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OPALESQUE ISLAMIC FINANCE INTELLIGENCE

Featured Structure
Islamic Business Contracts and Microfinance A case of Mudaraba
By Azhar Nadeem

Lex Islamicus
Operational Excellence is the Key to Unlocking Lasting Value in Islamic Finance
By Hdeel Abdelhady

Industry Snapshot
E.P.L. in Islamic Finance - Education (Extra Time)
By Joy Abdullah

We have compiled a great mix of content for this edition of OIFI, and we start with our Editorial's anecdotal perspective of the MENA region. Having repeatedly received inquires regarding consumer appetite for Islamic finance products, our Featured Resource section compiles various country studies on consumer awareness, behaviour and perception.

Mudaraba applied in the context of microfinance is the theme for the Featured Structure segment, as scrutinized by practitioner Azhar Nadeem. Hdeel Abdelhady provides an operational perspective to Islamic finance in Lex Islamicus - with particular emphasis on governance and Shariah Board reports (SBRs).

Having spent time in Matsushima (one of the three famous "views" of Japan) in the north of Miyagi prefecture, it is a welcome coincidence that the Kulliyyah Korner features the research of Kyoto-based Nagaoka Shinsuke. Our best goes to him and everyone in Japan.

The Industry Snapshot offers a further analysis of Education based on the EPL concept (Education, Perception, Liquidity), as seen by strategist Joy Abdullah. This is followed by Douglas Clark Johnson who shares his perspective on Bahrain in our Opinion Column.

We hope you enjoy the sixteenth edition of OIFI and as always we are glad to hear from our readers and welcoming all comments & feedback. 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

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Kelly Lemon, Robert Seabrook, Bob Rayner

In the Name of Egypt

By Bernardo Vizcaino, CAIA

The month of January started out as uneventful and the rest of 2011 seemed confined to the same fate... clearly the demonstrations, protests and clashes that have engulfed the Middle East since then have proven otherwise. Very few could have foreseen the depth of this change (which is still unfolding) - with a substantial impact on the socio-political landscape of the region. Even more difficult to predict the breadth of this change - simultaneously across various countries and different political systems.

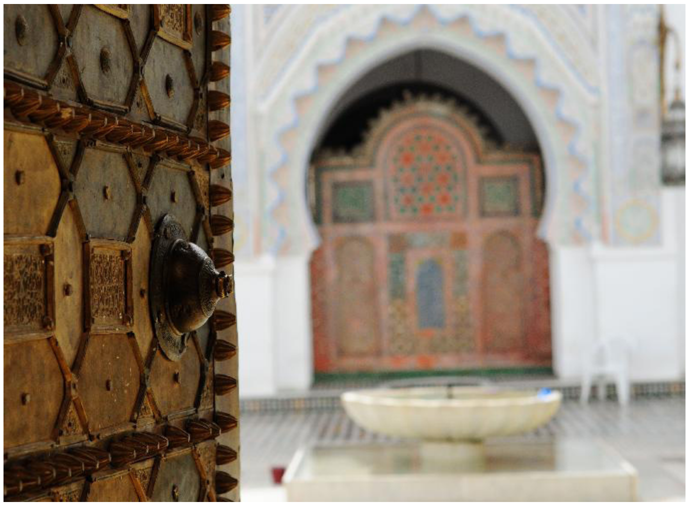
What this means to the region (and to Islamic finance) is near-impossible to predict. With such a complex landscape and an ambiguous outlook it is best to get back to basics. During this time it can be difficult to make sense of what we see, hear and read but this can be a time to renew our convictions and remind ourselves of our ideals.

Hence I find myself pondering: what draws us to Islamic finance, what fuels that interest in the concept and in the people around this industry? Unfortunately for the reader this has rekindled several anecdotes...

In the beginning...

My introduction to Islamic finance can be traced back to research conducted several years ago on Islamic investment funds. There was an emphasis on making the scope of the research global so special interest went into markets that, in my view at least, had been sidelined or ignored. This exploration included countries such as Pakistan, Morocco, Indonesia, Canada, South Africa and Egypt (just to name a few).

In fact it seems I hold the rather dubious honor of being the first person to write a comprehensive analysis of Islamic funds in some of these countries (specifically Indonesia, Pakistan and Egypt). This analysis can still be found in the form of articles published with the likes of Islamic Finance News, Eureka hedge and elsewhere. 'Dubious' because it highlights the inadequate attention that the industry service providers have given to these markets. Witnessing such an imbalance is a strong reminder of how much we should cherish views that are objective, balanced, and faithful to that long-lost art of common sense.



The Moroccan Connection

Morocco was particularly intriguing, since it presented a thriving capital market with numerous investment products (albeit none of which seemed to be Shariah compliant) and this also offered the opportunity to practice my fast-decaying French vocabulary. After a few calls (and admittedly some dead ends) I bumped into an energetic gentleman, Mohammed Mejai, who offered his help to figure out exactly how many Islamic funds there where in the market.

We spoke again a few days later and to my surprise he had proceeded to call every fund manager in the country (from Marrakech to Casablanca!) and thus confirmed the existence of a discretionary account (managed according to Islamic principles) and one 'proper' Islamic mutual fund. Indeed that lonely Islamic fund, Attijari Al Moucharaka (see reference link) from Wafa Gestion, remains one of my favourites. Partly due to is great track-record but most poignantly from the methodical initiative of this unsung hero.

My Saudi Cousin

If one surveys Islamic mutual funds it is an imperative to cover Saudi Arabia and this eventually saw me inquiring with Tadawul, the local stock exchange (see reference link). Local fund managers had warned me that the data might not always be reliable and this was confirmed early on - in particular with the lack of a complete historical archive (for mutual funds it is crucial to have performance data since inception, not halfway-through the life of a fund). Explaining this to a marketing manager at Tadawul, a fellow by the name of Mohammad Saab, he seemed adamant on finding a solution to my problem.

He conferred with colleagues and further quizzed the IT department but to no avail, the data did not exist or was impossible to extract. He then contacted a friend of his (perhaps a distant cousin) who devised a most intriguing solution: somehow they had painstakingly recorded the Tadawul reports for several years and compiled them on a CD-ROM. This joyful piece of polycarbonate plastic soon found its way to my desk via express courier. It was heartbreaking that I could not use this data in any way (since it was not an official source) but I avoided mentioning this to them, instead opting for expressing my immense gratitude to them. Afterwards I proceeded to interrogate half of Saudi Arabia to obtain the official data for each fund (no fun there). However, I still have this 'gift' and I regard it as one of my most prized possessions. It is testament to how much humility and commitment one can find in certain individuals in this industry.

My Kuwaiti Cousin

Next on the list was Kuwait. This was another industry orphan: while the Central Bank of Kuwait listed more than 50 finance companies that conduct their business in accordance with Islamic Share'a (see reference link), the number of Islamic mutual funds reported by fund portals did not match this reality. There was something amiss.

The neglect was surprising, talking to a VP from one of the largest fund managers in the country I soon stumbled on one of their conventional funds (i.e. not Islamic) which had been classified as such by one of the major fund portals. It seems that just because one of their mutual funds had an Arabic name it somehow made it 'Islamic'. I highlighted the error and the guys had a good laugh, then proceeded to correct the mistake. Worryingly, this pointed to a recurring theme: market research and data collection have often failed to keep up or keep current (or both). One can forgive this happening in frontier markets, but one can hardly argue that Kuwait is at the periphery of Islamic finance.

Still we managed to uncover some fascinating products, like the ones from Al Madina for Finance and Investment. This unassuming team had recently launched an India Fund (see reference link) which was not only Shariah compliant but apparently the world's first. Most importantly, they had done this without much fanfare or the usual fireworks that are associated with new launches and unique product offerings. Here you actually had a one-of-a-kind product, which had successfully beaten the market and their peers despite a very difficult time for Indian equities. There is no industry award for being down to earth, but if it existed then the guys at Al Madina would certainly get my vote for that accolade.

Egypt = Misr

And then there was Egypt. The reduced number of Islamic finance products in the country made for a straight-forward exercise. One of the banks with such offerings was Banque Misr and the name of the product 'Banque Misr Fund IV' (see reference link) left little to the imagination. This singularity prompted me to ask them what 'Misr' meant. "It means Egypt" the voice on the other end of the phone relayed, and indeed I soon realized that Misr is the modern official name for the country. It left me with an uncomfortable feeling, it was either too painfully obvious or just undeniable evidence of my geopolitical ineptitude.

Something told me that there was more to the story so I decided to do some investigating on my end. I referenced encyclopedias and dictionaries and they solidified the answer (and my ineptitude): Misr means Egypt. I frolicked on the internet for further references and the answer was pretty much the same: Misr means Egypt. My ego severely bruised I finally opted to check a book on the history of the Middle East. Rummaging the pages eventually landed me on a short paragraph which delved into the term in detail: Misr means - without a shadow of a doubt - Egypt.

