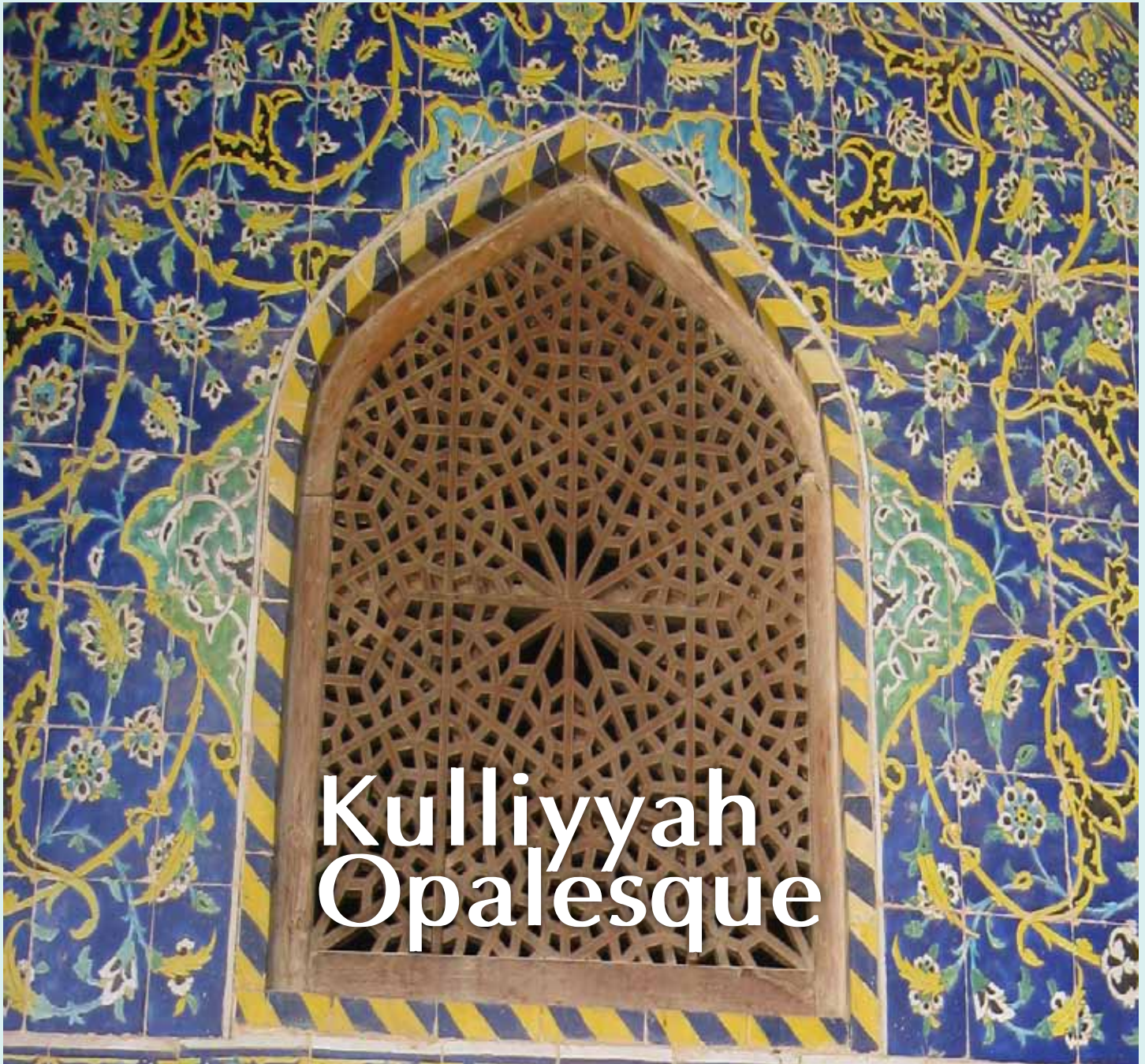


OPALESQUE

ISLAMIC FINANCE

INTELLIGENCE



Kulliyyah Opalesque

Manager Interview

Nick Barisheff, President & CEO,
Bullion Management Group Inc.

Opinion Column

Repair Initiatives Post Banking Crises
- Can Islamic Finance contribute?

Industry Snapshot

The Islamic Window: Consumer
Perception and Market Research in
Islamic Finance

Welcome to the seventh issue of Opalesque Islamic Finance Intelligence, once again we bring together a wide array of content that is as diverse as the industry itself. Each of our editions has always delivered a wide range of topics (as this allows us to present relevant material for everyone), but it is increasingly clear that inquisitive research, relevant empirical evidence and timely academic studies are in dire need. This is not only true of their origination but also of their dissemination, thus we gravitate around this particular theme for OIFI VII.

To begin with, our editorial section delves into the realm of data and information providers and how this space is evolving. In addition, we introduce a new academic-oriented section which we affectionately term the 'Kulliyah Korner'. Its aims is to provide a glimpse into the latest topics that are being discussed and analyzed across the industry - whether this is within the context of a faculty (or kulliyah), think tank, etc. Above all, the Korner aims to highlight the rich material available from academic institutions (usually available through industry periodicals and journals) while presenting them to a wider audience.

Hence the first installment of Kulliyah profiles the research of Anne-Sophie Gintzburger, who has developed an extensive study on the regional variations of Islamic financial instruments as part of her thesis at the Australian National University. We complement this with our Featured Resource which outlines a variety of past & present case studies at the country-specific level. Furthermore, Lex Islamicus sees Khalil exploring the Universality and Codification of Islamic Contracts, as it pertains to their enforceability of these in a court of law and the relationship with Lex Mercatoria.

Nikan provides further insights into Shariah compliant principal protected notes as part of the Featured Structure section. This allows for an interesting contrast to our Fund Manager Interview which talks to Nick Barisheff, President & CEO of Bullion Management Group (BMG), and their recent entry into the field with their Shariah compliant BMG Bullion Fund. Taking a look forward, our Opinion Column hears from Professor Mahmood Faruqui, who inquires on where can Islamic Finance contribute as part of repair initiatives in the aftermath of the global financial crisis. Finally, Joy Abdullah makes inquiries in our Industry Snapshot section regarding the need for consumer data and market statistics - with a particular focus on investor awareness and their perceptions of the Islamic finance industry.

We welcome your comments & suggestions and a reminder that you can check the ever-growing archive of Opalesque Islamic Finance Briefing and Opalesque Islamic Finance Intelligence, all available free ([see reference link](#)).

Thanks & Regards,
Bernardo
Editor, Opalesque Islamic Finance Intelligence

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Learning Rushdi-Speak

By Bernardo Vizcaino, CAIA

Islamic finance is “a market which is still screaming for quality, informed, objective, independent and up-to-date information, data and analysis” so reminded us Mushtak Parker in a recent article he wrote ([see reference link](#)). He was referring to the recent news from Thomson Reuters of the launch of their Islamic finance gateway, which has been developed under the watchful eye of their global head of Islamic finance, Rushdi Siddiqui. What was rather curious was how Mushtak labelled their entry as mere “indulgence in self importance” and the elaborate announcements as mostly “Rushdi-Speak”. What does that mean exactly? Let's find out.

One must understand Mushtak's apprehension, he has vast experience in the field and has seen many products (and promises) come and go. Nevertheless, there are several points that need to be raised further with regards to this portal (and others) in terms of what it augurs for the industry. In a way this relates to our own decision to develop OIFI - a response to the seemingly widespread failure of industry media to provide non-commercial, non-advertorial and non-aligned content.

For the sake of disclosure, I have had the pleasure of meeting both gentlemen (I doubt they would remember though!) and in a way OIFI has sought to combine the independent and inquisitive nature of Mushtak with the product knowledge and practitioner perspectives of Rushdi. The truth is that we need more of both of these gentlemen, clone them if we have to. So please allow my own “indulgence in self-importance” as I feel that there is an underlying story hidden in the midst of all the hype and it needs to be told.

Market Signals

The fact that a media giant has deployed an Islamic finance portal has to be recognized for what it is: a concrete and positive market

signal. It is a handshake to Islamic finance, because they haven't indulged us with a MENA-dedicated gateway, this is not a simple news service (with some bells & whistles), nor some sort of self-promotional industry guide (we have seen too many one-offs already). Reuters is here to stay - and stay for the long term - by bringing on board not an industry personality but a pragmatic and eloquent promoter of Islamic finance.

Overall, what we have here is a considerable step towards addressing industry needs, but also a signal for other data providers to take notice (and perhaps take further action). It has not escaped my attention that the modus operandi of many service providers (not just of data provision) tends to be that of complacency and minimalist effort. Getting away with what they have for as long as they can with as little effort as possible. We should welcome Reuters (and the rest of the pack), the question that we should ask is not whether it is necessary to rattle the cage but instead is it being shaken hard enough.

Why delve in market signals though? Take for instance one of the IFSB summits from few years ago, in which a panel discussion engaged one of the IFSB seniors, the director of one of the largest investment banks in the world and Mushtak Parker himself (among others). It was in good form that the gentlemen from IFSB suggested that the invited investment bank should consider IFSB membership - after all this would provide a highly visible and positive signal to the markets (and in any case this would entail little internal impact for the bank since IFSB guidelines are non-enforceable). What followed in response was a 15 minute masterclass by this director on how to avoid the topic. It remains one of the most comical (and visceral) episodes I have ever witnessed in this industry. Simply embarrassing and a prime example of what market signals we don't need.



Editor's Note

Make no mistake, silence and/or avoidance are market signals all the same and should not to be underestimated - they can be as powerful as the loudest announcement or glossiest of press releases.

Thus when reading that "some Islamic bankers who have had a preview of the Gateway are bemused exactly how it will guide a disparate global industry to its next phase of development" I feel the need to remind them that the entrance of Reuters has to be regarded above all as positive, a thumbs-up to the impact and presence of Islamic finance in the global landscape. In that sense the entry of this (or any other) mainstream provider should not be bemusing but instead welcomed openly for what it communicates to the world (especially to the one outside of Islamic finance). As a matter of fact, I might further inquire as to the job specification of these so-called Islamic bankers since one of the most massive issues for the industry remains trading volume and transaction liquidity. The introduction of a trading platform would only help trade execution by institutions and their intermediaries (although this might perhaps reduce the fees that these Islamic advisors charge).

In that sense we don't need a Reuters global trading platform. We need a dozen of them.

