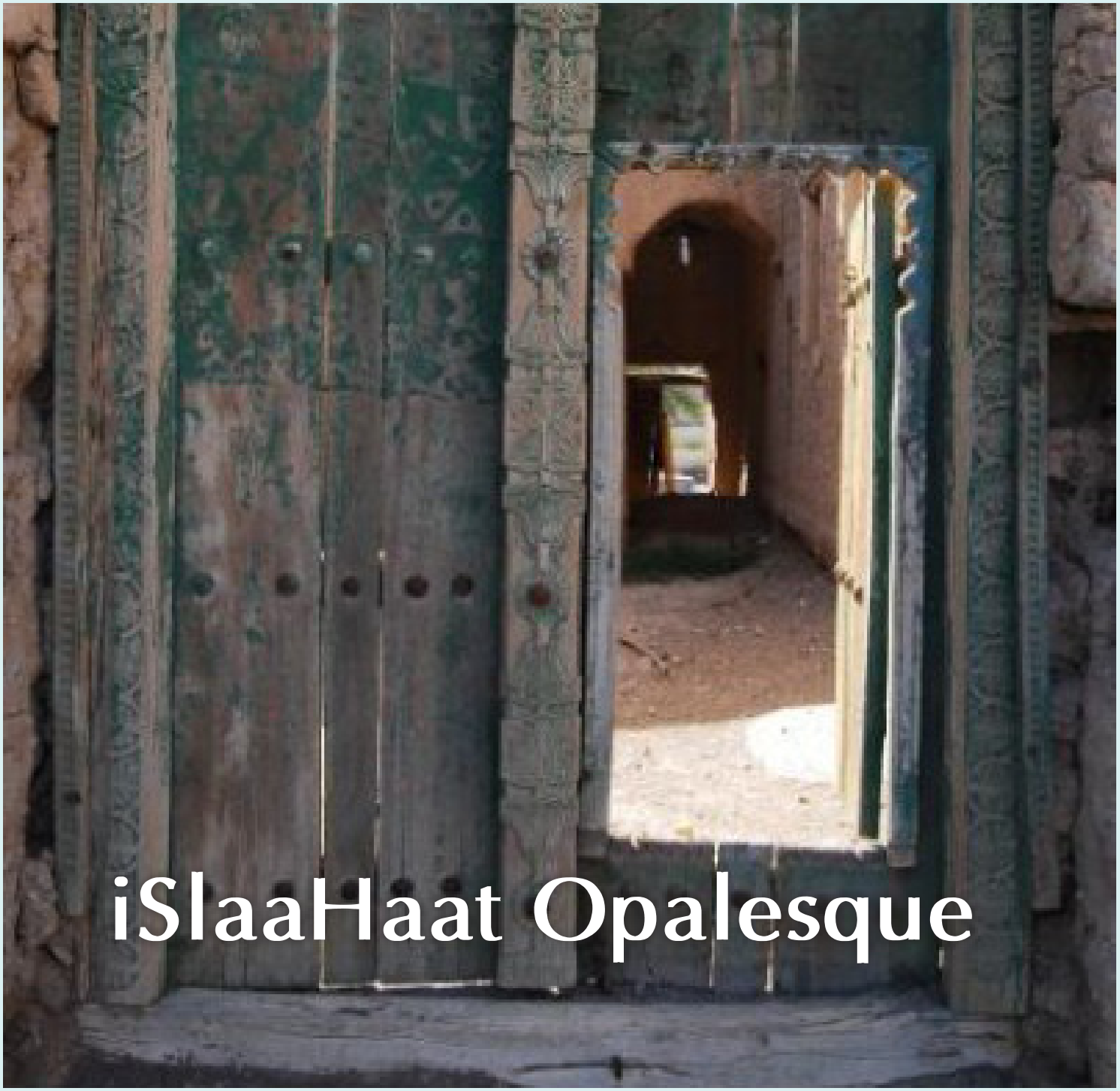
ISSUE 14 • 15 December, 2010

OPALESQUE

ISLAMIC FINANCE INTELLIGENCE



iSlaaHaat Opalesque

Featured Structure
Towards a Universal Islamic Deposit Insurance System
by Mohammed Khnifer

Lex Islamicus
Standardisation v Harmonisation: Towards Recognition?
Hakimah Yaacob

Industry Snapshot
Islamic Dinar Revisited
Mobasher Zein

Welcome to the fourteenth edition of OIFI, our last edition for the year, and as we look back at 2010 we sincerely thank everyone that has supported us along the way. The industry itself has much to look forward to in the coming years and this is the recurring theme for this edition. Our Editorial tackles the evolving role of AAOIFI as it pertains to governance and regulation of Shariah scholars. Our Featured Resource is a compilation of some the most noteworthy discussions from our online forum.

Mohammed Khnifer takes on our Featured Structure section with an extensive analysis on the implementation of Islamic deposit insurance, with particular attention given to Malaysia's IDI framework. This is promptly followed by Lex Islamicus where ISRA'a Hakimah Yaacob provides a fresh approach to the standardisation debate, including novel references to international conventions for the harmonisation of private law and coordination of civil and commercial matters.

The industry Snapshot welcomes back Mobasher Zein as he continues his analysis of an Islamic commodity-backed currency with further attention given to the monetary framework that would be required to make this happen. Last but certainly not least Toby Birch shares his views on our Opinion Column with regards to the underserved retail market in Islamic finance and what are some of the obstacles that need to be addressed in coming years.

Always glad to hear from our readers and welcoming all comments & suggestions and please remember that you can visit our online archive (see reference link) for access to our ever-growing databank of Opalesque Islamic Finance Briefing as well as all of the back issues of Opalesque Islamic Finance Intelligence.

Best Regards,
Bernardo
Editor, Opalesque Islamic Finance Intelligence

Please contact us, we would love to hear from you:
Publisher: Matthias Knab - knab@opalesque.com
Editor: Bernardo Vizcaino - bernardo@opalesque.com
Advertising Director: Denice Galicia - dgalicia@opalesque.com

In This Issue

Photography by: Kelly Lemon, Robert Seabrook

AAOIFI's Perestroika

By Bernardo Vizcaino, CAIA

With increased calls for the Islamic finance industry to review (and reform) its governance framework, AAOIFI finds itself as a key participant of this process. A perestroika in the making. The increased scrutiny revolves around the role of scholars and structure of Shariah Supervisory Boards. This includes issues pertaining to concentration of board seats in a handful of scholars, an individual holding seats in competing organizations (regardless of concentration), greater accessibility/understanding of the rationale behind rulings, as well as cultivating a wider pool of experienced professionals. While the debate has focused on the potential conflicts of interest, the next step would be to determine what mechanisms can be implemented to strengthen the overall system.

AAOIFI Leads the Way

Such industry feedback has prompted AAOIFI to look into drafting rules to regulate scholar's shareholdings and limit the number of seats they can hold, this in turn has triggered dismissive responses from various scholars. For an industry body that is comprised of scholars the challenge of regulating its own members might require that it leads by example. It can do so in several ways:

1. Transparency (short term) - AAOIFI has issued various standards (currently a total of 86) covering areas such as accounting, auditing, governance as well as ethics, and transparency will be somewhere in there. AAOIFI standards should fit the acronym, they should be Available Anytime Online Ideally Free Immediately. Currently they are only available as paid-for bulky hardcopy publications, and this does not encourage those wanting to learn form them and makes it very difficult for those keen to help disseminate them further. One can even draw a parallel with perestroika (reform) which was introduced together with glasnost (transparency).

The argument is compelling when we consider that similar industry standards are available online such as the Sarbanes Oxley Act of 2002 (see reference link); The International Standards on Auditing (ISA's) issued by the IAASB (see reference link), and closer to home the IFSB Guidelines (see reference link). Perhaps a compromise approach similar to that used by the IFRS Standards (see reference link) where the core material is available to everyone and the complete standards (together with implementation guidance and the basis for conclusions) require a subscription. If we are to question scholar independence we should equally question why an industry body is selling hardcopy books as a revenue stream. This might sound mundane but this has the potential to trigger over-regulation, since there is an incentive to issue more standards (as this would mean more revenues). This is a clear moral hazard.

2. Rotations (medium term) - Once again, if we are to demand from scholars that they relinquish their tightly held board seats, it is natural that AAOIFI reflects the same. Rotating their headquarters across the Islamic world (say every three years) would help project this industry body globally and even capitalize on the hospitality of the many would-be Islamic finance hubs. Again a compromise here could be to retain their Manama headquarters but break-up responsibilities to other satellite offices (say the Accounting Standards Committee or the Shariah Standards Review Committee), this would further encourage IFIs in the chosen country to consider membership (more on this below).