My self-esteem now equivalent to a microbe... I turned the page in a last gasp attempt to release me from this agony. The paragraphs that followed where rather surprising: Misr traditionally refers to Egypt (yes, nothing new there!) but historically denotes a frontier or limit. The term was used (circa the 14th century) to identify garrison cities at the borders of the Arab world (an alternative definition being that of fortress or fortification). The root is Semitic (see reference link) similar to the Akkadian mişru (border territory) and the Aramaic mişrā (frontier).

The plural being amşār, this refers to a variety of outposts such as Qomm in Iran, Fustāt in Egypt, Qayrawān in Tunisia. In fact Basra and Kufa are also named as being part of this family of regionally important cities. They had a significant role in terms of interaction and trade with other regions, cultures and civilizations.

Furthermore, the term amṣār, which is phonteically closer to “imisr” is also considered as a root word for emissary. While you certainly have military overtones (a garrison is no playground), the overall feeling is that this term had a broader concept. Each misr was a portal linking the Arab world with the outside world (be that the lands north of the Mediterranean, sub-Saharan Africa, of the Far East). And the plural term was further focused on the notion of a cultural/economic periphery.

Relating misr/amsar to modern Islamic finance was therefore quite appealing - as we have multiple ‘frontier towns’ (from Toronto to Singapore, Luxembourg to Sydney) bridging a gap between Muslims and non-Muslims, transmitting (perhaps unwittingly) a message of goodwill to others. This linguistic excursion always reminds me that there can be more underneath a story if we care to be slightly inquisitive and challenge even the most obvious answer.

What is Next?

It seems out of place to consider how Islamic finance can ‘benefit’ from the political turmoil of recent weeks. I would much prefer to see how the industry can ‘contribute’ to the rebuilding of society and the reassembling of normalcy.

In fact it is rather un-assuring to witness the technocrat frenzy to provide predictions and forecasts. Personally, I just hope that we can promptly return to gathering more anecdotes from so many colorful individuals and uncovering even more surprises in this wonderful region. Thus my fondest wishes and prayers go to everyone in Misr, although which Misr that might be is up to you to decide.

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

The Islamic Finance Consumer

Blogger™ As Featured in the Islamic Finance Resources Blog

An emerging theme in the Islamic finance industry is the need to better understand the consumer. The 'Muslim consumer' has become a well defined market segment but research is hard to find on this area. Even the broader segment of 'Islamic Finance consumers" (Muslim and non-Muslim alike) is equally lacking appropriate data metrics. Here is a shortlist of papers that have tackled the mindset and perception of the Islamic finance consumer in various markets:

An Empirical Survey of Individual Consumer, Business Firm and Financial Institution Attitudes towards Islamic Methods
A. H. Gait and A. C. Worthington, University of Wollongong

Banking behavior of Islamic bank customers: perspectives and implications
Saad A. Metawa, Associate Professor of Finance, College of Business Administration, University of Bahrain, Bahrain
Mohammed Almossawi, AssistantProfessor of Marketing, College of Business Administration, University of Bahrain, Bahrain

Bank Patronage Factors of Muslim and Non-Muslim Customers
Sudin Haron, School of Management, Universiti Utara Malaysia
Norafifah Ahmad, School of Management, Universiti Utara Malaysia
Sandra L. Planisek, Grand Valley State University, Allendale, Michigan

Conceptual Framework for the Adoption of Islamic Retail Banking Services in Malaysia
Seethaletchumy Thambiah, Uchenna Cyril Eze, Khong Sin Tan, Robert Jeyakumar Nathan, and Kim Piew Lai
Multimedia University, Selangor, Malaysia

Conventional versus Islamic Finance: Student Knowledge and Perception in the United Arab Emirates
Jorg Bley and Kermit Kuehn

Customer satisfaction and awareness of Islamic banking system in Pakistan
Naveed Azeem Khattak, Shaheed Zulfikar Ali Bhutto Institute of Science and Technology, Islamabad, Pakistan
Kashif-Ur-Rehman, Iqra University, Islamabad, Pakistan

Islamic banking: a study in Singapore
Philip Gerrard, Division of Banking and Finance, Nanyang Business School, Nanyang Technological University, Singapore
J. Barton Cunningham, School of Public Administration, University of Victoria, Canada

Islamic Banking in Malaysia: A Study of Attitudinal Differences of Malaysian Customers
Ahasanul Haque, Faculty of Economics and Management Sciences, International Islamic University Malaysia

Libyan Business Firm Attitudes towards Islamic Methods in Finance
Alsadek H. Gait and Andrew Worthington, Griffith Business School

Perceptions of Malaysian Corporate Customers Towards Islamic Banking Products & Services
Sudin Haron, School of Management, Universiti Utara Malaysia
Norafifah Ahmad, School of Management, Universiti Utara Malaysia

Who patronizes Islamic Banks in Indonesia?
Muhamad Abduh, Department of Business Administration, International Islamic University Malaysia
Mohd Azmi Omar, Department of Business Administration, International Islamic University Malaysia

Islamic Business Contracts and Microfinance A case of Mudaraba

By Azhar Nadeem

Azhar Nadeem is a microfinance practitioner by profession and is currently associated with a leading microfinance institution of Pakistan.

Microfinance is defined to be providing small loans to poor people who are traditionally excluded from the financial system. Microfinance is a powerful tool to fight poverty. Microfinance means building financial systems that serve the poor and helps them raise income, build their assets, and cushion themselves against external shocks. Microfinance will reach its full potential only if it is integrated into a country's mainstream financial system. According a CGAP survey almost 72% of people in Muslim countries do not use the formal financial services because financial system is interest-based which is prohibited in Islam (Karim, Tarazi and Reille, 2008).

The Islamic world is enormous with approximately 1.2 billion people across different countries. However, poverty is rampant and widespread across the Islamic world. Access to finance is very low based on their religious beliefs. This is a huge population under poverty and needs immediate and significant consideration to achieve the goal of making poverty history by 2015 as pledged in the Millennium development goals.

These poor Muslim micro entrepreneurs need and demand access to financial services which do not compromise their religious beliefs of interest prohibition. Their demand can be met by designing financial products which are compatible with norms of Islamic finance which are based on prohibition of interest, avoidance from Gharar, Halal or permissible use of funds and non exploitation.

The Islamic alternative to interest-based conventional loan is partnership based, trade based or lease-based credit that permits the ownership and/or use of commodities or physical assets needed for productive enterprise. Partnership based modes work on profit and loss sharing and there exists a mutual agreement between financier and micro entrepreneur for a specific business. Combination of business contracts in this category includes Mudaraba, Musharka and diminishing Musharka. Our current write up is focused only on Mudaraba.

What is Mudaraba

Mudaraba is an Arabic word which means a business (project) in which capital is provided by one party (a company or individual) while effort and skill are contributed by the other party (beneficiary, entrepreneur or borrower). "Mudaraba" is a kind of partnership where one partner provides financial capital or (Capital) to the other for investing it in a commercial enterprise. The owner of financial capital is called "rabb-ul-mal", and the partner with entrepreneurial skills is called the "Mudarib". Work and management is the sole responsibility of Mudarib and "Rabb-ul-Mal" or capital owner is a sleeping partner. The capital owner has a choice to impose a restriction on "Mudarib" about the nature of business for investment. If he imposes a restriction on "Mudarib" this will be called as "Restricted Mudaraba" otherwise it will be "Unrestricted Mudaraba". The capital owner can engage more than one person as "Mudarib" but for the sake of simplicity we will only consider a two-party Mudaraba.

Distribution of profit in Mudaraba

It is necessary for the validity of Mudaraba that profit sharing ratio is agreed between the parties; right at the beginning of the contract profit sharing has to be in proportionate terms and a “Lump sum” amount cannot be allocated either to capital owner (Rabb-ul-Mal) or to the Mudarib. Profit Sharing ratios may take many variations under different situation. Share in expected profit is the reward for both parties. “Mudarib” can claim any compensation as salary for the work he has done. However he can claim logical business expenses on actual basis subject to certain conditions. If the Mudarib has undertaken more than one business initiatives and has incurred loss in some transactions and has gained profit in some others, the profit shall be used to offset the loss at the first instance, and then the remainder, if any, shall be distributed between the parties according to the agreed ratio. In case of overall loss the capital owner will lose his capital and “Mudarib” will lose his potential reward from profit. Neither party can claim financial compensation in case of loss.

Termination of Mudaraba

The contract of Mudaraba can be terminated at any time by either of the two parties. The only condition is to give a notice to the other party. However to avoid adverse effects for both parties they can specify the conditions which may lead to termination of Mudaraba while entering into the contract.

