Islamic Finance Country Index (IFCI): methodology and results

The Islamic finance industry has come a long way from its humble roots to assume a significant position in the wider financial framework. IFIs total around 500 and are geographically spread across 75 countries. The size of the industry is approximately USD 1.1 trillion and estimated to have an annual growth rate of 10% per annum despite the difficult overall economic environment. It is now time for the masses to establish with greater certainty where the industry really stands, and see if an objective view can be taken on the current state of affairs in the industry, in order to formulate policies / strategies towards a sustainable future course. Indeed central banks, regulatory bodies, state governments, investors, financial institutions, consumers and other stakeholders in the industry would like to take a more informed decision based on objective reasoning, as opposed to merely following subjective fantasy.

An area of particular interest is gauging the depth and incidence of Islamic finance across the globe. It is also important to understand the elements that make one country more conducive to progressing with Islamic finance as compared to another. Even when relying on quantitative information, it is important that conclusions

VARIABLES AND THE DESCRIPTION

VARIABLES	**DESCRIPTION**
Muslim Population	Represents the absolute number of Muslims living in a country
Number of Institutions involved in Islamic Finance Industry	Represents both banking and non-banking institutions involved in Islamic finance in a country
Number of Islamic Banks	Represents fully fledged Islamic banks in a country of both local and foreign origins
Size of Islamic Financial Assets	Represents all assets relating to the industry in a country
Size of Sukuk	Represents total size of sukuk issued but still outstanding in a country
Regulatory and Legal Infrastructure	Represents the presence of regulatory and legal environment enabling IFI to operate in the country on a level playing (e.g., Islamic banking act, Islamic capital markets act, takaful act etc.)
Central Shari'a Supervisory Regime	Represents the presence of a state-representative body to look after the Shari'a-compliancy process across the IFI in a country
Education and Culture	Represents the presence of an educational and cultural environment conducive to operations of the IFI (this could be formal Islamic finance qualifications, degree courses, diplomas, and dedicated training programmes)

are not based on univariate observations. Unfortunately, however, a common perception about country ranking is based on univariate analysis.

Univariate analysis is the usual way of assessing countries against one another based on one or more variables. In doing so, however, each variable is studied in isolation from others, and as such, it is unable to help form a definitive collective view. Mere dependence on individual observation to a particular question of interest could be misleading if due weight is not attached to each observation. An isolated analysis, though useful, therefore remains limited in terms of its reliable acceptance.

It is only fair to rank countries by looking at all the available information and form a collective view – a multivariate analytical approach. This study therefore aims at developing a unique and completely objective Islamic Finance Country Index (IFCI) – the first of its kind and a major breakthrough in appraising the industry. IFCI is based on multivariate analysis of available information on countries included in the analysis, whereby each category of information is assigned weights by the analytical system in a purely statistical fashion. Below, we describe the process of constructing the IFCI, together with the description of data used and its respective limitations.

The IFCI aims to rank countries involved in the industry on the basis of available information/data on various variables of interest across each of these countries, by conducting a multivariate analysis in a purely objective manner to avoid any personal bias / a priori judgement affecting the outcome. Construction of the IFCI began with letting the data speak for itself. To that end, the IFCI focused on gathering data on 15 different variables of interest across 75 countries in the world. The heterogeneous nature of each of these countries and inadequacy of data resulted limited the IFCI to only 36 countries, with the focus reduced to just 8 variables. In all cases, data has been collected from various secondary sources; including central regulatory bodies, individual IFI's published accounts, global agencies' websites, various periodicals, authentic newspapers, and other country specific resources involving extensive data search procedures. Below is the list of these variables and the way they are defined for the purposes of IFCI:

Data was gathered on the above 8 variables for all 36 countries included in the IFCI. The data was then coded and organized to enable multivariate analysis and eventual construction of the IFCI using SPSS. In a multivariate analysis, one is always interested in knowing first the structure of data/information collected – i.e. whether the various levels of moments are observed to see if data has any useful information content to draw inferences from. Factor analysis is one correlational technique to determine meaningful clusters of shared variance in the data set. It attempts to identify underlying variables that explain the pattern of correlations within a set of observed variables. This procedure is often used to reduce the number of variables in a data set but can also be used to explore the latent structure of the variables in the data file – a purpose for which we employed Factor Analysis.