AAOIFI currently places four year terms on the members of its Shariah board (although these are renewable), but no rotation is stipulated so these seats can be held indefinitely. If we are to suggest the existence of a conflict of interest with entrenched scholars one would expect that AAOIFI take steps to ensure the same does not happen with its own management. AAOIFI has taken clear steps to include more scholars in its board and make it more representative, recent appointments to the AAOIFI Shariah board include Sheikh Aflah bin Ahmed Al Khalili, Sheikh Walid bin Hadi, Dr. Abdulla bin Mohammed Al Mutlag, and Mr. Abdulla bin Hmood Al Ezzi (among others). Instead of rotations one could place a limit on consecutive terms (i.e. no more than 3 consecutive

terms held by a board member) or selecting board membres at random who must train a younger scholar by allowing them to 'shadow' them during their four year term.

3. Memberships (long term) - While AAOIFI standards have an impact on current member firms one has to question whether the membership list is representative of the global industry and whether efforts should be directed towards building membership numbers. Following AAOIFI chairman Shaikh Ibrahim bin Khalifa Al Khalifa statement that "the confidence in the AAOIFI stands behind its worldwide application" (see reference link) it would be imperative to ensure global representation. Therefore the growth of AAOIFI membership is of great importance.

Currently there are over 149 members (according to AAOIFI's website), of which approximately 40 are central banks or service providers, effectively leaving us with roughly 100 IFI's. These numbers should grow further if one considers that there are over 180 Islamic insurance operators (as per the World Islamic Insurance Directory); 139 Islamic rural banks in Indonesia (as per Bank Indonesia); and the banker magazine listing the top 500 Islamic financial institutions (with over 600 registered) - although one could simply focus on the nearly 300 IFI's reporting shariah-compliant assets of almost $900 billion (according to the same list). In the best case scenario AAOIFI membership reflects 30% of the global family of Islamic finance institutions, and it might be more like 15%.

Scholars Lead the Way

For any analysis to be objective it should also consider the perspective of scholars, and Sheikh Nizam himself has highlighted how they should be "treated like other professionals in the field" such as lawyers and accountants (see reference link). With regards to scholar independence, there are two important aspects which must be distinguished from each other: independence in fact (real independence) and independence in appearance (perceived independence). In other words, even if scholars are held to a higher standard in the performance of their duties (independence in fact), the benefits to the institution would be curtailed if the perception by consumers is that the process is deficient (independence in appearance).

We can take various queues from the audit profession on how to mitigate conflicts of interest, whether real or perceived:

1. Audit firm rotation (low probability) - One suggested approach to mitigate conflicts is the periodic rotation of Shariah audit firms (mandatory or self-imposed), in fact the Sarbanes Oxley Act considered such a proposal but this was not included in its final version. This was in great part due to the significant industry lobby (from audit firms) against such a measure. Certain jurisdictions have enforced such a measure such as Italy, where audit firms must change after 9 years (although the implosions of Parmalat and Alitalia are not supportive of its efficacy). The net effect is to: lower/remove incentives for auditors and the firm to work in cahoots (i.e. more likely to maintain arms-length relationships); decrease the possibility of an auditor being intimidated against issuing an unfavourable audit report (for fear of losing the client account); elevating the quality of audit reports (since audit firms will want to avoid any shortcomings being highlighted by the next audit team), etc.

2. Service Limitations (high probability) - The audit profession has segregated the offering of audit and consultancy services (since the Enron debacle), and to an extent this has been implemented in countries such as Malaysia where Bank Negara already stipulates limits on how many IFI's can be serviced by a single scholar in their "Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions" (see reference link). Hence a scholar can only offer services to one IFI per sector (Islamic baking, takaful, etc) although this does not stipulate which areas, so while a scholar acts on a supervisory role arguably this could be extended to other services (consultancy, asset management, capital raising, lead generation, etc).

3. Principals Rotation (low probability) - While audit firm rotation is not stipulated in Sarbanes Oxley, the rotation of audit principals certainly is. Section 203 of SoX (see reference link) provides for the rotation of audit principals (i.e. individuals) every five years to avoid developing a relationship that could be deemed too close with the client institution. This is harder to enforce in the Islamic finance context since scholars present themselves as individuals rather than legal entities. Nonetheless, there is the alternative of rotating board members (i.e. including a new member every three years) or simply rotating who is appointed as chairman of the board (i.e. rotating among existing board members every two years).

4. Peer Assessment (medium probability) - This is one of the key areas of criticism, as various practitioners argue that a scholar that approves a product cannot objectively audit that same approval process. Therefore the process could be strengthened by segregating the initial approval/certification from the periodic review/audit. This would in turn create a proper maker/checker function where explanations, clarifications and/or fine-tuning can be required of the product in question.

Murphy Leads the Way

While many of these suggestions sound good on paper, one should remember Murphy's law - if something has the potential to go wrong it probably will go wrong. To put it another way, could the industry be closing the door on certain conflicts of interest while opening the window for other kinds of conflicts? In that sense we should be wary of unintended consequences. Any proposed reforms would need to consider potential repercussions and/or side-effects, including:

1. Impact on competition - The main issue here is that limiting the number of board seats might put pressure on the availability and accessibility to expert and seasoned scholars. In this regard AAOIFI has

Editor's Note

taken positive steps with the introduction of their industry certification CSAA (Certified Shariah Advisor and Auditor). Nonetheless, limiting scholars to one IFI per industry sector might also unduly impact universal Islamic banks (those offering multiple services), just imagine the issues that might arise for these upcoming mega Islamic banks if they must find experienced scholars that are not board members of any competitor (an almost impossible task).

2. Quality of audit activities - Another source of contention is that any restrictions (especially firm rotation and scholar limitation) would be unduly disruptive to the Islamic finance institution. Such information leakage might occur when replacing individuals that understand and know how to navigate the inner workings of an IFI. Nonetheless, this can also be addressed by standardising the reporting documentation and to an extent commoditizing the compliance process (at least as it pertains to plain vanilla products). In fact the increased adoption of AAOIFI standards across the globe would be a positive development in this regard and mitigate the erosion of quality of the Shariah compliance function.

3. Costs of audit services - If we add more moving parts to the process and require more individuals involved this could translate into greater costs for the IFI. This would be counterproductive, especially for small entities, start-ups and boutique IFIs. Furthermore, if service limitations and peer assessments are put in place this could raise the number of issues highlighted in an audit/review (although this does not necessarily translate into raising the quality of the audit/review itself). Overall, costs will be a function of having an increase supply of providers (i.e. qualified and experienced scholars), which will in turn encourage a healthy price competition for their services. Publishing pricing guidelines for scholar services could also help clarify what are the costs involved, since the quotes involved can vary significantly (in some cases the range of quotes can vary by as much as US$40k to even US$80k).

4. Market Reaction to changes - Far more difficult to predict is how the industry will react to any reforms. To an extent a certain cross-border arbitrage has been observed in Malaysia (where scholars have service limitations to only one entity per industry sector) since some scholars have started offering their services in other countries. This would have very little impact in Southeast Asia (most of the industry is split between Malaysia and Indonesia, with very little overlap) although this would not be the case in the GCC (where IFIs are much more intertwined as they compete in multiple markets, with many having operations within the regional hub of Bahrain).
Another by-product of service limitations is the propensity for product exclusivity. If a Shariah advisory firm can only offer its services to one IFI per market, then the incentive is for them to promote products that are more complex (i.e. which garner greater fees and revenues) and to an extent more risky (since they will be far from plain-vanilla and untested). Similarly these can become one-off products since their sophistication would be protected by intellectual property rights (making them even more expensive for the pioneering IFI) and this could curtail product innovation (harder for competitors to gain access to the same offering).

There is also a separate trend towards moving from individual scholars (as consultants) towards the emergence of advisory firms (as partnership-based). As long as these are not one-man entities they can increase the supply of experienced scholars and address the issue of competency, since younger scholars will be able to reply on a team of seasoned colleagues. Once again accreditation programs such as those from AAOIFI can play a big part and we might even see advisory firms being formed without any high profile scholars (instead a team of individuals who are equally well-qualified).

Service limitations should also be considered with regards to requirements to have a board with a minimum of three scholars (as some jurisdictions require). Here an IFI might retain the services of one experienced scholar and use other less-well known scholars. This might not be an issue on the surface but this can increase key man risk as the SSB will have a tendency to rely too much on the opinion of that one scholar. Nevertheless, it is also equally likely that the board members will represent various geographical reasons (as they would be sourced from non-competing markets), which will in turn increase the cross-border appeal of Islamic banking products and services. This however does nothing to support single-country or single-product providers.

We Lead the Way

Are we asking for AAOIFI to reinvent the wheel or should we just ask them to fix the flat tire? It is quite possible that existing AAOIFI standards can accomplish the intended benefits without any major changes, the key requirement is to broaden their implementation. Once again (argumentum ad nauseam) the growth of AAOIFI membership is crucial. AAOIFI can stand alone in these efforts or it can get our full encouragement to find the right balance between regulation and promotion.