A Mudaraba Model of Microfinance

Under a Mudaraba contract the bank provides the capital needed for a micro enterprise while the micro entrepreneur offers labor and expertise. The profits (or losses) from such financing are shared between the bank and the entrepreneur at a fixed ratio. Financial losses are assumed entirely by the microfinance program; the liability of micro entrepreneurs is limited to their time and effort. The contract between the Microfinance program and the entrepreneur is known as restricted Mudaraba because the Microfinance program agrees to finance specific business activities by micro entrepreneurs and to share relative profits according to an agreed percentage. To engage in Mudaraba transactions a bank must meet the following legal obligations:

• Details of the parties to the contract, description of the objects, nature of business to be undertaken, Period of contract and all other relevant details including any limitations and restrictions should be clearly documented. Contracting partners should ensure that the terms and conditions of contracts are clear, concise and unambiguous, and are not intentionally misleading in any way which would confuse an investment account holder or result in his entering into a relationship the impact of which he does not appreciate

• Microfinance program should bear the entire financial risk and should not demand collateral to reduce it.
• Profit-sharing ratios must be determined and agreed before execution of Mudaraba. These sharing ratios can only be a percentage of the profit. Fixing a lump sum amount is not allowed.

• It is the right of the micro entrepreneur to have full control over the business management while effective supervision is right of Microfinance Program.

Assumptions of the Model

1. Since Muslims participating in Islamic Microfinance programs are devote Muslims and they do not indulge in cheating, deceit fraud and other malicious activities. They refrain away from Riba as well all other acts which can spoil their Halal earnings. They always keep in mind the sayings of Holy Prophet (P.B.U.H) that “Whoever bears arms against us is not one of us, and whoever cheats us is not one of us.” (Saheeh Muslim)

2. It is assumed that business activity being financed by Mudaraba gives a fixed profit per month. This is not an oversimplified assumption we may certain business which give fixed profit over a certain period of time e.g. an ice cream vendor who sells branded ice creams will get almost fixed profits due to the price tags on the products. Being a famous brand everybody knows the price. In this case profits are relatively easy to calculate.

3. Loan officers of Islamic Microfinance programs are competent and trained enough to carefully select the product type and successfully execute it.

A person approaches the Islamic Microfinance program with his request of financing. A loan officer from the program will check the qualifying criterion and if qualified will ask about his/her business activities. By interviewing client Loan officer assesses the suitable product. If the business nature of the customer is such that it is possible to calculate the profits easily he will adopt Mudaraba as the right product to be offered to client. We suppose that prospective "Mudarib" is a grocery store owner and he wants to add a cold dink corner to his existing business where he will be selling cold drinks of a famous brand like "Coca Cola or Pepsi". Since being the famous brand sale and purchase prices are known and profits can be calculated. It is assumed that prices and profits margins do not change over the span of Mudaraba so that assumption of fixed profit remains true.

Famous cold drink brands provide sellers with deep freezer to chill their products free of cost and electricity charges are to be paid by seller. It is assumed that prospective "Mudarib" is able to calculate the electricity cost of the deep freezer. Such an understanding of cost is necessary as he will not be selling cold drinks alone but a variety of other items as well. Upon getting all the necessary details and successful completion of required verifications Islamic Microfinance program approves his application and enters into Mudaraba agreement with him on following terms and conditions:

i. Contribution of Islamic Microfinance program will be Rs, 10,000 and the "Mudarib" will contribute by his labor.

ii. Profit sharing ratio is 20:80 i.e. Share of Islamic Microfinance Program will be 20% while that of Micro enterprise or Mudarib is 80%.

iii. Tenure of Mudaraba will be one year.

iv. As Microfinance program cannot remain partner for indefinite period. For successful completion of Mudaraba "Mudarib" or micro enterprise will purchase the capital invested by the Microfinance program over the period of Mudaraba.

For the sake of simplicity it is assumed that Invested capital is divided into 12 equal shares and "Mudarib" will buy one (01) share on monthly basis. Profits will also be shared on Monthly basis. In this case "Mudarib" will buy a share worth Rs.833.33 on Monthly basis or 8.33% of total share.

Now the amount disbursed to the Mudarib for onward investment in Cold drinks business. According to our assumption of fixed profit micro enterprise earns a profit of Rs. 2000 till the end of 1st month. During the 1st Month Microfinance program was 100% owner of capital so it will receive Rs. 400 as profit share while the profit share of micro enterprise or "Mudarib" will be Rs. 1400. As per agreement micro enterprise will bur a share from invested capital worth Rs. 833.33/. Total payment by the "Mudarib" to the program will be:

Profit Share of Microfinance program + Price of one Share from capital= Total Monthly Payment Rs.400 (20% of 2000) + 833.33 (price of share) = Rs. 1233.33

The second month will start in a way that Microfinance program has sold one share from its total ownership of capital. Now Microfinance programs own 91.67% of the total capital and will be entitled to profit share according to its capital ownership. Share of capital sold to the "Mudarib" belongs to him and he has right over 100% of the profit generated by this unit or share. Now suppose that micro enterprise earns a profit of Rs.2000 during second month as well. 91.67% of total profit or Rs. 1833.4 will be shared according to profit sharing ratio. Total payment by Mudarib at the end of 2nd month will be:

Profit Share of Microfinance program + Price of one Share from capital= Total Monthly Payment Rs. 366.68 (20% 1833.4) + Rs. 833.33 (Price of share) = 1200

We can note that "Mudarib" or micro enterprise has to make a payment less than what he paid at the end of 1st month. Now the 3rd month will start in a way that share of Microfinance program has reduced further. At the start of 3rd month Microfinance program owns 83.33% and its profit share will be less accordingly. Micro enterprise will have to make even lesser payment at the end of 3rd month. Similarly ownership and profit share of micro enterprise will rise in subsequent month while for Microfinance program both will recede over time. At the end of 12th month equity share of Microfinance program will be zero and Mudaraba will conclude. We can summarize a sample repayment schedule in a tabulated manner for better understanding.

Month (A)	Capital ownership of MFP at start Month (B)	Capital ownership of "Mudarib" (C)	%age of profit to be shared (D)	Total Profit (E)	Share of MFP (20%) (F) =D*20%(E)	Price of Share (G)	Total Payment (H)
1	100%	0%	100%	2000	400	833.33	1233.33
2	91.67%	8.33%	91.67%	2000	366.68	833.33	1200.01
3	83.33%	16.66%	83.33%	2000	333.36	833.33	1166.65
4	75.01%	24.99%	75.01%	2000	300.04	833.33	1133.37
5	66.68%	33.32%	66.68%	2000	266.72	833.33	1100.05
6	58.35%	41.65%	58.35%	2000	233.4	833.33	1066.73
7	50.02%	49.98%	50.02%	2000	200.08	833.33	1033.41
8	41.69%	58.31%	41.69%	2000	166.76	833.33	1000.09
9	33.36%	66.64%	33.36%	2000	133.44	833.33	966.77
10	25.03%	74.97%	25.03%	2000	100.12	833.33	933.45
11	16.7%	83.30%	16.7%	2000	66.8	833.33	900.13
12	8.37%	91.63%	8.37%	2000	33.48	833.37	866.81
13	0%	100%	0%	2000	0	0	0
Total						10.000	12.600

Note: Row No.13 is for illustration purpose only

Compared to conventional microfinance programs which adopt an easy methodology of repayments in equal monthly installments this is rather complex to understand and manage. Such a program has many built in challenges which can be summarized as follows.

Challenges for the Model

Since Islamic Microfinance is a new phenomenon and, like every other program, has its own challenges. Every challenge needs to be considered and explored in order to find a way out.

Monitoring of Loan: Monitoring of a loan is important for each microfinance institution (MFI). Loan monitoring is very important for effective loan utilization and for timely repayments. Higher repayment rates drives profitability and enables MFI's to become price competitive profitability of MFI's. Higher repayment rates provide MFI's an opportunity for expansion and outreach. Effective loan monitoring helps MFI's overcome the some of the challenges like asymmetric information, adverse selection and moral hazard. It also helps MFI's improve their delivery mechanism, remove bottlenecks and design new products and services.

Mudaraba is the riskiest of all the financial products, since the capital (fund) provider has no "real" control over the management, while fully responsible for any financial losses arising from the business. Under a Mudaraba arrangement profit is shared on the basis of pre determined ratios while financial loss is to be absorbed by the Islamic Microfinance institution only. Such a situation when financier has no direct control over financial capital may lead to agency problem. Agency problem exists when the borrower may not work sincerely thinking that he has nothing to lose financially in case of business failure. In our example he may not give proper time to his cold drinks business, does not maintain proper backup inventory and variety of other reasons. This will put an Islamic MFI under difficult situation and its outstanding portfolio will be at risk which has further implications. Microfinance experience suggests that borrowers show good repayment behavior at the start of a loan and tend to default on later stages. In our example, risk arising out of agency problem will be maximum at the start of loan and it will decrease with every installment. With more shares "bought back" by the "Mudarib" his behavior will become more of principle rather than agent. Besides this there are other reasons which can play a role in risk management of a Mudaraba contract.

Firstly, Muslims opting for Shari'ah compatible products are supposed to be devout Muslims who believe in the eternal concept of life, in which honesty is reward able and dishonesty punishable. This is a non-material incentive for people to be honest. Secondly, all financial Institutions tend to have a long term relationship with their clients based on their repayment behavior in case of borrowers. For this purpose they offer incentives in repeat loan cycles like enhanced loan amounts etc and such incentives compel borrowers to keep their credit history clean. On the same grounds there is a financial incentive for entrepreneurs to be honest and behave in a way acceptable to Islamic MFI.