In order for Factor Analysis to be applicable, it is important that the data fits a specification test for such an analysis. The Kaiser-Meyer-Olkin Measure of Sampling Adequacy is a statistic that indicates the proportion of variance in observed variables that might be caused by underlying factors. High values (close to 1.0) generally indicate that a Factor Analysis may be useful with data. If the value is less than 0.50, the results of the Factor Analysis probably won't be very useful. We found this measure to be 0.8, which is reasonably close to 1.0 and hence provided us comfort that the data was fit for Factor Analysis. Bartlett's test of sphericity is another specification test which tests the hypothesis that the correlation matrix is an identity matrix, which would indicate that given variables are unrelated and therefore unsuitable for structure detection. Small values (less than 0.05) of the significance level indicate that a factor analysis may be useful with the data. In our case, this test value was found to be significant at 0.00 level which was another strong confirmation that the data set was of a high quality and very fit for Factor Analysis.

Once satisfied with specification tests, we ran Factor Analysis to compute Initial Communalities using Principal Axis Factoring method of factor extraction. For correlation analyses, Initial Communalities measure the proportion of variance accounted for in each variable by the rest of the variables. This procedure provided us a statistically significant method of assigning objective

VARIABLES AND % WEIGHTS

VARIABLES	% WEIGHTS
Number of Islamic Banks	21.8
Central Sharia Supervisory Regime	19.7
Number of Institutions involved in Islamic Finance Industry	20.3
Size of Islamic Financial Assets	13.9
Size of Sukuk	6.6
Muslim Population	7.2
Education and Culture	5.7
Regulatory and Legal Infrastructure	4.9

weights to all 8 variables entering the data set in a collective fashion. As a result of data speaking for itself in a multivariate manner, any subjectivity or univariate objectivity was completely ruled out in assigning the weights. These weights, in order of their respective significance, are reported in the table below:

The above table indicates interesting findings as to which variables contribute greatly towards the ranking of countries. Interestingly, it appears that countries with a higher number of full fledged Islamic banking institutions stand greater chances of ranking high in the list. On this basis, one would expect Bahrain to top the list with 26 banks, followed by Iran, Malaysia, Indonesia, Sudan, UAE, Saudi Arabia and Kuwait. However, as confirmed by the results of the multivariate analysis, this is not the case in reality – indeed what is clear from the findings here, is that future growth lies in establishing more Islamic banking and financial institutions (with a greater emphasis on these being fully fledged Islamic as opposed to Islamic windows) . The most striking observation to note is that countries with a formal state level Shari'a supervisory regime are better placed to rank higher (Iran, Malaysia, Pakistan, Indonesia, Bahrain, Kuwait and Sudan may sound as the only candidates on this basis as such regimes do not exist at the moment in other countries in the world). A clear message to emerge from this finding is that prospects of growth are higher in those counties where Central Shari'a Supervisory regimes are already in place or in the making. In the past, the most popular measure of a country ranking used has been to look at the size of Islamic financial assets. On this basis, one can intuitively expect countries like Iran, Saudi Arabia, Malaysia, UAE, Kuwait, Bahrain and Qatar to top the list. However, as noted by the multivariate country index discussed below and the lower weight assigned to it in the table above, this is indeed a misleading measure of a country ranking – the contribution of this variable is yet reasonably strong at a level of 14%. Surprisingly, being active in the sukuk market does not necessarily contribute extensively in country ranking. This is also true in case of the size of the Muslim population in a country and as such mere presence of Muslims in a country does not necessarily guarantee a higher place in the ranking. While one would expect presence of a supportive regulatory and legal framework to have a high positive correlation with ranking of the country, it appears, on the contrary, to contribute least by having a lower positive correlation. Educational and cultural awareness in a country is also an important contributor but far less than a Central Shari'a Supervisory regime for example.

The weights listed in the table above were then used to create an additive country index accounting for all 288 observations across 36 countries and 8 variables. The index model followed the specification below:

$$IFCI(Cj_{j=36}^{j=1}) = \sum_{i=8}^{i=1} Wi.Xi$$

Where C = Country
W = Weight for individual variable
X = Variable

Using the above specification and the objectively calculated weights, we construct the **first ever objective ranking of the countries involved in the Islamic Finance Industry** as shown in Figure 1 and 2 below. This ranking does not rely on observing individual variables and even when we were able to estimate the relative importance of each of these variables, they were employed together in a multivariate manner to come up with a final ranking. As shown by the calculations, **Iran** tops the list by ranking 1st in the list of 36 countries. It is followed by **Malaysia** while **Saudi Arabia** stood 3rd. It is important to note that on a univariate basis, if, for example, a view was to be taken on the basis of Size of Islamic Assets only, while Iran would have maintained 1st position Malaysia would have ranked 3rd (a potentially misleading observation). On the other hand, if a univariate view was taken based on number of total Islamic financial institutions, Malaysia would have topped the list, followed by Saudi Arabia and then Iran. However, multivariate findings have asked us to be careful in drawing conclusions based on isolated analysis of these variables.