Effectively any reforms risk falling into lengthy discussions and circular debates, whereas perestroika and glasnost came alongside uskoreniye (acceleration) which reminds us that these reforms need to be incorporated in a timely manner. Timely so that the Islamic finance industry is ready to expand alongside the recovering global markets.

The above lines should therefore be taken as constructive criticism and support for the advancement of the industry. While there is a great need to promote the industry, this should be done with an objective assessment of the market reality. With so many issues at hand and so many moving parts it is imperative that AAOIFI receives our support in carrying out these reforms, but it also needs to receive our honest feedback. Perestroika, glasnost and uskoreniye, they are all needed in equal measure.

Your feedback and comments are very important to us, please feel free to contact the author via email.

Featured Resource

Linkedin Discussions - Highlights of 2010

Blogger™ As Featured in the Islamic Finance Resources Blog

Looking back at 2010 our online Linkedin forum (Global Islamic Finance Resources) has been quite busy and it recently crossed the 4,700 membership mark. There are far too many discussions to highlight but here is a brief summary of some of the noteworthy threads and we welcome you to join us there:

In a Bold move, AAOIFI turns AGAINST its Scholars

Do you agree that Islamic finance should move from shariah compliant products to shariah based products?

Islamic Finance Seeks Young Scholars to Lead Growth

Is Islam getting Commercialised?

Islamic nations need dedicated exchange

Islamic or not? Top sharia scholars and their rulings

Shariah or Islamic Law is incompatible with Australia's Western values?

Towards a Universal Islamic Deposit Insurance System

By Mohammed Khnifer

Mohammed Khnifer is regarded as part of a second generation of Islamic banking practitioners who have a solid academic background in Islamic finance. He is a holder of an MSc. in Investment Banking & Islamic Finance from Reading University and is a Chartered Islamic Finance Professional (CIFP) from INCEIF. He is one of the most prolific and well-known journalist specializing in Islamic Finance today. For the past six years he has been in charge of the editorial content for the Islamic Banking section of Al Eqtisadiah (Kingdom of Saudi Arabia). By 2011, he is expected to earn his MBA in Islamic Banking & Finance after he won the Silver Scholarship Award from Bangor University. He has authored various papers and articles on Islamic finance (see reference link).

The concept of deposit insurance in the Islamic finance industry is still relatively new as practitioners are struggling to comprehend whether it conforms to Sharia. Very few countries with Islamic economies have an Islamic deposit insurance system in place as it is a complicated balance between maintaining profit-loss sharing Sharia principles and protecting bank customers (Baeshen, 2010). Islamic deposit insurance is a Sharia-compliant system that provides protection to depositors against the potential loss of an Islamic bank's failure (Arshad, 2009).

In this research I try to highlight how the concept of Islamic Deposit Insurance (IDI) developed in the Muslim world. Over the past 10 years, the concept of insuring Islamic deposits started in the Gulf Cooperation Countries (GCC) until the concept reached its maturity after it was institutionalized and adopted in Malaysia.

Due to the absence of guidelines and papers on this topic, it is imperative to point out the controversial areas in designing Islamic deposit insurance system and how they were resolved. The Malaysian model is being heavily reviewed and the researchers at the International Association of Deposit Insurers (IADI) are trying to understand whether such a system can enhance the stability of the Islamic financial system. Therefore, it makes sense for this research to examine the Malaysian IDI system and to look into the possibility of its adoption in the GCC.

First stage: a concept in the making

Segregation of funds - Between 2000 and 2004 researchers started to debate whether there is a need to insure some types of Islamic banking accounts. Banks with Islamic windows used to commingle the Sharia deposits with conventional funds (and used for conventional purposes) or provided Islamic returns that may have been derived from such commingled sources. Some Sharia scholars observed this and asked commercial banks to establish appropriate controls to avoid commingling of Islamic and conventional funds.

In operational terms, this required banks to establish different capital funds and separate accounts, books and reporting systems evidencing the complete segregation of funds (Yaquby, 2000). Indeed, before designing any Islamic deposit insurance scheme, it is a requirement to separate streams of cash flows and block any leakages. This separation of funds caused the first thoughts about deposit insurance for sharia-compliant accounts.

Determine the Guaranteed Deposits - Sources of funds in Islamic banks can be grouped into four general categories, 1) Islamic banking funds, 2) customers' deposits, 3) corporate banking activities, and 4) treasury activities or placements (IADI, 2006). It is estimated that the financial institutions offering Islamic products now collectively hold US$750 billion of assets. Of this, US$350 billion

is held by fully Islamic financial institutions and the remaining US$400 billion by conventional banks that offer Islamic banking services (Sabourin, 2009).

In early 2000, there was a healthy debate over which of the customer's deposits should be guaranteed. Before we examine these deposits, we need to point out that Islamic banks do have demand deposits, savings deposits, and general and special investment deposits. Savings and demand accounts are normally based on Wadiah (safe custody or safe keeping with guarantee) or Qardul Hassan (benevolent loan) contracts, while general and specific investment accounts are based on Mudarabah (IADI, 2006).

Wadiah Deposit and Qardul Hassan - Under Wadiah Yad Dhamanah, where the nominal value is guaranteed, Islamic banks act as custodian or guarantor of the funds deposited by customers, e.g., demand deposits. Customers may withdraw their balances at any time (IADI, 2006). By using this product, depositors no longer supply funds to earn a fixed income. Instead, they place deposits for protection (Rosly & Zaini, 2008). Banks are not supposed to use these funds as a source of investment and financing or risk-bearing projects. However, in reality they do.

It is hard to quantify those banks that use Wadiah accounts, but we do know that some banks provide a token of appreciation known as hibah to depositors for banking with them. It should be noted that since the custodian service is given without a price, the Islamic bank holds no legal obligation to pay depositors a fixed return and may do so only on voluntary basis (Rosly & Zaini, 2008) . However, the banks are obliged to reimburse the funds at par value to their depositors in the event that a loss does occur (IADI, 2006).

The second type of widely used contract for Islamic deposit is Qardul Hassan. Under the Islamic Fiqh Academy ruling, shareholders are obliged to guarantee those deposits because they received returns from utilizing the deposits in investment projects (Othman, 2006).

PLS Deposits and the Risk of Eroding Sharia Principles - The profit and loss sharing (PLS) or Mudarabah forms the bulk of Islamic deposits. PLS was and still is a centre of debate on multiple levels. To begin with, The prohibition of interest in Islamic banking is replaced by PLS arrangement whereby the rate of return on financial assets held with banks is not known and not fixed prior to the undertaking of each deposit transaction, also known as ex-post rate (IADI, 2006). In this partnership structure, no guarantee is given for capital protection or a fixed income. This product structure is run under the principle of sharing equity. Unfortunately this makes it a risky product for depositors as the underlying contract is based on profit–loss sharing system (Rosly & Zaini, 2008).

Under a *Mudarabah* contract, the depositors act as providers of funds who place a specified sum of money to the bank, while Islamic banks act as entrepreneur through investing the funds and sharing the investment profit according to the predetermined profit sharing ratio (IADI, 2006). Profits are acquired only when the investments are gaining ground, while capital may depreciate or even diminish if the investment does not turn a profit (Rosly & Zaini, 2008). Banks bear the entirety of the loss if there is negligence and mismanagement on the part of the bank.

While conventional banks guarantee the capital and rate of return, the Islamic banking system can not provide such to PLS depositors. Some practitioners in the industry would argue that insuring a deposit goes against the PLS principle (Baeshen, 2010). Hence, depositor will not incur any risk, which contradicts the basic concept of Mudarabah. Other researchers are beginning to debate if protecting Muslim depositor funds, by providing guarantee, can erode Sharia principles.

First Attempt to Guarantee PLS - Before Malaysia took the helm, the concept of designing a complete Islamic deposit insurance system started in the GCC as a relatively innocuous idea that was based on understanding the economic and Sharia justification of the necessity of protecting depositors by guaranteeing PLS. For example, depositors are the ones who provide funds for specific investment activities by the bank. Thus, shareholders should consider sharing their distributed profits fairly to the small depositors who are bearing the risk.

The second justification on why Islamic Banking scholars favoured a guarantee of investment deposits (PLS) was based on the fact that conditions of Mudarabah contracts were not applicable to investment deposits and therefore the bank should guarantee nominal value on the deposits. This opinion was based on the fact that Islamic banks were so diversified that if a loss did occurred in one investment, there would still be enough profits to cancel out any defaults to depositors. (Othman, 2006).

