy people might also think that they are equal to god, like the pharaohs during prophetic times. But, this does not mean that the beggars are better off in the eyes of Allah compared to rich people. Prophet Muhammad S.A.W. said:

“God loves one who adopts the path of labour to save himself from depending on others.”

43 Ibid at slide 15.
44 Ibid at slide 22.
46 Maulana Fazul-ul-Karim, Imam Gazzali’s Ihya Ulum-id-din (Book 2), Sind Sagar Academy, Lahore, at p. 56.
47 Ibid at p. 54.
Furthermore, when the prophet Muhammad saw a young man running to his shop and bypassing, without stopping at the mosque of Medina, he said:

"If the young man runs with the object of not depending on others and refraining from begging, he is in the way of god."\textsuperscript{48}

The point here is that being wealthy is not a sin, but instead, it is a gift from Allah. Consequently, wanting to be rich through investment activities are permitted by Islam. By being wealthy, a Muslim could also help those in need by donating more money, for the course of Islam. What matters here is that wealth created through investments must be from halal sources, based on Shari’ah principles; and wealth must also be spent for good purposes and not to be wasted on unnecessary things.

\textsuperscript{48} Ibid at p. 54.
Microfinance in Sudan and Ethiopia

By

Professor Badr El Din A. Ibrahim*

Abstract

The purpose of this paper is to review and compare the distinct features and practices of Sudanese and Ethiopian microfinance sector. Analysis includes general characteristics of both sectors such as institutional structures/characteristics, policies, programs, regulation, strategies, wholesale markets, technical assistance etc. Moreover, the major characteristics of microfinance institution (MFIs) in both countries are compared, and a review and comparison of some performance criteria of MFIs is made. The methodology consists of analyzing and examining issues at hand using some indicators and qualitative information. The paper come up with some recommendations regarding the constraints facing microfinance (MF) sectors in the two countries, and also suggests how the two microfinance experiences can learn from each other. The Sudanese MF experience, we argued, can give a lesson from its diversified wholesale market via the government-owned Wholesale Guarantee Agency. The paper also propagates the merits of Islamic microfinance as practiced in Sudan to Ethiopia-Muslim minorities. We argued that this can be carried out via new windows or specialized branches within the existing MFIs; no need for a new legislations or a new MFIs structure. Sudan can learn from the role and functions of AEMFI, to establish the Sudanese Association of Microfinance Institutions. Sudan can also learn from the Ethiopian social management system to self monitor the social impact of microfinance on their clients. The paper is constrained by the limitation of quantitative data, especially financial data, regarding the Sudanese MFIs. This hinders deep comparison of the financial performance of MFIs in the two countries. More research is required in this area.

Keywords: Microfinance Institutions, Islamic microfinance, Micro insurance.

1. Introduction

The Sudanese microfinance experience is one of the rare ones that have been greatly supported by the Central Bank legislation and policies. It is full-fledged,
nationally-supported Islamic microfinance practice, based on gap and need-filling, managed to produce a full-fledged and nationally integrated Islamic microfinance model, described by the World Bank's Consultative Group to Assist the Poor (CGAP) as:

“A laboratory for Islamic microfinance delivery where developments could shed light on effective Islamic microfinance practices”\(^1\).

Moreover, the recent International Monetary Fund (IMF) Report, the IMF Article of Consultation, 2013 (Sudan) stated that:

“The microfinance sector is small but growing rapidly, thanks to the authorities’ active promotion. The results of this push have been impressive to date. The number of MF borrowers went from 49,000 at end-2007 to 494,000 by 2012. In terms of active clients, Sudan and Bangladesh are easily the global leaders in Islamic finance microfinance, with Sudan likely to take top spot given current growth rates”\(^2\).

Likewise, the Islamic Development Bank, IDB, highly appraised the outcome and the vision of the US$ 60-million MF Partnership with the Central Bank of Sudan and declared its replication in other member states.\(^3\) Similarly, the Ethiopian microfinance experience is also supported by the Central Bank legislation and policies. It is also one of the pioneering (and significantly growing microfinance) sector in Africa, in terms of outreach, portfolio, performance and sustainability. It is also one of the successful experiences in clients’ saving-mobilization and building of saving culture among MF clients. This expands outreach and led to low-cost micro-lending.

The purpose of the paper is to review and compare the nature, distinct features and practices of Sudanese and Ethiopian microfinance sector, as an example of two African experiences. The methodology consists of a critical review and examination of existing experience using some indicators. The major objective is to come up with certain conclusions regarding the ways and means for cooperation between the two experiences. Analysis includes general characteristics of both sectors such as: institutional structures/characteristics, MF policies, programs, regulation, strategies, wholesale markets, technical assistance etc. It will then move to assess the major characteristics of MFIs in both countries. The review of some performance criteria of MFIs (outreach, efficiency, Portfolio at Risk (PaR), operating expenses, growth of microfinance sectors) will follow. The final section covers means for cooperation in MF between Sudan and Ethiopia.

### 2. General Characteristics of Microfinance Sectors in Ethiopia and Sudan

Both Sudan and Ethiopia microfinance sectors are fast growing ones. Nevertheless, the gap between the clients covered and the potential clients is still wide. According to the new National MF Strategy in Sudan, around 1.5 million clients need to be reached in

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\(^3\) IDB Conference on Employment, Riyadh, March 2014.
the year 2017, compared with less than half a million client reached in 2012⁴. Estimates of potential clients by the writer are 7.2 million (out of nearly 15 million estimated poor), and only around 8% of those potential clients were covered⁵. In Ethiopia studies indicating that 85% of rural poor remain without access to finance. 10.4 million are expected to receive loans over the next decade by around 106 million Birr.⁶ The following Table (Table 1) shows some general characteristics of MF in the two countries.

Table 1: Some General Characteristics of MF Sectors in Sudan and Ethiopia.

<table>
<thead>
<tr>
<th>Description/Countries</th>
<th>Sudan</th>
<th>Ethiopia</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Regulatory Body</td>
<td>The Central Bank of Sudan (CBOS)</td>
<td>The National Bank of Ethiopia, NBE (the Central Bank)</td>
</tr>
<tr>
<td>Institutional Support</td>
<td>National intuitional support. In addition to the regulator (the Central bank of Sudan), there are national councils, MF planning units, and MF Co.</td>
<td>A regulator (National Bank of Ethiopia). In addition to the active MF Association.</td>
</tr>
<tr>
<td>Wholesale Market and wholesale Guarantee Agent</td>
<td>Include funds from the CBOS, commercial banks, states funds to MFIs, donors/foreign sources and wholesale funds from partnership program (CBOS/IDB partnership). Works to establish a government-financed Wholesale Guarantee Agency is completed and the Agency will be launched soon.</td>
<td>No wholesale guarantee Agency exist, but some commercial banks lend to MFIs with strong third party guarantee (regional governments or donors), in addition to the Development Bank subsidized fund. Most of lending is coming from MFIs clients' deposits, and some from donations and grants money from their mother NGO in addition to income from lending activities. The National Bank of Ethiopia is not part of the wholesale lending.</td>
</tr>
</tbody>
</table>

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### Apex Institution/s

| Apex Institution/s | The Sudanese Microfinance Development Company (SMDC). The Microfinance Unit of the Central Bank of Sudan (MFU/CBOS) and the CBOS/IDB partnership are also taking the role of an Apex Institutions. | Non-existing. |

### Microfinance Association

| Microfinance Association | Non-existing. | Exists since 1999. |

### Loan Tracking System

| Loan Tracking System | Unified system exists. | Each MFI has a small suitable loan tracking system. |

### Credit Bureau

| Credit Bureau | Existing for all MFIs clients. | Non-existing. |

### Technical assistance

| Technical assistance | Through the Sudanese Microfinance Development Company, MFU/CBOS, and CBOS/IDB partnership program. | Through the Association of Ethiopian Microfinance Institutions (AEMFI). |

### Potential MF clients

| Potential MF clients | 1.5 million Clients are expected to be reached in the year 2017 (The National Microfinance Strategy). Estimates of the national potential MF clients by the writer is 7.2 million out of nearly 15 million poor, estimated officially (total population in Sudan is around. | Studies indicating that 85% of rural poor remain without access to finance. Additionally, 10.4 million need to receive loans over the next decade by around 106 million Birr. |

In the two countries, the regulatory body of the MF sector is the Central Bank. Moreover, there are MF strategies in both countries. The Sudanese MF experience is fully-Islamized with a role played by Islamic insurance (takaful- solidarity). Moreover, the wholesale market and technical assistance to the sector are wide in coverage and many institutions are involved. The Sudanese experience realizes the role of the apex institution, despite the fact that it is still limited. The existence of credit registry of MF clients’, national support to the sector via councils and units, as well as the wholesale guarantee agency are credit to Sudanese experience. On the other hand, the microfinance association (AEMFI) and deposit-taking MFIS are credit to the Ethiopian experience.

Both Sudan and Ethiopia microfinance outreach is growing very fast. In Ethiopia, the number of active clients was only about 746 thousand in 2003, increased gradually to 2.8 million in June 2013. The active loan portfolio increased from 589 million Birr to 11.2 billion Birr during the same period. Average loans increased from 789 Birr to more than 4 thousands Birr, and the total savings from 324 million to 6.7 billion during the same period (covering about 60% of outstanding loans). Moreover, out of outstanding portfolio in the first quarter of 2013 of 10 million, saving was Birr,7 million Birr. Moreover, MFIs, according to the Five Year Development Strategy are expected to provide loans of about 11 billion Birr during 2011-2015, and attract saving of about 8.8 million Birr. MFIs managed to mobilize nearly half of that amount (around 4.1 million
Birr) in two and a half years (up to mid-2012). The Ethiopian microfinance sector is characterized by its rapid growth, with strong government backing and emphasis on social aims, rural areas (and rural poor), the promotion of both credit and saving products and on sustainability of MFIs. The sector outreach is impressive and the financial performance of the sector is good, although the operational margins and profitability are low.

Likewise in Sudan the number of microfinance clients (banks and MFIs) increased from 244 thousands in 2011 to 490 thousands in 2012, further to 970 thousands in June 2014. The volume of banks finance increased from SDG 1060 million in 2011 to SDG 1670 million in 2012. Nevertheless, Sudan financial inclusion indicators, according to the Global Findex, 2012 were far below other developing countries' groupings. For example, the percentage of clients 15 years and above who have loans from a financial institution in Sudan were only 2%, compared with 11% for lower-income countries, and 5% in Sub-Saharan Africa. Likewise, the percentage of clients 15 years and above who have credit card in Sudan were only 1%, compared with 2% in lower-income countries, and 3% in Sub-Saharan Africa. Only 7% who had account at formal financial intuitions in Sudan compared to 20% in other lower-income countries, and with 24% in Sub-Saharan Africa. Only 7% who make saving at a financial intuition, compared with 11% in other lower-income countries, and 14% in Sub-Saharan Africa. The degree of financial inclusion coverage witnessed an improvement. According to our calculation from the CBOS and the, Population Cenus' statistics, the financial inclusion’s coverage among the officially estimated Sudanese poor for both banks and MFIs is improving over time. In 2012 banks and MFIs were capable to cover 8.2 of the total economically active poor 18 years and above compared with only 0.66% in 2007.

The following table (Table 2) shows some indicators related to MFIs in the two countries.

Table 2: MFIs in Sudan and Ethiopia- some comparative indicators.

<table>
<thead>
<tr>
<th>Description/Countries</th>
<th>Sudan</th>
<th>Ethiopia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Duration of finance.</td>
<td>One year or less.</td>
<td>6 months to 5 years.</td>
</tr>
<tr>
<td>Profit Margin(interest/Murabaha)</td>
<td>15-18% -declining rate - per year (Murabaha; sale-based margin).</td>
<td>10-25% flat rate; average 14% (flat rate per year interest rate).</td>
</tr>
<tr>
<td>Type of finance.</td>
<td>Type of finance.</td>
<td>Mainly group lending via associations. Individual loans are also granted.</td>
</tr>
</tbody>
</table>

Number of MFIs.  

<table>
<thead>
<tr>
<th>Non-deposit-taking institutions</th>
<th>Deposit-taking institutions</th>
</tr>
</thead>
<tbody>
<tr>
<td>MFIs are diversified (privately-owned MFIs, cooperatives credit union, foreign NGO-transformed MFIs, states-supported MFIs, women and youth associations MFIs, commercial banks-affiliated microfinance Cos. (MFIs) etc.</td>
<td>'share companies'. Most MFIs are NGO-transformed into MFIs (local NGO-affiliated MFIs). Few are regional government - supported MFIs and privately-owned MFIs.</td>
</tr>
<tr>
<td>More than 170 branches of MFIs.</td>
<td>More than 1000 branches and sub-branches.</td>
</tr>
</tbody>
</table>

Sectors financed (types of loans).  

| Agricultural loans, livestock loan, crafts, petty-trade, services, commerce, industry loan, Small-holders agricultural loans and others. | Agriculture, housing, petty trade, general purpose loan, input loan, staff loans for school fees, micro and small enterprises, trade, services, consumption loan and others. |

Micro-insurance  

| Existing (Islamic micro Takaful). | On small scale and by some MFIs (crop, health and home insurance). |

On small scale and by some MFIs (crop, health and home insurance).  

| Provided by the clients and reviewed by an MFI. | Provided by the clients and reviewed by an MFI. |

Average loan size.  

| SDG 20 maximum (approx. US$ 4000). | Depending on capital volume (maximum 1% of capital), ranging between US$ 50-US$ 600; US$ 212 on average. |

Collateral.  

| Individual guarantee, personal guarantees of a third party supported by a cheque, mortgage of movable properties, guarantee funds for loans of the civil society organizations, undertakings of the local community, security of the monthly salary, attachment of savings, mortgage of salaries, incomes and pensions, keeping documents in custody, legal undertakings not to dispose of assets, etc. | Individual and mainly group guarantee: leased land, third party guarantee, building house, fixed asset, semi-blocked saving account machinery, salaries, guarantee from municipality, individual guarantee, own/third party asset, donors group guarantee, peer pressure, group guarantee etc. |

The Ethiopian microfinance market is dominated by few large MF players (in terms of borrowers, gross loan portfolio), some of which are closely linked to regional government ownership and Credit and Savings Institutions. Likewise in Sudan the sizes (portfolio and borrowers) of MFIs are different, and so the date of establishments. Some are Social Development Institutions in Khartoum and Kassala, pensioners' Institution (in
Khartoum) and Rural Development Company (in Khartoum) dated back to 1970s and 1990s and turned into MFIs in 2008 and 2009 respectively. Most of MFIs were established in 2013 on ward. In all states there are government owned MFIs, and all MFIs are guided by the Regulatory Framework to Establish MFIs issued by the CBOS in 2011 (amended in 2014).

In Sudan the financing policies of the CBOS set a reference to Murabaha margin around 15%. MFIs need to work around that margin. In 2014 MFIs and banks are required to set their own rate that is suitable to the type of clients in the sector. The rate is still between 15-18%. In Ethiopia and until 1996 interest rates were set by the National Bank of Ethiopia (NBE), and capped at 12.5% per year. In May 1998, the NBE increased the maximum ceiling of the lending interest rate of MFIs to 15.5% per annum. Since 2002 the cap has been removed and the directive stated that interest rates should be determined by each MFI’s board of directors. In Sudan trade and commerce are the dominant sectors for microfinance, and agriculture comes next, while the craft sector is the least favorable sector. In terms of sector composition in Ethiopia, agriculture is the main sector for microfinance, however loans aimed at micro and small enterprises also feature, as well as housing loans, consumption loans and equipment loans.

According to Table 2 above, there are many similarities, mainly in Portfolio at Risk (PaR), profit margin, collaterals, and the number of MFIs, but all Ethiopian MFIs are deposit-taking, with more than 5 times numbers of branches compared with the Sudanese MFIs. Ethiopia MFIs mainly practiced group-lending and have a high clients’ outreach than Sudan. Savings consist of compulsory savings, voluntary savings and term deposits. Other products such as insurance (e.g. for crops, health and home) are offered by some MFIs, particularly the government sponsored programs, as well as money transfers and pension administration. Sudan MFIs, on the other hand are not deposit institutions and finance come mainly from the wholesale market in addition to self-financial resources. MFIs in Sudan have fewer borrowers per loan officers, and a higher maximum loan size compared with Ethiopian MFIs. Islamic micro-insurance is dominant and 13 insurance companies are offering this service. In recent years, insurance is getting momentum, following the CBOS issuance of the Micro Comprehensive Insurance Document. Money transfers are practiced, but on a small scale. This product will be activated in the coming years. Mobile banking is underway.


The National Bank of Ethiopia (EBE) took over the responsibility to license and organize the working of MFIs. The NBE is helping MFIs through prudential regulations. These regulations were aimed at promoting the sector to alleviate poverty, introducing financial discipline and best delivery of financial services, protecting depositors prohibiting NGOs which mix charity with lucrative lending. NBE license, supervise and regulate financial institutions such as banks, insurance companies, microfinance institutions and savings and credit cooperatives. The Licensing and Supervision of Banking Business Proclamation No. 84/1994 allowed for the first time the establishment of MFIs in Ethiopia. In 2011, the CBOS issued a new framework to establish MFIs, which included guidelines on the regulatory framework, licensing, supervision, and prudential regulations. This framework aimed to provide a conducive environment for the development of the microfinance sector in Ethiopia.

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9 Directive No. MFI/11/98
of private financial institutions, thus breaking the state monopoly. To date, six private banks and eight private insurance companies have been established.

The MF first step was in 1996 when Proclamation 40/1996 was issued as a regulatory and supervisory framework of financial services delivery MFIs to provide licensing for deposit-taking MFIs in Ethiopia all are wholly owned by Ethiopian nationals or by organizations that are wholly owned and registered in Ethiopia. Now 31 MFIs were given licenses. The proclamation prohibits NGOs and any other institution from offering financial services and limited microfinance lending to MFIs, banks, and cooperatives. According to the Proclamation, any institution that needs to engage in microfinance activity should fulfill the following: (1) obtain license from the National Bank of Ethiopia; (2) formed as a company governed by the commercial code of 1960 (a share company owned fully by Ethiopian nationals and having its head office in Ethiopia); and (3) deposit the minimum capital required, i.e., 200,000 Birr in a bank. In 2009 another proclamation was issued that focuses on institutional financial discipline and transparency of MFIs. The proclamation allows MFIs to issue microfinance insurance policy as well. Moreover, the National bank of Ethiopia issues a directive (number 25/2013) raising minimum initial capital requirement of MFIs from around US$ 26300 to US$ 104000. The objective is to enhance the equity-base of MFIs and to protect depositors.

The inclusion of microfinance in the central banks policies in Ethiopia and Sudan was made some years ago. In Sudan and in 2007 an administratively independent MF Unit (MFU) was established at the CBOS to organize the MF sector. In 2011 The Regulatory Framework to Establish MFIs was issued. The Framework covers regulations of both deposit- and non-deposit taking MFIs, and includes three licenses: provisional license, final licenses and license to start the business. Conditions include licensing and its duration, regulations, forbidden activities, capital requirements as well as documents required for final license (business plan, market study etc.).

Sudan MF development is a unique, full-fledged nationally-supported experience. It is one of the rare experiences that have been heavily supported by the Central Bank of Sudan (CBOS) legislation and policies fully geared towards the entire Islamization of MF lending. The inclusion of microenterprises as a priority for banking finance was made for the first time in 1990 the Financing Policy of the CBOS incorporated the craftsmen as one of the priority sector for banking finance. In 1994/95 the CBOS financing policy incorporated “Craftsmen, Professionals and Small Producers Including the Productive Families” as a priority sector for financing, with some preferential treatments. To ease the finance the CBOS identified 15 types of guarantees/collateral suitable for this sector. The CBOS identified some Islamic lending modes of microfinance. The CBOS also includes MF as a priority sector for banking finance, with a minimum allocation of 12% of the banking portfolio and project finance of 20 thousands SDG (Sudanese pound; approximately US$ 4000) as a fund of ceiling. The Sudanese experience is working with nontraditional guarantees and include Islamic insurance (Takaful) as guarantee via the Comprehensive Insurance Document (covering: money lend, assets and Takaful- physical disability or death). It introduces the wholesale lending to MFIs via a governmental agency (Wholesale Guarantee Microfinance Agency, Kafalat) to siphon banks’ wholesale
finance to MFI with 75% risk-sharing at a cost of 0.5% of the total loan via restricted Mudarabah contract.  

