

MIDDLE EAST INSIGHTS

ISLAMIC FINANCE SPECIAL

MIDDLE EAST INSTITUTE, NATIONAL UNIVERSITY OF SINGAPORE



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TOWARD THE REFORMATION OF ISLAMIC FINANCE: SOUTHEAST ASIAN PERSPECTIVES

BY CLEMENT M. HENRY

The present collection of papers evolved from a workshop organized 16-17 February 2016 by the Middle East Institute for academics and practitioners to exchange insights about the development of Islamic finance in Brunei, Indonesia, Malaysia, and Singapore. Why the MEI engaged in such an undertaking perhaps deserves a word of explanation. While it was the Middle East, principally Egypt and the countries of the Gulf Cooperation Council (GCC), which launched the international experiment in interest-free banking in the 1960s and 1970s, it may well be that the core countries of Southeast Asia become the principal guarantors of its future.

The numbers in the following table tell part of the story. Saudi Arabia, followed by the smaller GCC states of Kuwait, Bahrain, Qatar, and the United Arab Emirates (UAE), have amassed the greatest market shares of Islamic bank deposits (along with Lilliputian Brunei), but potentials for future growth lie elsewhere. Whereas the largest concentrations of Islamic financial assets are found among the relatively small and wealthy populations of the GCC, the biggest potential for Islamic banking lies in Indonesia, with its huge population including 220 million Muslims and, despite their relative poverty, a gross domestic product greater than that of any other Muslim majority country. Indonesia's 19 million Islamic bank accounts probably outnumber

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those of any other country with the possible exception of Bangladesh, and they are just the tip of the iceberg as we shall later see.¹

Table 1: Financial Surfaces of Muslim-Majority States, 2014.

	GDP	Population	Per capita		Deposits	Islamic %
	(billions)	(millions)	GDP	M2/GDP	as %M2	deposits
Algeria	\$213.5	38.9	\$5,484	70.9%	72.5%	1.6%
Bahrain	\$33.9	1.4	\$24,855	73.9%	95.1%	32.4%
Bangladesh	\$172.9	159.1	\$1,087	63.1%	87.5%	20.0%
Brunei Darussalam	\$17.1	0.4	\$40,980	67.5%	92.0%	41.0%
Egypt, Arab Rep.	\$286.5	89.6	\$3,199	80.4%	80.9%	10.3%
Indonesia	\$888.5	254.5	\$3,492	39.6%	86.6%	5.1%
Iran, Islamic Rep.	\$425.3	78.1	\$5,443	56.8%	94.4%	100.0%
Kuwait	\$163.6	3.8	\$43,594	72.2%	95.4%	47.3%
Malaysia	\$338.1	29.9	\$11,307	137.1%	95.0%	22.7%
Morocco	\$110.0	33.9	\$3,243	112.6%	75.8%	0.0%
Pakistan	\$243.6	185.0	\$1,317	40.6%	76.0%	10.3%
Qatar	\$210.1	2.2	\$96,732	65.9%	97.3%	26.0%
Saudi Arabia	\$746.2	30.9	\$24,161	55.9%	90.7%	49.6%
Turkey	\$798.4	75.9	\$10,515	60.5%	91.8%	6.6%
United Arab Emirates	\$399.5	9.1	\$43,963	56.2%	95.2%	24.7%

Malaysia is also of special interest, despite its relatively small population and middling GDP and per capita income, because it has engaged in greater financial deepening (M2/GDP), typical of more advanced economies, than any other Muslim majority country. Not only is its financial surface over 137 percent of its GDP. It also keeps 95 percent of its money supply inside the banking system rather than in fiduciary currency (cash stored at home or in one's pocket). Malaysians seem to trust their banks. 80.4 percent of those age 15 and above have bank accounts, compared to only 69.4 percent of the Saudis.² Consequently, despite an economy less than half the size of Saudi Arabia's, Malaysia has a larger money supply and an even greater deposit base than that of the Saudi banking system. While its Shariah-compliant market share was less than half that of Saudi Arabia in 2013, its total Islamic deposits and assets, already over half the latter's, were likely to grow more rapidly. Malaysia's Central Bank (*Bank Negara*

¹ The only possible competitors indicated in Table 1 are Saudi Arabia, Pakistan, and Bangladesh. The World Bank's *Little Data Book on Financial Inclusion* indicates that the 69.4, 13.0, and 31.0 percent of their respective adult (15+) populations (of 20.5, 120.5, and 109.6 million) had bank accounts in 2014, compared to 36.1 percent of 177.7 million adult Indonesians. Microfinance seemed as prevalent in Bangladesh as in Indonesia, and the country's greater Islamic share of deposits perhaps compensate for the smaller total population.

² World Bank, 2015 *The Little Data Book on Financial Inclusion*, Financial Inclusion Database.

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Malaysia or BNM) projects an Islamic market share of 40 percent by 2020; by then its Shariah-compliant deposits might actually exceed Saudi Arabia's.

Indeed, the other part of the story lies in Malaysia's financial management and corporate governance. Malaysia has pioneered a national model of supervision and regulation of Islamic finance that accelerated its penetration of the conventional banking system. Brunei and Indonesia are emulating this model. Its deliberate institutionalization of Islamic finance from above contrasts sharply with the more ad hoc processes of monetary authorities in other countries.

One key difference lies in the very definition of an Islamic bank and who defines it. Writing in 2000, Ibrahim Warde left the responsibility to religious scholars. 'Any bank with a supervisory board of Shariah scholars' became his working definition. But by this definition Dubai Islamic Bank, founded in 1975, would not have qualified until 1998, whereas some of Egypt's rogue *sharikat tawzif al-amwal* (investment companies) might have qualified in the mid-1980s, when they were using religious scholars for public relations to cover their pyramid schemes. The semi-official association of Islamic banks based in Cairo at the time did not recognize the upstarts, but even today no official transnational instance has the authority to evaluate religious scholarship and the compliance of a bank with the Shariah. The Islamic Financial Services Board (IFSB), established with help from the IMF to regulate Islamic financial institutions, "determines that appropriate *Shari'ah* compliance systems are in place;" in other words, this transnational authority merely supervises procedures. Islamic Financial Institutions are supposed to have a Shariah Supervisory Board (SSB) of at least three scholars. The banks and scholars are free to negotiate their relationships in much of the Middle East and Africa.

In Malaysia, by contrast, the BNM established a National Shariah Council to interpret Shariah and regulate the SSBs of individual Islamic banks and windows of conventional banks. This model is now attracting the attention of the monetary authorities of other states like Morocco that wish to avoid the ambiguities of conflicting interpretations of Shariah-compliant banking practices. In Indonesia, too, a National Shariah Board (NSB) consists "of the Islamic law experts (*fuqaha*) as well as practitioners and economists, particularly in the financial sector, both banks and non-banks."³ As in Malaysia, the Shariah boards of individual banks must adhere to the interpretations adopted by the NSB.

The *laissez-faire* alternative practiced in much of the Arab world has encouraged an alternative market-oriented way of harmonizing interpretations of Shariah consonant with Islamic finance. The outcome of negotiations between banks and religious scholars reveals remarkable concentrations of scholars affiliated with the Shariah supervisory boards of the banks. Murat Ünal (2011) counted 20 top scholars

³ National Shariah Board, Indonesian Council of Ulama, *Fatwa*, published in cooperation with the Central Bank of Indonesia, 2012, p. iv.

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occupying 621 board memberships as of December 31, 2010, while the remaining 260 scholars had only 520 positions in his data set, which included some 350 IFIs of Malaysia, Pakistan, the United Kingdom and the United States as well as most Arab countries. There was considerable overlap, too, between the top scholars serving on the boards of banks and those who set the global standards of Islamic finance in the IFSB, headquartered in Kuala Lumpur, and its sister Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in Bahrain. Eight of the top 10 scholars also each held from three up to 12 positions in these and other standard setting institutions such as unions, foundations, government entities, and consulting firms.⁴

Each bank board included at least three scholars, and the top scholars tended to share their extensive networks with each other, further consolidating their hierarchy. At the apex of the scholarly hierarchy in 2010 Abdul Satar Abdul Karim Abu Ghuddah of Syria, Nizam Muhammad Yacoubi of Bahrain, and Muhammad Ali Elgari of Saudi Arabia occupied respectively 101, 95, and 86 positions in IFIs and standard setting bodies. Each had at least a 50-50 chance of serving with one another on any of their respective boards.⁵ In fourth place, serving only 43 offices, but third in terms of his multitude of connections with other scholars, came a Malaysian, Muhammad Daud Bakar, despite the fact that scholars in his own country were prohibited from being members of SSBs of more than one IFI and its related Islamic businesses.⁶ The top scholars served on boards of IFIs in many countries.

These transnational networks of scholarly authorities insured a certain harmonization of interpretative practices but raise questions about possible conflicts of interest. Indeed, in an earlier paper Walid Hegazy, one of our Workshop participants, compared the scholars to secular accountants. He observed that since the Enron scandal and the demise of the Arthur Anderson accounting firm, US legislation prohibits accountants from auditing firms for which they have also offered consultancy services. Shariah scholars, however, audit the banks as well as advising them on matters of Shariah. The Shariah scholars, moreover, are heavily involved in setting the standards of Islamic accountancy in AAOIFI as well as implementing them in the banks they serve.⁷ The logic of their compromises among one another, or “shariah arbitrage,” leads to ever increasing convergence and between the practices of Islamic and conventional banks.⁸

⁴ Murat Ünal, *The Small World of Islamic Finance: Shariah Scholars and Governance – A Network Analytic Perspective*, v.6.0 (18 January 2011), Funds@Work, p. 4.

⁵ *Ibid.*, pp. 5, 8, 10, 22-23.

⁶ *Ibid.*, pp. 5-6.

⁷ Walid Hegazy, *Fatwas and the Fate of Islamic Finance*, in S. Nazim Ali, ed., *Islamic Finance: Current Legal and Regulatory Issues*, Islamic Finance Project, Harvard University, 2005, pp. 139-141

⁸ Mahmoud A. El-Gamal, *Limits and Dangers of Shari’a Arbitrage*, in S. Nazim Ali, *op.cit.*, pp. 117-132, <http://www.ruf.rice.edu/~elgamal/files/Arbitrage.pdf>

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The present set of papers examines the alternative Southeast Asian experiences of national control over the SSBs. Malaysia has progressed furthest in this direction and actively promotes Islamic finance, but Brunei and Indonesia have observed their neighbour and are following similar trajectories, at least up to a point. The issues to be discussed here are financial inclusion, Shariah governance, differing interpretations of Shariah-compliance with respect to bank investments (deposits) and *sukuk* (bonds), and conflicting approaches, in the final analysis, to accounting standards. The prospects of Islamic finance in the region and, more generally, of state centered development will then be discussed by way of a conclusion.

Financial Inclusion

Table 1 indicates that Malaysia scores highest among Muslim majority countries in financial development. The proportion to GDP of its broad money supply held inside the banking system exceeds that of any other country reported in the table. By financial inclusion, however, is meant the proportion of a given population actually served by banks and other institutions such as post offices, cooperatives, and savings and loans associations. The World Bank's *Little Data Book on Financial Inclusion* presents a variety of indicators, three of which are reported in Table 2.

Table 2: Financial Access in Muslim-Majority States, 2015

	Bank account holders		Borrowed Money		Religious
	% age 15+	poorest 40%		from bank	reason vs. banks
Algeria	50.5%	36.7%	23.1%	2.2%	7.6%
Bahrain	81.9%	80.1%	60.1%	21.3%	0.0%
Bangladesh	29.1%	21.2%	48.3%	9.9%	4.8%
Egypt	13.7%	5.0%	34.1%	6.3%	2.9%
Indonesia	35.9%	10.0%	56.6%	13.1%	1.8%
Iran	92.2%	91.1%	80.1%	31.6%	n.d.
Kuwait	72.9%	65.6%	53.8%	14.1%	3.7%
Malaysia	80.7%	75.6%	56.1%	19.5%	0.4%
Morocco	39.1%	27.3%	n.d.	4.3%	26.8%
Pakistan	8.7%	6.3%	49.8%	1.5%	8.5%
Qatar	65.9%	54.1%	n.d.	12.6%	12.2%
Saudi Arabia	69.4%	63.5%	53.5%	12.2%	25.1%
Turkey	56.5%	50.6%	50.4%	20.0%	7.2%
United Arab Emirates	83.2%	78.6%	50.1%	15.4%	4.0%

Malaysia comes in third place, after Iran and Bahrain on a variety of indicators. Table 2 also reports that substantial percentages of some of these Muslim-majority populations, notably of Morocco and Saudi Arabia, cite religious reasons for not having bank accounts. While the question of whether Islamic finance really mobilizes greater

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financial inclusion went beyond the scope of the workshop, Dr. Ascarya, a senior research analyst of the Bank of Indonesia, presents his ideal vision of Islamic finance at work among Indonesians who may be too poor to access formal financial institutions. While few avoid banks for religious reasons, poor people seem to have little access to the formal banking system even though more than half of them borrow money from family, friends, or money lenders outside the formal banking system.

His paper presents the logic and values underlying an important Islamic financial institution outside the formal banking sector, the *baitul maal wa tamwil* (BMT). It is in his words “to empower the poor to step gradually from extreme poverty to some form of economic activity, eventually as an independent micro entrepreneur.” The BMT really consists of two “houses,” the *baitul maal* charity for the poor and the *baitul tamwil* financing arm for micro entrepreneurs. *Zakat*, *waqf*, and other “Islamic social tools” finance the former, whereas micro-savings and funding from other banks and other commercial sources serve the financing for prospective micro-entrepreneurs. Interviews with nine experts and nine practitioners indicated the underlying Islamic priorities to be the preservation of wealth, faith, intellect, and life, and the chief commercial objective to be financial sustainability. Dr. Ascarya also noted the dangers of “institutional mission drift,” observable in both conventional and Islamic banks, whereby “microfinance” is stretched to ever larger packages for economies of scale that reduce transaction costs.⁹

His vision is an integral part of the Indonesian Islamic Financial Market Development Framework presented for the workshop by Dr. Rifki Ismal (Appendix I). The Financial Services Authority (OJK) planned in 2016 to bring the country’s BMTs under its direct authority, even though the most prominent of them, some three hundred, were already under the supervision of the Ministry of Cooperatives. There were already reports of over 4000 BTMs in 2008 (CIMB 2016, 152), but they still constituted a very small percentage of Indonesia’s large sector of informal financial institutions involved in microfinance.

As Table 1 indicated, the market penetration of Islamic finance in 2014 reached a peak of some 5.1 percent of deposits held in the formal, regulated banking sector. It declined slightly in 2015. By 2016, however, some of the strategies advocated in Dr. Rifki’s *Framework* were already being implemented. In particular, President Joko Widodo took charge of a national Islamic finance committee (KNKS) proposed in Pillar 1 to regulate a concerted national effort from above, as in Malaysia, to give Islamic finance a second wind after its spontaneous expansion since 1992 by demand from below. Explicitly modelled on Malaysia’s International Islamic Finance Center, KNKS might not only coordinate such delicate matters as the regulation of the BMTs but also

⁹ The Indonesian Financial Services Authority (OJK) defines the upper limit of a microfinance loan to be IDR 50 million (less than \$4000 in 2016).

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mobilize some of the funds of state enterprises and ministries for Islamic banks.¹⁰ In particular, personal savings funds for the hajj could expand the Islamic finance share of the market. The comprehensive *Framework* does not provide specific targets. The Governor of the Bank of Indonesia projects modest growth, with the Islamic component reaching 6 to 8 percent in the coming five years “unless the structural problems remain unresolved,” whereas CIMB Islamic of Malaysia was projecting 11 to 13 percent. By contrast, Malaysia’s central bank was planning that Islamic banking in Malaysia occupy 40 percent of the market by 2020.

Shariah Governance

One of Indonesia’s possible “structural problems” in the eyes of bankers may be the cumbersome adaptation of shariah law to the business of banking. In his PowerPoint presentation Cecep Maskanul Hakim, Assistant Director of Indonesia’s Financial Services Authority (OJK), points to the complex procedures involving Shariah certification of new financial products (Appendix II). Before launching the new product, a bank must first seek approval first from its own SSB and then from the National Shariah Board consisting of some sixty Shariah scholars from Islamic financial institutions and the OJK. Its most active members join a working committee with representatives from the central bank and the Indonesian Accounting Association. The committee then recommends a *fatwa* to the National Shariah Board. Since its founding in 1999, the NSB has issued some hundred *fatwas* on such matters as the simple *murabaha* (instalment sales) and complex derivatives, such as hedging with foreign currency swaps.¹¹ The procedures for certification are so lengthy and subject to such a diversity of authorities, however, that Indonesia has so far managed to develop far fewer modern financial instruments than Malaysia. The grassroots of Shariah governance are the SSBs of the individual banks, whose members must be approved by the OJK. The regulatory authority’s “four pillars” or criteria for the functioning of these boards are competence, independence, discretion, and consistency in their rulings. In his presentation Hakim pointed to difficulties recertifying the SSBs of some 2000 financial cooperatives coming under OJK supervision.

As in Malaysia, to prevent conflicts of interest, scholars are restricted in the number of boards they may serve. One constraint, also alluded to by Rifki Ismal, is the difficulty of having Shariah scholars who also understand modern finance. With its more hierarchical approach managed by the BNM, Malaysia has developed new financial products more efficiently. Shamsher Mohamad and Zulkarnain Muhamad Sori present the formal structures and their corresponding functions of Shariah Risk

¹⁰ Rifki Ismal (2011, 10) observed that ten percent of the available financial assets of state enterprises together with the hajj funds stored in conventional banks could have almost tripled the asset base of Islamic banks in 2010.

¹¹ For more about the NSB see Hefner (2003) and Henry (2015). For useful background on the evolution of Islamic finance in Indonesia, see Angelo M. Venardos (2013, 138-150).

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Management Control, Shariah Review, Shariah Research, and Shariah Auditing. The BNM's Shariah Advisory Council governs the SSBs of the individual financial institutions and ensures consistent shariah rulings. The authors argue that rulings are indeed consistent and the system prevents the "fatwa shopping" practices of some Middle Eastern countries, where service on many boards may also involve conflicts of interest. Based on interviews with 17 chairmen of Malaysian SSBs, however, they still note possible conflicts in their country. Bank managers

"are usually keen to fulfil their short-term 'key performance indicators' to earn their targeted remunerations. Furthermore, the Shariah committee members usually receive remuneration from the IFIs which could lead to legitimizing unlawful or dubious operations, products and services because of the monetary incentive."

Consequently the unregulated pay scales of Malaysian Shariah scholars, notably of expensive foreigners, may still lead to some conflicts of interest. The authors also cite a report of the International Shariah Research Academy (established by the BNM in 2008) that "more than 54% of *fatwas* issued between Malaysia and the GCC are in direct conflict with each other." Many Malaysian *sukuk*, for instance, are not recognized in the GCC as being Shariah-compliant, an important point to be further discussed below.

Possibly the very success of the BNM in promoting Islamic finance has sacrificed its credibility. Rosana Gulzar Mohd presents a brilliant challenge, asking whether the German financial system, with its cooperatives and savings and loans *Sparkassen*, is not more truly in the spirit of Islam than Malaysian Islamic banks, which so effectively compete against conventional banks by mirroring them. She also observes that the *Sparkassen* originally inspired Dr. Ahmad Najjar, the early Egyptian pioneer of Islamic finance in rural villages north of Cairo. Her critique is designed to be constructive and suggests ways in which Islamic finance may regain its credibility through greater public control and regulation of key financial sectors and less reliance on greedy private financiers. She also recognizes that the BNM "made a laudable attempt to right the ship" in 2013, in a Financial Services Act that included a provision for investment accounts designed to reflect profit and loss sharing in addition to regular demand deposits and savings accounts.

Bank Deposits and Investment Accounts

Until recently, mandatory deposit insurance covered the deposits of all licensed banks, Islamic as well as conventional, in both Indonesia and Malaysia, despite the risk sharing ethos of Islamic finance. The issue of whether deposit insurance should cover deposits in Islamic banks was under discussion in 2015 in Indonesia but without any definitive rulings as yet by the National Shariah Board. In Malaysia, however, as Rodney Wilson explains, the new investment accounts were intended to reflect the Islamic prescription of risk sharing although in practice any investment losses are also to be covered by the

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Malaysia Deposit Insurance Corporation (PIDM). The Malaysian authorities argue that the investor and the Islamic bank are still sharing risk since it is a third party, the PIDM, which protects the investor from losses.

In his detailed analysis of the banks' treatments of these new investment accounts, Saiful Azhar Rosly also shows that the investors do not receive profits commensurate with those received by those who really do share profits and losses, namely the shareholders of the banks. Consequently these investment accounts do not really reflect the Islamic ethos of profit and loss sharing that had originally inspired them. In his words "Such discrepancy in performance of deposit funds and capital funds may trigger Shariah non-compliance risk." Profits tend to mirror those of conventional banks' interest revenues, and the principal is protected like that of an ordinary bank deposit.

Sukuk Financing

As noted above, there are sharp divisions of opinion concerning Shariah-compliant *sukuk*. Walid Hegazy, who has extensive experience with legal practices in the GCC, insists that they must be backed by a real asset or contractual arrangement concerning its use, such as an infrastructure project. An analogy in conventional security markets might be preferred stock with fixed dividends. Many *sukuk*, however, are asset-based rather than asset-backed and consequently more closely resemble conventional long term debt than equity. The principal is usually guaranteed, whereas an asset-backed *sukuk* may lose value. Tahir Ali Sheikh, in charge of Islamic Banking Asset Management & Investments for Malaysia's CIMB Islamic Bank, presents the same definition in his PowerPoints (Appendix III) as Hegazy, but most Malaysian *sukuk* are asset based, with the principal being guaranteed.

Hegazy observes an interesting correlation between *sukuk* issues with oil prices and shows new issues undergoing a sharp decline in 2014 and 2015. He also notes that most GCC countries will probably follow Saudi Arabia in relying more on conventional bond issues than on *sukuk* to meet their financial shortfalls caused by diminishing oil revenues. By contrast, Sheikh raises prospects of greater *sukuk* issues to meet Asia's infrastructural needs, if given the appropriate legal frameworks. He also observes Indonesia "to be the most prolific sovereign *sukuk* issuer to date." Malaysia, however, offers the friendliest environment for business enterprises to raise funds by issuing *sukuk* because of the government's "tax neutrality," "cost neutrality," and favourable legislation; in fact, *sukuk* issues usually exceed those of conventional bond issues each year (Appendix III, 25-27). The majority of the world's outstanding *sukuk* (which total over US\$300 billion) have been issued in Malaysia, for the most part in local currency.

Accounting Standards

Arcane issues of accounting turn out to illustrate some of the differences between the Malaysian and other approaches to Islamic finance already emerging in the

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segmentation of *sukuk* markets. While visiting Brunei, the editor of these workshop papers met Denny Hanafi, whom the sultanate's leading Islamic bank had commissioned immediately in 2015 to convert to the new International Financial Reporting Standards (IFRS), following Malaysia's lead. In Brunei, the orders came from the Sultan, who is also finance minister, while his son heads the Monetary Authority of Brunei Darussalam (AMBD). For a snapshot of Brunei's financial system see Appendix IV. The task of converting the bank's accounting system would be time consuming. At issue is how to account for profits and losses in various financing contracts between Islamic banks and their customers.

In Appendix V Denny Hanafy illustrates the differences in a simple instalment sales agreement between the standard accounting practices prescribed by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and IFRS. The Islamic "profit rate" of 7 percent is the precise equivalent of an effective interest rate of 10.916 percent in his example of a five year financing of a sale with an initial cost of US\$100,000. Whereas the 7 percent profits are recognized each year under AAOIFI rules, the identical annual repayment schedule of US\$27,000 results under IFRS in significantly higher financial profits, with important consequences for the income statements and balance sheets of the financial institution and possibly also for the performance evaluations of bank managers.

Rosman et al spell out the characteristics of Hanafi's exemplary *murabaha* and compare the treatment of its profit rates with the interest rates of conventional instalment sales or mortgages. They carefully explain how Shariah scholars may view the discounting techniques required by IFRS to be in conflict with the Shariah-compliant prescriptions of AAOIFI. In Malaysia, however, the BNM has accepted an analysis of ISRA that distinguishes between mathematical techniques for recording transactions, which may involve discount rates, and the actual transaction generating profits, not interest. "The application of the time value of money is permissible only for exchange contracts that involve deferred payment and is strictly prohibited in loan transactions." It is acceptable if the economic substance of the contract is for financing rather than trading. The authors carefully compare the IFRS accountant treatment illustrated by major Malaysian Islamic banks with the AAOIFI procedures illustrated by a major Bahrain bank. They note "cases which reveal the inadequacy of IFRS in catering to the unique characteristic of Islamic financial transactions" and judiciously conclude "In the case of the *murabaha* contract, the financial reporting objectives can be achieved by disclosing greater information in the notes accompanying the financial statements."

Dodik Siswantoro pursues a parallel line of inquiry about Indonesia's efforts to engage with IFRS in the treatment of *sukuk*. He compares Indonesia's efforts with those of Malaysia and closely examines the revision of its Statement of Financial Accounting Standard (SFAS) 110 in 2015 to accommodate IFRS. The process of revision was a lengthy one, involving public hearings as well as extensive consultations between bank managers, accountants, regulators, and Shariah scholars.

Clearly Indonesia is “stricter” than Malaysia in its interpretation of Shariah because its scholars reject the use of discount and interest rates for the valuation of *sukuk*.¹² The scholarly consensus in Indonesia seems to reject the Malaysian distinction between charging interest and recording the substance of a transaction as if it were interest-based. “Riba (usury) concerns not only the person who is charging interest but also the one who records the interest rate transaction,” argued one of Siswanto’s sources.

In practice some Indonesian Islamic banks were ready to apply IFRS and initially objected that the revision of SFAS 110 did not go far enough. Siswanto shows, however, how the balance sheets and income statements of six leading banks were gradually being brought in line with Indonesia’s new compromise standard.

Regional Prospects

To date, the oil-rich GCC countries have driven the demand for Islamic finance since the oil shocks of the 1970s. Wealthy Gulf investors diversified their portfolios and seemed eager not only to place some of their funds in “Islamic” banks but also to invest in Shariah-compliant securities, such as *sukuk* with fixed rates of return. With declining oil prices and increasing debt in the GCC, however, the concerned governments seem to be turning more to conventional bonds than to more problematic *sukuk*. The question now is whether the novel enterprises of Islamic banking and capital markets will gain traction among the growing masses of Muslims who are engaging in financial activity. Southeast Asia, with its proximity to expanding Far East markets, is the key testing ground. Building on the Malaysian experience, it may also be a proving ground for *sukuk* financing of major infrastructure projects.

Whether with respect to accounting standards or Shariah-compliance, differences remain between Indonesia, on the one hand, and Brunei and Malaysia on the other. The potential giant of Islamic finance takes slow, deliberate steps towards increasing the market share of Shariah-compliant products and seems attentive to scholars who might otherwise issue warnings of “Shariah non-compliance risk.” Consequently it does not emulate conventional banking techniques as rapidly as the more efficient Malaysian system.

The workshop concluded the discussion of the region’s prospects by proposing greater interchanges between the four Southeast Asian countries in efforts to develop common standards (see Appendix VI). Daud Vicary, the CEO of INCEIF, suggested STARS, a five-point review of how each set of country actors could learn from one

¹² Siswanto also points to another example, the *bay al innah* — “permissible in Malaysia but not in Indonesia. This is because that scheme contains two transactions in one contract, which is prohibited in Indonesia. In practice, it is like a loan in a sale-and-buy-back that does not really occur.

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another about Shariah, taxation, accounting, regulating, and standards. Despite the infinitesimal share of Singapore's Islamic finance market, this international centre, too plays a significant regional role. As Zubir Abdullah, an official of the Monetary Authority of Singapore, explained to the workshop,

Singapore's role in the Islamic financial industry is to complement and not to compete with Malaysia and Indonesia. Singapore's approach is to regulate Islamic finance under one common regulatory framework. After discussions with other jurisdictions, the Monetary Authority of Singapore is of the opinion that apart from Shariah, the prudential and regulatory considerations for regulating Islamic financial entities are the same as conventional entities. Since Singapore is a secular country, it has taken a similar approach to the United Kingdom. Hence it is the onus of financial players involved in Islamic finance to strengthen their corporate governance in respect to Islamic finance transactions.

By utilizing a common framework, we do not have a separate framework to regulate Shariah or provide separate licenses for Islamic banks. The Islamic Bank of Asia was regulated under the same framework as any bank. This also means that once MAS has approved a license, the institutions have the option of conducting conventional and/or Islamic transactions. That is why there seems to be an anomaly, where you don't see Islamic finance institutions in Singapore. However, it is actually growing because they are connected by windows.

Regional financial integration, an ongoing ASEAN process, may facilitate greater interaction and competition among Islamic as well as conventional banks. While the Indonesian authorities have delayed the formation of an Islamic Megabank to meet the competition from Malaysia's larger banks,¹³ they are slowly coordinating the efforts of various ministries, state enterprises, professional associations, and regulatory authorities.

Perhaps, as Rosana Gulzar Mohd suggests in her paper, the prospects of Islamic finance hinge on larger societal developments. Indonesian democracy in particular may lead the way in adapting Islamic finance to the exigencies of the modern world. While new product development is slower and less efficient than that of Malaysia, it rests on more secure foundations of consensus reached by the scholarly community with bankers, regulatory authorities, and business professionals.

¹³ The proposed "megabank" would be the result of combining the Islamic financing arms of four state-owned banks: PT Bank Rakyat Indonesia, PT Bank Mandiri, PT Bank Negara Indonesia, and PT Bank Tabungan Negara.

Clement Henry, who wrote until 1995 under the name of Clement Henry Moore, has conducted research on political parties, the engineering profession, and financial institutions in various parts of the Middle East and North Africa since 1960. Before coming to Singapore in November 2014 he was chair of the Department of Political Science at the American University in Cairo, after having retired from the University of Texas at Austin in 2011. Earlier he had directed the Business School at the American University of Beirut, taught at the University of California, both at Berkeley and Los Angeles, at the University of Michigan, and at the Institut d'Etudes Politiques in Paris. He is currently studying Islamic finance, following up on his Politics of Islamic Finance (2004), co-edited with Rodney Wilson, and is also working with Robert Springborg on a third edition of their Globalization and the politics of development in the Middle East (2001, 2010). He has also tried to trace the career patterns and politics of a cross section of Algeria's retired political elite, drawn from interviews with student leaders whom he interviewed in 1955-1962: Témoignages (2010, 2012). Recently he co-edited The Arab Spring: Will It Lead to Democratic Transitions? (2013). Clement Henry received his PhD in political science from Harvard University and an MBA from the University of Michigan.

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MIDDLE EAST INSIGHTS

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HOLISTIC FINANCIAL INCLUSION BASED ON MAQASHID SHARIAH THROUGH BAITUL MAAL WAT TAMWIL

BY ASCARYA

ABSTRACT

Holistic financial inclusion (HFI), an integration of social inclusion delivered by not-for-profit MFIs and financial inclusion delivered by for-profit MFIs, is actually not a new concept in Islamic perspective. This study aims to develop holistic financial inclusion based on *Maqashid Shariah* through *Baitul Maal wat Tamwil* (BMT) using Analytic Network Process (ANP), by acquiring the knowledge of nine experts and nine BMT practitioners. The results show that the most important *Maqashid Shariah* to be achieved by HFI are safeguarding the wealth (28.7%), since poverty leads to infidelity (Imam Al-Bayhaqi), to preserve safeguarding the faith (20.0%), which is in line with the objective of Islamic social tools, especially *zakat*, *infaq*, *shadaqah* and *waqf* (ZISWaf), to alleviate poverty, as well as to empower the poor (mustahiq). The most important aspects of HFI are the commercial objective of financial sustainability (17.59%), followed by economic impact (14.05%) and social impact (12.75%), financing programs (12.48%) and Islamic microfinance services (11.70%), development program (11.30%) and social programs (10.53%). The social objective of poverty outreach (9.60%) is the least important. The most important elements of HFI are funding independent (2.26%), consumption smoothing (2.17%), simplicity (2.16%), micro financing (2.15%) and income increase (2.14%), followed by easy access (2.10%), mindset change (2.10%), empower (2.06%), micro savings (2.05%)

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and basic needs fulfillment (2.01%). The design of BMT-HFI should also have Social Inclusion (basic needs fulfillment, bailout of debt, savings programs and regular meeting), as well as Financial Inclusion (simplicity, easy access, micro financing and micro savings) to achieve Double Bottom-line (total deposits, number of members, funding independent and operational efficiency), as well as Welfare Impact (consumption smoothing, income increase, mindset change and empowerment). Mindset change of the poor (mustahiq), as the one of most important HFI elements of all, is very important to inspire them to transform.

Keywords: Social Inclusion, Financial Inclusion, Holistic Financial Inclusion, *Baitul Maal wat Tamwil*

The idea of financial inclusion arose in response to the financial exclusion of the disadvantaged and low income groups of society, especially the poor. The principal objective was to alleviate poverty (Leyshon and Thrift, 1995). Financial inclusion to alleviate poverty through conventional microfinance institutions (CMFI), however, presents certain problems, such as financial sustainability and institutional “mission drift” (Frank and Lynch, 2008; Ghosh and Tassel, 2008; Armendariz and Morduch, 2010; Armendariz, et al., 2011; Zeller and Meyer, 2002).

CMFIs in fact have a “double bottom line” or twin goals of not only high outreach to the poor, but also of financial sustainability. Mission drift means that CMFI has been moving away from its original objective of poverty alleviation due to formalization (Frank and Lynch, 2008), commercialization (Ghosh and Tassel, 2008; Hamada, 2010; Abrar and Javaid, 2014), financial sustainability (Augsburg and Fouillet, 2010; Wagenar, 2012) and high operational costs (Cerano-Cinca and Gutierrez-Nieto, 2012). One solution proposed by Battilana and Dorado (2010) was to build sustainable hybrid organization, combining development logic to help the poor and banking logic to be financially self-sufficient.

Moreover, Zeller and Meyer (2002) believed that due to shifts in paradigms, strategies, and development practices in the 1990s, microfinance really confronted not two but three overarching policy objectives, namely financial sustainability, outreach to the poor and a positive impact on welfare that outreach to the poor did not necessarily achieve. Although MFIs tried to achieve these objectives, many of them stressed one particular objective over the other two.

In the Islamic perspective, financial inclusion is an integral part of Islamic microfinance institutions (IMFI), which were designed to provide various Islamic financial products and services needed by low income and poor groups of society. Islamic microfinance provides a more holistic framework than conventional microfinance in enhancing financial inclusion, eradicating poverty, and promoting a healthy economy through microfinance, MSE financing, and micro insurance (Naceur, 2015). The concept of financial inclusion in the Islamic perspective is based on two main pillars, namely redistributive and risk sharing instruments (Mohieldin, et al., 2012; Iqbal and Mirakhor, 2012 and 2013; Iqbal, 2014), and they encourage social as well as financial inclusion.

One well known type of Islamic microfinance institution (IMFI) in Indonesia is *Baitul Maal wat Tamwil* (house of wealth and business) or BMT. *Baitul Maal* (Bait = House, al-Maal = Wealth) focuses on social inclusion as it collects compulsory taxes and voluntary charities, such as *zakat*, *infaq*, *sadaqah*, *awqaf*, and then optimizes their distribution by applying Shariah based management. Meanwhile, *Baitul Tamwil* (Bait = House, at-Tamwil = Finance/capital) focuses on

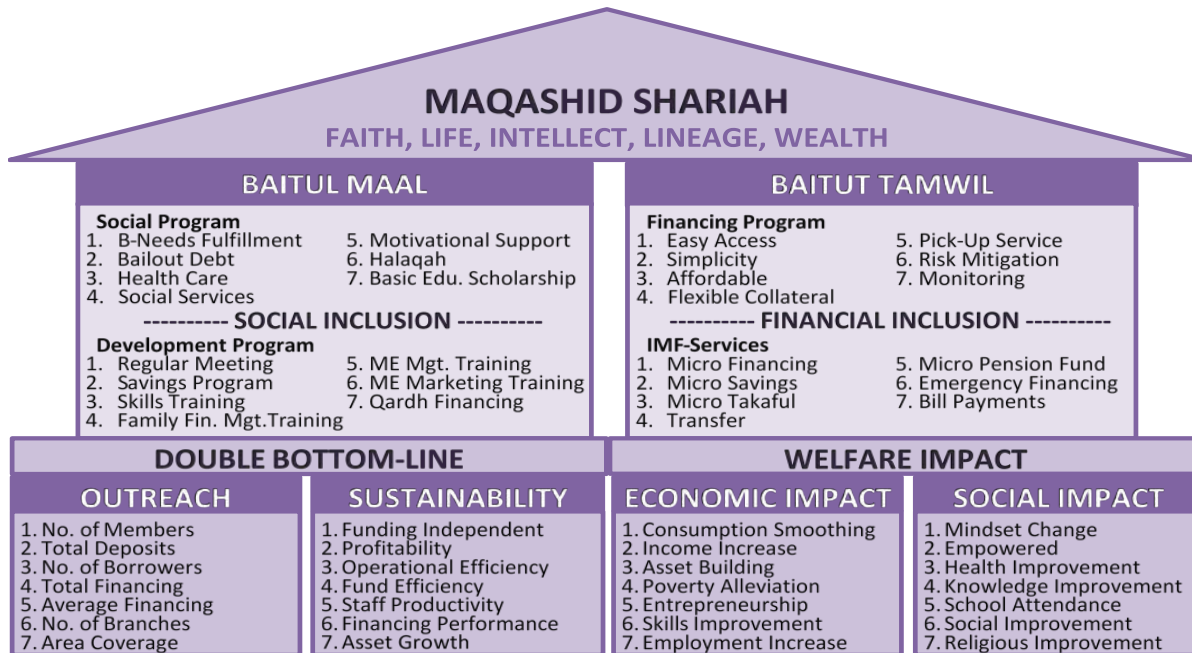
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financial inclusion by developing productive businesses and investing in micro and small scale economy.

This study aims to design the model of holistic financial inclusion (HFI), which includes social inclusion and financial inclusion by BMT to empower the poor to step gradually from extreme poverty to some form of economic activity, eventually as an independent micro entrepreneur.

This study uses the Analytic Network Process (ANP) with 9 experts and 9 practitioners as respondents, while the framework as can be seen in figure 1.

Figure 1: Framework of Holistic Financial Inclusion based on Maqashid Shariah.

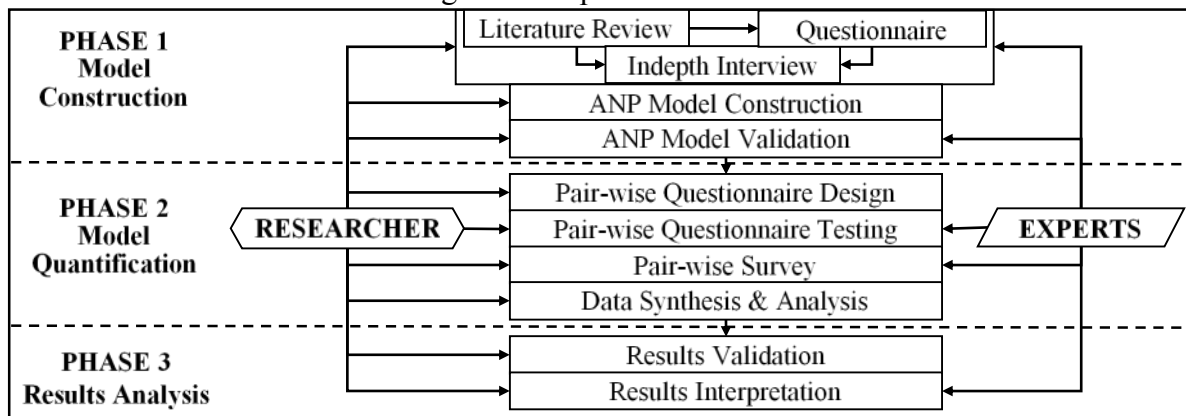


ANP is described by its inventor Thomas L. Saaty as a multicriteria theory of measurement used to derive relative priority scales of absolute numbers from individual judgments (or from actual measurements normalized to a relative form) that also belong to a fundamental scale of absolute numbers. The ANP provides a general framework to deal with decisions without making assumptions about the independence of higher-level elements from lower level elements and about the independence of the elements within a level as in a hierarchy. In fact the ANP uses network analysis without the need to specify levels (Saaty, 2005).

The ANP was developed to analyze the feedback networks of the Analytic Hierarchy Process. (Saaty and Vargas, 2006, p.2). In AHP, problems are illustrated as a linear top down structure with no feedback from lower to higher levels. In ANP, problems are structured as a network and it provides feedback among clusters. Problems could not always be structured hierarchically as in AHP, because they involve dependence, interaction and feedback among higher level clusters and lower level clusters, and among clusters in the same level (Saaty and Vargas, 2006, p.7).

There are three steps or phases to be done in ANP (Ascarya, 2014), namely model construction, model quantification and results analysis (see figure 2).

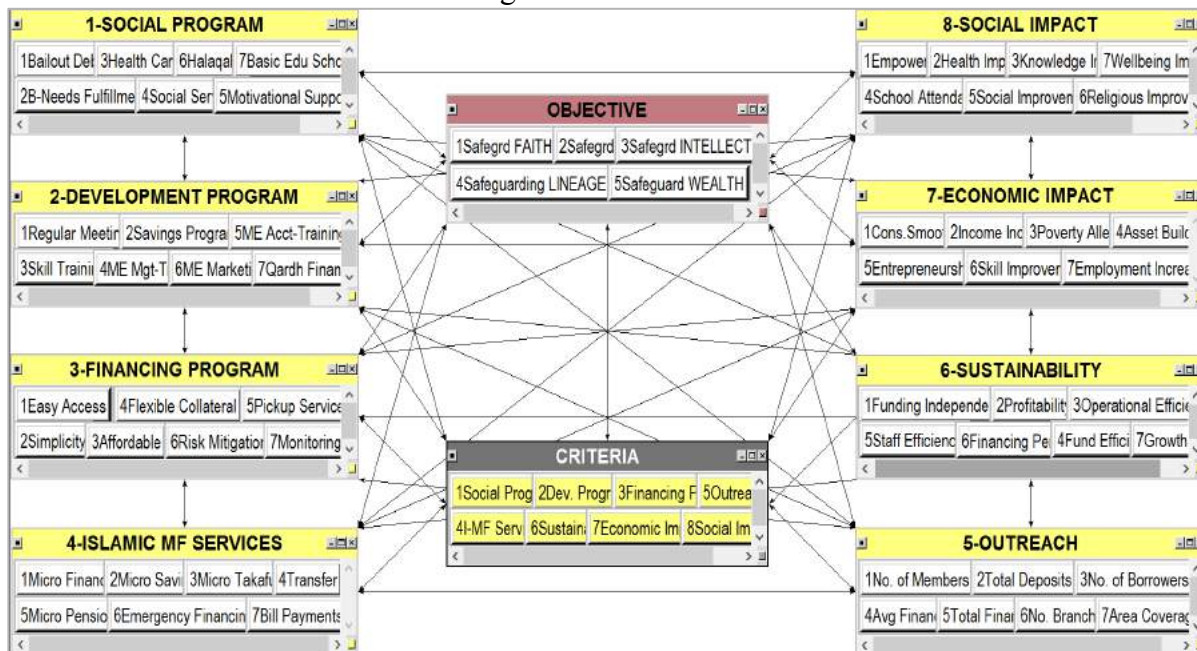
Figure 2: Steps of ANP Research



Source: Ascarya (2014)

Phase 1 is model construction or decomposition to identify, analyze and structure the complexity of the problems into an appropriate ANP network, which includes: a) Literature reviews, questionnaires and in-depth interviews with experts and practitioners to comprehend the problem fully; b) Construction of ANP network based on information gathered, as summarized in figure 1; and c) Validation of ANP network with experts. The result is ANP network as in figure 3.

Figure 3: ANP Network



Phase 2 is model quantification or pair-wise comparison, which includes: a) Design pair-wise questionnaires in accordance with ANP network; b) Test the pair-wise questionnaires with expert respondents; c) Survey to selected experts and practitioners respondents to fill out pair-wise questionnaires; and d) Data processing and synthesis using ANP software SUPERDECISIONS, which includes checking the consistency, obtaining group judgment by calculating the geometric mean of all respondents' responses, and obtaining priorities.

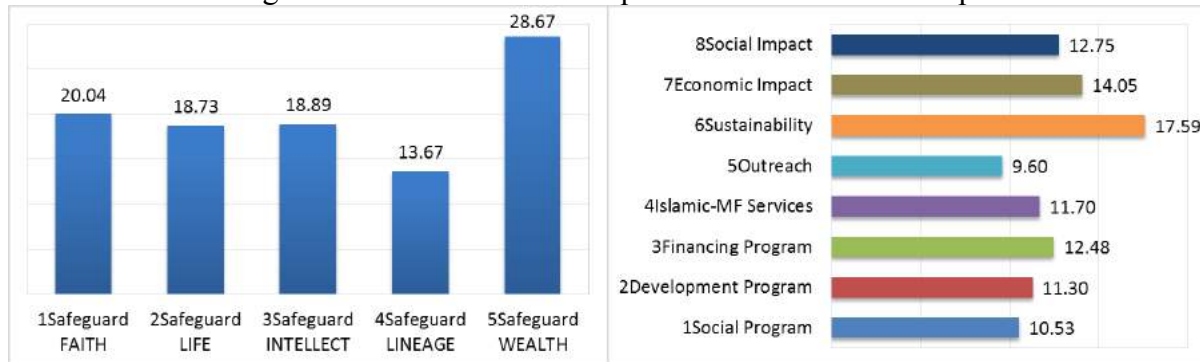
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Phase 3 is results analysis where outputs are manipulated in a separate excel file, which includes: a) calculation and presentation of general priorities and detailed results; b) Validation of the results; and c) Interpretations of the results.

Results

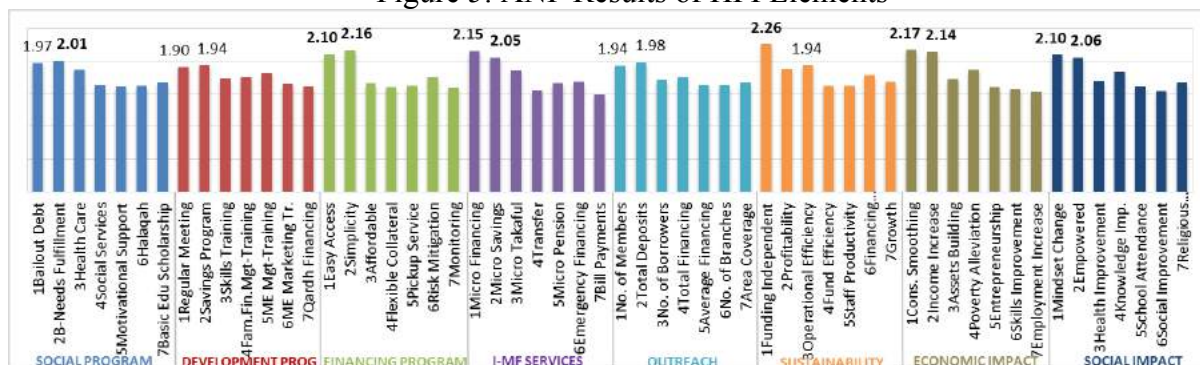
The overall results show that safeguarding WEALTH (28.67%) is the most important Islamic objective, followed by safeguarding FAITH (20.04%), safeguarding the INTELLECT (18.89%), safeguarding LIFE (18.73%) and safeguarding LINEAGE (13.67%). The most important aspect of HFI is the commercial objective of financial sustainability (17.59%), followed by economic impact (14.05%) and social impact (12.75%), financing programs (12.48%) and Islamic microfinance services (11.70%), and social programs (10.53%). The social objective of poverty outreach (9.60%) is the least important (see figure 4, right).

Figure 4: ANP Results of Maqashid Shariah and HFI Aspects



Moreover, the most important elements of HFI (above 2.00%) are funding independent (2.26%), consumption smoothing (2.17%), simplicity (2.16%), micro financing (2.15%) and income increase (2.14%), followed by easy access (2.10%), mindset change (2.10%), empowered (2.06%), micro savings (2.05%) and basic needs fulfilment (2.01%). The most important elements by cluster (see figure 5) are bailout debt and basic needs fulfilment (Social Program), regular meetings and savings programs (Development Program), simplicity and easy access (Financing Program), micro savings and micro financing (I-MF Services), number of members and total deposits (Outreach), funding independent and profitability (Sustainability), consumption smoothing and income increase (Economic Impact), mindset change and empowered (Social Impact).

Figure 5: ANP Results of HFI Elements

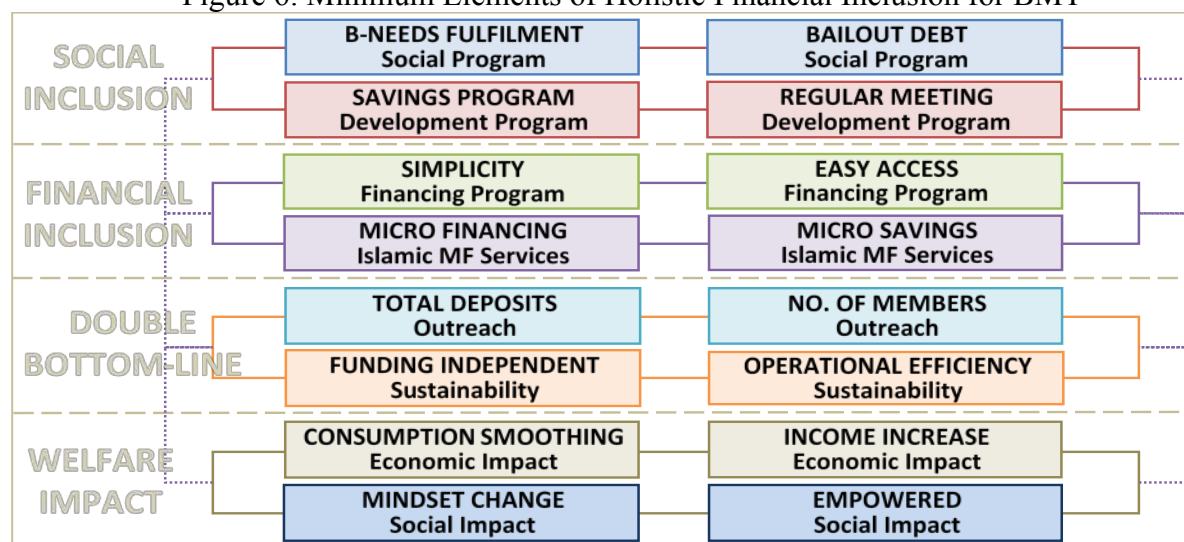


Recommendation

Baitul Maal wat Tamwil could become the most suitable IMFI to carry out holistic financial Inclusion (HFI), which should comprise social inclusion (including social program and development programs) using social/ZISWaf funds carried out by *Bait al-Maal*, and financial inclusion (including financing programs and Islamic microfinance services) using commercial funds carried out by *Bait at-Tamwil*. Social inclusion must have the minimum elements of Basic Needs Fulfillment and Bailout Debt (Social Program), as well as Savings Program and Regular Meeting (Development Program), while financial inclusion must have the minimum elements of Simplicity and Easy Access (Financing Program), as well as Micro Financing and Micro Savings (Islamic Microfinance Services).