Moral Hazard: Portfolio of the Islamic Microfinance Institution will be at risk due to asymmetric information because principle or capital provider has limited or imperfect information. On the contrary, borrower of the money i.e. agent has exact and full information. Thus this gives rise to the concept of moral hazard for the lending party i.e. Islamic MFI. Research in the field of Islamic finance has outlined few factors that can reduce agency problem for Profit and Loss sharing contracts. These are business skill, business reputation, business commitment, financial health of the project, length of the project.

Adverse Selection: Islamic Microfinance is a new and emerging concept. When Islamic Microfinance Institutions are entering new market and launching their initiatives in new place. They do not have complete information and credit history of their new borrowers. They have to rely on the available information and interview techniques of their prospective borrowers. Loan monitoring becomes very important in such scenarios. By exercising due diligence and effective monitoring Islamic Microfinance Institutions can have a good start in terms of portfolio quality which is required for their survival.

Uncertainty of profits: In our example we have assumed that profits will remain fixed over time. This looks like a very oversimplified situation. Even in a situation where it is possible to calculate profits on the basis of sales and purchase it will be much difficult to calculate exact profit. This is because sales always fluctuate depending on different circumstances. In this case where micro entrepreneur can be trained to obtain bills from his vendor and keep a track of daily sales on a simple format. Since the product is being purchased from a vendor of repute, risk of counterfeit bills or over invoicing is minimized. The situation can be more difficult in situations where sales and purchase prices are unauthentic. However investing in authentic brand names may be a good starting point for Islamic Microfinance programs.

Uncertainty of payment amounts: The second difficulty with this model is that borrower has to repay a different amount each period (and the loan officer has to collect a different amount each period). This makes it bit difficult compared with EMI arrangements. The margin for error is high in these situations. However this can be managed to some extent by rigorous training to loan officers. Once they have grasped the idea and the logic behind such calculation then it will get relatively easy. Loan officers usually have the ability to do mathematics and calculations. Under conventional Microfinance programs loan officers has to perform calculation in case of bullet loans.

It is often argued that Micro entrepreneurs do not keep accounts. This is partially true as they keep their accounts but in a very informal manner. They always maintain a record of their credit sales to the households, their sales and purchase. They always do calculate profits and returns of their investments. This shows that they have calculation skills and they need to be trained to change their way of book-keeping in a way that can serve the purpose of the Microfinance program as well. Application of such a model may be less hectic and more straightforward in other forms of trade like livestock fattening where calculations will be easier.

Conclusion

Microenterprises have a role to play in economic development of poor countries. A World Bank study pointed out the advantages of microenterprises as increasing the aggregate output, enabling the efficient use of capital and labor, initiating indigenous enterprise and management skills, bringing a regional balance, and improving the distribution of income. Microenterprises can significantly generate economics activities, employment, and demand and can contribute significantly to the economic development. Access to financial

resources is very important for economic development.
Access to financial services remains low all over the Muslim world partly due to religious beliefs. This gave rise to the evolution of Islamic Banking to serve the Muslim population with violating their religious beliefs. This new industry got a very welcome response and has witnessed enormous growth since its inception. The development of Islamic Finance has improved access to finance to some extent, but micro entrepreneurs remain mostly excluded from financial services. They lack collaterals and are unable to fulfill certain requirement to gain access to finance. Conventional microfinance played an important role in providing financial services to poor entrepreneurs on a collateral-free basis. Islamic Microfinance needs to be developed in the same manner to help Muslim micro entrepreneurs.
Islamic finance needs to be seen in a broader sense. It promotes risk sharing, entrepreneurship, materiality, and non exploitation. Islam prohibits one from involving in activities which are harmful for the society as a whole. Islamic financial services have a good degree of compatibility with microfinance. If promoted and developed properly Islamic Microfinance can have a big impact on overall poverty and economic development of many countries.

Islamic law allows room for financial innovation, and several Islamic contractual arrangements can be combined to design new products. Islamic Microfinance is capable to adopt microfinance best practices without compromise on Shari'ah compliance. Islamic Microfinance needs patronage especially by Islamic financial institutions that have developed over time and it will bear fruits and will contribute significantly towards poverty reduction. This will be a significant step towards the Millennium development goals.

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

Operational Excellence is the Key to Unlocking Lasting Value in Islamic Finance

By Hdeel Abdelhady

Hdeel Abdelhady is an Attorney and a Professorial Lecturer in Law at the George Washington University Law School in Washington, D.C. She served as Co-Chair of the American Bar Association Islamic Finance Committee and was the Program Chair of the May 2010 ABA-Hawkamah program, Taking Stock and Moving Forward: The State of Islamic Finance and Prospects For the Future.

It is not righteousness that ye turn your faces towards East or West;
But it is righteousness to believe in Allah and the Last Day,
and the Angels, and the Book, and the Messengers;
To spend of your substance, out of love for Him, for your kin, for orphans,
for the needy, for the wayfarer, for those who ask, and for the ransom of slaves;
To be steadfast in prayer, and practice regular charity,
to fulfill the contracts which ye have made;
And to be firm and patient, in pain (or suffering) and adversity,
and throughout all periods of panic.
Such are the people of truth, the God-fearing.
-The Holy Qur'an, 2:177

The quoted Qur'anic aya (verse) crystallizes a fundamental Islamic value: form does not trump substance, and outward adherence to religious injunctions does not, without more, equal piety.[2] Rather, piety is measured by deeds motivated by sincere faith, perceptible or imperceptible to others. The significance of this verse for individual Muslims is clear. And it applies to institutions that hold themselves out to the public as "Islamic", whether in the form of Islamic banks, Islamic windows of conventional banks, or other providers of Islamic financial products and services, such as takaful and financial advisory. Islamic Financial Institutions (IFIs) must ensure that behind the scenes, in their back offices, their operations are of a quality that ensures that representations about the nature of their business model, products, services, and commercial and legal objectives are true to the religion-derived principles to which they owe their market share. This requires operational excellence in the back offices of IFIs, which must be facilitated and reinforced at the industry level. Operational excellence is the key to unlocking lasting value in Islamic Finance.

This note discusses two published court opinions involving IFIs—The Investment Dar v. Blom ("Blom") and Shamil Bank of Bahrain EC v. Beximco Pharmaceuticals Ltd. ("Shamil") – and IFI Shari'ah Board Reports and their implications for governance and brand management.[3] In this note, the notions of operational quality and governance are broad, and are used interchangeably.

I. The Need for Operational Excellence in Islamic Finance is Particularly Compelling

The financial crisis and other well-known governance failures (recall Enron) are powerful reminders of a universal truth. Rules, whatever their source, are only as good as their enforcement. Laws alone are insufficient to prevent practices motivated by short-term gain, to the detriment of long-term value. This is particularly true for Islamic Finance, which operates globally without comprehensive industry-specific regulation, making external regulatory checks on governance moderate to non-existent. Further, the nature of the relationship between IFIs and consumers of their products and services, based on the Islamic profit and loss sharing construct (PLS), requires that IFIs be operationally strong, to maximize returns for consumers and shareholders.[4] Most obviously, IFIs, owning their existence to a religion-based ethical model, must be, and convincingly appear to be, ethical. Vigilant self-governance is required to preserve the Islamic brand, maximize profitability, and fill legal and regulatory gaps.[5]

II. Governance Shortfalls Revealed: Case Studies

In the last paragraph of the well-known February 2008 AAOIFI clarification on sukuk, AAOIFI's Shari'ah Board advised IFIs "to decrease their involvement in debt-related operations and to increase true partnerships based on profit and loss sharing in order to achieve the objectives of the Shari'ah."[6] The advice, seemingly a postscript to AAOIFI's sukuk clarifications, is broad in scope and applicability, and has ramifications for governance at the institutional and industry levels. Published court opinions and Shari'ah Board Reports (SBRs) issued by IFIs shed light on areas in which improvements to operational quality should be made. While court opinions and SBRs are, by their nature, specific to institutions and situations, they have industry-wide ramifications and their lessons should be heeded broadly.[7]

The Blom Case

In Blom, The Investment Dar ("TID"), an IFI, asserted its own failure to comply with Shari'ah as a defense to an apparently valid demand for payment by Blom Development Bank ("BDB"). TID's Memorandum of Association prohibited its engagement in "any usury or non-Sharia compliant activities."[8] In October 2007, TID and BDB entered into a wakala agreement, pursuant to which BDB deposited USD 10 million with TID as its agent, for Shari'ah-compliant investment in TID's "treasury pool."[9] The TID-BDB transaction and the form of master wakala agreement were previously approved by TID's Shari'ah Board.10 TID failed in its payment obligations and BDB filed suit in English court (pursuant to English forum and governing law clauses). After an initial hearing, BDB won summary judgment for USD [10] million, the principal amount deposited. TID sought permission to appeal the summary judgment, arguing, inter alia, that a full trial was required to determine whether the wakala was enforceable. According to TID, the wakala was interest-bearing, not Shari'ah-compliant, and therefore unenforceable because TID did not have the legal capacity to enter into the wakala.[11] Subsequently, TID's Shari'ah Board issued a statement asserting that the transaction was Shari'ah-compliant, and advised TID to abandon its lawsuit with BDB.[12]