After establishing the logical argument, the concept of tabarru (donation) was introduced in 2003 for guaranteeing the principal amount of PLS deposits. It has been suggested that the mudarib can voluntarily agree to compensate for any loss of principal amount of capital in a mudarabah contract (Al-Tegani, 2003). Then, Dr. Mohamed A. Elgari, one of the most influential Sharia scholars today, issued a fatwa

of its permissibility. In order to ensure the validity of such offer of guarantee as a pure gift, it should not be stated in the Mudarabah contract, neither explicitly or implicitly, nor should it be given except after the Mudarabah contract has already been concluded (Elgari, 2003).

It is unclear as to how many GCC banks established, at that time, in-house Islamic deposit insurance based on the concept of tabarru. As far as how the concept works, we know that banks retain a fraction of the yearly shareholders income in a special account of shareholders which would be used to compensate the depositors for any loss of their principal amount that may occur when taking risks with their money (Khan, 2003). For instance, a Saudi bank sustained large losses around the same time and its Board of Directors decided to have the bank's owners bear this loss on behalf of the owners of the investment accounts (Elgari, 2003). Maintaining such an account from contributions from shareholders income will be similar to paying an insurance premium to a third party to guarantee the depositors principal amount (Khan, 2003).

Prior to its establishment in 2005, Malaysia Deposit Insurance Corporation (MDIC), Malaysian banking officials were monitoring these non-institutionalized efforts in the GCC to design in-house deposit insurance schemes. Indeed, it was reported that MDIC studied several other frameworks including donation (Tabarru'), agency (Wakalah), and an approach based on government regulations (siasah syar'iyyah) (Baeshen, 2010). The Sharia Advisory Council (SAC) of Bank Negara Malaysia decided to adopt the Kafalah bil Ujr structure (explained below) as the most viable option. Keep in mind that the tabarru' concept was internally implemented by some GCC banks even though there were no third-party guarantee in place.

For a country striving to lead the way in developing standard international best practices relating to Islamic deposit insurance, the concept of tabarru' was not the answer. In its argument, MDIC stressed that tabarru' might not be a sufficient alternative to convince central banks that Islamic institutions could provide a guarantee as voluntary rather than a obligatory act (Baeshen, 2010). It added if Islamic banks were allowed to provide guarantee as a tabarru' act, they might abuse it and provide guarantee for Mudarabah investment deposits, and then allege that it was not an explicit guarantee, but only tabarru'.

Second Stage: Laying the Foundation of an Islamic Deposit System

In this section I will attempt to highlight some of the hurdles that may stand in the way of developing a sound Islamic deposit insurance (IDI) system. In order to understand how to overcome such obstacles, the Malaysia Deposit Insurance Corporation (MDIC) will be at the centre of this case study.

Dual Banking System - The vast majority of Islamic and Western countries have a dual banking system, which makes it difficult to design a deposit insurance model that is compatible with the principles of Islamic finance. The Malaysian deposit insurance system was introduced in September 2005 and was the first deposit insurance system to provide separate protection for conventional and Islamic deposits under one organization. Without such an entity, there would be a complete lack of consumer protection in the Islamic banking system. This would undoubtedly create an unfair disadvantage in the evolution and stability of the Islamic banking system (Sabourin, 2009).

Eliminating Commingling of Funds - The Sharia Advisory Council of Bank Negara Malaysia, which has one of the most respected group of scholars in the Islamic banking industry, issued a fatwa prior to the establishment of the IDI system that emphasized the need to separate funds in the operation of deposit insurance schemes for Islamic banking to ensure that the funds of such a scheme are invested in Sharia-compliant instruments. For Malaysia, it was already in compliance with that, but for the other few countries that have incomplete IDI system, they were not.

While other regulators lacked the willingness to make an effort to eliminate commingling of Sharia and conventional deposits, others failed to separate Islamic deposit insurance funds with conventional funds after receiving the scheme's insurance premiums. According to Moha-Pisal Zainal, INCEIF Joint Director of Research, (personal communication, 6 February 2010), Indonesia has one pool where all the premiums and returns out of purchasing securities are mixed. Hence, the paid capital of the IDI fund has been contaminated with conventional funds.

Third Party Guarantee for PLS - As in the GCC, the PLS or Mudarabah investment accounts were the centre of debate in Malaysia as observers argued as to whether PLS depositors should be protected. MDIC laid down two rationale why these accounts should be protected. First, deposit insurance is a prudential measure to promote the stability of the financial system due to significant proportion

of PLS vis-à-vis other types of deposit products in the Islamic banking industry. The public's interest should be taken into consideration as PLS accounts for more than 45% of total Islamic deposits and therefore accounts for the bulk of deposits mobilised in the Islamic banking system (Sabourin, 2009). Second, the protection will only take effect in the event of a bank's failure. In the normal course of banking operations the loss arising from investing PLS accounts will continue to be borne by the PLS holders. As such, the nature of the Mudharabah contract remains enforceable and the conditions are not voidable.

Under the Mudharabah contract, the entrepreneur is not allowed to guarantee the principal amount of PLS accounts. However, in 2003, Elgari issued a fatwa for the permissibility of such guarantees as long as it came from an unrelated third party. After that, the Shariah Advisory Council resolved that a third party guarantee is allowed to protect Mudharabah investment accounts (Sabourin, 2009). If an Islamic bank fails, MDIC would reimburse the PLS account holder up to the limit of deposit insurance coverage based on the value of their deposit at the date of payment and subject to priority of claims.

Public Interest Justifies Setting up Islamic Insurer

One of the justifications for setting up an IDI is for the public's interest (Maslahah) and the banking industry as a whole. According to MDIC, their Islamic deposit insurance system contains the element of maslahah in the several areas:

- First, the main objective of establishing a deposit insurance system is to protect the public's money and prevent the public from facing financial difficulty in the event of a bank failure. Such hardship would affect people's lives and cause even greater hardship to those who have limited financial resources.

- Second, IDI instils public confidence in the safety of depositors' funds in banks. The act of instilling confidence amongst members of the public in the safety of their deposits contributes and promotes to financial stability.

- It also promotes the competitiveness of the Islamic deposits and the banking system. Without the protection, Islamic deposits may lose their competitiveness against the conventional deposits which enjoy such protection. As a result, there is a possibility depositors would withdraw their funds in Islamic banks and place them in conventional banks. This would create liquidity issues to Islamic banks and dampen the development of the Islamic banking industry. (Sabourin, 2009).

Examining the Malaysian IDI System

After reviewing many concepts, the Sharia Council of Bank Negara endorsed its IDI system as long as its implementation is based on the arrangement of kafalah bil ujr, or guarantee with fee. This is a contractual guarantee given by a guarantor (MDIC) to take on the responsibilities and obligations of the depositors in the case that claims arise (Baeshen, 2010). The guaranteed party pays the guarantor a fee (Ujr) as consideration for the guarantee. In the event of a member's failure, MDIC will reimburse the insured depositors and banks be automatically subrogated to the rights and interests of the depositor's claim to the extent of the payment mode (Sabourin, 2009).

Funding and Premium Assessment - The Malaysian IDI system adopted an ex-ante funding where the premiums are paid annually. The operations of the IDI are funded by premiums received from members. This is compatible for both Islamic banks and those offering Islamic windows. Premiums are calculated by the MDIC through two different models: 1) a flat rate (2005-2007), and 2) a differential premium system (DPS).

A flat rate premium system is relatively simple to design, implement and administer (Baeshen, 2010). However, it is open to criticism as it does not take into account the level of risk that Islamic member institutions pose to the deposit insurance system. A flat rate premium system is also viewed as being less equitable since member institutions with lower risk profiles would effectively be subsidizing those with higher risk profiles (Baeshen, 2010). In 2008, MDIC switched to the DPS system, which is not intended to be an actuarially based measure of the risks posed to the deposit insurer by individual member institutions. Rather it is intended to send an early warning signal – with financial consequences – to the management and directors of member banks (Baeshen, 2010). The DPS aims to provide incentives for members to adopt sound risk management practices, differentiates members according to their risk profiles, introduce fairness into the premium assessment process and promotes the stability of the financial system (Sabourin, 2009). The DPS in a sense becomes a tool for MDIC to exercise financial discipline on behalf of depositors by charging higher premiums from banks that are more risky and prescribing

early corrective actions for troubled banks. These annual premiums are assessed on the amount of total insured Islamic deposits held by each bank as of 31 December of the preceding year (Sabourin, 2009).

Coverage - In term of coverage, MDIC provides separate protection for Islamic deposits and these include savings, demand and investment deposits accepted under various contracts such as Wadiah, Qardul Hassan and Mudarabah (PLS). However, this system excludes accounts such as deposits payable outside Malaysia, negotiable instruments of deposit, other bearer deposits and repurchase agreements (as is the case for conventional deposits). MDIC has the legal authority to also assess and determine the insurability of new Islamic deposits as and when the deposits are offered by members (Sabourin, 2009).