HFI should be able simultaneously to achieve the three objectives of microfinance, namely the social one of Outreach to the Poor, the commercial one of Financial Sustainability, and the Welfare Impact (Economic Impact and Social Impact). Outreach to the Poor must have minimum elements of Total Deposits and Number of Members, while Financial Sustainability must have minimum elements of Funding Independence and Operational Efficiency. Economic Impact must have minimum elements of Consumption Smoothing and Income Increase, while Social Impact must have minimum elements of Mindset Change and Empower.

Figure 6: Minimum Elements of Holistic Financial Inclusion for BMT



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MIDDLE EAST INSIGHTS

ISLAMIC FINANCE SPECIAL

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EFFECTIVENESS OF SHARIAH COMMITTEES IN THE MALAYSIAN ISLAMIC FINANCIAL INSTITUTIONS: THE PRACTICAL PERSPECTIVE

BY MOHAMAD SHAMSHER AND ZULKARNAIN MUHAMAD SORI

Abstract

An effective system of rules, practices and processes by which Islamic Financial Institutions (IFIs) are directed and controlled to ensure their business operations are Shariah-compliant has important implications on their reputation and their future growth. The Shariah Committee is a mandated requirement by the central bank on every Islamic Financial Institution (IFI) to ensure the expected level of Shariah-compliance in their business operations. Unlike their conventional counterparts that focus only on maximizing the wealth of shareholders, IFIs has an extra responsibility to protect the interests of all stakeholders (including shareholders) and ensure that no injustice of any kind is committed to any stakeholder. In performing their responsibilities, the Shariah Committees experience challenges both within and outside their institutions that adversely affect their effectiveness as gatekeepers of Shariah-compliance and hence mitigating Shariah non-compliance risk. Specifically, issues such as degree of independence, confidentiality, competence, and consistency and information disclosure might be compromised and mitigates the effectiveness of Shariah Committees.

Keywords: Shariah Governance, Shariah Committee, Islamic Financial Institutions, Independence, Competence, Consistency

The concept of Shariah governance has its foundation in the *Qur'an* and the *Sunnah*. It is the divinely ordained guidelines of conduct for Muslims in all aspects of their life, which includes financial matters. For financial transactions, any element of injustice to participants in any form and the presence of ‘interest’ (*riba*) is absolutely forbidden. The Shariah-based governance guidelines uphold the elements of transparency, fairness and accountability, and focus on the interest of *all stakeholders*. Weak or ineffective governance has always been the major cause of fiascos in both conventional and Islamic financial markets. In the Islamic financial markets, the failures of Ihlas Finance in Turkey, Islamic Bank of South Africa, and the Islamic Investment Companies of Egypt as well as the commercial losses of Dubai Islamic Bank are evidence of such fiascos.

Malaysia, being the global hub for Islamic finance, has in place a well-structured Shariah Governance Framework to support its growing Islamic finance industry. One of the requirements of the framework is that it is mandatory for all Islamic financial institutions (IFIs) to set up a Shariah Committee to provide independent oversight on the whole chain of activities of the IFI to ensure that all the operations are Shariah-compliant. Any failures to effectively enforce Shariah governance will create reputational risks and erode the credibility and competitiveness of the Islamic finance industry.

This article briefly highlights some real challenges for Shariah Committees in IFIs in fulfilling their expected responsibilities.

The Malaysian Central Bank's Shariah Governance Framework

Shariah governance is a set of rules and regulations put into place by the regulators for all Islamic financial institutions to comply with in all aspects of their operation. The Malaysian Central Bank (*Bank Negara Malaysia* or in simply BNM) has introduced the ‘Shariah Governance Framework for Islamic Financial Institutions’ (SGF) effective from 1 January 2011. The framework enhances the role of the Board of Directors, Shariah Committee and Management on Shariah matters, including enhancing the relevant key organs in executing the Shariah-compliance and research functions. The organizational structure of the framework depicted in Figure 1 below indicates a two-tier Shariah governance infrastructure comprising of two (2) vital components namely the Shariah Advisory Council (SAC) at the Central Bank and an internal Shariah Committee established in each IFI. The SAC has the ultimate authority on any financial matter relating to Islamic business operations, activities or transactions. The Shariah Committee is given a mandate to provide guidance to the respective IFIs on Shariah matters.

To ensure effectiveness of the framework, four main functions are outlined, namely, the Shariah Risk Management Control Function, Shariah Review Function, Shariah Research Function and Shariah Audit Function. Besides the key players of Shariah Governance and the four functions, Figure 1 also showed the line of communication or reporting between key players and main functions.

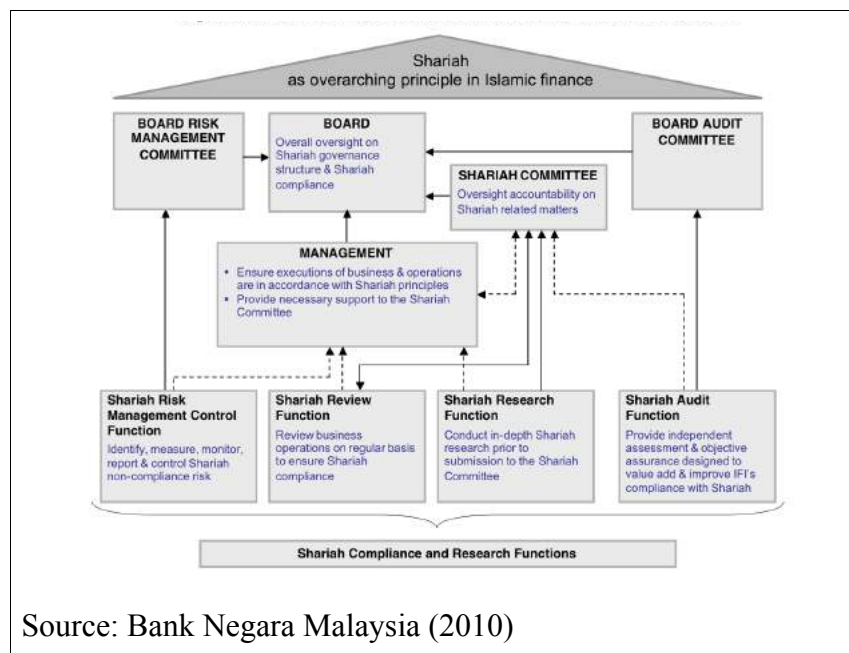


Figure 1: Shariah Governance Framework Model for Islamic Financial Institutions.

There are seven principles outlined in the framework to ensure effective Shariah-compliance on part of the IFIs. Among others, the Board of Directors is expected to understand the Shariah non-compliance risks associated with Islamic finance business and operations and its implications to the respective IFIs. The ultimate responsibility of Shariah-compliance lies with the Board of Directors though the Shariah Committee is the directly responsible gatekeeper. To meet this responsibility, the Shariah Committee is required to have at least 5 members, the majority of whom are Shariah experts (specifically in areas of *Fiqh* and *Usul Fiqh*) and at least one of whom is a qualified member in another discipline such as economics, finance or business.

The Shariah Governance Framework requires the IFI's Shariah Committee to be responsible to the Shariah Advisory Council (SAC) at the Malaysian Central Bank. Since 2009, the SAC has legal authority to take action against IFIs if they fail to comply with the issued Shariah guidelines and resolutions. This facilitates the decision making process as IFIs can always refer to the SAC at the Central Bank in the case of ambiguity in the law or any disagreement. Since it is impossible for IFIs to comply fully with Shariah requirements, the form and substance of actual commercial transactions being conventional in nature, there are a lot of contentious issues that requires advice from the SAC in the central bank. SAC, being the central reference point with legal authority, facilitates decisions on contentious issues so as to ensure uniformity in practice. The Shariah Committee will seek advice from the SAC on contentious issues and report to the Board of Directors (BOD) on the recommendations from the SAC. The board of the IFI will then advise the management of what is required to ensure compliance.

Having the framework and effectively enforcing the requirements are two separate issues. The next section discusses some issues raised by chairmen of the Shariah Committees of seventeen Islamic financial Institutions in Malaysia. A well-functioning Shariah Committee is expected to be effective, efficient, independent, consistent, and transparent in its deliberations and decisions, but questions were raised concerning the issues of independence, confidentiality, competence, consistency and disclosure by a Shariah Committee when delivering its responsibilities.

Is the Shariah Committee Really Independent of Management Influence?

It is important for Shariah Committee not to be influenced by the management when deliberating on the compliance of products and services. It is possible that management may not want to compromise on their performance and therefore influence the Shariah Committee to endorse the new product or service that the committee is still not clear about, concerning its compliance status, but that is important for management in order to achieve their profit targets and expected remunerations.

Is the Shariah Committee able to make objective decisions independently, without any form of influence or coercion from management? In fact Shariah Committees can only express opinions that give rise to resolutions, or provide expert testimony, but they do not have the legal authority to ensure that management adhere to these resolutions. From a practical perspective, a substantial amount of resources are usually spent by the management of an IFI in developing the processes and the products, and they are usually keen to fulfil their short-term 'key performance indicators' to earn their targeted remunerations. Furthermore, the Shariah Committee members usually receive remuneration from the IFIs which could lead to legitimizing unlawful or dubious operations, products and services because of the monetary incentive. If this is the case, then the product review could just be perfunctory, with Shariah Committees relenting to IFI management pressure.

In Malaysia, the appointment, removal and renewal of Shariah Committee members in IFIs is regulated directly by the Central Bank. For appointments, the IFI recommends the candidate to the Central Bank with the required details and the final decision is made by the Central Bank after due diligence. The IFI can only request a change or removal of a member to the Central Bank and the latter will have the final decision after due deliberation. The only reasons usually for which the Central Bank removes a member from the committee before his term expires are regular absences from scheduled meetings or health problems. However, with regards to the remuneration to the members by the IFI, the Central Bank does not have any guidelines, and the respective IFIs display significant variation in their scales for remuneration, which vary from just RM1,000 per month to over RM10,000 per month depending on the status of the IFI. Foreign Shariah scholars that are invited by large IFIs are usually more costly as they charge high retention fees. A more effective method to mitigate any potential conflict of interest might be to establish a separate independent fund supervised by the Central Bank that pays a standard remuneration to Shariah Committee members of all IFIs. There should also be standard guidelines for engaging prestigious foreign scholars on Shariah Committees. Standard pay scales would also mitigate the issue of relenting to management pressure.

Do the Shariah Reports Serve their Intended Purpose?

In practice, Shariah Committees are required to provide information on their activities through formal reports on an annual basis and to highlight Shariah pronouncements and declarations of Shariah-compliance to the Central Bank. Before an IFI prepares a report, it is required to undergo a Shariah review process by an independent internal Shariah auditor to ascertain the conformance or non-conformance of all transactions. Although there is a standard guideline from the central bank for the collection, compilation, analysis and reporting of information, in practice IFIs need not follow the guideline and can submit their report in any format as long it discloses the required information.

Multiple Appointments – Are there Possible Conflicts of Interest?

The rapid growth of the Islamic finance industry on a global scale has led to the increase in the need for more qualified Shariah scholars and has highlighted the issues of multiple appointments of the same scholars in many IFIs. In Malaysia a scholar may not sit on the Shariah Committee of more than one bank, but in many Middle Eastern countries, multiple appointments are allowed and many IFIs take pride in appointing scholars known for their knowledge and reputation and perhaps even their leniency in endorsing products and services of IFIs.

Multiple appointments could lead to conflicts of interest. For example, the Shariah scholar's relationship with other members of a Shariah Board could affect the impartiality and objectivity of their decisions. Taking similar views on similar issues under different jurisdictions (in the interest of expediency) might not be objective as the case might actually require different considerations due to different circumstances. Also of concern is the capability of scholars to manage their time to be on many committees at the same time. It is therefore imperative for a proper policy or regulation on this issue to safeguard the credibility of IFIs and the Islamic finance industry. Adopting the Malaysian practice could certainly mitigate if not eradicate the 'fatwa shopping' among IFIs. In Malaysia, Section 16 B (6) of the Central Bank of Malaysia Act 1958 does not allow any Islamic financial institution (IFI) to appoint any member of the Shariah Committee of another Islamic financial institution in the same industry. However, they can be a member of the Shariah Committee of another Islamic finance industry like *takaful*, but cannot be members of more than two Shariah Committees at the same time.

Are the Fatwas¹ Consistent?

The inconsistency and conflicting views on similar issues in different jurisdictions further clouds the progress and harmonization initiatives in the Islamic finance industry. This compromises the consistency of judgments across IFIs. For example, the General Council for Islamic Banks and Financial Institutions (CIBAFI) reported that ten percent of the 6,000 *fatwas* issued by different IFIs with over 100 Shariah scholars were not consistent across IFIs (Iqbal and Mirakhor, 2007). The diversity of the interpretation of Shariah affects the determination of certain rulings on a particular issue, where an IFI would accept a new product as being Shariah-compliant in one jurisdiction while other jurisdictions would decide it to be non-compliant. A recent study published by ISRA (2012) reports that more than 54 percent of *fatwas* issued between Malaysia and the GCC are in direct conflict with each other.

A case in point is the issuance of *sukuk* in Bahrain, Kuwait and UAE compared to *sukuk* issued in Malaysia. The former countries consider Malaysian *sukuk* non-compliant due to the government guarantee on the capital invested. This inconsistency undermines investors' confidence and impedes the healthy growth of the Islamic finance industry. However, on a positive note, the inconsistencies in the Shariah resolutions are not totally unexpected as there are different schools of thought that allow a diverse level of interpretation and leniency on the same issue. For example, in the case of *bay al inah*, the Shafi' school of thought allows it to overcome the problem of lack of liquidity in the market on the grounds that suspicion of evil intent is not sufficient to render a transaction invalid. Conversely, the Maliki and Hanbali schools of thought disallows it as it is considered as a legal trick (*hila*) to circumvent *riba*. In Malaysia, though the Shafi' school is predominant, it

¹ Opinions of scholars.

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is not imposed on Shariah committee members to base their decisions on a particular school of thought. By default, since most of the Shariah committee members are from the Shafi' school of thought, the decisions are biased towards this school.

Conclusion

Malaysia, being the hub of Islamic finance, is committed to provide the required infrastructure, the Shariah Governance Framework, to support this niche and growth industry. In fact, this framework is a part of the 5-year plan for the Islamic finance industry (or formally known as Islamic Finance Industry Framework) chartered to guide a proper growth and competitiveness of the industry.

This paper highlights the challenges faced by Shariah Committees in safeguarding the Shariah-compliance of IFIs in their business operations. The Shariah Governance Framework requires all IFIs to set up and effectively operate Shariah Committees. Effective Shariah governance that emphasizes elements of transparency, trust, and integrity provides credibility to the IFIs and the Islamic finance industry. The role of Shariah Committees has become even more important in the light of the recent turmoil in financial markets. Having the governance infrastructure provides no guarantee of effective governance if there is no an equal commitment from the IFIs to follow through on the guidelines and achieve the expectations.

On a practical note, IFIs require time and a gradual transition to provide the expected effectiveness, and in the process to identify any flaws of the framework of this dynamic industry and economy and to improvise more practical yet objective measures or initiatives to improve the credibility of the Islamic finance industry.

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MIDDLE EAST INSIGHTS

ISLAMIC FINANCE SPECIAL

MIDDLE EAST INSTITUTE, NATIONAL UNIVERSITY OF SINGAPORE

GERMAN BANKS: MORE ISLAMIC THAN ISLAMIC BANKS?

BY ROSANA GULZAR MOHD

“Islamic banking, in its current form, will go down in history as a mighty deceit based on an operational principle that is simply unfeasible. Islamic banks give and take interest as a matter of course, though under the guise of commissions, fees, penalties or profit shares. The holder of a “halal” credit card pays a penalty on unpaid balances; this penalty is proportionate to the size of the balance, which makes it equivalent to interest.”

Timur Kuran in a 2013 Financial Times interview¹

While this is an accurate description of Islamic banking currently, where Kuran is wrong however, is in his assertion that the fault lies with the *Shariah*. That they are unsuitable for current times. This paper argues that genuine Islamic banking *is* possible when there is an ecology of institutions and people who embrace the precise values that drive this form of finance. The malaise that afflicts Islamic banking currently is brought on by an unthinking submission to the free market objectives of profit-maximisation at the expense of justice, equity and social welfare.

Malaysia is a classic case in point. Its latest scandal, involving the country’s multi-billion-dollar pilgrims’ fund, *Tabung Haji* (TH),² belies deep fractures in the financial

¹ Barnes, W. (2013). Islamic finance sits awkwardly in a modern business school (Interview with Timur Kuran). Retrieved from <http://www.ft.com/intl/cms/s/2/ee2a2b36-9de5-11e2-9ccc-00144feabdc0.html#axzz3pjcHa6LI>

system. The issue is not only in the state of its Islamic finance. It goes further into whether the country has an economic system that is conducive to Islamic finance. Malaysia is at an interesting crossroad that may offer its people a chance of redemption or at least a change. Rocked by a political turmoil that has spilled into the economy, the calls for a new prime minister are getting louder, just as its long-serving governor of the central bank vacated the seat for her successor.

Under the patronage of Zeti Akhtar Aziz, the recently retired governor, Islamic finance's market share has grown to 26.8 percent of domestic banking assets³. Maybank, the country's largest, said that it disbursed more Islamic than conventional financing for the first time in 2015.⁴ A look beyond the numbers however, gives cause for worry. Islamic finance has been accused of being no different from conventional finance although their founding theories are diametrically apart.⁵ In theory, its ban on interest or *riba* calls for earnings that can only be justified through work, ownership or liability. By extension, the prohibition encourages a spirit of mutuality in helping one another shoulder burdens and share rewards. In practice, however, Islamic finance in Malaysia embodies more of the profit-maximisation, risk-transfer characteristic of *riba*-based conventional banking.⁶

Recognising this conundrum, Bank Negara Malaysia (BNM), its central bank, has made a laudable attempt to right the ship. As part of the Islamic Financial Services Act (IFSA) 2013, it requires Islamic banks to make a clear distinction between deposits and investments. The former are principally guaranteed while investors, in the spirit of profit and loss sharing in Islam, need to accept market-based returns, even if that means a loss. Islamic banks are not surprisingly resisting these efforts, citing their incompatibility with current financing and legal systems.⁷

² Tabung Haji is a development financial institution (DFI) that is *not* regulated by the central bank. It falls under the auspices of the Ministry of Finance, which is headed by Malaysia's Prime Minister (PM). Concerns over the institution came to a head in January 2016 when letters from the BNM governor, Zeti Akhtar Aziz, warning that TH is insolvent and that its reserves were in the red, were leaked to the press. The letters were sent to the PM's office and TH's chairman. TH assured contributors that the deposits are safe even as the possibility of a RM 1 billion government bailout was raised. This is because the TH Act provides this guarantee should the institution falter. In a bid to stem withdrawals, a minister in the PM's Department, Datuk Seri Jamil Khir Baharom said that depositors who withdrew their savings will lose their turn to perform the pilgrimage for up to 70 years.

³ BNM's 2015 Financial Stability and Payment Systems Report. Table A.2 Key Financial Indicators – Islamic banking and *takaful* sectors.

⁴ Maybank says Islamic loans overtake conventional financing for the 1st time. Bloomberg. 3 March 2016.

⁵ Azmat, S. et al. (2015). Can Islamic banking ever become Islamic?

Chong, B. S., & Liu, M. H. (2009). Islamic banking: interest-free or interest-based?

Khan, F. (2010). How "Islamic" is Islamic Banking? *Journal of Economic Behavior and Organization*, 76, 805–820.

⁶ Charap, J., & Cevik, S. (2011). The behaviour of conventional and Islamic bank deposit returns in Malaysia and Turkey.

Gulzar, R., Masih, M. (2015). Islamic banking: 40 years later, still interest-based? Evidence from Malaysia.

⁷ Presentation: 'The Shift of Mudharabah Products into Investment Accounts. Market Impact and Its Acceptance' by Standard Chartered Saadiq, 18 November 2015.

Bankers say there are still limited options for Shariah-compliant investments, both short- and long-term. And customers, including Muslims, are accustomed to deposit guarantees and fixed returns. How then do banks suddenly sell them an 'investment account' that promises neither? Most importantly, how does the dual system in Malaysia handle different rates of return for conventional and Islamic banks? Does BNM have a plan for the ensuing capital flight? These factors have led Islamic banks in Malaysia to do more, not less *commodity murabaha*, the contract known to offer *riba* through the backdoor.

BNM said in its '2015 Financial Stability and Payment Systems Report', "On the liability side, Islamic banks issued more fixed rate funding instruments such as *tawarruq* (fixed rate deposits) with longer contractual maturities to narrow the re-pricing gap against Islamic banks' fixed rate assets. As at end-2015, fixed rate deposits of Islamic banks increased to account for a significantly higher share of 56.8 percent (2014: 35.7 percent) of total deposits, or 42.7 percent (2014: 30 percent) of the total funding base."

It continues, "The shift towards *tawarruq* was also partly in response to the regulatory requirement to clearly differentiate between deposit and investment account products in accordance with the IFSA 2013. This increased demand for deposit products that are principal-guaranteed. In contrast, *mudarabah*-based general and specific investment deposits declined by 84 percent to account for 3.1 percent (2014: 19.7 percent) of the funding base."⁸

The reason for this failure is that the policy makers, in drafting IFSA 2013, seem to not have borne in mind the bigger economic setting in which their Islamic finance industry fits. As mentioned, for Islamic finance to flourish, it needs an ecology of people and institutions who are sympathetic to its higher ideals of social welfare and justice. The current reform effort can thus be likened to squeezing a square peg into a round hole. They just do not fit.

Comparing the Malaysian System Against Germany

This study thus sets out to compare the Malaysian system against another system which seems better at upholding the Shariah principles. Germany is an interesting case study because besides having a World Cup champion football team, the country also ranks highly for economic development, financial inclusion, funding for small and medium-sized enterprises (SMEs) and the provision of state welfare without losing competitiveness.⁹ There could thus be much to learn from such a society.

Specifically, this study compares the profitability and stability of banks in both countries between 2006 and 2014. This covers their performances before, during and after the global financial crisis. The profitability and stability are measured through the banks' returns on average equity (ROAE), returns on average assets (ROAA) and net loan to deposit and short-term funding. ROAE, which is net income/average shareholder's equity,

⁸ Ibid. Pg 46.

⁹ The World Bank's 2014 Global Findex survey and 'SME Finance Forum' which cites 'SME Performance Review EU, 2011'.

reflects the banks' ability to generate profits out of shareholders' monies. ROAA, on the other hand, measures net income/average total assets. It shows the management's efficiency in using assets to generate earnings. The stability indicator, net loan to deposit and short-term funding, is a proxy for Basel's Net Stable Funding Ratio, which measures the proportion of long-term assets funded by long-term, stable funding.¹⁰

Although it focuses on the Islamicness of Islamic banks, the present analysis extends to conventional banks and interest-bearing institutions in Malaysia because as mentioned, the form of Islamic finance currently is in essence, conventional finance. Thus, even if the country achieves its 2020 goal of a 40 percent market share, or becomes 100 percent 'Islamic', the system remains at heart, conventional. Another reason why the analysis includes other institutions such as conventional banks, development financial institutions (DFIs) and cooperatives is that, as mentioned also, in righting the ship for Islamic finance, one needs to bear in mind the broader economic setting and the Islamic banks' interactions with other institutions. Islamic finance does not exist in a vacuum, so correcting it will likely require changes in the overall system as well.

Germany's Unique System

Germany is chosen because of its unique financial landscape, which is made up of "three pillars". While it has private, commercial banks, the system is dominated by state-owned savings banks, or *Sparkassen* in German, and community-owned cooperative banks. Together, they contribute almost half of the financial system's assets.

Table 1: Type of banks in Germany

As of 2010	Number of institutions (% of total)	Assets (% of total)
Commercial	14.5	36
Savings¹	22.4	31
Cooperatives	59.4	11
Others²	3.7	22
Total	100	100

¹ Includes Landesbanken, which are the central banks for savings banks.

¹⁰ The data are sourced through Bankscope. While limitations abound, efforts have been made to plug the gaps as far as possible. For example, while the priority is to use the consolidated statements of each bank, when these are unavailable, their unconsolidated statements have been used. For the Malaysian financial institutions, the limitation is that while the list is mostly aligned with BNM, some institutions, such as Lembaga Tabung Haji and the Credit Guarantee Corporation Berhad could not be included as Bankscope does not have their data and they are not publicly available. Additionally, BNM classifies Bank Kerjasama Rakyat Malaysia Berhad as a DFI when the bank is in actual fact, a cooperative. This study thus classifies Bank Rakyat as a banking cooperative to more accurately reflect its business.

² Others include mortgage banks and building and loan associations.

Source: IMF. (2011). Germany: Technical Note on Banking Sector Structure, Country Report No. 11/370, pg 25.

Given the objective of drawing lessons for a system conducive to Islamic finance, this paper focuses on the latter two types namely, the savings and cooperative banks. In Germany, there are 439 savings banks and 1,140 cooperative banks,¹¹ which contribute almost half of the financial system's assets. The rest mainly comes from the three private banks there. The savings banks, which are owned by local governments, are not required to maximize profits although they need to avoid making losses. This allows them to pursue other goals such as supporting local cultural, social and economic development. The cooperative banks have a similar mandate but they are owned by their members who, in turn tend to be their depositors and borrowers. The cooperative banks operate a mutual guarantee scheme and their key role is to support the economic undertakings of their members, who represent about half of their customers. Essentially, both the savings and cooperative banks are geared to provide financial services to the German public and SMEs.

Germany presents an interesting case study for Islamic finance because its long history of savings and cooperative banks shows how the society has embodied the *Shariah* principles of pooling resources for a greater, common good as in the case of *takaful*. These two types of banks also show how the country has embraced the mutual sharing of profits and losses, a key requisite of the *musharakah* contract in Islamic finance. Their success seems to be due to the fact that the savings and cooperative banks are under less pressure to maximise profits compared to commercial banks because the shareholders are the state or the communities themselves. This allows them to focus on due diligence to spot sustainable businesses for financing, after which they will partner the companies over the long haul. These features have not only helped the less credit-worthy members of their society gain financing but has also made the German financial system more stable.¹² In fact, a 2010 study by S. Rehman and Askari found that the German economy is more Islamic than Malaysia. In their 'Economic IslamicityIndex', Germany is ranked 26 while Malaysia came in at number 33, the highest for a Muslim majority country.¹³

Indeed the founder of the world's first Islamic bank, Ahmed El-Najjar, was impressed with how the German savings banks aided the economic recovery of West Germany after World War II. In 1963, he set up Mit Ghamr local savings bank in Egypt by combining the German savings banks' way of inculcating thrift with the village people's deep religiosity. Most significantly, El-Najjar's bank showed how we can foster a

¹¹ Source: IMF. (2011). Germany: Technical Note on Banking Sector Structure, Country Report No. 11/370, pg 25.

¹² The German Financial System and the Financial Crisis, Detzer, Daniel; Intereconomics/Review of European Economic Policy, March 2014, v. 49, iss. 2. Pg 63-4.

¹³ The study involved a ranking of 208 Islamic and non-Islamic countries based on their adherence to the theoretical workings of an Islamic economy. The researchers developed 113 proxies under three broad headings; achievement of economic justice and sustained economic growth, broad-based prosperity and job creation, and lastly, the adoption of Islamic economic and financial practices.

responsible financial attitude among customers, something grossly lacking in today's consumeristic and debt-laden world. Specifically, the way his bank linked investment financing to the investment accounts may offer lessons for the architects of Islamic finance reform. El-Najjar used profit-sharing contracts such as *mudaraba* and *musharakah* for the investment accounts, the monies of which could only be withdrawn after a year. The returns would be commensurate with the size of the deposit and the bank's profits. Another incentive for investors was their access to investment loans.¹⁴

Even the way the loans were disbursed offers lessons. They went exclusively towards the setting up of small businesses in the area. When investors showed promise but lacked the initiative to secure financing, the bank's staffs would help. For one such customer, the bank built a factory and gradually transferred ownership to him. Mayer, A. E. (1985) cited someone who observed the project, R K Ready, as saying that the villagers were deeply grateful for the critical financing, which they believed would not have come from other sources. El-Najjar's model was, however, short-lived due to a dispute with the Egyptian government.¹⁵

Another renowned academician, Mahmoud el-Gamal, argues that the concept of mutuality, as exemplified by the German *Sparkassen* and cooperative banks, can bring contemporary, erroneous practices of Islamic finance back to its roots. It simultaneously addresses corporate governance as well as religious concerns.¹⁶ The former is an issue, especially for investment accounts, because their owners lack protection both internally through board representation or externally through market discipline.

The religious concern that mutualisation can ameliorate is ironically the prohibition of *riba*. As El-Gamal argues, Islamic banks currently avoid the formal prohibition in a money-for-money transaction by turning it into a money-for-property transaction (in *murabaha* financing) or money-for-usufruct transaction (in *ijara* financing). But high levels of interest, or profit, as Islamic banks call it, can still occur since there are no legal ceilings on profits in sales. Add to that the profit-maximisation drive of current Islamic banks and borrowers will most likely end up with the highest interest rates possible as depositors get paid the lowest. Mutualisation, by aligning the interests of investment account holders with the banks' shareholders, ameliorates the current warped incentive structure where managers prioritise the interests of shareholders by maximising profits at the expense of customers on both sides of the balance sheet.

Issues with Malaysia's Islamic Finance

Malaysia has parallels to the German system. It has two groups of financial institutions: one falls under BNM and the other is supervised by various government ministries. BNM

¹⁴ Mayer, A. E. 1985. Islamic Banking and Credit Policies in the Sadat Era: The Social Origins of Islamic Banking in Egypt. Arab Law Quarterly, pg 36-7.

¹⁵ Hegazy, Walid S. (2007) "Contemporary Islamic Finance: From Socioeconomic Idealism to Pure Legalism," Chicago Journal of International Law: Vol. 7: No. 2, Article 13. Pg 585-9.

¹⁶ El-Gamal, M. A. (2005). Islamic bank corporate governance and regulation: A call for mutualization. Pg 9-15.

supervises the commercial banks (Islamic and conventional), investment banks and six DFIs. The rest, made up of non-bank financial institutions such as cooperatives,¹⁷ other DFIs and a building society, are supervised by the government ministries.

Like Germany, Malaysia has commercial banks, state-backed development banks and cooperatives but unlike Germany, the commercial banks dominate the system in terms of assets. They are the largest providers of funds in the banking system, as reflected in the first four rows of the table below.

Table 2: Type of banks in Malaysia

As of 2014	Assets (% of total)
Commercial banks:	
Conventional banks	65.3
Islamic banks²	18.2
Investment banks	2.1
DFIs³	10.0
Cooperatives	4.4
Total	100.0

² This differs from the 25.5 percent market share in 2014 as the latter includes DFIs.

³ DFIs refer to development financial institutions (both under/not BNM).

Source: BNM Financial Stability and Payment Systems Report 2014, BNM monthly statistical bulletin, December 2014, 1.7 Banking System: Statement of Assets, Malaysia co-operative societies commission.

Note: The table excludes other sectors such as insurance companies, pension fund etc.

Herein lies the issue with the way Malaysia has built its Islamic finance practice. Like most countries in the world today, Malaysia adopts a mixed economic system where free market principles intersperse with a degree of economic planning and state-directed activities.¹⁸ Largely a reflection of the free market principles, its banking system is dominated by commercial banks. This creates a problem for Islamic banks because they are made to compete head-on with other commercial banks in a profit-maximising arena when they are based on diametrically opposite founding theories of a prohibition of interest and,

¹⁷ Malaysia has nine types of cooperatives such as banking, credit, housing and farming but this study focuses on the banking cooperatives because Bankscope has data only on this group. It is the largest type of cooperative in terms of assets and profitability. Noteworthy also is the fact that the group is made up of only two members; Bank Rakyat and Bank Persatuan Malaysia Berhad but data in this group is mainly from Bank Rakyat as there is limited data from Bank Persatuan; it not being regulated by the central bank.

¹⁸ BNM Financial sector blueprint 2011-2020, p 18.

therefore, non-profit maximisation. Indeed Bankscope data confirmed the hypothesis that Malaysian Islamic banks are significantly more profitable and more efficient at using assets to generate income compared to German savings banks (Table 3).¹⁹ The trend largely holds except for a blip in ROAA in the pre-crisis years.

Table 3: Profitability: Malaysia Islamic banks vs German Sparkassen

Types of banks	ROAA			ROAE		
	2006-7	2008-10	2011-14	2006-7	2008-10	2011-14
Malaysia (Islamic)	0.10	0.65	0.56	42.13	9.03	9.10
Germany (Savings banks)	0.17	0.12	0.20	3.17	2.37	2.53

Source: Bankscope, January 2016.

This race for profitability belies a dire issue. In order to survive, the Islamic banks have had to quickly adopt contracts that mirror their conventional counterparts. This led to an adherence of the interest prohibition in form, but not spirit²⁰. Likewise, the Islamic banks have compromised on their social obligations in exchange for maximum profits²¹. Another casualty seems to be the system's stability. Although the German savings banks are less profitable than the Malaysian Islamic banks, their recovery post-crisis was stronger. The German savings banks enjoyed an ROAE rebound of 6.75 percent²² compared to the 0.78 percent²³ improvement for Islamic banks. Further, the formers' ROAA jumped 66.7 percent post crisis compared to a decline of 13.8 percent for Islamic banks. These results affirm Ahmed El-Najjar's observations of the German savings banks' tenacity in riding out a crisis while supporting the notion that Islamic banks in Malaysia, in their drive for profit-maximisation, are as unstable as their conventional counterparts.

In terms of their lending aggressiveness too, an interesting trend unfolds when Malaysian Islamic banks are compared against the German savings banks. The former are getting more aggressive post-crisis compared to German savings banks (Table 4). Before the crisis, their net loan to deposit and short-term funding ratio was lower than the German savings banks. This ratio became comparable during the crisis and continued northwards in recent post-crisis years. This may be due to the government's concerted effort to increase the market share of Islamic finance to 40 percent by 2020.²⁴

¹⁹ Given their ideological link, the Malaysian Islamic banks are specifically compared against the German savings banks.

²⁰ Theedgemarkets.com. (2015). Special Report: The shariah debate on Islamic financing.

²¹ Public Lecture by the Recipient of The Royal Award for Islamic Finance 2014, Datuk Dr Abdul Halim Ismail (Malaysia).

²² Obtained from Table 3: $(2.53-2.37/2.37) * 100$.

²³ Obtained from Table 3: $(9.10-9.03/9.03) * 100$.

²⁴ BNM's 'Financial sector blueprint 2011-2020', p 49.

Table 4: Lending aggressiveness: Malaysia Islamic banks vs Germany Sparkassen

Type of bank	Net loan/Deposit & short-term funding		
	2006-7	2008-10	2011-14
Germany (Savings banks)	68.70	65.93	65.43
Malaysia (Islamic banks)	57.30	63.39	72.89

Source: Bankscope, January 2016.

This fixation of registering ever higher numbers, however, may have worrying implications. The most obvious is the higher liquidity and default risks that Islamic banks are piling on with an increasing loan-to-deposit ratio. The urgency to grow has also led to a focus of form over substance. While the German savings banks are known for inculcating thrift and riding out crises, Islamic banks in Malaysia are accused of using ‘shariah-compliant’ contracts which are not anchored on Islamic principles of justice and equity. Contracts used for home financing such as *bai bithman ajil* or BBA and more recently, *murabahah*, *musharakah* and *ijarah* have left customers with most of the risks and Islamic banks most of the profits.²⁵

In one landmark ruling in 2006, the judge of a local, civil court said in a case involving a home financing default²⁶ that a borrower under a *riba* loan would have paid less interest than a purchaser under the ‘Islamic’ facility.²⁷ The High Court then reduced the amount sought by the bank from the home buyer by RM 376,000. BNM later avoided future embarrassing judgments by mandating its Shariah Advisory Council as the ultimate decision maker on cases involving the Shariah-compliance of its Islamic banks.²⁸

The 2020 goal also means the country has less than four years to garner an additional 15 percent market share when it has taken over 30 years to reach the current 26.8 percent. In short, as long as the Islamic banks in Malaysia are made to compete head-on with conventional banks in the private sector, we may fall short, quantity-wise, of the 40 percent target market share, not to mention, the apparent disconnect, in terms of quality, between their profit-maximisation drive and the Islamic values that the banks are supposed to embody.

Malaysian DFIs and Cooperatives

²⁵ Theedgemarkets.com. (2015). Special Report: The shariah debate on Islamic financing.

²⁶ Affin Bank Berhad versus Zulkifli bin Abdullah.

²⁷ Seeni Mohideen, H. (2006). Affin Bank Bhd vs Zulkifli Abdullah – Shariah perspective. *Malayan Law Journal*. Pg 3.

²⁸ This was done by adding clause no. 58 to the Central Bank of Malaysia Act 2009.

Another issue with the Malaysian financial system is that while it has ‘community-oriented’ financial institutions such as the DFIs and cooperatives, they are dwarfed in asset size.²⁹ Additionally, since the 1970s, they have been beleaguered with allegations of misconduct of senior executives, fund misappropriations and even predatory lending tactics.³⁰ So although the DFIs and cooperatives have the largest potential to uplift the economic well-being of Malaysian society, especially the lower-income groups, they have had the opposite effect in Malaysia. The country’s level of financial inclusion, while higher than its benchmark group of countries, shows a 5-7 percent disparity between all adults and the poorest 40 percent and those living in rural areas. Similarly, while Ministry of Micro, Small and Medium Enterprises (MSME) form almost all types of enterprise in Malaysia, they only contribute to a third of the GDP.

Comparable, if Not Higher, ROAE and ROAA than Commercial Banks

Indeed Bankscope findings on Malaysia’s DFIs and cooperatives are startling. Firstly, in terms of profitability, both the ROAE and ROAA for DFIs and banking cooperatives are comparable, if not *higher*, than commercial banks (Table 5).³¹

Table 5: Profitability of Malaysian financial institutions

Type of institutions	ROAA			ROAE		
	2006-7	2008-10	2011-14	2006-7	2008-10	2011-14
Banking cooperatives	2.18	2.57	2.42	16.57	23.37	16.86
DFIs	0.99	1.23	1.62	38.08	10.20	9.16
Banks (weighted average of commercial, Islamic and investment banks)	0.85	0.95	0.85	21.60	10.47	9.57
Islamic banks	0.10	0.65	0.56	42.13	9.03	9.10

Source: Bankscope, January 2016.

²⁹ DFIs and cooperatives contribute 14.4 percent of assets in the banking system in 2014 (Table 2).

³⁰ New Straits Times. (2005). Help for troubled coops to stop.

Othman, I. W. et al., (2013, January). Cooperative Movements in Malaysia: The Issue of Governance.

³¹ The anomaly for ROAE in 2006 is because the numbers for Islamic banks and DFIs are inflated by one institution in each category, namely Bank Islam and Bank Simpanan Nasional (National Savings bank). Otherwise, the trend holds.

That the DFIs and banking cooperatives are *more* profitable than the commercial banks, even the Islamic banks, are unexpected as the former two institutions are supposed to focus on financial inclusion at the expense of higher profits. Indeed, German cooperatives and savings banks have lower ROAEs and ROAAs than their commercial and investment banks.

DFIs and Banking Cooperatives are Alarmingly Aggressive in their Lending

The second surprise was in the lending aggressiveness of the DFIs and banking cooperatives. While the commercial banks seem prudent in their lending using short-term funds, these two institutions are alarmingly aggressive (Table 6). During the crisis, DFIs increased their proportions of net loans using short-term funding by 55 percent when other types of banks increased theirs by 8.5 to 10 percent.

Table 6: Stability of Malaysian financial institutions

Type of institutions	Net loan/Deposit & short-term funding (%)			Impaired loans/Gross loans (%)		
	2006-7	2008-10	2011-14	2006-7	2008-10	2011-14
Banking cooperatives	83.96	91.09	94.77	6.73	4.35	2.40
DFIs	128.52	199.53	145.02	15.20	18.31	15.42
Banks (excluding investment banks)	57.15	62.96	65.58	5.80	3.23	2.48
Islamic banks	57.30	63.39	72.89	7.18	3.78	3.62

Source: Bankscope, January 2016.

To an extent, this is understandable as the crisis and post-crisis period was one of deleveraging for banks. As leverage shifted from the private to public sector, public institutions such as DFIs and cooperatives stepped in to provide finance while banks retrenched. However, the extent of lending aggressiveness in these institutions is still alarming. In comparison, a study of credit unions worldwide, a particular type of

cooperative, showed loan to deposit ratios which on average, is well below unity.³² Given that the Malaysian DFIs and banking cooperatives also have higher percentages of impaired loans compared to commercial banks, these suggest that the Malaysian financial system is less stable than Germany *not* because of the profit-driven commercial banks but because of its DFIs and cooperatives.

This is surprising because the presence of these latter two institutions tend to add, not reduce stability. On the other hand, profit-driven commercial banks tend to be blamed for bringing the 'house' down with their risky practices and reckless trading positions. In Malaysia, it seems to be the other way round.

Issues with the DFIs and Cooperatives

Indeed the DFIs and cooperatives in Malaysia suffer from a number of issues, namely their aggressive lending and a lack of protection for depositors. To be fair, these institutions constitute a small part of the banking system or 14.4 percent of assets, to be exact (Table 2). But as the recent scandal involving the country's multi-billion-dollar pilgrims' fund, TH, shows, concerns over their financials can quickly escalate and lead to wider systemic risks. This is not to mention the erosion in confidence of the social and religious values that these institutions are expected to uphold. As Malaysia heralds the adoption of Islamic finance across all financial institutions, including DFIs and cooperatives, it is worth asking, just how 'Islamic' are these institutions?

The fact that Malaysia's DFIs and banking cooperatives are reporting comparable, if not, higher profits than commercial banks, on the back of aggressive lending, is an issue. While Islam allows both profit and debt, the latter is not to be taken lightly and profiting from debt is to earn *riba*. Admittedly, not all DFIs and cooperatives adhere to Islamic finance but as mentioned earlier, Islamic finance in Malaysia currently mirrors its conventional counterpart. Thus even if all of the institutions become Islamic, the form would in essence, still be conventional finance.

Further, any wrongdoing by the DFIs can pose reputational and Shariah non-compliance risks to the Islamic finance sector because 7.4 percent of the 25.6 percent market share in 2014 came from DFI assets while 18.2 percent was from Islamic banks (Table 2). This means that DFIs contribute almost one-third of the Islamic assets in Malaysia.

Lending on a High

To put into proper context the DFIs' net loans to deposit and short-term funding ratios, one needs to understand whether they have alternative sources of funding. According to BNM's 2015 Financial Stability and Payment Systems Report, 65 percent of their funding came

³² Al-Muharrami, S. M., & Hardy, D. (2013). Cooperative and Islamic Banks: What can they Learn from Each Other? Pg 8.

from deposits, including those by statutory bodies (Table 7). Given that deposits *are* their main source of funding, the fact that their net loans are two to three times more than their deposit and short-term funding is worrying and questionable from a Shariah perspective.

Table 7: Sources of funds for Malaysian DFIs, 2015

	RM million	% of total
Shareholders' equity	36,217.60	13%
Liabilities		
Deposits accepted	177,492.00	65%
Borrowings	23,035.30	8%
Government	11,391.60	4%
Multilateral/ International agencies	3,930.30	1%
Others	7,713.40	3%
Debt securities issued	17,692.30	6%
Others (eg government assistance, miscellaneous liabilities)	20,371.40	7%
Total liabilities	238,591.00	87%
Total sources of funds	274,808.60	100%

Source: BNM's Table A. 14: Development Financial Institutions:

Sources and Uses of Funds.

Note: Under 'liabilities', the percentages do not add up to 87 percent because of rounding.

The government and central bank seem aware of these issues and have been taking steps, since early 2000, to ameliorate them. In BNM's Financial Sector Masterplan for 2001-2010, its recommendations for DFIs include a ringfencing of the government's loans, presumably to increase accountability. It then encouraged DFIs to raise funds through the capital market as far as possible. Also, BNM called for a better regulation of the DFIs so that their policies will be brought in line with national policies.³³ Since then, six of the country's 13 DFIs have come under its watch and a guideline has been issued to enable DFIs to source cheaper funds from the interbank market.³⁴ Still, as of 2015, debt securities formed only 6 percent of the DFIs' source of funding while the portion of deposits and government borrowings has increased from 66.7 percent in 2009³⁵ to 69 percent (Table 7). As the TH scandal reminds us, Malaysia faces reputational and Shariah non-compliance risks if more is not done to tighten regulations for the country's 13 DFIs.

³³ BNM Financial Sector Masterplan for 2001-2010, pg 91.

³⁴ Monetary and Financial developments, Economic report, 2008/2009. Ministry of Finance. Pg 138.

³⁵ Ibid, pg 139.

Lack of Depositor Protection

The other issue that afflicts DFIs and cooperatives in Malaysia is the uneven regulation when it comes to deposit protection. While Germany has more than sufficient deposit insurance for all financial institutions, including its savings and cooperatives banks,³⁶ Malaysia's deposit insurance is compulsory only for its conventional and Islamic banks but *not* the DFIs and cooperatives.³⁷ This means that in the case of bank runs, depositors of conventional and Islamic banks are assured of receiving a maximum of RM 250,000 each but not all who deposited with DFIs and cooperatives are backed by government guarantees of bailouts. The International Monetary Fund (IMF) picked up on this issue when invited by the Malaysian government to assess its deposit insurance system.

In a report dated February 2013, the IMF said, "Membership in PIDM is compulsory for all licensed commercial and Islamic banks. However, there are other deposit taking institutions which together comprise about 10 percent of the deposits in the banking system which are not members of PIDM. The majority of these deposits are held in institutions that are subject to explicit or implicit government guarantees of their deposits (although these institutions do not pay a premium for the coverage) but there are others (credit cooperatives) that are not part of any deposit insurance system and do not have such guarantees. It is not clear that the credit cooperatives are subject to the same level of supervision and regulation as the commercial banks." IMF added that the deposit-taking institutions, which do not pay premiums for deposit insurance but have explicit or implicit government guarantees, are gaining an unfair advantage over banks which pay deposit insurance. IMF rated Malaysia 'largely compliant' for this aspect of the assessment.³⁸

Playing with the Pilgrims' Funds

Three years on, the situation has become worse with the TH scandal. Being a DFI, its deposits are not insured by PIDM but Section 24 of the TH Act provides for a government bailout should the institution falter. This, however, may not mean much at a time of drying government coffers. Further, the nation's pilgrims' fund is also guilty of blurring the lines between deposits and investments. This creates two issues, one of which is the difficulty in rationalising the products to determine whether they qualify for deposit insurance. The other issue is more alarming because it involves the extent of TH's Shariah-compliance.

³⁶ BAFIN, Deposit protection and investor compensation.

http://www.bafin.de/SharedDocs/FAQs/EN/Consumers/BankenBauSparkassen/SicherungEntschaedigung/03_institutssicherung.html?nn=3024646

³⁷ PIDM (Perbadanan Insurans Deposit Malaysia) <http://www.pidm.gov.my/For-Public/About-Deposit-Insurance/Member-Banks>

³⁸ Largely compliant means "when only minor shortcomings are observed and the authorities are able to achieve full compliance within a prescribed time frame".

TH is currently using terms such as ‘deposits’ alongside ‘bonus’ or what is commonly cited in the press as ‘dividends’. This creates a Shariah issue because deposits under the *wadiah* (safekeeping) contract should bear no return while those under investment-type of contracts such as *mudaraba* should pay market-based returns. TH, and Islamic banks in dual systems such as Malaysia, however face the problem of capital flight if their returns on deposits are lower than conventional banks. Thus, they have turned the contract into a *wadiah yad dhamanah* (safekeeping with guarantee) where the banks will get to invest their customers’ monies in exchange for providing a principal guarantee. The banks then use *hibah* (gift) as a concept to pay depositors rates that match what other banks are paying. While technically allowed in Shariah, this is one of numerous examples of how Islamic banks conform to the Shariah in form but not spirit. In essence, the Islamic banks have devised a way to operate just like their conventional counterparts.

In fact, IFSA 2013 precisely tries to solve this conundrum by requiring its Islamic banks to make a distinction between deposits and investments. This new regulation interestingly does *not* apply to TH since it is not regulated by the central bank. It does however apply to another DFI, Bank Rakyat, which is under BNM supervision.³⁹ This uneven regulation raises the question of why some financial institutions provide deposit protection while others do not and why some such as TH can continue to blur the lines between deposit and investments when others have had to make a distinction between the two. As the TH scandal shows, these conundrums lead to questions not only on the financial institution’s going concern but also the extent to which it upholds the Islamic values that it purports to serve its customers.

Why the Uneven Regulation?

In Malaysia, however, the DFIs and cooperatives seem sidelined in the financial institutional framework. PIDM is a government-backed insurance scheme, whose board of directors include the Ministry of Finance (MoF)’s Secretary General of Treasury as well as the Central Bank Governor. Both MoF and BNM also share regulatory oversight of the DFIs so why exclude these institutions from the deposit insurance scheme?

The answer could be in the qualification criteria for PIDM. The premiums paid by the banks depend on their scoring, which have quantitative and qualitative components. The former, which has a 60 percent weightage, looks into indicators such as the capital buffer, return on risk-weighted assets ratio and loans to deposits ratio.⁴⁰ The qualitative aspect, on the other hand, evaluates among others, whether the bank has received any letter of warning from a regulator on a deficient or non-compliant aspect of its business and whether the bank has received any form of assistance, financial or otherwise, from BNM or PIDM.

Given the issues raised in this paper about the DFIs’ unexpectedly high profitability,

³⁹ Bank Rakyat 2013 annual report, page 181.

⁴⁰ Malaysia deposit insurance corporation (Differential premium systems in respect of deposit-taking members) (Amendment) Regulations 2015, pg 23, 32.

aggressive lending and dependency on government assistance, it is perhaps not surprising why these institutions cannot be held on par with commercial banks when it comes to regulations. This however begs more questions: is the government guarantee then an implicit recognition and encouragement of the DFIs and cooperatives' substandard practices? Should not more have been done to bring standards on par with commercial banks as is the case in Germany?

Lessons for Islamic Finance Reform

The study of Germany's financial system shows that a truer type of Islamic finance is possible. The presence of cooperatives and savings banks in the system has led to higher financial inclusion and stability, albeit at a lower profitability when compared internationally. Both institutions embody values such as being welfare-oriented that should have resonated with Islamic banks in Malaysia.