The Shamil Case[13]

The appellate court decision in Shamil was issued six years ago, but the case remains relevant. The Shamil dispute arose out of two murabaha and related agreements between Shamil Bank of Bahrain and Beximco Pharmaceuticals, its corporate affiliates and directors (collectively "Beximco"). Beximco defaulted on its obligations, and Shamil Bank brought a claim in English court, pursuant to English governing law and forum selection clauses. Shamil prevailed at trial and on appeal.[14]

The disputed transactions were certified by Shamil Bank's Shari'ah Board prior to the litigation. Nevertheless, at trial, Beximco argued that the murabahas and related agreements with Shamil Bank were interest-bearing loans with Islamic names. The English court appeared to accept this characterization, stating that: "if the Sharia law proviso were sufficient to incorporate the principles of Sharia law into the parties' agreements, the defendants would have been likely to succeed."[15] Due to a governing law clause that did not effectively incorporate Shari'ah as a source of governing principles, it cannot be known whether the court's prediction of a favorable outcome for Beximco would have materialized, had Shari'ah applied.

III. Addressing Governance Shortfalls at the Institutional Level

Instruments Susceptible to Shari'ah Challenge

• Innovation in Islamic Finance: Back to Basics. TID and Shamil involve agreements that were characterized by litigants as effectively interest-bearing, and repugnant to Shari'ah. These characterizations, accurate or not, raise a frequently asked question about whether Islamic Finance has innovated sufficiently to meet consumer demand, develop and expand its market share, and bolster Shari'ah compliance. Much has been written on the subject of innovation, and the way forward would best be paved by Shari'ah experts, business professionals, and economists. For the purposes of this note, it is sufficient to state that IFIs and the Islamic Finance Industry should revisit the issue of whether the "bank" operating model assumed by many IFIs is congruent with the Islamic PLS model. Owing to real commercial pressures, IFIs frequently use off-the-rack instruments (e.g., murabaha, wakala, tawarruq) that have been susceptible to Shari'ah challenges because, as implemented, they most directly compete with the term loans, fixed return investment instruments, and treasury products used by their conventional counterparts. IFIs are, after all, for-profit entities, and their responses to real commercial pressures are understandable. However, it is reasonable to question whether the continued reliance on products that are readily susceptible to accusations of Shari'ah violations and innovation shortcomings are in the best long-term interest of IFIs and the Industry. More important, the wide use of such instruments, to the exclusion of innovative Islamic PLS-based offerings, denies the Industry the opportunity to know and capitalize on its true potential market share, as many consumers will avoid products that appear to be Islamic in name only.

• Ensuring Shari'ah Compliance, From Cradle to Grave. The TID and Shamil cases both involved claims that "Islamic" agreements were effectively interest-bearing. Such accusations, if made frequently and publically, undoubtedly will have damaging effects for specific IFIs and the Industry at large. IFIs must ensure that their instruments and transactions are structured, documented, and executed in a manner that minimizes the risk of Shari'ah challenges. This means that the letter and spirit of fatawa, forms of agreements, and transaction structures reviewed and approved by Shari'ah Boards must not be altered over the course of their lifetime, unless re-submitted and re-reviewed for Shari'ah compliance. Coordination and vigilance across operational units (e.g., management, compliance and legal, risk management, and transaction teams) is essential to ensure that the Shari'ah character of instruments remains intact after Shari'ah Board approval.

Managing Litigation and Derivative Commercial Risk

• Legal Risk Management Should Reflect Sound Governance. Legal risk is as much a part of doing business as commercial risk, and legal risk management is part and parcel of corporate governance. IFIs (like other entities) must conduct their affairs in a manner that demonstrates an appreciation of legal risk, before legal disputes arise. As a matter of policy, legal risk and litigation management protocols should be written, periodically reviewed (internally and with outside counsel), and explained and disseminated to IFI personnel at regular intervals. Well-crafted protocols should address, among other issues: (1) internal approvals and considerations necessary in deciding to proceed with litigation (e.g., based on the nature of disputes, amount in controversy, likelihood of publicity, etc.); (2) forum type (e.g., arbitration, mediation, national courts); (3) jurisdiction (considering, e.g., quality of courts, typical duration of litigation, expense, and ability to adjudicate substantive issues); (4) governing law; (5) likelihood and extent of commercial risk attendant to litigation strategy; (6) internal document retention and record-keeping procedures; (7) and, the ability to produce evidence.16 Legal risk and litigation management protocols should facilitate informed decisions about litigation, including whether the potential benefits of a legal strategy are outweighed by any attendant commercial risks.

• Sound Legal Risk Management Requires Coordination Across Back Office Functions. The Blom case presents a striking example of the harm that can result from a lack of coordination in making litigation decisions. The assertion in court of Shari'ah-non-compliance by an IFI whose constitutional documents prohibit its engagement in Shari'ah-non-compliant transactions is striking, to say the least.[17] Where Shari'ah compliance is potentially subject to dispute, the IFI's Shari'ah Board should be asked to review, with the assistance of legal counsel and relevant departments, germane documentation and transaction history and assess Shari'ah merits, before any litigation strategy is pursued. The wisdom of this approach is borne out by the TID Shari'ah Board's untimely advice that TID abandon its legal dispute with BDB.

• Evidentiary Inadequacy of Post Hoc, Wholesale Certification of Islamic Transactions. In the Shamil case, Shamil Bank submitted year-end Shari'ah Board Reports (SBRs) as proof that the disputed transactions with Beximco had been "certified" by its Shari'ah Board. The certifications were not specific to the Shamil Bank-Beximco transactions. They stated: "The Board believes that all the bank's business throughout the said year, including investment activities and banking services, were in full compliance with Glorious Islamic Sharia'a."[18] The evidentiary value of the certifications was not scrutinized because Shari'ah principles were not applied to decide the case. As a general matter, IFIs should be aware that such post hoc, sweeping certifications (in SBRs or otherwise), without more, might not be sufficient proof of Shari'ah-compliance or adequacy of Shari'ah oversight in litigation or in other contexts. With this in mind, IFIs should consider whether internal records of Shari'ah approval, review, and compliance are of a type and quality that would evidence Shari'ah compliance in litigation or other contexts. A good record-keeping and retention policy should address such issues.

• Governing Law and Forum Selection Should Demonstrate Commitment to Shari'ah-Compliance. Many parties to Islamic Finance contracts select secular (e.g., English) law and courts in their governing law and forum selection clauses, for good reason. English and other jurisdictions outside of Islamic Finance hub jurisdictions provide the transparency and predictability necessary for effective dispute resolution. At the same time, as was the case in Shamil, secular courts will often refuse to apply Shari'ah, apply it in a limited fashion, or are ill-equipped to interpret Shari'ah if applied.[19] IFIs, while reasonable in choosing such jurisdictions, should draft their governing law and forum selection clauses to ensure that Shari'ah principles are applied to decide the substantive elements of legal disputes. The use of governing law clauses that effectively incorporate Shari'ah is in the interest of IFIs and the Industry generally. If Islamic Finance cases continue to be decided under secular law, to the exclusion of Shari'ah, legal ambiguity will continue to hinder sustainable long-term growth because of legal uncertainty. Separately, IFI-drafted governing law clauses that have the foreseeable effect of excluding Shari'ah suggest a lack of commitment to Shari'ah and its enforcement. As the trial judge noted in Shamil: "The English court, as a secular court, is not suited to ascertain and determine highly controversial principles of religious-based law and it is unlikely that the parties would be satisfied with any such ruling; that is not what they were wanting by their choice of law clause."[20]

Shari'ah Board Reports: Disclosure Quality and Brand Management

As succinctly stated by the Islamic Financial Services Board (IFSB): "Compliance with Shari'ah rules and principles is the raison d'être of the Islamic Financial Services Industry."[21] Shari'ah Board Reports (SBRs) issued by IFIs should reflect this existential truth, in two ways. First, IFIs should ensure that their SBRs fully describe the Shari'ah governance apparatus in place, to communicate to consumers, shareholders, regulators, and the public the importance and role of Shari'ah governance at the IFI level. Second, SBRs are an excellent marketing medium for IFIs, and they should be used to bolster the Islamic brand.

• Bolster the Level of Disclosure in SBRs. IFI SBRs tend to share a common structure. First, they state that operations complied with applicable fatawa and Shari'ah generally. Second, they assure readers that all profits derived from non-Shari'ah-compliant transactions were set aside and paid as zakat (charity). Third, SBRs usually reiterate that responsibility for governance, including Shari'ah governance, rests with IFI management. Fourth, SBRs typically state that the Shari'ah Board discharged its oversight functions based on information and documentation (e.g., audit reports) provided by IFI management. Finally, the signatories of SBRs often are scholars known to have held multiple Shari'ah board positions during the reporting year. These five common features highlight places where disclosure can be enhanced, along the following lines.