4. MF Institutional Development, Wholesale Market and Technical Assistance

4.1 Institutional Development

The Sudanese experience successfully managed to build smoothly run, organize and coordinate MF institutions, councils and units, namely: the Higher Council for Microfinance (HCMF). The objectives of this national council are: (1) re-orient the political speech towards a correct understanding of MF as an investment based activity (2) ensure Transparency and establish a mechanism to protect clients, (3) change the CBOS Vision for the Development and Promotion of MF (2007-2012) to a National Comprehensive MF Strategy (NCMS) and implement it (4) incorporate MF indicators into macroeconomic and sectoral policies, (5) determine priority sectors for financing at the state levels, (6) enhance export development and import –substitution MF projects, (7) link small- and large producers via Value Chains, Franchise and Sub-Contracting and (8) spread and Develop Self-Employment Culture, Initiation and Entrepreneurship. In addition each state formed a State Councils of Microfinance. There are also Microfinance Units at the Central Bank of Sudan’s regional branches and at each headquarters of commercial banks, as well as Microfinance Planning Units at related ministries, Microfinance Institutions and Microfinance Project Development Centers.

As for mechanisms of consumer protection the two countries are different. AEMFI has been working with several initiatives, including the Smart Campaign, the Social Performance Task Force and MF Transparency to advance consumer protection within the microfinance sector. Sudan has not gone further than discussing the relevance and the importance of the seven principle of smart campaign. The relation of MFIs with the MIX Market in the two countries is different. The majority of Ethiopian microfinance institutions reported financial and operational performance data to MIX Market since 2009, showing the sector’s adherence to international reporting standards. In Sudan, with the exception of one MFI (PASED), all others do not report data to MIX Market. As for rating of MFIs, some Ethiopia MFIs have gone into ratings checks of their financial and operational performance. In Sudan none of MFIs have gone into rating agency whether local or international.

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12. This government agency was meant to guarantee wholesale finance from commercial banks, CBOS, and other donors to the licensed non-deposit taking MFIs. The major objective is to drain off the remaining un-used funds of the 12% of the banks' microfinance portfolio from banks to non-deposit taking MFIs. Works is now underway for the Agency to start operation very soon.


14. In accordance with the direction of the HCMF, the first Microfinance Project Development Centre (PDC) was inaugurated early January 2013 by Gezira State. Moreover, Project Planning Units (PPU) were established in 8 state ministries to perform studies of projects related to the ministry, to provide technical information and perform annual plans to execute each ministry-related microfinance projects, coordinate with stakeholders and finance providers, conduct feasibility studies and organize clients into groupings.
4.2 Technical Assistance

To provide technical assistance to MFIs, the CBOS signed an agreement in 2011 with the Islamic Development Bank (IDB) to allocate $59.5 million joint fund for technical support, IT and wholesale finance to MFIs. The CBOS and the Ministry of Finance and National Economy (donors and the World Bank) established a $20 million capital Sudanese Microfinance Development Company (SMFC) to support MFIs via disseminations of best practices, technical assistance, training and wholesale financing. The CBOS also reorganized government MF specialized banks (Saving and Social Development Bank and Agricultural Bank of Sudan) for more effective microfinance service delivery. The CBOS/MFU since 2007 is active in providing MF training awareness programs (for credit officers, training of trainers, TOTs, managers, parliamentary members, mediators, local and foreign NGOs etc.

Most of the technical assistance (training) to this sector is undertaken by the Association of Ethiopian Microfinance institutions (AEMFI). This association was established under the Ministry of Justice in June 1999 as a nonprofit, non-governmental organization. Since its establishment, AEMFI’s goals and activities have expanded to include training, research, promotion of professional standards, experience sharing, exposure visits, performance monitoring and benchmarking and provision of technical assistance.

4.3 Wholesale Market

The wholesale programme in Sudan is dominated by the CBOS and shared by commercial banks, SMDC, and partnership with IDB. As of May 2014, out of SDG 328 millions funds allocated for microfinance by the MFIs, the share of self employed financial resources 14%, the CBOS share 53%, IDB partnership18%, SMDF 10%, and commercial banks 5%.

The wholesale market in Ethiopia is scattered and narrow as most of lending is coming from MFIs clients’ saving (deposit financing). Moreover, there is no role played by the National Bank of Ethiopia in this market. Some commercial banks lend to MFIs with strong third party guarantee (regional governments or donors). Most of MFIs in Ethiopia started as NGOs with grants and concessional loans from donors, government and international financial institutions. The major wholesale program in Ethiopia is the Rural Financial Intermediation Programme I and II. The programme is a nationwide initiative to reduce rural poverty, through providing sustainable access to rural households to a range of financial services through a nationwide network of some 31 MFIs and about 5,500 RUSACCOS (and 100 unions of RUSACCOS), particularly in the country’s pastoral and agro pastoral lowlands, and to encourage MFIs to open branches in these areas and establishing about 1,000 new rural saving and credit cooperatives (RUSACCOS) and 45 unions. By programme completion, it is expected that MFIs and RUSACCOS will have expanded outreach in the delivery of financial services to 6.1

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million MFI clients and 765,000 financial cooperative members respectively (of which half will be females).

4.4 Microfinance Strategies

Encouragement of MFIs in Ethiopia is part of the main instrument to combat poverty and provide food security, as identified by the Growth and Transformation Plan and the Five-Year Micro and Small Enterprise Development Strategy, via increasing financial access to the excluded population by nearly 4 times from 20%. In the Five-Year Micro and Small Enterprise Development Strategy it was expected to provide 11 billion Birr to 2.2 million clients, via the development of financial products, enhance saving, enhance the capacity of MFIs and make use of the best international practices in microfinance.

In Sudan, the CBOS started the development of the microfinance through the Vision for the Development and Expansion of MF Sector in Sudan -2007-2012. The vision includes: conducive legal and policy environment (revision of banking laws, diversification of services/products, alternative collaterals and MFU at CBOS); support of MFIs (develop sustainable MFIs), and supportive infrastructure (information base, coordination of MF activities, set benchmarks and standard performance, capacity building programs). Nowadays the Higher Council for Microfinance (HCMF) is embarked on a national strategy (the National Comprehensive MF Strategy, 2013 -2017), to replace the CBOS Vision for the Development and Expansion of MF Sector in Sudan, 2007-2011 (HCMF, 2013). The strategy was approved by the Higher Council of Microfinance (HCMF) on 13th of May 2013 and become effective. This microfinance strategy, covering the period up to 2017, will includes all microfinance stakeholders. The expected outcome of the strategy is to (1) achieve 3% share of this sector to GDP, up from 1% (calculated as a volume of MF to GDP ratio), (2) increase the number of beneficiaries of limited income group from 494 thousands in 2012 to 1.5 million in 2017, (3) achieve 20% increase in MFIs at least, 200% increase in the number of poor clients (18 years and above), from 8.2% in 2012 to 24.6% by 2017, (4) increase the volume of female finance from 30% to 50% at the end of the strategy, (5) 50% increase in the number of commercial banks working in MF and 100% increase in the MF portfolio at least and (6) reduction of the informal sector by 5%.

5. Overall Performance, Constraints and Recommendations

In accordance with the 3 major criteria to assess the international best practices of microfinance institutions: innovation, sustainability and impact, we made value judgement of the two countries depending on the information herein as follows:

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Table 3: Sudanese and Ethiopia Microfinance Performance in the Global Best Practices

<table>
<thead>
<tr>
<th>Rating</th>
<th>High</th>
<th>Moderate</th>
<th>Low</th>
<th>High</th>
<th>Moderate</th>
<th>Low</th>
</tr>
</thead>
<tbody>
<tr>
<td>Countries</td>
<td>Sudan</td>
<td>Ethiopia</td>
<td>Sudan</td>
<td>Ethiopia</td>
<td></td>
<td></td>
</tr>
<tr>
<td>International Best Practices in:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Innovation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Characteristics of clients’ chosen</td>
<td>-</td>
<td>X</td>
<td>-</td>
<td>X</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Social performance management.</td>
<td>-</td>
<td>-</td>
<td>X</td>
<td>X</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Innovative financial systems.</td>
<td>X</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>X</td>
<td>-</td>
</tr>
<tr>
<td>Sustainability</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Strategies.</td>
<td>X</td>
<td>-</td>
<td>-</td>
<td>X</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Decentralization model.</td>
<td>X</td>
<td>-</td>
<td>-</td>
<td>X</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Use of technologies.</td>
<td>-</td>
<td>X</td>
<td>-</td>
<td>-</td>
<td>X</td>
<td>-</td>
</tr>
<tr>
<td>Design of products.</td>
<td>-</td>
<td>-</td>
<td>X</td>
<td>-</td>
<td>-</td>
<td>X</td>
</tr>
<tr>
<td>Impact</td>
<td></td>
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<tr>
<td>Monitoring of assessments.</td>
<td>-</td>
<td>X</td>
<td>-</td>
<td>X</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Focus of assessment *</td>
<td>-</td>
<td>X</td>
<td>-</td>
<td>X</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Overall Performance</td>
<td>3</td>
<td>4</td>
<td>2</td>
<td>6</td>
<td>1</td>
<td>2</td>
</tr>
</tbody>
</table>

* Client’s economic and no-economic situation: institution as a whole/environment and society.

If we assign points to performance in such a way that the high performance receives 3 points, moderate 2 points and low 1 point, then out of overall points of 27, Sudan scores 19 points (71.4% out of the total points) and Ethiopia scores 22 points (81% out of the total points). This overall result clearly indicates that the overall performances in the two countries are good, and Ethiopian performance is relatively better than Sudan.

One of the major constraints and challenges of microfinance in Sudan is that the MF is mainly viewed as intervention to reduce poverty and not integrated to the macro-economic objectives. Moreover, MF is viewed only as credit-based lending, with little use of micro-insurance, micro-saving, money transfer. Most clients believe that credit should be before growth (loan before the existence of the project itself). Most people working in MF area believe that MF profit margins (Murabaha- sale-based margin) should be centrally controlled to protect the clients. Some clients viewed microfinance as a charity lending, not a lucrative business, and some MF providers believe that microfinance activities do not lead to institutional sustainability. Finally, Most MF activities are intended to meet local-demand. They are not export oriented.

In Ethiopia in spite of the significant outreach of the microfinance institution, mostly in terms of number of clients reached, a significant amount of saving mobilized among the clients, a good repayment rates, a very good and personalized relationship
with clients \(^{18}\), but there are constraints need to be addressed. Among these are limited supervision and technical support by the Government, low interest rates charged (affecting self-sustainability), gap in serving more structured micro enterprises, low technical capacity, lack of product diversification, inadequate management information system, weak awareness of the role of microfinance in poverty alleviation, weak legal system, limited capacity of the national Bank of Ethiopia, limited capacity of MFIs and poor infrastructure, and lack of access to foreign capital and donor funding.

Sudan microfinance sector needs to ensure real public awareness programs to remove many misconceptions. Moreover, provision of financial literacy programs, establish investment maps, and exhibitions. Ensuring a social development-oriented microfinance sector and a full use of Islamic MF potential are also required. In addition, the sector need to coordinate the already strong national microfinance efforts, guarantee client-protection policy and mechanism, move towards export-orientated MF products and ensure international performance measurement of banks/MFIs, and make certain an evidence-based MF polices. Finally, this experience is also required to diversify projects and make heavy use of modern technology. \(^{19}\)

In both Sudan and Ethiopia, there are common constraints that hinder the development of MFIs such as poor management information systems (MIS) and lack of efficient loan tracking and accounting soft-wares, and lack of skilled personnel, lack of means to protect clients and lack of specialized consulting firms and local rating agencies and specialized training institutes in addition to politicization of microfinance.

6. **Means for Cooperation**

One of the lessons from Sudanese MF experiences that Ethiopia can learn from is Islamic microfinance via specific branches or windows in geographical areas where Muslims are dominant (Afar and Somali land, for example).

The Islamic microfinance does not need strong guarantees because the Islamic system focuses on the operations more than the customer’s financial capabilities, as it is the case in the *Musharaka* (Islamic partnership) because this formula of partnership in profit and loss is the best invisible security for microfinance and the customer does not have to pay against risks of loss. Also, since the Islamic system basically depends upon the principle of partnership, any request by the bank for a guarantee shall be a guarantee against cheating or procrastination in repayment and not to cover the risks of loss. In addition, the net rewards (and the return on capital) of Islamic partnership arrangement are greater than the net income (and the returns on capital) from


paying the typical interest rate. Islamic MF can avoid ‘double burden’ of loss of finance and livelihood in the case of total failure as well as the suffer from “hyperinflation” if it is a partnership-based. Partnership modes are developmentally friendly modes that will not leave clients with unpaid debt and has advantages of avoiding the loss caused by hyperinflation.

Ethiopian MF experience is constrained by lack of foreign capital and inadequate local wholesale funding, and lack of local institution that can attract funds from different sources and provide wholesale funding. Moreover, there is a weak relationship between MFIs, commercial banks and insurance companies. In this respect, the Sudanese MF experience in diversified wholesale market, including commercial banks and donors, via the government-owned Wholesale Guarantee Agency is useful to Ethiopia.

On the other hand, Sudan can learn from the role and functions of AEMFI. The establishment of microfinance associations in Sudan is vital in helping microfinance institutions. Under this association, the MFIs are able to get the support in terms of training, networking and information sharing. Sudan needs to consolidate microfinance providers' network via technical support to establish the Sudanese Association of Microfinance Institutions (SAMI) along the lines of the successful experience of AEMFI. Sudan can also learn from Ethiopian experience to conduct a study on the social management system similar to the one created by the Ethiopian microfinance institutions to self monitor the social impact of microfinance on their clients.

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21. For example, a US$ 100 capital loan from a conventional bank charging 36% interest per year and generating a 50% rate of return on capital ($50 dollar) ends up with total return on capital of $14 per year (14% return on capital per year, 1.2% per month). With the same capital allocated for partnership equally shared by the bank and the client, and the same client’s rate of return 50% the picture is quite different. If the partner gets 20% of net profit as a reward of his management and the bank gets 5%, then the total non-capital shares out of the net profit of $50 is $12.5 ($10 partner's reward for management and $2.5 for the bank's following up). The remaining profit ($37.5) is distributed equally and the partner gets $18.75 ($37.5/2). The total partner's return therefore is $28.75, and the return on capital will be 28.75 % (2.4% per month, compared with a little more than 1 percent for the interest loan).


Empirical Study of the Proximity of Rotating Savings and Credit Associations to Islamic Principles of Financing in Ilorin Metropolis

By
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Prof. Mohammed Olanrewaju Ibrahim (Ph.D)

Abstract

The study empirically investigates the Level of Compliance of Members of Rotating Savings and Credit Associations (ROSCAS) in Ilorin Metropolis with Islamic Principles of Financing (IPF). Muslims are mandated to enter Islam completely (Q2:208). A day would come when all men would be asked of their worldly pleasures (Q102:1-8). Previous studies have not given the level of application of Islamic Principles to the operation of ROSCAS in Ilorin Metropolis. In this study, four hundred structured-questionnaires are administered on the purposefully selected respondents. Three hundred and twenty-eight of the returned ones were good for descriptive and inferential analysis via SPSS software. Three hypotheses were formulated on the biography of respondents to establish the relationship between operational strategies of ROSCAS members and IPF. Result of the tests conducted at 5% significance level on the gender of respondents does not conform to the a priori assumption while those of occupation and education do. The study reveals that male, highly-educated, and self-employed respondents have better compliance to IPF than their counterparts. Respondents with higher proximity to IPF must carry along their counterparts in Islamizing ROSCAS and add them to the Models of Islamic Finance. The study recommends that Muslim dominated nations should also start ROSCAS among themselves.

Keywords: Muhsinun, Human Development, Islamic Finance

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1. Introduction

Land is accepted as a free gift of nature in conventional economics, but as one of the creations of Allah ((SWT)) in Islamic Economics. However, output of land does not satisfy human desires. It is developed by man’s labor, to suit human desires as permitted by Islamic belief that Allah (SWT) created everything before Man and for Man (Q2:22). Man is encouraged by Allah (SWT) to be Muhsunun, i.e. one who transform things from bad to good (Q2:11); good to better and benefit from it (Q5:2; 16:90; 18:110; and 45:15). Transformation and sales of land assets makes man to become rich and lend them out.

Lenders are divided into three categories based on the desire for interest. One, for personal aggrandizement, some rich men, and capitalists lend their money to the poor or the deprived ones in return for principal and interest. Two, in order to alleviate poverty, some rich men and philanthropic organizations lend money to the poor ones without any recourse to interests, but return of principal. Thus, for personal and group development, low income earners or people tested with financial deprivations rally round themselves to form financial associations. Such associations are called cooperative societies, self-help groups, Rotating Savings and Credit Associations (ROSCAS). ROSCAS are the unofficial, irregular and informal associations for savings and obtaining credit on rotational basis (Olowe, 2011). Three, for the sake of Allah (SWT), those with surplus resources give out their resources to those with no resources without the expectation of returns of neither the principal nor the interests, but only the compensation from Allah (SWT).

Ilorin Metropolis is a Muslim dominated society (Ambali, 2011; Lambo, 2012; Yusuf, 2012). Majority of the people of Ilorin Metropolis are low income earners and civil-servants who do not have access to bank loans and are members of ROSCAS. The financial institution that has interest free-services is ROSCAS (Aliero, 2004). No one knows the level of compliance of ROSCAS’ Members to the IPF. Thus, the research questions are to what level does sex, education and occupation of respondents affects the proximity of their behavior to IPF.

General objective of the work is to investigate the level of compliance of ROSCAS’ members to IPF. Specific objectives of the study are to find out the pattern of behavior of ROSCAS members according to gender, education and employment with respect to IPF. It also wishes to suggest ways of improving behavior of ROSCAS’ members in Ilorin Metropolis to meet the level desired by Islam. Three Hypotheses are formulated to test the proximity of behavior of respondents (ROSCAS’ members) with respect to gender, education, and occupation to the Islamic Principle of Financing, IPF. They are stated in null form.

Notable acronyms in the paper are: 'IEDPU'; 'IPF'; 'PTO'; 'Q'; 'ROSCAS'; ‘S.A.W’; ‘S.W.T’; and 'WAM' which means “Ilorin Emirate Descendants’ Progressive Union”, 'Islamic Principles of Financing’, 'Proximity To One’, ‘Qur’an’, 'Rotating Savings and Credit Associations’; ‘Solallahu Alaehi Was-Salaam’ which means ‘Peace and Blessing of Allah be on him’, ‘Subuanahu Wa Tahaala’ denoting ‘Glory and Exaltations be to Him’; and 'Weighted Arithmetic Means' respectively.

2. Literature Review

2.1 Concept of Savings, Financing in Conventional and Islamic Perspective

Excess of income over expenditure on consumption is Savings (Keynes, 1936). Thus, Savings is the unexpended income of an economy. Savings is allowed in Islam and
believers are encouraged to fear Allah (SWT) and look at what they have prepared (saved) for tomorrow (Q 59:18). Short-term savings is encouraged for individual persons, in Islam. A Hadith 1103 reported in Khan (1994) where the Holy Prophet (S.A.W) says: ‘if the mount Uhud is turned to gold for him, he will not allow any of it to remain with him for more than three days except that with which he would pay debts’. However, ‘the curse of Allah (SWT) is on back-bitters and slanderers who engage in excessive capital accumulation’ (Q104:1-3). Thus, excess income could be saved for providing it to ROSCAS’ organized by believers, for prompt spending and repayment made as agreed by members.