The banks' business models are also supported by an institutional set-up that 'forces' or makes it conducive for them to cultivate long-term relationships with customers. This is how the banks gather in-depth knowledge of the financing needs and risk profiles of their retail customers and businesses. For example, the savings and cooperatives banks in Germany follow a 'regional principle', where deposits from a region can only be disbursed for loans within the region. This aligns the banks' interest with customers in that they both benefit from the region's economic development and prevent the bank from 'cherry-picking' customers from more prosperous regions.⁴¹

Further, the ownership structure of both banks has elements of protection against the profit-maximisation goal of certain types of shareholders. The cooperatives, by nature, are owned by their customers, who exert pressure on the banks' management to advance their interests. Interestingly, the savings banks in Germany have the legal status of being 'institutions incorporated under public law'. This protects them from being taken over by "private banking groups or investors, whose principal aim is generally to increase profits."⁴² Thus, the savings banks have no owner and cannot be sold.

Care too seems to have been taken to reduce an abuse of power. The population in the region that the savings bank operates is represented in its supervisory board through representatives from the city council. But first, these representatives need to prove that they are financially-competent.

Contrast these with Malaysia. Making the Islamic banks run head-to-head alongside their conventional counterparts in a celebrated dual system has been more of a curse than a blessing. The Islamic banks have had to compete tooth and nail for profits in an environment that does not allow them to pay any more than lip service to social welfare considerations. Nor the time and space to better understand customers. The constant competition for higher numbers, especially to a parent who owns both conventional and Islamic banking businesses, naturally means the

⁴¹ German Savings Banks Association. (2012). Constitutive Elements of a (German) Savings Bank.

⁴² Ibid.

interests of the Islamic bankers are more aligned with the profit-driven ambitions of their shareholders than any customer.

Rethinking the Drivers

It is thus worth questioning Malaysia's strategy of pushing Islamic finance via its private sector. For it to succeed in creating a truer Islamic finance system, Malaysia needs a government and policy makers who can envision a whole economic system, and within it, a banking structure that, like Germany, balances the need to be profitable with social welfare considerations. For starters, Malaysia may need to rethink the drivers of her financial system. Germany's savings and cooperative banks are thriving because they are still a large part of the system. The private sector commercial banks contribute only one-third of assets. With size comes bargaining power and financial clout to be as they are. The German government has resisted calls to privatise more of its banking system. Malaysia on the other hand, is led by the private sector, with profit-maximisation as the *raison d'être*. Can Islamic finance thrive in such an environment?

Secondly, there may need to be institutional prop-ups to protect the social welfare functions of this new system from the incursions of the profit-driven capitalists. The public ownership of the savings banks in Germany for example, is a deliberate move to protect them from the ever pervasive hands of private investors. The 'regional principle' also has shown to be effective in securing the long-term commitment of the savings and cooperative banks. A natural outcome of which is their in-depth understanding of that region's customers' needs. Coincidentally, this is exactly what Islamic banks need if they are to transform themselves, under IFSA 2013, from being mere financial intermediaries to investment bridges.

Thirdly, this study's comparison between Germany and Malaysia has shown the need to condition or educate Malaysians on a different risk-reward system if we are to truly embrace Islamic finance. The analysis of the German system indicates a trade-off between profits, stability and financial inclusion. The Germans seem to have given up more opportunities for profit-making in exchange for a stable system and one that includes the less credit-worthy members of its society and SMEs. This is more in line with the Shariah of Islam. Malaysians may thus need to be weaned off their private sector tendencies for guarantees and predictable returns. In exchange, we may finally be able to walk the talk with a form of Islamic finance that genuinely rewards investors for their effort and risks taken.

Fourthly, if Malaysia is truly keen to build a genuine Islamic finance industry, there needs to be a better regard for shariah-compliance. As this research shows, the country has taken one too many questionable steps in its fixation to register ever higher numbers for Islamic finance. While Malaysia has undeniably built an entire infrastructure which spans education, regulations and ancillary supports such as Islamic capital and money markets, the country has also gained a reputation, not entirely unfounded, for allowing a number of questionable practices and contracts in Islamic finance. While steps have also been taken to

align Malaysia's Shariah standards with the Middle East, the other dominant region of Islamic finance, a truer type of Islamic finance may only be possible with a rethink of the drivers of her financial system.

Cleaning Up the DFIs and Cooperatives

In rethinking the drivers, the DFIs and cooperatives in Malaysia actually hold the most potential to help bring about genuine Islamic finance. As Germany has shown, the spirit of mutuality, as in the sharing of burdens and rewards, which is among the key features of Islamic finance, is better uplifted through institutions that are welfare-oriented and thus, not strictly profit-maximising. In Malaysia however, the DFIs and cooperatives seem to be sidelined. Their depositors receive no deposit insurance protection, regulatory oversight remains weak and in academia too, there is scant research on their issues. If Malaysia is to lead the world in Islamic finance, it will need more commitment from the government and regulator to clean up its DFIs and cooperatives and bring them to national standards.

For cooperatives specifically, because of their different business model, one may argue that their members should not be covered with deposit insurance because the idea *is* for them to partake in the cooperative's financial performance. Somewhat like *musharakah*, the profit-and-loss sharing contract in Islamic finance. The reality, however is that the collapse of any financial institution in a country poses systemic risks to the entire financial sector through a loss of confidence. Hence the series of government bailouts for its troubled cooperatives since at least 30 years ago.⁴³ Also the sharing of profits and losses works best in a functional system with proper governance. This, however, is a major issue for the cooperatives in Malaysia, and it needs rectification.

Overtly, there are numerous attempts by the government to improve the regulatory oversight of its DFIs and cooperatives. For the latter specifically, there is the second National Cooperative Policy (NCP) for the years 2011-2020, a number of amendments to the Cooperative Act and the setting up of the Malaysia Cooperative Societies Commission (MCSC) under the Ministry of Domestic Trade, Cooperatives and Consumerism. But the sector is still riddled with issues of corporate governance, accountability and poorly qualified or ignorant management. Othman et al (2013) cited an MCSC 2010 economic report⁴⁴ for instances of cooperative board members abusing their positions. According to the published research, "Some even meddle with illegal investment activities, characterised by dodgy quick-rich schemes. The absence of authentic cooperative principles and values has resulted in certain unscrupulous and irresponsible people in the society to form cooperatives and take advantage by collecting investments and deposits for their own personal gain."⁴⁵

Another issue with DFIs and cooperatives in Malaysia that needs rectification is the number of academic research reports on their challenges and viability. So far, research on

⁴³ New Straits Times. (2005). Help for troubled coops to stop.

⁴⁴ The report seems to have been removed from the website.

⁴⁵ Othman, I. W. et al., (2013). Cooperative Movements in Malaysia: The Issue of Governance.

these institutions is a fraction of what has been published about the conventional and Islamic banks in Malaysia.⁴⁶ To help DFIs and cooperatives play their much needed roles in society, academics need to extend their research into the issues facing these institutions.

Conclusion

In conclusion, not only are the German banks, particularly its savings and cooperative banks, more Islamic than Islamic banks in Malaysia, their entire system upholds the Islamic values of justice, equity and social welfare better than any Muslim country. The German model is proof that these Islamic values are sound and time-tested in a different cultural setting. In one word, universal. In Malaysia, however, while BNM has made a commendable attempt to right the ship through IFSA 2013, it has in effect, pushed Islamic banks in the opposite direction. This study thus concludes with two reform recommendations: a rethink of the economic drivers in Malaysia and a sprucing up of the DFIs and cooperatives' balance sheets towards national standards. Until then, Germany will continue to show the way because their banks, leaving aside the *riba* elements, are indeed more Islamic than the financial institutions in Malaysia.

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MIDDLE EAST INSIGHTS

ISLAMIC FINANCE SPECIAL

MIDDLE EAST INSTITUTE, NATIONAL UNIVERSITY OF SINGAPORE

DEPOSIT INSURANCE IN ISLAMIC BANKING

BY RODNEY WILSON

Following the global financial crisis many countries introduced or enhanced deposit protection schemes to increase customer confidence in their banking systems. In the Eurozone, for example, bank deposits of up to €100,000 (US\$112,000) are guaranteed. In China, as part of its financial reforms in 2015, deposits of up to CNY500,000 (US\$75,000) are protected by the Peoples Bank. Only a minority of Muslim majority countries have formal deposit protection schemes, Malaysia being the pioneer, with the scheme provided by Perbadanan Insurans Deposit Malaysia (PIDM) covering deposits of up to RM250,000 (US\$61,000); less generous cover than the Chinese scheme. A similar Deposit Insurance Company was established in Indonesia, in 2004, but its cover is worth even less. In the Arab World there is an informal understanding that governments will bail out depositors in the event of a bank collapse, but such guarantees are unlikely to provide much assurance, especially in failed states.

The status of Islamic bank deposits raises additional complications, as risk sharing is a key principle of *Shari'ah* compliant financial transactions. If all risks are transferred from depositors to governments or its agencies this potentially violates the principle. There is the moral issue of whether the fiscal priority in the event of a financial crisis should be to compensate depositors who are more affluent or to aid the poor who usually do not have bank accounts. *Shari'ah* scholars on the boards of Islamic banks distinguish between current account deposits where there is no income and investment accounts based on *mudaraba* contracts where the depositor shares in the bank's profits. Funds in current accounts can be guaranteed, but this does not extend to investment accounts where deposits are regarded as equity. Is such a distinction valid and what are the policy implications?

The Islamic Deposit Insurance Group

There has been little research on deposit protection from an Islamic perspective. The major work was a survey undertaken by the Islamic Deposit Insurance Group of the International Association of Deposit Insurers, a division of the Bank for International Settlement based in Basel, the results of which were published in March 2010.¹ Since then there have been no new initiatives despite the implementation of Basel III and the continuing fragility of emerging markets, including Muslim majority countries adversely affected by oil price declines. The ability of governments in the Islamic World to offer open ended guarantees has clearly been reduced, but should the banks and their clients pay for their own protection?

Profit sharing investment accounts were of particular concern to the Islamic Deposit Insurance Group, with *Shari'ah* scholars arguing that the losses borne by these account holders are inherent in *mudaraba*, which is how the accounts are designated. It can therefore be argued that such depositors should not enjoy protection, as this would imply solely profit sharing and not profit and loss sharing. A contrary view is that profit sharing investment depositors should be protected for the following three reasons:

- (1) Although the profit-sharing contract does not allow an Islamic bank to protect the investment account holder, protection by third parties, such as deposit insurers, is permissible;
- (2) The investment account holder is only protected in the event of an Islamic banking failure and not in the normal course of business;
- (3) If the investment account holders are major players in the financial system, protection will contribute to stability.

These arguments by the Islamic Deposit Insurance Group have merit, but are not entirely convincing. Firstly third party guarantees are more a matter of necessity as failing banks will by definition not have the resources to bail out their depositors. Whoever provides the guarantees there is a risk transfer away from the depositors, undermining the justification for their profit shares. Secondly in the normal course of business there is no risk of loss, the main purpose of protection schemes being to assure depositors that their money will be safe if conditions deteriorate. A more interesting issue is whether the risk appetite of investment depositors remains constant or reduces in downturns with depositors becoming more risk adverse. This is really an empirical matter which can only be addressed by attitude surveys to ascertain the behaviour of investment account depositors. The third point regarding the dangers to the financial system if uninsured Islamic investment depositors are significant players concerns systemic risk. This can only be measured by calculating the share in total deposits of Islamic banks and what proportion of these deposits is accounted for by investment accounts. Even in the countries where Islamic finance is well developed, such as Malaysia and the Gulf, the share of Islamic investment deposits is arguably too small to pose systemic risks.

Discrimination in deposit protection implies there will not be a level playing between Islamic investment deposits and conventional savings accounts. If only the latter are protected this may result in unfair competition to the detriment of those seeking *Shari'ah* compliant services. Discriminatory treatment may disadvantage those with Islamic

¹ Islamic Deposit Insurance Group, *Deposit Insurance from the Shari'ah Perspective*, International Association of Deposit Insurers, Bank for International Settlements, Basel, February 2010.

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investment deposits. If the whole banking system collapses, as was almost the case in the global financial crisis of 2008, it would arguably be unfair for Islamic investment depositors to be bailed in and suffer losses while conventional depositors were bailed out. This would be particularly unjust as Islamic banks did not cause the crisis but rather conventional institutions such as Lehman Brothers which behaved in a highly dubious way from a moral perspective.²

Risks with Restricted and Unrestricted Investment Deposits

There are two categories of investment deposits with Islamic banks: restricted and unrestricted.³ The latter account for by far the largest share of Islamic investment deposits, but the restricted deposits have a long history since they were first offered by Jordan Islamic Bank in the late 1970s. In Jordan the funds placed in restricted accounts are not guaranteed whereas deposits in the unrestricted deposits are guaranteed.⁴ Those clients with restricted accounts are regarded as investors, but those with unrestricted accounts are designated simply as depositors. Those with unrestricted accounts in Jordan are issued with certificates of deposit which can be redeemed at the bank subject to periods of notice. They can also sell the certificates to third parties as is the case with conventional certificates of deposit. This could enable certificate holders to obtain cash without exit penalties there being an incentive to buyers if the expected returns on the certificates are higher than those currently offered by the bank. From the perspective of Jordan Islamic Bank the advantage is that less liquidity is required to fund immediate withdrawals. These product features mean that the unrestricted investment deposit is securitized and tradable, with the possibility of modest capital gains or losses for certificate holders, although these are wiped out if the certificates are held to maturity with the redemption conditions respected.

Usually the returns to restricted Islamic account holders are higher than those of the unrestricted investment accounts as the investment is more focused, but this also results in greater risk which is reflected in higher volatility. As the unrestricted account holders' profits are derived from those of the bank which reflects a broad portfolio of assets this tends to have a smoothing effect. Classifying the unrestricted and restricted accounts for regulatory purposes also has challenges as there are no conventional equivalents.⁵ They could be equated with investments in mutual funds but this might be misleading in the case of unrestricted account holders as the profit shares paid to depositors are usually lower than the dividend pay-outs to equity investors. Furthermore, equity investors can profit from capital gains, but the best case scenario for investment account holders is to have their deposits refunded in full, as if the bank experiences major financial difficulties they face liability for losses.⁶

² Ahmed, Adel, "Global financial crisis: an Islamic finance perspective", *International Journal of Islamic and Middle Eastern Finance and Management*, 3.4 (2010): 306-320.

³ Rodney Wilson, *Legal, Regulatory and Governance Issues in Islamic Finance*, Edinburgh University Press, 2012, pp. 45-55.

⁴ <http://www.jordanislamicbank.com/en/?427dacca3edd8203f5aceefbb0637378fc4d0aabc773c0>

⁵ Archer, Simon and Rifaat Ahmed Abdel Karim, "Profit-sharing investment accounts in Islamic banks: regulatory problems and possible solutions", *Journal of Banking Regulation*, 10.4 (2009): 300-306.

⁶ The rights of investment account holders are set out in detail by Jordan Islamic Bank: <http://www.jordanislamicbank.com/en/?427dacca3edd8203f5aceefbb3637b78fc4d0aabc776c3>

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The risks for the restricted investment account holders depends on how this type of deposit is structured. If the bank is simply serving as an agent, connecting the investor with the business seeking funding, then arguably the *mudarabah* contract is between the client and the user of the funds. In the event of the bank being liquidated there would be no claim on the restricted account holder, as their liability would only be to the business using the funds.⁷ Indeed, if the bank as agent failed to provide accurate information to the restricted investment account holder on the business being funded, the account holder could litigate against the bank claiming negligence or perhaps even alleging that they had been deliberately mislead. If the restricted investment account is structured as a two-tier *mudarabah*, then the depositor has a liability if the bank is liquidated but not for the bankruptcy of a business using the funds, as in this instance the liability is borne by the bank only. Given these risk factors it is unsurprising that the two tier *mudarabah* model favoured by the early supporters of Islamic finance in the 1970s has never taken-off.⁸

Consequences of Loss Sharing

While *Shari'ah* scholars insist that *mudaraba* implies profit and loss sharing and not simply the former, how to apply this principle is debatable. With multiple stakeholder groups involved in modern Islamic banking, there is the issue of pecking orders and who bears what losses. For example, if the bank is making losses because its administrative costs have risen significantly, reducing the workforce or cutting salaries may be more appropriate than penalising depositors in order to resolve the underlying problem. Similarly, if the losses are arising because of the need to make provisions for non-performing debt, possibly at the insistence of the regulator, then it is hardly just to shift the burden to investment depositors. In any case only restructuring can address the problem, simply imposing losses on investment depositors can at best only postpone the measures needed. Furthermore, in normal circumstances when banks get into difficulties it is the shareholders who absorb the losses as the share prices decline, not the depositors. The shareholders as owners are expected to primarily bear the losses, followed by holders of junior debt, such as bonds which get bailed in, a process known as having a haircut. It would arguably be unfair for depositors to be forced to absorb losses in order to reduce the liabilities of these other stakeholders who are higher up the pecking order of those accountable for losses.

These issues would not arise if the Islamic financial institution adopted a pure *mudaraba* model, with no shareholders and no current account depositors. Investors as *rabb-al-mal* would share the profits from the projects they funded, with the financial institution also earning a profit share as *mudarab*, this being justified by its role in project appraisal and selection and its subsequent managerial role in administering the payments. Such an institution would be an investment trust, but not a bank, as there would be no liquid accounts that could be used for payments. An Islamic investment trust would be able to take on more risk, as with no depositors it would not require central bank regulation. It is noteworthy that in Pakistan such institutions are not regulated by the State Bank, but rather function under a special company law.⁹

⁷ Djojosegito, Reza, "Mitigating legal risk in Islamic banking operations", *Humanomics*, 24.2 (2008): 110-121.

⁸ Anwar, Muhammad, "Islamicity of banking and modes of Islamic banking", *Arab Law Quarterly*, 18.1 (2003): 62-80.

⁹ Rehman, Wasim Ul, et al. "Intellectual capital performance and its impact on corporate performance: empirical evidence from the *modaraba* sector of Pakistan", *Australian Journal of Business and Management Research*, 1.5 (2011): 8-16.

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In Malaysia the Islamic Financial Services Act of 2013 specifies that investment accounts should be subject to both profit and loss sharing, as hitherto holders of such accounts in practice only shared profits.¹⁰ As a consequence of the legislation leading Islamic banks have revised the terms and conditions of their investment accounts to be in compliance with the new law. In the case of Maybank Islamic, the leading Islamic bank in Malaysia and the third largest in the world, more than 350,000 customers with *mudaraba* deposits had to be contacted to provide consent for their accounts to be converted to profit and loss sharing.¹¹ Those unhappy with this change of terms and conditions were offered other types of account. Most kept their accounts as the returns offered were relatively generous with 3.25 percent paid annually on the accounts of minors and 4 percent offered on term accounts.

Loss sharing by investment account holders has yet to be tested, as it remains unclear exactly when a depositor liability might arise. Is it only in the event of an Islamic financial institution becoming insolvent that the investment depositors have to share in the losses? If losses are incurred but the bank remains solvent it is more problematic to argue for deposits being written down. In such circumstances depositors may not be paid a profit share, as there are no profits, hence their deposits will have more of the characteristics of current accounts. The underlying issue is that deposit guarantees bring certainty, but if these are prohibited for investment account holders – the inevitable consequence is greater uncertainty.

Islamic deposit insurance schemes

In response to these uncertainties there has been debate about the merits of establishing specialist Islamic deposit insurance schemes.¹² The aim of such schemes is to prevent depositors from experiencing financial difficulties, increase the confidence of investment account holders about the safety of their deposits, ensure the stability of Islamic financial systems and maintain the competitiveness of Islamic deposits. These aims could arguably be served by a conventional deposit insurance institution, but such institutions hold assets such as bonds which earn interest and are therefore not *Shari'ah* compliant. There are also issues of conflict of interest between the stakeholders in conventional insurance schemes, which can be overcome by providing *takaful*.¹³

In Malaysia both Islamic and conventional bank deposits were protected by Perbadanan Insurans Deposit Malaysia (PIDM), a government agency established in 2005 which was overseen by Bank Negara, the Central Bank.¹⁴ Following the Islamic Financial Services Act of 2013 the insurance for Islamic deposits was separated with the new protection contracts based on the concept of *kafalah* (guarantee) and *tabarru'* (donation). In line with these principles, the relevant member institutions make donations to the Malaysia Deposit Insurance Corporation (PIDM) which then provides depositors with insurance coverage and ensures pay-outs in the event of bank failure. Islamic deposits are

¹⁰ Law of Malaysia, Act 759.

¹¹ Media Release, "Maybank's *mudarabah* investment accounts to provide potentially higher and stable returns", Kuala Lumpur, 22nd April 2015.

¹² Md Khairuddin Hj Arshad, *Implementation of an Islamic Deposit Insurance System for the Islamic Financial Services Industry*, Islamic Financial Services Board, Kuala Lumpur, 17th November 2011.

¹³ Wahab, Abdul Rahim Abdul, Mervyn K. Lewis, and M. Kabir Hassan, "Islamic *takaful*: business models, *Shari'ah* concerns and proposed solutions", *Thunderbird International Business Review*, 49.3 (2007): 371-396.

¹⁴ <http://www.pidm.gov.my/Home.aspx>

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covered separately from conventional deposits up to an amount of RM250,000 per depositor per member institution. Islamic deposits eligible for coverage include savings and investment deposits, both *mudaraba* and *non-mudaraba*, but exclude deposits payable outside Malaysia, foreign currency deposits, negotiable instruments of deposit, other bearer deposits and repurchase agreements, as is the case for conventional deposits.¹⁵

Conclusions

Whether these changes are semantic or substantive is debatable, as they raise the issue of form versus substance which is prevalent in many areas of contemporary Islamic finance. Investment account protection insurance is compulsory in Malaysia, the costs being covered by the Islamic banks on behalf of their clients. As insurance is provided by a third party, PIDM, it is argued that this does not violate the profit and loss sharing *mudaraba* contracts between the banks and their clients. Furthermore the PIDM protection is only triggered in the event of bank failure, and not in the normal course of business which involves profits and losses. However the latter are not shared either, the worst case scenario for the client being no profit share payment. The exclusion of loss sharing is of course a win-win situation for the client that they are unlikely to complain about. In reality they have a profit sharing contract, which admittedly provides rate of return risk sharing, but not liability to losses which might be one risk too far. The best that might be said is that the debate about protection for Islamic deposits has increased awareness of the issues, but has not provided solutions that will satisfy everyone.

Rodney Wilson is an Emeritus Professor in the International Centre for Education in Islamic Finance (INCEIF). Previously he has been involved in research and teaching in Islamic economics and finance for over 30 years and he founded the Durham University Islamic Finance Programme. Before joining INCEIF, he was a Visiting Professor at the Qatar Faculty of Islamic Studies. Professor Wilson has authored 12 books and over 50 articles. His most recent books are Legal, Regulatory and Governance Issues in Islamic Finance, Edinburgh University Press, 2012 and Economic Development in the Middle East, Routledge, London and New York, 2013. He has edited numerous books, most recently Islamic Banking and Financial Crisis: Reputation, Stability and Risks, (co-editors Habib Ahmed and Mehmet Asutay), Edinburgh University Press, 2014. His current work includes a book on Islam and Economic Policy, which will also be published by Edinburgh University Press in May. Professor Wilson has extensive consultancy experience including with the African Development Bank (2011 and 2012), the Qatar Central Bank (2010) and the Islamic Financial Services Board Working Group on Shari'ah Governance (2007- 2009). In 2014 he was awarded the Islamic Development Bank Prize in Islamic Banking and Finance in recognition of his contribution to the subject. He is also receiving the United States based Lariba recognition award for excellence in riba free banking.

¹⁵ Rebecca Simmonds, "Impact of the implementation of the Islamic Financial Service Act, 2013", *Islamic Finance News*, 11.14, 9th April 2014.



MIDDLE EAST INSIGHTS

ISLAMIC FINANCE SPECIAL

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CREDIT-RISK SHARING IN ISLAMIC BANKING: THE CASE FOR ISLAMIC DEPOSITS AND INVESTMENT ACCOUNTS (IA) IN MALAYSIA

BY SAIFUL AZHAR ROSLY

This paper argues that the introduction of the investment account (IA) in Islamic banking amongst others should reduce potential Shariah non-compliance risk arising from the disproportionate distribution of income to depositors and banks. While impairment expenses are charged to depositors, the returns on *mudaraba* deposits (ROMD) do not seem to favour depositors as the ROMD has been consistently lower than return on equity (ROE) despite evidencing some form of credit-risk sharing between banks and *mudaraba* depositors as outlined by Framework of Rate of Return of Bank Negara Malaysia. When investment accounts are channeled to fund *murabaha* transactions, the credit risk should be solely carried by the IA holders and hence, the return on investments accounts (ROI) can be the reference point in assessing the risk-taking activities of investment account holders which is comparable to the ROE of bank's shareholders.

Keywords: credit-risk sharing, rate of returns on *mudaraba* deposits, investment accounts

Banks take deposits in order to make loans to borrowers. In the Islamic banking business, the extension of financing to customers is mainly funded by deposits, comprising of transaction and term deposits contracted on *mudaraba* and *wadiah* principles respectively. The nature of *mudaraba* contracts warrants the sharing of profit and loss of the related

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exposure between depositors and bank while *wadiah* contracts specify the protection of savings, hence the taking of loss by the bank alone. While banks can acquire funds from non-deposit sources such as the money market, this paper will give focus only on issues related to deposit funds.

Banks also hold capital against their lending driven by deposit funds. The high cost of capital does not merit banks using capital to make loans, hence making loans from borrowed funds has been the traditional banking model, which is also true for Islamic banks. Profits are mainly derived from the difference between rates charged on loans or financing and rates paid to depositors. Since, there is a likelihood that loans may not be paid in full, potential loss is absorbed by banks through the provision on loan impairment. For example, in 2014 UOB provided a sum of S\$635,303 for the impairment expenses which is charged to net income of the bank at S\$4,557,733 million. Table 1 below:

Income Statements

for the financial year ended 31 December 2014

	Note	The Group		The Bank	
		2014 \$'000	2013 \$'000	2014 \$'000	2013 \$'000
Interest income	3	7,189,330	6,508,197	3,889,959	3,467,326
Less: Interest expense	4	2,631,597	2,388,405	1,084,135	991,533
Net interest income		4,557,733	4,119,792	2,805,824	2,475,793
Fee and commission income	5	1,748,893	1,730,645	1,132,029	1,117,470
Dividend income		48,014	53,020	260,492	276,630
Rental income		115,403	113,912	97,994	97,385
Net trading income	6	598,831	511,006	543,483	471,623
Net gain/(loss) from investment securities	7	218,107	33,297	213,593	2,300
Other income	8	170,355	158,548	185,306	139,462
Non-interest income		2,899,603	2,600,428	2,432,897	2,104,870
Total operating income		7,457,336	6,720,220	5,238,721	4,580,663
Less: Staff costs	9	1,825,041	1,712,311	1,000,375	939,620
Other operating expenses	10	1,321,319	1,185,868	839,184	759,076
Total operating expenses		3,146,360	2,898,179	1,839,559	1,698,696
Operating profit before impairment charges		4,310,976	3,822,041	3,399,162	2,881,967
Less: Impairment charges	11	635,303	428,850	350,626	243,798
Operating profit after impairment charges		3,675,673	3,393,191	3,048,536	2,638,169
Share of profit of associates and joint ventures		149,195	190,943	-	-
Profit before tax		3,824,868	3,584,134	3,048,536	2,638,169
Less: Tax	12	560,675	559,059	357,325	339,898
Profit for the financial year		3,264,193	3,025,075	2,691,211	2,298,271
Attributable to:					
Equity holders of the Bank		3,249,101	3,007,900	2,691,211	2,298,271
Non-controlling interests		15,092	17,175	-	-
		3,264,193	3,025,075	2,691,211	2,298,271
Earnings per share (\$)	13				
Basic		1.98	1.84		
Diluted		1.97	1.84		

Table 1: Overseas Union Bank (OUB) Profit and Loss Statement 2014.

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Following Table 2 for Maybank Islamic, a similar approach of impairment charges may not hold for Islamic banks as some banking exposures were funded by *mudaraba* deposits which in principle are based on equity contracts. As such, the charging of the impairment expenses of RM82.62 million was made to the shareholders and as well as to the *mudaraba* depositors on the accumulated revenues of RM5.761 billion million which leaves RM5.68 billion for distribution. The income attributable to depositors of RM3.06 billion constitutes the cost of deposits, comprising of *mudaraba* and non-*mudaraba* deposits which is net of the impairment expenses. This is a significant departure from conventional practices where in the latter the impairment expenses were only charged to the shareholders (see Table 1) which means that risk of default is only carried by the bank. The practice is in line with Bank Negara Malaysia's guideline on Framework of the Rate of Return (FROR) asserting that "this is in accordance with the *mudharaba* contract whereby the provisions in Islamic banking operations are shared by both the depositors and the bank, unlike conventional banking operations where the provisions are solely borne by the bank" (BNM/RH/GL 007-5 2013).

Maybank Islamic Berhad
(Incorporated in Malaysia)

Income statement
For the year ended 31 December 2014

	Note	2014 RM'000	2013 RM'000
Income derived from investment of depositors' funds	22	5,521,124	4,461,652
Income derived from investment of shareholder's funds	23	240,664	212,015
Allowances for losses on financing and advances	24	(82,622)	(1,016)
Total distributable income		5,679,166	4,672,651
Income attributable to the depositors	25	(3,067,032)	(2,363,026)
Total net income		2,612,134	2,309,625
Overhead expenses	26	(959,279)	(874,032)
Finance cost	28	(94,770)	(42,200)
Profit before taxation and zakat		1,558,085	1,393,393
Taxation	29	(416,517)	(322,589)
Zakat		(19,190)	(21,467)
Profit for the year attributable to equity holder of the Bank		1,122,378	1,049,337
Earnings per share attributable to equity holder of the Bank - basic/diluted (sen)	30	467.5	730.7

Table 2: Maybank Islamic Income Statement 2014.

Credit-Risk Sharing in Islamic banks

Based on Table 2, some form of credit risk-sharing is visible in Islamic banking where risk of default was taken by both bank and the depositors. This is true for *mudaraba* deposits only while *non-mudaraba* deposits contracted under the *wadiah* and commodity *murabaha* principles are not expected to absorb potential loss from default. The FROR provides clear guidelines on the sharing of profit and loss in the Islamic banking operations so as to manifest fairness and justice in the distribution of profit as defined by the *mudaraba* contract. The FROR says:

“The need for the framework arises from the contractual relationship in Islamic banking, particularly the *mudharabah* (profit-sharing) contract between the depositors and the Islamic banking institutions (IBIs). Under the *mudharabah* contract, a depositor that deposits his funds with the IBI also assumes the role as capital provider. The IBI assumes the role as the entrepreneur where it will invest the depositor’s funds. Profits accrued from investment and financing are shared between the depositor and the IBI based on pre-agreed profit sharing ratio. Losses, if any, will be borne by the depositor, except in cases where there is evidence of negligence by the IBI in managing the depositor’s funds. Given this unique relationship where the depositors would have a direct financial interest in the IBI, a standard calculation of the rate of return is imperative to ensure that depositors will receive their portion of the investment profits in a fair and equitable manner. It will also address the BNM/RH/GL/007-5 Islamic Banking and Takaful Department Framework of Rate of Return Page 3/44 information asymmetry between the IBI and its depositors by enhancing the level of transparency of Islamic banking operations” (BNM 2013).

To that effect, the FROR provides a method of deriving net distributable income and the distribution of profits to depositors via the 1) calculation table (CT) and 2) distribution table (DT) with an objective to set a minimum standard in calculating the rate of return and providing Islamic banks with better means of assessing the efficiency of Islamic banking institutions (IBIs) as well as their profitability, prudent management and fairness. Hence, all financial reports issued by IBIs relating to distributable income and income distributed to depositors are derived from the methodology of the FROR, which this study uses to compute the return on *mudaraba* deposits (ROMD)

The Calculation Table (CT)

The CT provides the methodology in deriving the net distributable income which amounts to RM2.35 billion for BIMB, which this study uses as the case bank. The CT defines specific

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expenses as deductible and non-deductible items. Deductible items include the impairment loss, income-in-suspense, direct expenses and profit distributable to other related parties i.e. specific investment deposit holders, bank capital and interbank placements. For example, in 2014, BIMB charged impairment expenses of RM59.9 million to both depositors and banks. Non-deductible items are only charged to the bank, which include overhead expenses, salary expenses, depreciation of assets and amortization expenses, general and administrative expenses, general marketing expenses, information technology expenses and premiums paid to the Malaysian Deposit Insurance Corporation (PIDM). For example, in 2014, RM463.5 million of personnel expenses were charged to the bank after deducting income to depositors of RM859.9 million. The FROR also provides guidelines on the use of deposit funds. For example, deposit funds are not allowed to be used to acquire fixed assets and investment in subsidiary or associate companies. They can only be utilized in the provision of financing and advances, investment in securities and inter-bank placements. Based on the above, the CT gives an example on the computation of weighted average rate of return on assets (WAR), as given below:

$$\text{WAR} = (\text{Income} / \text{average daily amount of financing}) \times (365 / \text{no of days for the month}) \times 100\%$$

Suppose income generated from *murabaha* exposure of RM100,000 = RM850, the monthly WAR = $(850 / 100,000) \times (365 / 30) \times 100\% = 10.34\%$. The distribution table (DT) will explain how income generated from the above *murabaha* transaction (i.e financing with 10.34% yield) is distributed to the depositors and bank respectively.

The Distribution Table (DT)

The DT serves to guide Islamic banks on the proper distribution of net distributable income posted on the CT to the respective deposit funds such as current, savings and *mudaraba* deposits. For our purpose, attention is given to compute the returns on the 1-month *mudaraba* deposit. Three basic parameters are in play, namely 1) the nominal size of the *mudaraba* deposit (i.e. 1-month deposit; 2) total size of *mudaraba* deposits; and 3) the profit-sharing ratio (PSR). Table 3 provides a hypothetical illustration in arriving at the rate of return of a 1-month *mudaraba* deposit, which serves to assist Islamic banks in their disclosure of income distributed to depositors. The distributable income as given in CT is

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RM517 with a predetermined 75:25 profit-sharing ratio (PSR) as agreed by the *mudaraba* depositors as fund providers (*rabbul maal*) and the bank as the entrepreneur-manager (*mudarib*). The DT gives RM119.74 as income distributed to the 1-month *mudaraba* deposits which is equivalent to 5.83 percent per annum. Profit attributable to *mudaraba* depositors is a proportion of their shares in the contract which is 75 percent of RM119.74 or RM89.81 and equivalent to 4.37 percent per annum.

Table 3: Computation of rate of return of *mudaraba* deposits summarized in Table 3.

1-month <i>mudaraba</i> deposit	RM20,000
Total deposits	RM108,000
Distributable profit	RM517.30
PSR	75(depositor):25 (bank)
Gross rate of return of 1-month <i>mudaraba</i> deposits	$(119.74/25,000) \times (365/30) \times 100\% = 5.83\%$
Profit distributable to depositors = distributable profits x PSR	$119.74 \times 0.75 = 89.81$
Net rate of return (NROR) = Gross rate x PSR	$5.83\% \times 0.75 = 4.37\%$

Source: Source: BNM Framework of rate of return 2013.

Computation of Return on *Mudaraba* Deposits (ROMD)

We use Bank Islamic Malaysia Berhad (BIMB) as the case bank in computing ROMD. Data on distributable income and income distributable to depositors is obtained from Table 4 while data on size of *mudaraba* and total deposits is provided by Table 5. Table 5 gives additional RM300,000,000 from bank placements making up total deposits to RM41,321,556,000. Table 6 gives further information about the deposits. While the NROR and ROMD are not comparable by number, the fact that NROR remains low relative to ROE

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may indicate that income attributable to shareholders may not be in line with the credit-risk sharing arrangements as specified in the FROR.

As the credit risk is shared by both parties, it is expected that returns on *mudaraba* deposits (ROMD) will be comparable with return on equity of the bank (ROE). We compute ROMD by dividing the income attributable to *mudaraba* deposits to size of *mudaraba* deposits, which is derived from the income statement and balance sheet of Islamic banks. We will illustrate the computation of ROMD by using Bank Islam Malaysia Berhad (BIMB) as a case study.

Bank Islam Malaysia Berhad

(Company No. 98127-X)
(Incorporated in Malaysia)

Statements of Profit or Loss and Other Comprehensive Income for the financial year ended 31 December 2014

		Group		Bank	
	Note	2014 RM'000	2013 RM'000	2014 RM'000	2013 RM'000
Income derived from investment of depositors' funds	22	2,032,085	1,851,278	2,032,085	1,851,289
Income derived from investment of shareholders' funds	23	404,741	393,827	399,311	393,019
(Allowance)/Reversal for impairment on financing and advances	24	(59,993)	15,009	(59,993)	15,009
Reversal/(Allowance) for impairment on investments	25	2,978	(9,211)	1,322	(9,211)
Reversal for impairment on other assets		710	5,570	710	5,570
Direct expenses		(17,966)	(25,773)	(17,966)	(25,773)
Total distributable income		2,362,555	2,230,700	2,355,469	2,229,903
Income attributable to depositors	26	(851,126)	(779,465)	(851,638)	(780,302)
Total net income		1,511,429	1,451,235	1,503,831	1,449,601
Personnel expenses	27	(463,122)	(443,262)	(457,591)	(438,850)
Other overhead expenses	28	(345,556)	(330,341)	(345,050)	(327,733)
		702,751	677,632	701,190	683,018
Share of results of associate company		-	(349)	-	-
Profit before zakat and tax		702,751	677,283	701,190	683,018
Zakat		(12,803)	(12,584)	(12,747)	(12,568)
Tax expense	31	(179,446)	(178,973)	(179,412)	(178,805)
Profit for the year		510,502	485,726	509,031	491,645
Earnings per share (sen)	32	22.16	21.44		

Table 4: Income Statement Bank Islamic Malaysia Berhad.

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Table 4 above provides two important items in deriving ROMD, namely 1) total distributable income; and 2) income attributable to depositors. Both items were derived based on BNM's framework of rate of return (FROR) via the calculation table (CT) and distribution table (DT) given in the guideline. BIMB's bank level data for 2014 are shown in Tables 4, 5 and 6 where total distributable income and income attributable to depositors were RM2.35 billion and RM0.85 billion respectively, total deposits of RM41,021,556,000 and size of *mudaraba* deposits at RM7,984,286,000.

Bank Islam Malaysia Berhad

(Company No. 98127-X)

(Incorporated in Malaysia)

Statements of Financial Position as at 31 December 2014 (continued)

	Note	Group		Bank	
		31.12.2014 RM'000	31.12.2013 RM'000	31.12.2014 RM'000	31.12.2013 RM'000
Liabilities and equity					
Deposits from customers	15	41,010,332	37,245,002	41,021,556	37,272,452
Deposits and placements of banks and other financial institutions	16	300,000	1,529,975	300,000	1,529,975
Derivative financial liabilities	6	32,407	13,565	32,407	13,565
Bills and acceptance payable		127,524	170,598	127,524	170,598
Other liabilities	17	576,228	481,402	572,599	476,626
Zakat and taxation	18	44,601	43,994	44,573	43,941
Total liabilities		42,091,092	39,484,536	42,098,659	39,507,157
Equity					
Share capital	19	2,319,907	2,298,165	2,319,907	2,298,165
Reserves		1,409,683	1,028,670	1,410,721	1,031,209
Total equity		3,729,590	3,326,835	3,730,628	3,329,374
Total liabilities and equity		45,820,682	42,811,371	45,829,287	42,836,531
Commitments and contingencies	39	12,135,967	11,211,680	12,135,967	11,211,680

Table 5: Liabilities - Bank Islam Malaysia Berhad.

Bank Islam Malaysia Berhad

(Company No. 98127-X)

(Incorporated in Malaysia)

15. Deposits from customers**(a) By type of deposit**

	Group		Bank	
	31.12.2014	31.12.2013	31.12.2014	31.12.2013
	RM'000	RM'000	RM'000	RM'000
Saving Deposit	5,091,650	4,674,482	5,091,650	4,674,482
<i>Wadiah</i>	3,052,428	2,379,204	3,052,428	2,379,204
<i>Mudharabah</i>	2,039,222	2,295,278	2,039,222	2,295,278
Demand Deposit				
<i>Wadiah</i>	10,535,088	9,888,119	10,539,744	9,891,476
Term Deposit	25,296,865	22,594,379	25,303,433	22,618,472
Special Investment Accounts				
<i>Mudharabah</i>	5,022,921	18,659,039	5,025,258	18,682,231
General Investment Accounts				
<i>Mudharabah</i>	919,816	2,012,162	919,816	2,012,162
Term & Special term deposit-i				
<i>Tawarruq</i>	17,895,591	-	17,899,695	-
Negotiable Islamic Debt Certificates (NIDC)	1,229,025	1,466,205	1,229,025	1,466,205
Waheed-i	134,453	358,516	134,580	359,417
Ziyad	95,059	98,457	95,059	98,457
Others	86,729	88,022	86,729	88,022
Total Deposits	41,010,332	37,245,002	41,021,556	37,272,452

Table 6: Deposits- Bank Islam Malaysia Berhad.

As shown in Table 7, ROMD for BIMB at 2.1 percent is obtained based on four items captured from BIMB's financial report following the format of the FROR. These items are 1) distributable income; 2) income distributable to deposits; 3) size of *mudaraba* deposits; and 4) total size of all deposits. ROMD of 2.1 percent is obtained by dividing income attributable to depositors to the total size of *mudaraba* deposits. It means that for every 1 ringgit placed in *mudaraba* deposits, the depositors get 2.1 sen per annum as return on their investment.

Distributable income	2,355,469
Income distributable to depositors	851,638
Size of <i>mudarabah</i> deposits	7,984,296
Size of total deposits	41,321,556
% <i>mudaraba</i> deposits	$7,984,296 / 41,321,556 = 19.32\%$
ROMD	$(0.1932 \times 851,638) / 7,978,296 = 0.0206 = 2.06\%$

Table 7: Computation of ROMD

Source: Author's computation.

Based on our methodology for computing ROMD, ROMDs for 5 Islamic banks are given in Tables 8 and 9 below. Our methodology of calculating ROMD is based on annual size of *mudaraba* deposits and the size of profits attributable to it. As the 2014 income statements and balance sheet items of the five Islamic banks are guided by the FROR of BNM, there should be no significant variance between the two methodologies adopted in arriving at NROR and ROMD. The ROMD is computed on annual basis while NROR are based on monthly basis. Thus the numbers presented in Tables 8 and 9 cannot be identical to the bank's internal NROR. Understandably enough, the author has no access to Islamic banking internal data to compute the NROR. For this reason, we use the hypothetical illustration of computing NROR available from the CT and DT of the FROR.

Table 8: Islamic Banks Return on Mudaraba Deposits (ROMD)

POST IFSA 2014					
Islamic Banks	Income attributable to depositors (cost of deposits) (RM'000)	Mudaraba deposits (RM'000)	Total deposits (RM'000)	Income attributable to mudaraba deposits (RM'000)	Return on mudaraba deposits ROMD
BIMB	851638	8284296	41021556	171988.1439	0.021
BMMB	447026	12637873	17629228	320459.7397	0.025
Public Bank	850759	321692	34347718	7967.99264	0.025
OCBC Al-Ameen	296862	1355534	12536119	32099.76982	0.024
Maybank Islamic	3067032	27068708	99695272	832743.5391	0.031
PRE-IFSA 2013					
BIMB	467524	20994393	12536119	782968.2051	0.037
BMMB	416713	14335955	18761029	318424.9017	0.022
Public Islamic	705387	3363924	31190134	76077.52691	0.023
OCBC Al-Ameen	193644	1179977	9230716	24753.81825	0.021
Maybank Islamic	2363026	24975803	83017613	710915.0664	0.028

Source: Annual Reports 2014, various Islamic banks.

In 2014 and 2013, the ROMD averages stood at 2.5 percent and 2.6 percent per annum respectively, suggesting returns similar to interest-bearing fixed deposits. Interestingly, as shown in Table 8 the ROE for the five Islamic banks averaged at 12.1 percent and 14.4 percent respectively. This substantial amount of variance between ROMD and ROE can be quite disturbing for the *mudaraba* depositors whose funds are deemed risky but who were not compensated accordingly to the profit-and loss principle of *mudaraba*.

Table 9: Islamic Banking ROMD and ROE

POST IFSA 2014					
Islamic Banks	Net profit (RM'000)	Equity (RM'000)	Impairment charges to depositors and shareholders (RM'000)	ROE	Return on <i>mudaraba</i> deposits (ROMD)
BIMB	509031	3730628	59993	0.136	0.021
BMMB	167186	1741363	-55290	0.096	0.025
Public Bank	353780	2651599	90045	0.133	0.025
OCBC Al-Ameen	70529	788764	161329	0.089	0.024
Maybank Islamic	1122378	7228970	82622	0.155	0.031
PRE-IFSA 2013					
BIMB	491645	3329374	15009	0.148	0.037
BMMB	149454	1596373	-81692	0.094	0.022
Public Islamic	357040	2591446	100756	0.138	0.023
OCBC Al-Ameen	107493	595167	56054	0.181	0.021
Maybank Islamic	1049337	6435555	1016	0.163	0.028

Source: Annual Report 2014, various Islamic banks.

Reports from the Shariah Committees of Islamic banks tend to indicate that the allocation of profits and charging of losses relating to the investment account has readily conformed to the principles of the Shariah. Two samples of such reports from Maybank Islamic and Bank Islamic Malaysia Berhad are shown in Table 5. The charges of losses can mean two things, namely 1) the expected loss (EL) i.e. expenses for financing impairment which are charged to the bank and *mudaraba* depositors; and 2) the unexpected loss (UL) i.e. write-offs from bad loans/financing that reduces bank's capital. While it is not common to see *mudaraba* deposits suffer material depreciation due to bank losses, the charges of impairment provisions to the *mudaraba* depositors is visible evidence of credit risks taken by them.

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Based on the above, in our opinion:

Maybank Islamic Berhad
(Incorporated in Malaysia)

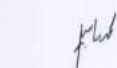
Shariah Committee's report (cont'd.)

- (c) The main funding sources and investments of the Bank disclosed to us conform to the basis that had been approved by us in accordance with the Shariah rules and principles;
- (d) The allocation of profit and charging of losses relating to investment accounts conform to the basis that had been approved by us in accordance with Shariah principles; and
- (e) The Shariah non-compliance events and disposal of any earnings from prohibited sources/means by the Bank during the year ended 31 December 2014 had been channeled to the donation/charity fund as disclosed in Note 39; and
- (f) The financial statements of the Bank for the year ended 31 December 2014 together with the calculation of Zakat disclosed to us are in compliance with the Shariah rules and principles.

We beg Allah the Almighty to Grant us all the Success and Straight-Forwardness and Allah Knows Best.



Assoc. Prof. Dr. Azman Hasan
Chairman of the Committee



Assoc. Prof. Dr. Ahcene Lahsasna
Member of the Committee

Kuala Lumpur, Malaysia
25 February 2015

1. The contracts, transactions and dealings entered into by the Bank, excluding the three (3) minor Shariah non-compliant incidences mentioned above, during the financial year ended 31 December 2014 that were reviewed are in compliance with the Shariah rules and principles;
2. The allocation of profit and charging of losses relating to investment account conformed to the basis that has been approved by us;
3. The computation, payment and distribution of business zakat are in compliance with the Shariah rules and principles;
4. All earnings that have been realised from sources or by means prohibited by the Shariah rules and principles amounted to RM3,360.01 were disposed to charitable causes.

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Bank Islam Malaysia Berhad

(Company No. 98127-X)
(Incorporated in Malaysia)

Report of the Shariah Supervisory Council (continued)

Shariah Governance (continued)

On that note, we, the members of Shariah Supervisory Council of Bank Islam Malaysia Berhad, do hereby confirm that, in our level best, the operations of the Bank for the year ended 31 December 2014 have been conducted in conformity with the Shariah rules and principles.

We bear witness only to what we know, and we could not well guard against the unseen!
(Surah Yusuf, verse:81)

Table 10: Shariah Committee Reporting: Maybank Islamic and BIMB 2014.

The fact that *mudaraba* depositors have received relatively lower returns than shareholders indicates that the distribution of profit was not adequately made in accordance with the taking of loss. This can constitute a breach of Shariah rules which may not be visible in contract law but a practice that defies the legal maxim, *al-ghorm bil ghuni* which means that profit is acquired with risk. Shariah non-compliance risk (SNCR) is at stake here given that in the distribution of credit risk to banks and the *mudaraba* depositors, profits were accorded not in proportion to the risk taken.

While we look forward to relatively higher returns for *mudaraba* deposits over interest-bearing term deposits as the latter (i.e. conventional term deposits) do not carry credit risks, it is highly unlikely to suggest that ROMD equals ROE as the bank's holding of capital against unexpected loss (UL) implies that it should also be rewarded for the additional risks taken which include market and operational risks. However, this can be quite tricky since the bank whose role as a *mudarib* (i.e. entrepreneur/manager) is also required to hold regulatory capital against the exposures funded by funds derived from the

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depositors who served as *rabbul-maal* (i.e. funds provider). Understandably enough, it is possible for a *mudarib* to pose a sum of money as a guarantee against loss due to negligence. But this is not what bank capital is for. The role of bank capital is to absorb unexpected losses usually arising usually from systematic risks. The FROR may also need to explain the reasons behind the use of *mudarib's* capital (i.e. bank's capital) in income generation (i.e. income generated from shareholders' fund) which may disfigure the nature of the *mudaraba* contract. We also notice that no explanation is given by FROR on the allocation of impairment expenses to the bank and *mudaraba* depositors. This would leave doubts about the loss absorbing role of the two parties and who primarily absorbs the larger portion of the loss. This is because the PSR can only indicate the sharing of profits and not losses. While losses from credit risk should be carried by the *mudaraba* depositors, we should expect them to absorb all of the impairment provisions but information on this matter is not explained in the FROR.

Islamic Financial Service Act (IFSA) 2014

One salient feature of IFSA 2014 is the defining of the bank's funding into deposit funds and investment funds. Prior to this new law, exposures funded by deposit funds had to be backed by regulatory capital even when such deposits were based on *mudaraba*. As equity funds, investment accounts (IA) are expected to stimulate profit-loss sharing financing and enhance entrepreneurship in the real sector. It can also help reduce the high intensity of credit financing in Islamic banks which is hazardous to the bank in the event of shocks. The introduction of the investment account as a new funding product is expected to free the bank from holding capital against business and financial risks which is now transferred to the investment account holders who should enjoy relatively higher returns in relation to the higher risk taken in the investment. The bank will act as the fund manager which is fee-driven similar to asset management services. The idea is the matching funding and financing risk-appetite of the surplus and deficit sectors respectively, which is not possible when deposit funds are matched with profit-loss sharing financing instruments. IA can be mobilized independently by Islamic banks or they can participate in mobilizing the IA funds via the Islamic Account Platform (IAP) as given in Appendix 1. Participating banks can supply information for companies seeking funding via the IAP where potential investors can choose the projects they want.