- The nature of the Shari'ah governance apparatus in place (e.g., the manner in which Shari'ah compliance audits are conducted and their frequency, clarity as to whether the Shari'ah Board itself reviewed documentation (e.g., by sampling) or relied on summaries of documentation). - Information about the human, technological, and departmental resources that are devoted to Shari'ah compliance, etc., and their place in the IFI's organizational structure. - The setting aside of improperly gained profits is itself an element of Shari'ah compliance. However, disclosures of such instances must be reasonably explained and accompanied by details of remedial measures that were or will be implemented to avoid or reduce instances of non-compliance in the future.

• The SBR as Marketing Tool. SBRs serve necessary (and in jurisdictions where they are required by regulation, mandatory) functions. But they also should be used proactively as marketing tools. SBRs provide IFIs with a rare opportunity to educate a diverse pool of readers about the nature of their business model and objectives, and to differentiate their brand. Using SBRs as effective marketing tools requires that they be written eloquently and thoroughly, to achieve the purpose of informing readers about the importance of Shari'ah governance, the Shari'ah governance processes in place within the publishing IFI, the commercial and ethical objectives of Islamic Finance, and distinctions between IFIs and their conventional counterparts, etc.

The Role of Shari'ah Boards

• Empowering Shari'ah Boards. Shari'ah Boards sit at the narrow apex of the Shari'ah compliance pyramid. They make and interpret the rules, and they are charged with a degree of oversight. But, with few exceptions, they are not full-time employees of the IFIs which they serve. IFIs must ensure that Shari'ah Boards are equipped with the resources necessary to discharge their duties. Such resources might include assigning full-time, dedicated Shari'ah governance personnel (e.g., legal counsel, compliance professionals, accountants, etc.) with responsibility for reviewing documentation, audit reports, and transactions on a regular basis. Such dedicated Shari'ah Board personnel should report directly to the Shari'ah Boards that they serve, and should have a meaningful degree of independence from other operating units of IFIs.

IV. Industry-Level Facilitative Measures: Building a Specialized Legal Infrastructure

Many Industry participants and observers have called for binding standardization to promote predictability and transparency in Islamic Finance. Whether standardization is a feasible and wise option in the near-term is open to debate. In the meantime, other measures can be taken to promote predictability and transparency.

• Facilitate Development of Contemporary Islamic Economic Law. Shamil and Blom are two of many cases involving IFIs that have been tried in secular courts. Frequent and widespread resort to secular fora, over the long term, will stunt the development of contemporary Islamic economic law. As demonstrated by the Shamil case, secular courts will not always apply religion-derived law to settle disputes. The result is that modern Islamic economic instruments are not being scrutinized under the laws with which they purport to comply, thus perpetuating legal ambiguity.

• Specialized Dispute Resolution Fora. As Islamic Finance continues to grow, so will the number of disputes. The need is clear for specialized fora to resolve Islamic Finance disputes, accommodate parties, and facilitate the transparent development of contemporary Islamic economic law. The accumulation of legal decisions through such fora would engender standardization of norms, without the potentially negative consequences of standardizing rules based on insufficient Industry experience. Of course, any such specialized fora, to be viable, must offer a degree of transparency, predictability, and efficiency on par with English and other secular systems, with the much needed benefit of substantive Shari'ah expertise.

• Shari'ah Expert Vetting, Training and Roles. In the Shamil case, as in others involving Islamic law and tried in secular fora, the services of Islamic legal experts were utilized. So long as Islamic legal experts are needed, the Islamic Finance Industry has an interest in ensuring that persons acting as Islamic banking and finance experts are qualified to do so. Relatively modest measures can be taken to promote and maintain quality amongst experts. For example, training and certification programs and the creation of a register of experts through such programs. Of course, measures would be necessary to ensure that such measures do not have the undesirable effect of excluding any Shari`ah interpretations or points of view, as long as competency is guaranteed.

V. Conclusion

Without question, contemporary Islamic Finance has grown tremendously in a short period of time. This growth and the raised visibility that has accompanied it present challenges and opportunities. Islamic Finance has reached the point of maturity at which introspective questions about its essence and place in the world of financial services must be asked and considerately answered. Unanimity of opinion among Industry participants and observers as to the future of Islamic Finance is unlikely. Whatever the outcome, the path to sustainable growth must begin with operational excellence, which is the key to unlocking lasting value in Islamic Finance.

Footnotes

2 This aya (verse) appears in Surat Al Baqara, Chapter Two of the Holy Qur'an. Surat Al Baqara, comprised of 286 ayat (verses), is the longest Chapter in the Qur'an and is said to sum up "the whole teaching of the Qur'an." Abdulla Yusuf Ali, THE MEANING OF THE HOLY QUR'AN (Amana Publications, 11th ed. 1425AH/2004AC) at page 16.

3 The Investment Dar Company KSCC v. Blom Development Bank SAL, 2009 EWHC 3545 (Ch), available here (last accessed October 2010); Shamil Bank of Bahrain EC v. Beximco Pharmaceuticals Ltd., 4 All E.R. 1072 (2004), available here (last accessed October 2010).

4 Consumers of Islamic financial products are more akin to equity investors, partners, and co-venturers than they are to consumers of conventional debt-based products. In assessing equity-based investments and ventures, the soundness of management and operations figures prominently. The quality of the management and operations of IFIs should figure equally prominently in the assessment of Islamic products.

5 A recent survey of Islamic Finance leaders in the Middle East revealed that 66% of survey respondents believed that the Islamic Finance industry is "under-regulated." See The Deloitte Islamic Finance leaders survey in the Middle East, Benchmarking practices, Biannual Survey Issue 1, at page 13, available here (last accessed October 2010) (hereinafter the "Deloitte Survey").

6 Resolution on Sukuk, ACCOUNTING AND AUDITING ORGANIZATION FOR ISLAMIC FINANCIAL INSTITUTIONS, February 2008, available here (last accessed October 2010).

7 Indeed, only 59% of respondents to the Deloitte Survey stated that the entities they represented had in place "corporate governance/procedures", while 39% did not. At the same time, 58% percent of survey respondents "viewed corporate governance and Sharia'a governance as prerequisites for best practices." See Deloitte Survey, supra note 5, at page 12.

8 Blom at para. 14.

9 Blom at para. 3.

10 Blom at paras. 16, 17.

11 Blom at para. 16.

12 See Investment Dar Gets Sharia Board Blow to Blom Case, arabianbusiness.com, June 9, 2010, available here (last accessed October 2010).

13 A more detailed discussion of the Shamil case is at Hdeel Abdelhady, Islamic Law in Secular Courts (Again): Teachable Moments From the Journey, ABA INTERNATIONAL LAW NEWS VOL. 38, NO. 4 (FALL 2009), reprinted at OPALESQUE ISLAMIC FINANCE INTELLIGENCE DECEMBER 2009, available here (last

accessed October 2010).

14 The trial court opinion is Shamil Bank of Bahrain v. Beximco Pharmaceuticals Ltd., 2 All E.R. (Comm) 849 (2003) (herein “Shamil I”).

15 Shamil at para. 55.

16 Where agreements call for litigation before national courts, as in the Blom and Shamil cases, the likelihood of a published opinion (particularly at the appellate stage) is high. On the other hand, if parties have opted for arbitration, the likelihood of a published opinion is slim to none, depending on the terms of arbitration, e.g., the forum selected, procedural rules, and confidentiality provisions, etc.

17 Note also that TID had a Shari'ah-based obligation to fulfill the contract that it made. See, e.g., Qur'anic verse 2:177 from Surat al Baqara quoted above.

18 Shamil at para. 8.

19 In Shamil, the disputed agreement contained a governing law provision stating that: “Subject to the principles of the Glorious Sharia'a, this agreement shall be governed by and construed in accordance with the laws of England.” Shamil at para. 1. The English court did not apply Shari'ah, because under English law, the law of decision in English courts must be a law of another country, and not a “non-national” system of law. Therefore, the Shamil case was decided under English law, even though, as noted, the English Court in that case commented that the outcome likely would have been different if Shari'ah had applied.

20 Shamil I at para. 36.

21 Guiding Principles on Shari'ah Governance Systems for Institutions Offering Islamic Financial Services, ISLAMIC FINANCIAL SERVICES BOARD, December 2009, available here (last accessed October 2010).