The process of raising funds or capital for any kind of expenditure is financing (Britannica, 2007). Finance is much more than raising funds or capital, but management of money (Olowe, 2011). The limitation of the concept of finance to management of money belittles the meaning of finance. Wealth, in Islamic Economics, encompasses monetary, timely, material, and spiritual assets of man. Wealth and children are trials for man and with Allah (SWT) is the great reward, (Q64:15). Thus, wealth management is a compulsory duty for all men. Therefore, finance, is the willingness and ability of an economist (individual person, household or family, firm or business and or social organization, government and the global community) to spend his assets or wealth for the promotion of well-being of another economist in this world and hereafter.

The institutions for financing development in Islamic Economics organized on profit-loss sharing scheme as Mudaraba, Musharaka, Murabaha, Ijara, Salam, Istisna, Sukuk, Wakala and Wadia according to Fakhrul Ahsan (1988), and Aliero (2004). The exclusion of ROSCAS from the above list makes it incomplete.

Concerning security of wealth, Gatawa (2007) asserts that Islam wants to ensure that lender’s assets are secured, as such compulsory provisions are made for the documentation of wealth transfer, guaranteeing and mortgaging of loans. Molla, et al. (1988) observes that communal farming, communal industry and totally different methods that distinguish between Halal (permissible) and Haram (forbidden) items are ways of attaining development in Islam. Gusau (1988) called for Islamic cooperation for development at an international level.

2.2 Review of Empirical Literature on ROSCAS

Existence of Iqqub (Ethiopian name for ROSCAS) predated modern banking (Aredo, 1993). ROSCA is formed when a man in financial need asks his friend to form an Iqqub for him and wants interest-free loans (Aredo, 1993). Entrepreneurs meet to raise funds (Chiteji, 2002); and do not have access to formal credit markets (Besley, Coate and Loury, 1994). People do contribute into ROSCAS in cash, kinds and labor (Ardener, 1964); Aredo (1993) and Shuaib, 2000).

Abdul-Yakeen (2006) does not venture on ROSCAS, but discovered that there was no persistent promotion of Islamic Banking Windows in Ilorin and Sokoto Metropolis. Abdul-Yakeen (2012) studied ROSCAS and discovered that Savings to ROSCAS’s purse were not idle, but active funds which could lead to an instantaneous multiplier effect of over one hundred and forty percent to the growth of the economy as it led to improved cordial relationship between lenders and borrowers; employment generation; increase in output; consumption; savings; investment; price stability because interest charges were negligible in most of their dealings; and could be improved to meet Islamic tastes but there was no Islamic interpretation of the data obtained.
2.3 Overview of Islamic Principles of Financing (IPF) for ROSCAS’ Members

Islamic Economics is based on divine revelations of truth and does not condone ignorance, assumptions and theories which never overcome truth (Q43:29-30) and Believers are named Muslims (Q22:78). Under IPF, financing done for the sake of Allah (SWT) is equated to one or straight line in concord with a Qur’anic verse (Q36:61). Issues reviewed here bothered on the principle of objectivity, knowledge, productivity, savings, interest-free loans, documentation, periodicity, selflessness, consultation, familiarity, patience, association, prompt debt repayment and contentment. They go thus:

Objective (\textit{An-Niyat}) of doing things must be for the sake of Allah (SWT) (Q22:78); do good in order to meeting Him (Q18:110, and 36:83); Saving life of a man is tantamount to saving lives of all men (Q5:32 and 51:56) and the virtue to develop other people (Q 22:40; 22:78; 30:47; and 51:57). To associate with fellow believers for believers are like building, \textit{Hadith} 2026 mentioned in Khan (1994). Believers are permitted to run away from \textit{Fitna}, \textit{Hadith} 19 in Khan (1994). Reason for an action can be because wastage is forbidden (\textit{Hadith} 1106 in Khan (1994). Islamic encourages to preserve for future (Q28:77); protect yourself and family (Q66:6) and best accumulation is fear of Allah through piety (Q2:197) etc.

Regarding knowledge, the first message of Allah (SWT) revealed to the Holy Prophet (SWT) advised him to read (Q96:1-5). Education is promoted as Islam places emphasis on reading (Q73:20). Knowledge and good deeds are extolled by Islam (Q26:83; 27:40; and 27:42. Prophet is a messenger on the straight path, and Qur’an of the Wise, revealed by Allah (SWT) is to warn ignorant people (Q36:1-6).

On productivity, believers must work for Allah (SWT) as He loves \textit{Muhsinun}, the good doers (Q5:13); and \textit{Amalan Solihan} (good deeds) is better than wealth and children to earn eternal reward (Q10:46). Islam forbids begging and enjoins that there shall be among you people who would be encouraging what is good and forbidding what is bad (Q3:104) and reward for good deed is in multiple of ten (\textit{Hadith} 919 mentioned in Khan, 1994).

\textit{Riba} (Usury or Interest) is forbidden, but doing good things and trading is permitted (Q2: 275–279; 30:39 and 4:161). Instead of \textit{Riba}, Allah (SWT) encourages man to give \textit{Qardul Hassanah} to Allah (SWT) (Q5:12). As consolation for loss of value of money, Prophet Muhammad (SWT) used to voluntarily repay debts handsomely (\textit{Hadith} 1104 mentioned in Khan, 1994).

On periodicity or period of contribution, savings and expenditure, believers are allowed to store food for a year for their family (\textit{Hadith} 1886 mentioned in Khan, 1994). Another prophetic tradition implies that man can expend all his wealth in Allah’s (SWT) way within three days except the ones with which debts will be paid (\textit{Hadith} 1103 mentioned in Khan, 1994). On documentation, Qur’an says when transferring wealth for future payment, document it and have witnesses (Q2: 282). Oral agreement is allowed if dealers are in a journey and cannot find scribes and witnesses (Q 2:283).

Members’ familiarity and doing good to other members of associations like ROSCA is encouraged as in one of the prayers of Prophet Ibrahim (ASW), “Oh Allah, give me among the righteous” (Q37:100). Association in good deeds is encouraged in Islam (Q18:110). Islam guides that good deeds even benefit the doers’ themselves (Q 29: 6). Debt payment is the first expenditure after earning of income for Allah (SWT) orders believers to fulfill pledges (Q2:177; 5:1; and 61:2-3). Quran warns that ‘Do not eat wealth of others illegally’ (Q2:188).
3. RESEARCH METHODOLOGY

The study area was Ilorin Metropolis, capital of Kwara State of Nigeria. Primary method was used to obtain cross-sectional data on different entities for a single period in accordance with Stock and Watson (2007). Research instruments used were participant-observation, questionnaire, and discussion. Demographic features of respondents studied are gender, education, and occupation while the IPF are objectivity, period of contribution, number of ROSCAS joined currently, most desired box, decision on who takes the next bundle, documentation, interest payment, how loans multiplies contributions, what contributions shall do, familiarity among members, why borrowing, other contributions, secrecy, other financial institutions, why respondents join ROSCAS, first expenditure after earning income and feelings of respondents as ROSCAS members. The issues raised are measured with the adoption of Weighted Arithmetic Means (WAM) as suggested by Gupta (2005) in conjunction with Likert Scale discovered by Likert (1932) as a statistical method of measuring character and personality traits of respondents; and recommended by Boone & Boone (2012).

Purposeful sampling method was used to administer Four hundred questionnaires on respondents but only three hundred and twenty eight of the returned questionnaires were good for analysis. The study borrow a leaf from Aliero (2004) who studied ROSCAS at Sokoto state and administered questionnaire and structured interview from one hundred and fifty ROSCAS members and fifty ROSCAS coordinators. The study also follows Ijaiya (2009), who administered four hundred questionnaires when studying ROSCAS in Offa town of Kwara State.

Ordinal Scaling Method as in Gujarati (2004) is used. Award of values or scales or weights under WAM is on fractional basis where, for example, if the options are five in number, option 'A' earns '5/5', 'B' earns '4/5' up till the last option, option 'E' that's worth '1/5'.

Boone and Boone (2012) opine that researchers can use Likert Scale Data to measure Centrality (Mean), Variability (Standard Deviation), Association (Pearson’s r) and Other Statistics (ANOVA, t-test and Regression).

Qur’anic quotations cited are obtained from the Holy Qur’an translated by Khan (1996/1417AH) in addition to Khan and Al-Hilali (2011), and the Ahadith are quoted from Sahih Bukhari translated by Khan (1994/1415AH).

4. DATA ANALYSIS, TESTS OF HYPOTHESES, RESULTS, AND DISCUSSION.

4.1 Data Analysis.

<table>
<thead>
<tr>
<th>N</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Sum</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statistic</td>
<td>Statistic</td>
<td>Statistic</td>
<td>Statistic</td>
<td>Statistic</td>
<td>Statistic</td>
</tr>
<tr>
<td>AVERAGE SCORE OF FEMALES</td>
<td>146</td>
<td>.5125</td>
<td>.8669</td>
<td>104.935</td>
<td>.7187</td>
</tr>
<tr>
<td>AVERAGE SCORE OF MALES</td>
<td>146</td>
<td>.5925</td>
<td>.9188</td>
<td>107.682</td>
<td>.7375</td>
</tr>
<tr>
<td>Valid N (list wise)</td>
<td>146</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Data obtained shows that the first 146 respondents who are of feminine and masculine genders are analyzed. Average score of male respondents is 0.74 while that of female respondents is 0.72. Thus, male respondents abide to Islamic principles slightly more than the females.

Inferential Statistical analysis on the relationship between the proximity of male and female respondents to IPF is:

\[
F = 0.63 + 0.21M \\
\text{Std. Error} = (0.064) \quad (0.086) \\
T = 9.88 \quad 1.4 \\
\text{Sig.} = 0.000 \quad 0.163 \\
R^2 = 0.116
\]

The meaning of the above equation and numerical figures is that there is a positive relationship between the proximity of male respondents and female respondents to IPF. The null hypothesis of no significant difference between the proximity of male respondents to IPF and the proximity of female respondents to IPF is not accepted since the calculated t-statistic is 1.4 and probability value is 0.163. Following this, the R² score shows that only about twelve percent changes in the behavior of female respondents can be explained by the male respondents.

Table 2: Proximity of ROSCAS’ Practice to IPF (Education-wise Response)

<table>
<thead>
<tr>
<th>Education</th>
<th>N</th>
<th>Range</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Sum</th>
<th>Mean</th>
</tr>
</thead>
<tbody>
<tr>
<td>NCE HND AVERAGE SCORE</td>
<td>14</td>
<td>.16</td>
<td>.63</td>
<td>.79</td>
<td>10.03</td>
<td>.7165</td>
</tr>
<tr>
<td>DEGREE HOLDERS SCORE</td>
<td>14</td>
<td>.25</td>
<td>.61</td>
<td>.87</td>
<td>10.25</td>
<td>.7325</td>
</tr>
<tr>
<td>POST GRADUATE AVERAGE SCORE</td>
<td>14</td>
<td>.34</td>
<td>.62</td>
<td>.95</td>
<td>9.88</td>
<td>.7060</td>
</tr>
<tr>
<td>PRIMARY SCHOOL AVERAGE SCORE</td>
<td>14</td>
<td>.33</td>
<td>.64</td>
<td>.96</td>
<td>10.05</td>
<td>.7176</td>
</tr>
<tr>
<td>SECONDARY SCHOOL AVERAGE SCORE</td>
<td>14</td>
<td>.25</td>
<td>.67</td>
<td>.92</td>
<td>10.88</td>
<td>.7772</td>
</tr>
<tr>
<td>Valid N (list wise)</td>
<td>14</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Respondents with postgraduate certificates have average of 0.706. National certificate holders are with average score of 0.717. Holders of first degree certificate score 0.732 as their average. Secondary school certificate holders score 0.777 and primary school certificates scored an average score of 0.718. Higher education respondents are nearer to IPF those with lower education.

The inferential analysis of the relationship between the proximities of variables analyzed under educational qualification is as follows:
PRI = 0.21 – 0.5SEC + 0.89NCE + 0.4DEG -0.1POST

It is observed that there is a positive relationship between the proximity of primary school certificate holders to IPF and proximities of NCE and first degree holders to IPF. This indicates the fact that when proximities of secondary school certificate and postgraduate certificate holders to IPF rise, the proximity of primary school certificate holders to IPF would fall and vice versa. The calculated F-statistic is 2.312 while the probability value of F-statistic is 0.136 which implies that we cannot accept the hypothesis that says there is no significant difference between the proximity of primary school certificate holders to IPF and the proximity of other certificate holders to IPF. The value of goodness of fit test, $R^2$ is 0.51 and it means that only fifty-one percent variations in dependent variable can be explained by the independent variables.

**Table 3: Proximity of ROSCAS’ Practice to IPF According to Respondents’ Occupation**

<table>
<thead>
<tr>
<th></th>
<th>N</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Sum</th>
<th>Mean</th>
<th>Std. Dev.</th>
</tr>
</thead>
<tbody>
<tr>
<td>AVERAGE SCORE OF CIVIL SERVANTS</td>
<td>161</td>
<td>0.5125</td>
<td>0.9188</td>
<td>116.073</td>
<td>0.720955</td>
<td>0.0690993</td>
</tr>
<tr>
<td>AVERAGE SCORE OF SELF EMPLOYED</td>
<td>161</td>
<td>0.5425</td>
<td>0.8813</td>
<td>118.238</td>
<td>0.734399</td>
<td>0.0673314</td>
</tr>
<tr>
<td>Valid N (list wise)</td>
<td>161</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The table above shows that the practice of ROSCAS by 161 civil servants (mean score = 0.72) is not nearer to IPF than the 161 self-employed respondents (mean score = 0.73). Inferential analysis of the relationship between the two variables is discovered as:

$$\text{SELF} = 0.76 - 0.046 \text{CIVIL}$$

The equation above shows that there is a negative relationship between the proximities of respondents to IPF with respect to their occupation.

### 4.2 Results and Discussion

Male respondents have greater proximity to IPF than their female counterparts. This indicates that the head of the families in the study area are abiding to Islamic teachings than their second-halves (wives).
The higher the education of respondents, the greater the probability of complying with IPF. Thus, there is a good omen for any economy where fairly educated people who join ROSCAS are of high moral standard.

Self-employed workers have greater proximity to IPF than the civil servants. This discovery spells doom for Nigeria because civil servants sometimes are administrators and if administrators are not complying with IPF, who else will do it.

ROSCAS’ Practices in Ilorin Metropolis can be converted to Islamic Mode of Financing.

Usage of Likert Scaling method to construct regression models as suggested by Boone and Boone (2012) used to lead to very low R². Thus, the independent variables may not predict changes in the dependent variable.

5. Conclusion and Recommendations

We conclude from our results that male, highly educated and self-employed respondents do operate ROSCAS as per Islamic principles than the Female, less educated and civil servant respondents. Thus, ROSCAS can be operated and free from major criticisms meted on Islamic and conventional banking systems.

It is recommended that Male, Self-employed and Highly-educated respondents shall be advising the Female, Civil-Servants and Fairly educated people to put Islam first in all their doings so as to have cause to promote ROSCAS to the level desired by Islam. All heads of families, heads of business organizations and educational institutions are enjoined to assist in establishing and promoting the Islamically acceptable ROSCAS under their control.

Above all, Muslim dominated nations are advised to form Islamically Acceptable savings and credit associations where the nations with lesser level of physical development will always take their share or bundle before the nations with higher level of physical development. For instance, nations like Niger, Sudan, Nigeria, Iran and Saudi Arabia can establish an Islamically Permissible Savings and Credit Associations (IPSACA). The rule of taking the bundle under IPSACA shall be that Niger will always take the first bundle, Nigeria will always be a middle-nation and Saudi Arabia will always take the last bundle. Similarly, Sudan will always take her share before Nigeria which will always precede Iran in the taking of the bundles. IPSACA funds can be lent to the private sector at no interest but administrative charges; and used to produce tangible, public and merit goods.

6. REFERENCES


Revisiting the Design of Interest Free House Finance

By

Salman Ahmed Shaikh*

Abstract

In this paper, we revisit the design of interest free house finance. First, we discuss the current practice in conventional banking and Islamic banking. Then, we discuss an alternate design for interest free house finance. The proposal we present attempts to analyze the implication of using market based rent setting in place of using an interest rate benchmark. In the alternate design, the Islamic bank buys the house by paying the house owner full amount of the house upfront. Then, the bank gives the house on rent to the client and the Islamic bank also enters into an options contract as the call option writer. If the call buyer does not exercise the call option, the options contract expires and the Islamic bank is in a position to give the house on rent again. We present numerical examples of computing rents in two separate structures. In structure I, call option is used with the lease contract. In structure II, house is resold at market price with stated price floor.

Keywords: Mortgages, House Finance, Personal Finance, Islamic Banking, Options, Diminishing Musharakah, Lease.

JEL Codes G21, G28

1. Introduction

At the very start and towards end of their lives, people in their non-working age usually have no or lower incomes. In the middle period of life, people are able to generate income from labor supply which usually increases with work experience. However, purchase of durable goods like house and automobiles require substantial resources which most people are not able to generate solely through their periodic incomes. Hence, they can either postpone their purchase until they accumulate enough amount or obtain financing from a financial institution. Postponing in the case of house would require more time to accumulate resources and with soaring prices, owning a house during their

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lifetime would remain elusive for most people. Hence, finance from banks is the option most people take.

Shirazi et al. (2012) use UN-Habitat (2006) methodology and their estimates suggest that the IDB member countries need around 8.2 million houses per year to accommodate poor and low income urban people. This translates into nearly 22,421 dwellings per day in order to accommodate the expected urban population growth. Muslim population comprises approximately quarter of World’s population, but half of global poor are Muslims. Hence, the challenge is to provide affordable house finance to the masses of low to middle income people in OIC countries.

Since interest is prohibited in Islam, the Islamic finance alternative to finance houses avoids interest. Nevertheless, due to unavailability of a distinctive price benchmark, Islamic banking has also been using the interest rate benchmark in pricing the assets and computing rents. The financial structure of products from cash flow perspective does not differ much in Islamic banking from conventional banking. The practitioners argue that the difference lies in contract mechanics. They contend that as long as the prices are specified, the method used for pricing the product does not matter. An often repeated example is given that Halal and Haram food products may cost and taste same, but the way some ingredients are procured creates a distinction between permissible and impermissible food from an Islamic perspective. Analogically, it is argued that what makes Islamic finance contract permissible is not because they are cheap in price. It is because they involve legitimate and actual sale of goods and services and comply with the juristic principles of sale including specification of price, subject matter, delivery mode and timing of price payment. Once the price is fixed, it does not change irrespective of whether the payment is made on due date, before the due date or after the due date.

Keeping aside the justification and compliance of this argument from Shari’ah principles, it is still a fact that in current practice, the cash flows involved in Islamic contracts resemble those of conventional contracts. In pricing products, Meera & Dzuljastri (2009) show that the mathematical derivation for the Islamic mortgage is similar to the formula used in conventional loans, but nonetheless with the interest rate replaced with the rental rate. Siti & Azira (2013) investigating the house financing products offered in Malaysia disclose that the banks still use conventional interest rate as a benchmark. Hasan (2012) also shares the same concern and concludes that the Islamic banks invariably use annuity formula to determine the fixed installment payments in house financing amortization. He argues that the formula has explicit compounding of return.

In this backdrop, can we redesign interest free house finance contract in a way that is more flexible and inclusive from the perspective of the client. In this paper, we present a proposal of an alternate way to provide house finance which is different from conventional mortgage not only in form, but also in substance. Going forward, section 2 gives account of current practice in conventional and Islamic finance to provide house financing. Section 3 presents the proposal. Section 4 gives the application of the proposal. Section 5 presents some numerical examples of computing rents in alternate scenarios.

2. Current Practice

In this section, we give an account of current practice in providing house finance in both conventional banking as well as in Islamic banking.
2.1 Conventional Mortgage

In conventional banking, the bank provides loan to the client after ensuring client’s creditworthiness. The title of the house is immediately transferred to the client. However, the bank retains the right of foreclosure as recourse to recover the due amount of unpaid portion of loan. The client pays the loan over the years usually in monthly installments. Each installment comprises two components, i.e. interest on balance due and principal repayment. Series of equal installments to be paid over the years by the client are computed using present value of annuity formula.

\[ \text{PVA} = A \left[ \frac{1 - \frac{1}{(1 + i)^n}}{i} \right] \] … (1)

Where,

- \( \text{PVA} \) = Amount of loan ($).
- \( a \) = Periodic installment to be paid each period ($).
- \( i \) = Interest rate (%).
- \( n \) = Period of loan in years.