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The separation of funding is effective from 15 June 2014 after which capital charges will not be imposed on exposures funded by investment account. Islamic banks are, however, given options to convert existing *mudaraba* deposits into investment accounts or to convert them into commodity *murabaha* term deposits or any other non-*mudaraba* deposits such as *wakala*. Table 9 provides an example of the strategic shift of BIMB funding from *mudaraba* deposits to investment account and commodity *murabaha/tawaruq* term deposits. In the transaction accounts, no significant shift from *mudaraba* to *wadiah* products is evident, although the former slightly declined from RM2.95 billion in 2013 to RM2.04 billion in 2014. However, substantial shifts from *mudaraba* to *tawaruq* term deposits took place where the former declined from RM20.69 billion in 2013 to RM5.94 billion in 2014. This 71.2 percent dropped in *mudaraba* accounts may signal the problem in mobilizing investment accounts. At the same time, *tawaruq* term deposits increased from zero in 2013 to RM17.89 billion in 2014. Adverse bank's risk-appetite policy towards equity financing and lack of demand from funds providers whose risk-appetite remains attracted to fixed deposits, can contribute to BIMB's funding business model. In other words, the lack of demand for the post-IFSA IA products by prospective fund providers may be due to their liking for pre-IFSA deposit product as opposed to post IFSA investment account products.

Bank Islam Malaysia Berhad

(Company No. 98127-X)

(Incorporated in Malaysia)

15. Deposits from customers

(a) By type of deposit	Group		Bank	
	31.12.2014 RM'000	31.12.2013 RM'000	31.12.2014 RM'000	31.12.2013 RM'000
Saving Deposit	5,091,650	4,674,482	5,091,650	4,674,482
<i>Wadiah</i>	3,052,428	2,379,204	3,052,428	2,379,204
<i>Mudharabah</i>	2,039,222	2,295,278	2,039,222	2,295,278
Demand Deposit				
<i>Wadiah</i>	10,535,088	9,888,119	10,539,744	9,891,476
Term Deposit	25,296,865	22,594,379	25,303,433	22,618,472
Special Investment Accounts				
<i>Mudharabah</i>	5,022,921	18,659,039	5,025,258	18,682,231
General Investment Accounts				
<i>Mudharabah</i>	919,816	2,012,162	919,816	2,012,162
Term & Special term deposit-i				
<i>Tawarruq</i>	17,895,591	-	17,899,695	-
Negotiable Islamic Debt Certificates (NIDC)	1,229,025	1,466,205	1,229,025	1,466,205
Waheed-i	134,453	358,516	134,580	359,417
Ziyad	95,059	98,457	95,059	98,457
Others	86,729	88,022	86,729	88,022
Total Deposits	41,010,332	37,245,002	41,021,556	37,272,452

Table 11: Bank Islam Malaysia Berhad 2014: Deposits from Customers

The shift from the *mudaraba* investment accounts to *tawaruq* term deposits should evidence some changes to the impairment expenses charged to the fund providers. First, impairment expenses will not be charged to the *wadiah* and *tawaruq* deposits as these deposits do not carry credit risk, which the bank will carry alone. Secondly, when IA funds are channeled to finance credit sale transactions, credit risk is passed to the IA holders and they will expect to see the matching of return on investment (ROI) to risks as the impairment charges will be made to that specific IA fund alone. This helps mitigate the potential Shariah non-compliance risk evidence in the distribution of profit for general investment account (GIA) and specific investment account (SIA) contracts under *mudaraba* discussed earlier. The same applies when IA funds are channeled to equity investments. The following discussion based on Tables 10 and 11, attempts to examine the possible impact of returns on funding strategies.

Converting Existing Mudarabah Deposits to Tawaruq Deposits

As we assume a high degree of credit intensity in Islamic banking, *tawaruq* deposits will be channeled to fund *murabaha* transactions. By contract, *tawaruq* deposits are able to stipulate upfront a rate of return, hence the bank's profit is simply the spread between term charges on *murabaha* at 7 percent and cost of deposits at 3 percent. The bank carries the risk of default and holds capital against unexpected loss from credit risk. Returns on *tawaruq* deposits should be similar to conventional fixed deposits as both behave similarly.

Table 12: Shifting *Mudaraba* deposits to *Tawaruq* deposits

Assets	Liabilities
\$100m <i>Murabaha</i> @7% RW = 80%	\$100m <i>Tawaruq</i> deposits @3%
Profits = $(0.07 - 0.03) \times \$100 = \4m Bank carries credit risk and impairment provisions charged to the bank alone. Bank holds capital against \$100m; $K = \$100 \times 0.08 \times 0.8 = \6.4 million	

Converting Existing Mudarabah Deposits into Investment Accounts

When the *murabaha* financing is funded by investment accounts, the bank does not hold capital against the exposure as all risks are now taken by the IA holders. Hence, in the case of full repayment, the return on investment should be relatively higher than conventional fixed deposits. In the event of default, recovery depends on the collaterals set against the exposures and the remaining balance after default.

We expect that smaller banks may opt for the IA option as practically no capital is required to cushion potential loss from the credit exposures. Bigger banks may choose the *tawaruq* option in view of the higher spread they can earn from the *murabaha*. For example, from *tawaruq* funding at 3 percent, the spread is 4 percent against RM6.4 million regulatory capital. Using IA would mean less income from fees but this is possible without putting bank's capital at risk.

Table 13: Shifting *Mudaraba* deposits to Investment Account

Assets	Liabilities
\$100m <i>Murabaha</i> @7%	\$100m Investment Account@n%
a) IA carries credit risk b) No bank capital charge c) i) Pay in Full: Profits = $(0.07 \times \$100) - \text{other expenses} - \text{Bank's commission} = \m $n\% = (\$m / \$1000) \times 100$ ii) Default: $LGD = EAD - \text{collateral} / EAD$; CreditVaR	

Conclusion


When the underlying contract between an Islamic bank and the depositors is based on *mudaraba*, a profit-loss sharing arrangement is evident by the charging of impairment expenses to the *mudaraba* depositors. While this is the case, the returns on *mudaraba* deposits (ROMD) do not seem to reflect the risks shared by both parties as the ROMD has been consistently lower than ROE despite evidencing some form of credit-risk sharing between them. Such discrepancy in performance of deposit funds and capital funds may trigger Shariah non-compliance risk. The introduction of the investment account (IA) in Islamic banking amongst others, should reduce such unwanted risk. When investment accounts (IA) are channeled to fund *murabaha* transactions, the credit risk should be solely carried by the IA holders and hence, the return on investments accounts (ROI) can be the reference point in assessing the risk-taking activities of investment account holders which is comparable to the return on equity (ROE) of bank's shareholders.

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Appendix 1



Fortifying Internationalisation of Islamic Finance

Launch of IAP

17 Feb 2016, 9.30 - 11.30 a.m.
Sasana Kijang, Kuala Lumpur

IAP is a multi-bank platform to facilitate channelling of funds from individual and institutional investors to finance viable projects and ventures.

The platform will allow investors to choose from a wide range of ventures and projects sponsored by different Islamic banking institutions for investments.

IAP also provides entrepreneurs and businesses with a new financing option for variety of projects and business activities.

It is envisaged for IAP to be eventually positioned to facilitate fund intermediation across borders.

RSVP to iap@bnm.gov.my by 11 Feb 2016

INVESTMENT ACCOUNT PLATFORM

Officiated by:

TAN SRI DR. ZETI AKHTAR AZIZ
 Governor of Bank Negara Malaysia (BNM)

Who will attend:

- CEOs of banking groups
- CEOs and senior management of Islamic banking institutions
- Heads of government agencies
- CEOs or key personnel from institutional investors
- Leading academicians and Shariah scholars
- Key figures of legal and accounting firms in Islamic finance
- Representatives from embassies and chambers of commerce



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A LEGAL AND GEOPOLITICAL PERSPECTIVE ON *SUKUK* IN THE GCC

BY WALID HEGAZY

It is no secret that oil production is the primary source of liquidity for petroleum rich Gulf Cooperation Council (GCC) states. GCC states have employed their capital in the expansion of their own infrastructure, and through different forms of investment in the wider MENA region. With the steady decline in oil prices, GCC states will have to decide whether they can continue to expend their resources at the same rate. GCC countries must find new sources of secure much-needed financing to maintain their economic development and growth plans. *Sukuk*, which are Shariah-compliant financial instruments sharing characteristics of bonds and investment certificates, may represent a viable option for the government and the private sector in the GCC region. This paper offers a theoretical explanation of *sukuk* and its legal requirements followed by an analysis of the potential role that *sukuk* can play in the context of current political and economic shifts in the region.

What are *Sukuk*?

Sukuk (singular: *sak*), are certificates of equal value issued in exchange for tangible or intangible assets that grant their holder an ownership stake in a particular asset or contractual arrangement involving the asset.¹ This ownership stake entitles the *sukuk*-holder to the profits and exposes him to the risks inherent to the performance of such *sukuk* assets. In this respect, *sukuk* are similar to investment certificates.

¹ The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), in their most recent *Shariah Standard No. 17* defines “Investment Sukuk” as “certificates of equal value representing undivided shares in ownership of tangible assets, usufruct, and services or (in the ownership of) the assets of particular projections of special investment activities...”

Typical Sukuk Transaction

The first step in the *sukuk* process is the creation of a Special Purpose Vehicle (SPV). SPVs are created to hold *sukuk* assets and to facilitate the transactions between the issuer, the investors, and any relevant third parties. The SPV is a separate legal entity independent of both the originator and the investors. The SPV is responsible for issuing the *sukuk*, while also serving as the trustee over the funds received. The legal implications of such arrangements represent a mutual benefit to the originator and the investors. On one side, a change in the originator's structure (i.e. merger, acquisition, or dissolution) does not affect the contractual relationship of the SPV to the investors (*sukuk* holders), or their mutual rights or obligations. On the other side, the SPV, rather than the originator, is liable to the investors for delay or default, minimizing the risk to the originator.

The issuer receives the proceeds of the *sukuk* issuance for the purpose of investing such proceeds in accordance with the agreed terms of the transaction. On the other hand, the investors receive the return on such investments through periodic distribution amounts over the course of the *sukuk*'s tenure. Periodic distribution amounts are not the same as interest payments, because the underlying concept is that the investor is entitled to the periodic profits that result from the asset or transaction, and there is a contractual understanding that the periodic distribution amounts are proportional to the ownership stake, and fully dependent on the asset's performance or the success of the transaction. Therefore, the receipt of the periodic distribution amount is not guaranteed, at least in theory. In practice, some *sukuk* provide terms that guarantee a minimum level of return in addition to recovery of capital.

“Islamic Bonds?” Differentiating Between Bonds and Sukuk

Both *sukuk* and bonds can be traded in secondary markets, allowing the owner to exchange them for readily useable liquidity, if necessary. Conventional bonds do not meet the standards of Shariah-compliance mainly due to the Islamic principle of *riba*. *Riba* is often translated as “usury”, and its prohibition under Islam is sourced from the Quran, which states “And Allah has permitted trade and forbidden usury.”² This verse may be interpreted narrowly or broadly. In its most narrow interpretation, Muslims are prohibited from charging any additional amount or benefit over and above the principal amount of a loan. Conventional bonds represent a debt obligation as the bondholder receives an interest rate above principal paid in. While the investor in a *sukuk* transaction becomes a joint owner of an asset along with his fellow investors, receiving the period distribution amount as a form of ownership profits; a bondholder is simply lending money to the issuer, and profiting from the interest that he is charging the issuer on that loan.

Like bonds, *sukuk* have a tenure, which is the length of time during which the investor will possess the ownership stake in the underlying asset, as well as the time period over which the underlying transaction will occur. The investor is paid a dissolution payment at the end of the *sukuk*'s tenure, which represents the value of his ownership stake at the end of the arrangement. While the investor expects that the ownership stake will increase in value over time, he enters into the transaction with the understanding that it may not increase, and in fact, might depreciate. *Sukuk* comply with the principle of *kharaj bi daman*, return follows risk. In contrast, purchasers of bond certificates are not exposed to any risk related to the assets or investments underlying the bond issuance while profiting from debt. Also, whereas the price of *sukuk* is usually determined according to the quality of the underlying asset or initial transaction, the price of bonds is usually

² Quran 2:275.

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determined according to the issuer's credit rating. It must be noted, however, that despite being controversial from a Shariah perspective, most *sukuk* issued to date include an undertaking that the issuer is obligated to buy back the *sukuk* assets from investors at the maturity date at the original purchase price paid by the investors for the same assets at the inception of the transaction.

Classification of Sukuk: Asset Backed versus Asset Based

The crucial elements in differentiating between asset-backed and asset-based *sukuk* are the type of ownership stake represented by the *sukuk*, the extent of Shariah-compliance, and the sources of periodic distribution payments. Asset-backed *sukuk* are issued by SPVs, and the investor is granted full legal ownership in this asset in exchange for his purchase of the *sukuk*, in proportion with his share. The SPV is able to sell the ownership stakes as the originator has sold it the tangible assets prior to the commencement of the *sukuk* issuance. The implications of legal ownership are that the investor, in theory, has the right to benefit from the asset and dispose of the asset, a right restricted only by his contractual role and obligations as an investor. The role of the SPV in issuing the *sukuk* prevents the investors from holding the originator liable for any losses incurred. Should these losses take place, the losses are derived from the poor performance of the underlying asset, because the underlying asset is the source of revenue, profit, and loss. Therefore, asset-backed *sukuk* are a form of equity, with the ownership shares of existing, tangible assets securitized and sold for a profit. Asset-backed *sukuk* are in full compliance with Shariah because the transaction is based on a source of legitimate revenue that exists, and the investor is profiting from the asset itself, not from debt or lending, which would be *riba*.

Asset-based *sukuk* do not fit the requirements for Shariah-compliance despite the rationale for the creation of asset-based *sukuk* being investors' discomfort with the level of risk inherent in asset-backed *sukuk*. They wanted a debt-like instrument with guaranteed principal and returns above the principal. Asset-based *sukuk* are quite similar to conventional bonds, in that the source of revenue is the capital of the originator. The originator, in the case of asset-based *sukuk*, does not form an SPV, but issues the *sukuk* directly to the investors. The investors do not have legal ownership of any revenue-providing asset, but rather a form of beneficial ownership of assets legally owned by the originator. The originator contracts with the investors to purchase certain assets that he will utilize to gain profit. The price of the *sukuk* is paid directly to the company, and the company then owes this money to the investors, in addition to any profit. While the issuers of asset-based *sukuk* do not go so far as to label the periodic distribution amounts as interest payments, in practice, the difference is nominal. In sum, those who invest in asset-based *sukuk* are trading and profiting in the debt of the originator.

Asset-based *sukuk* also violate the *kharaj bi daman* principle, in that the investors, should the originator fail to pay the periodic distribution amounts, can actually seek legal recourse against the originator. The investors not only expect to receive their payments, participating in a reward-bearing transaction at no risk to themselves, but they may, if they so choose, force the originator to fulfill their rights, even in the face of severe losses. It had even become customary for *sukuk* issuers and investors to conclude a repurchase undertaking agreement. A repurchase undertaking agreement expressly obligates the originator to repay the full purchase value of the *sukuk* to the investors, whether at the end of the *sukuk*'s tenure or in the case of default. The practice became so common, that Sheikh Muhammad Taqi Usmani, the chairman of the Bahrain-based International Shariah Standard Council at the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), declared in 2007 that 85 percent of *sukuk* were not

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Islamic.³ As such, the use of the term “*sukuk*” in the remainder of this paper, will refer to the *Shariah-compliant sukuk*, which are asset-backed *sukuk*.

Common *Sukuk* Structures

Wakalah *Sukuk*

Sukuk are also classified according to the underlying Islamic transaction involving the assets. As such, there are various types of *sukuk* structures. The three *sukuk* structures with the highest issuance value in 2015 were *wakalah*, *murabahah*, and *ijarah*.⁴ The value of most *sukuk* issuances dropped over the last three years presumably due to lower oil prices. Yet, unlike *murabahah* and *ijarah sukuk*, the value of which decreased between 2014 and 2015, *wakalah sukuk* have been steadily increasing in issuance value since 2013.⁵ The underlying transaction is a simple agency agreement, which allows *investors* to access a larger variety of diverse assets not available to them under *murabahah* or *ijarah sukuk* which enjoyed an initial burst of popularity in 2008. These factors have increased their popularity among investors and issuers. First, the SPV issues the *sukuk* to the investors. Investors gain legal ownership of the underlying assets in the *wakalah* transaction with the accompanying benefits of the periodic distribution payments and the dissolution amount at the end of the transaction’s tenure. Using the proceeds from the *sukuk*, the SPV is then able to enter into a *wakalah* (agency) agreement with a third party, the *wakeel*, who will then invest the funds entrusted to him in a pool of *wakala* assets, the specifics of which are agreed upon in advance by the investors, the originator, the SPV, and the *wakeel*. It is crucial that the necessary details of the *wakalah* assets be specified to the greatest extent possible in all legal documents relating to the assets concluded between the four main parties to the *wakalah* transaction and the *sukuk* issuance. The fundamental criterion for the assets is that they not be related to profits gained from *Shariah*-prohibited activities.

However, the *wakeel*’s investment in these assets is not a direct process. The *wakeel* first purchases the assets from another third party, the seller. Once he owns the assets, he can then exploit them for maximum profit. The somewhat convoluted process is an attempt to comply with another principle in Islamic finance: the concept that one cannot trade in assets that he does not already own, or be almost certain that he will own. Hence, the basis of the transaction is that the SPV is selling ownership stakes in assets that the *wakeel* will purchase and invest on behalf of the SPV. The order in which the documents are concluded bears additional gravity to the situation. The SPV must sign the *wakalah* agreement with the *wakeel* before the *wakeel* purchases the assets; otherwise, the *wakeel* would have purchased the assets on its own behalf, not on behalf of the SPV, and the SPV would have sold the investors assets that it did not actually own, erasing the intended *Shariah*-compliant nature of the transaction. It is incumbent on financial institutions wishing to issue *sukuk* that they respect the proper timing.

As the *wakalah* assets become profitable and generate regular returns on the investment, the SPV uses those returns to pay the periodic distribution amounts to the investors. The *wakeel*’s payment comes from the excess in profits after the periodic distribution amount has

³ Reuters, “Most Sukuk ‘not Islamic’, body claims”, *arabianbusiness.com*. Reuters, November 22, 2007. <http://www.arabianbusiness.com/most-sukuk-not-islamic-body-claims-197156.html#.V2ppbPI96M8>

⁴ Thomson Reuters, “Issuance by Structure”, *Industry at a Crossroads: Thomson Reuters Barwa Sukuk Perceptions and Forecast 2016*, p. 7.

⁵ Thomson Reuters, “Sukuk Structure Growth Comparison (2014- Q3, 2015)”, *Industry at a Crossroads: Thomson Reuters Barwa Sukuk Perceptions and Forecast 2016*, p. 36.

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been paid, which serves to incentivize him to make the strongest and most profitable investment decisions, as his compensation is directly proportional to the quality of his work. The dissolution price is paid to investors upon the conclusion of the transaction's tenure, which can occur through the SPV activating the clause of the purchase agreement requiring the originator to purchase the assets on that particular date. Or, it can occur earlier, if the originator wishes to purchase the assets prior to the maturity date. The sale price of the assets is termed the "exercise price",⁶ and the *sukuk* holders are paid the dissolution amount in accordance with that price.

Murabahah Sukuk

The sharp decline in the cumulative value of *murabahah sukuk* offerings may be due to increased concern over the Shariah-compliance of this structure. Whereas *murabahah sukuk* were worth US\$65.3 billion in 2013, their issuances amounted to a paltry US\$12.5 billion in 2015.⁷ The most likely reason for this drastic decline, which cannot be explained by the drop in oil prices alone, is that AAOIFI standards do not permit the trading of *murabahah sukuk* in secondary markets, as these *sukuk* are closest to debt.⁸ The debt-like nature of *murabaha sukuk* can be derived from the structure of the underlying *murabaha* transaction, and the relation of the investors to the assets in that transaction as a source of revenue. A *murabaha* transaction is usually translated as "cost plus" or "deferred price" financing, as it consists of the sale of assets to the customer in exchange for a deferred price. The deferred price is, by nature, greater than the price of the assets themselves. Of course, the difference is charged not through interest, which is prohibited, but through a pre-agreed "cost plus" amount to which the seller is entitled for facilitating the transaction and providing the assets in advance.

As such, following the SPV's issuance of *sukuk* to the investors, the investors do not legally own any fungible assets. Rather, they are simply entitled to the proportional share of the deferred price. *Murabahah sukuk* are justified on the grounds that the debt obligation does not involve the charging of interest, which makes it permissible under the *Shariah*. Similarly to other *sukuk* arrangements, the SPV is the trustee of the *sukuk* proceeds on behalf of the investors. The originator then acts as the buyer, agreeing to purchase assets from the SPV on a cost plus basis, should the SPV acquire the assets. The SPV acquires the assets via purchase arrangement with a third party, using the *sukuk* proceeds as funding for the transaction. The purchase price of the assets in the SPV-third party transaction is then assessed as the delivery cost, the principal, of the transaction between the SPV and the originator. The tenure of the *sukuk* is determined by the length of time allocated for the payment of the deferred price. Rather than pay the deferred price as a lump sum at the end of the *sukuk*'s tenure, the originator pays the deferred price to the SPV in regular installments, which are then paid to the investors as the periodic distribution amount. The Shariah-compliance of this type of *sukuk* transaction is based in the reality that the investors are not possessing debt *per se*, but are actually possessing a right to a deferred price to which they are entitled following the sale of assets purchased on their behalf, using their liquidity.

Ijarah Sukuk

Notwithstanding the increasing value of *wakalah sukuk* issuance, 2015 survey statistics show that *ijarah sukuk* are still the preferred form of *sukuk* for a plurality of issuers and investors

⁶ Islamic Banker, "Sukuk Al Wakalah", *islamicbanker*. <https://www.islamicbanker.com/education/sukuk-al-wakala>

⁷ Thomson Reuters, "Sukuk Structure Growth Comparison (2014- Q3, 2015)", *Industry at a Crossroads: Thomson Reuters Barwa Sukuk Perceptions and Forecast 2016*, p. 36.

⁸ AAOIFI Shariah Standards.

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(24% and 23% respectively).⁹ Although *ijarah sukuk* do not allow the issuer to have a diverse portfolio of Shariah-compliant assets, the underlying transaction is as simple as the *wakalah* transaction, while being less risky. The increased value of *wakalah* transactions can thus be explained as permitting greater profit margins than *ijarah* transactions, which justifies the increased risk if issued in large amounts with significant subscription rates. Unlike *murabahah sukuk*, there are no doubts as to the Shariah-compliance of the *ijarah sukuk*; as long as the investors become legal owners of the tangible assets underlying the *ijarah* transaction, and the *ijarah sukuk* can be traded on secondary markets.¹⁰ Investors obtain rights to periodic distribution payments and the dissolution amount in accordance with their ownership of the asset. The SPV uses the *sukuk* proceeds to buy assets from the originator on behalf of the investors. These assets are then leased back to the originator for a lease period corresponding to the *sukuk*'s tenure. During the lease period, the originator must abide by the service agreement compelling him to undertake regular maintenance of the assets, to protect the investment from depreciation or destruction. Once the originator repurchases the assets, whether at the conclusion of the lease period or due to his exercise of an option in the sale agreement, the exercise price is paid to investors proportionally in accordance with their ownership percentage of the asset.

Legal Documentation of *Sukuk* Transactions

Legal documents for *sukuk* transactions can generally be classed into several categories: agreements between the investor and the SPV, agreements between the SPV and the originator, agreements between the SPV and third parties (whether *wakeel*, supplier, seller, etc.), agreements between the originator and third parties, and supporting documents detailing the conditions of the *sukuk*, whether for legal or tax purposes. This section will discuss the legal specifications of the *sukuk* offering as presented to potential investors, as well as those pertaining to the *ijarah* agreement as an example of documentation for the underlying transaction. All agreements must not only comply with the principles of Shariah, but they must be valid and actionable under the law of the country in which the *sukuk* are issued.

Sukuk Offering

The *sukuk* offering contains the percentage of the issue price, the year in which the *sukuk* reach their maturity, and if applicable, dates in which the investor can exercise the option to redeem his *sukuk* certificate in advance of the maturity date. Furthermore, it explains the conditions of the subordinated certificates; descriptions of the SPV, issuer, bank, and assets, with additional information regarding the asset quality; principle shareholders, management, and capital adequacy; an explanation of the country's financial system for foreign investors; tax considerations; and the conditions of subscription and sale. The impetus behind the *sukuk* offering is to provide the investor with as much information as possible before he invests his funds in the purchase of the certificate.

The risks of the *sukuk* are clearly explained in a section entitled "Investment Considerations", while the investor is made aware of the SPV's limitations and the permissions in accordance with which it may act. In a sample offering, it was noted that the issuer could not allow the redemption of the certificates except with written permission from the originator, which happened to be an Islamic financial institution. In regards to the issuance of the

⁹ Thomson Reuters, "Survey Findings-Structure Preference", *Industry at a Crossroads: Thomson Reuters Barwa Sukuk Perceptions and Forecast 2016*, p. 36.

¹⁰ AAOIFI Shariah Standards.

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certificates themselves, the offering must inform the investor under which national or international financial authority the *sukuk* were issued, for both legal recourse and tax purposes, as well as specific legal codes that do not govern the *sukuk*; to prevent the investor from advancing legal claims regarding the *sukuk* ownership under codes that may be unfavorable to the issuer or the originator, or which do not govern *sukuk* effectively. The investor is also apprised of the lead managers of the offering, which tend to be international banks with experience in arranging *sukuk* issuances, such as HSBC.

The value of the *sukuk* offering must be specified in terms of amount and currency denomination, along with the relevant deposit information for the customer's funds once the certificate has been purchased. If the *sukuk*'s currency differs from the country's national currency, the *sukuk* offering will usually contain a historical pattern of exchange rates for a similar period to the *sukuk*'s tenure, while reminding the investor that any forward statements regarding exchange rates or any other element of the transaction are merely expectations, and as such, may not be correct. This relevant financial information is supplemented by the foreign exchange risk data, which comprises the foreign currency assets and liabilities of the issuer and the bank, concluding with the net structural position of each. The bank's data is then classified by sector and by geographical region, with a separate section on the bank's Islamic finance operations. The bank's non-interest income should always be highlighted.

Potential investors will also be apprised of their earnings, in the event of their purchase of a *sukuk* certificate. The earnings per share are calculated based on quarterly, biannual, and annual net profits, divided by the weighted average number of ordinary shares, as anticipated by the issuer and the originator. If, as a consequence of high demand, the offering is oversubscribed and the issuer then decides to issue an additional number of *sukuk*, this earning per share calculation may be adjusted in future documents. Of course, the offering distinguishes between the basic earnings per share and the diluted earnings per share. The diluted earnings per share adjusts the weighted average number of issued ordinary shares for the number of potentially issued shares, factoring in the effects of the share option. The diluted earnings per share is thus, slightly less than the basic earnings per share amount. In tandem with the description of the earnings, the potential investors are supplied with the tax information that may apply to the *sukuk* under the laws in which the *sukuk* are issued. This tax information may include the presence of capital gains taxes, a gift or inheritance tax, relevant duties and registration fees, and the legal consequences or permissibility of withholding taxes.

The offering will also give a summary of all relevant documents to the transaction. These typically include the trust deed, the agency agreement, the SPV-Issuer purchase agreement, the management agreement, the purchase undertaking deed, the sale undertaking deed, and the costs undertaking deed. Following this summary, it will detail the obligations of each of the parties under the various agreements, as well as the timing according to which the agreements be concluded relative to each other. Every relevant party will be identified in the offering document; not only the issuer, trustee, SPV and bank; but also the legal advisers, auditors and listing agents.

The offering may also impose some obligations on the recipients. For example, if the offering is sent electronically, then the recipient's acceptance of the email and viewing of the offering circular is equivalent of his representation of himself as fulfilling all of the eligibility requirements for the offer. The recipient may not forward the offer to any address or person in a country that has been expressly mentioned in the offering as not having jurisdiction over the *sukuk* offering. Failure to comply with these obligations nullifies the recipient's capacity to accept the offer and purchase a *sukuk* certificate in the future. The drafters of the offering will be certain to note that the *sukuk* offering is neither an offer to sell nor an offer to buy; nor should the recipient reply to the offer directly in order to purchase *sukuk* certificates, as the purchase must

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take place as a transaction directly between the investor and the SPV. The careful drafter will also make sure to emphasize that any viruses or malware that might possibly be attached to the email are not the fault of the sender; the recipient is responsible for protecting his own electronic devices, and the sender is not responsible for any damages that may occur as a result of the recipient's own negligence.

Ijarah Agreement

If the underlying transaction of the *sukuk* is *ijarah* financing, then an *ijarah* agreement will be concluded between the SPV in its capacity as the trustee, and the originator. The *ijarah* agreement will identify the parties and specify the assets subject to the transaction, along with their relevant features and identifying details, if needed. The originator, as the lessee, will accept the conditions of use imposed the trustee as the lessor, while agreeing to perform all regular maintenance, repairs, and insurance documentation for the assets. The lessor, in contrast, is responsible for insuring the assets, and in the case of damage to the assets resulting in an insurance reward, the lessor alone is entitled to that reward.

In the case of extraordinary events resulting in damage not resulting from the lessee's fault or negligence, the lessor will bear the financial responsibility of the repairs. The lessee must also permit the lessor's representatives to have regular access to the assets to examine them and confirm their status. This clause is especially relevant when the *ijarah* transaction is the basis of *sukuk*. The SPV is not only acting as a lessor, but as the trustee of the assets entrusted to him by the investors that he has purchased, and then leased, on their behalf. Should the assets depreciate in value or be irreversibly damaged, there would be no profit for the investors. The value of the deposit and the lease payments are explicitly outlined in a schedule, with an appointed payment date, with the posting of payments earlier, should the payment date fall on a business day. Additionally, the lessee must pay all necessary administrative fees and taxes necessary for the licenses required to operate or possess the assets.

Finally, all primary concerns for investors are addressed in the *ijarah* agreement. If, for some reason, the assets are used for criminal activity, or they are operated in a way that causes damages to a third party, then the originator is the only responsible party for the damages or the legal ramifications of the criminal activity. The *ijarah* agreement stipulates that if the originator enters bankruptcy or liquidation proceedings, and is rendered unable to pay the lease payments on the time, or at all, then the SPV is entitled to repossess the assets. The assets cannot be liquidated along with the originator's other assets, nor can they be used as collateral in the fulfillment of separate debt obligations.

GCC Sukuk in an Age of Low Oil Prices

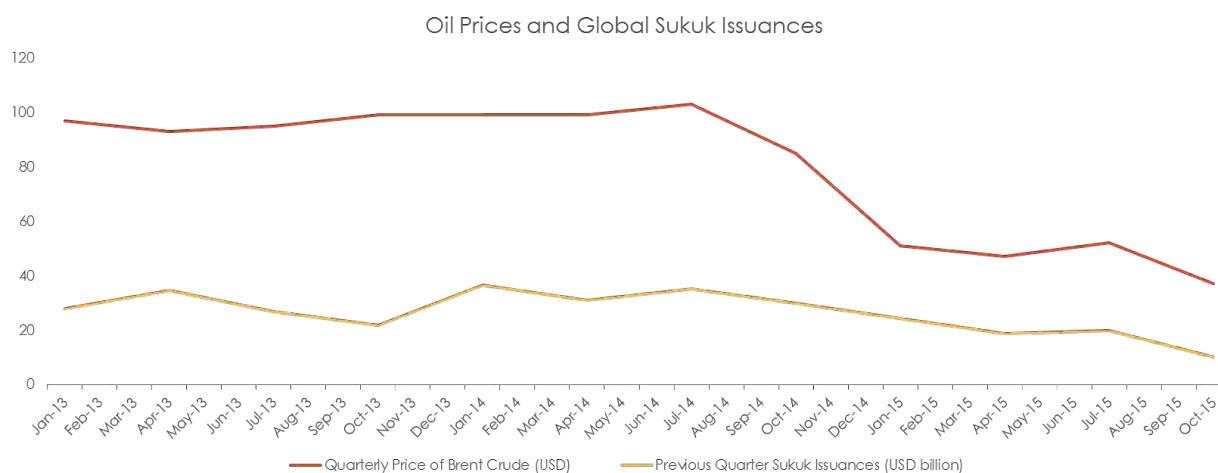
The Global Sukuk Market

The global *sukuk* market is concentrated in Southeast Asia and in the GCC. Malaysia is the worldwide leader in *sukuk* issuances, although GCC members have rapidly expanded their presence in this market. While the US Islamic finance sector is underdeveloped, the US Dollar is the preferred denomination in which to issue *sukuk*. The UK and Luxembourg, two of the premier European financial centers, entered the *sukuk* market with sovereign issuances in 2014. The Luxembourgish issuance is especially noteworthy because it represents the first euro-dominated *sukuk* issued by an EU-member country.

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In light of this theoretical, legal, and global framework, it is now possible to discuss the practical application of the *sukuk* market in the GCC. In a recent survey, 62 percent of purchasers expressed negative expectations regarding *sukuk* as a result of the drop in oil prices.¹¹ Concrete evidence supports this proposition as well. In 2014, US\$114 billion worth of *sukuk* were issued; whereas the first three quarters of 2015 only witnessed the issuance of US\$48.82 billion of *sukuk*.¹² When this data is compared to the same point in 2014, the difference is stark. By the end of the third quarter of the 2014 fiscal year, US\$99.27 billion in *sukuk* had been issued. One can argue that the drop in oil prices reversed a formerly positive trend in *sukuk* issuance. The *sukuk* issuance for 2014 was 24.5 percent higher than the previous year; whereas the 2015 *sukuk* issuance was 50 percent lower than that of 2014. Even accounting for the Central Bank of Malaysia's decision to freeze its *sukuk* issuances, apparently the drop in oil prices created uncertainty among potential investors, who were reluctant to invest in what is essentially a niche financial market with inconsistent regulation.

Given that, most recently, an attempt in Doha to fix oil prices failed, the price of oil stubbornly refuses to increase. One place where low oil prices are perceived to impact the financial sector is through reduced *sukuk* issuances. Standard & Poor's, reflecting the expert consensus, predicts that low oil prices will dampen *sukuk* issuances. We decided to test this consensus using data assembled from Google Finance, Kuwait Finance House, Malaysia International Financial Centre, and Standard & Poor's. We believe that the chart below is first chart comparing historical oil prices and *sukuk* issuances.



This chart suggests that there is a correlation between reduced oil prices and reduced *sukuk* issuances. In examining the two, one cannot forget that Malaysia, the worldwide leader in *sukuk*, which is not usually considered a petroleum-reliant economy, still receives roughly 30 percent of government revenue from Petronas, its state-owned oil company. Other leaders in *sukuk*, especially those in the Gulf Cooperation Council, are also heavily reliant on oil revenues.

GCC countries have responded to the decline in oil prices and the contraction of the *sukuk* market by turning to conventional bonds. Saudi Arabia, for example, has expenditures on multiple fronts. It provides foreign aid to less fortunate neighbors such as Egypt. It is heavily invested in military expenditures to oust Iran-backed Houthi rebels from adjoining Yemen, while propping up the weak Sunni government. This is not to mention the costs of maintaining the

¹¹ Thomson Reuters, "Survey Findings – With the Drop in Oil Prices, Do You Think Sukuk Performance Will", *Industry at a Crossroads: Thomson Reuters Barwa Sukuk Perceptions and Forecast 2016*, p. 51.

¹² Thomson Reuters, "Global sukuk growth for the first 9 months (2011-2015)", *Industry at a Crossroads: Thomson Reuters Barwa Sukuk Perceptions and Forecast 2016*, p. 24.

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living standards of the extended royal family and maintaining Saudi Arabia's image as a successful, cash-rich provider of funds. This image is essential to Saudi Arabia's regional influence, especially as Iran re-enters the international community. Last summer, for the first time since 2007, Saudi Arabia issued SAR20 billion (US\$5.33 billion) in development bonds that are set to mature over varying lengths of time.¹³ In contrast, Saudi Arabia's last *sukuk* issuance was for only SAR2.7 billion (US\$720.12 million) of perpetual *sukuk*.¹⁴ Saudi Arabia's actions demonstrate a lack of confidence in the potential of *sukuk* as a reliable tool for long-term infrastructure financing.

This is not to say that all actors in Gulf countries are demonstrating the same reluctance. Prior to Saudi Arabia's decision to issue bonds, Emirates Airlines in the UAE issued US\$913 million of *ijarah sukuk* with a ten year tenure,¹⁵ with the objective of funding the acquisition of additional aircraft and expanding the airline's operations. Emirates Airlines' initiative is reflective of Dubai's positive stance towards *sukuk* as well, given the close ties between the emirate's transportation center and the government of Dubai's sole international airline.

One of the issues seems to be a lack of coordination between GCC countries on their *sukuk* policies, with each state independently issuing *sukuk* geared toward its own narrow financing objectives. Sovereign *sukuk* in the GCC comprised 29 percent of the total value of *sukuk* issuances in the region, as opposed to the 8 percent that were quasi-sovereign during the period from August 2014 until August 2015.¹⁶ In addition to the Emirates Airlines *sukuk* mentioned in the previous paragraph, other quasi-sovereign entities that have issued *sukuk* include the Saudi Electricity Company and Saudi Telecom. Lead arrangers and issuers have historically preferred sovereign and quasi-sovereign *sukuk*, presumably due to the explicit or implied backing of a government for these structures.

GCC Sukuk Performance Expectations, Analysis, and Predictions

GCC *sukuk*, while exposed to the same international stresses as those in other regions, also suffer from a unique set of factors. As opposed to the bond market, where there is active trading of debt securities, *sukuk* are held by a small number of investors, who tend to follow a buy-and-hold model of investment. This means that there is no equivalently active secondary market to provide liquidity. If GCC countries were to issue sovereign *sukuk* in 2016, in separate tranches with ten and fifteen year tenures, these funds could not only be used to fund financial infrastructure, but they would provide the international community a means through which to launch the rebuilding of war-torn areas, without concentrating the burden on any specific country.

Furthermore, while the AAOIFI is located in Bahrain, and their Shari'ah and accounting standards have been promulgated nationally in countries such as Pakistan, many countries do not have sufficient *sukuk* standards and regulations. This lack of national standards is compounded by the lack of universally-acceptable standards. Given that there is wide diversity within Islam, it follows that there is wide diversity in approaches to Islamic finance, including *sukuk*, so worldwide standardization will be challenging. However, through integrating the AAOIFI into a

¹³ Ahmed Al Omran, Nicolas Paraisie, "Saudi Arabia Issues Bonds Worth \$5 Billion to Plug Budget Shortfall", *The Wall Street Journal*. August 11, 2015. <http://www.wsj.com/articles/saudi-arabia-issues-bonds-worth-5-billion-to-plug-budget-shortfall-1439305126>

¹⁴ Sukuk Database, "National Commercial Bank (Perpetual)", *Sukuk*. 2015. <https://www.sukuk.com/sukuk-new-profile/national-commercial-bank-perpetual-4697/>

¹⁵ Sukuk Database, "Khadrawy Limited", *Sukuk*. 2015. <https://www.sukuk.com/sukuk-new-profile/khadrawy-limited-3935/>

¹⁶ Rasameel Market Finance, "Sukuk Issuance by Value, Number, and Type", *GCC Market Update*. <https://www.sukuk.com/wp-content/uploads/2015/09/GCC-Market-Update-August-2015.pdf>

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larger GCC, or preferably worldwide, regulatory body for *sukuk* and Islamic finance, the Gulf could not only reposition itself as the investment capital for *sukuk*, but as the regulatory center as well. This possibility appears slightly more realistic in light of the contraction of the Malaysian *sukuk* market. Unfortunately, should the GCC countries not take these steps, it remains likely that smaller GCC states will take Saudi Arabia's lead, and resort to bonds rather than *sukuk*. This step, in what is considered to be the ideological fulcrum of the Muslim majority world, could further reduce confidence in *sukuk* as a viable investment and financing initiative.

Although historically *sukuk* issuances and oil prices have been correlated, there are several pathways suggesting that this could change. Perhaps an acceptance of reduced hydrocarbon revenues would lead GCC governments to seek alternative funding pathways, which presumably would include an increase in sovereign *sukuk*. In the long term, *sukuk* could be backed by any asset, so there is potential for *sukuk* to be used in connection with alternative forms of energy. These "green *sukuk*" to finance wind and especially (given the weather in the GCC) solar power could build the *sukuk* market in the GCC and decouple *sukuk* issuances from oil prices.

Conclusion

By understanding that *sukuk* are not simply "Islamic bonds," one can take a nuanced view of their position of the GCC and global financial markets. The difference between *sukuk* and bonds is clearer when one follows best practices in preferring Shariah-compliant asset-backed *sukuk*.

In analyzing the most common structures for *sukuk*, one observes how the balance between investors' goals and Shariah-compliance leads to complexity and diversity. The lack of universally-accepted standards creates further complexity, and the potential for confusion. Due to this complexity and diversity, it is imperative that *sukuk* offerings provide appropriate investors with all needed information.

Historically, *sukuk* offerings and oil prices have moved together. In 2015, *sukuk* offerings took two major blows from the Central Bank of Malaysia's pause on new issuances and sustained low oil prices. In response to the second blow, Saudi Arabia returned to conventional debt markets in 2015. It remains to be seen if other GCC countries follow the Saudi lead.

One bond issuance does not signal the beginning of the end of the GCC *sukuk* experience. *Sukuk* can be backed by any permissible asset, so there are opportunities for environmentally-conscious energy projects in the GCC to revitalize the *sukuk* market.

Walid Hegazy has over 20 years of legal experience representing and advising clients on transactions and disputes involving the commercial laws and regulations of many Middle East countries, including Egypt, the UAE, the Kingdom of Saudi Arabia, Qatar and Libya. Dr. Hegazy's main areas of expertise include Islamic banking and finance, project finance, corporate restructuring and corporate governance. He has SJD (Doctor of Juridical Science) and LLM degrees from Harvard Law School.

His representative experience includes advising a major Saudi real estate investment group in connection with a SR1 .2 billion Murabaha facility; advising a major Saudi real estate developer in connection with structuring and documentation of Shari`ah-compliant facilities for the financing of a mix use real estate project in Mecca; advising Credit Suisse on a US\$1.2 billion lease-backed securitization based

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in the Kingdom of Saudi Arabia, in which he developed an innovative Shari `ah-compliant structure based on the Islamic contract of Hawala (assignment of debt). He has written extensively on Islamic finance in a number of academic journals. Before launching Hegazy & Associates, Crowell's affiliated law firm in Cairo, Dr. Hegazy was heading the Islamic Finance Practice Group at the international law firm of Freshfields Bruckhaus Deringer (Dubai, UAE and Riyadh, KSA). The other international law firms at which He practiced law include: Fulbright & Jaworski (Houston, TX), Baker & McKenzie (Riyadh, KSA), White & Case (New York), Groupe Monassier (Paris), formerly known as "Monassier & Agassi," and Zaki Hashem (Cairo).



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FINANCIAL REPORTING OF *MURABAHA* CONTRACTS: IFRS OR AAOIFI ACCOUNTING STANDARDS?

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MEZBAH UDDIN AHMED⁴

Abstract

Financial reporting of Islamic financial transactions is still a subject of unsettled debate among the accountants, auditors and industry observers of Islamic financial institutions (IFIs). In Malaysia, the issues in financial reporting of Islamic financial transactions have been discussed since early 2000 by both academicians and practitioners. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) caters to the unique characteristics of the contracts that govern the operations of IFIs, whereas the International Accounting Standards Board (IASB) does not have any specific International Financial Reporting Standards (IFRS) for Islamic contracts adopted by IFIs. However, IFRS are accepted by the majority of the world, including Malaysia. The Malaysian Accounting Standards Board (MASB) has concluded that it would not be in conflict with the Shariah to apply conventional accounting standards, namely the IFRS, for accounting of Islamic financial transactions. Nevertheless, in 2011, the IASB established the Consultative Group for Shariah-Compliant Instruments and Transactions to discuss any issues related to the financial reporting of Islamic financial transactions. This paper

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reviews and analyses the two main underlying issues in adopting IFRS as compared to AAOIFI accounting standards, which are substance over form and the time value of money, concerning recognition, measurement and disclosure requirements in the financial reporting of a *murabaha* contract. This paper also compares financial reporting presentation and the disclosures of Bank Islam Malaysia Berhad (BIMB) and ABC Islamic Bank, examples respectively of IFRS and AAOIFI FAS based reporting entities. The findings of this paper provide a basis for the inclusion of the substance over form and the time value of money in financial reporting of the *Murabaha* contract.

Keywords: AAOIFI, IFRS, financial reporting, Islamic financial institutions, *murabaha*.

Introduction

The Asian-Oceanian Standard-Setters Group (AOSSG) (2015) revealed that national standard-setters generally view specialized Islamic accounting standards as incompatible with the objective of convergent of International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB). A previous study by the AOSSG (2010) showed that there are significant differences between the IFRS and the Financial Accounting Standards (FAS) issued by the AAOIFI. The study also argues that in jurisdictions where Shariah interpretations support an approach that differs from IFRS requirements, standard-setters may have to review such interpretations and allow or require departures from those requirements for Islamic financial transactions. They conclude that although IFRS is an attempt to be the globally accepted single set of standards, there is resistance by those who believe that some IFRS principles are irreconcilable with their interpretations of Shariah.

Issues of the Accounting Principles

The AOSSG (2010) has examined two contrasting views on how to account for Islamic financial transactions: (i) a separate set of Islamic accounting is required; or (ii) IFRS can be applied to Islamic financial transactions. Accordingly, the differing approaches to accounting for Islamic financial transactions can be generally be attributed to opposing views on two main underlying issues which are: (i) the conventional approach of recognising and measuring the economic substance of a transaction, rather than its legal form; and (ii) the acceptability of reflecting a time value of money in reporting an Islamic financial transaction. However, the Malaysian Financial Reporting Standards (MFRS),⁵ which serve as the basis for financial reporting in Malaysia, have been rendered fully convergent with the IFRS since 1st January 2012 (Bank Negara Malaysia (BNM), 2016). In para 8.1 of the BNM policy document, it states:

Pursuant to section 74 of the IFSA [Islamic Financial Services Act 2013], a licensed person shall ensure that financial statements are prepared in accordance with the MFRS ... and shall disclose a statement to that effect in the financial statements.

A footnote of the policy document further states that:

In line with the MASB's consultative approach, a licensed person is to refer to MASB when there is divergence in practices regarding the accounting for a

⁵ MASB subscribes IFRS by IASB and issued IFRS-compliant MFRS in November 2011, in respect of its application in Malaysia.

particular Shariah compliant transaction or event, or when there is doubt about the appropriate accounting treatment and the licensed person believes it is important that a standard treatment be established.

Moreover, the policy document highlights that the licensed person should take into account the differences between Islamic banking transactions and conventional banking transactions which may arise from the application of the Shariah contracts that involve trade-related transactions, partnership-related transactions, and profit and loss sharing transactions. The accounting of each Islamic transaction is to be viewed closely to determine the most appropriate treatment, taking both the Shariah and economic effects of such transactions into account. Furthermore, the policy document in Para 8.3 states that a licensed person shall comply with the resolution of the Shariah Advisory Council (SAC) of BNM on the applicability of the following accounting principles adopted in the MFRS as being consistent with the broader view of Shariah principles:

- i. Accrual basis: The effect of a transaction and other events is recognised when it occurs (and not as cash or its equivalent is received or paid) and is recorded in the accounting records and reported in the financial statements of the periods to which it relates.
- ii. Substance over form: The “form” and “substance” of the transaction must be consistent and shall not contradict one another. In the event of inconsistency between “substance” and “form”, the Shariah places greater importance on “substance” rather than “form”.
- iii. Probability: The licensed person is to consider the degree of uncertainty of the future economic benefits associated with the transaction in the reference to the recognition criteria.
- iv. Time value of money: In a transaction involving time deferment, the asset (liability) is carried at the present discounted value of the future net cash inflow (outflow) that the transaction is expected to generate in the normal course of business. The application of the time value of money is permissible only for exchange contracts that involve deferred payment and is strictly prohibited in loan transactions (qard).

Hence, it is important to revisit the issues highlighted earlier on the different views of the underlying principles used between the MASB (IFRS-compliant) and the AAOIFI in general and then provide some illustration on the reporting of Islamic financial transactions. The next section discusses in brief the experience of Malaysia in the accounting and reporting of Islamic financial transactions.

Research Methodology

This paper reviews and compares the financial reporting based on the MASB and the AAOIFI standards by selected IFIs in Malaysia and Bahrain, with an examination of comparative recognition, measurement, and disclosure requirements for *murabaha* contracts. The review focuses on two main opposing views by the two standard-setters in the financial reporting of Islamic financial transactions, which are (i) the conventional approach of recognising and measuring the economic substance of a transaction, rather than its legal form; and (ii) the acceptability of reflecting a time value of money. The review of these points will facilitate a faithful and transparent financial reporting of the *murabaha* contract.