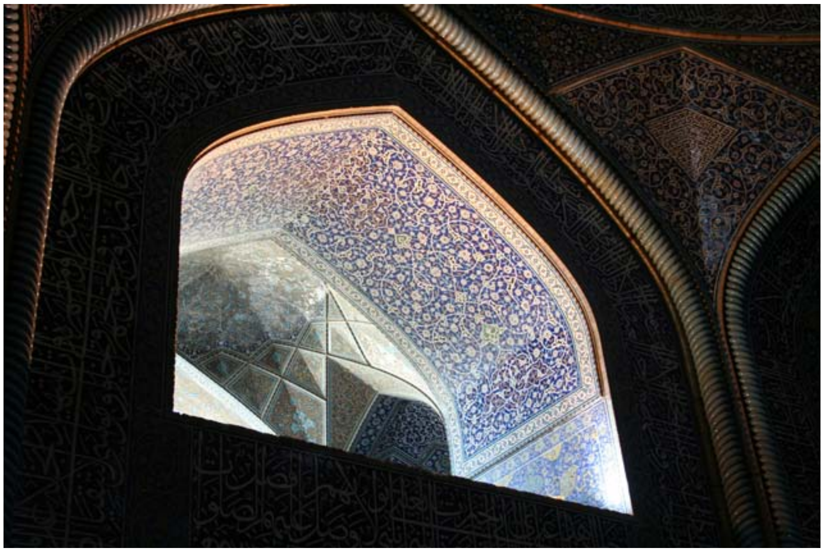
Your feedback and comments are very important to us, please feel free to contact the author via email.

On the Theoretical Dichotomy of Islamic Finance

By Nagaoka Shinsuke Ph.D.

The author is Postdoctoral Research Fellow at Kyoto University in Japan. He has published the paper "Beyond the Theoretical Dichotomy in Islamic Finance: Analytical Reflections on Murabahah Contracts and Islamic Debt Securities" in the Kyoto Bulletin of Islamic Area Studies, and the paper can be viewed in full through the following link.

Introduction



In general, the field of research on Islamic finance (which is often called "Islamic economics") is closely related to its parent industry. This is because in the twentieth century, Islamic economics emerged as a movement to launch a new economic system in the modern world, which is based on Islamic teachings, and subsequently, it was required to submit practical designs to those who wished to establish Islamic economic institutions such as Islamic banks. To date, a considerable number of works have been released and most of these contain such practical claims and recommendations, even if their authors are purely academic scholars.

In contrast, my paper "Beyond the Theoretical Dichotomy in Islamic Finance" neither contains any claims, policy recommendations, or immediate information about the industry, nor does it show a new interpretation of the Islamic jurisprudence of the Sharia scholars' circle. Therefore, the tone of my paper seems peculiar or peripheral in the literatures of Islamic economics. In this short essay, I attempt to explain why, being a Japanese academic researcher, I write (or should write) such papers with such tone..

Back Story: Islamic Finance, Islamic Economics, and Japan

The first reason is that Islamic finance is not necessarily thriving in the domestic market; therefore, there is little demand for writing practical papers for the industry. Since 2001, several Japanese banks and insurance companies have entered the Islamic financial markets overseas. In contrast, Japanese banks are extremely reluctant to start providing Islamic financial services in the domestic market in spite of the fact that the Japanese government amended the Banking Law in December 2008, which enables domestic banks to open subsidiaries engaging in Islamic finance. Currently, there are no Islamic banks or Islamic branches in Japan. Although they have jointly established a practical research team on how to launch Islamic finance in the domestic market, their research is limited only to primary investigations and mainly relies on the advice of world-famous Sharia scholars and local consultants. In such a situation, there is no scope for Japanese academic researchers to write practical papers for the industry. Of course, I can write such kinds of papers responding to scarce demand, but this will reduce the raison d'être of academic researchers in terms of a comparative advantage.

The second reason is that my original motivation to study Islamic finance is not to commit to the practical movement to launch the Islamic economic system but to find some crucial keys to criticize modern capitalism from this movement. It is well known that the movement of Islamic economics originally aimed to provide an alternative way to modern capitalism. However, it seems that the current practice of Islamic finance almost abandons this motivation. This is because Islamic finance develops nearly similar products as well as modern capitalistic finance in order to be highly competitive with it. It can be said that my research aims to rediscover this original motivation of Islamic economics and to find a distinctive feature of the economic concept of Islam. This means that I ought to write on "what Islamic finance is," not "what Islamic finance should be." Here, we should consider that our explanation should be such that mainstream economists can fully understand its argument. This is because existing literatures on Islamic economics have been criticized as "dogmatist" and as displaying the tendency to be satisfied only when discussions are held on their terms. The underlying feature of Islamic finance is written with this criticism in mind.

The third reason is that studies on Islamic finance are still inadequate in Japan; therefore, Japanese academic researchers need to adopt an original or unique approach in order to show their comparative advantage over the considerable number of works released in Islamic economics. In my opinion, there are two ways to show this advantage: 1) analysis from an outsider's perspective and 2) historical approach. The first approach is what I adopt in this paper (see reference link). Most works that contain any claims and policy recommendations are written from the author's individual standpoint, and subsequently, they tend to ignore opinions provided by the opponent party or have no interest in such opinions. Therefore, it is extremely difficult for readers to understand the point and framework under arguments. In contrast, my paper adequately presents the opinions of both proponents and opponents regarding the arguments on Murabahah and the Islamic debt securities, and clarifies the framework of the arguments. As for the second point, the historical approach, I adopt another paper—"Islamic Finance in Economic History: Marginal System or Another Universal System?"—which was presented at the workshop of EM Strasbourg Business School (March 17, 2010).

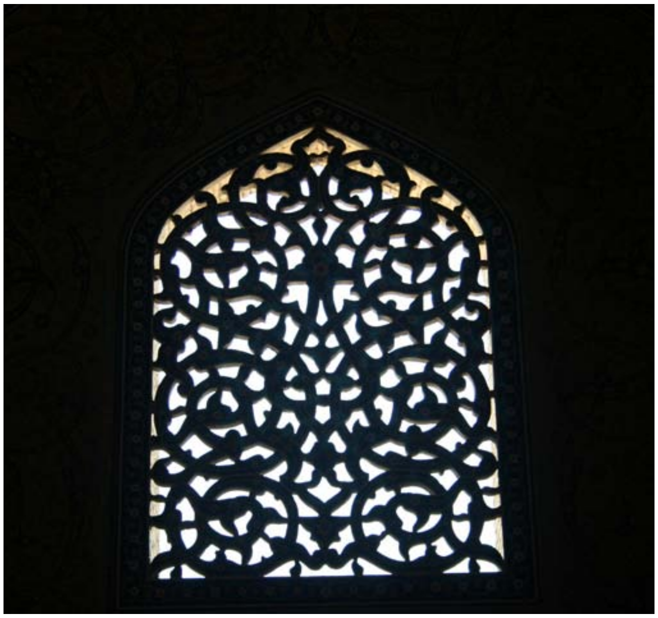
Towards "Global Islamic Economic Studies"

My research methodology is beyond the realm of Islamic economics, although I learn considerably from it. Therefore, I want to call this new methodology, which has its own features of "third-party perspective" and "historical approach," as "Global Islamic Economic Studies." Islamic economics is not necessarily understood by outsiders such as mainstream economists because it has not had sufficient conversation with mainstream economics or because it has been completely absorbed into mainstream economics. "Global Islamic Economic Studies" will not only present issues regarding the current theory and practice of Islamic finance as mentioned in this paper but also consider how basic economic concepts such as money, labor, and market are treated in Islam (both in history and present days). When we can clarify the distinctive features of these concepts in Islam with an explanation that mainstream economists can fully understand, we can have a better conversation with mainstream economics. This does not indicate the convergence of Islamic economics into mainstream economics. Instead, we can cast doubt on the universality of mainstream economics by showing a different world on an equal footing.

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

E.P.L. in Islamic Finance - Education (Extra Time)

By Joy Abdullah



With dual expertise in strategic business planning and brand marketing, Joy Abdullah is a Strategic Brand Enabler. Such synthesis of strategic planning enables Joy to aid brands in having a strong reputation, clear image and efficient delivery. Joy's areas of focus are on creating synergies in the business plan objectives and assisting the brand to deliver growth and profitability for an organisation by encompassing governance requirements, corporate values, identifying critical brand risk areas amongst key stakeholders, and market forecasting into the brands' activities.

He has written various articles on the importance of ethical brand marketing encompassing brand reputation management, employee-brand relationship and CSR.

Post the global financial crisis, the business world has been transformed drastically in more ways than one. Industries have had to, quite literally, pull up the hand-break, come to a screeching halt and turn on a dime, in terms of adapting to the changing socio-economic scenario. Irrespective of whether the businesses are in B2B (business to business) or B2C (business to consumer) functions, many of the golden rules have had to be cast aside and new game rules learnt in order to simply ensure survival.

The Islamic Finance industry is not impervious to these changes. In fact the industry is at a crossroad: Does it carry on as it has (and probably) fades away in time, gets relegated to a 'regional financial management facility', or does it absorb the changes around it and re-aligns to the realities and grow?