2.2 Diminishing Musharakah Structure

In Diminishing Musharakah, the client approaches the bank for joint purchase of a house. Designated valuation agencies are consulted for the valuation of the house. The seller of the property is paid by the bank and the bank and the client enter into a Musharakah Agreement. It is referred to as ‘Diminishing Musharakah’ because the ownership stake of the client (tenant of bank’s share) increases and that of the bank decreases or diminishes with the regular installments paid by the client.

The share of the bank in house is divided into units. These units are purchased by the client periodically. When the client has purchased all units, he becomes the sole owner of the house. Rent is not charged immediately and is charged at the end of the month for the use of house. Rent for at least one period is fixed. Unit price fixed for a period does not change during that period. The rent is calculated based on interbank rates. In Musharakah agreement, the floor rate (minimum rate) and the ceiling rate (maximum rate) is stated based on which the rent can vary. In Musharakah agreement, it is stated that if payments are made on time, the transfer of ownership will take place accordingly.

A numerical example will further explain this product structure. Table 1 presents the details. The formulas used to compute the results are listed below in equation (2) through equation (6):

\[ u = n \times m \] … (2)

\[ p_u = \frac{AFN}{u} \] … (3)

\[ R_m = \left( \frac{r}{m} \right) \cdot p_u \] … (4)

\[ TR_m = R_m \cdot u_a \] … (5)

\[ A = TR_m + p_u \] … (6)

Where,

- \( u \) = Number of units.
- \( n \) = Lease period in years.
\begin{align*}
P &= \text{Frequency of payment in a year.} \\
P_a &= \text{Price of one unit of a house (\$).} \\
AFN &= \text{Amount of financing required by the client (\$).} \\
R_p &= \text{Rent per unit per month (\$).} \\
TP &= \text{Total rent per month (\$).} \\
N &= \text{Number of outstanding units.} \\
A &= \text{Monthly installment (\$).}
\end{align*}

Table 1: Rental Computations in Islamic Mortgage

<table>
<thead>
<tr>
<th>Expected Rentals - House</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Financing Amount of Asset Required ($)</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Rental Rate (%)</td>
<td>15</td>
</tr>
<tr>
<td>Tenure of Lease (Years)</td>
<td>10</td>
</tr>
<tr>
<td>No. of Units</td>
<td>120</td>
</tr>
<tr>
<td>Unit Price ($)</td>
<td>16,666.67</td>
</tr>
<tr>
<td>Rent Per Unit Per Month ($)</td>
<td>208.33</td>
</tr>
<tr>
<td>Total Starting Rent ($)</td>
<td>41,666.67</td>
</tr>
</tbody>
</table>

Table 2 presents extract of a payment schedule. It can be seen that monthly payments are declining with decrease in rents. It is because the units in ownership of bank decrease with each additional unit purchased by the client every month. Monthly interest payment in a conventional amortization schedule is replaced by monthly rent. Plus, the principal repayment in a conventional amortization schedule is replaced by unit price.

Table 2: Payment Schedule in Islamic Mortgage

<table>
<thead>
<tr>
<th>Month</th>
<th>Monthly Rent</th>
<th>Per Unit Price</th>
<th>Monthly Payment</th>
<th>Balance Units</th>
<th>Balance Unit Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td></td>
<td></td>
<td></td>
<td>120</td>
<td>2,000,000</td>
</tr>
<tr>
<td>1</td>
<td>25,000</td>
<td>16,667</td>
<td>41,666</td>
<td>119</td>
<td>1,983,333</td>
</tr>
<tr>
<td>2</td>
<td>24,791</td>
<td>16,667</td>
<td>41,458</td>
<td>118</td>
<td>1,966,667</td>
</tr>
<tr>
<td>3</td>
<td>24,583</td>
<td>16,667</td>
<td>41,250</td>
<td>117</td>
<td>1,950,000</td>
</tr>
<tr>
<td>4</td>
<td>24,375</td>
<td>16,667</td>
<td>41,041</td>
<td>116</td>
<td>1,933,333</td>
</tr>
<tr>
<td>5</td>
<td>24,166</td>
<td>16,667</td>
<td>40,833</td>
<td>115</td>
<td>1,916,667</td>
</tr>
<tr>
<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
</tr>
<tr>
<td>116</td>
<td>1,042</td>
<td>16,667</td>
<td>17,708</td>
<td>4</td>
<td>66,666</td>
</tr>
<tr>
<td>117</td>
<td>833</td>
<td>16,667</td>
<td>17,500</td>
<td>3</td>
<td>50,000</td>
</tr>
<tr>
<td>118</td>
<td>625</td>
<td>16,667</td>
<td>17,292</td>
<td>2</td>
<td>33,333</td>
</tr>
<tr>
<td>119</td>
<td>417</td>
<td>16,667</td>
<td>17,083</td>
<td>1</td>
<td>16,666</td>
</tr>
<tr>
<td>120</td>
<td>208</td>
<td>16,667</td>
<td>16,875</td>
<td>-</td>
<td>(0)</td>
</tr>
</tbody>
</table>
Analyzing the various house financing products offered by Islamic banks in Malaysia, Siti & Azira (2013) conclude that typically, the bank does not bear any risk regarding the ownership of the house or property. The legal title of the house or property lies with the customer from the beginning of the contract and the bank just acts as a trustee. Along the same lines, Shaikh (2006) comparing the similarities and differences in the operations of Islamic and conventional banking in the provision of house finance conclude that there is almost no dissimilarity in the substance of transactions, cash flows and liability. Even though contract mechanics stipulate that bank will be liable to bear any ownership related risks, but such are mitigated through insurance. Insurance cost is included in the rent amortization schedule and the customer has to agree on that schedule before bank buys property. Table 3 compares the features of conventional mortgage with Islamic mortgage financing.

<table>
<thead>
<tr>
<th>Features</th>
<th>Conventional Mortgage</th>
<th>Diminishing Musharakah</th>
</tr>
</thead>
<tbody>
<tr>
<td>Benchmark rate</td>
<td>Interbank rates</td>
<td>Interbank rates</td>
</tr>
<tr>
<td>Price/rent basis</td>
<td>Interbank rates</td>
<td>Interbank rates</td>
</tr>
<tr>
<td>Nature of installment</td>
<td>Interest + Principal</td>
<td>Rent + Sale of units</td>
</tr>
<tr>
<td>Prepayment penalty</td>
<td>Yes</td>
<td>Units sold at high price</td>
</tr>
<tr>
<td>Rent + Sale contract</td>
<td>Dependent</td>
<td>Separated by Wa’d</td>
</tr>
<tr>
<td>Installment composition</td>
<td>Interest falls</td>
<td>Rent falls subsequently</td>
</tr>
<tr>
<td>Ownership transfer</td>
<td>Principal repayment</td>
<td>More units purchased</td>
</tr>
<tr>
<td>Changes in interest/rent</td>
<td>Based on interbank rates</td>
<td>Based on interbank rates</td>
</tr>
</tbody>
</table>

3. Critical Issues in Diminishing Musharakah Structure

For remaining competitive as a small player in the banking industry dominated by conventional banks, Islamic banks are constrained to use Islamic contract structures that mimic cash flow structure of conventional banking. That is why; the debt based modes of Islamic finance are more prevalent (Ismail, 2011). In practiced Islamic banking, taking an undertaking from the lessee in lease contracts is just like buying a put option from the lessee with put premium equal to zero. The lessee acts as a put option writer. What this essentially does is that it hedges the Islamic bank to avoid price risk.

The Islamic bank only buys the house when it has obtained a unilateral undertaking from the client that is legally enforceable and which allows the bank to lock the subsequent lease contract and charge stipulated periodic installments before committing any of its funds. Masri (2002) expressing the concern over using unilateral undertaking to mitigate risk writes:

“Some modern jurists have moved such a unilateral promise (wa’ād) from the category of voluntary offer (tabarru’āt) to that of commutative contracts, (mu’awadāt), so as to replace the contract. That is because these proponents have found that (Murabaha, i.e., a resale contract with specification of gain (cost plus original price) is not permissible, since it falls under the sale of goods that are not in one's possession (the goods are not in the bank's possession). So, they replaced the contract with the unilateral promise (wa’ād), that is to
say, they made the contract a unilateral promise (wa’d). Had they stopped at that point, and had the unilateral promise (wa’d) remained non-binding, there would not have arisen any problems; but, in fact, they went on to say, and herein lies the gravity of their position: we will make the unilateral promise (wa’d) binding.”

Then, in conclusion, the noted scholar writes:

“In summary, it is inadmissible for the unilateral promise (wa’d) as an alternative to a proscribed contract, such as selling goods that are not in one’s possession, to be binding, because a binding unilateral promise (wa’d) is analogous to a contract. Any views for making it binding upon both or either parties, explicitly or implicitly, by virtue of a Memorandum of Understanding (MOU), a sideline agreement, or any other circumvention, are not founded on any legitimate basis.”

On the use of these contract mechanics in prevalent Islamic banking to replicate quantitatively similar cash flows as in conventional banking, Chaudhry (2006) notes that a narrow juristic interpretation of the Shari’ah is followed, leaving aside the Tawhidi core. Highlighting the inertia behind these practices in the need to achieve competitiveness as a small player in big industry, Ismail (2011) argues that growth in the industry has taken more precedence over Shari’ah compliance in letter and spirit.

In academic circles, some scholars have presented alternate proposals like Zubair (2011a) and Ebrahim (2009) for house finance. Zabair’s diminishing balance method was criticized by Meera (2012) for being similar in nature to interest based mortgage. Ebrahim’s (2009) proposal of using co-operatives does not clearly answer as to how it avoids a loan transaction and hence justify the premium on loaned sum of money.

4. Alternate Proposal for Interest Free House Finance

In this section, we present an alternative proposal which will make the transaction look much more transparent and realistic. If the above mentioned put option provision is reversed, the client would buy the call option and the financial institution will sell the call option i.e. acts as a call option writer. To make it conform to Islamic principles, call premium can be removed or if taken, it could be regarded as token amount for subsequent purchase of house. In case, if the client does not exercise the call option, then, this amount will be returned. In this way, the upfront call premium, if taken, will be a valid consideration.

This alternative could work as follows:

a) The Islamic bank buys the house by paying the house owner full amount of the house upfront. The Islamic bank is now the owner of the house.

b) Then, the Islamic bank gives the house on rent to the client and the Islamic bank also enters into an options contract as the call option writer.

c) If the call buyer does not exercise the option, the options contract expires and the Islamic bank is in a position to give the house on rent again.

d) If the call buyer exercises the option, the Islamic bank gets the house price plus the rental income for the period before the expiration of the options contract.
Furthermore, the proposal meets following specific objectives:

a) To allow people the choice to lease only or lease with purchase. It is done by making them call option buyers and hence, they get a choice. It will decrease the monthly lease payments and hence it will allow more people to qualify the income requirement for obtaining the lease.

b) To achieve separation of tenancy and sale contract as it is a requirement in Islamic jurisprudence. This is achieved in Islamic finance currently through a unilateral undertaking which is legally enforceable. Hence, current mechanism to separate tenancy and sale are not ideal and are just legal solutions to the problem unlike this proposal.

c) To propose a mechanism that still allows the financial institution to have reasonable returns even when future prices are low and when they are high. Future prices will determine the client’s decision to exercise or not to exercise the call option contract.

d) To propose a mechanism that still allows the client to have a place for living and an option to purchase the house at a fixed price rather than paying fixed installments until maturity.

e) To propose a mechanism for setting rentals which reflects true market rent rather than linking it with an interest based benchmark.

No matter how high the strike price of house \( S_{F_c} \) in call option is, the customer would always be in a position not to pay higher than market prices \( S_{F_p} \). It is because the customer can decide not to exercise the call option. In a nutshell, if \( S_{F_c} > S_{F_p} \), the option is in the money for the client. Given other things constant, most people would exercise the call option. If \( S_{F_c} < S_{F_p} \), the option is out of money for the client. Given other things constant, most people would not exercise the call option and let it expire.

5. Analysis of Effects of the Proposal

Apparently, it may seem unattractive to financial institution as the financial institution will have to take on more risk. This proposal disallows the financial institution any differential and preferential treatment. Nevertheless, we mention some of the benefits that will accrue to the financial institution from the proposal:

a) Rent for some period could be fixed by linking it with rental benchmark. It can be changed later on. For the purpose of hedging, some advance rent could also be taken and this would be an alternative to upfront down-payment.

b) Rent could be set as a multiple of benchmark (House Rent Index), but that always depends on bargaining power of both the parties. There could be cap and floor on rent just like in current practice.

c) Option price together with targeted rentals will enable the financial institution to cover its cost profitably.

d) If house prices are increasing, the house rent will also increase. So, if prices are increasing, all benefit will not accrue to the lessee alone. With increase in rents, shareholders and rabb-ul-maal (depositors) of the financial institution will also benefit.
Adding to point c) above, we present the average inflation rate in 30 Organization of Islamic Cooperation (OIC) countries for the period 1993-2013. Table 4 reports the average inflation rate in 30 OIC countries during 1993-2013. The average of the average inflation rate during 1993-2013 in these 30 OIC countries had remained at 6.30%. If a financial institution had provided financing in year 1993 for 20 years, then in 2013, the average house price increasing by the general inflation rate would have a value of 3.4 times the 1993 value (an increase of 240%).

Table 4: CPI Values from 1993-2013

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td>9.52</td>
<td>Kuwait</td>
<td>2.97</td>
</tr>
<tr>
<td>Algeria</td>
<td>7.82</td>
<td>Lebanon</td>
<td>5.23</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>5.72</td>
<td>Libya</td>
<td>2.93</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>6.3</td>
<td>Malaysia</td>
<td>2.64</td>
</tr>
<tr>
<td>Benin</td>
<td>5.36</td>
<td>Mali</td>
<td>3.76</td>
</tr>
<tr>
<td>Burkina Faso</td>
<td>3.92</td>
<td>Morocco</td>
<td>2.28</td>
</tr>
<tr>
<td>Cameroon</td>
<td>4.27</td>
<td>Mozambique</td>
<td>8.65</td>
</tr>
<tr>
<td>Chad</td>
<td>4.45</td>
<td>Niger</td>
<td>4.3</td>
</tr>
<tr>
<td>Egypt</td>
<td>8</td>
<td>Nigeria</td>
<td>19.48</td>
</tr>
<tr>
<td>Gabon</td>
<td>3.63</td>
<td>Oman</td>
<td>1.79</td>
</tr>
<tr>
<td>Guinea-Bissau</td>
<td>12.06</td>
<td>Pakistan</td>
<td>9.03</td>
</tr>
<tr>
<td>Guyana</td>
<td>6.22</td>
<td>Senegal</td>
<td>3.45</td>
</tr>
<tr>
<td>Indonesia</td>
<td>10.8</td>
<td>Syria</td>
<td>8.28</td>
</tr>
<tr>
<td>Jordan</td>
<td>3.84</td>
<td>Togo</td>
<td>5.17</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>8.93</td>
<td>Uganda</td>
<td>7.83</td>
</tr>
</tbody>
</table>

6. Analysis Using Numerical Computations

We take a numerical example to present necessary computations for the proposal. Let us say a client needs financing of $2,000,000 for a 10 year period for purchasing an already built house. Inflation in the economy is expected to grow by 12% per annum. Monthly rent shall be paid by the client for the use of house owned by Islamic financial institution. Let us suppose the useful life of house in current state of structure and renovation is 20 years and the client desires to have a lease period of 10 years. Monthly rent can be calculated by equation (7):

\[
R_{\text{m}} = \left(\frac{1}{1 + r}\right)^n \times GDP_h \quad \text{... (7)}
\]

Where,
\[
\begin{align*}
R_{\text{m}} & = \text{Monthly rent}. \\
n & = \text{Lease period in years}. \\
\omega & = \text{Frequency of rent payment in a year}. \\
d & = \text{Useful life of house in current structure of built and renovation}. \\
GDP_h & = \text{Historical cost price of the house}.
\end{align*}
\]
The ratio \( \frac{n_i}{n_l} \) is the proportion of asset value that the financier could recover from the contract. The financier can influence it since it chooses \( n_i \). If the market price data is readily available, then the bank can choose market price \( (MP_i) \) in place of \( (CP_i) \).

Total rent \( (TR_{ri}) \) can be computed from equation (8):

\[
TR_{ri} = R_{ri} \times (n \times m) \quad \ldots \text{(8)}
\]

If we want to compute the real value (net of inflation) of total rents paid over the lease period, we can use equation (9):

\[
PV_d = \frac{(1-inf)^{n-m}}{inf} \quad \ldots \text{(9)}
\]

Where \( inf \) is the inflation rate.

We present two possible structures that can be used. In structure I, call option will be used and the strike price will be stated. In structure II, no call option will be used. The house will be sold at a market price with a floor that can be set at 100% historical cost of house or at other values.

In Table 5, we present a numerical example of structure I. It can be seen that the bank will be able to earn substantial total cash flows by choosing an appropriate strike price. Real value of cash flows could be more than historical investment when strike price is approximately more than 250% of the cost. It is to be noted that in recent years, banks have earned even negative real returns on their loan portfolios in some of the developing countries.

**Table 5: Structure I Using Call Options**

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Scaling</th>
<th>Values</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost Price of House</td>
<td></td>
<td>2,000,000</td>
</tr>
<tr>
<td>Period of Lease (in Years)</td>
<td></td>
<td>10</td>
</tr>
<tr>
<td>Period of Lease (in Months)</td>
<td></td>
<td>120</td>
</tr>
<tr>
<td>Total Asset Value Covered from Rents</td>
<td></td>
<td>0.50</td>
</tr>
<tr>
<td>Average Inflation Rate During 1993-2013 in 30 OIC Countries</td>
<td></td>
<td>0.063</td>
</tr>
<tr>
<td>Monthly Rental Value</td>
<td></td>
<td>8,333.33</td>
</tr>
<tr>
<td>Total Rent Paid</td>
<td></td>
<td>1,000,000</td>
</tr>
<tr>
<td>Present Value of Total Rent Paid</td>
<td></td>
<td>740,523</td>
</tr>
<tr>
<td>Strike Price (Asset Value: 200%)</td>
<td>2x</td>
<td>4,000,000</td>
</tr>
<tr>
<td>Strike Price (Asset Value: 300%)</td>
<td>3x</td>
<td>6,000,000</td>
</tr>
<tr>
<td>Strike Price (Asset Value: 500%)</td>
<td>5x</td>
<td>10,000,000</td>
</tr>
<tr>
<td>Real Asset Value: (Strike Price = 200% of Cost)</td>
<td></td>
<td>2,171,338</td>
</tr>
<tr>
<td>Real Asset Value: (Strike Price = 300% of Cost)</td>
<td></td>
<td>3,257,006</td>
</tr>
<tr>
<td>Real Asset Value: (Strike Price = 500% of Cost)</td>
<td></td>
<td>5,428,344</td>
</tr>
<tr>
<td>Real Value of Total Cash Flows (Strike Price: 200% of Cost)</td>
<td></td>
<td>2,911,861</td>
</tr>
<tr>
<td>Real Value of Total Cash Flows (Strike Price: 300% of Cost)</td>
<td></td>
<td>3,997,530</td>
</tr>
<tr>
<td>Real Value of Total Cash Flows (Strike Price: 500% of Cost)</td>
<td></td>
<td>6,168,867</td>
</tr>
</tbody>
</table>
In Table 6, we present the results from Structure II. It can be seen that the bank will be able to earn substantial total cash flows by choosing an appropriate minimum price of house. In our illustration, real value of cash flows could be more than historical investment when market price is approximately more than 250% of the cost. We have shown before that if a financial institution had provided financing in year 1993 for 20 years, then in 2013, the average house price increasing by the general inflation rate would have a value of 3.4 times the 1993 value (an increase of 240%).