Murabaha Structure and Type

The *murabaha* contract is a true sale-based contract between two contracting parties to acquire a specified asset excluding monetary assets such as debt, and the cost and mark-up must be disclosed to the purchaser in the selling price (ISRA 2012). The IFIs should bear risk in the trade by being responsible for the *murabaha* assets prior to their sale and actual delivery to customers (Abdul Rahman 2010). AAOIFI via Financial Accounting Standard 2 (FAS 2) classifies two types of *murabaha* arrangements: (i) *murabaha*, where an Islamic financial institution sells assets to a willing purchaser and, (ii) *murabaha* to the purchase orderer, where an Islamic financial institution acquires an identified asset by the orderer (customer) who promises to buy from the IFIs at specified cost plus mark-up. The IFIs then execute the *murabaha* contract to conclude the sale and purchase of the identified asset with the orderer. Below are the illustrations of the generic structures of the *murabaha* and the *murabaha* to purchase orderer as classified by the AAOIFI:

Figure 1.1: *Murabaha* Structure

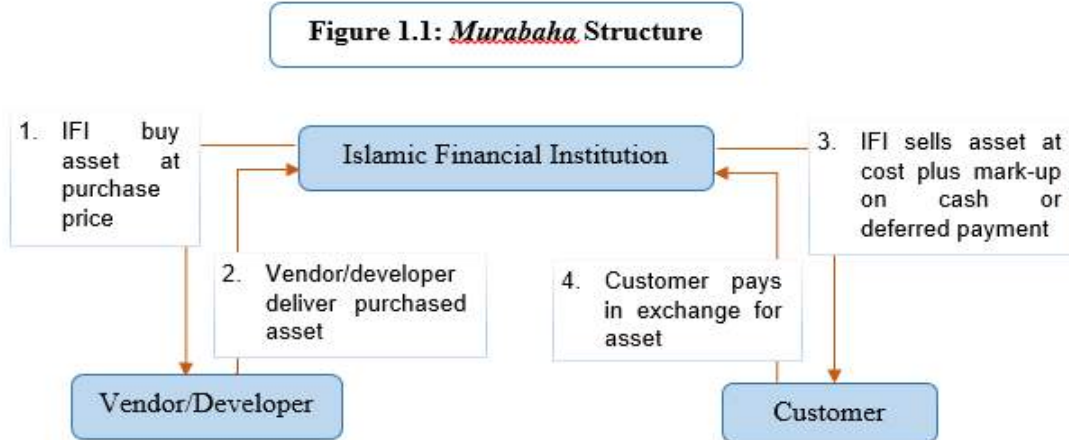
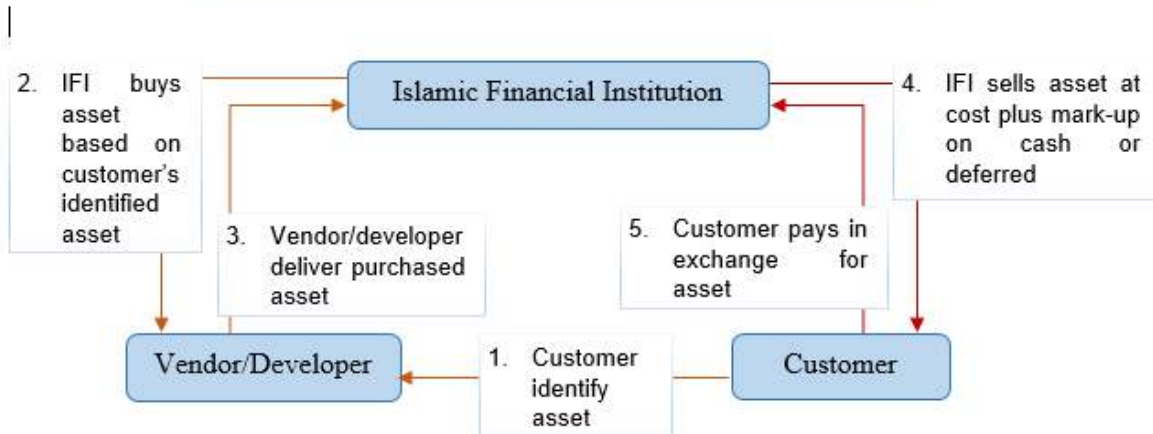


Figure 1.2: *Murabaha* to Purchase Orderer Structure



Financial Reporting of the *Murabaha* Contract

Recognition of the Murabaha Contract

The IASB in its Framework for the Preparation and Presentation of Financial Statements defined recognition as “the process of incorporating in the statement of financial position and income

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statement an item that meets the definition of an element” (i.e., asset, liability, equity, income or expense). The underlying principles of IFRS require consideration of the economic substance of a transaction rather than the legal form of a contract in recognition of an item or element in the financial position and income statement. The point is that “substance over form” is considered faithful representation of the economic behaviour, and is deemed to be an inherent part of it (ISRA 2012). Further to this principle, IFRS had since published two different standards relating to financing and trading arrangements. The discussion by the IASB Consultative Group on Shariah-Compliant Instruments and Transactions in its minutes of second meeting on 5 September 2014 further highlights the relevant IFRS to be applied for the *murabaha* contract. For instance, IFRS 9 *Financial Instruments*⁶ is applicable when the economic substance of the *murabaha* contract is classified as a financing arrangement. On the other hand, IFRS 15 *Revenue from Contracts with Customers*⁷ is applicable when the economic substance of the *murabaha* contract is classified as a trading arrangement.

The second type of *murabaha* contract classified by AAOIFI is widely practised by today’s IFIs (ISRA 2012). They acquire an asset only when there is a demand and promise to purchase the asset by a customer. Therefore, the IFIs do not actually hold the *murabaha* asset as inventory. The *murabaha* structure is merely to facilitate the financing of the desired asset through the purchase and sale of a *murabaha* asset (commodity). The structure directly defines the customary business of an Islamic financial institution as a financier instead of trader. Thus, it was concluded that the economic substance of the transaction is financing, based on the main objective of the contract concluded between the IFIs and the customers, and not the processes of sale and purchase of the *murabaha* asset in the contract (IASB Consultative Group on Shariah-Compliant Instruments and Transactions 2014). Thus, the applicable accounting standard to reflect *murabaha* financing as the economic substance of the transaction is IFRS 9, which requires the Islamic financial institution to recognise the right to receive cash flows from the *murabaha* contract as a financial asset in the statement of financial position.

The AAOIFI appears to be ambiguous about its views on substance over form (AOSSG, 2010). The Statement of Financial Accounting 1 (SFA 1) AAOIFI acknowledges that it is necessary for the transactions to be accounted for and presented in accordance with its economic substance as well as the legal form. In addition, the SFA 2 AAOIFI Para 111 states that “...reliability means that based on all the specific circumstances surrounding a particular transaction or event, the method chosen to measure and/or disclose its effects produces information that reflects the substance of the event or transaction,” which appears to support the substance of the transaction. However, the application of FAS 2 AAOIFI *Murabaha and Murabaha to the Purchase Orderer* requires the *murabaha* contract to be treated as a trading instead of financing arrangement, thereby suggesting that AAOIFI gives priority to the legal form of the contract over the substance of the transaction. Clearly the consideration is based on the purchase and sale of the *murabaha* asset that was concluded between the Islamic financial institution and the customer, and not the customary business of an Islamic financial institution as a financial intermediary whereby the main objective of the contract concluded is to facilitate financing of a desired asset by the customer. In order to reflect the trading arrangement, the FAS 2 AAOIFI recognises inventory risk attached to the *murabaha* asset prior to resale to the customers, as well as the legality of binding promises requiring the Islamic financial institution to disclose the obligation of promises made in the sale of *murabaha* to the purchase orderer. The

⁶ Issued in July 2014 and supersedes IAS 39 Financial Instruments – Recognition and Measurement.

⁷ Issued in May 2014 and supersedes IAS 18 Revenue.

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FAS 2 AAOIFI also recognises a *murabaha* receivable as an asset in the statement of financial position, and any unearned deferred profits shall be offset against the *murabaha* receivables.

This paper only reviews the comparable IFRS standard in accordance to economic substance that is widely practised by IFIs in Malaysia against the AAOIFI standard. In this case, the comparable standards are IFRS 9 against FAS 2 AAOIFI. Appendix 1 illustrates the comparative recognition of *murabaha* asset in the statement of financial position of IFIs that applies the MASB (IFRS-compliant) and the AAOIFI. To summarise the difference, Bank Islam Malaysia Berhad of Malaysia (BIMB), which applies IFRS 9, recognised *murabaha* contracts as financial assets in its statement of financial position to reflect the customary business of BIMB as a financial intermediary and *murabaha* as a financing arrangement. On the other hand, ABC Islamic Bank of Bahrain applies FAS 2 AAOIFI and recognises *murabaha* receivables in its statement of financial position to reflect the legal form of the contract as a *murabaha* trading arrangement.

Measurement of a Murabaha Contract

The measurement of a *murabaha* contract is also at issue. SFA 2 AAOIFI Para 7 clearly states the time value of money to be an example of a concept that is inconsistent with Islamic Shariah. The SFA 2 AAOIFI Para 8 also emphasises that in accordance with Shariah, money does not have a time-value aside from the value of goods that are being exchanged through the use of money. However, a majority of Muslim scholars have recognised consideration of the time value of money as an element in *murabaha* profits, to uphold justice between the contracting parties (deferred price should be higher than the spot price to strike a balance of benefit over future consumption) (ISRA 2013). The SAC of BNM in its 71st meeting, dated 26 & 27 October 2007, resolved that the application of the time value of money in Islamic financial reporting is permissible only for exchange contracts that involve deferred payment, and prohibits it for deferred repayment of a loan (BNM, 2010). Thus, the MASB concluded, as noted earlier, that it would not be in conflict with Shariah to apply IFRS for financial reporting of IFIs.

IFRS 9 Para 5.1 constitutes initial measurement of financial assets (excluding those with a significant financing component⁸) at acquisition at fair value plus or minus. In the case of a financial asset acquired not at fair value through profit or loss (FVPL), the asset shall be measured by transaction costs that are directly attributable to its acquisition. For subsequent measurement, IFRS 9 Para 5.2 states that the acquired financial asset shall be measured at amortised cost⁹ or fair value through other comprehensive income (FVOCI) or FVPL. With reference to IFRS 9 Para 4.1, the classification of financial assets for subsequent measurement are as follows; (i) a financial asset is measured at amortised cost if it is held to collect contractual cash flows that solely represent payments of principal¹⁰ and interest¹¹ on the principal amount

⁸ A contract contains a significant financing component when an entity adjusts the promised amount of consideration for the effects of the time value of money as agreed by both parties on timing of payments (either explicitly or implicitly) that provides any significant benefit of financing the transfer of goods or services to the customer. A significant financing component may exist regardless of whether the promise of financing is explicitly stated in the contract or implied by the payment terms agreed to by the parties to the contract (IFRS 15).

⁹ Amortised cost is the amount at which the financial asset is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount and, adjusted for any loss allowance (IFRS 9).

¹⁰ Principal is the fair value of the financial asset at initial recognition. However, that principal amount may change over the life of the financial asset (for example if there are repayments of principal) (IFRS 9).

¹¹ Interest consists of the consideration for the time value of money and credit risk associated with the principal amount outstanding during a particular period of time and for other basic lending risks (for example, liquidity risk)

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outstanding; (ii) a financial asset is measured at FVOCI if it is held to collect contractual cash flows that solely represent payments of principal and interest on the principal amount outstanding, and selling financial assets; (iii) a financial asset is measured at FVPL if it does not meet criteria of amortised cost or FVOCI. However, regardless of the business model, an entity can elect to measure at FVPL if by doing so it will reduce or eliminate a measurement or recognition inconsistency (accounting mismatch). The impairment requirements also shall apply to financial assets that are measured at amortised cost and FVOCI.

From the above, it can be concluded that the subsequent measurement for financial assets is reliant on the objective of the entity's business model in holding the financial asset and their contractual cash flow characteristics (PwC 2014). Hence, assessment of the business model and contractual cash flow characteristics of a *murabaha* contract needs to be performed to determine whether to apply amortised cost or FVOCI or FVPL for subsequent measurement of the contract. The classification of a *murabaha* contract as financing arrangement in light of its economic substance, as discussed earlier, met the first condition of business model assessment, where the *murabaha* contract is concluded with the objective of collecting the contractual cash flows from the financial asset. Next, concerning whether the contractual cash flows represent payments solely of principal and interest on the principal amount outstanding, IFRS 9 establishes that financial assets with contractual cash flows that are solely payments of principal and interest on the principal amount outstanding are consistent with a basic lending arrangement, where consideration for the time value of money and credit risk¹² are typically the most significant elements of interest. The characteristics of contractual cash flows in *murabaha* contracts appear to be similar to basic lending arrangements because of the allocation of *murabaha* profits. The legitimacy of *murabaha* profits is based on the exchange contract and underlying asset (ISRA 2013). Moreover, the application of credit risk in considering *murabaha* profits is in parallel with the Islamic theory of profit, which recognises risk as one of the elements in profit determination (Rosly 2005). Provision for the risk of default is attached to the financial asset held during the deferred payment duration. Both the business model and contractual cash flows of the *murabaha* contract meet the conditions for subsequent measurement of financial asset at amortised cost.

IFRS 9 para 5.4 requires amortised cost measurement to apply the effective interest method¹³ which shall be calculated by applying the effective interest rate to the gross carrying amount of a financial asset except for credit-impaired financial assets. IFRS 9 defines the effective interest rate as the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the gross carrying amount of a financial asset or to the amortised cost of a financial liability. IFRS 9 further explains that when calculating the effective interest rate, an entity shall estimate the expected cash flows by considering all the contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) but shall not consider the expected credit losses¹⁴. Under this method, the *murabaha* profit allocation is calculated based on the effective profit rate against the principal amount outstanding, which subsequently will be deducted from instalments paid by the

and costs (for example, administrative costs) associated with holding the financial asset for a particular period of time, as well as a profit margin that is consistent with a basic lending arrangement (IFRS 9).

¹² Credit risk is the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation (IFRS 7).

¹³ The effective interest method is the method that is used in the calculation of the amortised cost of a financial asset or a financial liability and in the allocation and recognition of the interest revenue or interest expense in profit or loss over the relevant period (IFRS 9).

¹⁴ The expected credit losses is the weighted average of credit losses with the respective risks of a default occurring as the weights.

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customers. Then, the balance will be set off against the principal amount outstanding. Appendix 2 illustrates the *modus operandi* of the effective profit method and the profit allocation reducing trend (reported profit higher in the earlier years and lower in the later years) against the principal balance set off in a rising trend (reported principal balance set off lower in the earlier years and higher in the later years).

The profit allocation reducing trend raises controversy about risk-sharing and fairness between the Islamic financial institution and customers. The higher allocation of profit to IFIs at earlier stages of the deferred duration seems to suggest a lack of trust in the customer's capability to make future payments. It may represent the intention of IFIs quickly to compensate for the profit risk attached to the financial asset, so that in the event of default, they may not have to incur such huge losses from the unearned profits, and at the same time customers are liable for a greater sum of the outstanding principal compared to AAOIFI. Furthermore, the concept of the time value of money and effective interest rates raises concerns about discounting receivables and imitating traditional interest-based financing arrangements, since according to Shariah money does not have a time value aside from the value of goods (Uddin and Rosman 2015).

Measurement of the *murabaha* contract by FAS 2 AAOIFI requires measurement for the *murabaha* assets (inventory) and *murabaha* receivables to reflect trading arrangements, which carries inventory risk and binding promises. At initial measurement, the FAS 2 AAOIFI requires a *murabaha* asset to be recognised at historical cost¹⁵. The subsequent measurement relies on the obligation of the purchase orderer to fulfil the purchase promise. If the purchase orderer is not obliged to fulfil the purchase promise as defined by the IFIs, the *murabaha* asset shall be measured at cash equivalent value¹⁶ or net realisable value, if there is an indication of non-recovery of the costs (FAS 2, Para 4). A provision is also required for decline in asset value, to reflect the difference between acquisition cost and the cash equivalent value. On the other hand, if the purchase orderer is obliged to fulfil the purchase promise as defined by the IFIs, *murabaha* asset shall be measured at historical cost unless there is a decline in value due to damage, destruction, or other unfavourable circumstances, in which case valuation to reflect the decline in asset value is to be measured at the end of the financial period (FAS 2, Para 3).

Upon financing the customer, the *murabaha* receivables shall be recorded at the time of occurrence at their face value, and be measured at the end of the financial period at their cash equivalent value (amount due less any provision for doubtful debts) (FAS 2, Para 7). At initial measurement, *murabaha* receivables at face value represent the selling price (cost plus *murabaha* profits) of the *murabaha* asset to the customers. In contrast with IFRS 9, AAOIFI adopts the proportionate allocation of profit over the period of the credit whereby each financial period shall carry its portion of profits irrespective of whether or not cash is received. FAS 2, Para 9 requires for deferred profits received from customers to be deducted from *murabaha* receivables in the statement of financial position. The proportionate method recognises *murabaha* profit over the deferred period without consideration of time value of money as a measurement attribute. Even though the cumulative profit earned from adoption of AAOIFI and IFRS is equal, the reported profit earned across the financial period shall be different. Appendix 2 illustrates the differences in profit allocation between AAOIFI and IFRS. At end of the 14th month, due to different measurements adopted, the MASB (IFRS-compliant) allocated profit is RM1,446.08, whereas it was only RM917.42 for AAOIFI. The outstanding amount of deferred

¹⁵ The purchase price or acquisition cost of the asset and any other related expenses incurred by the Islamic financial institutions at asset acquisition. For instances, customs duties and other purchase taxes, transport and loading charges, insurance.

¹⁶ The no. of monetary unit that would be realised as of the current date (SFA 2, Para 89).

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profit for MASB (IFRS-compliant) was RM144,507.74, considerably less than the RM152,292.09 remaining in AAOIFI's profit allocation. The outstanding principal in MASB accounting exceeds that of AAOIFI by the same amount, RM7,784.35. The illustration from Appendix 2 suggests that the proportionate method better upholds the risk-sharing and fairness between the IFIs and customers, as the profit is recognised consistently throughout the deferred period. There is no issue as in MASB of collecting higher profits at earlier periods to minimise the exposure to credit default or unearned deferred profits.

Disclosures of Information about Murabaha Contracts

Notes to the statement of financial position of selected Islamic banks under Appendix 1 illustrate that both the MASB-IFRS compliant and AAOIFI standards require qualitative and useful information on *murabaha* contracts to be disclosed and explained. The main differences are on what and how the useful information is disclosed and presented. BIMB disclosed the method of financial asset measurement as well as all the types and amounts of Shariah financing contracts, including *murabaha*, in the statement of financial position. This is to adhere to the requirements stated in the IFRS 7 *Financial Instruments: Disclosure* (requires an entity to provide qualitative disclosures in the notes to the financial statements), and IFRS 9 (outlines the transition disclosure requirement if there are changes in the application of the financial asset measurement category as well as carrying amount).

Alternatively, the ABC Islamic Bank disclosure focused on the items incorporated in the *murabaha* receivable, such as deferred profit, the obligation on promise to purchase made in the *murabaha* to the purchase orderer, the guaranteed carrying value for non-performing *murabaha* receivables, and the amount of tangible collateral to *murabaha* contracts. The bank thereby adheres to the requirement stated in the SFA 2 of AAOIFI, Para 130 that adequate disclosure of all material information that is useful to the users in their decision making be included in the financial statements, the notes accompanying them or in additional presentations. It also adheres to the FAS 2 of AAOIFI, Para 16 that requires disclosure on consideration of the promise made in the *murabaha* to the purchase orderer as obligatory or not in the notes to the financial position. The standard also requires that Financial Accounting Standard 1 General Presentation and Disclosure in the Financial Statements (FAS 1) be observed, such as disclosing accounting policies adopted that are not consistent with the concepts of financial accounting for Islamic banks, and earnings or expenditures prohibited by the Shariah.

Conclusion

Generally, both IFRS and AAOIFI aim to provide transparent and faithful presentation and disclosure of useful information to the users of financial statements. This is to satisfy the needs and accountabilities of the stakeholders, who require IFIs to develop specific presentations and disclosures by taking into consideration the Shariah requirements (Abdul Rahman 2010). For instance, Malaysia developed MASB Technical Release (Tri-3) to serve as guiding principles in considering the unique characteristic of Islamic financial transactions (Abdul Rahman 2010). Although it is notable that the AAOIFI standards uniquely cater to the characteristics of Islamic financial transactions, the survey made by Islamic Finance Working Group of AOSSG in 2013 noted that the jurisdictions that adopted AAOIFI FAS also applied IFRS in financial reporting, in cases where AAOIFI is silent. There are also cases which reveal the inadequacy of IFRS in catering to the unique characteristic of Islamic financial transactions. In the case of the *murabaha* contract, the financial reporting objectives can be achieved by disclosing greater information in the notes accompanying the financial statements.

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Appendix 1 – Statement of Financial Position & Notes

Statement of financial position and as at 31st December 2014 of MASB-IFRS based reporting namely Bank Islam Malaysia Berhad and AAOIFI based reporting namely ABC Islamic Bank.

Bank Islam Malaysia Berhad		ABC Islamic Bank	
Statement of Financial Position As At 31 December 2014			
	<u>Note</u>		<u>Note</u>
<u>Assets</u>		<u>Assets</u>	
Cash and short term funds	3	Cash and bank balances	3
Deposits and placements	4	Due from financial institution	
Financial assets held for trading	5	Investments	4
Derivative financial assets	6	Murabaha receivables	5
Financial assets available for sale	7	Ijarah receivables	
Financial assets held to maturity	8	Ijarah	6
Financing, advances and others	9	Equipment	
Other assets	10	Other asset	7
Statutory deposits with BNM	11		
Current tax assets			
Deferred tax assets	12		
Investment in subsidiaries	13		
Property and equipment	14		
Total Assets		Total Assets	

Notes to Statement of Financial Position			
9 Financing, Advances and Others		5 Murabaha Receivables	
(a) <u>by type and Shariah contract</u>		- International Commodity Murabaha XXX - Murabaha Receivables XXX - Deferred Profits (XXX)	
BBA Murabaha			
At amortised cost		The Group considers the promise made by the purchase orderer in the murabaha contract as obligatory.	
Term financing		Murabaha receivables, which are non-performing and whose carrying values is been guaranteed by ABC (BSC) as of 31 December 2014, amount to XXX. The Group also holds tangible collateral, the fair value of such collateral at 31 December 2014 amounts to XXX.	
- House	XXX		
- Syndicated	XXX		
- Others	XXX		
Staff financing	XXX		
Trade bills discounted	XXX		
Trust receipts	XXX		

Source: Extracted from respective statements of financial position.

Available at www.bankislam.com.my and

<https://www.bankabc.com/world/IslamicBank/En/Pages/default.aspx>

Appendix 2 – Profit Allocation

Cost of purchased (COP)	RM200,000	
Credit period	180 months	
Profit margin (yearly)	9%	
Profit margin (monthly)	0.75%	
Monthly instalment	RM2,028.53	
Selling price (SP)	RM365,135.97	(2,028.53 x 180)
Deferred profit (DP)	RM165,135.97	(365,135.97 - 200,000)
Effective profit rate (monthly)	0.40%	for MASB (IFRS-based financial reporting)
Proportionate COP (monthly)	1,111.11	(200,000 / 180) for AAOIFI-based financial reporting
Proportionate Profit (monthly)	917.42	(165,135.97 / 180) for AAOIFI-based financial reporting

MASB (IFRS)						
Month	Instalment (RM)	Payment of Profit (RM)	Payment of COP (RM)	Outstanding Amount (RM)		
				SP	COP	DP
0	-	-	-	365,135.97	200,000.00	165,135.97
1	2,028.53	1,500.00	528.53	363,107.44	199,471.47	163,635.97
2	2,028.53	1,496.04	532.49	361,078.91	198,938.98	162,139.93
3	2,028.53	1,492.04	536.49	359,050.38	198,402.49	160,647.89
4	2,028.53	1,488.02	540.51	357,021.85	197,861.98	159,159.87
5	2,028.53	1,483.96	544.57	354,993.32	197,317.41	157,675.91
6	2,028.53	1,479.88	548.65	352,964.79	196,768.76	156,196.03
7	2,028.53	1,475.77	552.76	350,936.26	196,216.00	154,720.26
8	2,028.53	1,471.62	556.91	348,907.73	195,659.09	153,248.64
9	2,028.53	1,467.44	561.09	346,879.20	195,098.00	151,781.20
10	2,028.53	1,463.23	565.3	344,850.67	194,532.70	150,317.97
11	2,028.53	1,459.00	569.53	342,822.14	193,963.17	148,858.97
12	2,028.53	1,454.72	573.81	340,793.61	193,389.36	147,404.25
13	2,028.53	1,450.42	578.11	338,765.08	192,811.25	145,953.83
14	2,028.53	1,446.08	582.45	336,736.55	192,228.80	144,507.75
....
180	2,028.53	15.1	2,013.43	0	0	0

Month	AAOIFI					
	Instalment (RM)	Payment of Profit (RM)	Payment of COP (RM)	Outstanding Amount (RM)		
				SP	COP	DP
0	-	-	-	365,135.97	200,000.00	165,135.97
1	2,028.53	917.42	1,111.11	363,107.44	198,888.89	164,218.55
2	2,028.53	917.42	1,111.11	361,078.91	197,777.78	163,301.13
3	2,028.53	917.42	1,111.11	359,050.38	196,666.67	162,383.71
4	2,028.53	917.42	1,111.11	357,021.85	195,555.56	161,466.29
5	2,028.53	917.42	1,111.11	354,993.32	194,444.45	160,548.87
6	2,028.53	917.42	1,111.11	352,964.79	193,333.34	159,631.45
7	2,028.53	917.42	1,111.11	350,936.26	192,222.23	158,714.03
8	2,028.53	917.42	1,111.11	348,907.73	191,111.12	157,796.61
9	2,028.53	917.42	1,111.11	346,879.20	190,000.01	156,879.19
10	2,028.53	917.42	1,111.11	344,850.67	188,888.90	155,961.77
11	2,028.53	917.42	1,111.11	342,822.14	187,777.79	155,044.35
12	2,028.53	917.42	1,111.11	340,793.61	186,666.68	154,126.93
13	2,028.53	917.42	1,111.11	338,765.08	185,555.57	153,209.51
14	2,028.53	917.42	1,111.11	336,736.55	184,444.46	152,292.09
....
180	2,028.53	917.42	1,111.11	0	0	0



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THE INFLUENCE OF IFRS 9 ON THE SUKUK ACCOUNTING STANDARD IN INDONESIA

BY DODIK SISWANTORO

Abstract

This paper analyzes the influence of International Financial Reporting Standard (IFRS) 9 on Indonesia's *sukuk* accounting standard. The latter was revised to be more in harmony with the dominant global standard. The writer interviewed senior accountants of Islamic banks who were aware of the issue, as well as reviewing and comparing the *sukuk* accounting of Islamic banks after the revised standards were applied. IFRS adds market valuation and any changes recognized in other comprehensive income (OCI). Therefore, Indonesia's Statement of Financial Accounting Standard (SFAS) 110 was revised to accommodate IFRS, but a more complete adoption of IFRS 9 requires further review from Islamic scholars, especially in regard to the use of discount and interest rates for valuation. Islamic scholars in Indonesia prohibit this method for valuation.

Keywords: Sukuk accounting, IFRS, Islamic banking, bond

Not many countries adopt the accounting standards of Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). As of this moment, only Bahrain and the United Arab Emirates refer to them. Indonesia has specific accounting standards for Islamic financial

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institutions (IFIs), but they still refer to AAOIFI (Azmi, 2010). Others use IFRS for their Islamic banking accounting standard (Siswantoro, 2015).

The focus of IFRS 9 accounting treatment in this research is on fair value treatment and financial statement presentation. These new treatments caused Indonesia to revise the accounting for *sukuk*. In the beginning, a distinct *sukuk* accounting standard was issued in Indonesia because IFRS was based on discount or interest rates for the valuation, which is not in line with Islamic teaching.

The problem of harmonization between Indonesia's *sukuk* accounting standard and IFRS 9 occurs here. Islamic scholars have a role in analyzing the suitability of IFRS 9 for Islamic teaching, given the differences between the IFRS and Islamic accounting principles (Siswantoro and Hameed, 2010). Yet financial statements should be recognized globally, so that accounting standards have a common template and financial statement presentation.

This paper tries to analyze how revising the accounting treatment of *sukuk* in Indonesia has affected fair value accounting and financial statement presentation. The process of revision included developing a consensus among Islamic bank accountants first, then asking for the opinion of Islamic scholars. The process is debatable, however, as there is no standard procedure for revising Indonesian accounting standards. The Shariah Accounting Standards Board (DSAS) of the Indonesian Institute of Accountants (IAI) must ensure that the standard has complied with Islamic teaching.

The Development of the Sukuk Accounting Standard

a. Issues in Sukuk Accounting

In 2004, before the accounting standard for *sukuk* was established, the Securities and Exchange Commission (SEC) evaluated the development of Islamic capital markets in Indonesia. Implicitly, it was assumed that the accounting treatment would have to differ from conventional standards in order to prepare reliable and suitable reports. In addition, the Asian-Oceanian Standard-Setters Group (AOSSG, 2010) researched Islamic accounting and identified two out of 15 outstanding issues concerning *sukuk* accounting.

AOSSG questioned the relevance of "sukuk valuation as many *sukuk* are "tradable," but they are usually not. Do they need to be measured at fair value? If so, how?" The response is that *sukuk* usually refer to market value, and that valuation should not be based on interest rates as it may contradict Islamic teaching. In general, a *sukuk* is asset backed and may not need valuation which is based on interest rates. Moreover, those that are not asset backed but merely asset-based are criticized by Islamic scholars because they may violate Islamic teaching for non-real asset transfers (Siswantoro, 2015). However, some asset-based *sukuk* may also be permissible due to complex and difficult factors (Hasan, 2013 on ISRA – Fatwa in Islamic Finance). Different structures can be seen in table 1. Generally, the *ijarah* structure is asset-backed while the *mudaraba* tends to be asset-based in Indonesia. In the *ijarah sukuk*, the rental fee of an underlying asset can be used as the source of payment to a *sukuk* holder.

Table 1. Differences between Asset-Backed and Asset-Based Sukuk

Classification	Asset-Based Sukuk	Asset-Backed Sukuk
Accounting Treatment/ Concept	Usually designed as ON balance sheet (for obligor/originator) (treated like a debt)	Can either be ON or OFF balance sheet (for obligor/originator) (treated like a true-sale which has legal and off-balance sheet criteria)
Ownership	Sukuk investor only attains beneficial ownership	Full transfer of legal ownership of the underlying asset

Income source for the Sukuk-holder	Main source of payment usually comes from the issuer's/obligor's cash flow	Main source of payment is the revenue from the underlying sukuk assets
Funding Cost	Market driven, depending on originator/credit issuer	Capital driven, depending on the strength of the asset cash flow
Rating	Corporate rating of issuer	Strength of asset cash flow

Source: Hasan (2013).

AOSSG studied accounting practices for Islamic financial transactions and institutions. Some countries, such as the United Arab Emirates, Indonesia, South Africa, and Syria, have specific accounting standards for *sukuk*. The UAE, Indonesia, South Africa, and Pakistan evaluated *sukuk* at market prices, much like IFRS (AOSSG, 2011). However, in the case of Indonesia, SFAS 110 prohibits the use of interest rate valuation. This is the main reason why Indonesia has a different accounting treatment for *sukuk* valuation.

b. Relevant Issues in Revised SFAS No. 110

Differences in valuation between *sukuk* (SFAS No. 110) and conventional accounting standards in Indonesia (Siswantoro, 2015):

1. *Sukuk* are based on a business model similar to IFRS 9. This assumes that *sukuk* transactions are held to maturity. *Sukuk* are not based on interest rate valuation.
2. The calculation of Present Value, which requires using interest rates, is prohibited.
3. Present Value, or discounted value, is ignored in impairment testing. Other methods that do not use interest rates are permitted.

The main issue is the use of interest rates, which may not be in line with Islamic teaching. On the other hand, IFRS 9 is heavily based on interest rates for valuation. Furthermore, it relates to Present Value and discount rates, which are generally used in impairment analysis (in the event of default). However, other methods for valuation are available: either earning asset quality as defined by the Financial Services Authority (OJK) or a real sector index method developed by the Bank of Indonesia. The index method is based on a real rate of return in some economic sector.

In the due process of establishing or revising an accounting standard in Indonesia, there is a public hearing forum in which other stakeholders are asked to give their opinion and to discuss the proposal of the revised standard. Concerning the original *sukuk* accounting standard, in the public hearing on 22 June 2011 in Jakarta, some practitioners made objections because they had been prepared to adopt the new conventional (IFRS-based) accounting standard (Siswantoro, 2015).

Then in 2015 the revised standard gave a slightly different accounting treatment, as Table 2 indicates.

Table 2. Revision of SFAS 110 (2015)

Items	SFAS 110 (2015)	SFAS 110 (2011)
Classification	- Acquisition cost - FV OCI - FVTPL	- Acquisition cost - FV
Measurement in the beginning	FV OCI, change is to OCI FV OCI, change is to PL	n.a
Fair value	- Quoted price - Other (observable)	- Quoted price - Current price - Other fair value
Impairment	Decreasing value as loss	n.a

Source: Indonesian Institute of Accountants (IAI).

SFAS 110 does not fully adopt IFRS 9. The main difference is that SFAS 110 still does not permit the use of discount or interest rates for *sukuk* valuation. Even the coupon rate is understood to be a rental or leasing (*ijarah*) rate or a profit sharing (*mudaraba*) indicative return rather than a market interest rate. Malaysia, on the other hand, permits valuation and impairment based on discount rates (Suandi 2015). The Malaysian argument is that discount rates used in the valuation are only for calculation, not for charging the interest to a borrower, which is explicitly prohibited. Since they are not explicitly forbidden, the Malaysian Accounting Standard Board (MASB) accepts the IFRS methods of valuation. MASB withdrew current Islamic accounting standards and replaced them with IFRS standards. Indonesia is stricter in implementing Islamic teachings for Islamic banks than Malaysia. Another example is the *bay al innah* - permissible in Malaysia but not in Indonesia. This is because that scheme contains two transactions in one contract, which is prohibited in Indonesia. In practice, it is like a loan in a sale-and-buy-back that does not really occur. Other differences with IFRS are:

1. In the case of the time value of money, the issue here is not only charging interest on the loan but also valuation using discount or interest rates that would recognize loss or gain directly on the income statement or as OCI. This may be similar to *riba* (usury) as it is predetermined gain or loss activity. *Riba* concerns not only the person who is charging interest but also the one who records the interest rate transaction.¹ Therefore, Muslim scholars in Indonesia are cautious. It is safer to avoid *riba* in any related activities.
2. Indonesia's Islamic Accounting Standard was already established in 2003, while convergence with IFRS came later, in 2006. Islamic banks in Indonesia have effectively adopted the Islamic accounting standards, which were established bottom up, strongly supported by society. Some international standards, at least, can accommodate the Islamic scheme of financing, and "What cannot be completely attained, should not be completely left".² On the other hand, IFRS does not have an Islamic accounting treatment for Islamic financial transactions. So far, current SFAS 110 can accommodate the characteristics of Islamic financial transactions, enabling stakeholders to trust Islamic banks.

So far, the Indonesian Council of Ulama (MUI) only permits two *sukuk* structures, those of *mudaraba* and *ijarah*. In Malaysia, by contrast, other structures such as *murabahah*, *salam*,

¹ Jabir said that Allah's Messenger PBUH cursed the acceptor of interest and its payer, and one who records it, and the two witnesses, and he said: They are all equal (Narrated by Muslim No. 1598).

² This legal maxim was written by Abdul Hamid Hakim in Book of Mabadi Awaliyah.

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istisna'a, and *musharakah* are also permitted, whereas some Indonesian scholars consider that *sukuk* based on selling schemes may be *riba* if there is a change in price in the secondary market.

Table 3. Comparison between IFRS 9 and SFAS 110

	IFRS 9	SFAS 110
Valuation Basis	Discount rate	No discount rate
Structure	Interest rate	- Lease (ijarah) - Profit sharing (mudaraba)
Underlying assets	n.a	Available
Treatment as issuer (in balance sheet)	As liability	- Lease (ijarah) as liability - Profit sharing (mudaraba) as temporary shirkah funds account
Treatment as investor (in balance sheet)	- Amortized cost (based on interest rate) - Fair value OCI (based on interest rate) - Fair value PL (based on interest rate) (in the income statement)	- Acquisition cost - Fair value OCI - Fair value PL (in the income statement)
Impairment	Based on discount rate, 3 stages model	No discount rate

Source: SFAS 110, Connolly (2015) and Deloitte (2014).

Furthermore, *sukuk* in Indonesia are always based on an underlying asset which transfers ownership to the *sukuk* holder, so that it is not like a loan but more like an investment such as preferred stock. On the liability side the *mudaraba sukuk* issuer accounts for it in a temporary *shirkah* fund due to profit sharing risk. As for *ijarah*, it can be classified as a liability. And as for the investor, both IFRS 9 and SFAS 110 have analogous classifications, but IFRS 9 depends heavily on interest rate-based calculations, as noted earlier. Also for impairment, SFAS 110 does not permit the interest rate calculations connoted by discounting. Table 3 compares the accounting treatments prescribed by IFRS 9 with those of SFAS 110.

The use of discount or interest rates is unlawful for *sukuk* valuation because that valuation of *sukuk* can create gains or losses which directly affect the fair value of PL or OCI. The projected income is discounted in IFRS 9 by the expected market interest rate. The determination of this rate is based on interest rates. The behavior of fixing the projected income is analogous to *riba* (usury) in financing activity. The comparison of *sukuk* valuation between IFRS 9 and SFAS 110 can be seen in figure 1.

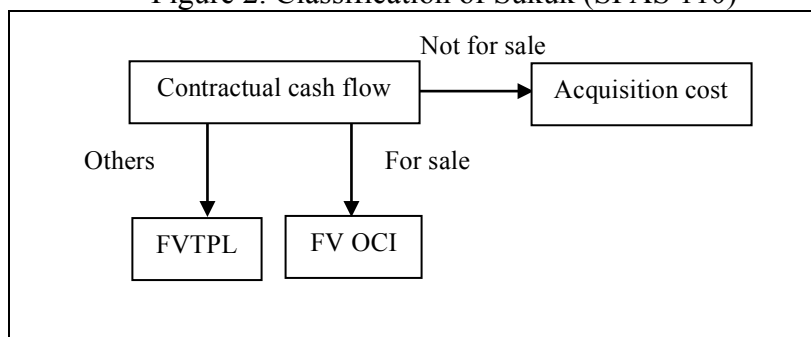
Figure 1. Comparison of Method between IFRS 9 and SFAS 110

For example, A bank buys <i>ijarah sukuk</i> (5 years maturity), US\$5 million with <i>ijarah</i> rental coupon 5% per year on 1 January 2015. The question is how to report on 31 December 2015 if the expected market interest rate is 7% on that day?			
IFRS 9			
Year	Expected Cash Flows	7% discount factor	PV (m USD)
31 December 2016	5m USD x 5% = 0.25m USD	0.935	0.233
31 December 2017	0.25m USD	0.873	0.218
31 December 2018	0.25m USD	0.816	0.204
31 December 2019	0.25m USD + 5m USD	0.763	4.005
			4.661
Under IFRS 9 the bank would create a loss of 0.339m USD on their OCI or PL. If the expected market interest rate is 4%, it would create a gain.			
SFAS 110			
The bank would refer to the Financial Services Authority (OJK) earnings asset quality regulation to determine the Allowance for <i>Earning Assets (PPAP)</i> . Another method could be to refer to a real sector index based on real economic returns by the Bank of Indonesia.			

Source: IFRS 9, Bank Indonesia, Islamic banks

The classification of *sukuk* in SFAS 110 is quite simple (see figure 2). If the *sukuk* is not for sale, it is classified at acquisition cost. If it is for sale, it can be classified as fair value through other comprehensive income (FVOCI) or through profit and loss (FVTPL).

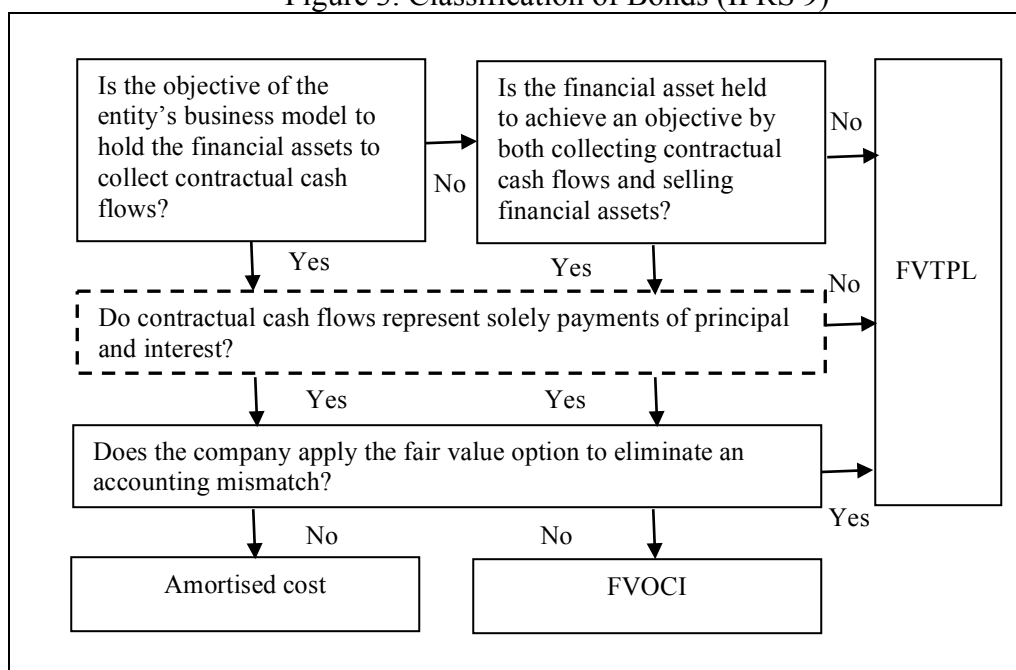
Figure 2. Classification of Sukuk (SFAS 110)



Source: SFAS 110 (interpretation).

IFRS 9, on the other hand, specifies whether a bond's fair value is to be derived from comprehensive income (FVOCI), from profit and loss (FVTPL), or from amortized cost based solely on payments of principal and interest. Figure 3 presents the guidelines for classification and implies that the fair value option for a *sukuk* should be based on FVTPL rather than FVOCI. The contractual cash flows may indeed be different from principal and interest, especially for a *mudaraba* structure in which the coupon fee may not be fixed. In fact, SFAS 110 does not specify any requirements for FVTPL. SFAS 110 does not even state any requirements for FVTPL classification.

Figure 3. Classification of Bonds (IFRS 9)



Source: PwC (2014).

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The revised SFAS 110 only introduces slight changes to transition accounting treatment for FVOCI (but none for FVTPL), as Table 4 indicates. The FVTPL classification may have been accommodated in SFAS 110 (2011) implicitly as “Fair value” since in the previous standard (2011) FV referred to FVTPL. Naturally, a *sukuk* is an investment which is held until maturity. Some Islamic banks actually utilize short-term *sukuk* as an Islamic money market but their liquidity may be a problem: it may ignore the purpose of a *sukuk* investment that requires being held until the maturity date.

Table 4. Transition Implications of SFAS 110

Revision 2011		
Before	After	Implication
Fair value to profit and loss and available for sale	Acquisition cost	Change is amortized
Available for sale	Fair value	OCI reclassified to R/E
Held to maturity	Fair value	Retained Earnings (R/E)
Revision 2015 (addition)		
Fair value to profit and loss	Fair value OCI	Record as the beginning
Acquisition cost	Fair value OCI	OCI

Source: Indonesian Institute of Accountants (IAI).

Table 5 displays the differences in accounting treatment for investors between IFRS 9 and SFAS 110. To determine fair value from comprehensive income (FVOCI), SFAS 110 requires amortization during the period if there has been a change, whereas IFRS 9 does not. IFRS 9 states that any change would directly impact its classification. SFAS 110 is more flexible as the change after acquisition would be allocated proportionately during the period.

Table 5. Accounting Treatment for Investors

Accounting Treatment	IFRS 9	SFAS 110
Subsequent:		
- Acquisition cost	Change is to PL	Change after acquisition is amortized to PL during period.
- FVOCI	Change is to OCI	Change after acquisition is amortized to PL during period. Change is to OCI
- FVTPL	Change is to PL	Change is to PL
Impairment:		
- Acquisition cost	Model (general, simplified, special provision), 3 stages to determine loss (12-month expected credit loss, lifetime expected credit losses, lifetime expected credit losses-net)	Loss if less than nominal value
- FVOCI	Model (general, simplified, special provision), 3 stages to determine loss (12-month expected credit loss, lifetime expected credit losses, lifetime expected credit losses-net)	Loss if less than nominal value + OCI
- FVTPL	Model (general, simplified, special provision), 3 stages to determine loss (12-month expected credit loss, lifetime expected credit losses, lifetime expected credit losses-net)	n.a

Source: SFAS 110 and Deloitte (2014).

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In impairment, SFAS 110 does not specify any requirements for predicting losses. By contrast, IFRS 9 develops models of expected losses, all of which are based on discount rate valuation.

1. Practices of Islamic Banks

How in practice were the revisions in accounting standards being applied? Three senior managers from major Islamic banks in Indonesia were interviewed about the issues related to the revision of SFAS 110.³ Additionally, secondary data were gathered from financial statements of companies issuing *sukuk*. Other Islamic banks' financial statements were analyzed to see how they recorded *sukuk* in 2010. To see the effect of changes in the *sukuk* accounting standard, the financial statements of 2013 and 2014 were compared with those of 2015.

a. Revised Sukuk Accounting Treatment

- (i) Before the *sukuk* accounting standard was introduced, each Islamic bank had a different treatment of accounting for *sukuk* treatment (Siswantoro 2015):
 - Bank Muamalat Indonesia (BMI) amortized the government *sukuk* and their Islamic sub-debt. BMI categorized *sukuk* under three categories from March to September 2010: trading, available for sale, and held to maturity.
 - BSM had *sukuk* under the category of fair value through profit and loss (*sukuk* retail). It refers to PSAK 55 Financial Instrument.
 - BNI put them under AFS.
 - Panin Bank Syariah still categorized *sukuk* as trading.
 - BMI classified *sukuk* as financial assets; others classified them as investments.
 - Bank Jabar dan Banten Syariah (BJB) records *sukuk* under HTM (PBI No.10/24/PBI/2008).
- (ii) After SFAS 110 was introduced in 2011, in general all *sukuk* were classified as 'held to maturity' (HTM) or at cost, although some retail government *sukuk* were recorded at fair value. Bank Muamalat used the cost method for a BSM *sukuk*, which was previously recorded as available for sale. They recorded retail government *sukuk* at fair value. On the other hand, BCA referred to SFAS 55 on Financial Instruments. A difference occurred when they had to treat for a *sukuk* default. Only BSM recorded a default as loss to equity, while BCA reclassified it as available for sale, and others had no specific treatment (Siswantoro, 2015).
- (iii) After the revision of SFAS 110 in 2015 three banks published their financial statements in detail online. Only Paninbank directly adopted the revised standard in June 2015. The differences are that they were using discount rates in December 2014 and June 2015, but then eliminated them in September 2015. However, they did not mention SFAS 110 explicitly in September 2015 but simply stated the use of a contractual cash flow model, which is an at cost model (see table 6).

³ Trustworthy research presupposes credibility, transferability, dependability, and confirmability. Credibility is achieved here by choosing the competent respondent and by triangulation in observing the public hearing meeting. Transferability can be explained in detail case by case. Dependability is achieved by following issues raised in *sukuk* accounting. Confirmability is achieved by explaining how to get the data so that it can be checked by others.

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Previously (before the revised *sukuk* standard), they stated that they used fair value, which affected other comprehensive income (OCI). In fact, Paninbank does not refer to discount rates but to Bank Indonesia regulation (based on earnings asset quality). The rates only apply to government *sukuk*, which do not have a reserve for potential default. Some banks, incidentally, carry no reserves for any *sukuk* default.

In December 2015 financial statement, Paninbank introduced a different accounting policy for *sukuk* that harks back to its June 2015 policy. BNI Syariah, by contrast, remained consistent with its June 2015 treatment.

Table 6. Treatment of Islamic Banks in Indonesia for Sukuk (Dec 2014 through Sept 2015)

	December 2014		
	BMI	BNI	Panin
Classification	At cost and fair value	n.a	At cost and fair value
Reference	SFAS No. 110 (revised 2011)	n.a	Implicit
Fact	Corporate sukuk at cost	n.a	All sukuk at cost Impairment with the recoverable amount (discount rate)
	June 2015		
Classification	At cost and fair value	At cost and fair value	At fair value, Held to maturity, AFS
Reference	SFAS No. 110 (revised 2011)	SFAS No. 110 (revised 2011)	SFAS No. 110 (revised 2015)
Fact	Corporate sukuk at cost	All are at cost	At cost and fair value (OCI) Impairment with discount rate
	September 2015		
Classification	n.a	n.a	At fair, Held to maturity, AFS
Reference	n.a	n.a	Implicit
Fact	n.a	n.a	Contractual cash flow model
	December 2015		
Classification	n.a	At cost and fair value through profit and lost	At cost, fair value (OCI) and fair value through profit and lost
Reference	n.a	SFAS No. 110 (revised 2015)	SFAS No. 110 (revised 2015)
Fact	n.a	All are at cost	At cost and fair value (OCI)

Source: Annual report 2014, 2015, Financial Statement June, September 2015.

BMI= Bank Muamalat Indonesia, BNI=Bank Negara Indonesia Syariah, Panin=Panin Bank Syariah.

b. Responses of Senior Managers

Some responses are given by Islamic banks as follows:

1. Classification of Sukuk Investment Accounting

The new standard adds fair value to the classification, which affects other comprehensive income (OCI). This is usually used for fixed income mutual funds in banks. In fact, the bank uses the fair value method for *sukuk*, especially for retail government *sukuk* (Bank Syariah Mandiri response). Paninbank adopted standards available for sale (AFS) before the *sukuk* standard. After the standard issuance, they applied *sukuk* prices at cost (held to maturity-HTM using contractual cash flow) based on management intention. After the revised *sukuk* standard in 2015, they used available for sale only for liquidity purposes. They recorded at fair value, which affected other comprehensive income (OCI). By contrast, Bank Muamalat has not applied the revised standard and still records any changes to profit and loss.

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2. Valuation After Beginning Recognition

The previous standard explicitly stated that the change would be recognized in the income statement. Some banks still practice this accounting treatment despite the fact that the revised standard offers FVOCI. Paninbank changed the classification to fair value from available for sale. However, they changed it to “at cost” in June 2015 and then added fair value to other comprehensive income (OCI) in December 2015.

3. Sukuk Investment Fair Value

The revised fair value classification only has two types — quoted and other quoted price — but they can be observed. This change is actually easier to implement than the previous classification, which had three types: quoted, transaction, and equivalent instrument (which requires prediction). Banks that have government *sukuk* use quoted price, which is available as they use as secondary reserves or liquidity. In addition, banks bought *sukuk* with investment grade, so that the price is readily available.

4. Transition Regulation

The transition only applies to changes from fair value recognition to other comprehensive income (OCI). Some banks actually recorded *sukuk* at acquisition cost with profit and loss recognition in the income statement. As such, the transition had little effect.

More generally, the revised *sukuk* accounting treatment did not have much of an effect on the banks’ accounting treatment, as banks may have prepared for the IFRS standard even before the *sukuk* accounting standard (SFAS 110) was issued. The treatment of fair value accounting is also applied to fixed income mutual funds, where any profit or loss will affect other comprehensive income (OCI). Other banks also used the fair value method for *sukuk* through profit and loss (FVTPL). Up till now, the standard only provides for normal *sukuk* transactions, not for detailed valuation or impairment cases. These differ from IFRS 9.

Conclusion

Revised SFAS 110 shows that permissible accounting treatments are (a) cost method and (b) fair value, which offers other comprehensive income (OCI) but was previously recorded as profit or loss in the income statement. This change actually may not contradict Islamic teaching, as no principles are violated.

However, the standard does not determine the method for valuation. Up till now, the Shariah Accounting Standards Board (DSAS) prohibits the use of interest rates or discount rates, as it implies the forbidden *riba*. Problems may occur if investors must impair their *sukuk* due to default or other causes. They may forcibly use discount rates or interest rates to revalue *sukuk*. Therefore, Bank Indonesia prepares for a real sector index for the benchmarking of interest rates. So far, Islamic banks just adopt earnings asset quality regulation to determine the Allowance for *Earning Assets (PPAP)* from the Financial Services Authority (OJK). The valuation of *sukuk* in Indonesia can be standardized because it is derived from an independent body that would minimize subjectivity in the valuation.