Each country can set its own deposit insurance limit under such IDI systems, although there are still some questions on how such limits will be applied. Furthermore, if a country has already an established conventional deposit insurance system, is the insurance coverage limit per depositors under Islamic deposit insurance comparable or equal to the limit of the conventional deposit insurance system? (IADI, 2006)?

Management of Islamic Deposit Insurance fund - MDIC then established a separate fund, the Islamic Deposit Insurance Fund (IDIF). For this purpose, MDIC maintains distinct and separate accounting records and financial statements for both conventional and Islamic deposits. In managing both funds, MDIC ensures that there is no commingling or cross-subsidisation between the conventional and Islamic IDIs. All premiums received from the Islamic banks and Islamic windows are channelled into the Islamic fund, which is then invested in Sharia compliant instruments (Sabourin, 2009).

Payments in the event of the failure of member institutions are similarly separated and no transfer of funds between the IDI and conventional IDI are permitted. Instead, MDIC is statutorily permitted to increase funding from the government should there be a need (Othman, 2006). Moreover, MDIC ensures all expenditures charged to the Islamic IDI fund are incurred through permissible activities. If an expense cannot be specifically attributed to either the Islamic or conventional funds, the expense is apportioned to the respective fund based on the amount of premiums collected in the preceding year (Sabourin, 2009). Any non-permissible expenses will also be borne by the conventional fund.

Payment and Priority of Payment - To maintain confidence in the financial system when a member institution fails, MDIC is required to reimburse depositors quickly, and by law no more than three months from the date of the issuance of a winding-up order. All reimbursements for Islamic deposits must be made from the IDI fund. In the event of a shortfall in the Islamic fund, MDIC would use the credit line from the government or funding from the market, which would be structured in a sharia-complaint fashion (Sabourin, 2009).

The priority of claims accorded to depositors would affect the amount that may be recovered by the deposit insurer or resolution costs incurred. Depositor's would automatically subrogate to MDIC their rights and interests to their funds, but only to the extent of the payment made by MDIC (Sabourin, 2009). In respect to the priority of Islamic deposits, the legislation sets out the priority of payments based on the underlying contracts of the deposits where, given the nature of Wadiah deposits, they are given the highest priority over all other Islamic deposits.

Components of a Financial Safety Net

After elaborating on the micro-factors that support the initial infrastructure of a sound IDI system, it is time to add a macro-economic perspective. Deposit insurance has become an increasingly used tool by governments in an effort to ensure the stability of banking systems and protect depositors from incurring large losses due to bank failures. Almost all countries have financial safety nets in place which include explicit and implicit deposit insurance, bank regulation and supervision, a central bank lender-of-last-resort facilities, and bank insolvency resolution procedures (Othman, 2006).

The Islamic financial industry recognizes the important role of ethical banking in contributing to economic growth. This includes the intermediation function between providers and users of capital, but also a country's payment and settlement system are particularly important (Sabourin, 2009). The preservation of the stability of the financial system is essential to a country's economic growth. For observers of financial safety net systems, the recent crisis has showed even sophisticated economies are susceptible to financial upheavals. According to the IMF the cost of cleaning up the financial crisis is estimated at US$12 trillion, which is equivalent to one fifth of the world's annual economic output.

Safety net arrangements are intended to maintain the stability of the financial system. If there is a lack of confidence in the stability of the financial system, any news of problems faced by one or more financial institutions may lead to bank runs. Bank runs can be one of the primary causes of a liquidity crisis; as there simply is not enough cash on had to meet every depositor's needs at once. More importantly this type of event has the ability to pollute the entire banking system and cause a systemic crisis (Sabourin, 2009).

To ensure a strong and robust banking system, policy makers have at their disposal a toolkit of safety net components. These encompass ways to manage the full spectrum of activities throughout the life cycle of a financial institution, from birth to death of the institution (Sabourin, 2009). In a speech by Jean Pierre Sabourin, CEO of MDIC, he highlights the components of a robust financial safety net. This covers the chartering or licensing function, prudential regulation and continuous supervision, lender-of-last-resort facilities, intervention and resolution mechanisms including liquidation and depositor reimbursements (Sabourin, 2009).

Chartering Function - Character and capital requirements are at the front end of any financial safety structure. Typically, this gate-keeping function is performed either by the ministry of finance, central bank, or supervisory authority but certain deposit insurers also play a role, such as the Federal Deposit Insurance Corporation in the United States. The first safety net component is the chartering or licensing function. The chartering function imposes minimum set-up capital and character requirements on the underlying financial sector (Sabourin, 2009). Minimum set-up capital requirements typically ensure that the new entries to the financial system have sufficient capital to conduct a sound business and financial operations.

Prudential Regulation and Supervision - The second component of the financial safety net is the prudential regulation and supervision function which, amongst others, include disclosure and capital adequacy requirements as well as restrictions on selected business activities. The aim of prudential regulation is to reduce unwarranted or unmitigated risk taking while supervision is to monitor banks to ensure that they are complying with regulations in order to maintain the safety and soundness of the banking system (Sabourin, 2009).

Lender of Last Resort - The lender of last resort is another safety net component. Typically performed by the central bank, the lender-of-last-resort function is available to provide liquidity to a solvent but illiquid bank, should a run against an institution occur (Sabourin, 2009). Should contagion occur, the lender of last resort can also provide liquidity to the entire banking system, as we famously saw in 2008 and 2009.

Intervention and Resolution Mechanisms - The fourth component of any safety net is the framework of intervention and resolution mechanisms. A timely and effective strategy for handling problem or failed banks help to substantially mitigate costs and avoid adverse effects on the public, the banking industry, and the economy. One author (Sabourin 2009) points out that it is important to have a public policy in place to remove troubled banks from the system quickly. This should be done in an orderly manner to mitigate contagion, promote discipline, mitigate moral hazard and ensure that depositors are promptly reimbursed their insured deposits. The monetary authority (central bank) also has to play a vital role in the safety net and this fact should be known by all those involved.

Deposit Insurance - The role of Islamic deposit insurance is to provide explicit protection in the form of a promise to pay depositors of member banks in the event of a bank failure. This promotes and contributes to confidence in the financial system, thereby reducing potential contamination of healthy banks (Sabourin, 2009). Globally, deposit protection has become an integral part of the financial safety net. Over the past two years 47 countries raised deposit insurance coverage or adopted depositor guarantees (Parker, 2009). These included temporary measures in 26 countries that will be scaled back in the foreseeable future.

Dual deposit insurance is not intended to be structured to singlehandedly deal with an entire meltdown of the financial system. In such situations, it is the role of all safety net providers to play their respective part under proper coordination (Sabourin, 2009). There is also a wide spectrum of deposit insurers with varied mandates, powers, roles and responsibilities. These range from supervised funds with limited mandates that only reimburse depositors after a bank fails, but also risk minimisers that have a mandate to take pre-emptive action necessary to minimize the loss of bank failures on the financial system (Sabourin, 2009).

Before any Islamic deposit insurance scheme is set in place, stakeholders should strive to educate small depositors and allow them to be fully informed about the benefits and limitations in order to help mitigate bank runs during bad times as they are unlikely to trust an agency that they have never heard of. Unfortunately it has been noted that having depositors with no knowledge of deposit insurance, is as good as having no deposit insurance (Sabourin, 2009). What depositors do not know does not benefit them.
A country's national deposit insurer should require banks to disclose to depositors which products are insured and those that are not protected prior to making financial decisions (Sabourin, 2009). On the other hand, Islamic banks are also exposed to bank-run risks when the financial system loses public confidence. Islamic deposit insurance systems, whether they are explicit or implicit, can play an important role in easing bank-runs and thereby promotes financial stability (IADI, 2006).

Regional status of Islamic Deposit Insurance

The concept of Islamic deposit insurance has come a long way over the last ten years. It grew from a simple idea of guaranteeing PLS deposits to the creation of actual comprehensive Islamic deposit insurance systems in Malaysia and to less extent in Turkey, Sudan and Indonesia. Jordan and Bahrain are the closest countries in the Middle East to adopting an Islamic deposit insurance scheme for their banks. The rest of the GCC has implicitly adopted the deposit insurance scheme, and thus there is no formal regulation that explains the scheme. Instead the individual country is relied upon to observe the situation informally (Othman, 2006).

During the recent credit crisis, many GCC countries used public statements for deposit guarantees rather than introducing legal protection. These were primarily countries that made political rather than legal commitments to protect depositors. Current plans for easing temporary or special protection (for depositors) should be deconstructed within the next few years, with the majority split between 2010 and 2011 (Parker, 2009). One can only wonder what will happen to Islamic deposits when these temporary deposit insurance measures expire. The Islamic finance industry in the GCC needs a sustainable and comprehensive Islamic deposit insurance system in order to have a level playing field with conventional banking.