Ignorance is Bliss

Once again we are in agreement with Mushtak that this is "a market notorious for its fickleness, under-developed culture of banking transparency, poor data collection and research". As a matter of fact my background in this industry specifically delved on the last two points (alert, another anecdote is around the corner), since my previous work involved research specifically covering Islamic funds. During that time the awareness and understanding of Islamic investment funds increased significantly - expanding the coverage of about 60 funds (100 estimated universe) to 700 funds (800 estimated universe). However, this was not due to a sudden spike in industry growth but to the sheer complacency of data providers - and in some cases an indisputable dosage of either ineptitude or negligence (or both). If one discounts the illiquid (and mostly outdated) investment products from the list of 700 then I must admit that the Reuters portal (which covers 555 products) is the only one that has come anywhere near the coverage and up-to-date data that this industry rightfully deserves. The hope is that other providers would take notice - although some have even stopped trying altogether.

I have to disagree that the "Islamic finance industry coped and developed over the last three decades without the support of Reuters, APs, Dow Jones and the Bloomburgs of this world". In fact it is a minor miracle that the industry has survived as it has - instead of us boasting industry growth numbers we should lament that these could have been much higher figures. The simple fact is that many investors didn't (and still don't) know any better. They remain ignorant to the great opportunities around them, and why should we be surprised - after all their wealth managers are not meant to educate them (the less their clients know means the more they can charge them).

Regrettably some are still being duped into paying large amounts of money for some of the most trivial and sloppy information services ever developed in the history of media, and I am not exaggerating. They are happy with what they've got, but that doesn't mean they are getting the best product in the marketplace (or that we should remain numb about it). Reuters may or may not be the best (who knows), but the underlying fact is that it presents users with one more choice and this is a good thing. Moreover, one should not be surprised that the gateway comes with a subscription price, what is far more important is whether Reuters (and other providers) can justify the price tag, and even more important is whether this will put downward pressure on the price being charged by other providers.

Cost competition will benefit us all - even if we never lay eyes on a Reuters screen.

Aggregation and Combination

It was rather odd that "one Islamic banker stressed, "Why would I want to go to the Reuters Gateway if I want to access an S&P report on Islamic finance. I would go directly to S&P." The simple answer is aggregation - we can surf the internet for hours to identify, access, download and digest relevant information (if indeed it is available online) or instead have it all presented in an amalgamated portal. Aggregation of information is one of the most significant trends in online data dissemination, and hopefully something that can spread like wildfire across other Islamic finance portals. Maybe this Islamic banker doesn't understand the concept of information search costs, but accelerating the flow of information (whether it is free or subscription-based) should again be viewed a positive development.

If there is "no prospect (at least in the short-to-medium-term) for any generic competitor from OIC countries or from the South" one must inquire whether this is actually relevant. If Islamic finance is growing and expanding beyond its so-called natural borders, do we really need to ask a localized enterprise to attempt to do what it is ill-equipped to offer? On the other hand, it might be interesting to suggest the potential joint venture or combination of one or more local industry portals as a competitive response. Although I'm sure they have thought about that already.

Editor's Note

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Innovation - A Matter of Perspective

It would be disappointing if Reuters decided to “spend extra resources in training and sharpening the knowledge base of their reporters and analysts on Islamic finance” because the industry doesn’t need any more insiders, instead it needs new perspectives and refreshing points of view. Islamic finance operates – for better or for worse – within the framework of conventional banks and one cannot comment on one without understanding the other. The test for Reuters will be to avoid getting sucked into the love affair with glossy magazine front-covers and self-congratulatory conference/parades. Fortunately the evidence thus far points to the contrary.

The curious thing about innovation in this neck of the woods (whether it is daily news, market data, editorial opinion or technical content) is that it is not too important who does it first but whether the others recognize it and adapt to it. We can have a great portal and/or online community, but it is far more professionally rewarding to see competitors taking notice and action. This again benefits everyone.

This rings true because we can quote several examples:

- The development and dissemination of our blog (packed with case studies and structures) has not remained unnoticed, as others began including case studies and papers of their own, but most importantly it proved that information hubs (whether they are free or subscription based) can provide value for users.
- When deploying original content (such as our listing of training programs and certifications) it was a compliment of sorts to see the list being plagiarized elsewhere, not exactly pleasant but testament to what a simple and honest contribution can do. We leave the chasm of originality (and good business etiquette) for another day.
- The growth of our online community (and the nurturing of open/public discussions) has supported a new phase of openness in the industry. This has also triggered what we like to call the war of the online forums (we know this since some of our competitors candidly asked for our advice on how to develop their own forums, others have just copied).
- This has further highlighted the urgent need (and the positive impact) of hearing from industry leaders and in particular from Shariah Scholars. Thus we have seen a renewed effort across some data providers in bringing their opinions to the fore (as well as feedback the other way around).
- The fact that we disseminate our Islamic Finance Briefing on a daily basis and with the use of RSS feeds (which might be regarded as old technology for many) is not as important as seeing other data providers having followed suit a few months later (with their own daily quickie digest of news and the deployment of their own RSS feeds).

We are certainly not the only ones using innovative media (and we are not the first ones either) there are many other efforts – whether these are blogs, yahoogroups, facebook, twitters, wikis, libraries, or anything else. The common denominator being the need for faster and easier information flow. The more the merrier, since consumers are the eventual beneficiaries (to the dismay of certain Islamic bankers!).

The real inquiry for Reuters is whether they will further encourage this flow. Some might innovate others might imitate, but the eventual beneficiary of all this will be the end user. After all they are the real story.

Your feedback and comments are very important to us, please feel free to contact the author [via email](#).

Country-Specific Case Studies

 **Blogger** As Featured in the [Islamic Finance Resources Blog](#)

This is an overview of various papers on country-specific case studies, spanning a wide variety of Islamic finance themes. Featured below are some of the most pertinent texts as they relate to each country:

The Contribution Of Islamic Microfinance Institution In Increasing Social Welfare In Indonesia

H. Nur Kholis, S.Ag, M.Sh.Ec
Head of Islamic Economic Department,
Islamic University of Indonesia

Islamic Banking in Bangladesh: Achievements & Challenges

Abdul Awwal Sarker
IBTRA

Islamic Finance: Growth and Prospects in Singapore

Habibullah Khan & Omar K. M. R. Bashar
U21Global

Towards Islamic Banking: A Case Study of Pilgrims Management & Fund Board, Malaysia

Khalid Rahman
Director, Institute of Policy Studies

Banking Behavior of Islamic Bank Customers in Bangladesh

Mohammad Saif Noman Khan, M. Kabir Hassan & Abdullah Ibneyy Shahid
IBTRA

Embracing Islamic investment in Australia using the Malaysian model: challenges and opportunities

Mahmood Nathie
Griffith Islamic Research Unit

Performance of Islamic Banking and Conventional Banking in Pakistan: A Comparative Study

Muhammad Shehzad Moin
University of Skövde

Islamic Banking Theories, Practices and Insights for Nigeria

Toni Uhomoibhi Aburime
Deakin University

Islamic finance: a recent history with France, a longstanding history with its banks

Ghassen Bouslama, PhD.
Professor of Finance, Reims Management School

Islamic Microfinance: A Case Study of Australia

Abu Umar Faruq Ahmad, Professor A. B. Rafique Ahmad
Journal of Islamic Economics, Banking and Finance

Islamic Banking Performance in the Middle East: A Case Study of Jordan

A. S. Saleh and R. Zeitun
Faculty of Commerce - Economics,
University of Wollongong

Bank Runs in Emerging-Market Countries: The Experience of Turkey's Islamic Banks in the 2001 Crisis

Martha Starr, American University
Rasim Yilmaz, Dumlupinar University

Shariah Compliant Principal Protected Notes

By Nikan Firoozye, PhD

Nikan has over 14 years experience in leading Wall Street and City firms on the buy and sell-side including Lehman Brothers, Goldman-Sachs, Deutsche Bank, Sanford Bernstein Alliance, Citadel and Nomura where he is currently Head of European Rates Strategy. He has worked in a variety of primarily technical or quantitative fixed income roles from Rates & Hybrids Structuring to Rates Strategy and Quantitative Modelling to Asset Allocation and Risk Management to Prepayment Analysis and Securitization and Capital Markets. Education: PhD Mathematics (Courant Institute, NYU), Asst Prof University of Illinois.

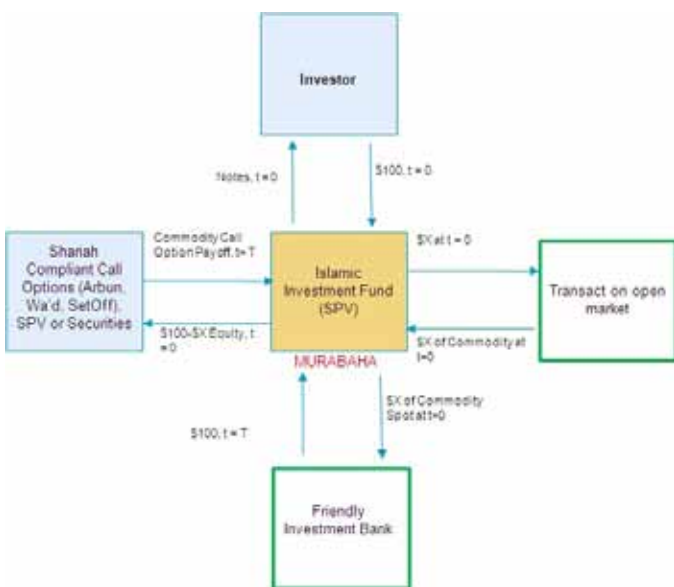


Figure 1: Sample Principal Protected Note Flowchart
Source: Author's own

The Structure: At the risk of being mundane, but for the sake of completeness, we wanted to describe a principal protected structured product in greater detail. How can we have benefits with no downside risk in Islamic Finance? Well, the answer is really quite trivial.

For one thing, we have already talked about Shariah-compliant call options, specifically call options thru debt set-off ([see reference link](#)). This is just one of many possible mechanisms for a Shariah compliant call option to be manufactured. Additional methods for generating calls (some are yet to be discussed here) include the following:

- **Set-off** (as discussed, combining Salam and Murabaha contracts with the same counterparty together with a contractual set-off)
- **Bay' al Arbun** (downpayment with revocation sale, as allowed by Hanbalis, now with much wider acceptance)
- **Wa'd** (which will be familiar to the concepts unilateral promise, promissory note, estoppel)

There are probably less natural ways of synthesizing calls through profit-rate swaps (i.e. PRS - rolling and offsetting murabahas) and total-return swaps or Islamic swaps (i.e. TRS - rolling bilateral Wa'd). Both of these are means of synthesizing a swap which can be used to generate a series of more or less risky cashflows in place of a simple call option.