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MIDDLE EAST INSIGHTS

ISLAMIC FINANCE SPECIAL

MIDDLE EAST INSTITUTE, NATIONAL UNIVERSITY OF SINGAPORE

REGIONAL DEVELOPMENTS QUESTIONS AND ANSWERS

- WITH DAUD VICARY (CHAIR, INTERNATIONAL CENTRE FOR EDUCATION IN ISLAMIC FINANCE),
- CECEP MASKANUL HAKIM (BANK INDONESIA),
- ROSANA GULZAR MOHD (INTERNATIONAL CENTRE FOR EDUCATION IN ISLAMIC FINANCE),
- MAKHTAR ABDULLAH (CENTER FOR ISLAMIC BANKING, FINANCE),
- ZUBIR ABDULLAH (FINANCIAL CENTRE DEVELOPMENT DEPARTMENT, MONETARY AUTHORITY, SINGAPORE),
- NIZAM ISMAIL (RHTLAW TAYLOR WESSING),
- RODNEY WILSON (INTERNATIONAL CENTRE FOR EDUCATION IN ISLAMIC FINANCE)

BY RETNA DEVI

Daud Vicary (chair): The need for greater collaboration. The approach is still insular as Islamic finance seems to be rather country-specific. How do we make this happen? How to prioritize the areas that need attention in terms of global collaboration? Maybe this is the problem as everyone has their own set of priorities or the situation is different in each country.

Daud Vicary: Singapore should look at closer collaboration with Malaysia because Singapore has advantages such as asset management and being a money centre while Malaysia has the expertise and infrastructure of Islamic finance.

Makhtar Abdullah: There are 65.8 percent Malays in Brunei of which 26.8 percent are 15-29 years of age and 42 percent are 30-59 years of age. This big group of people will need greater collaboration and support in terms of development. The ASEAN Economic council in 2018 will ensure countries collaborate whether they like it or not. While Brunei may not have enough people or production, it has the expertise in capacity building. They will go

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into capital market stock exchange in 2017 or 2018. To have 411,000 people exchanging in stock is not enough, so Brunei needs more people or Foreign Direct Investments (FDIs) to come in.

The Centre for Islamic Banking finance and management was asked to look at non-oil and gas industries. The aim is to reduce the influence of oil and gas. The task was to get more people to understand finance and capital markets. They have established some programmes in the two universities in Brunei, which are addressing the issue of financial literacy. His Majesty clearly mentioned in his New Year wishes in December 2015 that the country has to focus on other industries such as tourism and agriculture.

In terms of regulatory matters, the Monetary Authority of Brunei Darussalam (AMBD) started only in 2011 with only 60 staff but now it has over 100 staff. The growth indicates the seriousness of the regulator in addressing these financial issues for Brunei.

Cecep Maskanul Hakim: We have annual discussions with Malaysian scholars. These meetings have become a gauge for other collaborations so with the coming of Southeast Asia economic society, human resources in Indonesia needs to be improved. This is what we need from Singapore and Malaysia in terms of managing assets. Recently Otoritas Jasa Keuangan received assistance from Civil Service College (CSC), Singapore to upgrade our structure in teaching financial management and more. CSC also has a relationship with the Central Planning Development Board. International Centre for Education in Islamic Finance (INCIEF) is already visiting us. The state-owned enterprises need to be able to expand their resources. Indonesia can look to Malaysia and Singapore for help and they can develop their expertise in *sukuk* with us. There is still a vast area to be developed in Indonesia.

The Planning Development board reports to the President. Its members such as the National Shariah Board are responsible for education, development and creating a good investment environment in this industry. This is the first time that there is an element of the government involved in Islamic finance, other than the Ministry of Finance.

Nizam Ismail: One of Singapore's biggest *sukuk* issuance last year was by Cagamas, Malaysia's national mortgage company. It illustrates collaboration with Singapore and Malaysia. Another interesting deal was one seeking to raise funds in China. Sichuan Development Holding Company engaged Silk Routes Financials to advice in setting up a Shariah-compliant fund in China. Given our limited and finite resources, it makes sense for us to look for opportunities outside of Singapore. Being a global financial center with product manufacturers who are familiar with setting up complex fund structures and other wealth management products, that is where we can work with jurisdictions who engage in Islamic finance. The priority is regulatory harmonization. There are different legal frameworks in different jurisdictions. What is doable are small pockets of harmonization of standards of products whether it is *sukuk* or other products as well as broadening the mutual recognition arrangements within ASEAN and also between ASEAN and the Middle East. This is already occurring on a bilateral basis, such as between Malaysia and Hong Kong. A multilateral arrangement will add more value. We should also think about creating some form of international dispute resolution standards for Islamic finance, and how they interweave with conventional financial systems. In the conventional financial systems, there is an explosion of financial technology (fintech) that allows for the emergence of alternative platforms that disrupt the conventional financial services. It is happening in Asia as well. We have seen Shariah-compliant fintech structures. There is a Shariah crowdfunding platform in Singapore, and also a capital-raising platform. This is probably the way forward.

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Question: Comment on China's involvement. What does it take to set up Islamic finance in a jurisdiction?

Daud Vicary: Came up with acronym-- STARS: Look at the Shariah, tax, accounting and regulating and the standards framework. What can we make common?

Nizam Ismail: Vast potential in China. Between Singapore and China: there have been a lot of initiatives whether at the Government to Government or Business to Business levels on deepening economic ties. The STARS framework is a very succinct way of putting it. Interestingly, Singapore doesn't have a National Shariah Council. Whether it is needed now is debatable. Whilst the Monetary Authority of Singapore (MAS) has created exemptions to facilitate Islamic finance transactions, it is time to think about implementing an Islamic finance framework. This is important to create legal clarity and efficiency.

Zubir Abdullah: Singapore's role in the Islamic financial industry is to complement and not to compete with Malaysia and Indonesia. Singapore's approach is to regulate Islamic finance under one common regulatory framework. After discussions with other jurisdictions, the Monetary Authority of Singapore is of the opinion that apart from Shariah, the prudential and regulatory considerations for regulating Islamic financial entities are the same as conventional entities. Since Singapore is a secular country, it has taken a similar approach to the United Kingdom. Hence it is the onus of financial players involved in Islamic finance to strengthen their corporate governance with respect to Islamic finance transactions.

By utilizing a common framework, we do not have a separate framework to regulate Shariah or provide separate licenses for Islamic banks. Islamic Bank of Asia was regulated under the same framework as any other bank. This also means that once MAS has approved a license, the institutions have the option of conducting conventional and/or Islamic transactions. That is why there seems to be an anomaly, where you don't see Islamic finance institutions in Singapore. However it is actually growing because they are connected by windows.

As for cooperation between countries, Abdullah stated that the preferred method is to leave it to the market. Many funds are in collaboration with Malaysia, Indonesia, Brunei and even the Middle East. He used the presence of Middle Eastern banks offering Islamic banking as part of their activities in Singapore as an indicator of Singapore's interest in Islamic finance. He seemed optimistic about the country's involvement in the industry due to the establishment of the ASEAN Economic Committee and the inclusion of Islamic banking in the FTA between Singapore and the GCC.

Nizam Ismail: Singapore can play an intermediation role for European or Middle Eastern companies to set up a structure here to attract pools of liquidity. Is there space to develop the retail market here? There are retail products in Singapore but they tend to be quiet. If we aspire to be an Islamic financing hub, we need to offer a whole range of products. They are pockets of financial advisors specialising in Shariah-complaint products. For instance, there is a shortage of Shariah-complaint housing loan products and that is a very vast market. Housing loans form a very big part of banks' balance sheets. Those kind of issues need to be reviewed.

Rosana Gulzar Mohd: The hiring practices in different countries may add to its insular nature. For instance, in Malaysia about five years ago the foreigner in a banking industry would have been replaced by a local in two years. The hiring practices in Brunei also reflect this. Such practices impede the industry's ability to grow. Especially so since a lot of human talent development is being done outside of Malaysia.

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Daud Vicary: Such practices are no longer an issue. Attitudes have changed. The broader issue is that as an industry we have to improve our professional standards, especially making it universally applicable.

Makhtar Abdullah: Hiring in Brunei is open to all. In Brunei, you have the option of having an Islamic license or a conventional license. There is no such thing as windows.

Cecep Maskanul Hakim: We have two Malaysian banks in Indonesia that operate similarly to Indonesian banks. There are some regulations for hiring, but there are no severe restrictions against foreigners. The problem Indonesia has is to develop our natural resources and attract investors to build our infrastructure.

Rodney Wilson: What is the scope of building on each country's local currency in terms of developing Shariah-compliant products?

Nizam Ismail: We have an interchangeable currency with Brunei and more can be done in terms of offering products or other funds.

Question: What are the strategies for the Middle East market when they have one for China? When the Islamic Bank of Asia (IBA) existed, there was no China fund project that was Shariah-compliant. Singapore has a good relationship with China with regards to conventional projects but not for those related to Islamic finance. So now without IBA, who will lead the initiative? There have been no initiatives for infrastructure projects. ASEAN has a lot of infrastructural projects but there has been no effort to create one that is *sukuk* driven.

Daud Vicary: The Asian Development Bank (ADB) is not averse to Shariah-compliant projects.

Nizam Ismail: Responsibility should not solely focus on any one Islamic bank. The likes of Maybank and CIMB are very aggressively promoting Islamic bank options. The challenge is the matter of efficiency. If one can create a conventional structure that is more efficient then there is the belief that there is no need to create an Islamic structure. This is an ongoing challenge. I think a lot of education is needed for issuers. The advantage of being in the early stages of the game for Singapore is that there is plenty of potential. It is incumbent on regulators, professional advisors to nudge people to look at Islamic finance options.

Wrap up:

Nizam Ismail: There should be freer movement of professionals and cross border cooperation and harmonization.

Cecep Maskanul Hakim: Indonesia is ready to have a Nusantara project to be developed in the region.

Makhtar Abdullah: Brunei is clearly focused on mission 2035 that will see an increase in contribution of non-oil and gas sectors to the GDP. Islamic finance will be a major initiative.

INDONESIAN ISLAMIC FINANCIAL MARKET DEVELOPMENT FRAMEWORK



ISLAMIC FINANCE WORKSHOP

Middle East Institute, National University of
Singapore

DR. RIEKI ISMAL

FEBRUARY, 16-17TH, 2016

OUTLINE

- ❑ Underlying condition
- ❑ Assessment on Framework of the Islamic financial Market
- ❑ Framework of the Indonesian Islamic financial Market
- ❑ Strategies of every pillar

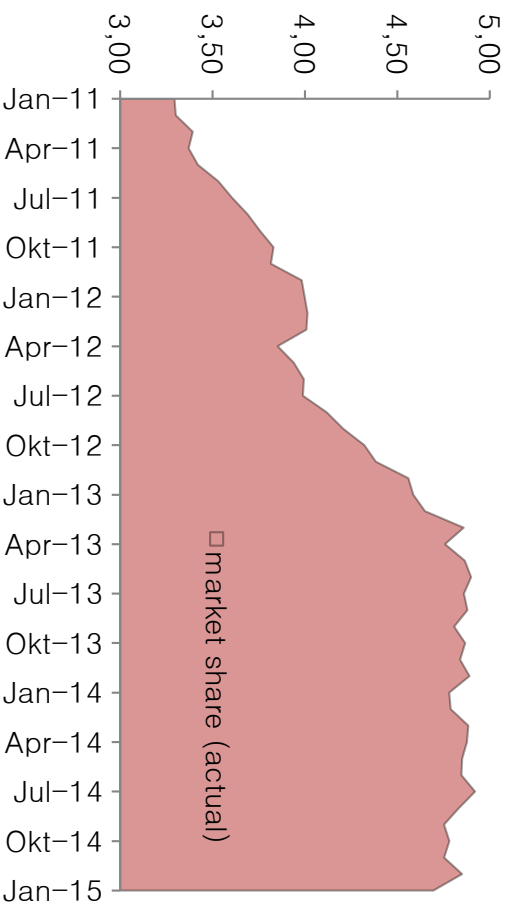


Underlying condition

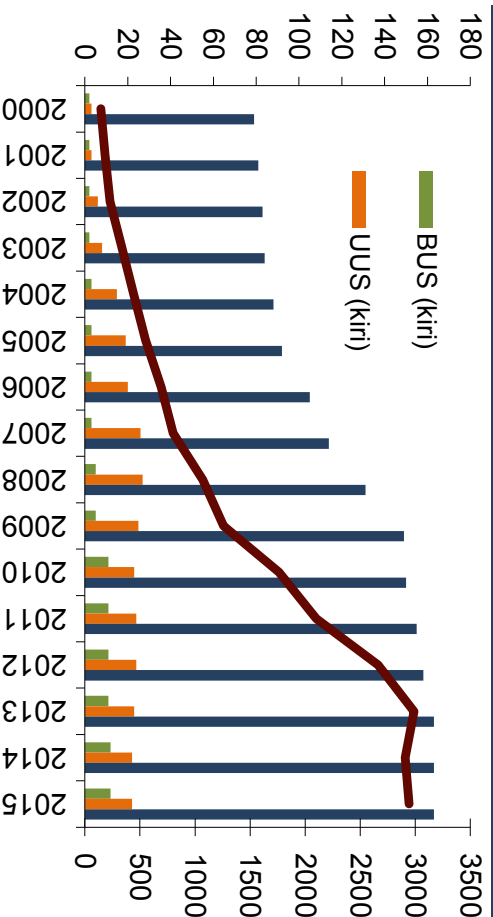
- ❑ **Current condition and challenges**
- ❑ **Triggering factors in Islamic finance**

CURRENT CONDITION AND CHALLENGES

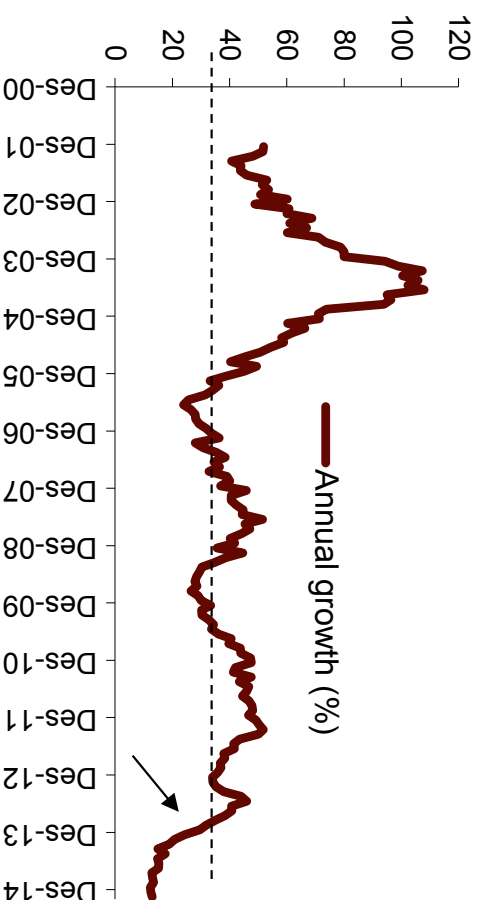
5% Market share has not been met



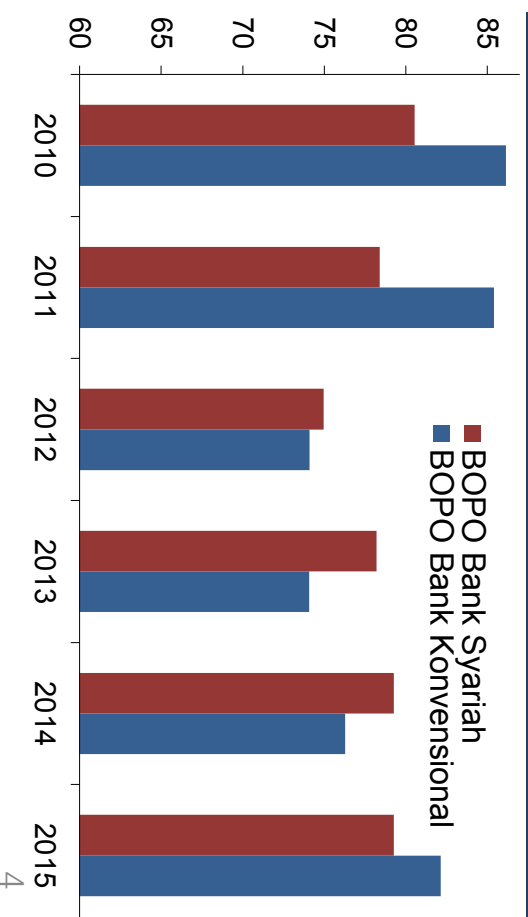
Infrastructures are stagnant



Growth of Assets (yoy) is slowing

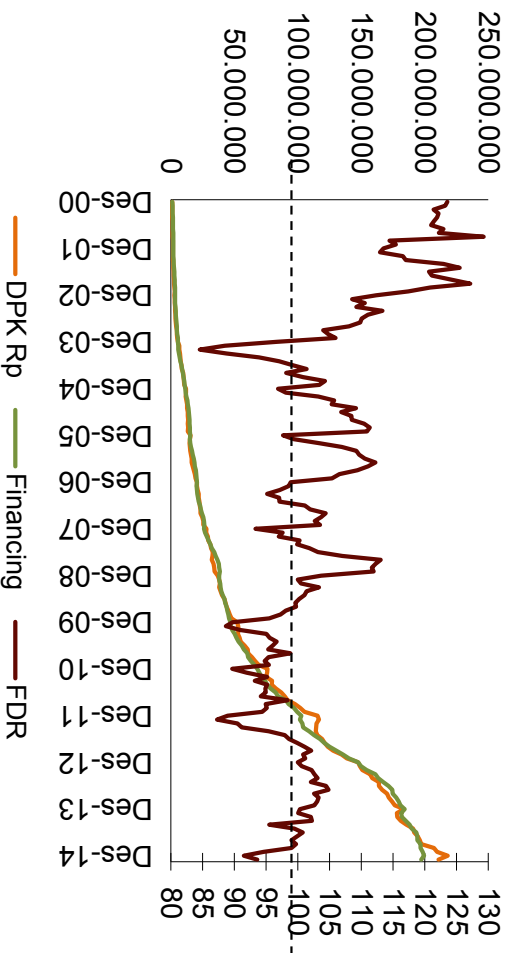


Cost of operations are high

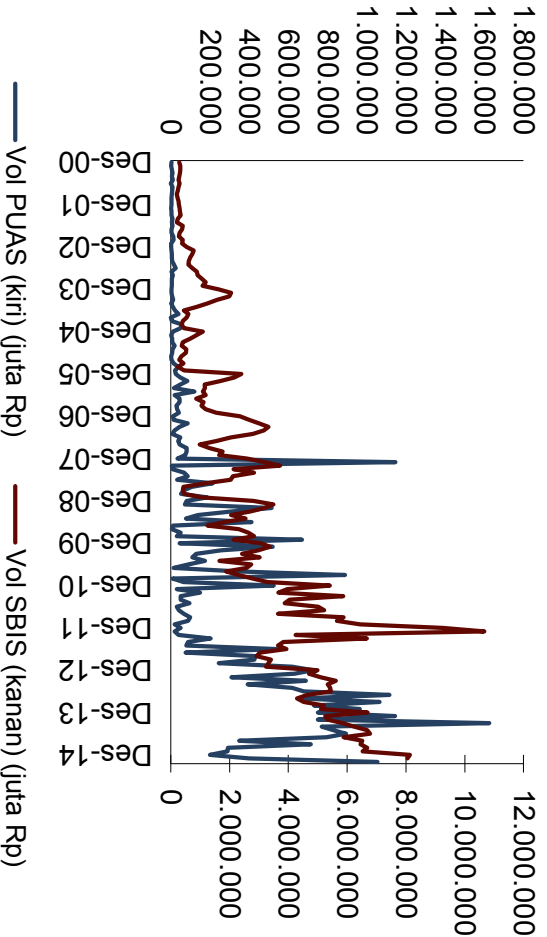


CURRENT CONDITION AND CHALLENGES

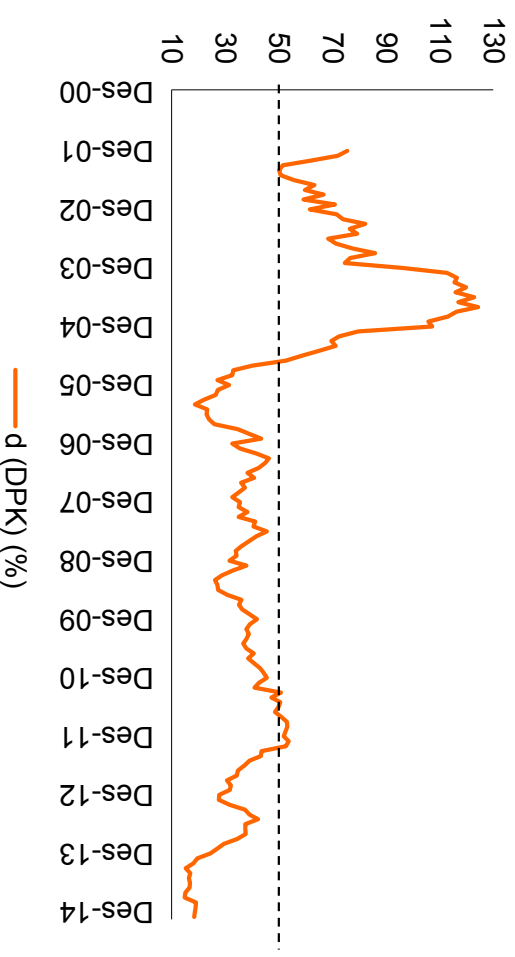
FDR>100%, High demand for financing



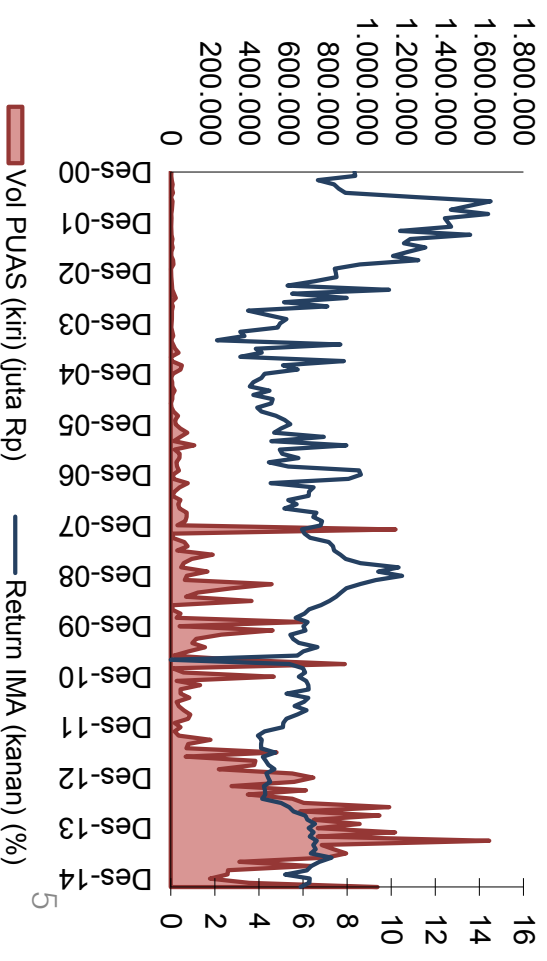
Volume of SBIS > Volume of PUAS



Growth of TPF (yoy) is slowing

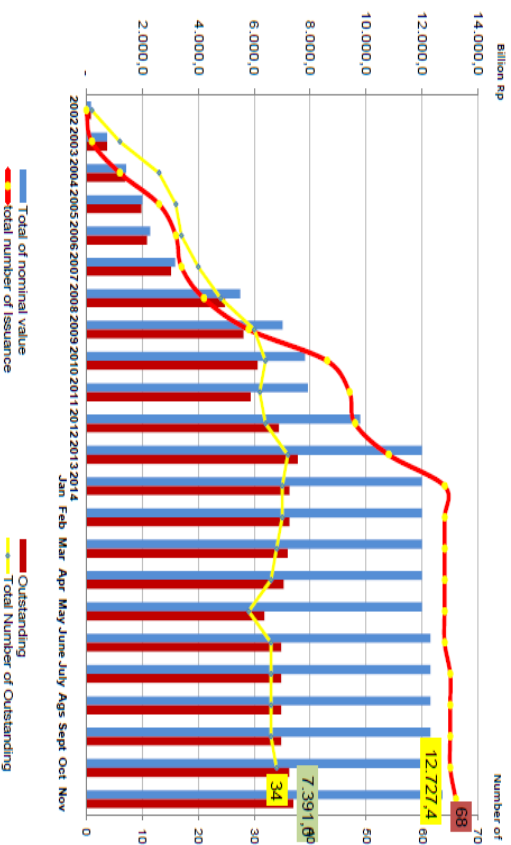


Activities of money market is active



CURRENT CONDITION AND CHALLENGES

Share of Sukuk is still limited



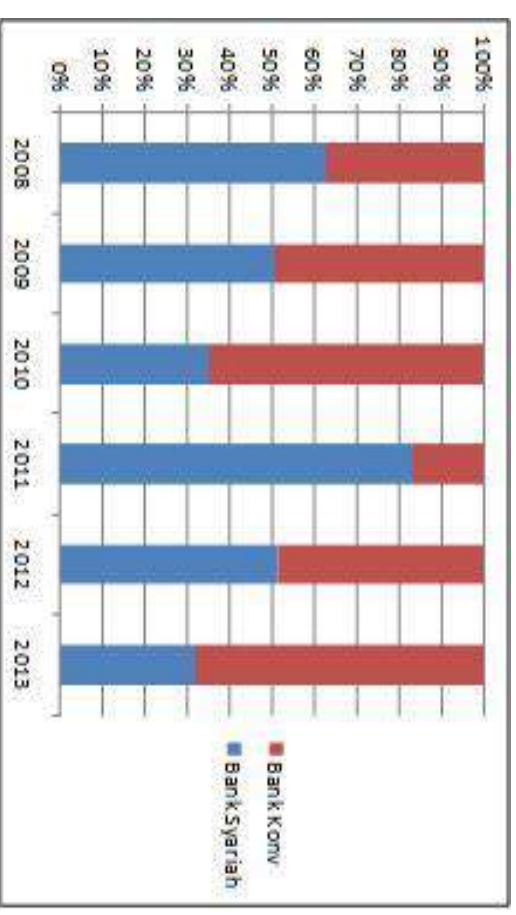
Potential investors

Negara	Jumlah Penduduk (Juta)	Jumlah Investor di Pasar Modal (Juta)	Persentase Investor Pasar Modal dibanding jumlah penduduk
Singapura	5,08	3,05	60,00%
Hongkong	7,00	1,23	17,50%
Malaysia	28,90	3,61	12,50%
Korea Selatan	49,10	4,17	8,50%
Jepang	127,53	10,20	8,00%
Indonesia	238,00	0,33	0,14%

sumber (data diolah): - Komite Tetap Kebijakan Keuangan Kadin (Dalam acara roadshow Pasar Modal 2010)

- Primora Hartalaga ("Sebuah Tinjauan Strategi Marketing & Promo")

Portion of CB is higher in PUAS

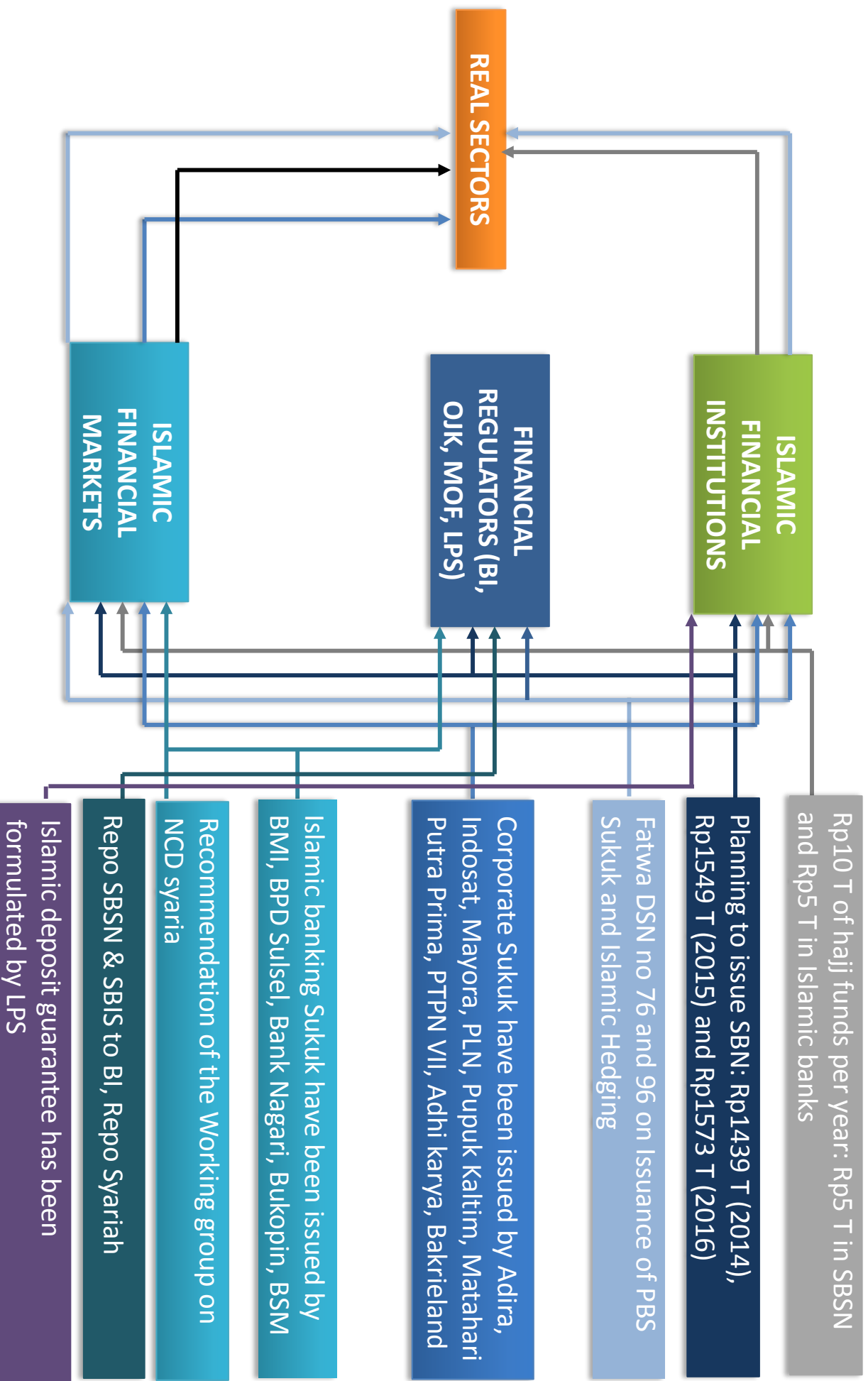


Accounts of Potential Investors

Investor	Sub Rekening
Asing	12.390
Lokal	334.474
Total	346.864
Investor	Sub Rekening
Individu	332.182
Institusi	15.267
Total	346.864

Sumber : PT KSEI

TRIGGERING FACTORS IN ISLAMIC FINANCE



Assessment on Framework of the Islamic financial market

- ☐ Sharia and business aspects in Islamic financial market
- ☐ Frameworks of other countries
- ☐ Assessment on Framework of Islamic Financial Market
- ☐ SWOT analysis
- ☐ BI Policies on deepening the financial market
- ☐ Other regulator policies

SHARIA & BUSINESS ASPECTS IN ISLAMIC FINANCIAL MARKET

- **Sharia aspects in deepening the Islamic financial market:**
 - ✓ Islamic financial markets should link with the real sector
 - ✓ Financial intermediaries is fund providers for the real sector
 - ✓ Financial intermediaries is not fiat money or inflation creators
 - ✓ No interest, speculation, gharar and gambling
- **Business purposes and aims of financial market deepening in Islam:**
 - ✓ Increasing number and variety of Islamic financial market instruments to further foster the economy
 - ✓ Be a solution to liquidity problems in Islamic financial institutions
 - ✓ Boosting TPF in Islamic banks to support real financing
 - ✓ Public participation in Islamic financial market and financial institutions
- **Target of financial market deepening:**
 - ✓ Increasing the issuance of new Islamic financial market instruments: Islamic banks Sukuk, Sukuk of conventional banks, Corporate Sukuk (BUMN), NCD syariah, SBSN, Sukuk of local governments.
 - ✓ Improving the 2nd market performance (players, transactions, etc)

FRAMEWORKS OF OTHER COUNTRIES

- MIFC to integrate inter authorities policies
- State budget is 100% in Islamic banks
- Open sharia (fiqh) approach
- Various Islamic financial products
- Government and BNM supports
- Hajj funds is in lembaga tabung haji
- Islamic banking acts was approved in 1983
- Islamic finance subject are in all universities

Malaysia

Iran

- Government is the owner of all banks
- Islamic economics is the state economic system
- Shiah sharia (fiqh) approach
- Independent but does not want to be the world Islamic financial hub.
- Variety of Islamic finance products including for the agriculture financing.

Middle
East

Pakistan

- Oil revenue is the main driving factor
- Strong commitment of the muslim conglomerates to support Islamic finance.
- Liberal sharia (fiqh) approach
- Variety of Islamic financial products in the financial markets
- Want to be the world Islamic financial hub (for example Dubai, Qatar, etc)

- Islamic economy is one of government commitment, even it was the state economic system (early 1970s).
- Classic Sunni approach
- Strong support from SBP & Islamic scholars
- Islamic finance subject are in all universities
- Variety of Islamic finance products
- Political is still dominant besides people driven to development Islamic finance.

ASSESSMENT ON FRAMEWORK OF ISLAMIC FINANCIAL MARKET

UNDERLYING CONDITIONS

SWOT ANALYSIS

- Strength
- Opportunities
- Weaknesses
- Threat

BANK INDONESIA POLICIES

- Monetary policies
- Macroprudential policies
- General framework of financial market deepening
- Monetary operations

POLICIES OF OTHER REGULATORS

- Blue print of Islamic banks (OJK)
- Master plan of capital market
- Development program of SBSN

INTERNATIONAL VIEWS

- 10 Years IDB master plan
- Working plans of IILM and IIFM

SURVEY TO THE MARKET PLAYERS

Challenges

Potential

CURRENT CONDITIONS

- Performance
- Achievement

SYARIAH ASPECTS IN FINANCIAL MARKET DEEPENING

FINANCIAL MARKET DEEPENING POLICIES OF OTHER COUNTRIES

SUPPORT OF THE REGULATORS: BANK INDONESIA, OJK, LPS, MINISTRIES, DSN, IAI
PUBLIC SUPPORTS AND ECONOMIC CONDITIONS

ISLAMIC FINANCIAL MARKET DEVELOPMENT FRAMEWORKS

- PILLARS
- STRATEGIES
- PROGRAMS
- ACHIEVEMENT INDICATORS

SWOT ANALYSIS OF THE INDONESIA FINANCIAL MARKET

S

- Continuous growth of Islamic financial markets
- 12 BUS, 23 UUS and 163 IRB
- Islamic insurance, pawnshop, financing, etc.
- Strong support from parent companies
- Moderate and under controlled liquidity pressures
- Loyal depositors (insensitive with interest)
- Positive performance and resilience with the crisis
- Focus on SMEs and retail (less risky)
- Liquidity facilities (Islamic repo to BI)

W

- Growth of TPF tends to decrease
- Improper business expansion planning
- Sensitive with economic performance
- Limited market share (+/- 5%)
- Limited business operations and banking models
- Limited Islamic money market instruments: SBIS, SBSN, SPNS, SIKa, SIMA
- Problems in HR and technology
- Limited underlying asset to issue Sukuk

O

- Issuance of Corporate Sukuk (Islamic banks, State owned companies, state government, private, etc)
- Issuance of other Islamic securities besides Sukuk (NCD, dll)
- Financing government projects (MP3EI) with Sukuk
- Issuance of project based Sukuk by the government
- Enlarging potential issuers and instruments
- The roles of National Committee on Islamic Finance (KNKS)
- Involvement of conventional banks or state owned enterprises as issuers or buyers of Sukuk
- Involvement of local government as issuers or buyers of Islamic securities (Sukuk, etc)

T

- Foreign Islamic banks have long experiences in Islamic financial markets
- AEC will increase competition among Islamic institutions as well as financial markets
- Competition with conventional banks
- Multiple effects from Islamic money market activities
- Indirect impact from interest rate movement in the conventional banks
- Proposals of Islamic contracts which are not sharia compliant with fatwa DSN.
- Foreign Islamic banks with higher capital, advanced IT, more well-experienced HR

BI POLICIES ON DEEPENING THE FINANCIAL MARKET

Monetary Stability Framework

- Interest rate policy
- Exchange rate policy
- Capital flows management
- Market regulation and Instrument
- Macro prudential policy

Financial System Stability Framework

- Surveillance
- Macro prudential policies
- Financial market regulation
- Payment system regulations

Macro prudential Policies

- Monitoring financial system
- Identification of risks
- Measurement of risks
- Signal of risks
- Design and policy implementation
- Evaluation of effective policies

Financial Market Deepening General

- Institutions
- Regulation and standard
- Market infrastructure
- Market instrument
- Education and socialization



Financial Market Deepening Program

Mini MRA, Swap hedging, hedging, MTD, NCD, CP, asset securitization, foreign exchange derivative market, financial inclusion

Monetary Policy Transmission Mechanism

Monetary policy (with monetary instruments) will affect market liquidity and price of assets, exchange rate, interest rate, credit, company's balance sheet, and expectations. These will influence domestic demand, output gap and finally inflation.

Monetary Operation Strategies

Managing excess liquidity with monetary policy strategies to target the O/N money market (PUAB) interest rate

Monetary Instruments

- OMO: (i) injection and (ii) liquidity contractions: SBI, SDBI, SBIS, Term deposit, SBN, repo, foreign exchange intervention
- Standing facility: (i) injection and (ii) liquidity contractions: deposit facility and lending facility

OTHER REGULATOR POLICIES

Master Plan Islamic Economics IDB

- Transparent market dan adequate capital
- Financial access dan sharia compliance
- Competent HR dan product innovation
- Accounting standard dan legal framework
- Interbank dan capital market structure
- Public awareness dan collaboration among institutions
- Financial linkages with international markets

ILLM (Intl Islamic Liquidity Market)

- Short term Sukuk
- Secondary market trading
- Alternative of source of fund for Sukuk issuers

IIFM (Intl Islamic Financial Market)

- Standardization of products
- Construction of Islamic financial market contracts
- Harmonization of verdicts
- Products development

Ministry of Finance

Research and development of ASEAN Bond Market including Sukuk (with Nomura – Japan)

Blue Print of Islamic Banking (2002-2023)

- Strong structure of Islamic banks to support the economy
- Resilient and competitive Islamic banking industry
- Integrated regulation and supervision for synergy and efficiency
- Collaboration of micro and macro prudential for financial system stability
- Banking access and customer protection to foster Islamic banking development

Strategic Management of SBSN (DP2R)

- Primary market development
- Secondary market development
- Development of SBN
- Simplifying serial number of SBN
- Improving basis of investors
- Optimizing SBN issuances due to the demand for financing and financial market practices



Ministry of Economic Planning

Indonesian Islamic Finance Architecture (AKSI) & National Committee on Islamic Finance (KNKS)

Framework of the Indonesian Islamic financial market

- ☐ **Vision & Missions**
- ☐ **Pillars to develop the Islamic financial market**
- ☐ **Strategies to develop the Islamic financial market**
- ☐ **Programs to develop the Islamic financial market**

VISION & MISSIONS

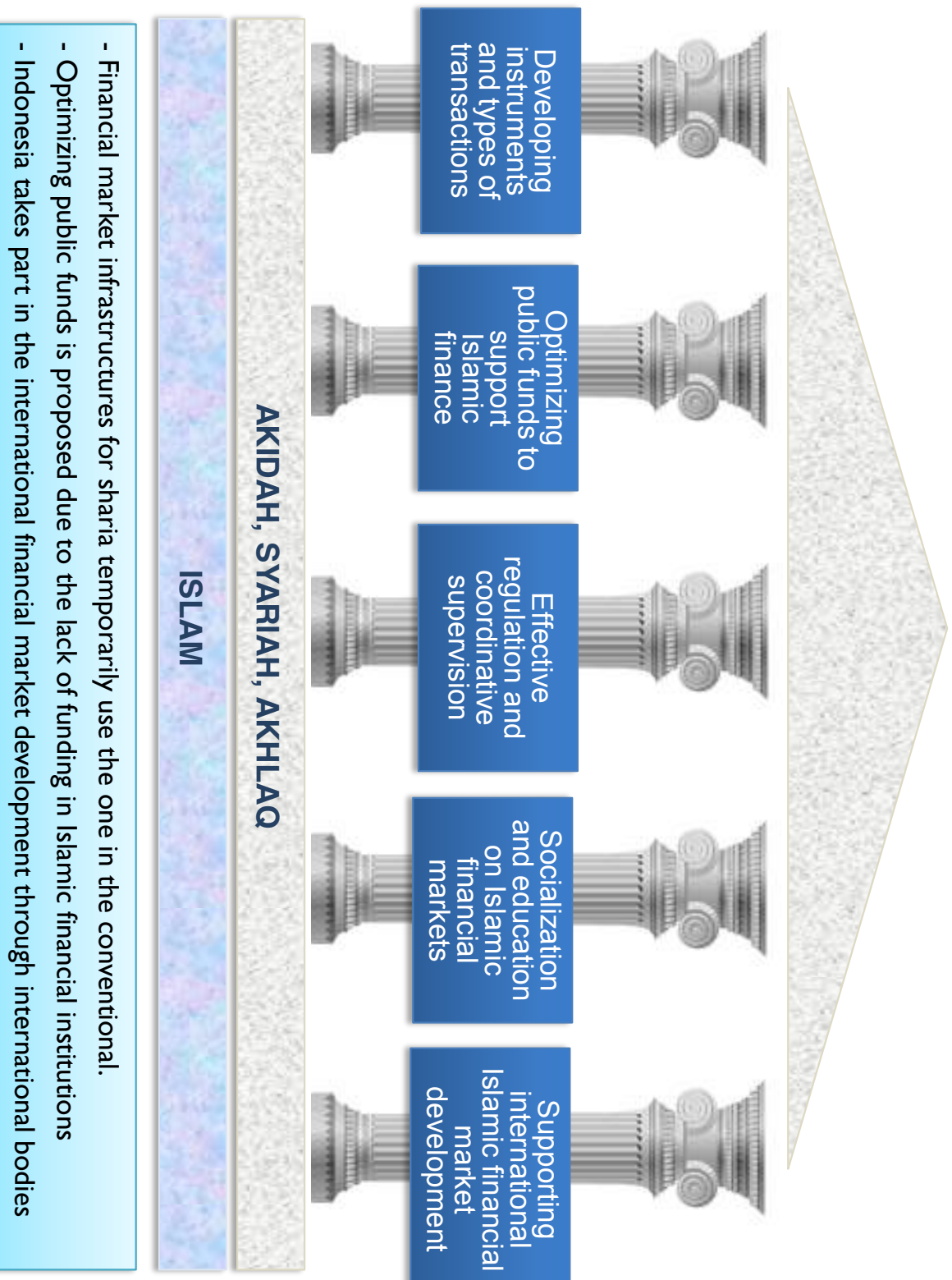
Vision

Having a real sector based and supportive Islamic financial markets which highly contribute to the financial system stability and global development of Islamic financial markets

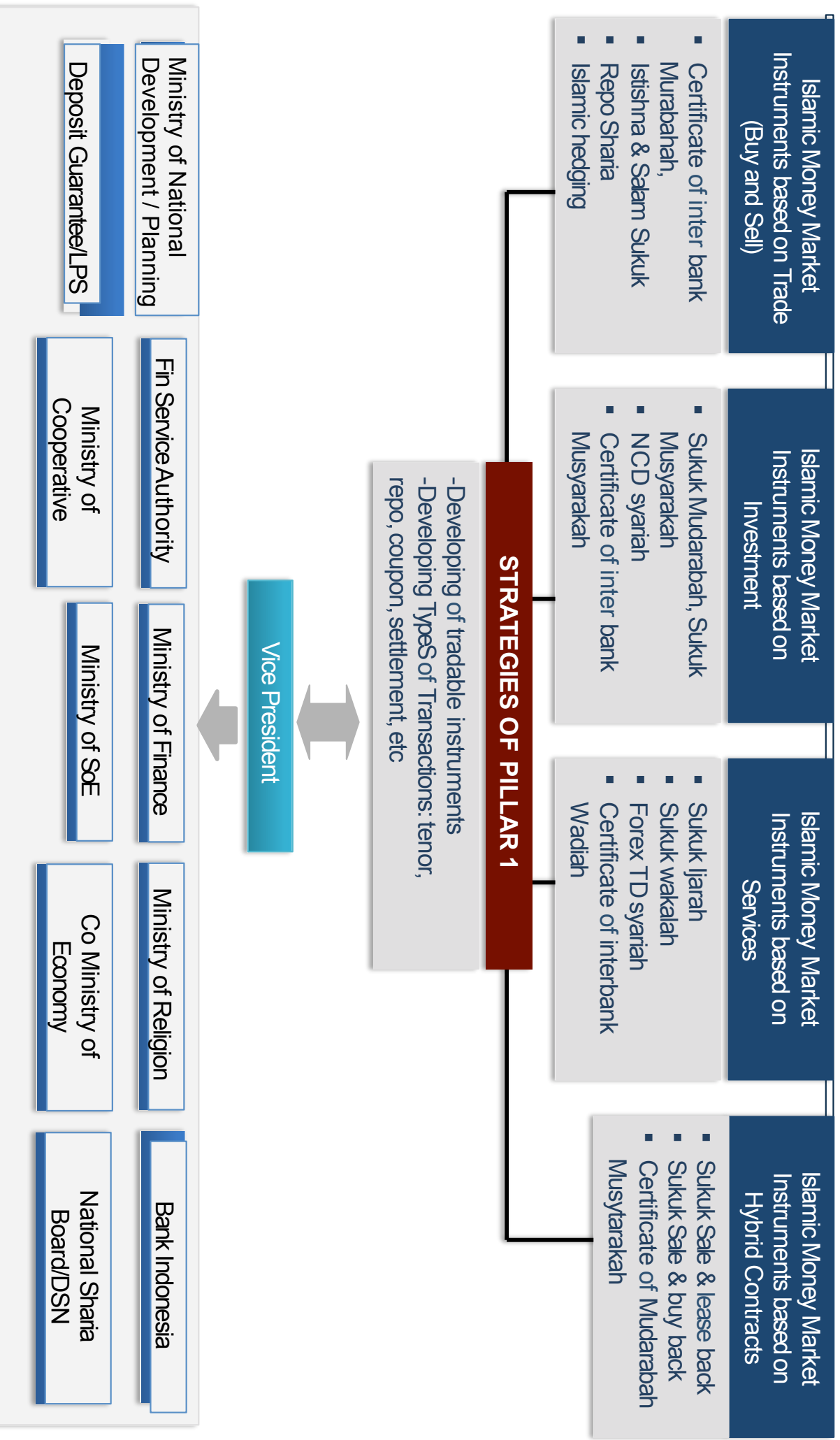
Missions

- Increasing the Islamic financial market activities through more issuance of Islamic securities, increased volume and frequency of transactions which are in line with real sector financing.
- Increasing participation of public funds in Islamic securities and inviting banks (conventional and Islamic), government (central and regional), corporates (SOE and private) as well international parties to issue more Islamic securities.
- Improving supervisory and regulation of the Islamic financial markets with regard to instruments, types of transactions, macroprudential aspect and financial system stability.
- Supporting the global Islamic financial market development through active participation in international Islamic finance organizations.