The editorial article of OIFI's January issue –Islamic Finance Incommunicado– (see reference link) aptly summed up the current state of affairs in Islamic Finance by saying "It seems that Islamic finance is getting a makeover". There definitely exists an issue of awareness and perception of 'Islamic Finance' both from within the industry and at the outskirts at the consumer/retail level. This is substantiated by this short news item entitled "Islamic Finance still faces challenges" (see reference link) where Professor Volker Nienhaus, an academic under the Securities Commission-Universiti Malaya Visiting Scholar Programme says the following:

--› "more people were looking at Islamic finance because it was more resilient and efficiency."
--› "But the Islamic finance practiced now is not much different from the conventional system,"
--› "A lack of participatory finance, like low retail penetration, is another stumbling block,"

This boils down to a lack of "education" (i.e. awareness and comprehension) of what exactly is the value proposition of Islamic Finance. In order to survive the industry has to adapt and grow. To do this, it needs to re-focus itself on to what the consumer wants. The key lies in the industry being willing to be "consumer-centric". At the end of the day, in any industry, the consumer is the reason one is in business (see reference link) and it is critical to identify a strong 'value proposition' that connects with the consumers at different levels. Without a well-articulated and robust value proposition there is no strategic platform for a commercial enterprise to have sustainable growth. Without growth there is no future. In this scenario, it's important to note that the consumer in this case is the individual decision maker for an organisation (B2B) who also is interested in his personal financial management (B2C).

Can Islamic Finance be consumer centric?

Perhaps this may seem easier said than done. But it's not impossible. The key ingredient, in order to achieve this turnaround is commitment. Commitment in understanding the global socio-economic trends and in providing necessary EDUCATION to people in order for them to have a clear understanding and thus, the correct, perception of Islamic Finance.
Where does this commitment come from?
The encouragement will come from within the Islamic Finance industry by the organisations (IFI's and IB's) evaluating their long term strategic direction and taking the efforts to forge partnerships with the various academic institutions (globally) in order to:

I. Provide knowledgeable industry practitioners to teach (the specific operational requirements of the industry) to the students thus leading to ensuring that the industry has a properly skilled talent pool each year

II. Jointly research (on key subject matters including product development and consumer needs) in order to improve current products and processes thus ensuring sustainability and growth

How do we bring this about?

Daud Vicary (Global Leader of the Deloitte Touche Tohmatsu (DTT) Islamic Finance Industry group) in his article—"EPL in Islamic Finance: Education" has very correctly shown the three key areas in which education on Islamic Finance needs to be implemented and implemented with the objective of ensuring clarity and comprehension. Of the three areas, the single most important one is "*General Mass Awareness*".

Improving mass awareness is critical in ensuring that Islamic Finance retail products are accepted and used. However the retail market has its own set of complexities. Depending on the geographical market, awareness and comprehension, of Islamic Finance varies from negligible to aware but not convinced and coupled with that comes specific biases based on socio-cultural conditioning. There is, unfortunately, not a "one-size'fit-all" strategy for educating the mass. In each end market one will have to adapt according to the needs of the retail consumer.

However, on a macro level, one of the industry bodies will have to take the lead and put in place an "educational campaign" that is not an Islamic Finance Module 101 BUT a "Financial Literacy" module that focuses on the salient points of investment, savings, individual financial management from the perspective of Islamic Finance and, most importantly, the value proposition of Islamic Finance.

The content (of this campaign) would be the key in ensuring increasing awareness and comprehension and would need to ensure it:
• demystifies Islamic Finance and clearly puts forth a rational value benefit
• highlights what is the benefit of key retail products
• simplifies the investment products and communicates transparently on how the 'back-end' works

In terms of delivery of the campaign a multi-media approach, with emphasis on social media utilization, would be necessary in order to allow the mass to interact with selected industry practitioners and enable:
a) feedback--which would help measure improvements of the educational campaign--AND
b) let the practitioners to know the 'pulse' of the mass i.e. what are their financial needs

Business strategy-wise such a campaign will enable the Islamic financial institutions to identify what the consumers want in terms of investment and retail products and thus ensure product portfolio profitability. Therefore, the crucial question for the industry at this time is: To Be Consumer Centric or Not To be?

Whilst Islamic Finance continues its growth based on corporate business. Will this provide it a sustainable growth? Would global organisations want Islamic Financing? OR should the industry develop a strong retail base in order to ensure this sustainability? Educations of the masses can assist in the growth and in fact ensure preference for Islamic Financial products but it will lead to improving current perceptions and thereby bring about a preference in the category from up and coming generations. The question remains unanswered, will the industry choose to be consumer centric?

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

Bahrain: Time to be Truly Business-Friendly

By Douglas Clark Johnson

Douglas Clark Johnson is CEO and Chief Investment Officer of Codexa Capital. He has held previous roles in Prudential Financial and Merrill Lynch and is a frequent commentator on global industry trends. Johnson holds dual master's degrees in finance and international affairs from Columbia University, with an emphasis on Asia and its capital markets. He earned a bachelor's degree in finance from Georgetown University, and studied at Sophia University in Tokyo.

Over coffee in Kuwait, friends encouraged me not to go to Bahrain. I was admittedly nonchalant. "Not much ever happens there," I said, relying on 20 years of uneventful travel to the island country. And besides, Gulf Air 216 is an easy end-of-the-day shuttle flight.

From a car maneuvering past the Pearl Roundabout, the demonstration seemed to me largely peaceful, although accompanied by plenty of unflattering placards about the current regime. I credited it to freedom of expression and assembly. These are values not well appreciated across many of the other countries in which we operate.

Bahrain seemed to me the last place in the Gulf where a government would react aggressively. The subsequent TV images of tanks in Manama were difficult to digest.

As career-long advocates of the financial regulatory infrastructure promoted by Bahrain, my colleagues and I have always felt that we owned a bit of the place, metaphorically speaking. We consider the unilateral approach to regulation (offshore and onshore) advocated by Bahrain regulators to be more efficient than the bilateral approach (offshore or onshore) promulgated elsewhere. We have had funds approved by the Central Bank; we use service providers in the market; we have many friends in the local investment and banking industry.

We now have to wonder how the international community will react when we advocate for engagement with Bahrain. We can only hope that industry policy will remain separate and distinct from political maneuvering. Whatever the Shiite demands on the Sunni-led government, few have ever spoken against ongoing development of the financial services sector, which accounts for roughly 25% of the country's GDP.

Economically speaking, Bahrain seems more or less a model nation by comparative objective metrics. We consider three indicators:

Corruption. Bahrain meets a reasonable standard here. Transparency International ranks the country as 48th in the world in its 2010 Corruptions Perceptions Index. The ranking is better than Malaysia's and in line with those of Poland and the Czech Republic. See transparency.org (see reference link) for more information.

Competiveness. Bahrain holds its own in providing business opportunities. In the regional version of the World Bank's Doing Business survey, the country ranks second in the 18-country Middle East and North Africa grouping. Saudi Arabia is at the top of the list. See doingbusiness.org (see reference link) for more information.

Income Equality. One measure of wealth distribution is the Gini coefficient, with 0 representing perfect equality and 100 representing perfect inequality. The data estimates for the GCC range from 30 to 39, with Bahrain sitting solidly at 36. The number for the United States is actually farther from equality at about 45. See visionofhumanity.org (see reference link) for context.

Gini coefficients may measure equality of income, but they assuredly do not measure equality of opportunity. That may be the crux of the matter behind this civil unrest. The Khalifa family is the focal point for dashed aspirations, magnified by the global downturn. Literacy has climbed from 70% in 1981 to more than 90% today, but the rise in value-added labor positions has been relatively weak, at least on an observational basis. Official unemployment lingers at 5.5%, but the number seems fanciful for 15-to-24-year-olds.

In the absence of hydrocarbon resources, Bahrain tends to play the role of poor cousin among its GCC brethren. The country actually may not be so underprivileged—both Saudi Arabia and Oman have lower per capita income levels than Bahrain. The nation's decades-long emphasis on growing other business segments, especially finance, has evidently been paying off.

Bahrain's shortage of oil accompanies a wealth of visible sectarian issues, especially compared to other Gulf nations. The Shiite majority has been vocal in declaring a lack of economic opportunity. The attendant rage is common to humankind.

Not long ago, the entry stamps inside my passport started proclaiming "Business Friendly Bahrain." The slogan is the foundation of a public relations and advertising campaign rolled out by the Bahrain Economic Development Board. Interestingly, this government department is chaired by Crown Prince Salman Bin Hamad Al-Khalifa, who stepped to the forefront as the monarchy shifted away from a hawkish stance toward an appeal for national dialogue with demonstrators.

Having seen the prince in action as his country's business ambassador, we have some confidence in his ability to listen, synthesize, and articulate solutions. Commercial interests in flourishing trade and open markets tend to form the most potent long-term force for peace and understanding. Our point is pragmatic, not cynical.

Now more than ever, Bahrain needs to figure out how to be truly "business friendly." If the nation's economic strategy relies on the enthusiasm of the international business community, regaining global confidence will be critical to providing economic opportunity of any degree, let alone parity among citizens. The government has a very full plate.

The picture of Bahrain unveiled to the world in mid-February is quite different from the one depicted on the website of the Bahrain Economic Development Board (see reference link). We look forward to a return to alignment.

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

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