Featured Structure

A conventional principal protected note is merely the combination of a zero-coupon bond and some call options, with their maturity and exercise set to be identical. So if we invest \$100 and the zero rate for 5Y is X%, the price of the zero is $100/(1+X\%)^{5}$ and the remainder is invested into calls, typically struck at spot. Depending on the prevailing rates and underlying volatility, it may be possible to give more or less than 100% of the upside of the underlying (which can be equities, commodities, etc).

The last thing needed for the structure is a zero-coupon bond/money market instrument. This can be obtained through a number of ways, including:

- **Commodity Murabaha/Tawarruq'**
- **Bay al Inah** (sale at spot, resale with deferment and increase)

Hence an Islamic principal protected note is the combination of a Murabaha and Islamic call options, with matching maturity and exercise.

Notes for Prospective Buyers/Remarketers

Once we let the cat out of the hat with a Shariah-compliant call option, and we've had a risk-free rate/money-market/zero-coupon bond for some time, combining the two was inevitable. In fact, the distinction between the risk-free cashflow (the Murabaha) and the more leveraged and technically challenging risky portion (with a floored downside portion) is more than trivial. This is because some redistributers choose to source only the risky component from international investment banks, and effectively issue their own zero-coupons, packaging them together at the final stage. It would be possible as well to use this Murabaha + Risky Investment (with floored downside) as a basic model for CPPI-based strategies (constant proportional portfolio insurance, essentially a portfolio strategy similar to dynamic hedging/replication of options, something we will go into more detail in a future article).

The payout will be the original principal + $M * \max(\text{Price}(T) - \text{Strike}, 0)$, where Price(T) is the price of the equity/commodity at maturity of the note, Strike is usually set to Price(0), today's price, but can be set wherever we like (slightly harder from a Shariah perspective but should be just fine), and M is the multiplier. We can get anywhere from say around 70% to 120% multipliers (for instance 70%-120% of the upside of the FTSE 100). The multiplier is usually the only figure that can be manipulated, so we must look to it and compare.

While this may appear wonderful to some, we should comment that, unlike more vanilla products (e.g., straight call options or zero-coupon bonds), pricing is not as easy to replicate and it is not absolutely trivial to know whether you are getting ripped off or not. Some useful guidelines:

- **Know what you can about pricing:** Try to price the call (with correct strike) and zero independently. Pricing the zero should generally be the easiest part.

- » If the underlying is liquid and calls are traded on it (e.g., calls on oil, calls on gold, etc), then it is likely that only at-the-money (ATM) options are active (i.e., ATM struck at the forward price). Spot-struck options are generally less liquid, involve pricing on a skew, which you as customer are not as aware of. Expect hidden fees.
- » If the underlying is liquid but calls are not actively traded (e.g., DJIM Index), the bank will use calls on whatever similar futures that they can get ahold of. The basis or the fact that these two index that they can use to hedge and that the underlying index in the note do not mimic each other exactly--they will charge extra for that. So on top of the skew, you get charged for their inability to hedge perfectly.
- » Make sure you know whether dividends are paid to you or are not. Does the index accrue with no dividends? It makes it cheaper for them to pay it to you, and they should pay you that much more (i.e., the multiplier on the upside should be larger, e.g., S&P offers a price index with no dividends, and a total return index. Owning the market is more like owning the total return index, but most structured products pay the price index and consequently can usually pay higher multiples, e.g., 115%, 120%, etc).
- » It's oftentimes trivial to price a Treasury, Gilt, or Bund zero-coupon bond of the same tenor. It may not be as easy to price a zero-coupon bond of the underlying counterparty.

• **Shop around:** Note that even though it seems like rocket science, it isn't. Every bank and their brother does this same deal. Smart users will ask for several quotes, even of Shariah-compliant products like this (vanilla shariah-compliant). Banks are used to giving quotes for reverse-engineered products (i.e., customer describes payout, bank finds price). Banks charge different amounts: traders reserve different amounts of P&L for possible rehedging costs and model errors (releasing it gradually as the hedging costs turn out to be lower than worst-case) and sales-people take varying PCs. Redistributers are usually upfront. By the time the end-user has it, 2 points to 10 points could have been taken from the mid-price (really!). That is, you paid 10% upfront for the privilege of running this simple strategy. Smart buyers will ask for quotes from 10 banks, pick the best price and expect to pay 1%-2%.

Featured Structure

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- **Beware Winner's Curse and Counterparty Risk:** Sometimes the best price has a string attached--the bank themselves didn't charge enough to re hedge the product. This is not your problem until it may actually be your problem. Be careful and concerned about counterparty risk. Seemingly safe notes turn out to have a large credit component which could result in a loss of principal (if the note issuer defaults). Know the terms for the risky-cashflow (which is oftentimes generated by the investment bank, usually different from the issuer) and what happens in case of credit events. Usually it is the issuer who takes on the credit risk underlying the risky cashflow and insists on collateralization, but this is not the case for certain types of structures (e.g., Repacks) and it makes sense to be sure of all the contingencies.
- **Know what will affect repricing:** As opposed to the payoff (the pricing before maturity) something of importance for client reports, if it was bought on a margin which doesn't sound so shariah-compliant anyway, or if you might seek to unwind the product before final maturity. Lower prices do not necessarily imply the payoff is really impaired of course:

- » Credit Spreads. Whose Zero is it anyway? The commodity was bought and sold and now you have credit exposure to a large German or Swiss bank or worse yet, an American bank. If they get downgraded, you better believe the pricing of your product (prior to maturity) will look bad. If they file for Chapter 11, it could look far worse.
- » If volatility drops and suddenly the world looks less risky, your valuations may suffer. You are long an option and option prices drop when vol drops. Your pricing before maturity depends very much on vol and its dynamics and the whole skew shape (interaction between the underlying price levels, strikes and vol).
- » If prices rise of course, you are long a call and should expect your valuations to rise. This may be less than you think since the rise will be proportional to the call's Delta (calculated from Black-Scholes or some other fancy option valuation model). The more ITM (in the money) your option is, i.e., the more underlyings have risen in the past, the greater your price sensitivity. The more OTM (out of the money) your option is, i.e., the more you've lost, the lesser your price sensitivity. Higher volatility will lessen sensitivities in general. It pays to read up on option pricing, to get an intuition for how it works in the real world.

Structured Product, whether we take the view that it is Islamically acceptable or not, has both some pros and cons. More importantly, it is pushed by investment banks often because it is exactly what the clients want, but at the same time because the fees can be juicy, the pricing is often opaque, and the customers are not always up to snuff. Make sure you are.

Your feedback and comments are very important to us, please feel free to contact the author [via email](#).

Bullion Management Group Inc

Nick Barisheff, President & CEO, Bullion Management Group Inc

Bullion Management Group Inc. (BMG) established in 1998, offers the world's most secure, convenient and cost effective way of owning precious metals bullion. Currently, national and international investors can participate in the BMG Bullion Fund, the world's first open-end mutual fund trust that invests in equal dollar amounts of gold, silver and platinum bullion. As of 2009, this is Canada's largest Shariah-compliant mutual fund and the second largest in North America. Investors can also buy and store gold, silver and platinum bullion through BMG BullionBars. This is the most secure way to buy and store large amounts of bullion privately.

Finally, BMG recently launched the BMG Gold Bullion Fund, which holds only allocated gold bullion. There are many ways of buying precious metals bullion. New, exotic investment vehicles appear each day as the price of precious metals rises and gold once again regains its status as an alternative currency. BMG has maintained its reputation as one of the world's safest and most secure bullion ownership companies by selling and managing only unencumbered bullion—we do not sell any form of proxy for gold, silver or platinum. Most people buy precious metals as insurance against the systemic failure of other currencies or markets. Were this to occur, these proxies would be difficult to exchange for the underlying asset they claim to represent.

Q1. Can you provide some background to the philosophy behind the development of your bullion product range? What were the key deciding factors in developing such a product offering?

I started this project (setting up BMG) in 1998 for a couple of reasons: First of all, looking at how the trends would change and I thought that equities and real estate were already overblown in 1998 but I was a couple of years wrong and I looked at what the opportunities were going to be going forward and I concluded that the opportunities were going to be in: Precious metals, Energy Sector (Oil, Gas & Uranium) and Water. This was because those sectors would do well regardless of where the economy was going. Secondly, my belief at the time was that the economy was not going to do well for a very long time. I came to the conclusion that someone entering a secular bear market would face serious financial issues along the way.

So with that in mind I looked at the issue in Canada where investors could not hold Bullion in a Registered Retirement Savings Plan (RRSP) – which is the Canadian pension program for individuals. Being from the 'old school' where I look at Bullion as being money and I always consider you hold bullion in the same way that you hold cash in a portfolio, but this allocation would not depreciate with inflation. Given that you could not do that in Canada I looked at what was the best way to structure a securitized product that would qualify for RRSP and at the same time NOT compromise any of the fundamental attributes of Bullion. We did not (at the time) set out to create a Shariah compliant fund, instead we wanted to create a fund that would not compromise the benefits of Bullion.

The key attributes that we wanted to maintain were:

1. Liquidity of Bullion itself – as a result we chose an open Mutual Fund Trust model which purchased and redeemed. As a result we are buying bullion from the bullion market and selling it back. Liquidity of the fund is the same as that of Bullion itself and not the liquidity of shares traded on a single day as we have with closed-end funds or ETF's. Many of those products even if they are very large will have liquidity constraints. Large investors may be able to buy but to get out in any reasonable expedient manner it is difficult and they could crater the price. This does not happen in the Bullion market itself. The turnover in the physical bullion market (out of London) is \$24 Billion a day. The volume is not published anywhere but it is estimated at 5 to 7 times the turnover rate. Turnover is an unusual term

Fund Manager Interview

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that many people don't use but as an example if an LBMA member sells \$5M Gold in the morning and member B sells back \$15M of Gold in afternoon the turnover would be \$5 whereas the volume would be \$15.

2. No dependency on a portfolio manager. When you invest in Bullion it is not someone's liability or promise of performance, what we want a pure Bullion investment and not an investment in the skills of a portfolio manager to decide how to hedge, rebalance or leverage it. Notwithstanding how brilliant a manager might be they can make mistakes and we saw plenty of mistakes in '08-'09. So when investing in Bullion we don't want dependency on a portfolio manager for anything.