PILLARS OF ISLAMIC FINANCIAL MARKET DEVELOPMENT



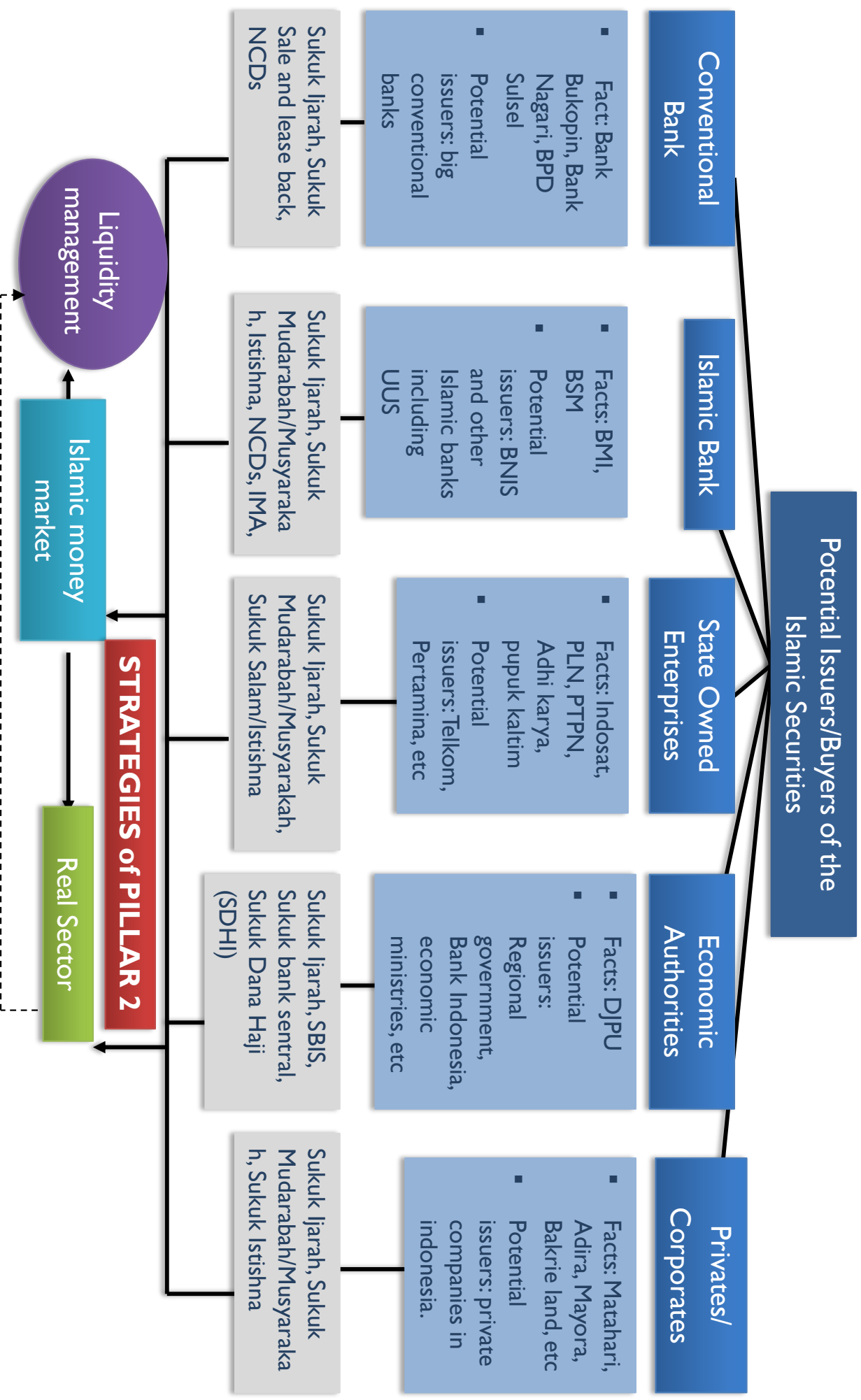
PILLAR 1 : DEVELOPING INSTRUMENTS & TYPES OF TRANSACTIONS



PILLAR 1: STRATEGIES

- **Developing the Islamic Money Market**
 - ✓ Instruments for Monetary and Financial Stability
 - ✓ Instruments to Boost Public Funding
 - ✓ Instruments for Islamic Liquidity Management
- **Developing Types of Islamic Money Market Transactions**
 - ✓ Regulating tenor, repo and interbank repo sharia
 - ✓ Regulating Mechanism for Sale and Buy Back in Repo and Interbank Islamic Repo
 - ✓ Islamic Monetary Operation of Bank Indonesia

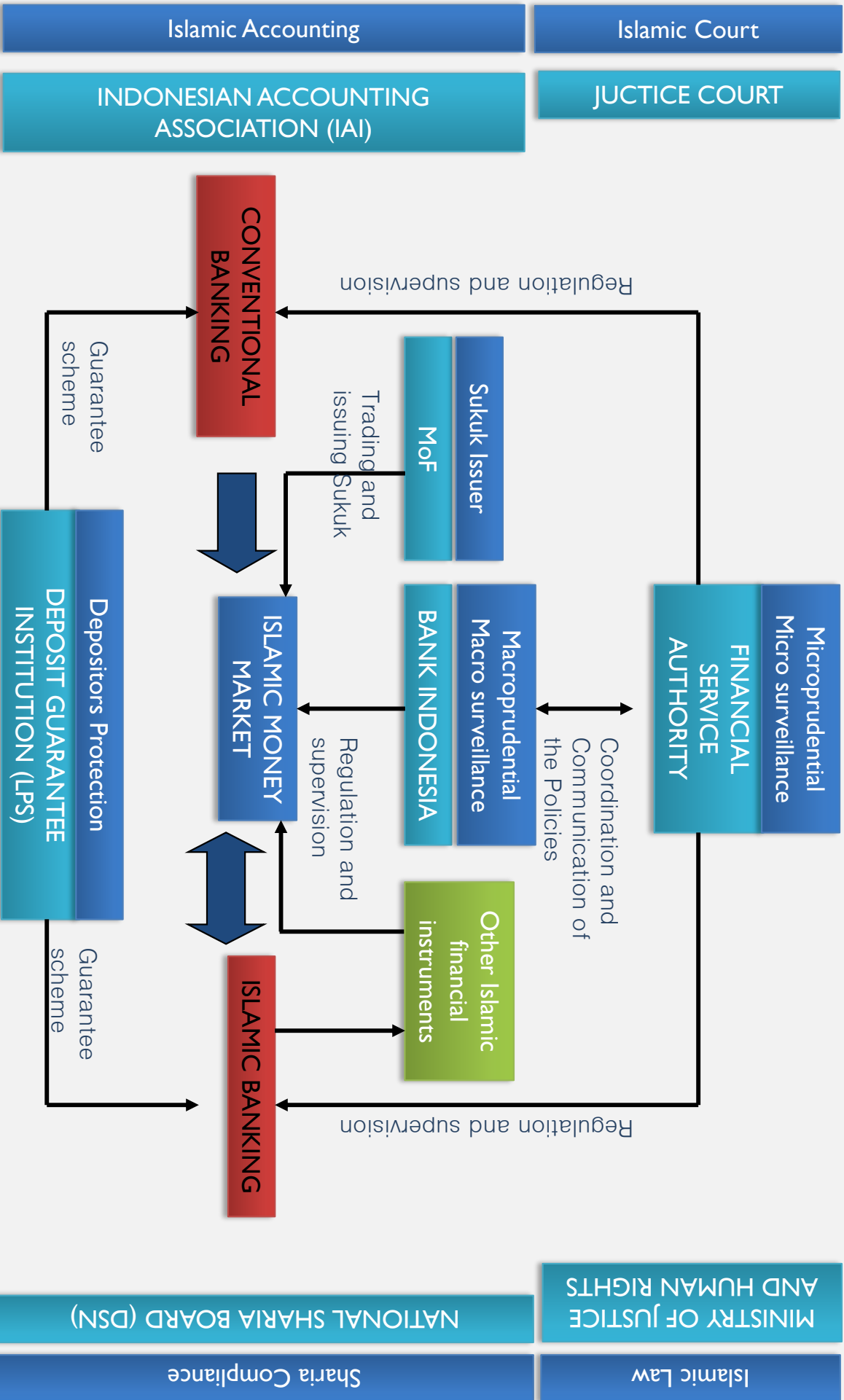
PILLAR 1 : OPTIMIZING PUBLIC FUNDS TO SUPPORT ISLAMIC FIN.



PILLAR 2: STRATEGIES

- **Across Authorities/Regulators**
 - ✓ Establishing bodies/institutions to boost Islamic funding.
- **Internal Bank Indonesia**
 - ✓ Establishing a division of research and development of the Islamic money market
 - ✓ Establishing a division of regulation, supervision and microsurveillance of the Islamic financial system
- **Islamic Financial Markets Players**
 - ✓ Activating the Indonesian Islamic Global Market Association (IIGMA)

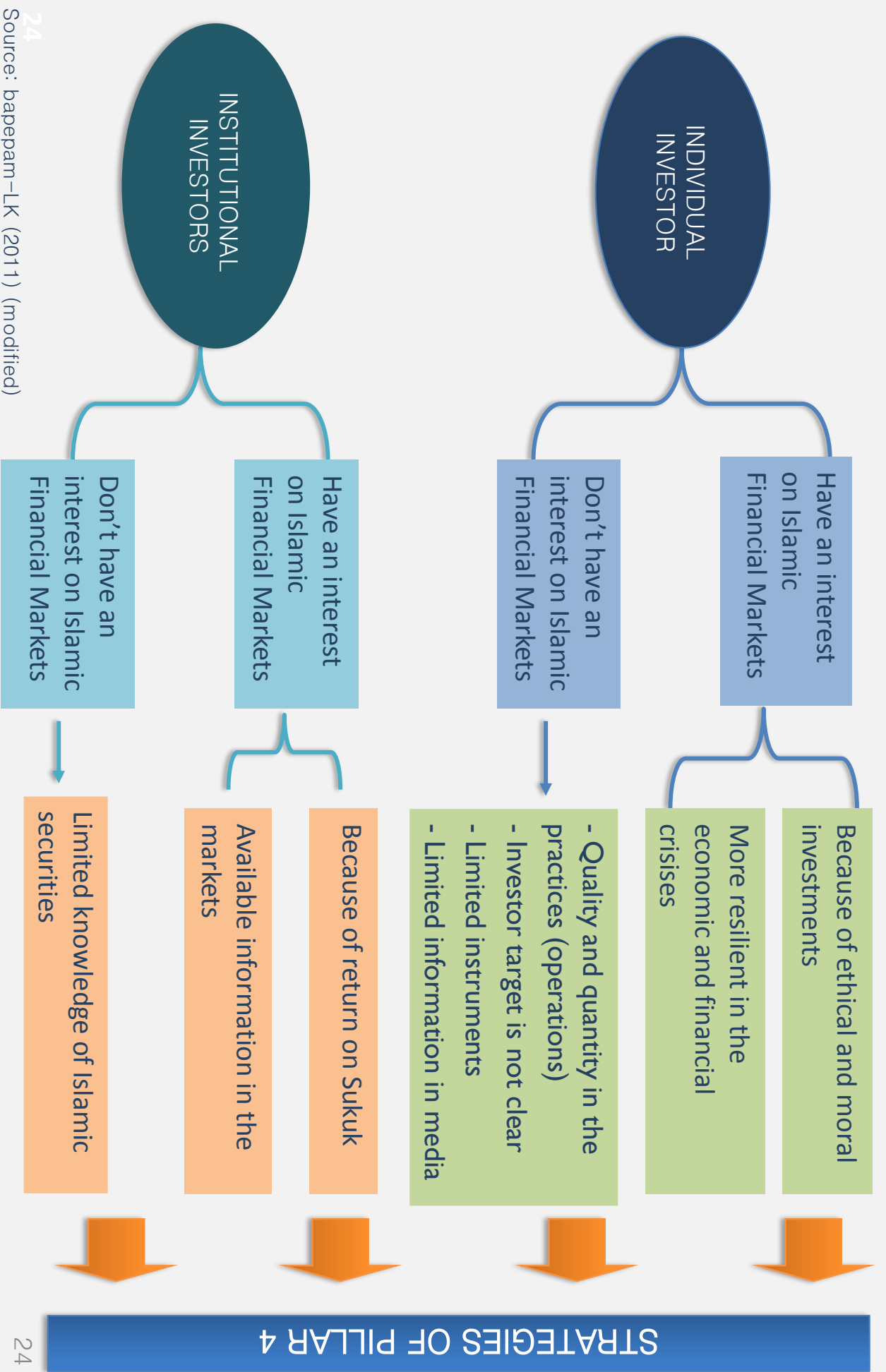
PILLAR 3: EFFECTIVE REGULATION & COORDINATIVE SUPERVISION



PILLAR 3: STRATEGIES

- **Regulation and supervision in the internal Bank Indonesia**
 - ✓ The roles of regulation and supervision (Micro surveillance) division on Islamic money market
- **Regulation and supervision outside Bank Indonesia**
 - ✓ Financial Service Authority (OJK)
 - ✓ Deposit Guarantee Institutions (LPS)
 - ✓ National Sharia Board (DSN)
 - ✓ Indonesian Accounting Association (IAI)
 - ✓ Directorate of Financing and Risk Management (MoF)

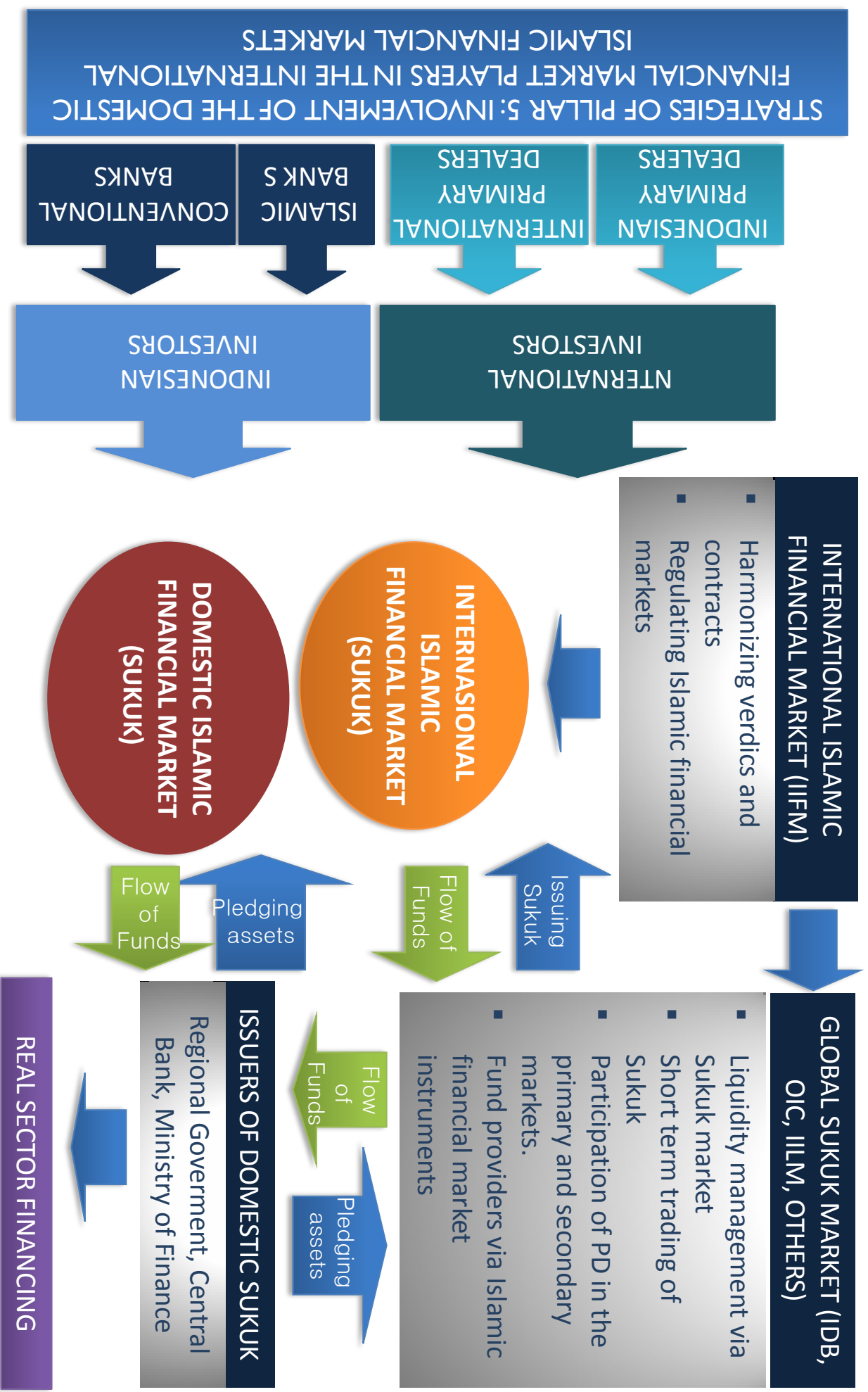
PILLAR 4: SOCIALIZATION AND EDUCATION



PILLAR 4: STRATEGIES

- **STRUCTURED AND PERMANENT SOCIALIZATION/EDUCATION PROGRAMS**
 - ✓ Join Program of BI and Islamic societies in Islamic finance and economics
 - ✓ Join Program of BI and other Regulators (AKSI, etc)
 - ✓ Join research and education between BI and universities/research institutions
 - ✓ Join program between BI and IDB, ILLM, IFSB and IIFM to socialize the Indonesian Islamic financial market development and policies to internationals.
 - ✓ Islamic Financial Market materials in the central banking course to universities
 - ✓ Conference/Seminar on BI Islamic financial market policies
- **UNSTRUCTURED AND AD HOC SOCIALIZATION/EDUCATION PROGRAMS**
 - ✓ Participation of BI in other authorities socialization/education programs
 - ✓ Publication of articles/research papers on Islamic financial markets in bulletin/journals, both domestic and international
 - ✓ Information on Islamic financial markets in BI publications (magazines, etc)
 - ✓ Meeting, FGD or discussion on investment potential in Islamic financial markets with banks, non banks and other potential investors
 - ✓ Socialization and education of the Islamic financial market are part of Islamic societies (MES. IAEI, PKES, FOSSEI) programs

PILLAR 5: SUPPORTING INTERNATIONAL ISLAMIC FIN. MARKET DEVELOPMENT



PILLAR 5: STRATEGIES

- **Various issuance of the Indonesian global sukuk**
 - ✓ Global Sukuk issued by the Indonesian government
 - ✓ Global Sukuk facilitated by international SPVs
- **Increasing participation PD in the Sukuk market**
 - ✓ Participation of domestic PD in the global Sukuk market
 - ✓ Participation of foreign PD in the domestic Sukuk market
- **Regulating global Sukuk in the money market**
 - ✓ Islamic repo with global Sukuk to Bank Indonesia
 - ✓ Interbank Islamic repo with global Sukuk
- **Assessing IIFM contracts to construct Islamic financial instruments**
 - ✓ Assessment of IIFM contracts in the Islamic money market

THANK YOU

SHORT BIO



Rifki Ismal is both a central banker and lecturer. He earned bachelor degree in economics from University of Indonesia, master in economics from University of Michigan, ann arbor (USA) and PhD in Islamic economics and Finance from Durham University (England). An Associate Professor in Islamic Banking and Finance is from the Australian Government (Australian Center for Islamic Financial Studies). Besides lecturing in some universities in Indonesia such as University of Indonesia, IPB, ITB, he ever lectured at Strasbourg University (France). In 2013, he published a book titling: Islamic Bank in Indonesia (John Wiley and Sons) and 2014 he contributed a chapter on Indonesian Islamic finance in another John Wiley and Sons titling: Handbook of Islamic Finance.

SHARIA GOVERNANCE IN ISLAMIC FINANCIAL INSTITUTION: BETWEEN STANDARD AND APPLICATION

Indonesian Experience

Cecep Maskanul Hakim

National Sharia Board- Indonesian Council of Ulama

Content

Background

Definition

Standard Requirement

Sharia Governance Principle

Competency

Independence

Confidentiality

Background

- In December 2009 Islamic Financial Services Board (IFSB) release Standard No. IFSB-10: Guiding Principles On *Shari`ah* Governance Systems For Institutions Offering Islamic Financial Services (IIFS) where set of requirements should be fulfilled by the industry and authority who provide Islamic financial services.
- The standard was written in the time that most of authorities in each country have their own path to develop sharia compliance for Islamic financial industry
- When the standard is reapplied to the member country the different result arises, as to whether the sharia governance in the country has fulfilled the criteria set in the standard
- Different opinions based on different sharia school of thought may become one of the reasons.

Definition

- “*Sharī`ah Governance System*” refers to the set of institutional and organisational arrangements through which an IIFS ensures that there is effective independent oversight of *Sharī`ah* compliance over each of the following structures and processes:
 - *Issuance of relevant Sharī`ah pronouncements/ resolutions*
 - *Dissemination of information on such Sharī`ah pronouncements/resolutions to the operative personnel of the IIFS who monitor the day-to-day compliance with the Sharī`ah pronouncements/resolutions vis-à-vis every level of operations and each transaction*
 - *An internal Sharī`ah compliance review/audit* for verifying that *Sharī`ah* compliance has been satisfied, during which any incident of non-compliance will be recorded and reported, and as far as possible, addressed and rectified
 - *An annual Sharī`ah compliance review/audit* for verifying that the internal *Sharī`ah* compliance review/audit has been appropriately carried out and its findings have been duly noted by the *Sharī`ah* board

Standards Requirement

Pillar I : Competency	measures to ensure reasonable expertise and skill-sets in Sharī`ah boards, to evaluate their performance and professional development.
Pillar II : Independence	safeguarding the independence of Sharī`ah boards, particularly from the management of IIFS, by highlighting various issues arising from potential conflicts of interest and recommending how they should be managed.
Pillar III: Confidentiality	observing and preserving confidentiality by the organs of Sharī`ah governance.
Pillar IV : Consistency	consistency in terms of the professionalism of members of the Sharī`ah board, which would be crucial in enhancing their credibility and confirming their integrity through a set of best practices.

Sharia Governance Principles

- Principle 1.1: The *Sharī`ah* governance structure adopted by the IIFS should be commensurate and proportionate with the size, complexity and nature of its business.
 - *No “single model” and “one-size-fits-all” approach*
- 3 kinds of industries with different kind regulations
 - Islamic banking Sharia Supervisory Board
 - Commercial Bank
 - Islamic Division of Conventional bank
 - Rural Islamic Bank
 - Non Banking Islamic Financial Institutions SSB
 - Islamic Insurance Company
 - Islamic Multifinance
 - Islamic Financial Cooperative
 - Islamic Capital Market (Capital Market Sharia Expert)
 - Self Regulatory Organizations (Bursa, Custodians, Clearing House, Securities Companies)
 - Sukuk

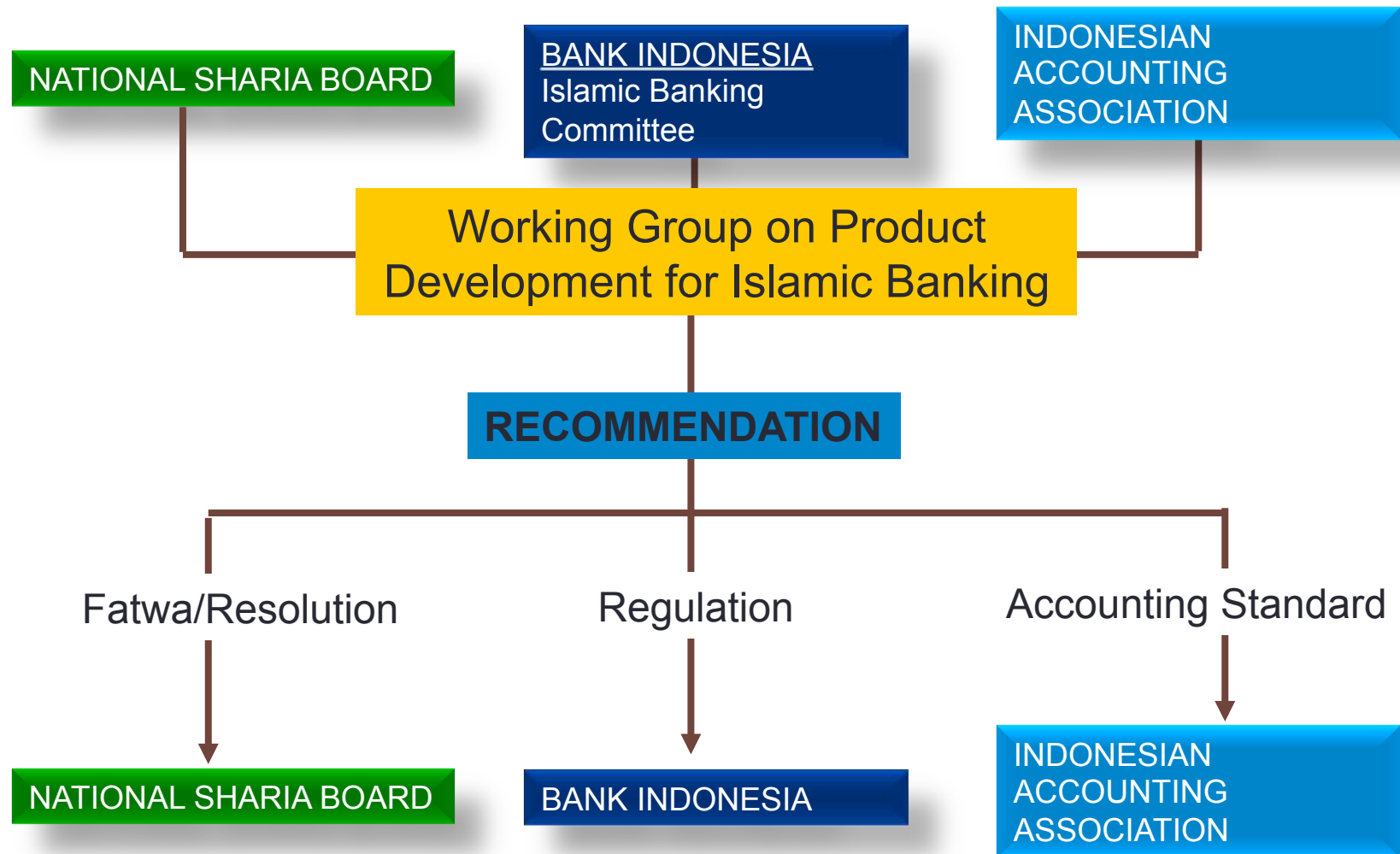
Sharia Governance Principles

- *Ex-ante considerations that should take place at the product design/development stage, before it is offered to the customers*

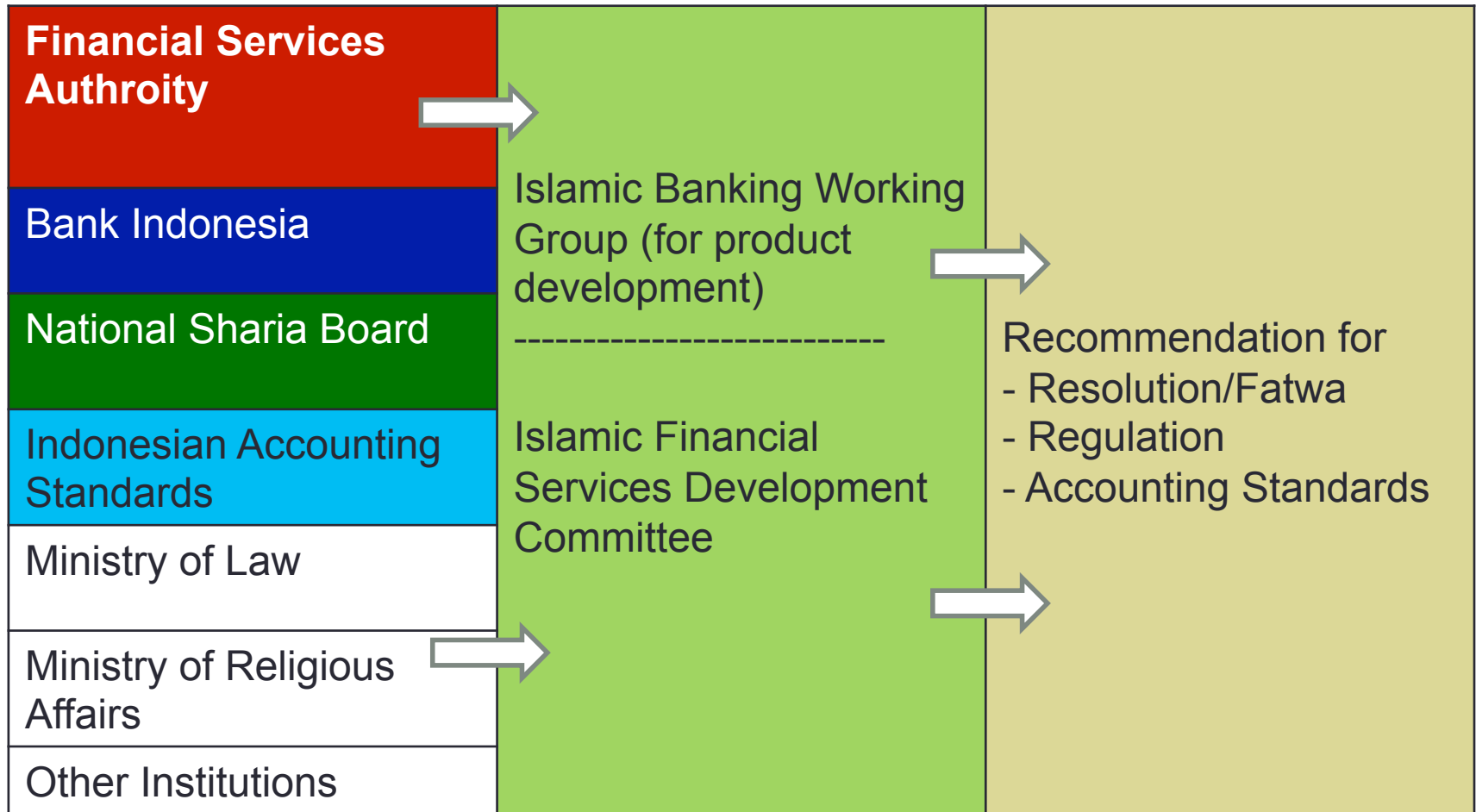
- All Islamic Financial Institutions should apply license to regulators before launching a new product (Islamic Banking Act, 2008)
- New product whose similarities with those granted license shall be required to report (Regulation, 2008)
- New product has not been issued its resolution will be forwarded to National Sharia Board (Regulation, 2008)
- Before new product forwarded to the regulator, it should pass review by Sharia Supervisory Board

- *Reff:*
- *Islamic Banking Act, No 21-2008*
- *Bank Indonesia Regulation No. 10/17/2009*
-

Development 2008-2013



Development From 2014



Sharia Governance Principles

- *Ex-post considerations that should be observed at the product offering stage – that is, after the product has been offered to the customers and transactions have been carried out*

- Annual Review by internal auditor
- Annual audit by regulator's specialist (sharia) auditor
- Annual audit/review by Sharia Supervisory Board
- Requirement by GCG regulation by Central Bank, (2009)

Sharia Governance Principles

- Prior to establishing or engaging its *Sharī`ah* board, an IIFS should be fully aware of its options, which include the following
 - to appoint a reputable and credible *Sharī`ah* board;¹³
 - to support the *Sharī`ah* board by appointing an ISCU or an individual *Sharī`ah* officer, whereby the *Sharī`ah* board shall be able to mandate and delegate some of its functions to the ISCU; and
 - for the *Sharī`ah* board to have at least three members, possibly trained in different schools of jurisprudence, have a mix of members with different lengths of experience,¹⁴ and where appropriate, comprise of different
- Cases reported
 - reputable Islamic scholar may not master fiqh muamalah although they are famous with their religious lecture on other cases
 - There are list of professors nominated to be SSB, failing to answer required questions on fiqh muamalah
 - Most of IIFS have their ISCU officer that might create further differences with management on sharia requirement on their business

Sharia Governance Principles

IFSB

- Principle 1.2: Each IIFS (Institutions offering Islamic Financial Services) must ensure that the *Sharī`ah* board has:
 - clear terms of reference regarding its mandate and responsibility;
 - well-defined operating procedures and lines of reporting; and
 - good understanding of, and familiarity with, professional ethics and conduct.

Adoption

- Appointment of SSB by Islamic bank and financial institutions in Shareholders meeting, followed by contract and code of conduct agreement
- Right and Duty of Sharia Supervisory Board in GCG Regulation for Islamic Banking (2009)
- Sharia Supervisory Board (banking, insurance) report to financial authority after biannual sharia audit (GCG for Islamic Banking, 2009)
- *Reff: Bank Indonesia Regulation No. 11/33/2009 on Good Corporate Governance for Islamic Banking and Islamic Business Unit*

COMPETENCY

Competency

IIFSB

- Principle 2.1:
- The IIFSB shall ensure that any person mandated with overseeing the *Sharī`ah* Governance System fulfils acceptable fit and proper criteria.

Adoption

Requirement by Authority

1. Knowledge
 1. Mastering in Fiqh Muamala and Principle of Islamic Economics
 2. Knowing basic knowledge of financial
 3. Knowing basic knowledge of financial supervision
2. Integrity
 1. Not involved in any case lead to financial service difficulties
3. Commitment
 1. Not more than certain number of institution (set aside by standard, previously suggested)
4. Test
 1. Interviewed by National Sharia Board
 2. Interviewed by Financial Service Authority

Competency

- ***Good Character***

- whether the person has been **convicted of a criminal offence**, particularly an offence relating to dishonesty, fraud or financial crime;
- whether the person has been **the subject of any adverse findings** or any settlement in civil proceedings, particularly in connection with banking or other financial business, misconduct or fraud;
- whether the person, or any business in which the person is a **controlling shareholder** or has a controlling interest or exercises significant influence, **has been investigated** and disciplined or suspended by a regulatory or professional body, a court or tribunal, whether publicly or privately;
- whether the person has been the owner, manager or director of a company, partnership or other organisation that has been **refused registration, authorisation, membership or a licence to conduct trade**, business or profession, or has had that registration, authorisation, membership or licence revoked, withdrawn or terminated, resulting in the person being refused the right to carry on a trade, business or profession requiring such a licence, registration or other authorisation;

Competency

- ***Good Character***

- whether the person has been a director, partner or otherwise involved in the management of a business that has gone into receivership, insolvency or compulsory liquidation while the person was connected with that organisation or within a reasonably short period (e.g. one year) after the person's departure from the institution;
- whether the person has been dismissed, asked to resign, or resigned from employment or from a position of trust, fiduciary appointment or similar position because of questions about honesty and integrity;
- whether the person has ever been disqualified from acting as a director or serving in a managerial capacity because of wrongdoing;
- whether the person has not been fair, truthful and forthcoming in dealings with customers, superiors, auditors and regulatory authorities in the past and has been the subject of any justified complaint relating to regulated activities; and
- whether the person demonstrates a readiness and willingness to comply with the requirements and standards of the regulatory system and other legal, regulatory, or professional requirements and standards.

Competency

IFSB

- Principle 2.1:
- (Continued)

Adoption

Cases under discussion:

- When Islamic cooperatives (financial and others) need similar treatment then the problem of massive certification of sharia board arises
- More than 2000 Islamic financial cooperatives under jurisdiction of Financial Services Authority should be re-certified their sharia board (almost 4000) through interview or sharia audit training to fulfill the criteria

Competency

IIFSB

- Principle 2.2: The IIFS shall facilitate continuous professional development of persons serving on its *Sharī`ah* board, as well as its ISCU and ISRU, if any.
 - ISCU = Internal Sharī`ah compliance unit/department
 - ISRU = Internal Sharī`ah review/audit unit/department

Adoption

- Requirement by Financial Authority to set aside certain budget for SSB to have a training, seminar and workshop to develop knowledge especially on product
- Sending SSB to National Annual Meeting of National Sharia Board, where cases and resolutions are discussed
- *Reff: Bank Indonesia Regulation*

Competency

IFSB

- Principle 2.3:
 - There should be a formal assessment of the effectiveness of the *Sharī`ah* board as a whole and of the contribution by each member to the effectiveness of the *Sharī`ah* board.

Adoption

- Requirement by Financial Authority to evaluate the report of SSB based on GCG requirement (2009) including
 - Attendance
 - Opinions' compliance to Resolutions and Regulations
 - Sampling and on-site supervision
 - Biannual Report to Authority
- *Reff: Bank Indonesia Regulation No. 11/33/2009 on Good Corporate Governance for Islamic Bank and Islamic Business Unit*

INDEPENDENCE

Independence

IFSB

- Principle 3.1: The *Sharī`ah* board should play a strong and independent oversight role, with adequate capability to exercise objective judgement on *Sharī`ah*-related matters. No individual or group of individuals shall be allowed to dominate the *Sharī`ah* board's decision-making.

Adoption

- Requirement for SSB member to be unrelated party to the management in families and other relationship
- Independency of SSB is part of Fit and Proper assessment in Governance regulation
- *Reff : Bank Indonesia Regulation No. 11/ 3 /PBI/2009 Islamic banks*

Independence

IFSB

- Principle 3.2: In order to fulfil their responsibilities, the *Sharī`ah* board should be provided with complete, adequate and timely information prior to all meetings and on an ongoing basis.

Adoption

- Access to information of the IIFS are equalized with the access given to other auditing/ reviewing party
- Failure of providing good cooperation in information related sharia auditing/reviewing is liable to sanction by authority under relevant regulation.
- *Bank Indonesia Regulation No. 10/17/PBI on Good Corporate Governance for Islamic Bank and Islamic Division Unit*
- *On site supervision regulation*

Independence

IFSB

- Principle 3.2:
- (continued)

Adoption

- Case reported:
- The SSB of an IIFS sent a letter of disagreement to the authority against the practice of management which is considered as not complying to sharia principle. In the shareholders meeting all SSB are replaced by new members.
- The similar case happens when one member of SSB disagree on the product to be proposed to authority while the parent company has been successful implement it in other area. The member are suggested to be replaced with other "complying member" before finally the IIFS is closed

CONFIDENTIALITY

Confidentiality

IFSB

- Principle 4.1:
 - *Sharī`ah* board members should ensure that internal information obtained in the course of their duties is kept confidential

Adoption

- Operational and GCG regulations for Islamic banking (2009) require SSB confidentiality commitment by acknowledging them as the part of the institution.
- Therefore the SSB considered as *related party* to the institutions where term and conditions for other management group is applied

Confidentiality

IFSB

- Principle 4.1:
 - *continued*

Adoption

- Some research put sharia compliance quality under the criteria of reputational risk since it may create spiral effect to all stakeholders
- It may also be caused by dissatisfaction by sharia expert on sharia compliance condition that cause them to put in their publication or speech. (unpublished)

CONSISTENCY

Consistency

IIFSB

- Principle 5.1: The IIFS should fully understand the legal and regulatory framework for issuance of *Sharī`ah* pronouncements/resolutions in the jurisdiction where it operates. It should ensure that its *Sharī`ah* board strictly observes the said framework and, wherever possible, promotes convergence of the *Sharī`ah* governance standards.
 - *Ex-ante (at the product design/development stage)*
 - *Ex-post (after the products have been offered to customers)*

Adoption

- Throughout the process of appointment of SSB the awareness of legal as well as financial system is introduced through regulation. SSB are liable to authority on reference of the product given by sharia authority and audit result by authority
 - *BI Regulation and Circular on GCG*
- The annual meeting of Sharia Supervisory Board always updates the members on the development of regulations by authority in all industries such as Islamic banking, non banking Islamic financial institutions and Islamic Capital Market;
 - National Sharia Board-Indonesian Council of Ulama

APPENDIX 1: Key Terms of Reference for the *Shari'ah* Board

IFSB

- Appointment, Resignation or Termination of Service
- Reporting Structure
- Powers and Authorities
- Primary Duties
- Delegation of Powers
- Review of Terms
-

Adoption

- Incorporated in Regulations on Governance Standard which liable to administrative sanction
- *Bank Indonesia Regulation No. 11/33/2009 on Good Corporate Governance for Islamic Bank and Islamic Business Unit*
- *Bank Indonesia Circular No. 12/13/DPbS on Implementation of Good Corporate Governance for Islamic Banks and Sharia Business Unit.*

APPENDIX 2: Operating Procedures of the *Sharī`ah* Board

IFSB

- Presentation of Request for Decisions on *Sharī`ah*-related Matters
- Reports by the *Sharī`ah* Board
- Chairman of the *Sharī`ah* Board
- Secretariat of the *Sharī`ah* Board
- Frequency of Meeting
- Quorum for Meeting
- Decision-making
- Attendance of the Senior Management
- Power to Invite Relevant Officers to Sit in Meetings
- Minutes of Meetings

Adoption

- Incorporated in Regulations on Governance Standard, except that the quorum is different. With requirement only 2 members (previously 3 as in National Sharia Board requirement) as present, the establishment of quorum cannot be set.
- *Bank Indonesia Regulation No. 11/33/2009 on Good Corporate Governance for Islamic Bank and Islamic Business Unit*
- *Bank Indonesia Circular No. 12/13/DPbS on Implementation of Good Corporate Governance for Islamic Banks and Sharia Business Unit.*

APPENDIX 3: Basic Professional Ethics and Conduct for Members of the *Sharī'ah* Board

IFSB

- Independence
- Personal Responsibility
- Care and Conscientiousness
- Confidentiality
- Alignment of Activities
- Disciplinary Sanctions
- Post-qualification Education

Adoption

- Incorporated in Regulations on Governance Standard
- Incorporated in the ethics of SSB member by National Sharia Board
- *Bank Indonesia Regulation No. 11/33/2009 on Good Corporate Governance for Islamic Bank and Islamic Business Unit*
- *Bank Indonesia Circular No. 12/13/DPbS on Implementation of Good Corporate Governance for Islamic Banks and Sharia Business Unit.*
- *NSB 3rd circular 2001, Basic ethics for Sharia Supervisory Boards*

CHALLENGE

Challenge

- On product development process
 - Different groups for developing products leads to time-consuming process, while market will not wait as long as the process by groups.
- On Sharia quality
 - Sharia compliance report has invert relationship with public transparency. Reputational risk may hamper public demand for proven sharia compliance condition of the IIFS. Research for this relationship is highly needed
- On effect of sharia quality
 - Report said that there is positive relationship between *Sharia rigorousness* with the slow groth of financial performance.
- On Sanction
 - Moral sanction for violation of Sharia principle is proven inadequate for management since the repeated mistakes are found in the SSB report. There is a discussion whether financial penalty is allowed since it might have more deterrent effect

Conclusion

- Adoption Sharia Governance Standard reach common result for authority supervising IIFS. Some differences are found because the practices already existed prior to the formulation of the standards;
- Pillars of Sharia Governance Standards are incorporated in Governance System through regulations and in Islamic financial industry as a compulsory element. Application of the standard needs consideration for massive IIFS (though small size) since they are in need similar treatment for sharia governance;
- Research are still needed to clarify issues related to the effect of shariah governance strength to the growth and development of Islamic Financial Industry

THE END OF PRESENTATION

Thank you for the attention



Middle East Institute

A Practitioner's Perspective on Sukuk Markets and Trends

Tahir Ali Sheikh

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Islamic Asset Management & Investments

A Practitioner's Perspective on Sukuk Markets and Trends

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Singapore
February 2016

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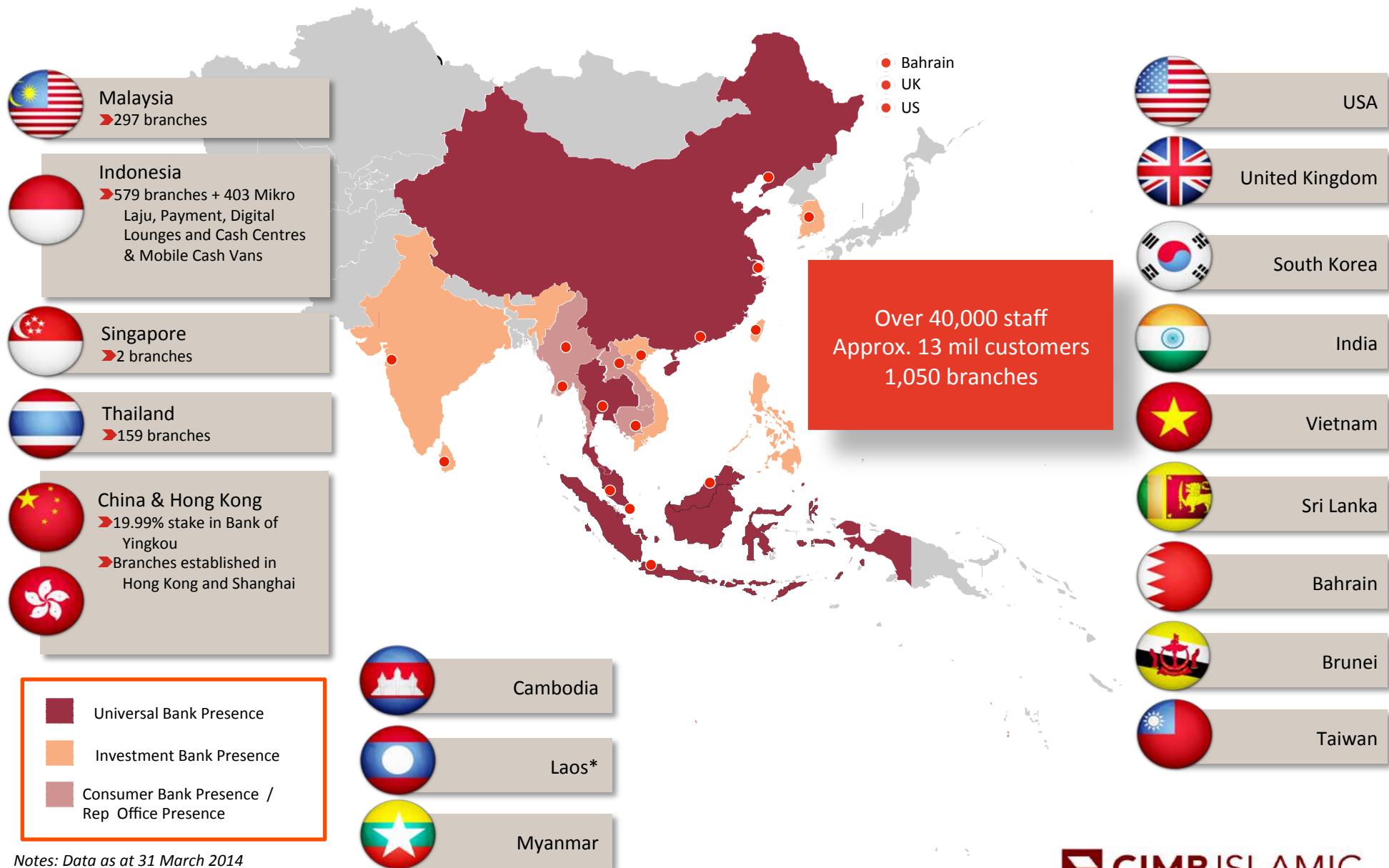
- Section 1 CIMB Islamic – an introduction
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- Section 4 Sovereign Sukuk
- Section 5 Growth drivers for a Sukuk market
- Section 6 China – the next frontier for Sukuk?

DISCLAIMER: The opinions expressed in this presentation are the speaker's own and do not necessarily reflect the view or policy of CIMB Islamic or the CIMB Group

Section 1

CIMB Islamic – an introduction

CIMB Group



Notes: Data as at 31 March 2014

* Pending completion

CIMB Islamic

- **CIMB Islamic is CIMB Group's global Islamic banking and finance franchise.** It operates in parallel with the Group's universal banking platform and covers **Islamic wholesale banking, Islamic consumer banking, Islamic commercial banking, Islamic asset management and Investment on a dual-banking leverage platform.** CIMB Islamic Bank Berhad, a licensed Islamic bank under the Malaysia's Islamic Financial Services Act 2013 is the main operating entity of the CIMB Islamic franchise.
- **CIMB Group's Islamic banking and finance business is supported by the Group's network of over 40,000 staff in 17 countries** comprising an experienced senior management team and a global team of Islamic finance professionals in all components of the financial market. CIMB Group also has the most extensive retail branch network in ASEAN, with more than 1,000 branches as at the 31 December 2014. **Outside of Malaysia, CIMB Islamic operates a universal offering in Indonesia and Singapore with a focus in wholesale banking in the other 15 countries.**

Award-winning Global Islamic finance franchise

► CIMB's Islamic finance franchise has won numerous international awards and accolades, and is a leading producer of Islamic financing solutions globally.

THE ASSET

- Sukuk House of the Year, Asia Pacific (2013-2015)
- Best Islamic Investment Bank /House in Asia Pacific (2010, 2013, 2015)
- Sukuk House, Malaysia (2014-2015)
- Best Islamic Investment Bank in Malaysia (2015)
- Best Deals in Hong Kong, Indonesia, Japan, Malaysia and United Kingdom (2015)
- Best Equity-Linked Deal (2015)
- Best Corporate Sukuk Deal (2012, 2013, 2015)
- Best Sovereign Sukuk Deal (2014, 2015)
- Islamic Deal of the Year (2014)
- Islamic Deal of the Year/Best Sovereign Sukuk Deal (2012, 2013)
- Best Quasi-Sovereign Sukuk (2015)
- Best New Sukuk (2015)
- Best Sukuk for Social Good (2015)
- Best REIT Sukuk (2015)
- Best Corporate Hybrid Sukuk/Best Local Currency Sukuk (2015)
- Best Corporate Hybrid Sukuk – Highly Commended (2015)
- Best Islamic Project Finance Deal (Malaysia) (2009, 2011, 2013, 2015)
- Best Islamic Deal, Malaysia Deal (2012-2014)
- Most Innovative Deal / Best Islamic Local Currency Deal (2012-2014)
- Best Islamic Equity Linked Deal (2014)
- Islamic Bank of the Year (2010, 2012, 2013)
- Best Islamic Bank of the Year Country Awards (2010, 2012, 2013)
- Best Quasi-Sovereign Sukuk/Best Islamic Equity-Linked Deal (2013)
- Best Islamic Deal, Bahrain (2013)
- Sukuk House of the Year, Asia (2012)
- Best Islamic Investment Bank in Asia (2012)
- Best Islamic Restructuring Deal (2012)
- Highly Commended Islamic Finance Deal - Malaysia Deal (2010, 2011)
- Best Sovereign and Corporate Sukuk (2011)
- Highly Commended Islamic Finance Deal (2010)

The Banker

- Global and Asia Pacific Islamic Bank of the Year (2013)
- Most Innovative Bank for Islamic Finance (2012,2015)
- Islamic Finance Deal of the Year (Asia Pacific) (2009, 2011, 2014)
- Islamic Finance Deal of the Year (America) (2014)
- Islamic Finance Deal of the Year Europe (2014)
- Highly Commended Islamic Finance Deal (2009)
- Global Islamic Investment Bank of the Year (2006)
- Real Estate Finance Deal of the

FinanceAsia

- Best Islamic Financing (2006-2008, 2010, 2011)
- Best Islamic Financing Deal (2008, 2012, 2014)
- Best Islamic Finance House (2006-2009, 2011, 2012, 2014)
- Best Project Financing (2014)
- Best DCM House Malaysia (2014-2015)

THE ASIAN BANKER®

- Asian Banker Achievement Award for Islamic Finance (2009, 2010)

IFR ASIA

- Asia's Islamic Deal of the Year (2011, 2013,2015)

THE WORLD ISLAMIC CAPITAL MARKETS CONFERENCE

- The World Islamic Capital Markets Excellence Award (2007)

EUROMONEY

- Best Islamic Bank in Asia (2005, 2008-2013)
- Best Innovation in Islamic Finance (2015)
- Best Islamic Bank in Malaysia (2012, 2013)
- Best Sukuk House (2008)
- Islamic Finance Deal of the Year (2005, 2011)
- Best Sukuk Deal (2009, 2010)
- Best Provider of Islamic Financial Services in Malaysia (2004)
- Best Domestic Market Sukuk House (2003)
- Most Innovative Deal (2012)
- Best Project Deal (2013)

Alpha

- Most Innovative Deal/Innovative Islamic Deal of the Year in South-East Asia (2010, 2011, 2013-2015)
- Best Islamic REIT Deal of the Year in Southeast Asia (2014)
- Special Marquee Awards: Best Islamic Finance Bank in South-East Asia (2010, 2012-2014)
- Best Islamic Finance Deal of the Year in South-East Asia (2007-2013)
- Best Islamic Finance House (Malaysia) (2008-2010, 2014)

Islamic Finance news

- Best Islamic Bank in Malaysia (2007, 2008, 2010, 2013, 2014,2015)
- Deal of the Year (2014, 2015)
- Turkey Deal of the Year (2015)
- Malaysia Deal of the Year (2009, 2012-2015)
- Most Innovative Deal of the Year (2013,2015)
- Social Impact Deal of the Year (2014-2015)
- Wakalah Deal of the Year (2015)
- Perpetual Deal of the Year (2013,2015)
- Infrastructure Deal of the Year (2009,2015)
- Project Finance Deal of the Year (2009,2015)
- Murabahah Deal of the Year (2014)
- Sovereign Deal of the Year (2009-2011, 2014)
- Indonesia Deal of the Year (2010, 2014)
- UK Deal of the Year (2014)
- Emerging Asia Deal of the Year (2014)
- Sukuk Deal of the Year (2014)
- Real Estate Deal of the Year (2014)
- Hybrid Deal of the Year (2014)
- Best Overall Islamic Bank 1st Place (2009, 2010), 2nd Place (2008), 3rd Place (2007)
- Most Innovative Islamic Bank (2009-2011)
- Murabahah Deal of the Year (2013)
- Tav (2013)
- Ijar (2011)
- Cro (2011)
- Best Islamic Bank in Malaysia and Asia (2008-2010,2015)
- Best Sukuk Bank (2010,2015)

RAM

- Inaugural Lead Manager Award for Foreign Currency Programme
- World's 1st Yen Sukuk (2014)
- World's 1st Rated Perpetual Subordinated Sukuk (2014)
- Top Lead Manager for Corporate Sukuk (2006-2008, 2013)
- Award of Distinction Blueprint Awards: World's first Islamic residential mortgage-backed securities deal (2006)
- No. 1 Lead Manager Award (Islamic) by Programme Value (1990- 2002, 2004, 2006-2009, 2013, 2014)
- No.1 Lead Manager Award (Islamic) by Number of Issues (1990-2002, 2004, 2006-2009, 2013, 2014)
- Innovation in Islamic Finance (2013)

ASIAN LEGAL BUSINESS

- Islamic Finance Deal of the Year (2009, 2010, 2013-2015)

ASIAMONEY

- Best Regional Islamic Bank in Asia (2010-2013)
- Best Islamic Bank in Malaysia (2010-2013)

Asia Asset Management

- Islamic Fund House of the Year (Malaysia) (2007, 2008)

CIMB's Innovative Sukuk Structuring Capabilities Put Us at the Forefront of the Sukuk Markets

Section 2

Sukuk refresher

What are Sukuk?