The Way Forward

Over the past decade differing views on Sharia interpretations between Malaysia and the GCC have contributed to some extent in the creation of a secular deposit insurance systems in the relative jurisdictions. However, this research concludes that when it comes to deposit insurance, there is a common Sharia ground between Malaysia and the GCC. Hence, there is a need for the political will if such system is to ever be implemented in the GCC.

Your feedback and comments are very important to us, please feel free to contact the author via email.

Standardisation v Harmonisation: Towards Recognition?

Hakimah Yaacob

Hakimah Yaacob is an Associate Researcher at the Islamic Banking Unit, International Shari'ah Research Academy (ISRA) for Islamic Finance.She holds a Bachelor of Laws (Hons), Bachelor of Syariah (Hons), a Master in Comparative Laws, from International Islamic University Malaysia and a diploma from Tokiwa International Institute, Japan. Previous positions held include Head of Law Reform & International Treaties, SUHAKAM, legal practitioner, as well as being the Drafter of International Standard Organisation 26000 on social responsibility. She has published many articles on alternative dispute resolution (ADR) in Islamic finance including arbitration, mediation and hybrid ADR.

Many speak about harmonisation and standardisation in Islamic finance at the international level. There are currently thirty nine (39) Conventions for the harmonisation of rules of private international law and for the promotion of international law and for the promotion of international judicial and administrative cooperation in civil and commercial matters. The greatest challenge in examining the Convention from Shariah perspectives lies in the difficulty in figuring out exactly what it means and what reforms would be required to give full effect to the object of the Convention. The current Hague Convention available discusses the application of civil and commercial matters, whereas a Shariah transaction does not fall within the ambit of civil or commercial matters. Where matters cannot be harmonised then the author propose that Islamic transactions should be recognised. Should they want to proceed with a treaty, a separate international treaty mainly for Islamic finance should be established. Alternatively, should we want to ratify the existing Hague Convention on Private International Law, then Optional Protocol should be established in order to show the recognition of a unique set of principles in Shariah.

An effective legal framework at the international level is needed to ensure a resilient development of Islamic finance. This relies on creating a framework that is accommodating and facilitates the development of the industry. This is also to ensure the enforceability of Islamic financial contracts and be given a credit on its own merit. Due to this, a credible and reliable forum for settlement of legal disputes arising from Islamic finance transactions is pivotal. The industry and supervisory authorities should not hesitate to take the lead in spearheading the development of Islamic finance through the issuance of clear policy decisions and directions from which market players could be certain in their involvement. This is to avoid any legal and Shari&trsquo;ah risks in the future. On the other hand, it could help in avoiding stigma at international level. Indeed the Convention needs to be carefully pronounced without causing any confusion to the industry. The law is to support the market, smooth out lingering legal anomalies with the conventional system and induce greater legal standardisation and convergence.

International conventions or treaties guarantee that the litigants will be judged according to the law of their choice. However, scrutinising the case of Mount Albert Borough Council v. Australasian Temperance & General Mutual Life Assurance Society Ltd,[1] the proper law of contract was defined as the law which the English or other Court is to apply in determining the obligation under the contract. In the absence of comprehensive legislation in governing Islamic finance across the globe, the parties should be given a freedom to enter into a contract with their own choice of law. It means they may opt for the best for the contract or the best for their interest and position. Thus, where the parties have an agreement extracting out the manner in which they have chosen to resolve their disputes, it should be respected in every way possible. It is common to see in an agreement the governing law clause written as “The Contract shall be governed by the law of England and any dispute, question or remedy however-so arising determined exclusively by the Courts of England.” This happens when the parties have not been given many choices in settling disputes involving their interests. Hence, they finally opted for an English court to decide on the validity of the contract.

Referring to Re Herbert Wagg & Co. Ltd.' it was held that "This Court will not necessarily regard the parties' choice of law as being the governing consideration where a system of law is chosen which has no real or substantial connection with the contract looked as a whole". The views concluded that the courts should have residual power to struck off, for good reason, choice of law clauses totally unconnected with the contract. However, in this case also, Re Helbert Wagg it was held that 'the parties may well contemplate that different parts of their contract shall be governed by different law. Is there any justification to exclude the intended terms of the agreeing parties in the contract and merely apply English law for the execution of the contract and to be considered as valid and name it as a proper law.

Standardisation can be defined as: "A framework of agreements to which all relevant parties in an industry or organization must adhere to ensure that all processes associated with the creation of a good or performance of a service are performed within set guidelines. This is done to ensure the end product has consistent quality, and that any conclusions made are comparable with all other equivalent items in the same class."[2]

Thus, standardizing the rulings would make it easier for both companies and ordinary people to understand it better. "The lack of standardized religious decisions leads to uncertainty, confusion, and unease among scholars and investors. This situation restricts the industry from reaching its potential because a number of inefficiencies arise from the lack of standardisation. For example, different interpretations of Shari'ah mean that one Islamic bank may not be able to accept or use as a model another Islamic bank's products, which can stifle the integration of Islamic finance at both the national and international levels."[3]

This is especially true for Islamic banking products that are far from being standardized across the different jurisdictions, thus creating obstacles at the international level. Apart from reducing the confusion and increasing efficiency, the standardisation would increase the consistency and transparency, reduce the costs, and provide more time for innovation.[4] One of the suggested solutions (although it may not be the perfect one) would be to establish an International Shari'ah Board that will consist of the members from the all schools of law and whose decisions will be mandatory for all jurisdictions.[5]

In brief, this article can be concluded as follows;

i. The existing Hague Convention on Private International Law is ill suited with the Islamic finance and consequently in appropriate to be harmonised.
ii. In relation to the above, by having its own intricacies and principals, the Islamic finance framework is different from Commercial or trade law which is based on Euro Centric since adaptation of 100 years ago.
iii. The author are of the view that the current existing Convention on trade and Commerce cannot be harmonised with Islamic commercial law. This is timely to recognise the difference and not to merely harmonise!
iv. The Convention may serves as platform to leverage the freedom of contract looking from Islamic point of view as part of Siyar.
v. The authors are of the view that OIC should promote the Convention at The Hague level and supported by AALCO. This is due to the fact that Islamic Finance is worldwide practiced and not merely in Islamic countries.
The issues of standardisation, as recommended above, is the issue on which, according to many, the whole Islamic finance industry depends on. It is the pre-requisite for this industry to go to the next level in its development and to be able to make changes in the banking industry in general. Cross-border transactions will be stuck with differences of opinions among Shari'ah scholars until and unless we sit together and come up with a unified voice.

References:

[1] [1938] AC 224, 240; [1937] 4 All ER 206, 214 (PC)
[2] Investopedia. (2010). "Standardization." Retrieved April 15, 2010, from http://www.investopedia.com/terms/s/standardization.asp.
[3] Shanmugam, B. and Z. R. Zahari (2009). A Primer on Islamic Finance. Charlottesville, VA, Research Foundation of CFA Institute, p. 93.
[4] Al-Jassar, J. (2002). 'Islamic Finance: Successes, Prospects, and Neglected Areas.' Islamic Finance: The Task Ahead - Proceedings of the Fourth Harvard University Forum on Islamic Finance. Cambridge, Massachusetts, Center for Middle Eastern Studies, Harvard University: 173-176, Shanmugam, B. and Z. R. Zahari (2009). A Primer on Islamic Finance. Charlottesville, VA, Research Foundation of CFA Institute, Smolo, E. (2009). 'Sustaining the Growth of Islamic Financial Industry: What Needs to Be Done?' Islamic Finance Bulletin (RAM) October-December(26): 15-23. Alvi, I. (2009, May). 'Standardization of Documentation in Islamic Finance & Role of the International Islamic Financial Market (IIFM).' Islamic Financial Sector Development (IFSD) Forum 2009. Ashgabat, Turkmenistan..
[5] Kamal, R. M. (2008). 'Standardization the Password to Progress.' Islamic Finance Asia. August/September: 28-30, Shanmugam, B. and Z. R. Zahari (2009). A Primer on Islamic Finance. Charlottesville, VA, Research Foundation of CFA Institute, Quoted from Smolo, Edib, Marjan and Hakimah, International Treaties for Islamci Finance, AAIOFI Bahrain, 1-2 December 2010.

Your feedback and comments are very important to us, please feel free to contact the author via email.

Islamic Dinar Revisited

By Mobasher Zein

The writer is an Islamic finance researcher who completed his MBA (Investment Management) from Concordia University and is a CFA Level 3 candidate. He was recently awarded the Islamic Finance Qualification (IFQ) designation.