3. It is not someone else's liability. Our structure is carefully designed so we are actually buying Bullion in an unallocated/trading account (temporarily) and then we take delivery to custodial storage. In custodial storage we obtain enough documentation to prove title - we know the refiner, the exact weight (to three decimal places), the exact purity (to three decimal places) and the stamped serial number of each individual bar. Under the trust agreement for the fund nobody has claims to that bullion other than the unitholders.

Q2. The development of your BMG Bullion Fund as a Shariah compliant product follows a very innovative approach, where you have retained your existing fund (which was launched in 2002) as opposed to launching a new one. Can you provide some background to this process, in particular with regards to the Shariah board? Has this been applied to other products under your suite?

The three essential components of our investment philosophy mentioned earlier (and part of our legal structure) provided is with the ability to accomplish Shariah compliance because the underlying principles are the same. The Shariah compliant review did not require any changes and the overall turnaround was extremely quick. As a matter of fact the Shariah Scholars highlighted to us that "this has always been Shariah compliant without knowing it". For instance, part of the process to satisfy the compliance of the product involved obtaining supporting documentation from the custodians to certify that no interest was being paid on the cash balance.

The Islamic Finance Advisory Board is an independent self-regulatory non-profit body, which provides Islamic Financial consultation services in Canada, and our team. This includes Shiraz Ahmed who is in charge of MENA business development and who worked closely with their scholars to ensure compliance (in fact it was Shiraz who initiated the compliance process). Their board includes Dr. Mohammad Iqbal Masood Al-Nadvi (Shariah Scholar & Board Chair), Dr. Hamid Slimi (Shariah Scholar), and Shaikh Nafis Bhayat (Shariah Scholar) and the overall experience has been very positive.

Q3. Where do you see a bullion fund fitting within a Shariah compliant portfolio (or a conventional one)? Does one follow a similar allocation approach or have you found that Islamic portfolios are over/under allocated to this sector?

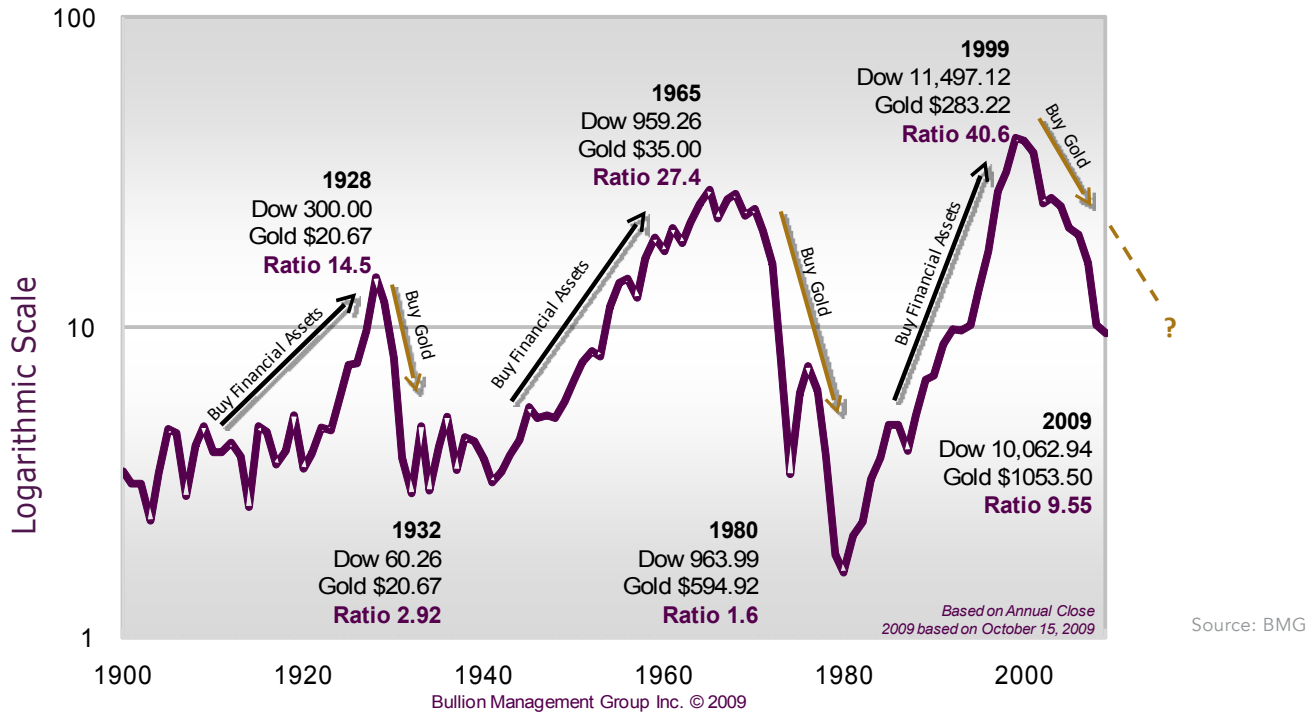
If you think of Bullion as an investment then you would think of it is a commodity (like copper or zinc) and you will have difficulty understanding it. Bullion is not an investment per se but has been (and continues to be) money. It has been money for several thousands of years and indeed across all cultures and religions. Clear evidence of this lies with central banks across the globe which still hold just as much gold today as they did back in the 1980's. Although there has been much press giving the impression that they are all only selling. Precious metals are traded in the currency desks of all the major banks and brokerage houses, and not on the commodity desks. When you look at the \$24 Billion turnover in the London market, it is clear to see that these are not jewelry buyers but instead currency traders.

If you take the position of bullion as money - you do not lose purchasing power through inflation (in most cases you gain purchasing power). From a risk-reward perspective the decision is whether to put bullion at risk (i.e. invest it in stocks or bonds) and this implies that I might not get my money back. Hence if gold is going to be put at risk, one needs to be convinced that (based on an acceptable level of risk) I'm going to get more gold ounces back (on top of the principal investment). For example, even though it seems that the stock market has gone up, the dow/gold ratio was 44 to 1 in the year 2000 and now it is approximately 9 to 1. So investing 44 ounces in 2000 would receive 9 ounces back if the investment was cashed in today - so there is little incentive to invest in equities with that type of relationship.

In that sense many questions that could be asked of a fund manager do not apply to us. Overall I would be hard pressed for someone to convince me that some investment right now is a better alternative than sticking to bullion. When looking at the vulnerabilities in the global financial system (currencies, equities, bond markets, sovereign debt, etc) there is more than enough evidence to say now is the time for bullion. Clearly at some point in the future, when P/E ratios approach 5, real estate has returned to normal levels, and interest rates are up 16 then maybe it will be time to deploy some of that bullion out.

Fund Manager Interview

Figure 1: Dow - Gold Ratio



Q4. Have you explored diversification into other metals and/or commodities? Would this be feasible for a follow-up product?

This might not be applicable to our overall strategy based on the three principles of bullion (which we outlined earlier) that we seek to benefit from.

Q5. Would you prefer to consider deploying the current BMG fund in a different way? How does this relate to the fee structure?

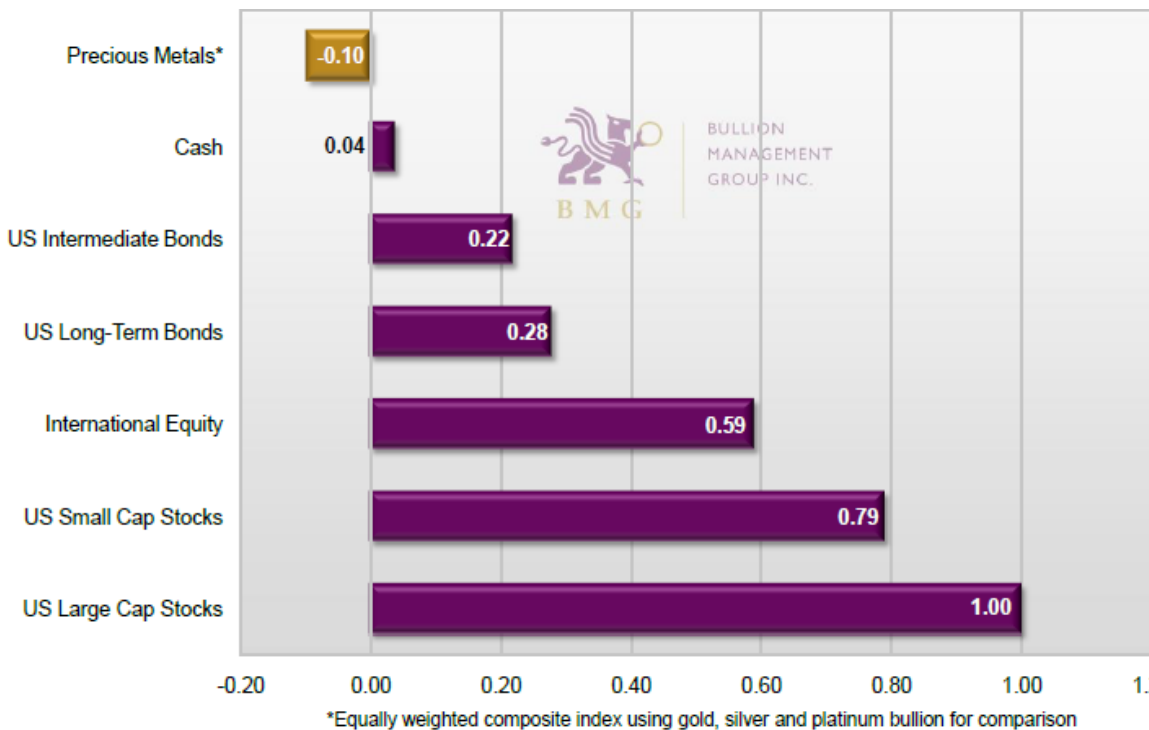
We have different classes of units suitable for retail, institutional, fee-based wealth managers, high net worth investors, etc. Curiously from our analysis of Shariah compliant investment products there is a stark limitation in the number of share classes offered (in fact most of the time there is only one, at best two share classes). This provides great flexibility in terms of offering this product to a wide range of investors so there is no great incentive to redeploy the same product. However if there was a institution that wanted to have a gold fund they could easily explore a white-label solution.