- **Sukuk are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity**

- Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)

Comparison between conventional bonds and Sukuk

Feature	Conventional Bonds	Sukuk
Issuer	An issuer of conventional bonds is not limited in its business activities	A Sukuk issuer shall itself be engaged in business activities which are permissible under Shariah
Issuance	To be approved by the relevant regulator(s) only	To be approved by the relevant regulator(s), Shariah regulatory authority (if applicable) and Shariah Adviser(s)
Structure type	Debt-based only	Asset-, equity- and debt-based
Utilization of proceeds	No restriction	Shariah-compliant as endorsed by a Shariah Adviser
Asset requirement	No, except for Asset Backed Securities transactions and secured transactions	Yes
Exposure	Conventional bonds are not acceptable to the Islamic investors. As such, limited exposure to conventional investors only	<ul style="list-style-type: none"> Sukuk issues enjoy a wider investor base from both sets of investors – Islamic and conventional, thereby maximizing the demand for the securities Sukuk may lead to more profiling/exposure for the issuer to different sets of investors, building its credit profile in new markets
Security	Can be structured as clean or secured	
Credit Enhancement / Ringfencing	Can be added	
Use of Special Purpose Vehicle (SPV) as issuing conduit	Usually not required except for asset backed securities transactions when bankruptcy remoteness is required	Required under selected structures to facilitate the underlying Islamic principles, and identified investors' market

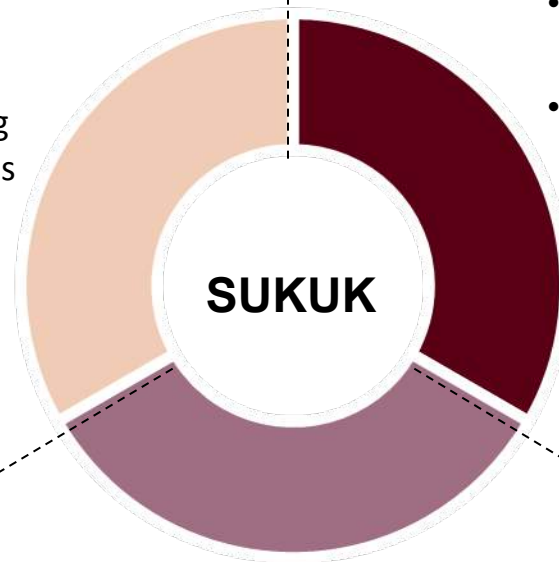
Features of Sukuk attracting issuers

Enhance Profile in Islamic Markets

- Increase recognition and awareness of the obligor's profile in Islamic-centric markets
- Major source of funds for ongoing and future capital raising exercises including equity financing

Diversification of Investors Base

- Exposure to a new segment of investors around the world
- Both conventional bond investors and Islamic investors can subscribe to Sukuk



Diversification of Funding Sources from new Asset Class

- Allows an additional avenue to source funding through a new asset class

Sukuk structures

Arrangement	Description
Lease Arrangement <i>Ijara</i>	Issuer uses acquisition cost to acquire an asset, holds it until the end of a specified term, leases it to the originator for a consideration and disposes it to the originator by the end of the specified term in return for the proceeds of the disposal
Agency Arrangement <i>Wakala</i>	Issuer appoints the originator as the Issuer's agent, and the originator uses the acquisition cost to invest in (typically) a lease arrangement (<i>Ijara</i>) and purchase and sale arrangement (<i>Murabaha</i>); the originator as agent manages the investment for the purposes of generating income or gains and disposes it by the end of the specified term in return for the proceeds of the disposal
Purchase and Sale Arrangement <i>Murabaha</i>	Issuer acquires an asset from a third-party on immediate payment of the acquisition cost to that third party, immediately disposes of it onward to the originator at acquisition cost plus markup that is payable on deferred terms, in lump sum or by installments, by the end of a specified term; and on the acquisition of the asset from the Issuer, the originator either immediately disposes the asset onward to another third party against immediate payment of a price equal to the acquisition cost or retains the asset for the originator's own use
Profits Sharing Arrangement <i>Musharaka / Mudaraba</i>	Issuer and the originator form a business undertaking by the Issuer contributing the acquisition cost and the originator contributing a sum of money or in kind or both, or contributing expertise and management skills; the business undertaking carries on business activities in accordance with the terms of the arrangement with the profits generated and the losses incurred to be shared according to ratios set out in the arrangement

Comparison of Sukuk structures

	Lease Arrangement <i>Ijara</i>	Agency Arrangement <i>Wakala</i>	Purchase and Sale Arrangement <i>Murabaha</i>	Profits Sharing Arrangement <i>Musharaka / Mudaraba</i>
Description	The leasing of Shariah-compliant leaseable assets such as land, building, plant, equipment, etc. over a specified period for a specific price (lease payments)	A contract of agency in which one party appoints another entity to perform a certain task on the former's behalf	The sale of certain Shariah-compliant commodities on a deferred payment and cost plus profit basis	A partnership contract between two or more parties, each contributing capital / capital and expertise respectively. The profits generated and the losses incurred to be shared according to ratios set out in the arrangement
Underlying Assets	Any Shariah-compliant leaseable assets e.g. land, building, and equipment	Any Shariah-compliant income generating asset or business venture; and Commodities	Any Shariah-compliant commodity (" Commodities ") e.g. palm oil, petroleum, platinum, and copper Commodities such as gold and silver that are used as a mediums of exchange are prohibited	Any Shariah-compliant tangible asset or any income generating asset or business venture owned by the Originator
Asset Lock-up	Yes (however, may be exchanged with other Shariah-compliant leaseable assets throughout the Sukuk tenure)	Yes (however, the tangible assets may be exchanged with other Shariah-compliant assets throughout the Sukuk tenure)	Not applicable as transaction on the assets occur at the point of Sukuk issuance	Yes (however, the tangible assets may be exchanged with other Shariah-compliant assets throughout the Sukuk tenure)
Secondary Trading	Allowed as the underlying assets consist of tangible assets	Allowed, provided at least 1/3 of the underlying assets consist of tangible assets	Only investors in the GCC region have Shariah concerns with respect to the trading of debt or receivables, other than at par. As such, investors in the GCC may buy Sukuk <i>Murabaha</i> so long as they are willing to hold it until maturity	May not be acceptable to certain Shariah scholars in the Middle-East
Specific Requirements of the Structure	-	Brokerage fees are payable for Shariah-compliant commodities that will be utilised	Brokerage fees are payable for Shariah-compliant commodities that will be utilised	-

Sukuk structures for global issuances

➤ Global acceptance

- *Ijara* and *Wakala* are widely accepted by global investors

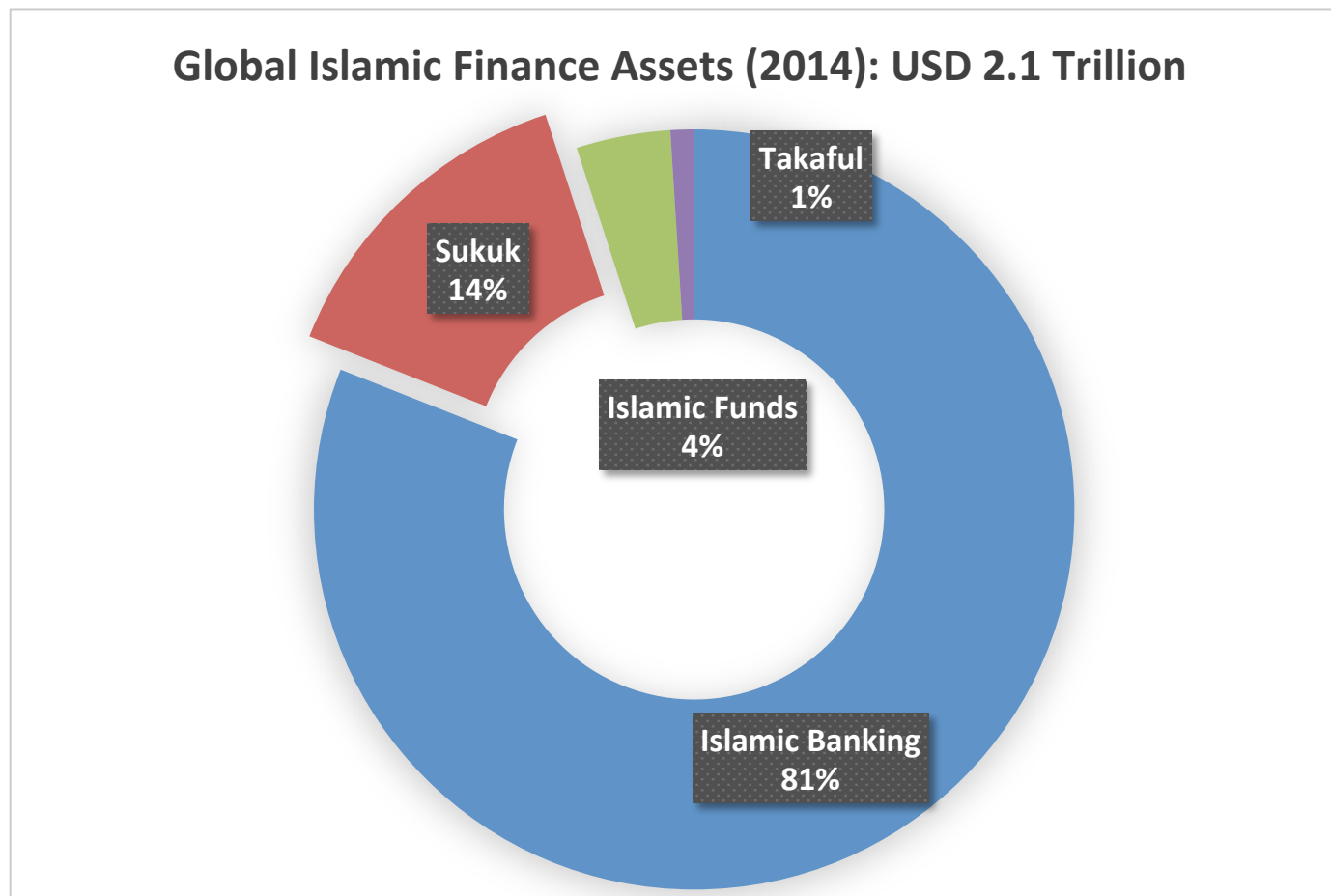
➤ Major consideration between *Ijara* and *Wakala*

<i>Ijara</i>	<i>Wakala</i>
<ul style="list-style-type: none">▪ Requires 100% leasable assets	<ul style="list-style-type: none">▪ Minimises the use of leasable assets as Commodities may comprise up to 2/3 of the nominal value of the Sukuk

Section 3

Sukuk market – an overview

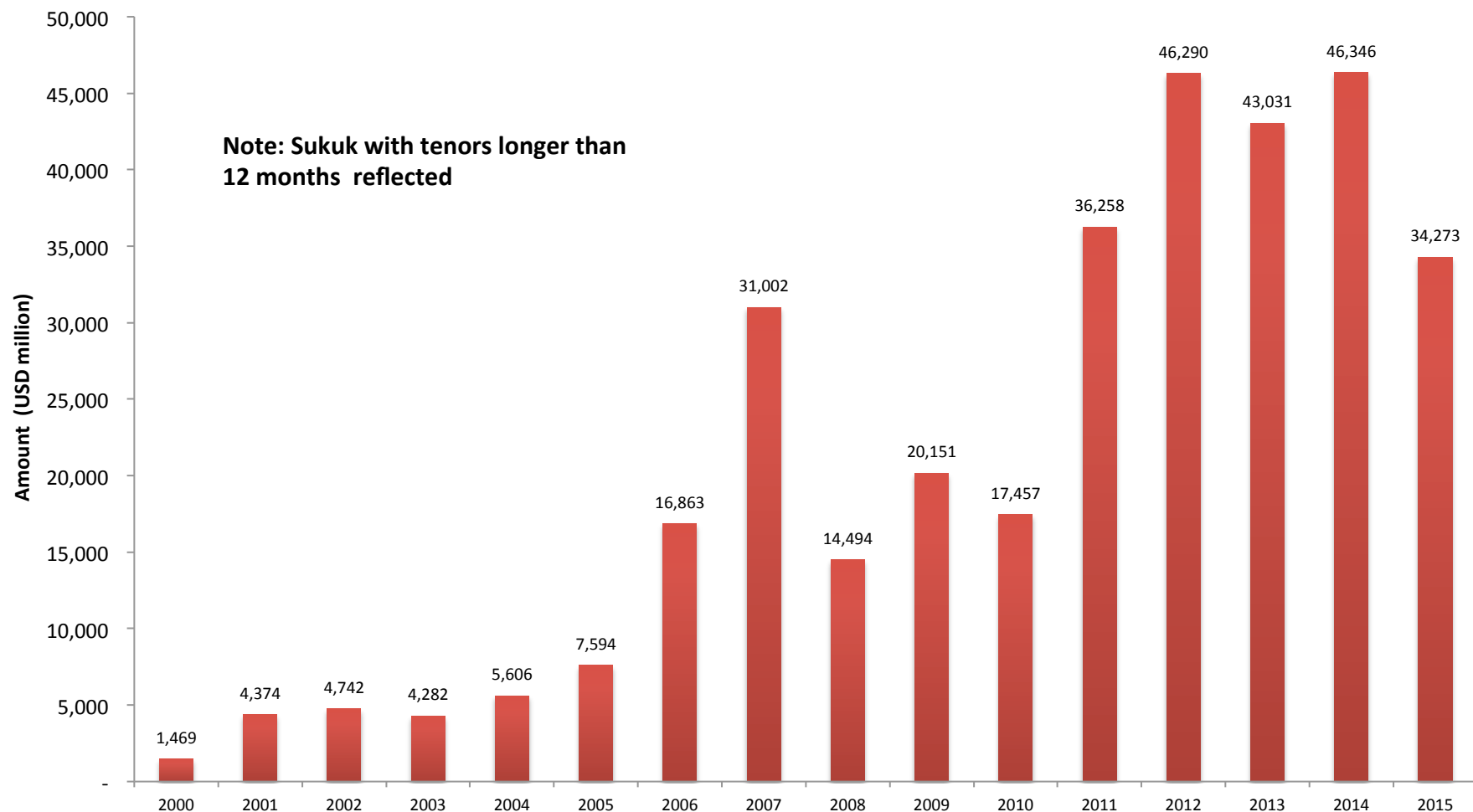
Overview of the global Islamic Finance industry



The total assets of the Islamic finance industry is expected to surpass USD 4.0 trillion by 2020

* Source: International Centre for Education in Islamic Finance (INCEIF) and Malaysia International Islamic Financial Centre (MIFC)

Global sukuk issuance



*Source: Bloomberg

Section 4

Sovereign Sukuk

The rise of sovereign Sukuk issuances

Apart from financing government spending, governments in nascent Sukuk markets have issued Sukuk to **establish a benchmark for future issuances**

The issuance of the Hong Kong, UK and Luxembourg debut sovereign Sukuk created new benchmarks and would help develop their domestic Sukuk markets

Sovereign and quasi-sovereign issuers are expected to drive growth in the global sukuk market

As the regulatory, tax and Shariah frameworks are assimilated, the market becomes active with sovereign issuances. **Corporate issuance are likely to emerge soon after**

The challenge moving forward is to extend the success of sovereign issuances to corporate issuances

Government support in providing a level-playing field and sovereign issuances will attract corporate participants into the market

Sukuk can also provide **'diversification'** opportunities for investors

Sukuk appeal to both sets of investors – the conventional fixed-income investors, as well as the vast Islamic financial community in search of “quality” papers

Top-down Approach = **THE** Preferred Approach

The importance of sovereign Sukuk issuances to the growth of the Sukuk market

- Several factors are driving sovereigns to participate in the Sukuk market, including:
 - the desire to establish a benchmark and to encourage the development of a corporate Sukuk market in the relevant country or territory
 - the need to develop a legal and regulatory framework that recognizes and facilitates the issuance of Sukuk - especially in jurisdictions where Islamic principles are not enshrined in national law
- As a result of these drivers, sovereign issuers constitute a greater proportion of the global Sukuk market than of the conventional bond markets
 - The value of international bond issuances reached around US\$6.4 trillion in 2014, only around 10% of which was issued by sovereign and quasi-sovereign entities
 - In comparison, the value of international sukuk issued in 2014 reached US\$114 billion, of which 85% was issued by sovereign and quasi-sovereign entities
- Despite the dearth of corporate issuances, the entrance of new issuers to the Sukuk market, particularly those governments representing strong credit, will nevertheless support growth in the Sukuk market over the longer term and help attract new investors to the sector, providing additional depth and liquidity to the Sukuk market

Source: Islamic Finance News (IFN)

List of global sovereign Sukuk issuances

Date of Issuance	Sovereign	Issue Size (USD million)	Tenure (years)	Structure
3 Jul 2002	Malaysia	600	5	Ijara
27 Jan 2005	Pakistan	600	5	Ijara
18 Mar 2008	Bahrain	350	5	Ijara
23 Apr 2009	Indonesia	650	5	Ijara
17 Jun 2009	Bahrain	750	5	Ijara
3 Nov 2009	Dubai	1250	5	Ijara
4 Jun 2010	Malaysia	1250	5	Ijara
6 Jul 2011	Malaysia	1,200 / 800	5 / 10	Wakala
21 Nov 2011	Indonesia	1,000	7	Ijara
22 Nov 2011	Bahrain	750	7	Ijara
2 May 2012	Dubai	600 / 650	5 / 10	Ijara
18 Jul 2012	Qatar	2,000 / 2,000	5 / 10	Ijara
26 Sep 2012	Turkey	1,500	5.5	Ijara
21 Nov 2012	Indonesia	1,000	10	Ijara
30 Jan 2013	Dubai	750	10	Ijara
17 Sep 2013	Indonesia	1,500	5.5	Ijara
10 Oct 2013	Turkey	1,250	5	Ijara

Source: CIMB, Bloomberg

List of global sovereign Sukuk issuances (cont'd)

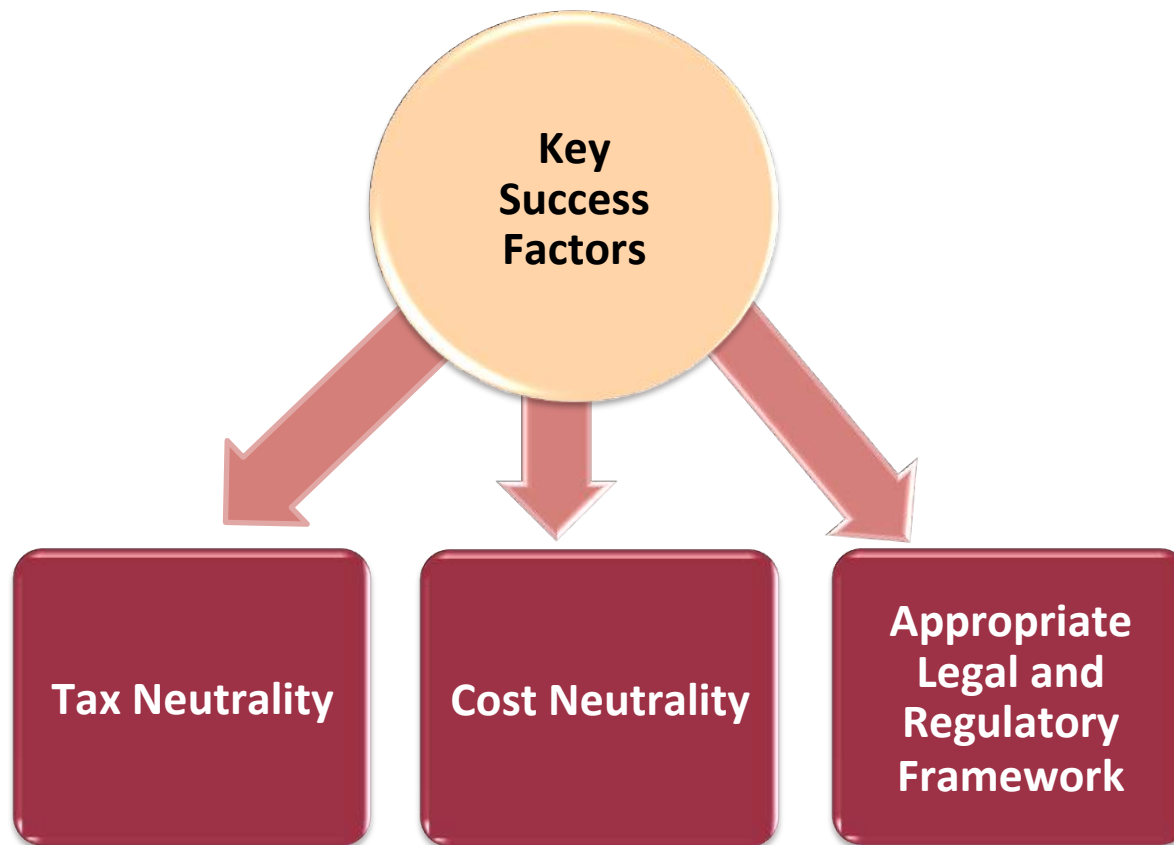
Date of Issuance	Sovereign	Issue Size (USD million)	Tenure (years)	Structure
30 Apr 2014	Dubai	750	15	Ijara
2 July 2014	United Kingdom	334 (<u>GBP 200</u>)	5	Ijara
10 Sep 2014	Indonesia	1,500	10	Wakala
17 Sep 2014	Sharjah	750	10	Ijara
18 Sep 2014	Hong Kong	1,000	5	Ijara
18 Sep 2014	South Africa	500	5.75	Ijara
7 Oct 2014	Luxembourg	254 (<u>Euro 200</u>)	5	Ijara
25 Nov 2014	Turkey	1,000	10	Ijara
3 Dec 2014	Pakistan	1,000	5	Ijara
22 Apr 2015	Malaysia	1,000 / 500	10 / 30	Wakala
28 May 2015	Indonesia	2,000	10	Wakala
3 Jun 2015	Hong Kong	1,000	5	Wakala
27 Jan 2016	Sharjah	500	5	Ijara

Source: CIMB, Bloomberg

Section 4

Growth drivers for a Sukuk market

Sukuk market growth drivers



Sukuk market growth drivers (cont'd)

Tax Neutrality

- Globally acceptable Sukuk structures, namely Ijara and Wakala, typically involve the transfer of beneficial interest in assets such as land and buildings
- Such transfers tend to attract taxes and/or stamp duty under national land laws/regulations
- To provide a level-playing field for Sukuk transactions, such transfers should be viewed as part of financing and therefore exempted from taxes and/or stamp duty that would otherwise be applicable

Cost Neutrality

- Having a level-playing field from a tax angle, so that a Sukuk issuer does not have to bear extra cost relative to issuing conventional bonds
- Transaction advisers, including legal, tax and accounting advisors, do not charge a premium for advising on Sukuk transactions - this would take place when Sukuk transactions become a norm in a particular jurisdiction and advisors become familiar with the workings and documentation involved

Appropriate Legal and Regulatory Framework

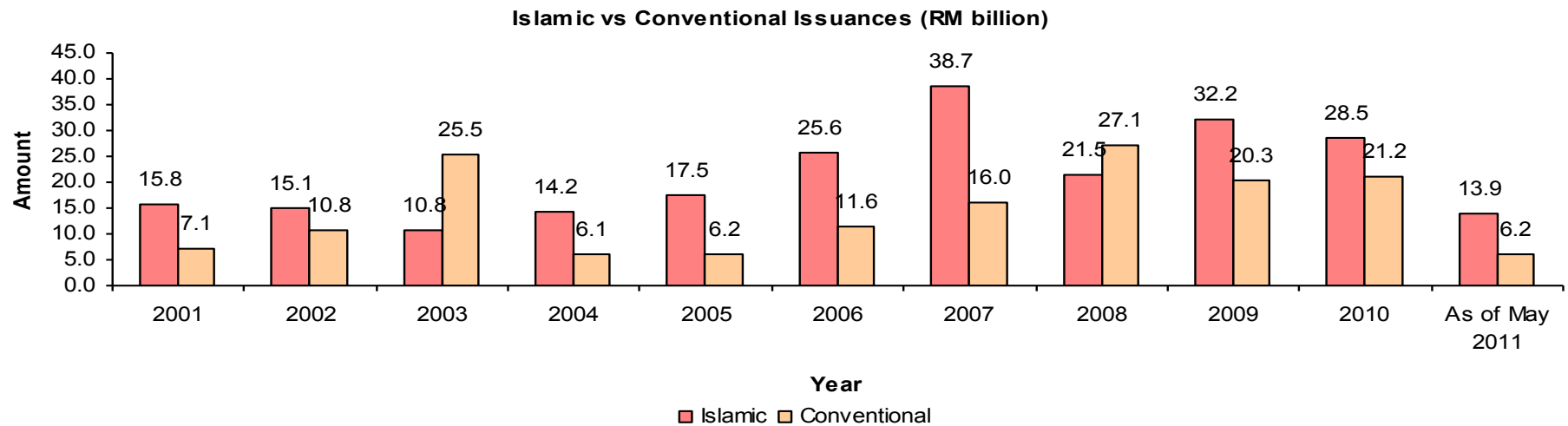
- The existence of frameworks that recognize and facilitate the issuance of Sukuk from a local perspective
- This should extend to remedies available to Sukuk investors in the event of default, which should be as comprehensive as that available for investors in conventional bonds

Malaysia

Legislation & incentives provided boost for Sukuk

- 2000: Comprehensive Islamic Capital Market Guidelines & Islamic Capital Market Master Plan introduced
- 2004: Introduction of Guidelines on Issuance of Islamic Securities by Securities Commission (“SC”)
- 2005: Tax legislations provide exemptions for banking & Islamic securities for sale, purchase and lease of assets
- 2006: Allowance of non-RM Sukuk issuances by foreign entities
- 2007: Securities Commission accorded specific flexibilities under the SC's Practice Note 1A to expedite the issuances of foreign currency - denominated Sukuk in Malaysia

Malaysia (cont'd)



Hong Kong

- In July 2013, the Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Ordinance 2013 was gazetted, conforming the tax treatment for Islamic securities to conventional debt securities
- The changes aim to create a "level playing field" for Sukuk and reinforce Hong Kong's position as the global financial center:
- **Although the law is not intended to confer preferable tax treatment for Sukukholders, it would encourage local issuers to consider tapping the Sukuk market given that the previous impediments have now been removed**

Hong Kong (cont'd)



**Government of
Hong Kong**
Sept 2014

USD1.0 billion Trust Certificates due 2019 - Ijara
- inaugural Sukuk issuance by the HKSAR Government

Assets:

Sukuk Assets (100%)

HKSAR Government-owned properties used by various HKSAR Government departments as offices



**Government of
Hong Kong**
May 2015

USD1.0 billion Trust Certificates due 2020 – Wakala

- second Sukuk issuance by the HKSAR Government
- asset-efficient structure with 1/3 Ijara assets and 2/3 Murabaha commodities

Assets:

i. Lease Assets (not less than 34%)

HKSAR Government-owned properties used by various HKSAR Government departments as offices

ii. Commodities (not more than 66%)

United Kingdom

- In 2007, a new concept in UK Tax law was created – the alternative finance investment bond (AFIB) (i.e. Sukuk). AFIB is treated as a loan relationship - all tax rules for corporate debt apply to the AFIB
- UK: Finance Act 2009 provided SDLT relief to Sukuk, capital gains tax relief for transfers of land to and from Sukuk issuance vehicles, and ensured entity or person obtaining financing continues to be able to claim capital allowances while land is held by Sukuk issuance vehicle.
- Financial Services & Market Act 2000 Order 2010 created new category for Sukuk and enabled Sukuk to avoid a higher regulatory burden compared to conventional bonds.

United Kingdom



**Government
of the
United Kingdom**

June 2014

GBP200.0 million Trust Certificates due 2019 – Ijara
- first sovereign Sukuk issued outside the Islamic world

Assets:

Premises (100%)

UK Government-owned land and buildings

Luxembourg

- In July 2014, the Luxembourg Parliament approved the draft law on a sale and buy-back transaction of real estate assets necessary to issue an Islamic finance bond. This paved the way to the issuance of Sukuk, a milestone in the continuous development of Islamic finance in Luxembourg

South Africa

- In 2011, tax amendments were introduced to allow the government to issue Sukuk. This was extended to public entities in April 2015

Indonesia

- Law No. 19 of 2008 on Sovereign Sukuk (Surat Berharga Syariah Negara) enacted, which set the stage for Republic of Indonesia to be the most prolific sovereign Sukuk issuer to date.

Singapore

- Under Financial Sector Incentive scheme, gave preferential tax treatment for Islamic finance, with a 5 year concessionary tax rate of 5% in 2002, and extended in 2008 for a period of 5 years until the end of 2013.

Section 6

China – the next frontier for Sukuk?

China – key questions

- **Framework for Islamic Finance.** Are the necessary amendments to the regulatory, legal and tax frameworks in place to facilitate Sukuk issuances and the development of a Sukuk market?
- **Recognition of transfer of beneficial interest in assets.** To facilitate the Sukuk transaction, the Issuer transfers beneficial interest in tangible and leasable immovable or movable assets to an SPV.
 - Does the law recognise the transfer of beneficial interest (as opposed to registered legal interest) in assets?
 - Does the transfer of assets require approvals from government, e.g. immovable assets?

China – key questions (cont'd)

- **Trust Laws.** The SPV holds assets on trust for the benefit of Sukukholders. Does the law allow trustees to hold assets/portfolios on trust for the benefit of Sukukholders?
- **Tax on transfer of beneficial interest.** Certain Sukuk structures would involve amongst others, the transfer of beneficial interest in tangible assets and the repurchase of the same assets upon certain events, including scheduled maturity of the Sukuk, solely for the purpose of facilitating an issuance of Sukuk. Do these transfers attract any relevant duties, gain tax, etc.?

China – key questions (cont'd)

- **Tax on disposal of assets.** Globally acceptable Sukuk structures (e.g. Wakalah and Ijarah) typically involve disposal of properties/assets. Do these transfers attract any relevant duties, gain tax, etc.? Does the tax framework recognise Sukuk issuances as similar to conventional bonds and therefore exempt disposals that facilitate a Sukuk issuance from otherwise applicable taxes?

Thank You

Please direct all queries to:

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Middle East Institute

Panel 5: Sukuk



Middle East Institute

Brunei Darussalam

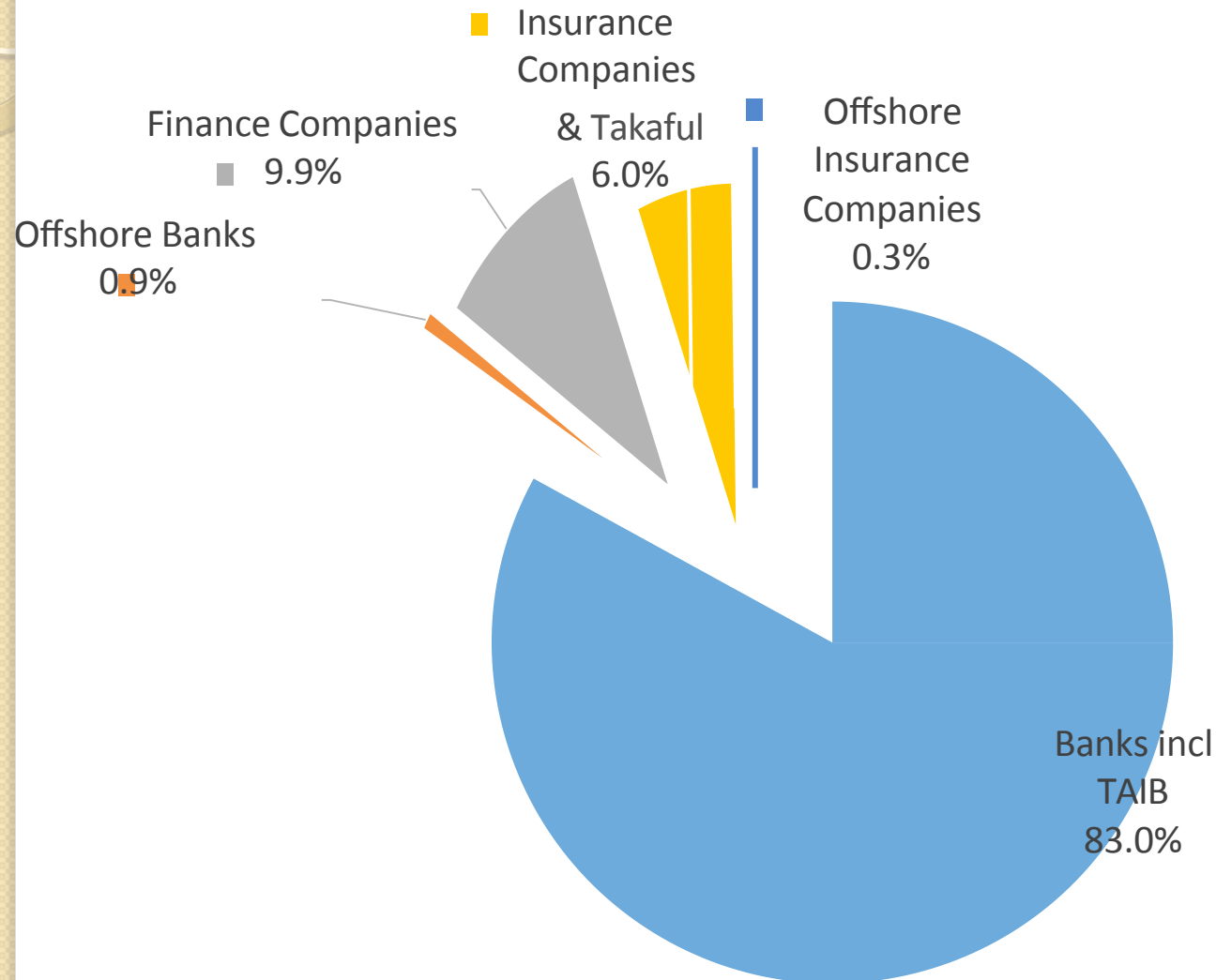
Mr Makhtar Abdullah

Former CEO
CIBFM Brunei

SNAP SHOT of Brunei

- IMF Recent Report 2015
- Asian Development Bank
- Industry Composition:
 - ✓ Banks (7 full banks + 1 restricted banking license)
 - ✓ 1 Islamic Trust Fund (Perbadanan TAIB)
 - ✓ 2 licensed off-shore banks under IBO 2006
 - ✓ 2 Takaful operators
 - ✓ 1 Islamic Leasing
 - ✓ Sukuk issued
- Islamic Banking Assets 2007 (39%)& 2014(41.1%)

Structure of Financial System



Structure of Financial System

Financial Institutions, Regulated by AMBD	2014	
	Amount B\$ mn	Share of Total Assets, %
Deposit Taking Institutions	21,051	93.8
Banks inc TAIB	18,627	83.0
Conventional	9,395	41.9
Islamic	9,232	41.1
Finance Companies	2,212	9.9
Off-shore Banks	212	0.9
Other Financial Institutions	1,396	6.2
Insurance Companies & Takaful	1,337	6.0
Conventional	952	4.2
Takaful	385	1.7
Offshore Insurance Companies	59	0.3
Total Assets	22,447	100.0

AMBD

- Est. 1/01/2011 under AMBD Order 2010
- Amalgamations of 4 div. previously under MOF:
 - Financial Institutions Division (FID)
 - Brunei Currency and Monetary Board (BCMB)
 - Brunei International Financial Centre (BIFC)
 - Part of the Research and International Division (RID)
- **MAIN FUNCTIONS**
 - Conduct of monetary policy
 - Currency Issuance and Management
 - Supervision of Banks and Financial Institutions

FUNCTION & OBJECTIVES

FUNCTION

We license, supervise and regulate all banks and finance companies (both Islamic and conventional).

To ensure safety and soundness of banks and finance companies

To ensure compliance by banks and finance companies with the provisions of the various legislations

To ensure a level playing field between the players in the industry

To formulate regulation from time to time to meet the needs and developments of the industry

To protect the interests of consumers and public in relation to banking products and services

Legislations & Regulations

- ❖ Banking Order, 2006
- ❖ Islamic Banking Order, 2008
- ❖ International Banking Order, 2000

➤ List of Notices & Guidelines issued pursuant to Banking Order, 2006:

<http://www.ambd.gov.bn/Pages/Legislation- And-Regulations>

Banks' Key Financial Soundness Indicators (FSIs)

Financial Sector Indicators, Percent	2013	2014	International benchmark
Capital Adequacy			
Regulatory Capital to Risk Weighted Assets	20.4	21.8	8.0
Tier 1 Capital to Risk Weighted Assets	21.2	22.3	4.0
Non Performing Loans (Net of Specific Provisions) to Capital Funds	4.5	4.1	NA
Assets Quality			
Non Performing Loans to Gross Loans (Exclude Interest in Suspense)	5.7	4.6	2.0
Net Non Performing Loans (Net of provisions) to Gross Loans	1.6	1.5	1.0
Provision Coverage (Specific Provisions to Total NPLs)	70.9	66.6	NA
Profitability			
Return on Assets (Before Tax)	1.3	1.5	1.0
Return on Equity (After Tax)	10.2	11.3	20.0
Non-Interest Expense to Gross Income (Efficiency Ratio)	50.3	49.1	50.0
Liquidity			
Liquid Assets to Total Assets	56.2	53.7	20.0
Liquid Assets to Total Deposits	64.9	62.5	NA
Liquid Assets to Demand and Savings Deposits (Non bank customers)	113.1	121.5	NA
Loans to Deposits Ratio	33.6	35.4	50.0



Incompatibilities between AAOIFI and IFRS

Accounting Standards:

Practical lessons learned from conversions

Denny Hanafy

Director, Accounting Advisory Service

February 2016



About KPMG Accounting Advisory Service



KPMG has more than
155,000 people
across **155** countries

KPMG Singapore Accounting Advisory Service

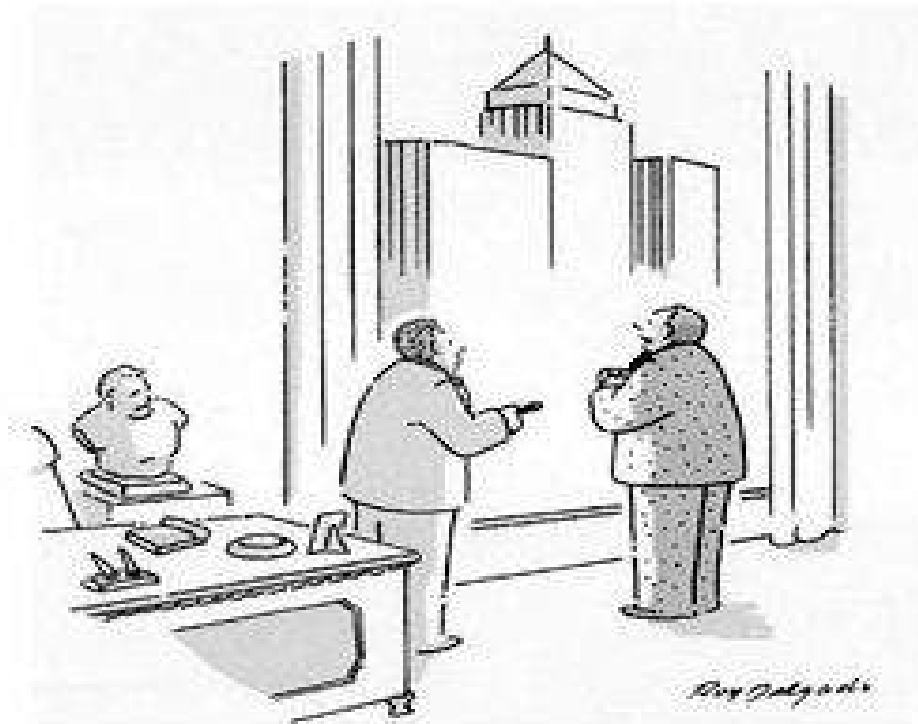
KPMG Accounting Advisory Services (AAS) team helps global and local companies respond to today's accounting and financial reporting challenges in a timely and efficient manner. We provide assistance in transaction structuring, IFRS adoption and conversion, technical accounting assistance, IPO advisory, M&A accounting advisory, training, among others.

KPMG in Singapore is led by more than 90 partners and hires over 2,400 professionals

We are one of the largest professional services firms in Singapore with a mix of both international and local clients. Our professionals possess practical, deep industry experience across key sectors of the domestic and global economies to ensure we have a clear understanding of our clients' needs, ensuring we respond with the right advice.



Perspective on Financial Reports



"We're in good shape.
Nobody understands our financial statement."

Source: www.cartoonstock.com

IFRS Around The World

Region	No. of jurisdictions	Require IFRS for all or most domestic publicly accountable entities	As a percentage of jurisdictions in the region	Permit/require IFRS for some (but not all or most) domestic publicly accountable entities	Neither require nor permit IFRS for any domestic publicly accountable entities
Europe	43	42	98	1	0
Africa	19	15	79	1	3
Middle East	9	8	89	1	0
Asia-Oceania	32	24	75	3	5
Americas	37	27	73	8	2
Total	140	116	83	14	10
Percentage of total	100%	83%		10%	7%

Source: IASB at www.ifrs.org



IFRS vs. AAOIFI Differences

- Recognition of financing profit
- Debt vs. Equity classification of profit sharing arrangements
- On vs. Off Balance Sheet treatment
- Finance lease accounting
- Takaful vs. Insurance accounting
- Others....

IFRS \neq AAOIFI

Illustrating The Impact

A Bank offers financing to a customer of \$100,000. The profit amount is \$7,000 per year (7%). The customer pays in instalments of 27,000 over 5 years.



Period	Balance Sheet (Financing Balance)	P&L (Profit)
1	80,000	7,000
2	60,000	7,000
3	40,000	7,000
4	20,000	7,000
5	0	7,000
Total		35,000

The IFRS Perspective

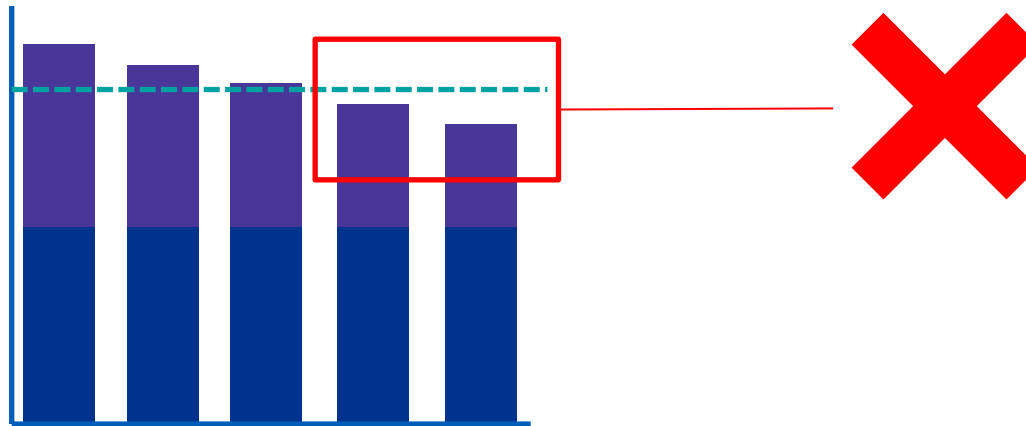
IAS 39.9 *“The effective interest method is a method of calculating the amortised cost of a financial asset or a financial liability [...] The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument...”*

Period	Straight Line		Effective Interest		Differences	
	Balance Sheet	P&L	Balance Sheet	P&L	Balance Sheet	P&L
1	80,000	7,000	83,916	10,916	3,916	3,916
2	60,000	7,000	66,077	9,160	6,077	2,160
3	40,000	7,000	46,290	7,213	6,290	213
4	20,000	7,000	24,343	5,053	4,343	(1,947)
5	0	7,000	0	2,657	0	(4,343)
	Total	35,000	Total	35,000		

Effective interest rate: **11%... Time value of money?**

Did We Meet Our Target?

Financial Statement Implications



- Depending on period of adoption, profitability changed. Budget, target and forecast are also impacted
- Total asset, total liability and equity also changed, resulting in changes in ratios (ex. leverage ratio) potentially impacting covenant and potentially regulatory ratios

Where's My Bonus?

KPI and Incentive Implications

- Profit recognized earlier under IFRS would not be reflected in future earnings as initially expected under straight line method
- Departmental KPIs changed as well, in particular if certain upfront profit has been recognized as a basis for performance evaluation
- IFRS adoption resulted in long discussion on the basis for performance evaluation



How Do We Do This?

Operational Implications

125,724 financings...

1 to 22 years left to maturity...

18,104,287 future cash flows to adjust to Effective Interest Rate method...

Additional complexity on restructuring, payment delays, delinquencies, etc



Contractual Aspects?

Legal, Regulatory and Contractual Implications

Period	Straight Line		Effective Interest		Differences	
	Balance Sheet	P&L	Balance Sheet	P&L	Balance Sheet	P&L
3	40,000	7,000	46,290	7,213	6,290	213

- Which balance do we report on our customer statements?
- Which balance will be honored in bankruptcy court?
- Which balance will be recognized by central bank for regulatory reporting purpose? (or tax filing for tax calculation purpose)
- IFRS prescribe continual accrual on outstanding balance even on payment delays, but these additional profit can not be claimed from the customer?
- If we use discounting / time value of money on our financial statement, will we still be Shariah compliant?

The Path Ahead – IFRS 9

One of the requirement for financial assets not to be fair valued (i.e. at amortized cost):

“the contractual term of financial asset give rise [...] to cash flows that are solely payments of principal and interest...” [IFRS 9.4.1.2(b)]

“interest consists of consideration for the time value of money, for the credit risk...” [IFRS 9.4.1.3(b)]

All Islamic financing products will need to be at **fair value** under IFRS 9?



Square Peg On A Round Hole?

- Greater representation in IASB
- Comparability vs. Uniqueness
- Alignment of interpretation





Thank you



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BIOGRAPHIES FOR APPENDIX CONTRIBUTORS

Denny Hanafy

Denny Hanafy is a Director in the Accounting Advisory Service line of business of KPMG Singapore where he provides advice to both conventional and Islamic financial institutions in areas such as accounting conversion, hedging transactions, lease structuring and other related topics. Mr. Hanafy is also a key technical topic team specialist in KPMG on new development of accounting standards – in particular on addressing how they impact different industries. Mr. Hanafy has worked extensively on accounting conversions and adoptions in various countries such as US, Japan, Singapore, Malaysia, and Indonesia. Prior to joining Singapore's Accounting Advisory Service group, Mr. Hanafy was a manager with KPMG New York where he had been involved in various financial institutions' risk management and control practices, as well as application of various accounting standards.

Tahir Ali Sheikh

Tahir Ali Sheikh has seventeen years of experience in asset management, capital markets, project financing and private equity in the Middle East, Central, South and South-East Asia. He is currently the Head, Islamic Asset Management and Investments at CIMB Islamic, managing Shariah aspects of CIMB Group's USD 5.7 billion AUM Islamic investment management business.

Mr. Sheikh was previously a Director with the private equity fund manager CapAsia, a one-time wholly owned subsidiary of CIMB Group. Prior to joining CapAsia, Mr. Sheikh led project and corporate finance transactions as Vice President with the Abu Dhabi Islamic Bank. Mr. Sheikh has also worked at the Islamic Development Bank as Projects Officer managing a portfolio of USD 2.3 billion. Mr. Sheikh started his career as an engineer with BP in Pakistan in 1996. Mr. Sheikh is a CFA Charterholder and has MPA degree from Harvard University in the United States. He also holds B.Sc. in Mechanical Engineering and MBA degrees from Pakistan.

Makhtar Abdullah

With legal and accounting background he had the opportunity to get hands on exposure in finance, corporate turnaround and international marketing covering various industries. Islamic banking and Shari'ah advisory is always his subjects of interest compared to oil and gas, retail, aviation, IT, capital market and modern farming which he has been exposed too. Assigned as the CEO (between 2011-2015) for Centre for Islamic Banking Finance and Management (CIBFM), under Ministry of Finance and Autoriti Monetari Brunei Darussalam, actively Involved in the setting up of CIBFM (focusing on Human Talent Development) to spearhead Brunei's government process of transformation Brunei financial sector from its current position of BND\$500 million towards BND\$8 billion mark by 2035. More than 3,900 participants from about 69 organizations (including 68% of Brunei financial industry work force) attended more than 190 programs organized since June 2011.

He was also appointed as part time lecturer in Brunei Islamic University and Brunei government servant leadership development program. Moderating international conferences and seminars in ASEAN and Middle East. Invited as committee member in various national level initiatives including IFRS conversion, Capital Market

Development (including Stock Exchange) and National Financial Shari'ah Council and Shariah Governance review. Initiated a unique Junior Shari'ah Scholars Training program for Brunei financial industry succession plan. Prior to his assignment at CIBFM Brunei, Makhtar worked with Amanie Islamic Finance Learning Centre in Dubai.

Cecep Maskanul Hakim

Cecep Maskanul Hakim is a Senior Bank Supervisor in the Islamic Banking Department at the Financial Services Authority of Bank Indonesia. He received both his Master in International Economics and his Bachelors in Economics from International Islamic University Islamabad. He has more than 20 years of experience working in the field of Islamic Finance.

Rifki Ismal

Dr. Rifki Ismal is a bank researcher at Directorate of Islamic Banking, Bank Indonesia. He is also a lecturer at Faculty of Economics, University of Indonesia where he got his BA in economics in 1997. Upon obtaining BA and working at Bank Indonesia for 3 years, Dr. Ismal received his master degree in applied economics from Department of Economics, University of Michigan, ann arbor, USA in 2003. Then, he got a PhD degree in Islamic Banking and Finance from Durham University, England. His areas of interest are Islamic banking and finance, Islamic economics and monetary policy and he was a visiting researcher (research on Indonesian bond market) at Bank for International Settlements (BIS) in Hong Kong besides a lecture on Islamic risk management at Strasbourg school of business (France). Currently, he is a member of IFSB working group on stress testing and one of the experts in UNCTAD (United Nations) experts on Service and Trade. During his routine activities, Dr. Ismal has published many papers in various international journals.