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Values</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost Price of House</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Period of Lease (in Years)</td>
<td>10</td>
</tr>
<tr>
<td>Period of Lease (in Months)</td>
<td>120</td>
</tr>
<tr>
<td>Total Asset Value Covered from Rents</td>
<td>0.5</td>
</tr>
<tr>
<td>Average Inflation Rate During 1993-2013 in 30 OIC Countries</td>
<td>0.063</td>
</tr>
<tr>
<td>Monthly Rental Value</td>
<td>8,333.33</td>
</tr>
<tr>
<td>Total Rent Paid</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Present Value of Total Rent Paid</td>
<td>740,523</td>
</tr>
<tr>
<td>Minimum Price (Asset Value: 250%)</td>
<td>5,000,000</td>
</tr>
<tr>
<td>Market Price</td>
<td>6,000,000</td>
</tr>
<tr>
<td>Asset Value Received (Nominal Value)</td>
<td>6,000,000</td>
</tr>
<tr>
<td>Real Value of Asset Sold</td>
<td>3,257,006</td>
</tr>
<tr>
<td>Real Value of Total Cash Flows to Bank</td>
<td>3,997,530</td>
</tr>
</tbody>
</table>

**Conclusion**

In this paper, we presented an alternate proposal for house finance. In our proposal, the Islamic bank buys the house by paying the house owner full amount of the house upfront. Then, the bank gives the house on rent to the client and the Islamic bank also enters into an options contract as the call option writer. If the call buyer does not exercise the option, the call options contract expires and the Islamic bank is in a position to give the house on rent again. We presented numerical examples of computing rents in different scenarios and it seems that the proposal is robust in different scenarios. Furthermore, it is substantially and meaningfully different from conventional finance in form and substance. To implement the model on small scale first as an alternative, Islamic financial institutions can fund residential areas with similar types of houses and prices. The market price in such areas is easy to identify and these areas comprise structured real estate with liquid secondary market.

**References**


The Comparison between Musharakah Mutanaqishah and Conventional Leasing Structures, Which One is better?

By

Muhammad Iman Sastra Mihajat*

Abstract

As an alternative to conventional interest-based leasing structure, Islamic finance has come with Musharakah Mutanaqisah (MMQ) mode of contract that is currently in existence. The MMQ is a form of a musharakah (partnership) in which one partner promises to buy the equity share of the other partner gradually until the title to the equity is completely transferred to him. Upon the purchase of property, the Bank will lease the usufruct of its undivided share in the property to the customer against rental payments (ijarah) through periodic installment. Each installment will contain purchase of Bank’s equity and lease rental. In the middle of financing if the customer default, he has some percentage of ownership over the asset, while in the conventional leasing, the customer will not own any percentage of ownership over asset unless and until the customer has made full payment until maturity period. The contemporary Muslim Scholars have consensus on the permissibility of the MMQ contract. This paper compares the MMQ model with conventional leasing structure and seeks as to which one is better. The paper concludes that the MMQ is better than conventional leasing structure for the customer and the Bank giving both several advantages.

Keywords: MMQ, Mushakarah, Conventional Leasing

1. Introduction

Home financing and car financing are the most noteworthy segments of investment in our present banking practices. Islamic banks developed more innovative products to keep themselves free from ribā and attract more customers in order to compete with conventional banks. In some countries, home and car are considered as a basic necessities

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for human life. Home is a place to dwell in comfort with family while car is a means of transport for human beings that deliver them from one place to another. People fulfill these needs either by purchasing or renting from others. Therefore, there are a lot of property agents and car rental companies that rent out homes and cars.

Accordingly, Islamic financial institutions have introduced a number of Shari’a compliant modes of financing to enable people to have a home and a car. There is one popular mode of financing and dominant in countries like Indonesia, Malaysia, Brunei and Middle East such as UAE, Oman, Qatar and Kuwait which is Musharakah Mutanaqishah (MMQ). The use of MMQ is approved by contemporary Shari’a scholars worldwide. Comparing to other Islamic modes of financing like BBA, which contract has been rejected by Middle Eastern Shari’a Scholars, citing that it is similar to conventional loans. According to Meera and Larbani (2004), the BBA contract in theory of finance predicts to be similar to the conventional finance due to the law of one-price. According to them, this similarity has caused Islamic finance to evolve from being a profit and loss banking towards a floating rate financing mode.

Meera and Abdul Razak (2005) argued that the MMQ contract is a better Islamic financing alternative for long durations compared with the al-Bay’ Bithaman (BBA) contract. This paper analyzes the practice of MMQ in Islamic banking that is an interest-free concept and the practice of leasing in conventional banks which deal with interest in financing home and car.

2. Musharakah Mutanaqishah (MMQ) Structure

The structure of Musharakah Mutanaqishah is based on a diminishing partnership concept. It is a form of partnership in which one of the partners promises to buy the equity share of the other partner gradually until at the end of agreed period the title of the equity is transferred completely to him. This transaction starts with the contract of musharaka, then ijarah, after which buying and selling of the equity takes place between the two partners (bank and customer). The promise and other agreement in MMQ must be independent one from other contract. The general rules for musharakah, ijarah, and sale buy agreement are applied to diminishing musharakah.

First the Bank and customer will form a partnership. The bank will appoint the customer to identify and purchase the asset (home or car). The Bank will provide the larger share of the equity for example 80% of the purchase price and customer will contribute the remaining 20% of the purchase price of the asset. Upon purchase of the asset, the Bank will lease the usufruct of its undivided share in the asset to the customer against rental payments through periodic installments under the ijarah concept. Each installment will contain the purchase of Bank’s equity and lease rental. In this regard, the customer will buy the Bank’s equity based on the concept of ‘bay’. Bank’s equity in the asset will be gradually purchased by the customer over the period of financing until the customer completely purchase 100% of Bank’s equity in the asset. The customer’s share ratio would increase after each rental payment due to the periodic redemption until eventually fully owned by the customer. Further, the Bank and the customer will agree a profit sharing ratio (as their respective shares in the asset) for sharing any profit resulting out of the sale of the property.

Bendjilali and Khan (1995) and Muhammad Taqi Usmani basically agreed on the implementation process of Musharakah Mutanaqishah. They agreed that this structure could help people to rely less on other types of financing structures such as murabahah,
ijarah, and BBA and the asset could be leased out according to the rental agreed by both parties. Taqi Usmani (2002) points out that all Islamic schools of thought allow the MMQ structure to be implemented in Islamic financial transactions as both join in ownership in purchasing the property, car, machinery etc. since the customer will gradually purchase the bank’s share until the end of financing period.

3. Implementation of MMQ structure in Islamic Banking

At present, there are a lot of Islamic banks in the world practicing Musharakah Mutanaqishah particularly to purchase property. In Malaysia, the MMQ structure has been widely used such as atRHB Islamic Bank, Maybank Islamic, Kuwait Finance House, in Indonesia such as Bank Muamalat Indonesia, in Middle East such as Al Yusr Islamic Banking Oman Arab Bank, Meethaq Islamic Banking Bank Muscat Oman, Standard Chartered Dubai, Kuwait Finance House, Al Rajhi Bank etc. The MMQ structure will refer to the below process flow:

1. The customer will identify the asset that needs to be purchased and approach the bank. Normally the customer will pay 20% of the purchased price to developer/dealer/seller at the beginning.

2. The financing proposal from the customer will go to the relevant committee for the approval or rejection.

3. After the bank approves the financing, the bank will disburse the financing (bank’s share) to developer/dealer/seller to purchase the remaining 80% of the asset’s share. Bank’s payment will form bank’s equity in the musharakah asset and the customer’s payment will form customer’s equity in the musharakah asset. In this stage, the customer and the bank become the owner of the musharakah asset based on the ratio of payment in purchasing asset.

4. The bank will lease its undivided share in the asset to the customer against periodic rental payment.

5. The customer will make periodic installment payments which will have two components which are, purchase of the bank’s equity and lease rental in consideration of usage of the bank’s share in the asset.

6. With each installment payment, customer will purchase a certain percentage (%) of bank’s share and this process will continue until the customer will complete the purchase of 100% of bank’s equity in the asset.

7. At the end of financing period, customer acquires 100% of bank’s share in the asset and gets the full ownership. The title of ownership of the asset will be transferred to the customer.

4. Shari’a Principles on MMQ structure

The majority Islamic jurists agreed upon the permissibility and Shari’a compliance of musharakah mutanaqishah (Osmani & Abdullah, 2010) and agreed on the validity of musharakah contract which is combined with lease and sale as long as these contracts are separated from one another (mustaqillah) (AAOIFI 2008 No 25 & Mihajat 2014). Smolo (2007) argue on the permissibility of the MMQ based on the consideration of public
interest and benefits for investment. The scholars who are disagreed over the practice of MMQ argue that the practice of MMQ is similar to interest as the purpose of this contract is to give loan with interest, is not a valid argument (Al-Kawamelah, 2008). Moreover, there is no clear text in Shari’a that prohibits the practice of MMQ. This argument is based on the Quranic ayah:

“If the man or woman whose inheritance is in question, has left neither ascendants, but has left a brother or a sister, each one of the two gets a sixth; but if more than two, they share in a third; after payment of legacies and debts; so that no loss is caused (to any one). Thus it is ordained by Allah. Allah is All-Knowing, Most Forbearing.” (Surah al-Nisa’ 4: 12).

Al-Kawamelah (2008) argue that based on this ayah, it is permissible to share a partnership over the property and is legal in the Shari’a. Therefore, the view that claims that MMQ is similar to interest seems to be short-sighted and incorrect since it is clear that the MMQ is joint partnership combined with sale and lease. Moreover, the International Fiqh Academy of OIC (2004) in its 15th session made resolution that MMQ is a valid contract in Shari’a.

Therefore, it is good to have some Shari’a guidelines and parameters for Musharakah Mutanaqishah as suggested by the scholars to avoid the rumor that MMQ practice is similar to conventional. Al Kawamelah (2008) and International Fiqh Academy (2004) have suggested some principles and guidelines for the MMQ contract. However, for clarity and detail, we suggest the Shari’a guidelines and parameters are as follows:

1. The contract of MMQ can be created only on tangible assets. MMQ can be limited to the specified asset(s) and not to the whole enterprise or business.

2. It is not permitted to stipulate that one partner should bear all the cost of the insurance or maintenance since this asset is owned by both parties (bank and customer).

3. It is not permitted to stipulate that one partner has a right to receive a lump sum out of the profit.

4. A binding promise that entitles the other partner to acquire, on the basis of sale contract to equity of the bank gradually can be taken, either according to market value or a price agreed at the time of acquisition.

5. All other terms and conditions as are essential to co-ownership, Ijarah and sale shall be fulfilled in respect of different stages in the process of MMQ arrangement.

6. Proportionate share of each co-owner must be known and defined in terms of investment.

7. Expenses incidental to ownership may be borne jointly by the co-owners in the proportion of their co-ownership.

8. Loss, if any, shall be borne by the co-owners in the proportion of their respective investments.
9. The amount of periodic payment would go on decreasing with purchase of ownership units by the purchasing co-owner.

10. Each periodic payment shall constitute a separate transaction of Sale.

11. A separate agreement/contract shall be entered into at different times in such manner and in such sequence so that each agreement/contract is independent of the other in order to ensure that each agreement is a separate transaction.

The sequencing of the agreements in the MMQ shall be as follows:

i) An agreement of co-ownership between the parties.

ii) An agreement of lease between the co-owners to lease out one’s share in such property to another for an agreed periodic payment in consideration of the use of the former’s share by the latter.

iii) The sale of units by one co-owner to the other co-owner as aforesaid shall be documented in such a manner as the parties may mutually agree.

5. Conventional Leasing Structure

Conventional leasing contract is a contract between a Lessor and a Lessee for the hire of a specific asset. The lessor retains the ownership of the asset. However, the right to use the asset is given to the lessee for an agreed period of time in return for a series of payments paid by the lessee to the lessor (Kamali, 2007). In case of leasing the property, it is a contract between a landlord and tenant for hire of a specific property. The lessor retains ownership of the property, and the right to use the property is given to the lessee for a period of time in exchange for a series of payments made by the lessee to the lessor, while the lessee is the owner of the lease property (Fatima, 2006). In financial institution, the customer also the one who own the property during the loan period. In case of car loan, the customer also retains the ownership of the car until the end of loan period. However, in the title of ownership of the car, it is stated that the car is mortgaged to the bank.

The bank will charge some penalty amount to the customer, if the customer as the lessee, delays in payment. In conventional leasing, there is no option for the customer to purchase the property or car at a bargain price. The leasing company will take over the property / car if the customer is not able to pay in three months while the customer has no right at all over the property / car. In addition to that, Kamali (2007) mentioned that on termination of lease contract, all obligations that are still executory on both sides are discharged. Lessor considers market related forces such as market rate of interest while scheduling lease payment for basis of lease determination. The leasing company does not recognize any selling profit in this structure since it is not equivalent to sale.

6. Comparison between MMQ and conventional Leasing Structure

Meera and Abdul Razak (2005) provided the comparison between Musharakah Mutanaqishah (MMQ) and Bay Bisaman Ajil (BBA). They concluded that MMQ has several advantages over the BBA for the customer. Mohd Noor (2008) provides a comprehensive comparison on the operational structure, Shari’a, problems in practicing
the product, and risk associated with BBA and MMQ. Noor concludes that MMQ is better as there is no interest charge or advance profit involved. It is based on the concept of rental payments and redeeming the bank’s share in the asset. Nevertheless, MMQ has several problems and practical issues in implementation (Meera and Abdul Razak, 2009).

In conventional leasing, for example the customer wants to buy property/car for RO 100,000 and approaches the bank. Upon acceptance of the application, the bank gives a loan to the customer and charges interest. The customer has to pay on monthly basis based on the agreed period. In conventional leasing, the customer owns the property/car immediately after the contract which is mortgaged to the bank. While in MMQ, the customer jointly buys a property/car based on musharakah and jointly owns the asset with the bank. The bank will lease its undivided share in the asset through periodic installment. Each installment will contain a portion of rental and a portion of purchase of the bank’s share. The bank’s share in the asset will be gradually purchased until the customer will complete the purchase of 100% of bank’s share in the asset.

In summary, the main differences between MMQ financing and conventional leasing are as follows:

1. There are three separate contracts under the MMQ method. The first is musharakah, the second is ijarah, and the third one is sale. The conventional leasing, is a loan contract plus interest which is ribā and prohibited in Shari’a.

2. Under conventional leasing, the ownership is retained with the bank/leasing company. While in the MMQ, the customer has the ownership of the asset based on his percentage of contribution.

3. Under conventional leasing, the customer bears totally the risk of the asset. Under MMQ, the bank and the customer will jointly bear the risk based on the ratio of the ownership. If the risk is due to the negligence of the customer, the customer shall bear the loss.

4. Under conventional leasing, the customer has to pay the rental at the beginning of the contract although the property is under construction. Under MMQ, the bank will give grace period until the property is ready and can be utilized. The customer will start to pay the rental at the time usufruct is created.

5. Under conventional leasing, the rental can be revised based on the fluctuation of the interest rate. Under MMQ, the rental rate can be revised periodically as is agreed by both parties which is a reflection of market condition or market rate of rental. It can be tied also to some economic variables like National Rental Index, House Price Index etc.

6. Under conventional leasing, there is no profit sharing between the bank and the customer. Under MMQ, the customer and the bank will share the profit based on the agreed distribution ratio resulting out of the rental and the sale of asset.

7. Under conventional leasing, the bank/leasing company will charge penalty to the customer over the late payment and the interest will be compounded.
While under MMQ, as per Shari’a the bank will charge the late payment charge that is not more than 1% and allocate it for charity. The charity cannot be retained as income or taken benefit of.

8. Under conventional leasing, if the customer default or fails to meet his obligation for certain period, the bank will terminate the contract and take over the asset. The customer has no right and ownership over the asset. Under MMQ, if the customer fails to pay the rental payment for certain period (default), the bank and the customer will sell the asset and share the proceed and profit (if any) based on the percentage of ownership at that point in time.

9. Under conventional leasing, the increase in cost of asset is based on interest rate. Under MMQ, it is prohibited to use interest, the increase in cost of asset should be based on the market price of the asset.

10. The MMQ is accepted internationally as Shari’a compliant contract and majority of Shari’a scholars agree on the validity of MMQ and the validity of the combination of three contracts in the MMQ (Al-Kawamelah, 2008; Smolo, 2007). Whereas in conventional leasing structure, all Shari’a scholars globally agree on its prohibition as it contains the element of interest (ribā).

7. Conclusion

This paper made a comparative analysis between the MMQ and conventional leasing structure as means for property and car ownership. In this regard, this paper attempted to argue in favor of the MMQ as a better alternative structure to the conventional leasing. The MMQ structure consists of musharakah, ijarah and sale contract where the equity of the bank follows a diminishing balance method while conventional leasing is a loan contract with interest. Contemporary Shari’a scholars have consensus on the permissibility of the MMQ structure and validity of combination of the three contracts.

In addition to that, Meera and Abdul Razak (2005) argue that the MMQ structure can be made to avoid interest (ribā) totally and can reduce the cost of homes and the duration of financing. The balance of finance, at any point in time, never exceeds the original price of asset, unlike conventional leasing. The MMQ is just and fair compared to the conventional leasing structure as there is no interest charge or advance profit involved in the musharakah mutanaqishah structure. It is purely based on rental payments of asset and redeeming the bank’s share.

Therefore, the paper suggests to use MMQ structure rather than conventional leasing concept due to several advantages for the bank and the customer. The MMQ also brings stability into the economy by promoting positive partnership instead of negative indebtedness thus assisting in the equal distribution of wealth.

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Islamic Financial Engineering:
An overview

By
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Abstract

The past two decades have witnessed phenomenal growth of the Islamic financial services industry. The whole industry has been thriving at about 15 percent per annum. This development brings a challenge to the Islamic financial engineering (IFE), which is lagging behind its conventional counterpart. Therefore, in order to achieve its goals, two approaches are available, i.e. 1) replicating engineering and 2) innovative engineering. We also try to emphasize the innovative strategy since it guards the Islamic identity of different financial products and processes, and thereby, improves the creativity in the Islamic financial industry. The attempt also centers on sukukization (Islamic securitization), liquidity management, and risk management and hedging in the Islamic financial system, as well as Islamic capital markets, as a fertile field for IFE. Finally, the challenges facing IFE are also addressed.

Keywords: Financial Engineering, Hedging, Risk Management, Securitization, Islamic Capital Markets, Islamic Financial Institutions

1. Introduction

Islamic financial services industry has experienced unprecedented expansion over the last two decades or so in many parts of the world. The whole industry has registered a growth rate of about 15 percent per annum. Shariah-compliant managed assets currently valued at $1.814 trillion and projected to rise at a remarkable pace in the coming years. Currently, there are over 400 Islamic financial institutions operating in more than 100 countries, gaining popularity in the five continents, and contribute enormously to the industry worldwide. It is increasingly becoming a subsector of mainstream international finance.
Islamic finance, IF, is a model that comply with Islamic principles, known as Shariah or Islamic law, based mainly upon the prohibition of riba (interest), speculation, gharar (excessive risk), unjustified enrichment, maysir (gambling), and other unethical practices, investments, and products. Moreover, IF is also based upon asset-backing tenets, i.e., each financial transaction must be tied to a tangible, identifiable underlying asset; sanctity of contracts; profit sharing, risk sharing, and other Shariah-compliant principles, (Djebbar, M., 2011, pp. 162-4).

There are a considerable (but not enough) number of Shariah–compliant financial products and services available in the market and designed to meet the growing demand and needs of those who seek to invest in accordance with Shariah principles. These include: Shariah-compliant stocks, Sukuk or Islamic bonds, Islamic investment funds, Islamic risk management instruments, such as Islamic derivatives, and, finally, Islamic structured financial products.