A Super Sovereign

Calls for reforming the international monetary system have picked up pace with Zhou Xiaochuan, Governor of the People's Bank of China opining that the IMF's SDR should be widened in scope and allocation and presents the best possible solution in securing global stability and facilitating world economic growth.[i] The criteria he presents in selecting an international reserve currency are:

i. Stable value
ii. Rule-based issuance
iii. Manageable supply[ii]

Clearly, a new Islamic Dinar weighted to equal 4.3 grams of gold and an Islamic Dirham weighted at 3 grams of silver will exceed the established criteria prescribed by the governor in terms of its intrinsic value, convertibility and flexibility. It is entirely independent from the economic conditions and geo-economic interests of any single country and directly addresses the Triffin dilemma by providing liquidity while maintaining value. Similarly, it is a far superior alternative to the Bancor currency proposal of John Maynard Keynes whose world currency unit fixed in terms of 30 commodities seems impractical and unstable.

Intriguingly, the UNCTAD's Trade and Development Report of 2010 also highlight the challenges being faced by the international monetary system and the use of US Federal Reserve notes as the world's reserve currency.[iii] Unfortunately, the solutions presented by the authors fall woefully short of meaningful financial reform where replacing the US dollar with an artificial SDR currency is seen as a remedy to budget deficits and instability. It would be difficult to expect the thoroughly discredited International Monetary Fund, with its standard prescription of shock therapy austerity measures for developing economies, to act as a neutral arbiter in supervising its implementation and working.

Proposals

A drastic restructuring of the existing financial disorder will require the Islamic Development Bank to play a leading role in transforming the current central banking warfare investment model[iv] that governs the planet with the establishment of a new monetary regime that

actually enhances economic welfare, help formulate monetary policy of all Organization of the Islamic Conference (OIC) member states and provide a platform and basis for greater economic integration of Muslim countries. Specifically, the Islamic Development Bank would be tasked to:

1) A new Islamic Central Bank (Baat ul Maal) -a bank of last resort for all OIC member central banks with powers and functions similar to the Bank of International Settlements tasked with engendering greater stability through guidelines and regulations across the entire spectrum of the Islamic financial system. Its principal task will be to coordinate and manage monetary policy of the new Islamic Dinar providing liquidity and limiting supply as international market conditions dictate. It will also be mandated to ensure that member central banks actively replace conventional banking practices with Sharia compliant operations in their respective jurisdictions. The new central bank will need to settle the debate on an Islamic interest rate and provide a principal benchmark rate that will be used to price all future Islamic financial contracts. The underlying drivers of the new Islamic interest rate will need to be carefully selected and endorsed by consensus with fatwa across all five schools of Islamic thought. Certainly, the IDB would need to mobilize member states particularly Saudi Arabia, Malaysia and Turkey to provide impetus and focus for an independent and empowered central bank that will lie of the heart of new Islamic financial system.

2) Regional commodity exchanges -across the Arab/Islamic world regional commodity exchanges will set commodity prices and settle trades in Islamic Dinars. Maintaining constant demand for the new Islamic Dinar will be necessary to gain traction and credence in the forex market. Possible options can include but are not limited to:

Commodity	Location
Oil	Dammam, Saudi Arabia
Gas	Doha, Qatar
Precious Metals	Dubai, UAE
Cotton	Istanbul, Turkey
Cocoa	Kuala Lumpur, Malaysia
Rice	Karachi, Pakistan
Jute	Dhaka, Bangladesh

3) Restrict derivative use -ban any form of 'naked' short-selling of the new Islamic Dinar across all international currency markets. The OIC should seek a treaty at the multilateral level if need be to protect the currency from harmful speculative attacks orchestrated by the economic hit-men of Wall Street and the City of London. The new Islamic Central Bank could consider charging a special tax on hot money flows that are outside the purview of normal monetary exchanges to desist speculators.

4) Islamic Monetary Union (IMU) - Develop a phased program for the adoption of the Islamic Dinar by OIC member countries provided certain macro-economic benchmarks are met. An Islamic version of the Maastricht treaty (as described by my colleague Bernardo Vizcaino), is initiated where the formulation of monetary policy at the state level is subordinated to a supranational body that will be responsible for coordinating and integrating Muslim countries under a single economic platform. The roll-out should be gradual and incremental on a country by country basis where admission to the program is contingent on matching specific economic criteria and membership is guaranteed through continued adherence with fiscal and monetary benchmarks of the program. Drawing upon the experiences of the Gulf Cooperation Council the new Islamic Monetary Union should seek to avoid the petty squabbling that marred the GCC monetary union debate through transparency and accountability of its proposed operations. An important outcome of the new monetary regime will be 'dinarization' that should occur as OIC member states seek to conform to the new IMU. The decline of the US

dollar will make it necessary for countries to seek alternative means to ensure fiscal and monetary discipline of individual member states. With dinarization central banks of member states will be in no position to print money ad infinitum thereby constraining local money supply, preserving the value of local currencies while resulting in an acceptable loss of seigniorage.

5) An exclusive Free Trading Zone - The formation of an expanded free trade area within the Arab/Islamic world is sorely needed. A free trading zone that harmonizes tariffs and trade with non-Muslim world while removing intra-trade barriers should provide the right ingredients for specialization and sectoral growth in the OIC. The new IMU using the Islamic Dinar as the principal currency of exchange while enabling the free mobility of capital and labor will unleash untapped economic synergies benefiting millions across the Islamic world. This should also provide the Islamic Dinar with the real chance of becoming an alternate reserve currency of the world as countries build up their Dinar holdings.

Conclusion

A strategic reform of the international monetary system has become a moral imperative for the world's economic managers. The question is one of willingness and capacity to replace the existing the disorder in the international financial system with one that is ordered, robust and stable. It is my firm belief that a new Islamic currency will play a critical role in the evolution of such a system although whether this call is heeded remains to be seen. Consensus-building will take time but the forces of globalization have provided an excellent opportunity for Muslim countries to develop their own economic bloc in this rapacious new world order. The urgent need to strategically reorder the Islamic financial landscape in to a system that underscores its moral and ethical value system is long over-due. The Islamic world needs a renaissance and no single dynamic will give it as much momentum as a new Islamic currency that binds the old with the new.

References

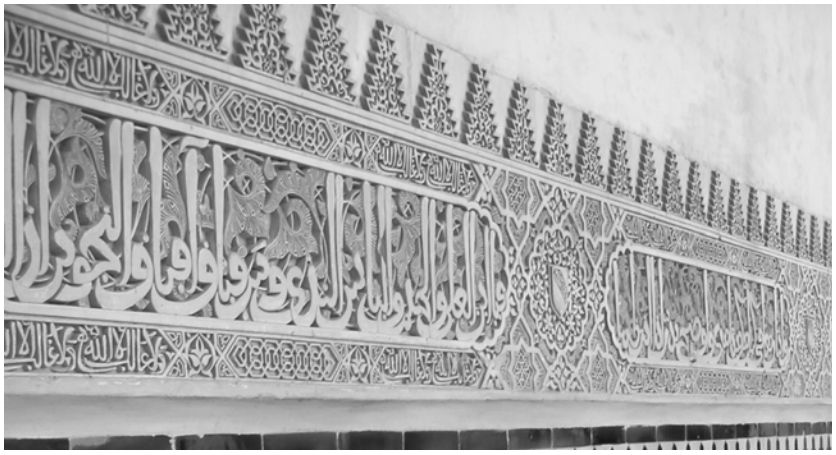
[i] The People's Bank of China, online article, September 9, 2010
[ii] Ibid
[iii] The Telegraph, "UN wants new global currency to replace dollar", September 9, 2010
[iv] Catherine Austin Fitts, online article, September 9, 2010

Your feedback and comments are very important to us, please feel free to contact the author vie email.

Ready for Retail?

By Toby Birch

Toby Birch is Managing Director of Oppenheim and Co Limited (investment management) and Guernsey Gold Limited (bullion dealing). He is a Chartered Fellow of the Chartered Institute for Securities and Investment and also hold's the Institute's Islamic Finance Qualification. He is author of The Final Crash, one of the most prescient predictions of the credit crisis published in May 2007. He was previously CEO at Blackfish Capital Holdings where he managed a resources-based hedge fund and senior investment manager at Bank Julius Baer in Guernsey.



Anyone with even a passing interest in Islam will be struck by the common sense and simplicity of its message. As a non-Muslim this is most striking when visiting any mosque and witnessing the relative informality of the clerical structure during prayers. If one delves deeper into its economic lessons then similar themes appear. It soon becomes apparent that there is profound wisdom and age-old understanding of human behaviour. Westerners struggle to comprehend why interest is a problem and shrug it off as a religious idiosyncrasy. However, there is nothing superstitious about refuting the use of usury. The UK will be spending more on interest than it does on defence in 2011 while the entire Euro currency block wavers under the weight of debt; exactly who is being irrational by urging its avoidance? Some smug commentators lump gold bugs and the 'interest-free crowd' into the same category, implying they are somehow unsophisticated. As one who is associated with both bullion and Islamic Finance, I would appear to be firmly wedged in that pigeon hole.