Our retail management fee is 2.25% (and we pay 1% trailing fee to advisors) whereas our institutional management fee goes down to 0.5% (with a \$50m investment). With regards to investors outside of Canada we are typically only open to accredited investors and this is our area of focus at the international level.

Q6. Does the BMG Bullion Fund follow a specific benchmark and if so, how do you select it? Does this also impact the way by which correlation and/or diversification would be measured?

Since we are a physical commodity fund, there is no real benchmark to be used. However that being said, a benchmark that could be used is a percentage of the London pm fix price: 33% gold, 33% silver, and 33% platinum as that is our fixed investment policy for the fund. Gold is the most negatively correlated asset class to the overall market and currencies (see the chart). For further reference, Ibbotson and Associates carried out a study that suggests having a portfolio allocation of anywhere between 5% to 15% would be considered fair (depending on a clients overall risk tolerance).

Correlation Coefficients of Annual Total Returns, 1972-2004 Compared to US Large Cap Stocks



Source: Ibbotson Associates, Portfolio Diversification with Gold, Silver and Platinum, 2005

Q7. There are no derivatives of any kind being used under your strategy, it could even be labeled as a classic long-only, does this suggest it is a high beta or even a beta-only offering? Would an investment in the fund need to be reassessed periodically or is it meant for a long-term allocation?

This is not a classic fund, rather it is a classic “I don’t want to invest” fund. Instead of delving in a money market fund or a cash fund, which is losing purchasing power every day, simply stay with bullion. When we receive inquiries as to why don’t we hedge the Canadian dollar, consider gold as the ultimate currency so why would we want to hedge?

Hedging entails huge risks - in particular if the markets move beyond the parameters of your modelling. We leave it up to investors and their advisors to consider any particular hedging. Moreover, hedging using conventional derivatives would undoubtedly make the fund non-compliant with Shariah law, as this incorporates a speculative view on currencies (which would also increase your overall portfolio risk and ultimately increase the expenses for the fund).

Q8. How important are the custodial and fund administration arrangements to ensuring the Shariah compliance of the product. What is the role and importance of these service providers in ensuring that the bullion fund maintains compliance?

The custodian relationship has gained importance ever since the Bernie Madoff fraud. Our custodian for bullion is the Bank of Nova Scotia, but this does not mean we are renting vault space from them, rather they are acting as a trustee. There is a big difference since the trustee is responsible for the unitholders for the safekeeping of the bullion. Furthermore, under the OSC Securities Law (81 - 102) not everyone can be a custodian, only the five major banks in Canada can be custodian and others under certain exemptions.

Fund Manager Interview

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RBC Dexia does our fund accounting calculation of NAV, and they have sole signing authority on the fund's cash. We as managers focus on reviewing the statements, approve expenses, but have no ability to sign any checks on the fund. In terms of the flow of funds, money arrives from a financial advisor through the fund's trust account that is managed by RBC Dexia (as a sub-custodian), we then place call to Bank of Nova Scotia to purchase the bullion and the confirmation slips (thru RBC Dexia). If this is as agreed – we authorize RBC Dexia to send payment for the bullion to Scotia. In the case of a redemption, we indicate to Scotia the redemption details and they the money back to RBC Dexia, and they in turn know who the redeeming financial advisor is so as to send the money to the client's account. This flow of funds and relationships makes it impossible to have a Madoff-type situation from occurring. Last but not least, KPMG as our auditor performs a third party audit of our fund and the bars – ensuring that the bars are all there and that the documentation matches (serial number, weight, purity, refiner etc).

Q9. You maintain a maximum of 5% position in cash. Does this include any cash-equivalents? Does this allow sufficient flexibility in managing the fund's liquidity (matching inflows/outflows, etc)? How do you mitigate any potential issues of concentration, liquidity or idiosyncratic risk?

There are no cash-equivalents it is simply a non-Interest bearing cash account – while the maximum allocation is stipulated as 5% we have typically held less than 1%. This has been possible because of low levels of redemptions, so there is no need to maintain a large position in cash. Nevertheless we retain the ability to increase to 5%, which provide ample room to manage both inflows/outflows in the fund.

Q10. What are the issues to be considered in terms of ensuring an effective placement/liquidation of positions?

This is a good area of inquiry, ScotiaMocatta itself is one of the ten market-making members of the London Bullion Marketing Association (LBMA) and as a result they only deal in 'good delivery bars'. Their definition of a good delivery bar is outlined in an extensive document by the LBMA. Not only will they set out the specification for London good delivery bars, but in addition frequently perform audits of the refiner and further scrutiny/approval of facilities. These specifications are crucial and make bullion instantly liquid – as long as the bullion remains within the LBMA trading system. If it doesn't then it must undergo an additional audit to ensure that it meets LBMA standards again.

Q11. Since the fund has an established AuM (of well over CAD \$280 million) this presents an interesting dynamic. What would you consider the critical size for such a fund, what is the overall target size for the fund and when would the fund reach capacity?

If we ran into size constraints then the price of gold would be 10,000 an ounce. There are no size constraints, if indeed we ran into a point where Scotia was unable to deliver any physical bullion then we would be forced to close the fund and investors will just have to sit there and watch the value of their investment goes upwards to 10,000 an ounce.

Q12. How do you differ from other similar offerings in the market place today?

There are other offerings in the market although there are some significant differences. For instance some gold funds, not to be confused with a gold ETF, which are basically closed-ended funds that will be listed and periodically they will issue new shares and use the money to purchase bullion. However this type of structure compromises our first point (that being the liquidity of bullion), since liquidity relates to the traded volume and for a listed fund of that size this won't be as liquid as pure bullion. For any large investor that wants to exit such a fund will result in a discount of the shares (and this would have an impact on other unitholders as well). We trade at NAV, we sell and redeem into the bullion markets, and it can't be anything but NAV.

Our specific structure took time to setup as it had never been done before. We developed this particular structure over the span of three years, although we analyzed many other legal structures (we could have setup a closed-end fund in sixty days!) but this would compromise the very principles of bullion. The again the characteristics of an ETF lend it to be traded multiple times a day, but that is not what our fund is about.

Your feedback and comments are very important to us, please feel free to contact the fund manager [via email](#).

Universality and Codification of Islamic Contracts

By Khalil Jarrar, J.D.

Khalil has a diverse educational and professional experience in both Information Technology and International Law. Working as a senior IT consultant for a range of multi-national corporations, he holds a law degree from the US (J.D.) in addition to International Law training at the Hague Academy and Strasbourg International Institute of Human Rights. He is a Bi-lingual and Bi-Cultural Arab-American with extensive knowledge of the MENA region. Khalil currently hold a position as an International law consultant for a Geneva based foundation.

One of the most notable challenges facing the enforcement of Islamic contracts (in particular in the context of Europe and North America) has been the lack of a clear reference to a state law. Earlier references to Islamic jurisprudence have been repeatedly rejected in US courts, these references being to Islamic law at large. The courts have indicated that they lacked sufficient knowledge of the subject matter so as to render judgment, even with the help of an expert witness (such as a scholar).

Freedom of contracts is a universally accepted principle if the contract provisions are clear and definitive, however the challenge arises if and when contract contract clauses make a generic reference to Islamic or Shari'a law. In other words there is not enough clarity regarding which laws, regulations or standards which are to be followed. Furthermore, how can it be expected for foreign courts to rendered judgment based on Islamic law when inconsistencies between Islamic countries applying such law have also arisen? An example that comes to mind is the sale of discounted debt instruments. Malaysia on one hand allows for the sale of discounted coupons where this view is completely rejected by Islamic jurists in the Arab Gulf states.

Sources of law can be traced to various religions or customs but this has since been incorporated into state and/or international law, and example of this being *Lex mercatoria* or the law of merchants ([see reference link](#)). The *Lex mercatoria* was composed of such usages and customs as were common to merchants and traders in all parts of Europe, and these varied slightly in different localities by special peculiarities (refer to [this paper](#) for a history of the development of Lex Mercatoria as it relates to international business law).

The same could be said about the application of Islamic law today where the combination of custom and usage, urf, has played a major role in shaping modern Islamic law among the major *Madhahib* of Islam. Shari'a is the larger all-encompassing umbrella that could include more than one school of thought, even calling on expert witnesses could create issues of bias or lack of knowledge of that particular school of thought or *Madhab*.



Conflicts of laws have a tendency to arise under private international law when a partial reference to a specific state law is used, leaving the burden to another court (in a different forum) to adjudicate, interpret or enforce such a contract. The Rome Convention under EU law ([see reference link](#)) allows for partial choice of law, however according to prevailing legal view the dual choice of law can only be applied to specific and clearly defined parts of a contract, due to the requirements of certainty. Specifically, this will govern:

- a. Interpretation
- b. Performance, with reference to *lex loci solutionis* (law of the place in which performance takes place)
- c. Consequences of breach, including the assessment of damages
- d. Ways of extinguishing obligations (and the limitation of actions)
- e. Consequences of nullity of the contract

One way to achieve acceptability of Islamic contracts is for of the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) to play the same role as the UNIDROIT principles ([see reference link](#)) on international commercial contracts in addition to *Lex mercatoria*.

Thus far English courts have taken a strict stand to the application of Shari'a law. In a landmark decision, *Shamil Bank of Bahrain EC vs. Beximco Pharmaceuticals Ltd.*, the English Court of Appeal has refused to enforce Shariah principles, based on three arguments:

- 1) The EU Rome Convention allows only the choice of State Law; so in order for an Islamic contract to be enforced in the England there must be a specific reference to a specific code of a sovereign state;
- 2) The court also asserted that a contract can only be construed under one single jurisdiction; meaning that the governing law has to exclusively reference to the law of a particular country; and finally,
- 3) it cannot be the parties' intention to entrust an English court with the interpretation of the Shari'a related principles.

The latter argument echoes earlier decision by the US court in a matrimonial dispute in the landmark case of *Shaban v. Shaban*, stating that parties cannot agree, without a premarital agreement as to basic terms, that a marriage will be governed by another country's laws and then fill in the basic terms by parol evidence, leaving the court with the burden of interpreting extrinsic evidence in accordance with Shari'a law.

In Germany, the prevailing view is that non-State law can be integrated into a contract by way of reference to substantive law instead of by way of choice of governing law. Hence the parties may agree to exercise or enforce their claims and other rights (under State Law) exclusively subject to compliance with the Shari'a rules. This view in my opinion takes us to square one, in other words what are Shari'a rules? According to what school of thought under Islamic law itself? To add another wrinkle to the issue at hand, the German financial services supervisor (BaFin) have advised that they would welcome Islamic Finance. However, major clarifications in respect of the tax regime seem to be necessary, in particular regarding real estate finance not using SPV structures, adding another layer of complexity to the task at hand for AAOIFI.