Up to now, there is no standard definition of financial engineering, FE, however, the most common one, generally attributed to Finnerty, involves the “design, the development, and the implementation of innovative financial instruments and processes, and the formulation of creative solutions to problems in finance”, (Finnerty, 1988, p. 14-15):

It is crucial noting here that Finnerty has already mentioned, within the scope of conventional FE, the form of asset-based financing which is a widely utilized form in Islamic financing, although it is largely controversial. He has also stated in his book that “project financing can best be thought of as a form of asset-based financial engineering. It is asset-based because cash financing is tailored around a specific asset or a related pool of assets. (Finnerty, 2007, p. 398)”.

The International Association of Financial Engineers (IAFE) defines FE as follows (Fabozzi, 2009, p. 417, 418):

- Financial engineering is the application of mathematical methods to the solution of problems in finance. It is also known as financial mathematics, mathematical finance, and computational finance.

- Financial engineering draws on tools from applied mathematics, computer science, statistics, and economic theory.

To sum up, it is important to point out that the FE is a relatively new field that uses mathematical, computational, and innovative tools in the domain of finance. It can be viewed as the strategies and techniques that are based upon innovation of new financial instruments and processes, including derivatives and structured products\(^1\), which lead to lower transaction costs, better risk management, higher investment returns, and provide

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\(^1\) A derivative product is a financial instrument (or a contract) that derives its value from its underlying asset. The main types of financial derivative instruments are: options, forwards, futures, and swaps. They are usually utilized to hedge against risks, particularly undiversifiable ones. Whereas, a structured product, SP, is a packaged investment constituted from two or more instruments, usually a fixed-return financial product for protecting the principal if held to maturity, (a risk-free bond, for instance); and a derivative product for making profits, (an option, for instance). SPs are utilized for portfolio diversification and risk management.
creative solutions to financial problems. It is usually applied to a wide range of fields and instruments, such as: derivatives pricing, portfolio management, risk management, corporate financing, trading, structured products and other sophisticated instruments, and restructuring of a company’s capital structure (balance sheet), and managing the risks it is facing; mergers, acquisitions, dividend policy, shares value management, and so on. FE also deals with some other major aspects such as legal, tax, and technological activities as well as the conceptualization, and creation of a large spectrum of consumer-type financial instruments, securities, processes, financial strategies, and solutions. These products and processes are often engineered specifically to meet some risk management requirements, achieve better returns, lower funding costs, stimulate market liquidity, and eventually enhance the whole efficiency of the financial system.

The remaining of the paper is structured as follows. The next section (section 2) covers the literature of Islamic financial engineering, IFE. Section 3, which is the main part of the paper, analyses various aspects of the IFE, focusing mainly upon the factors that contribute to its development. It also discusses the broader scope of IFE, its approaches, and pillars. It precisely highlights several aspects, such as, financial innovation, securitization, hedging and risk management, and liquidity management; and finally it deals with the challenges faced by IFE. Section 4 summarizes key points and concludes the paper.

2. Literature Review

The literature on Islamic Financial Engineering, IFE, is vast and addresses a wide spectrum of issues; and consequently, there have been considerable researches conducted on this area. Thus, many studies focus on IFE in general and its principles and approaches and how it is utilized to solve financial problems, (Bouhraoua, 2014; Sidiqqi, 2007; Solé, 2007; Al-Suwailem, 2007; Iqbal and Mirakhor, 2007; Kahf, 2004; Hassan, 2002; Iqbal, 1999). Innovation of Islamic financial instruments for different purposes, especially portfolio diversification and risk-management, has attracted many academics, (Dar, 2012; Parker, 2009; Dusuki and Abozaid, 2008; Rethel, 2007; Aziz, 2007; Bin Ibrahim, 2005). Asset securitization in Shariah framework has become the focus of attention from several scholars, (Al-Sayyed, 2010; Jobst, 2007; Kahf, 2004; Al-sheahabi, 2003; Abdi Dualeh, 1998). Islamic financial institutions, IFIs, and research bodies have also developed some hedging and risk management products and strategies, such as, Islamic derivatives, to meet their customers’ needs, (Haider and Azhar, 2010; Kunhibava, 2010; Damak and Voland, 2008; Al-Suwailem, 2006; Tariq, 2004; Latif and Crawford, n.d.). Other aspects of IFE, such as, Islamic capital markets, liquidity management, and different challenges have been discussed in detail by some researchers, (Laldin and Furqani, 2013; Ónal, 2013; Ul Hassan et al, 2013; Abdullah, A.S., 2011; Abdullah, D.V., 2010; IFSB, 2010; Haider and Azhar, 2010; Alvi, 2009; Usmani, 2008; Solé, 2007; Aziz, 2007; Rethel, 2007).

3. Islamic Financial Engineering

As we have already mentioned, Islamic financial industry, in tandem with its conventional counterpart, is experiencing an era of swift innovation, especially in the last two decades. This innovation, which is considered as the essence of financial engineering, FE, in Islamic financial system as well as in mainstream one, is fueled by many different triggers such as the rapid improvements in communication technology,
efficiency of the financial system, strong demand for Shariah-compliant financial products and services from both Muslim and non-Muslim investors, needs for better risk-management tools, liquidity enhancing strategies and instruments, and rapid growth of financial markets.

Islamic financial engineering, IFE, is also the “designing, the development, and implementation of innovative financial instruments and processes, and the formulation of a set of creative solutions to financing problems of companies within the Islamic framework, (Nessar, in Bouhraoua, 2014, p. 3)”. In a nutshell, it is clear that IFE shares many features with its conventional counterpart, and there are numerous characteristics in common, such as creating financial products, processes and strategies in order to achieve specific financial solutions. Thus, IFE also provides more investment opportunities and portfolio diversification, stimulates liquidity, responds to risk management and hedging needs, copes with tough global competition in a rapidly changing environment, and eventually enhances resource allocation efficiency. However what is particular in IFE is that all financial products, activities, transactions, processes, and solutions, are subject to and must comply with Shariah principles; i.e. Islamic rulings, jurisprudence, and norms of financial ethics.

3.1 Broader scope of IFE

IFE is not only concerned with the conceptualization and implementation of the financial products and processes, risk management, derivatives pricing, and restructuring companies’ capital structure during acquisitions and mergers’ processes, but also concerned with implementing necessary financial arrangements in cases of setting up Islamic ‘windows’ and subsidiaries, and more importantly, converting a conventional bank into a full-fledged Islamic bank. In this part of the paper we focus on this last process.

Transforming a conventional bank to an Islamic financial institution is a strategy followed by more than a dozen banks so far. The main reason for it is that many conventional banks and financial institutions are becoming increasingly interested in Shariah-compliant finance and investment since it is a profitable market segment, on one hand; and there is a stronger demand for Shariah-compatible financial products and services from Muslim and non-Muslim investors alike, on the other. Thus, those converted institutions aim to maintain their positions or even improve their market share. Moreover, it is worth noting here that banks seek full conversion when they have already gathered a considerable number of Shariah customers and investors; and thereby take advantage of the available opportunity.

However, when a conventional bank decides to completely convert into a full-fledged Islamic institution, it must ensure that all the items of its balance sheet, BS, are compatible with Shariah. Therefore, all interest-related elements in the BS, especially loans, must be changed into non-interest-bearing assets and liabilities. One way of transforming an existing loan is to replace it with a Tawarruq instrument.

In practice, Sharjah Islamic Bank (or SIB), originally founded as the National Bank of Sharjah in 1975, became the first bank in the world to convert into a full Shariah-compliant financial services provider in 2002. Until 2004 SIB, in tandem with its rival Dubai Islamic Bank (DIB), is performing well and leading the field of banking industry in the UAE.
3.2 Approaches to IFE

Product development is one of the most important goals of Islamic financial industry. To achieve this major aim, two approaches are utilized: reverse engineering and innovative engineering.

3.2.1 Reverse Engineering

This strategy of product amelioration so that it becomes Shariah-compliant instrument “entails taking an existing instrument in the conventional system and evaluating each component to find the closest substitute from the basic set of Islamic instruments, (Iqbal, 1999, p. 547)”. So this approach provides a rapid method of creating new Shariah-approved instruments through replicating conventional ones, (in terms of functions and techniques), especially those which are well established, recognized, and well understood by traditional investors. This will definitely improve products efficiency and ease Islamic financial market integration to financial mainstream.

Nevertheless, seeking Shariah-compatible “equivalents” by imitating conventional instruments is not without disadvantages and problems. In this regard, our distinguished scholar Al-Suwailem listed four main drawbacks of such a replication. First, this strategy gives more importance to form over substance, and means over ends. Second, the strategy makes the Islamic financial industry as a kind of follower to its conventional counterpart, and this contradicts creativity and innovation. Third, Islamic replicated instruments are subject to additional constraints of Shariah rulings, and, therefore, are inferior to conventional ones. Fourth, conventional instruments are designed to solve problems specific to conventional industry, therefore, replicating those instruments will bring the same problems to the Islamic industry, and the later will probably lose its identity, (Al-Suwailem, 2007, p. 95-6). Because of those shortcomings, replicated Islamic financial products may become more costly compared to their conventional counterparts.

In a nutshell, reverse or replicating engineering is an approach that takes already accepted conventional financial products and “forge” or “tailor” them so that they comply with Shariah principles, i.e. avoiding all aspects of, (and purify them from), riba, gharar, gambling, etc. Moreover, although this strategy is widely used in IFE, it is, however, not an ultimate goal, since it is a way of providing instruments capable to solve different financial problems in Islamic financial industry.

3.2.2 Innovative Engineering

This second strategy in product development in Islamic financial industry, which is better than the previous one, is to “design instruments de novo from an established menu of Islamic instruments. The result will be a new array of instruments, each having a unique risk-return profile, bought and sold in specialized markets compatible with Shariah principles, (Iqbal and Mirakhor, 2007, p. 208)”. Thus, this approach to IFE is to apply Shariah rulings and tenets to create, design, and develop new financial products that serve and satisfy a wide range of customer needs for investment and hedging purposes; and are cost-effective instruments, attractive to ordinary as well as Shariah investors alike.

2. Depending upon the starting point of the developing process, Al-Suwailem, S., (2007), distinguishes between 3 strategies of product development (instead of 2). These are: imitation (i.e., to start from conventional products), mutation (i.e., to start from Islamic products), and satisfaction (i.e., to start from the reel needs of customers).
However, this process, i.e., creating completely new financial products, faces serious obstacles. First, it needs deep understanding of different Shariah rulings (taalem), schools and thoughts, (especially the four mazhab), etc. Actual financial system needs also particular attention since it operates, in most times, and affected by, a conventional environment, including the monetary policy, and therefore, creating largely accepted Shariah-compliant instruments becomes an increasingly difficult task, costly, and time consuming. Second, after being Shariah-compatible, economically efficient, and easy to understand, the new products face the challenge of tough competition from old well established conventional counterparts. In this regard, Islamic financial instruments must be characterized by some high quality, positive value added, risk-sharing and other forms of hedging, and judicial compatibility, etc. Third, Islamic products should be demand driven products and capable of solving potential financial problems, and therefore, can attract sustainable investors, mainly those who seek risk-management and hedging instruments, as well as portfolio diversification.

Finally, for Islamic financial engineers, IFEs, to benefit from different strategies of product development, there should be some kind of combination between duplicating engineering and innovative engineering. Thus both strategies complement each other, and therefore, IFEs should take advantage of this complementarity and use both approaches at the short-, medium-, and long-terms practices in innovating new Shariah-compatible instruments, and ultimately, meet different customers’ needs.

3.3 Pillars of IFE

It seems at first glance that IFE deals with the same topics as its conventional counterpart, such as innovation, securitization, risk management, and so on, and in the same way. However, in fact, IFE differs to a great extent from its conventional counterpart, since all instruments, and a large part of the processes and activities are completely different from conventional ones.

3.3.1 Innovation

Van Horn considers that financial innovation as “one of the bedrocks of the American financial system and the life blood of efficient and responsive capital markets. He refers to it as a new product, such as a zero coupon bond, or a new process, such as a new delivery system for electronic funds transfer, (Van Horn, 1985, p. 621)”. Miller also noted, about the extreme importance of financial innovation, that the “word revolution is entirely appropriate for describing the changes in financial institutions and instruments that occurred during the 1970’s and the 1980’s, (Miller, 1986, p. 459)”. On the other hand, Merton links financial innovation directly to risk management emphasizing the role of derivatives in improving efficiency by expanding opportunities for risk sharing, by lowering transaction costs, asymmetric information, and agency costs, (Merton, 1995, p. 463).

Financial innovation is, therefore, a keystone in any modern and dynamic financial system, where hundreds of financial products and services are created and launched to raise capital, reduce costs, stimulate returns, hedge against risks and, in general, achieve financial objectives. The reasons behind different waves of financial innovation in conventional financial systems, particularly during 1970s and 1980s can be summarized into 9 categories, (Van Horn, 1985; Miller, 1986; Finnerty, 1988; Ramsay, 1993): (i) inflation, and nominal and real interest rates, (ii) tax laws (tax savings), (iii) regulatory or legislative changes, (iv) transaction and agency costs, (v) accounting benefits, (vi)
technological advances, (vii) academic work, (viii) opportunities to reduce or re-allocate risks, and (ix) opportunities to increase an asset’s liquidity.

With regard to Islam, it always encourages constructive creativity, learning, skill-getting, and all sorts of inventions that benefit the entire humanity. In this respect, the prophet Mohamed (PBUH) said the following Hadith, which may roughly mean, “In Islam, anyone who invented a good thing (sunna hassanah) will receive its reward and the reward of anyone who practiced (or followed) it afterwards without any detraction; and anyone who invented a bad thing (sunna sai’a) will bear its punishment and the punishment of anyone who practiced (or followed) it afterwards without any detraction, (from: Sahih Muslim, Ahmed, and Others). Of course a “good thing” in this hadith means all actions and realizations that help the Society to grow, improve, and be better off in all aspects of life, but not inventions in religious matters. Hence, this hadith could be considered as the basis for innovation and creativity in Islamic financial sphere; and an incentive to Islamic financial engineers to design, develop, and launch financial products, services, processes, and strategies that comply with Shariah tenets.

Moreover, it is worth noting that, the aim of Islamic financial innovation is not only creating different products and services, and strategies compatible with Shariah for different purposes, but it also interests in social responsibility and development goals. For achieving all that, it is required from IF Engineers large knowledge of modern financial techniques and practices, which become more and more sophisticated, on one hand; and deep understanding of Islamic jurisprudence (fikh) and Shariah rulings, on the other. All that should be accomplished and approved by Shariah supervisory boards, SSBs, which are usually constituted of competent Shariah scholars and experts. In the same order of ideas, Rethel (2007) considers that the involvement of big conventional market actors such as Citibank, HSBC, UBS, and Deutsche Bank has benefited Islamic financial innovation, as they have already accumulated huge innovative skills and means to invest in the development of Islamic financial products.

Indeed, there has been a significant innovation in Islamic financial products (greater diversity of Sukuk and other instruments), services, processes, and strategies, especially in Malaysia as a pioneer of Islamic Financial industry, although some of those innovations seem controversial and have been contested by some Islamic scholars and SSBs, mainly on their Islamic compliance.

Finally, it is worth noting that the most significant drivers of the development of the Islamic financial industry in general, and most influential factors responsible for financial innovation in particular are: strong demand for Shariah-compliant instruments, abundant liquidity available in different part of the world, particularly in the Middle East and other oil producing countries following the substantial rise in oil prices, academic work, transaction costs, assets’ liquidity and negotiability, risk reduction, and technological advances. Those triggers are not far from those in conventional financial innovation. Moreover, innovation gives also opportunities to IFE to grow and progress. The main Islamic financial innovations are Islamic structured products, Islamic hedge funds, Islamic derivatives, Islamic liquidity management tools, Shariah indexes, Convertible Sukuk, and so on.

3.3.2 Securitization

Jobst considers that the most important form of structured finance is capital market-based risk transfer (except loan sales, asset swaps and natural hedges through bond trading). This form includes two major asset classes, namely, asset securitization (used for funding purposes), and credit derivative transactions (as hedging instruments). This permits to issuers to better transfer and diversify risks, (Jobst, 2005, p. 2-3). Securitization is, therefore, a process whereby assets with an income stream are pooled and converted into securities for trading in the capital market. An example is the possibility of securitization of a country’s external debt, (Ramsay, 1993, p. 171). It should be noted that securitized instruments are a sub-set of structured finance products that are traded in capital markets as risk transfer instruments.

In light of all this, we can describe the term “securitization” as the process of pooling and converting some determined homogeneous real and financial assets, usually in a dormant situation, into liquid securities that could be easily traded in capital markets. It provides wider choice of investments and higher returns to investors (security holders), new alternative market-based funding sources to issuers, instead of debt financing, diversification and redistribution of different asset risks, reducing funding and transaction costs, and increasing portfolio liquidity (convert assets into cash).

With respect to Islamic finance, as we have already mentioned, it relies primarily upon asset-backed financing modes, and therefore, asset securitization should help the whole industry to develop and grow, and particularly Islamic financial innovation. Consequently, asset securitization has become the focus of attention from scholars and practitioners alike, since it increases the number of tradable financial instruments, enhances liquidity, and reduces costs.

According to Jobst, Islamic asset securitization describes the “process and the result of issuing certificates of ownership as pledge against existing or future cash flows from a diversified pool of assets to investors. It registers as an alternative, capital market-based refinancing mechanism to diversify external sources of asset funding…. (Jobst, 2007, p. 14, 15)”. On the other hand, Al-Sayyed argues that “Sukukization (Islamic securitization), is not equal to conventional securitization and refers to “Islamic Sukuk investment (as defined by AAOIFI4), which are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct, and services. In other words, sukukization is a process for an immediate liquidation, direct access to capital market, creation of a secondary market and risk segmentation –often referred to simply as Sukuk, (Al-Sayyed, 2010, p. 2, 3)”.

Hence, Islamic asset securitization referred to as sukukization or taskik or even sometimes tasnid is a relatively new phenomenon that has been taking place quite recently in Islamic capital markets; and Shariah-compliant securitization is the process of issuance of tradable securities compatible with Islamic principles, mainly Sukuk, which must be backed by tangible indentified assets. For a securitization structure to comply with Shariah tenets, the assets being securitized must also themselves comply with

4. AAOIFI stands for the “Accounting and Auditing Organisation of the Islamic Financial Institutions”.

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Shariah principles. For example, we cannot securitize Shariah-prohibited businesses and activities such as a leased factory devoted to produce and distribute pork-related products or an entertaining and gambling center.

Since every Islamic securitization must be asset-backed structure, all investors or Sukuk holders own tradable investment certificates representing an undivided share (ownership) in the underlying asset or the pool of assets. Therefore, they receive a proportional share of the income generated by the asset and the repayment of the principal amount and not a fixed interest.

Technically, Shariah-compatible asset securitization involves different parties, such as: the originator, an SPV (a trust), a guarantor (dhaman), investors, and the services of a rating agency. It also relies on true sale, i.e., the shifting of asset ownership from the balance sheet, BS, of the originator to that of the SPV, and ultimately to that of the investor, and therefore, sharing (shifting) risks. In doing so, acceptable (cost-effective) portfolio of assets is pooled and transferred to a SPV or the issuer (a tax-exempt entity or trust established for the purpose of funding the underlying assets). Once the assets are transferred to the SPV, there will be no recourse to the originator in case of bankruptcy. The SPV, then, issues tradable securities, usually Sukuk, sells them to investors and fund (the purchase of) the underlying assets from the originator or the asset owner, which is a true sale, then after using the proceeds of the Sukuk issuance to purchase tangible and income-generating Shariah-compliant assets. The issuer declares a trust over its assets for the benefit of the Sukuk holders or investors, who own the underlying assets, and therefore, they share both risks and return according to their proprietary interests, and the income depends on the performance of the assets. The main reason for all that is to reduce the risks inherent to those assets and diversify them on investors through asset-backed securitization.