We are now all-too-familiar with the tale of the Emperor's New Clothes, post-2008. The children's fable reminds us of our reticence to ask simple questions for fear of sounding stupid. It sometimes takes the naïve or innocent to bare the obvious (pun fully intended). Similar demands must be made of the Islamic Finance industry, especially in its formative years. Recent reports claim that the asset base of such institutions is set to hit $1.5 trillion in 2012. It is difficult to determine how such forecasts are derived given the wide variety of data sources for each industry sub-set. The total may well be swelled by the accumulation of petro-dollars at Islamic banks alongside the issuance of sukuk (bonds) plus takaful (insurance) business. While the numbers are impressive and the growth rates likewise, one wonders whether such bank deposits are actually doing anything useful for the wider economy or simply stagnating and devaluing with the dilution of the US dollar. Perhaps the real numbers to look at are those of penetration rates. There are close to 83 million Egyptians, most of whom are Muslim (estimates range from 80% to 95%), yet Islamic finance is an after thought. Indonesia is an even more compelling market. Yet few institutions have a regional strategy, let alone international presence, to enable distribution.

Given the history of Islam, one would expect its financial system to be a grass-roots phenomenon. After all, the religion was propagated by word of mouth, assisted by the example set by Muslim traders, known for their honesty and fair dealing. However, the modern industryhas a hard, institutional feel to it. Western investment banks are drawn by the hefty corporate finance fees on big sukuk bond

issues. There is minimal appetite for offering retail financial services. Small but sincere fund providersstruggle to afford the extra costs of Islamic compliance. Large institutions argue that if one cannot afford a single scholar for your fund's fatwa, let alone an entire Sharia Board, then hard luck, that's the market rate.Their wealth management armshave alsoattempted to milk money from the wealthy in the Middle East, offering Islamic-looking funds catering for exotic and esoteric themes. The average fund size is apparently around $30m so it would appear their uptake has been unspectacular. It is tough to track both the size and performance of such vehicles as the data is often the preserve of subscription-only services. The open qualities that spurred the spread of Islam appear to be lacking in its implementation. Another missing aspect is the simplicity, especially if one has ploughed through a Prospectus witha dizzying array of arrows on transactional diagrams. It is reminiscent of the illustrations for mortgage backed securities that supposedly proved their high credit ratings.

Institutions can rightly counter that the retail approach has struggled, citing the example of the Islamic Bank of Britain, requiring on-going funding from its shareholders. Like all modern businesses, scale is essential to compete with interest-based banking services. This is why Islamic retail banking requires more than just a large pool of Muslims to succeed; the customers need to have money to deposit as well. This allows banks to upsell services which are more profitable for both the institution and customers alike, and ultimately more useful for the wider economy. These are in the form of restricted and unrestricted accounts that allow greater flexibility for risk and reward. Ultimately this 'equity' approach is the most economically useful activity a bank can perform. It reduces systemic risk and counters the inflationary effect of credit creation. There is huge demand for borrowing by SME's (small to medium sized enterprises) that cannot find finance. Even when secured, credit is offered at extortionate margins by the interest-based lenders. The tragedy for western economies is that SME's generate the jobs but are being starved of financial fuel. For too-big-to-fail banks, the bail-out has been the greatest coup of the century. A generation of tax payers will have to fund their liabilities with none of the benefits. Like an implanted cuckoo, our banking system acts like a sibling but is really a parasite that gorges our food and throws us out of the nest once they have outgrown us. The government, like the host parents of the innocent bird, is tricked into feeding the invader until they are exhausted by its constant demands.

There are also enormous barriers from regulators, mainly in the form of the Basel Accords that encourage debt rather than equity-based assets by their very nature. The old Latin maxim of 'who guards the guards' springs to mind when considering such decrees. The proponents of usury permeate every institution, designing laws to protect bond holders and receivers of interest over those who take greater risk in the form of equity. There are also benign barriers to Islamic banking, even in tolerant countries like Canada whose regulators want banking availability for all religions, not just Muslims. Perhaps the religious tag needs to be replaced with an ethical one to widen its appeal and palatability. After all, the avoidance of usury is not just common sense but is also a common theme for People of the Book (a term encompassing several other religions).

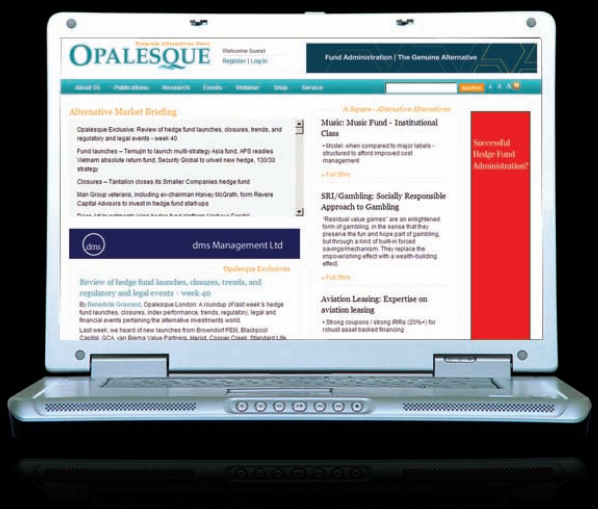
One would expect to see leadership in the Middle East where retail banking has more potential for significant success. However, Malaysia appears to be taking pole position with greater uptake for Islamic products and services. Just like any other service, the benefits of Islamic finance needs to be sold to customers. It cannot depend on duty or devoutness alone, especially when customers pay a higher price for the privilege. After all, why should individuals invest according to Sharia values when Muslim countries' Sovereign Wealth Funds fail to do so? Using these principals for investment and business transactions is not just the right thing to do but is beneficial for the economy and investors alike. It avoids the destabilising effect of derivatives and leverage while enhancing genuine yield generation and sustainability of the equity approach.

While recognising the need for capital markets one should not overlook the fact that institutional money is ultimately sourced from mass market deposits, pensions, insurance and investments. This stable source of capital could provide some of the liquidity and long-term funds Islamic banks are desperate for. Will a retail revolution arise in 2011? Probably not, if 2010 is anything to go by. We will likely endure another year of sponsor-driven conferences with their euphemisms, tales of growth paradigms and fancy funds. Like their western counterparts, some Islamic financiers want a speedy return to business as usual, finding formulae to mimic an interest-based– and ultimately self-destructive - system. Islam is the oldest yet the latest thing whose tenets stand firm as generations come and go. The lack of consumer empowerment has allowed the industry to follow fashion, dictating trends from the top;it would be wonderful for Islamic finance to flourish organically from the bottom-up.

Your feedback and comments are very important to us, please feel free to contact the author via email.

accurate
professional reporting service

No wonder that each week, Opalesque publications are **read by more than 600,000 industry professionals in over 160 countries**. Opalesque is the only daily hedge fund publisher which is actually read by the elite managers themselves



Opalesque Islamic Finance Briefing delivers a quick and complete overview on growth, opportunities, products and approaches to Islamic Finance.

Opalesque Futures Intelligence, a new bi-weekly research publication, covers the managed futures community, including commodity trading advisers, fund managers, brokerages and investors in managed futures pools, meeting needs which currently are not served by other publications.

Opalesque Islamic Finance Intelligence offers extensive research, analysis and commentary aimed at providing clarity and transparency on the various aspects of Shariah complaint investments. This new, free monthly publication offers priceless intelligence and arrives at a time when Islamic finance is facing uncharted territory.

Alternative Market Briefing is a daily newsletter on the global hedge fund industry, highly praised for its completeness and timely delivery of the most important daily news for professionals dealing with hedge funds.

A SQUARE is the first web publication, globally, that is dedicated exclusively to alternative investments with "research that reveals" approach, fast facts and investment oriented analysis.

Technical Research Briefing delivers a global perspective / overview on all major markets, including equity indices, fixed Income, currencies, and commodities.

Sovereign Wealth Funds Briefing offers a quick and complete overview on the actions and issues relating to Sovereign Wealth Funds, who rank now amongst the most important and observed participants in the international capital markets.

Commodities Briefing is a free, daily publication covering the global commodity-related news and research in 26 detailed categories.

The daily **Real Estate Briefings** offer a quick and complete oversight on real estate, important news related to that sector as well as commentaries and research in 28 detailed categories.

The **Opalesque Roundtable Series** unites some of the leading hedge fund managers and their investors from specific global hedge fund centers, sharing unique insights on the specific idiosyncrasies and developments as well as issues and advantages of their jurisdiction.

OPALESQUE

www.opalesque.com

OPALESQUE ISLAMIC FINANCE INTELLIGENCE

PUBLISHER
Matthias Knab - knab@opalesque.com

EDITOR
Bernardo Vizcaino - bernardo@opalesque.com

ADVERTISING DIRECTOR
Denice Galicia - dgalicia@opalesque.com

FOR REPRINTS OF ARTICLES, PLEASE CONTACT:
Denice Galicia dgalicia@opalesque.com

www.opalesque.com