Notwithstanding the fact that Islamic financial instruments have gained popularity with an unmatched growth in a short period of time; this growth comes with a price to pay. To regain universality, Islamic contracts have to be codified, such codification can be traced to the Ottoman empire where it took the form of Al-Majalla code which is tangible proof that general principles of Islamic law do exist. It is incumbent upon major stakeholders in Islamic finance to assert such universality with incorporating major principles of Islamic contracts into state laws. This can be a concerted effort working with AAOIFI standards as it has reached common grounds of acceptable practices of sales contracts.

Leaving foreign courts with the discretion of interpreting such contracts will open the door for inconsistency of judgment. Uniformity of law is paramount especially in jurisdictions where precedent applies; rendering a judgment on the wrong legal foundation will create a domino effect of decisions to follow. Remedies for breach of contracts can be inconsistent as well opening another door for forum shopping. It is time to set the path for Uniform Islamic Sales contracts or a Uniform Islamic commercial code, or in the absence of such uniformity, adequate reference to a substantive law or state code should be made clear in drafting such contracts. Such practice is not only good for judicial economy, it is equitable as well in conformance with the principles of good faith in Islamic law.

Your feedback and comments are very important to us, please feel free to contact the author [via email](#).

Regional Variations on the Permissibility of Islamic Financial Instruments

By Anne Sophie Gintzburger

Anne-Sophie has recently submitted an MPhil on Islamic finance at the Center for Arab and Islamic Studies of the Australian National University titled 'The Sources of Variation in the Application of Shari'a Compliant Finance Contracts'. Her research interests are Islamic finance in the Gulf Cooperation Council and Southeast Asia and she has conducted extensive fieldwork research with Islamic finance practitioners in the UAE and Malaysia. She was awarded the National Australia Bank Sheikh Fehmi El Imam scholarship of 2008 and is currently writing a book on Islamic Finance with Edgar Elgar Publishing. The following article is a brief overview of the conclusions of her MPhil thesis based on research and material gathered between 2007-2009.

In essence, Shari'a-compliant finance supports activities in the financial system that are in line with the principles for transactions and contracts detailed in Islamic commercial law. It has a clear set of approaches in contractual structures and product structures for financing operations. These financing operations share the same economic objectives as those of the conventional financial system yet do so with different underlying structures and customer-institution interactions. In Sheikh Delorenzo's words, 'while the economics are the same, the mechanics are different' (1).

Islamic finance in its applications has adapted to regional circumstances beyond the overarching prohibitions against *riba*, *gharar* and *maysir* in Shari'a-compliant transactions. A sign of this adaptability is the spectrum of perspectives on the permissibility of the implementation of some key Islamic transaction contracts. This variation has been the source of debates among practitioners in the industry, particularly and most notably recent debates around the permissibility of the *tawarruq* arrangement and certain *sukuk* structures.

Within the diverse cultural and socio-economic contexts in which Islam is practiced, and beyond regions where Islam is the predominant religion, the ways in which Shari'a-compliant finance is practiced varies around key yet narrow areas. True to the characteristics of adaptability reflected in the diversity of regions that Islam is practised in, Islamic finance, considered in the realm of secondary matters in which a variety of opinions is permissible, arguably reflects a corresponding capacity for adaptation to regions as diverse as the Middle East and Southeast Asia.

The consequence of this adaptability is that a variety of interpretations are needed to suit and mediate between specific environments in which Shari'a-compliant finance is practiced and between interpretations of what should or ought to be done in different parts of the world by various groups of Shari'a scholars, some of whom have differing opinions. Some would argue that the ways in which Islamic finance is practiced reflects and demonstrates a dynamic adaptation to distinct local norms and local regulatory environments.

Variations in Islamic Finance Between the GCC and Malaysia

Malaysia and the GCC are key to analyze these overarching trends in the application of Islamic finance contracts to financial products. As the two regions cover a major portion of the total market share of global Islamic finance, a comparative analysis of Islamic finance contracts applied by IFIs and their links to members of the Shari'a boards is representative of broader global trends.

Studies of the Shari'a-compliant financial system have presented the system as a whole while neglecting to understand certain pockets of divergence within the field. Such neglecting does not facilitate a clear understanding of the underlying structures of the sector in the transactional structures. Nor does it facilitate an understanding of the human and regional dynamics of the sector through the involvement of the members of the Shari'a boards of differing backgrounds.

Convergence Between the GCC and Malaysia

Universally accepted contracts in Islamic finance across the GCC and Malaysia, that are accepted in practice by Shari'a scholars of differing backgrounds and nationalities across the two regions, are the mudaraba contract to both project-financing and deposits; the musharaka contract to project financing; the musharaka mutanaqisa contract to asset financing; the ijara contract to asset financing; the murabaha contract to asset-financing and the istisna' contract to manufacturing and construction financing.

Looking at the composition of the countries of origin of the Shari'a boards of banks for this study, the permissibility of these contracts is recognized by jurists across the two regions: Saudi Arabian, Kuwaiti, Qatari, Egyptian, Bahraini and those operating in the Malaysian regulatory context (including a Sudanese and a Syrian). They are from a broad range of institutions, having being trained both in the Middle East and Malaysia and working on the boards of the institutions in Malaysia and the GCC. As such these contracts do not seem to pose any issue from a Shari'a perspective as scholars from a variety of backgrounds, working in a variety of regions, for institutions headquartered across the two regions of interest, are in agreement on its permissibility.

The contract of mudaraba is broadly accepted across the two regions and can be applied in the context of project-financing but is more commonly applied in the context of deposits or investment accounts in banking. It is especially applied to deposit accounts in Islamic banks headquartered in the GCC. The mudaraba contract in deposit accounts has a corresponding function to the wadiah yad dhamana contract which often is used for deposit accounts in the Malaysian market. It is recognized as permissible in institutions which have Shari'a boards made out of scholars of differing backgrounds. The study also indicates that the musharaka contract as the basis of project-financing is recognized and applied by IFIs across the GCC and Malaysia and so is musharaka mutanaqisa.

Slight Divergence in Interpretations

Differences of opinion may be identified in contracts that are exclusively offered in some regions or by particular IFIs and an analysis of this was made based on the composition of background of their Shari'a boards. These differences included those surrounding the application of the wadiah contract, the application of the mudaraba contract to the takaful model, the application of the contract of qard to deposit accounts, the use of the bai' al ina contract for cash-financing and as the basis of the deferred payment scheme of the bai' bithaman ajil scheme, the use of the tawarruq financing contract, the use of the murabaha contract in asset-financing underlying the bai' bithaman ajil scheme, the application of the wakala contract in the takaful model and the use of bai' al dayn in the Malaysian secondary market.

The wadiah contract is a readily available Islamic finance contract in the Malaysian market for savings and current accounts. From a sample of Malaysian Islamic financial institutions: all are Malaysia-based Islamic banks, and the contract of wadiah, as applied to deposits and current accounts, is approved by Bank Negara Malaysia's Shariah Advisory Council. Two Islamic banks headquartered in the GCC with regional subsidiaries in Malaysia were observed not apply the contract of wadiah for deposits and current accounts, but they both use the mudaraba and qard contracts for such purposes. Wadiah is not used for banking products in GCC-based Islamic banks. In Islamic insurance or takaful, the mudaraba contract is predominantly used in Malaysia. The GCC has seemingly a preference for the use of wakala (agency-based) takaful. There is however evidence that the preferred structure is moving towards a hybrid of wakala and mudaraba. Although there seems currently to be a trend towards the mudaraba-wakala takaful model, the single use of the contract of mudaraba as a base structure for the takaful model is popular mainly in Malaysia. From the information available from the study, it is mainly GCC-based companies that offer wakala-based takaful products.

The qard ul hassan contract, which is meant to be benevolent in nature, is generally not used by Malaysian Islamic banks for savings accounts. The contract of qard is applied by banks originating from the GCC in Malaysia but not by Malaysian Islamic banks. There is a general view in Malaysia that the use of the qard ul hassan contract, due to its benevolent nature, should not be for financing as the Islamic bank offers financing facilities with customers' deposits who expect returns. The use of the contract of qard or qard ul hassan for deposits is prevalent in the GCC-based Islamic banks. From the study, the make-up of Shari'a boards approving these is Saudi Arabian, Kuwaiti, Bahraini, Egyptian, Qatari, and Emirati.

The contract of bai' al ina in its application for cash-financing is widely utilized in the Malaysian Islamic banking context but not in the GCC. In Malaysia, it is also applied as the basis to facilitate the transaction of the bai' bithaman ajil product offering. Bai' bithaman ajil technically refers to a form of deferred payment arrangement between the bank and its customer out of a prior underlying transaction that can be either bai' al 'ina or murabaha. Thus bai' bithaman ajil is neither a financing nor a trading contract. Yet in Malaysia it has become a normal product term used by Islamic banks for specific asset-financing products. The murabaha-based bai' bithaman ajil is applied only in Malaysia by a Saudi Arabian bank as an answer to the broadly used Malaysian bai' al 'ina-based bai' bithaman ajil.

With regards to tawarruq (commodity murabaha or reverse murabaha), it is a recognized concept in the two regions and is increasingly regarded as a viable alternative to the bai' bithaman ajil based on the bai' al 'ina contract in Malaysia, but there still is a considerable amount of debate among Islamic finance scholars on its permissibility. The concept of bai' al dayn as applied in the secondary market is only applied in Malaysia and is rejected by scholars from the Middle East. There is no application of bai' al dayn in the GCC Islamic financial system, and there is therefore no Islamic money market in the GCC. The Islamic financial institutions of the GCC have to function with the conventional money market to some extent. In Malaysian Islamic financial institutions bai' al dayn refers to the sale of two types of debt: the sale of debt arising from the sale of a commodity and the sale of debt arising from credit. That the debt is sold to a third party at a discount is the main point of divergence between scholars of the GCC and Malaysia.

With regards to the sukuk market, discussions at a February 2008 meeting among Shari'a scholars of the board of the AAOIFI in Bahrain resulted in much confusion in the sukuk market about the permissibility of certain sukuk structures. What came out of the research was that the sukuk ijara structure was universally recognized by Shari'a board members as Shari'a-compliant.