Probably the best and most evident case of asset backed securitization in Islamic financial industry is the Ijarah-contract securitization. Since Ijarah is a flexible instrument and practically backed by the assets being leased during the period of the contract, the investors are the owners of those assets, and therefore, are not exposed to any credit risk. So there is some kind of dhaman (guarantee). Ijarah also provides a regular predetermined stream of cash flows (income), i.e., rental payments, which is a main characteristic of Shariah compliant as well as conventional securitization forms. Moreover, the Sukuk issued among Ijarah securitization structure represent ownership of the underlying assets, and are tradable in capital markets, and thus will attract increasing number of investors to Islamic instruments. In this respect, as an example, in March 2004, Beirut based BSEC Investment Bank and the Bahrain based Shamil Bank issued US $27 ml Shariah-compliant Ijarah investment Sukuk to securitize a Saudi-Arabian car fleet inventory (CARAVAN I Limited) over a three-year maturity term. A special purpose company, SPC, was set up, and which issued Sukuk notes to investors, (Jobst, 2007, p. 14).

In accordance with the principles of Shariah, asset securitization can also be carried out by the issuance and trading of Sukuk based upon Mudharabah, Musharakah, or Murabaha contracts. The Sukuk holders are the owners of the underlying projects or assets, and therefore, they do not receive predetermined fixed interests, but rather, they reap a part of the profits generated by those projects and activities. Furthermore, contracts such as Mudharabah and Ijarah can be combined to form an individual contract and then securitized by issuing Sukuk representing the ownership of assets of the mudharabah-
The *ijarah* project. In this way, securitization should be developed in order to finance different new projects and activities, on one hand, and providing liquidity to existing assets and trading Islamic securities in the secondary market, on the other. Finally, securitization is another pillar of IFE that provides more opportunities, pushes Islamic financial industry to grow, and help Islamic institutions to enhance their market share and, ultimately, a possible integration to global mainstream.

### 3.3.3 Hedging and Risk Management

Risk is referred to as all undesirable results and outcomes, particularly in economic and financial transactions (the chance of financial loss). Risk can also broadly described as the “chance that actual outcomes may differ from those expected, (Gitman, 2003, p. 15)”. Consequently, hedging and risk management’s studying becomes a crucial area of research in financial economics, since risk cannot be avoided and there is no asset or transaction without one form or another of risk. Thus risks exist in all aspects of economic and financial life, and therefore, as it has been already mentioned, the Islamic financial system is of great need of different risk management and hedging strategies.

Nevertheless, Islamic financial institutions, IFIs, and consequently products developed by those institutions, face different categories of risk. It should be noted here that Islamic institutions and financial instruments face most of the risks faced by their conventional counterparts. In addition to that, Islamic institutions and products, particularly *Sukuk*, face additional risks such as *Shariah*-compliance risk, risks related to assets, face value realization risk, benchmarking risk, staff related risk and so on.

Analogous to conventional risk management, Islamic risk management is also a process where risk is identified, assessed, evaluated or measured, in order to minimize, control, and monitor its impact upon the underlying investment. Nevertheless, according to Usmani (2002), risk management in Islamic financial system is more complex and difficult than in its conventional counterpart, due to the limited number of risk management tools. It is also characterized by risk sharing between different parts of the transaction. On the other hand, there are different approaches to manage risks without violating the basic principles of *Shariah*.

Risk management, according to *Shariah* precepts, is also carried out within those teachings and guidelines of Islamic financial industry, such as prohibition of *riba* (interest), *gharar* (excessive and unjustified uncertainty), gambling and speculation as well as the ban on financing unethical sectors. More importantly, it is also based on asset ownership, asset-backed transactions, and profit-and-loss-sharing principle.

With respect to tools and strategies, it should be clear that, in the Islamic financial system, conventional financial risk management instruments, especially conventional derivatives, are not compatible with *Shariah* tenets, because of the *gharar* they contain. Also a common reason why these hedging arrangements are seen as non-compliant is that, “although a financial risk management product is linked to the value of an asset, it does not require ownership risk in the asset itself and any profit earned is earned independently of trade ownership, or investment in such an asset, (Latif & Crawford, without date, p. 2)”. This means that those products used in conventional capital markets cannot be used as Islamic financial risk management tools. However, there has been an increasing demand for such instruments that are viewed as *Shariah*-compliant, to meet *Shariah*-investors’ needs for hedging arrangements.
Furthermore, hedging, as an investment position to offset potential losses/gains, in Islamic as well as in conventional financial systems is a fundamental means of controlling risks (beside diversification), particularly, in the case of systematic or general risks. Diversification, on the other hand, fits best unsystematic or specific risks. Hedging is, therefore, used to “denote neutralizing and minimizing risk. In this respect, it naturally belongs to Islamic economic objectives. Thus, hedging effectively means managing risk, rather than eliminating it, (Al-Suwailim, 2006, p. 57, 111)”.

Centering on hedging in Islamic perspective, as a risk management strategy, there are more difficulties than solutions, since most hedging techniques, though limited in number, depend heavily on derivative products, which are prohibited in the way they are practiced in conventional capital markets, as it has already been pointed out. So hedging or, more precisely, adapting or replicating conventional derivatives is an enormous controversy and provoked a large debate among Shariah scholars and Shariah Supervisory Boards, SSBs, about the Shariah compliance of most of those instruments.

Nevertheless, hedging in Islamic financial transactions gradually becoming an acceptable means of risk management, provided that those transactions themselves are not violating Shariah principles. Progress is evidenced, however, by the creation of a considerable number of Islamic hedging instruments, as a result of a great research effort and academic work performed by different Shariah scholars and research bodies.

Other Shariah scholars and jurists prefer to deal with Islamic derivative instruments in more detail and using the same connotations as their conventional counterparts. Agha, for instance, introduces some Islamic derivative models, such as Islamic swaps (i.e., FX swaps, cross-currency swaps, and profit rate swaps); Issoufou discusses Bay al-salam and Bay al-istisna’e contracts as alternatives to conventional future contracts, as well as urboon as an alternative to conventional options. Babatunde and Adeyemi also examine the permissibility of forward, future and other derivative contracts in Islamic finance. Moreover, Kunhibava goes deeper in treating the subject by introducing other instruments such as salam, istsina’e, urboon, istijrar, Islamic swaps, khiar al-shart, wa’ad and jualah, (Agha, 2013; Issoufou, 2013; Babatunde and Adeyemi, 2013; Kunhibava, 2010). This subject comes beyond the scope of this paper.

### 3.3.4 Liquidity Management

Another challenge which still faces IFE is to design, develop, and provide effective, flexible new Islamic liquidity instruments to meet issuers and investors’ requirements, and that satisfies the Islamic prohibition of riba, gharar, and provides sharing of profits and losses on underlying transactions, i.e., Shariah-compliant money market instruments. Daily practices show that, for day to day operations, some banks (Islamic and conventional alike) need liquidity to fulfill their obligations; and some other banks have excess liquidity, and therefore, both types of banks need to manage their liquidity according to their situations and goals. Furthermore, too much (dormant) liquidity in a bank is undesirable, since excess liquidity must be invested in an effective way, in order to maximize the return on total assets; and a shortage of liquidity is also undesirable, since it must be refunded in a cost-effective manner, and to avoid the situation of not having enough liquidity to meet any mismatch of the term structure of assets and liabilities, typically through interbank money market operations. Technically, as we have learned from financial theory, most problems of insufficient liquidity are due to financing long-term assets using short-term liabilities. In this regard, Önal describes the liquidity
management as the “ability of a financial institution to remain liquid enough to make its payments in time while maintaining an optimal cost-return balance to achieve that purpose by means of selecting and using the most appropriate tools for this aim, (Önal, M.I., 2013, p. 308)”.

The issue of liquidity management in Islamic finance is increasingly addressed due to the existence of a huge excess liquidity in Islamic financial institutions, IFIs, on one hand; and to the risk inherent to those mismatches that could take place in the balance sheets, BSs, of IFIs, and which has been seriously neglected by supervisory and regulatory bodies, particularly with greater demand for Shariah-compliant short-term instruments worldwide, on the other. In the same order of ideas, and also according to Önal, in countries which provide data, IFIs “hold two to ten times more excess reserves at central banks as a percentage of their deposits compared to conventional ones so as to be able to remain sufficiently liquid”. In addition to that, Ul Hassan et al recognize that the Islamic financial system has more equity based instruments than conventional system and promotes equity based instruments rather than debt based instruments, (Ul Hassan et al, 2013, p. 1700).

Therefore, it should be stressed that excess liquidity is harmful to those IFIs, since it has also a negative effect upon its competitiveness, and leads to higher costs of the risk management process as a whole. To achieve the objective of better managing liquidity, IFIs have already established a number of liquidity management centers to supply the appropriate needed instruments. Hence, early in 2002, Dubai Islamic Bank, Bahrain Islamic Bank, and Kuwait Finance House signed an agreement to establish the Bahrain-based Liquidity Management Centre (LMC), with a paid up capital of $15 m. The LMC is a market maker for Islamic secondary market instruments, and thereby, a segment of the International Islamic Financial Market, IIFM. LMC also seeks to develop an active secondary market for trading Shariah-compliant financial instruments, especially short-term ones; and facilitate the creation of an Islamic interbank money market that would enable IFIs to manage their liquidity effectively. By October 2010, Malaysia also established its own LMC, which is called the International Islamic Liquidity Management Corporation, IILMC. Its primary objective, as stated by the IFSB, is to issue Shariah-compliant financial instruments (particularly short-term ones), in order to facilitate more efficient and effective liquidity management solutions for institutions offering Islamic financial services, as well as to facilitate greater investment flows of Shariah-compliant instruments across borders. Malaysia had also established an Interbank Islamic Money Market, which has been operating since 1994 with several instruments, (Solé, 2007, p. 20).

The availability of instruments that are compatible with Shariah used by IFIs for interbank transactions and liquidity management is quite limited and varies widely among countries. In this regard, it is interesting to note that IFIs still rely heavily upon commodity Murabaha financing for short-term investment and liquidity management, due to the low risk, despite lower returns. IFIs also face two main issues related to liquidity risk management and interbank operations. One is the limited number of short-term actively tradable products; and the other is the lack of a developed money market in most Muslim countries.

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3.3.5 Islamic Capital Markets

As we have already mentioned, Islamic financial system refers to the system that is based upon Shariah principles, namely the prohibition of riba, gharar, maysir, and speculation; and the recommendation of profit and loss sharing, and asset-baking and ownership of the underlying assets. It is mainly constituted from the Islamic banking, Islamic insurance, and Islamic capital market, ICM. Thus, ICM, as an important segment of the financial system, is, in turn, made up of Islamic equity market, Sukuk market, Shariah-compliant derivatives and structured products, and Islamic stock broking, (IFSB in: Haider and Azhar, 2010, p. 19, 20). Furthermore, it is important to precise that a robust development of those components of Islamic financial system in general, and ICMs in particular, will definitely help the whole industry to grow and gain an increasing market share.

On the other hand, ICMs are another fertile field of practicing and implementing IFE and innovation. Therefore, product development, especially in primary market, where issuers of various securities raise needed long-term capital, takes place on a regular basis, and newly issued instruments are sold there. ICMs are also considered as the infrastructure for those innovations and financial engineering, mainly in providing liquidity management tools, hedging and risk management instruments, and ultimately strategies to solve financial problems.

However, ICMs face several issues and challenges, such as, the lack of a wide range of tradable products and services for potential investors to diversify their portfolios and hedge from risk, and which leads to better mobilization and allocation of funds; developed and transparent secondary markets, which enhance pricing efficiency and liquidity of instruments; harmonization of standards and practices in order to increase cross-border flows, which facilitates the integration in the mainstream; insufficient number of professionals and specialists; and finally, a suitable regulatory framework.

3.4 Challenges to IFE

Going forward in steady paces and gaining more global acceptance, and innovating more sophisticated tools for different purposes are the most important aims of IFE. In realizing that objective, Islamic Financial Institutions, IFIs, face several challenges. The most important of these challenges are (Laldin and Fyrkani, 2013, p. 4,5; Iqbal and Mirakhor, 2007, p. 222-5; AL- Suwailem, 2006, p. 141):

- **Product Development.** In order to compete with conventional finance, IFIs and regulators need to innovate, develop and cater, on a regular basis and according to customers’ needs, the markets with more sophisticated Shariah-compliant instruments. The new products should be flexible, cost-effective, diversifiable, lower transaction costs, enhance liquidity, and designed to meet the risk and return requirements of issuers and investors. Sukuk, money market investment instruments, Islamic structured products, Islamic derivatives, and other risk-management tools are some areas of financial engineering that need to be developed as soon as possible, for the sake of finding innovative solutions to

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6 - Analogous to their conventional counterparts, ICMs are also divided into two compartments, namely the primary market where securities are issued for the first time (new securities); and the secondary market where existing (old) securities are traded; (For more details refer to: Djebbar, M., 2011, p. 164).
financial and investment problems, without violating the norms of Islamic ethics. Thus, developing IFE, definitely, attracts more investors to the industry.

- **Standardization.** It is well known that in *fikh* (Islamic jurisprudence) there are 4 major *mazhab* or schools of thought, namely *Malikiya*, *Hanafiya*, *Hanabilah*, and *Shafiiah*. Sometimes, fortunately sometimes only, different scholars from those schools provide divergent *fatawa* or interpretations of *Shariah* tenets and rulings, which may deepen the misunderstanding in Islamic contracts and practices, particularly, to conventional investors. In this respect, Laldin and Furqani argue that the “relative lack of uniformity in market practices has the potential to trigger practical constraints in the development of Islamic finance. Legal uncertainties arising from the various interpretations of Islamic jurisprudence could have similar effect”. Moreover, both academics stress that the field of harmonization can refer to “various dimensions such as harmonization of various *Shariah* interpretations, harmonization between *Shariah* rulings and national laws, and harmonization between *Shariah* rulings and global standards, (Laldin and Furqani, 2013, p. 4)”. Thus, unification and convergence of opinions and views relative to different Islamic financial key issues become more and more important as Islamic financial industry is increasingly globalised; and growing at a considerable pace. Furthermore, establishing universal *Shariah* standards could help enormously to overcome the issue of complexity and lack of understanding of several Islamic contracts and instruments, such as Islamic financial structured products and derivatives; and ultimately ease operations.

- **Shortage of Skilled Staff.** It is agreed in financial literature that since the publication of the excellent academic work performed by two eminent conventional scholars namely Black and Scholes, i.e. the option pricing model, trading in options and other derivatives has grown enormously. Likewise, IFE faces the challenge of the lack of a sufficient number (shortage) of qualified *Shariah* scholars who should master, not only Islamic principles, rulings, and issues in finance, but also modern conventional financial techniques and practices. Consequently, special training is extremely vital to existing *Shariah* experts and staff, and more opportunities should be given to “newcomers” to the field, despite the cost of the process. Thus, *Shariah* scholars and experts play a key role in approving new innovated instruments, serving, thereby the task of expanding Islamic financial industry.

- **Shariah Compliance.** Interestingly, as early as 2008, Sheikh Mufti Usmani, a distinguished scholar and chairman of AAOIFI, revealed that “about 85 per cent of Gulf Islamic *Sukuk* do not really comply with *Shariah* law”. He argues that those *Sukuk* do not represent a real ownership of the underlying assets, the *sukukholders* receive regular distribution of returns (fixed percentages based on LIBOR), and the issuers, i.e. enterprises, guarantee the return of principal invested at maturity, and, moreover, the managers promise to repurchase the underlying assets at their face value and not at their market value, (Usmani, 2008, p. 3-5). He points out that, actually, those are the characteristics of conventional bonds. Consequently, this pronouncement raises a real and an extremely difficult challenge. The issue of *Shariah* compliance is the onus of *Shariah* advisory boards, academic councils, supervisors, and issuers alike. It is worth noting that those *Shariah* incompatible operations were practiced under the pretext to facilitate the acceptance and understanding of Islamic instruments and contracts in different markets.
Other Challenges to IFE. Iqbal, Mirakhor (2007) and other Shariah scholars have also mentioned several other challenges faced by IFE such as: collaboration and cooperation with conventional financial engineers in order to benefit from their large experience in the field; enhancing transparency and information dissemination; thinness and illiquidity of different secondary markets; some complex Islamic instruments and contracts are traditionally expensive compared to their conventional counterparts, due mainly to consultations with Shariah experts and training of staff; regulatory and legislative issues in conventionally dominated environment; serious research efforts are needed to fill the gap between theoretical and practical sides of Islamic finance, and enhance the understanding and acceptability of Shariah compatible financial industry; and finally, Kwan and Tan (2010) add the challenge of information technology (IT) systems and platforms for Islamic finance that are underdeveloped compared to the well established and wide array of IT solutions in conventional one.

4. Conclusion

As the Islamic financial industry continues to grow, Islamic financial Engineering (IFE), has become one of the most challenging tasks to Shariah scholars, experts and advisors, academic councils, research bodies, and more importantly, to issuers and investors. It is constantly facing a rapidly changing financial landscape and tough competition from its well-established and more experienced conventional counterpart. However, and despite the fact that several successful attempts have been made to address different issues related to IFE, particularly product development in the form of innovating more advanced and sophisticated Shariah-compliant Sukuk and equity-based products, services, contracts, and strategies; there are certain obstacles and challenges which still lie ahead, and consequently a great effort is still needed and a great deal of innovation is required, from different parties involved in the development of the Islamic financial industry in general and IFE in particular. First and most important, there is a great need for a considerable number of new types of financial instruments that are Shariah-compliant, flexible, tradable in secondary markets, and economically profitable on one hand, and respond to issuers and investors requirements on the other. This is particularly crucial in order to achieve designed practical goals, such as, raising cost-effective funds, hedging and risk management instruments (mainly Shariah-compatible derivatives, though controversial), liquidity management and money market tools, improving transparency and disclosure, and monitoring costs. In doing so, the main Islamic comparative advantage, i.e., all transactions and products are based upon the concept of asset backing, should be seized. Second, large harmonization in the interpretations of fikh (Islamic jurisprudence), and setting globally accepted Shariah standards in all Islamic financial practices, are strongly required. This will lead to more understanding and acceptability and continuous expansion and development of IFE worldwide. Third, training infrastructures and education centers should be established in Muslim as well as in non-Muslim countries, in order to generalize the awareness of Islamic finance. This will improve documentation, increase the number of Shariah investors, and push forward the development of the whole industry. Finally, Islamic financial engineers in tandem with Shariah boards and experts are required to collaborate closely with their conventional counterparts to benefit from the large experience they have accumulated in the field of financial engineering.
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Islamic Finance – Opportunities and Challenges

By
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Abstract

Islamic finance has achieved considerable growth and considered to be the fastest growing segment of the financial system. The main jurisdictions in the GCC and Malaysia have experienced notable growth. However other jurisdictions in Africa such as South Africa, Nigeria, Kenya and Ivory Coast and in Asia, such as Singapore and Indonesia and in Europe, such as Luxembourg, United Kingdom and Germany have also seen considerable growth in the sector. There however remain various challenges such as lack of human capital, Shari’ah standardization and harmonization, public awareness, regulation and supervision, access to finance, liquidity management and others. Various solutions have been provided in this paper including adoption of Shari’ah law standards across jurisdictions, creating mass awareness programmes by governments and banks, amendments to tax policies to level the playing field, creation of Islamic financial benchmark and Shari’ah harmonization with existing legal and policy frameworks.

Key words: Islamic Benchmark, Shari’ah Harmonization, Shari’ah Standardization, Shari’ah, Sukuk, Liquidity Management, Tax Policy

The Islamic financial system has witnessed considerable developments in the past four decades and is now regarded as one of the fastest growing segments of the global financial system. Islamic finance assets grew at double-digit rates during the past decade, from about US$200 billion in 2003 to an estimated US$1.8 trillion at the end of 2013 (Ernst & Young 2014; IFSB 2014; and Oliver Wyman 2009). The existing Islamic

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Finance market stands at an estimated $1.81 trillion in assets based on 2014 disclosed assets by all Islamic finance institutions (full Shari‘ah-compliant as well as those with Shari‘ah ‘windows’) covering commercial banking, funds, Sukuk, Takaful, and other segments. The breakdown by category is as follows: $1,346 billion for commercial banking, $33.4 billion for Takaful (insurance), $295 billion for Sukuk (bonds) outstanding, $56 billion in funds, and $84 billion for other financial activities. The Islamic finance industry has experienced robust and phenomenal growth over the past few years and recorded a compounded annual growth rate of 17.3% between 2009 and 2014. (IFSB Stability Report, 2015) The total Islamic finance assets are projected to reach $3.25 trillion by 2020. Islamic commercial banking assets are projected to reach $2,610 billion by 2020.