The Influence of the Shari'a Framework

Islamic finance is applied in regions as diverse as Southeast Asia and the Middle East. With such a variety in the contexts in which it is practiced and implemented, it is to be expected that there be variations at the level of the use of Islamic finance contracts. It is to be expected too that there will be disagreements and a divergence of perspectives on the permissibility of contracts based on the context and the time at which Shari'a pronouncements or fatawa are made. The variety in regions reflects a variety in needs, a variety in socio-economic and political contexts as well as differing economies and regulatory environments, to which Islamic finance was adapted at a particular point in time in the evolution of the sector.

Shari'a board members who are predominantly experts in fiqh al muamalat have played a key role in this process of adaptation as the contemporary financing needs of Muslims are as diverse as the regions they are based in. Additionally, the financing needs of Muslims have required interpretations beyond the classical contracts pre-existing the implementation of conventional finance in the Arabian Peninsula and the Indian subcontinent and this interpretative process has required Shari'a board members to exercise interpretation. With interpretations come variations and divergence of opinions and this divergence is respected in subsidiary matters in Islam. These subsidiary commercial matters are not core to the faith such as the tenets of the faith and its rituals. Secondary matters or subsidiary matters, such as those covered by Islamic commercial law, allow for this wealth and divergence in perspectives.

The Shari'a boards of the institutions offering particular Islamic financial products showed a distinctive composition or pattern based on the nationalities and backgrounds of Shari'a board members of the type of products likely to be permitted. An analysis of the regions of origin and regions of training of Shari'a board members revealed that a significant portion of the Malaysian members of the Shari'a boards have studied in the Middle East, and as such that they would be familiar with the opinions of members of the Shari'a boards in the GCC. As such the regional differences could not be linked only to the states of origin of the Shari'a board members. A reflection on the regulatory structures at the level of the formal and the informal Shari'a framework indicated that the difference in the centralized approach to guiding Shari'a interpretations in a jurisdiction, as in the case of Malaysia, and the decentralized approach in the GCC states, contributed most significantly to the regional variations observed. The Malaysian Shari'a framework is broader and more encompassing of the perspectives of the GCC Shari'a board members than the converse. Malaysia-specific applications of contracts such as bai' al ina and bai' al dayn are likely to remain localized to Malaysia and more steps are taken for Middle Eastern interpretations to be integrated to

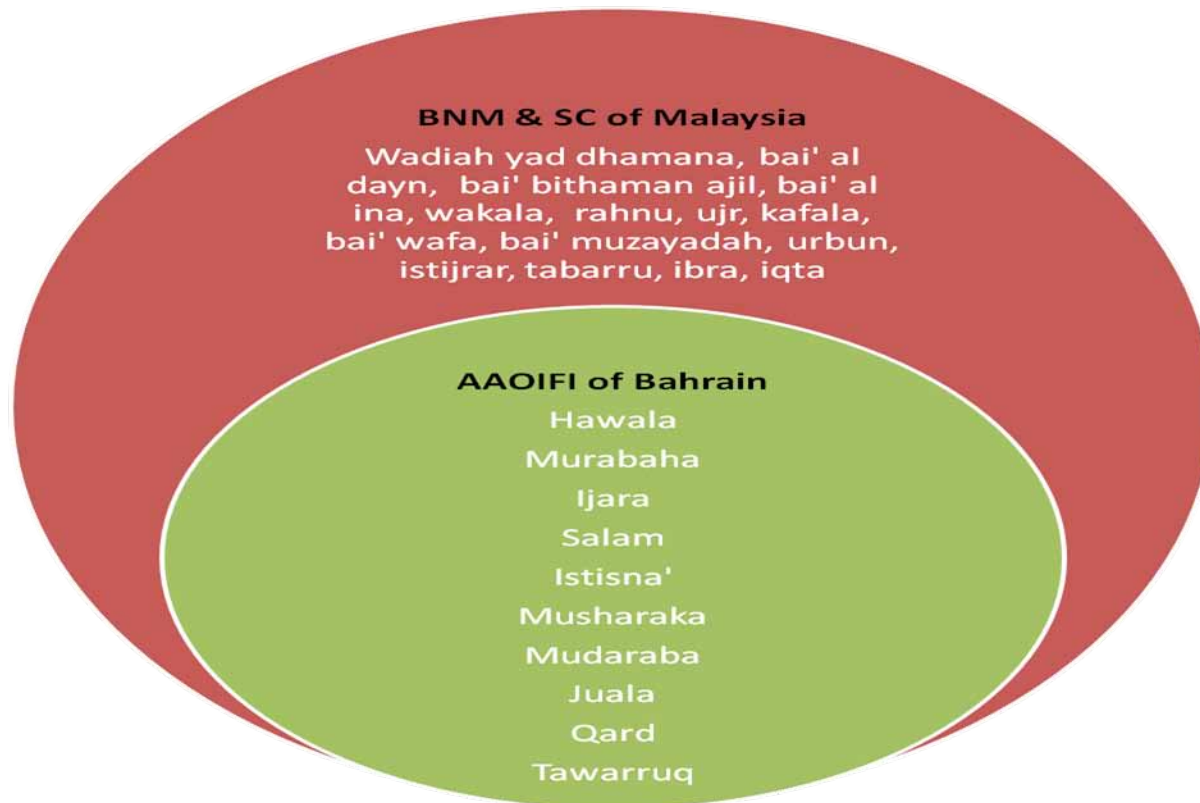
the local market by welcoming GCC-based Islamic financial institutions into Malaysia.

Additionally, dialogues among Shari'a experts have been conducted on a regular basis by both the private sector in Islamic finance – for instance the forums organized by Dallah al Baraka – and also at the level of international standard setting institutions such as the AAOIFI and the Islamic Fiqh Academy of the OIC and at the level of central financial authorities. These have been organized in Malaysia by the central bank of Malaysia, Bank Negara Malaysia, in the form of dialogues between Shari'a scholars of Middle Eastern and Malaysian backgrounds. The emergence of international Islamic financial hubs as well as these forums or dialogues indicates a harmonization and internationalization of Shari'a standards is taking place. It is at the regulatory level of the Shari'a framework that either a form of harmonization of fatawa will be carried out or a form of internationalization of fatawa from the GCC into other regions, such as Malaysia, will take place. And such a development can already be observed for the international dimensions of the Islamic financial sector, reflecting the internationalization of Middle Eastern perspectives into the Islamic financial sector of Malaysia. The internationalization may be interpreted to be one form of harmonization and it is likely that certain pockets of the Islamic financial sector will remain as they are, localized and Shari'a compliant based on the local Shari'a framework, primarily in the retail sector where there is less international interaction.

Beyond these variations - which include some divergence of opinion on the permissibility of Islamic contractual applications to transactions and financial products – the linking thread is that all these instruments are considered Shari'a-compliant by different Shari'a board members. These variations could be due to the diversity of backgrounds, schools of jurisprudence, regions and regulatory environments in which Shari'a board members need to function. Considering such contexts, they may diverge in their sanctioning of products and divergence of opinion for subsidiary matters is permitted. The divergence of opinion that is existent regarding the application of certain Islamic financial contracts can be regarded as a simple adaptation of Islamic finance to distinctive local norms and at distinctive local regulatory environments, or simply put, divergence is a local adjustment that is necessary for Shari'a-compliant finance to function in different environments.

(1) DeLorenzo, Yusuf. 'Shari'ah Compliance Risk', Chicago Journal of International Law 7 (2), Winter 2007, pp.1-12, p.1, 2

Figure 1: Commonalities in contract approval by Shari'a boards of key Malaysian authorities and the international standard-setting body AAOIFI



Your feedback and comments are very important to us, please feel free to contact the author [via email](#).

Repair Initiatives Post Banking Crises - Can Islamic Finance Contribute?

By Professor Mahmood Faruqi, Senior Advisor Bank of London and The Middle East

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The causes¹ of the banking crisis², termed as the worst in the last 100 years³, and the Regulatory repairs initiatives⁴, have been eloquently covered by industry voices. My 'Brief' this morning is to provide an Islamic Finance perspective to possible models post Banking crises. I am conscious that despite its high rate of growth in the last 10 years, Islamic Finance represents only about 1% of global Finance and you may well see me as a small pond frog lecturing Oceanic Whales on the art of safe swimming.

Crisis causing Mischiefs and Remedies

I will identify only two Mischief Drivers of the Banking Crisis and suggest some possible remedial solutions offered by the theory of Islamic Finance.

Mischief #1

Financial economy vanquished real economy. Financialisation of the economy increasingly accelerated. In 1970s, the volume of foreign exchange trade was double the volume of international trade and investment flows. In 2009 this had grown to almost 50 times e.g. two cents of real trade were supporting the inverted Forex transaction pyramid of one dollar. The Efficient Market theory and trade multiplier benefits law were sacrosanct.

Remedy

(a) Islamic finance, neither permits interest, nor financial transactions without an identifiable linked underlying trade transaction. The rationale is that the purpose of financial economy is to serve the real economy, not the other way round. Wall Street exists to serve, and not to unbridled rule over the High Street. Interest spurs Financialisation. The return to the financier is fixed ex ante independent of the success or failure of the project to be financed. The financier is less interested in adding value to the real economy, and more in extracting rent of money which in itself is sterile and should not be treated as commodity.

(b) Trade is encouraged in Islamic finance as it facilitates market liquidity and is beneficial to the real economy. But avarice inspired excessive trade volumes are not permitted. This rule negates the trade multiplier benefit rule. Recent evidence has shown that trade was growing faster in the 70's, when FX transactions volumes were twice trade and investment flows, than in 2009 when they had ballooned from 2 to 50 times. Thus, beyond the optimal point, larger trade volumes yield negative returns.

(c) Trading in debt instruments unlinked to underlying trade is not permitted by a section of Sharia'a scholars. This rule influences a pari passu growth between financial and real economy. Financial instruments are quicker to replicate than manufacturing tangible goods. Technology can easily initiate, close and replicate complex 100 million dollar deals by mere clicks of the keyboard. This swells trade volumes, fan traders herd instinct, increases volatility and fudges the measurement of value at risk.

Mischief #2

Derivatives and Hedge Funds have opacity, complexity and therefore high uncertainty facilitating 'miss-selling', particularly when trade opportunity slots are transient. As the margins are very fine, to earn relatively small amount of profit very large deals are to be done very quickly with exorbitant values at risk.