The key Islamic finance jurisdictions such as Malaysia and the GCC have gained much growth and traction over the past few years. However, other jurisdictions in Africa such as South Africa, Nigeria and Kenya have made considerable progress in the growth of Islamic finance as well. Bangladesh and Indonesia in the Asian region have shown key potential for growth in the industry. European countries such as UK and Germany have also shown heightened activities in the industry.

Islamic finance has made considerable progress in the African region, spurred by demand from Muslims and non-Muslims. The Nigerian central bank issued a license to Jaiz Bank Plc, to operate as a fully-fledged non-interest financial institution (NIFI). There are other Islamic banking windows operational in Nigeria, which serve the Muslim population of 173.6 million. There remains huge opportunity for Islamic Banks to setup operations in Nigeria given the huge Muslim population and growing demand. Nigeria has facilitated the issuance of Sukuk (Islamic Bonds) by amending the regulations by the Securities and Exchange Commission of Nigeria (SECN). The State of Osun sold $61 million of Sukuk in 2013 becoming the first state in Nigeria to sell Sukuk.

South Africa’s national treasury wants to make the country the hub for Islamic finance in Africa. The South African banking regulators have taken various measures to develop and promote the industry including amending tax laws to create an equitable and level playing field for Islamic finance. The country currently has one full-fledged Islamic bank; Al Baraka Bank was registered in South Africa in 1989. Other banks such as First National Bank (FNB), Absa Bank and HBZ Bank house Islamic finance windows alongside their conventional banking services. The South African Government issued their debut Sukuk in the third quarter of 2014. The $500 million 5.75-year was oversubscribed more than four times and attracted Middle Eastern and Asian investors.

In West Africa, Senegal successfully launched a four-year XOF100 billion (US$171.96 million) Sukuk in June 2014. This Sukuk represents a new era in the use of Islamic financing instruments in the country’s public finances. Senegal may consider additional Sukuk issuance to support the country’s infrastructure needs and Dakar is aiming to position itself as the continent’s hub for Islamic finance.

Cote d’Ivoire launched its debut 5-year 150 billion CFA issuance Sukuk priced at a profit rate of 5.75% in the last quarter of 2015. Cote d’Ivoire mandated the ICD as the lead manager for its inaugural local currency Sukuk program worth XOF300 billion (US$515.87 million), which will be issued over the 2015-20 period in two equal phases.

In East Africa, the government of Uganda has approved the Financial Institutions (Amendment) Bill 2015, paving the way for Islamic banking and finance in the country.
Kenya has set its sights on becoming the Islamic finance hub of the East Africa region. With two fully fledged Shari’ah-compliant banks in operation, licensed Takaful and re-Takaful businesses and a number of financial institutions offering products that comply with Islamic law.

There have been several key growth points for Islamic Finance in the Asian region. Bangladesh is the third largest Muslim country in the world by population. With a predominantly Muslim population of 160 million, the industry has doubled in size in the past four years. The Islamic Bank of Bangladesh Limited (IBBL) was launched in 1983. The country had seven standalone Islamic banks and 16 conventional banks with Islamic banking windows by 2014. (IFSB, 2014) The market share of Islamic banks in Bangladesh is sizeable and accounts for 18.9% of the total banking deposits and 21.1% of total financing. (Annual Report, Bangladesh Bank, 2013). There is also a sizeable Takaful market in Bangladesh with 8 Takaful operators. The central bank has a small short-term Sukuk (Islamic bond) programme which issues six-month tenors to help Islamic banks manage their liquidity requirements. The central bank auctioned three-month and six-month Sukuk on Jan 1. 2015, selling 855 million taka ($11 million) and 936 million taka respectively, it said in a statement.

Indonesia has the world’s largest Muslim population with 12.7% of the World’s Muslims. Indonesia’s capital market regulator has published a five-year strategy for the Islamic finance industry. Indonesian authorities want Indonesia’s Islamic banks to hold at least 15 percent of the market by 2023. Islamic banks in Indonesia comprise of 12 fully fledged Islamic banks and 22 conventional banks have Islamic banking windows. There are 45 Islamic insurance institutions in the country. Furthermore, there are 316 Shari’ah-compliant stocks which have been classified and listed under Shari’ah listed stocks comprising of 60% of the total stocks in Indonesia. Indonesia’s Islamic bond market is the second largest in East Asia. The Government issued its first retail Sukuk in Feb 2009 for $144.4 million. The government issued its first sovereign Sukuk based on the Ijara principle in August 2008 with the sale of 7-year (IFR0001) and 10-year (IFR0002) Islamic bonds. The Government has allocated IDR 6.94 trillion for infrastructure projects via Government Sukuk issuance.

There has been key growth in several European countries. The United Kingdom issued the first sovereign Sukuk by a European government. The government raised $339.5 million with a profit rate of 2.036% and 5-year tenure. The order book was oversubscribed by nearly 10 times the issuance size. The government-backed export credit guarantee agency has provided cover for a $913m (£617m) Islamic bond issued by Dubai’s Emirates Airline to purchase aircraft including the giant Airbus A380. More than 20 banks currently offer Islamic financial products and services in the UK. The value of Sukuk already listed on the London market exceeds $34bn (£21bn) over the past five years with more than 50 bonds quoted by the London Stock Exchange.

With a population of 4 million Muslims in Germany, holding an estimated wealth of 25 billion €, Germany potentially is a big market for Islamic finance. According to a 2010 survey, 72 % of Muslims living in Germany are interested in Islamic finance products. Germany launched its first fully-functional Islamic bank in Frankfurt under the name KT Bank AG. FWU Group, a Munich-based financial services company, issued a $20 million 5-year Islamic bond backed by insurance policies in October 2013 and issued a $55 million 7-year Sukuk through a private placement that was backed by intellectual
property rights in December 2012. Luxembourg issued a Sukuk for $253 million with five year tenure in October 2014. The Sukuk was twice oversubscribed.

**Challenges**

Despite the huge growth of the Islamic finance and banking industry over the past few years, the industry currently faces considerable challenges and in particular:

1. **Lack of Human Capital**

   Qualified human resources play a pivotal role in the development and success of any industry. There is a dearth of qualified bankers and professionals who are well versed in Islamic laws as well as contemporary economics and finance. Currently, various universities and training institutes are offering courses in Islamic finance, but they also face lack of competent human resource to conduct these courses. There also remains a huge lack of human resources on the expert level. There remains a significant shortage of Shari’ah scholars who are well versed in Islamic finance. Business schools and religious schools should offer Islamic finance qualifications in co-operation and conjunction with industry experts to create the next generation of Shari’ah experts and professionals. Academic institutions should also be encouraged to establish centres of excellence for the Islamic finance industry.

2. **Shari’ah Standardization and Harmonization**

   Islamic law accommodates for differences of opinion and interpretations of classical Islamic texts. This leads to different practices and policies adopted across different jurisdictions. This may impact on the growth and internationalization of the Islamic finance industry. Islamic finance laws, policies and practices should be standardized and harmonized in order to create more unification and consolidation within the industry. This would strengthen the industry from a Shari’ah perspective and root out weak and rejected views. Furthermore, Shari’ah scholars should adopt these policies and procedures to prevent and mitigate Shari’ah non-compliance risk.

3. **Lack of Public Awareness**

   There remains a low penetration rate and lack of critical mass in the Islamic finance industry. This is due to mainly a lack of public awareness and knowledge of Islamic finance. Islamic banks, regulators and governments should undertake mass awareness programmes to drive the growth of Islamic finance and create critical mass for the industry.

4. **Shari’ah Law and Legal Framework**

   There remains a great need to harmonize Shari’ah law with the existing legal framework. This creates huge difficulties and challenges in the event of disputes and legal matters as Islamic financial concepts are not recognized by certain legal frameworks. There should also be a drive to create more innovative products and gradual shift from products that closely resemble conventional financial products such as commodity Murabaha and Tawarruq.

5. **Regulation and Supervision**

   Islamic banks are exposed to various risks such as displaced commercial risk (DCR). This forces Islamic banks to lose profits in order to pay comparable returns to
investment account holders (IAH) and depositors. This creates huge challenges for Islamic banks in creating excess reserves to cover losses and how this is viewed from a regulatory perspective.

Islamic banks also face equity investment risk, rate of return risk, Shari’ah non-compliance risk in the event of perceived non-compliance and liquidity risk due to the shortage of liquidity products. Other challenges include the divergent interests of investment account holders and the Islamic bank’s shareholders. One of the major issues is that IAHs share profits and bear losses, but do not have shareholder rights (López-Mejía and others 2014). This leads to a lack of transparency in the reporting of profits and losses to the IAH. Various standards have been issued by the IFSB and AAIOFI. However many jurisdictions have failed to implement these standards.

There also remains a huge challenge in the adoption of Shari’ah Compliance. Various jurisdictions do not regulate and supervise the way Shari’ah compliance is adopted. There should be proper selection criteria for Shari’ah scholars. Many jurisdictions have begun adopting central Shari’ah boards in order to ensure harmonization of Shari’ah compliance within the industry.

6. Access to Finance

Muslim countries have shown a lower level of financial inclusion than other countries in the world. This can be resolved by creating a better business model, reforms to increase competition within the banking sector, consumer protection, better credit information and education.

7. Monetary Policy and Liquidity Management

Money and interbank markets for Shari’ah-compliant instruments have not yet developed in most countries, in part because of a lack of available instruments. There remains a huge shortage of Shari’ah central banking facilities. Moreover, many Islamic banks operate under a dual system of conventional and Islamic banking policy framework and are heavily influenced as a result by conventional banking instruments and conditions. Central banks should adopt more effective instruments and policies for Islamic banks. Many jurisdictions do not have a lender of the last resort for Islamic banks. Only 6 out of 24 jurisdictions for Islamic banking have a lender of last resort for Islamic banking.

8. Tax Policy

Regulatory/tax reforms play a pivotal role for the growth of any industry. There remain various tax issues which need to be resolved in order to level the playing field between Islamic banks and conventional banks. Some of these issues include the treatment of Islamic finance under income taxes, sales taxes (for example, value added taxes), specific transaction taxes, and bilateral tax treaties. International standards can encourage governments and jurisdictions to facilitate tax reforms.

9. Benchmark

The usage of the conventional interest based benchmark (Libor) creates a negative perception among investors who tend to associate the Islamic financial system with the conventional financial system due to the usage of the interest based benchmark. Furthermore, Islamic banks are placed at the mercy of the movements in the conventional money markets by using the conventional interest based benchmark.
Book Review

Islamic Capital Market, Equity, and Sukuk (2014)

Dr. Muhammad Hanif, Associate Professor (Islamabad)

By Camille Paldi

This scintillating and succinct book is a refreshing intellectual journey into the heart of Islamic equity markets. It is complete with an overview of different types of Sukuk and explanation of relevant Sukuk transactions in the form of Sukuk case studies. In addition, Dr. Hanif notes the key features of each type of Sukuk and provides a set of practice questions at the end of each chapter in order to test the reader’s knowledge. According to the author, approximately 2,000 issues of Sukuk were held with a global volume of around USD$200 Billion by the end of June 2010. Between 2011 and 2013, an additional USD$281 Billion of Sukuk were issued around the world. In addition to corporate Sukuk, sovereign Sukuk have also been issued by Pakistan, Jordan, the UAE, Thailand, Malaysia, Turkey, Indonesia, Bahrain, Qatar, the Cayman Islands, Singapore, Germany, Brunei, Gambia, and Kuwait.

In chapter one – Equity, the author describes a six part test, which can be used to test a security as a Shari’ah compliant investment. In Pakistan, Al-Meezan Investment Management Limited (AIML), subsidiary of a leading IFI (Meezan Bank) took the initiative and started screening of KSE listed securities through Shari’ah Compliance Filters and developed KSE-Meezan Index (KMI-30). For a security to be Shari’ah compliant based on KMI Criteria, it must meet the following six tests: (1) The principal activity of the business must be Halal; (2) Interest based debts to asset ratio should be less than 37%; (3) The ratio of non-compliant investments to total assets should be less than 33%, (4) The ratio of Shari’ah non-compliant income to total revenue should be less than 5%, (5) The market price per share should be greater than the net liquid assets per share calculated as (total assets – illiquid assets – total liabilities) divided by the outstanding number of shares, and (6) The ratio of illiquid assets to total assets should not be more than 25%. In addition to KMI, there are more than ten major Islamic indices operating worldwide including DJIM, FTSE, S&P, MSCI, HSBC, Ameri, BID, and Azzad. The filtering criteria differ among these indices and it is possible that a company is Shari’ah compliant under one index and not under another.

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In chapter two – Sukuk, the author defines Sukuk and the difference between Sukuk and bonds. It also explains the types of Sukuk and provides the Shari’ah rulings about Sukuk. Th author also explains in detail the Sukuk process from initiation, creation of the Special Purpose Vehicle (SPV), the issuance of Sukuk certificates until the maturity of the investment. Dr. Hanif describes in detail the Sukuk al-ijarah structure as well as gives an example of the Pakistan Motorway Sukuk issued by Pakistan International Sukuk Company Limited (PISCL) in order to illuminate the Sukuk al-ijarah process. The rest of the chapter is patterned on the same effective learning technique of providing explanations of different Sukuk structures accompanied with a Sukuk case-study illustrating the particular structure. The author next utilizes the JAFZ Sukuk issued by JAFZ Sukuk Limited in order to demonstrate the process of the Sukuk al-musharaka. Dr. Hanif also discusses the Sukuk al-mudaraba and Sukuk al-wakala structures in detail. The author uses the Saudi Holland Bank as an example of the Sukuk al-wakala combined with the DIFC Sukuk Guide explanation of the al-wakala Sukuk structure to inculcate into the reader a comprehensive understanding of the Sukuk al-wakala process. Furthermore, in order to shed light on the Sukuk al-isthmimar process or investment Sukuk, Dr. Hanif showcases the Saudi Electric Company Sukuk. The author goes on to write about the Istisna’a, Salam, and Murabahah Sukuk and provides one more case-study pertaining to a hybrid Sukuk, i.e. the Sadara Basic Services Company Sukuk, which is a combination of Istisna’a, Ijara, and Musharaka Sukuk. Lastly, the author concludes with a thoughtful discussion on whether or not Sukuk are in fact Islamic or have regressed into essentially what is the structure of conventional bonds. This is a solid academic instruction on equity and Sukuk in Islamic finance. This book is a must read and effective learning tool for any aspiring Islamic Banking aficionado, professional, academic, or student of Islamic banking and finance.
Country Model: Iraq

Islamic Banking started in Iraq in 1993 with the establishment of Iraqi Islamic Bank for Investment and Development. At present, Islamic banking industry in Iraq consists of twelve banks including eight full- fledged local Islamic banks and four foreign Islamic banks. The Central Bank of Iraq (CBI) also allowed the opening of two Islamic banking windows in 2011. These Islamic banking windows work as a separate department within a conventional bank and operate under guidance by an independent Shariah Advisory Board of the bank. Islamic banking window is allowed to offer its products and services through conventional branches or dedicated Islamic branches of the conventional bank.

Despite the volatility in the country, Islamic banks in Iraq are continuing their growth plans, including expansion in product and size. Iraqi Islamic Bank for Investment and Development acquired an insurance company with the intention of offering Takaful services.

Legal Framework for Islamic Banks in Iraq:

CBI regulates both conventional and Islamic banks through a single regulatory framework and Islamic banking activities fall under the domain of the Banking Law 2004. In the year 2011, the Central Bank of Iraq issued Islamic banking regulations. These regulations specified the activities that can be performed by the Islamic banks and activities which the Islamic Banks (and Islamic windows within conventional banks) are prohibited to carry out. Further, these regulations also stipulated funding and dealing mechanisms regarding the purchase of foreign currencies, foreign currency exchange companies, commercial papers and stock market, etc. The regulations also permit conventional and investment bank to open an Islamic banking window or to establish an Islamic branch.

In addition, work on further improvement in the Islamic banking law is under process and revised draft of Islamic banking is expected to be approved in the current year. The revised Islamic banking law will regulate the operations of the Islamic banks in a more detailed manner. One of the important articles in the draft law is to exclude Islamic banks and their branches from the taxes and fees arising from dealing in contracts relating to estate, land, cars, Murabaha and Ijara deals.

Shariah Board:

In terms of regulations issued by CBI in 2011, each Islamic bank and the Islamic banking window is required to establish Shariah Board which is responsible of providing

* Source: State Bank of Pakistan, Quarterly Islamic Banking Bulletin July-Sept 2015
a Shariah view on the operations of the bank in order to ensure its compliance with the Sharia Law. The main responsibilities of the Shariah Board are to recommend to the General Assembly of the bank or its Board of Directors all the necessary steps that need to be taken or carried out to achieve compliance with Sharia Laws. The decisions of the Shariah Board are binding on the executive management of the bank.

**Way Forward**

With growing significance of Islamic banking and finance across the world and a large Muslim population in the country, further growth in Islamic banking and finance is expected in Iraq.

**Sources**

- [www.islamicfinancenews.com](http://www.islamicfinancenews.com)
- [http://iraqdailymjournal.com](http://iraqdailymjournal.com)
### World Economic Development Indicators

#### Top 10 OIC Countries on Per Capita GDP

<table>
<thead>
<tr>
<th>Country</th>
<th>GDP Per Capita (US$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Qatar</td>
<td>93,352</td>
</tr>
<tr>
<td>Kuwait</td>
<td>52,198</td>
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<tr>
<td>UAE</td>
<td>43,049</td>
</tr>
<tr>
<td>Brunei</td>
<td>38,563</td>
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<tr>
<td>Saudi Arabia</td>
<td>25,962</td>
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<tr>
<td>Bahrain</td>
<td>24,695</td>
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<tr>
<td>Oman</td>
<td>21,929</td>
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<tr>
<td>Kazakhstan</td>
<td>13,172</td>
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<tr>
<td>Libya</td>
<td>12,029</td>
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<tr>
<td>Turkey</td>
<td>10,972</td>
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</table>

#### Bottom 10 OIC Countries on Per Capita GDP

<table>
<thead>
<tr>
<th>Country</th>
<th>GDP Per Capita (US$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Somalia</td>
<td>133</td>
</tr>
<tr>
<td>Niger</td>
<td>415</td>
</tr>
<tr>
<td>Gambia</td>
<td>488</td>
</tr>
<tr>
<td>Mozambique</td>
<td>605</td>
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<tr>
<td>Guinea-Bissau</td>
<td>608</td>
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<tr>
<td>Togo</td>
<td>610</td>
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<tr>
<td>Guinea</td>
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<td>Uganda</td>
<td>704</td>
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<td>Afghanistan</td>
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<td>Mali</td>
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Source: World Bank’s World Development Indicators

### Islamic Indices Indicators

#### Islamic Indices Performance (Return Percent Per Annum)

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<tr>
<th>Name of Index</th>
<th>2010</th>
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<th>2013</th>
<th>2014</th>
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<td>13.10</td>
<td>-6.00</td>
<td>13.40</td>
<td>20.40</td>
<td>3.90</td>
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<td>FTSE Shariah Developed</td>
<td>12.60</td>
<td>-4.10</td>
<td>13.30</td>
<td>23.70</td>
<td>4.70</td>
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<tr>
<td>FTSE Shariah Emerging</td>
<td>17.00</td>
<td>-18.60</td>
<td>14.20</td>
<td>-6.40</td>
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<tr>
<td>FTSE SGX Asia Shariah 100</td>
<td>15.90</td>
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<td>15.40</td>
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<tr>
<td>FTSE Shariah Japan 100</td>
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<tr>
<td>FTSE TWSE Taiwan Shariah</td>
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<td>7.00</td>
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<td>-2.90</td>
<td>16.50</td>
<td>17.30</td>
<td>-7.10</td>
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Source: FTSE
Note to contributors

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