Remedy

(a) Islamic Finance permits derivatives for risk management but not for gambling-like speculative bets. The Rule avoiding Gharar (eschew excessive uncertainty and unquantifiable risk) promotes due diligence and transparency, and reduces embedded surprises or inherent uncertainty. A transaction imbued with excessive uncertainty, is actuated by the taint of greed or fear and clouds risk assessment, a common phenomenon in the Banking Crisis.

(b) Even in normal conditions, complex products are less liquid than simple products. In the market breakdown of trust, derivative products were hard to shift because of suspicion as to which bank had what quantum of toxic assets parked in which SIV. This uncertainty congealed individual banks' funding liquidity and temporarily froze market liquidity - the classic Minsky moment: the investment banker orders "sell" and the broker replies "to whom?"

(c) Islamic finance general Rule prescribes that the seller must own and possess, actually or constructively, the subject of sale. This Rule acts as an effective antibiotic to: short selling, market manipulation and the opaque and unregulated culture of hedge fund-like vehicles.

Resolving Islamic Finance Strategic Issues

Islamic Finance needs to recognize its own issues and sincerely seek wisdom and their resolution road map from its big brothers of conventional finance. The unprecedented banking crisis is a last chance saloon situation. Because the repair and radical overhaul has to be all encompassing, even the small fry Islamic finance is in the same boat with Big Whigs International Banks who do realize that an unnoticed hole in Islamic finance may precariously wobble the boat. This real and present danger will force both Conventional and Islamic Finance to move out of their cloistered corners to evolve workable solutions to the specificities of Islamic Finance and to genuinely collaborate in their sustained implementation. To assist this process, I flag some strategic issues, rather than raising technicalities of Accounting, fair valuation, Capital adequacy and compliance concerns.

Issue #1

Islamic Finance is a young industry. The adolescent energies of some Islamic finance players need to be better directed, cooled and nurtured. They must face the reality that, despite its high growth rate, Islamic Finance has insufficient market depth. The business model is 'Universal Bank'. Hence small and new banks, tend to target the market of older & bigger banks, which fragments the market rather than add new segments. The small size of capital in absolute terms (even if regulatory capital ratio is not breached) is not enough to allocate high resources for investment in technology and human capital. Basel III & reform pressures will lead Regulators to nudge owners and controllers of smaller Islamic banks towards mergers.

Issue #2

Islamic Finance does not have accessible adequate size money market and robust liquidity management tools. Even Sukuk have only marginal liquid secondary market. Islamic products do not have a large portfolio across a wide range of markets. IIFM, AAOIFI and IFSB have developed templates and standards for liquidity management. However, as Islamic Finance enters the mainstream it needs industry acceptable tools and stable systems. The recent Bursa Suq Al-Sila' established in Malaysia is a right step forward.

Issue #3

Legal and Regulatory Framework, particularly in the GCC has to be girdled. Land & property rights & their effective registration, Insolvency, Enforcement of securities, harmonization of Regulatory and Sharia'a Standards and Home-Host Regulators responsibilities in a crisis; are some of the issues. Their satisfactory resolution will assure reasonable certainty to local and foreign stakeholders in Islamic finance transactions.

Issue #4

Corporate Governance, in a comprehensive sense, not just constituting Board Committees and appointing 'independent' Non Executive Directors. It is difficult even in the US where time and again a domineering chief executives have flagrantly binned Governance Rule Book-

Resolving Islamic Finance Strategic Issues without appropriate action by the Regulators and Reporting Accountants.

Issue #5

Moral Hazard: is common to both conventional and Islamic Societies. The ultimate sanction against greed and corrupting power is a belief in moral accountability, whether rooted in Maqasid-e-Sharia'a, or other divine faith or ethical foundations of a secular society. If Islamic finance can demonstrate in practice that its system of moral values and social distributive justice, does work, then it will gain greater credibility and consequential benefits to the entire financial universe.

The Way Forward

Islamic Financial Institutions, directly and via the Islamic Finance Stability Board under the aegis of the IDB-IFSB must allocate resources for timely and effective engagement⁵ with the office and committees of the new Global Financial Stability Board whose work will be assisted by relevant international and national agencies, trade and professional associations. If they do not, the case of Islamic Finance will go by default - noisy meetings and conferences, after the event, will sadly generate more heat than light.

Footnotes

1 - There are reams of reports analyzing the causes, some of which have been articulated earlier in the seminar. There is agreement that the causes are embedded in multi faceted complex interlinked cross sect oral relationships. In the blame game all come out diminished: Governments, Regulators, Market players, professional advisers like Accountants and Lawyers, Rating Agencies and investors.

2 - Since 1982, there have been at least 10 major financial crises. 1989: Collapse of the Japanese asset price bubble; 1992: Speculative attack on European Exchange Rate Mechanism currencies; 1994: Speculative attack and default of Mexican debt; 1997: Devaluations and banking crises across Asia; 1998: Russian financial crisis, devaluation of the ruble and default on debt; 2000: Dot.com crash; 2001: Breakdown of Argentine banking system; 2008: disastrous tsunami of US subprime assets. But this Crisis challenged the triumphal wisdom of, amongst others, the efficient market theory, creaking the Regulatory Architecture of several jurisdictions, and brought the financial and the real economy on the brink of Armageddon.

3 - Bear Stern, Lehman, Citi Group, UBS, Merrill Lynch, Washington Mutual, AIG, Northern Rock, ABN Amro, Fortis, RBS either wiped out or, but for Governmental action would have gone under. The tax payer will, over many years, have to pay the price and bear the burden of their resuscitation.

4 - Financial Stability Board is expected to make workable recommendations, not with a vengeance to punish, but to repair the damage and build sustainable barriers against repetition of Financial and Banking crises. The Volker Rule, announced by president Obama on the eve of Davos 2010, the transaction tax, the Insurance levy, are all ideas to inspire not theoretical but practical solutions for recovery and sustainable stability of the system.

5 - Particularly where specificities of Islamic Finance need to be properly appreciated in Macro and Prudential Regulation; Accounting and Valuation standards, standards for Rating agencies, capacity building for Sharia'a standards and their harmonization.

The Islamic Window - Consumer Perception and Market Research in Islamic Finance

By Joy Abdullah, Brand Strategist

Joy Abdullah, Brand Strategist, has more than 20 years of experience across ASEAN & the Indian sub-continent in developing and managing national, regional and international brands in a wide variety of industries covering Islamic Financial services, tourism, B2b Halal, telecommunications, beverages, real estate, tobacco, hospitality and healthcare.

The global Islamic Finance industry is a \$1 trillion industry with annual growth estimates ranging from 10 to 15 percent a year. Nevertheless, at the consumer level (and specifically retail banking) there is no 'real' market data available - certainly not in the open. Most of the industry statistics that are available have been focused on institutional preferences: after-the-fact product data and somewhat generic growth figures (alongside highly subjective forecasts).

Thus far the 'classic' type of market research seems to have eluded the industry, this despite the fact that door-to-door written surveys have been replaced with the ease and rapidity of online tools. Not only that, but the predominant audience of Islamic finance surveys are the Islamic finance practitioners themselves, introducing a clear (albeit unintended) bias to any survey result.

Furthermore, there is scant research available on the consumer perception and understanding of Islamic finance, from product specifics (i.e. what is ijara?) to the overall perception of the industry's value proposition (i.e. do consumers actually care?). Such critical analysis would be invaluable to the industry, specifically as input for the design of Islamic finance products that serve a real need amongst retail consumers.

Such consumer perception studies could provide the Islamic Finance industry with a platform to:

- I. Develop basic financing products adhering to Shariah, which are applicable across geographical boundaries, thereby providing globally-operating IFI's a common product pool to use across markets and jurisdictions.
- II. Support global standards as opposed to country-specific or even company-specific SSB certification/approvals.
- III. Encourage the industry to innovate on areas of brand identity through service improvements, technology inputs and consumer wealth development.

This would lead to an overall social and economic development in the markets that these IFI's operate in (and by virtue of that they would be living up to the essence/spirit of Islamic Finance). In this regard the following research papers provide some valuable insights:

The lack of information/data on how Muslim consumers perceive and behave towards using Islamic financial products.

Attitudes, Perceptions and Motivations of Libyan Retail Consumers toward Islamic Methods of Finance

By Alsadek H. Gait and Andrew C. Worthington
Griffith Business School, Griffith University

Key Points:

1. Little is still known on how Muslims and non-Muslims are affected by religious convictions in their financial decision-making. Despite the evolving literature on Islamic finance, much work remains to be done on consumer behaviour using more sophisticated choice-modelling techniques and more extensive samples.
2. This work on attitudes, perceptions and knowledge of Islamic finance has been undertaken in a particular national context, not across regions and certainly not globally.
3. Finally, one reason for the growth of Islamic finance worldwide has been the willingness of national governments with a sectarian-orientation to support its establishment. It is not known what particular role these governments have played in attempting to modify the perceptions, attitudes and knowledge of Islamic banking alongside any direct or indirect support or encouragement to the institutions themselves.”

The lack of comprehension amongst Muslim consumers ie Islamic finance and its co-relations to religious tenets**Choice of Financing amongst Malays—Between religiosity and perception**

By Wan Marhaini Wan Ahmad, Asmak Ab Rahman, Nor Aini Ali A and Azizi Che Seman
University of Malaya

Key Points:

1. The importance of this study can be viewed from two dimensions: impact of level of religiosity to sources of banking financing and determinants of credit selection criteria. In terms of religiosity, this study shows that a more religious customer will tend to choose Islamic financing. And a person tends to be religious when they receive higher formal religious education exposure. The findings point to the importance of this group as target customers for Islamic financing products since their tendency to subscribe it is higher.
2. For other groups especially those who were found to be casually religious and those without any formal Islamic education, a different approach than stressing the Islamicity of the products is necessary.
3. For financing selection criteria, a majority of them found that apart from favorable credit terms of the financing products, efficiency in services especially the after-hour and less hassle services of using the electronic services are the most important factors in choosing where they get their financing. Such factors should be considered seriously by bankers in designing their products and perfecting their customer services especially when developing their market strategies concerning working Malay Muslims.”

There is a clear lack of market data available that can lead to more precise conclusions, and the above research would be most welcome across a wider range of consumer markets. Hence it is increasingly obvious that a Consumer Survey is in much need to gauge awareness, perception, misconception and overall understanding. In the coming weeks we aim to develop and deploy such a study and share the findings to identify consumer segments, trends, as well as any country-specific issues. Hence we will be able to open a window into the mind of current (as well as prospective) consumers of Islamic finance products.

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