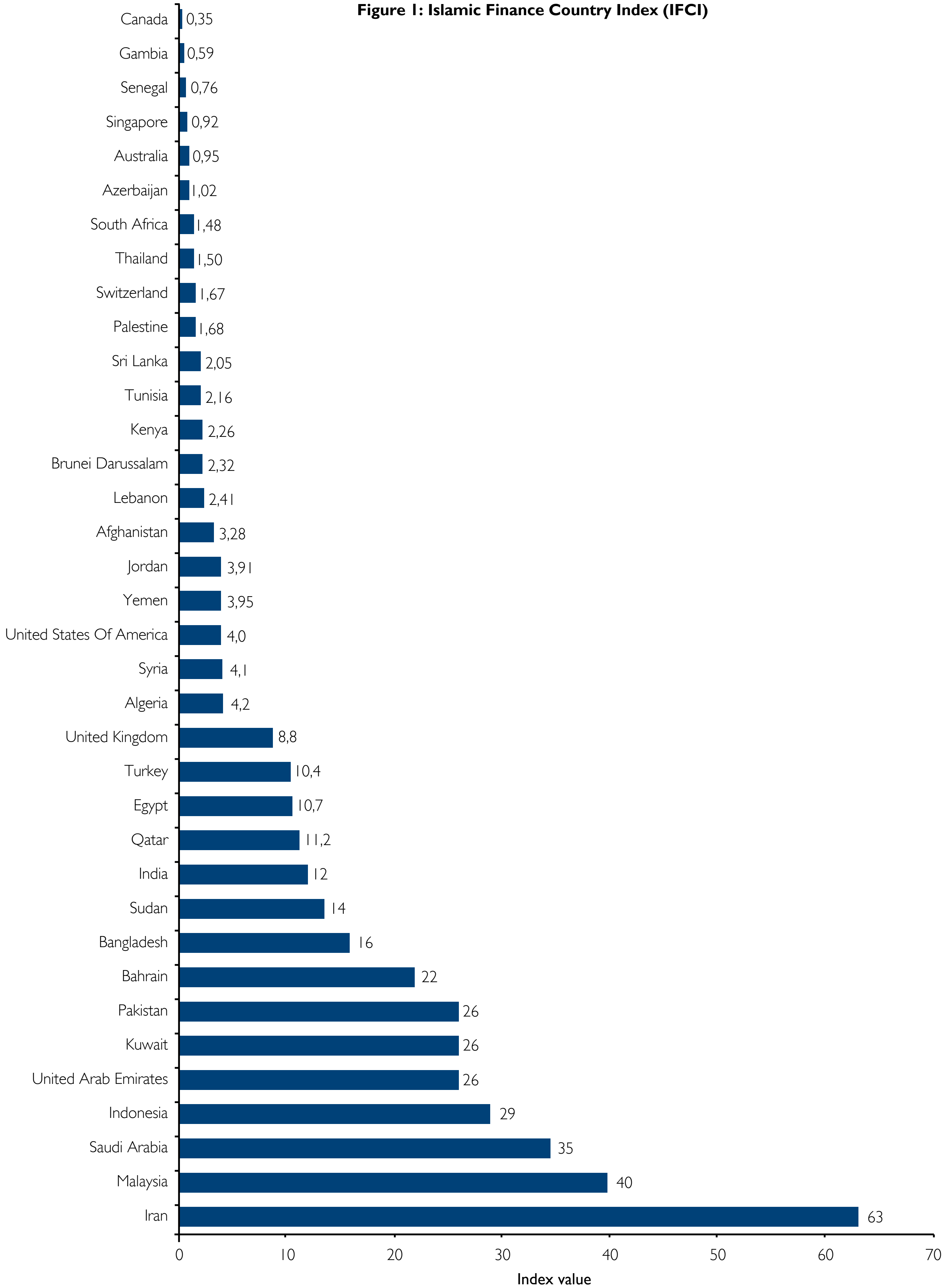
A very interesting and surprising observation is the ranking of **Indonesia** which has assumed 4th place in the country rankings despite, for example, the size of its Islamic assets being about 12 times less than its next ranked country of UAE. This finding is relatively insensitive to the population bias as well because of the objective weights assigned to all variables including population which contributes to only 7% to the index itself (on the basis of size of assets, Indonesia would have ranked 11th instead which indeed is misleading based on multivariate results).

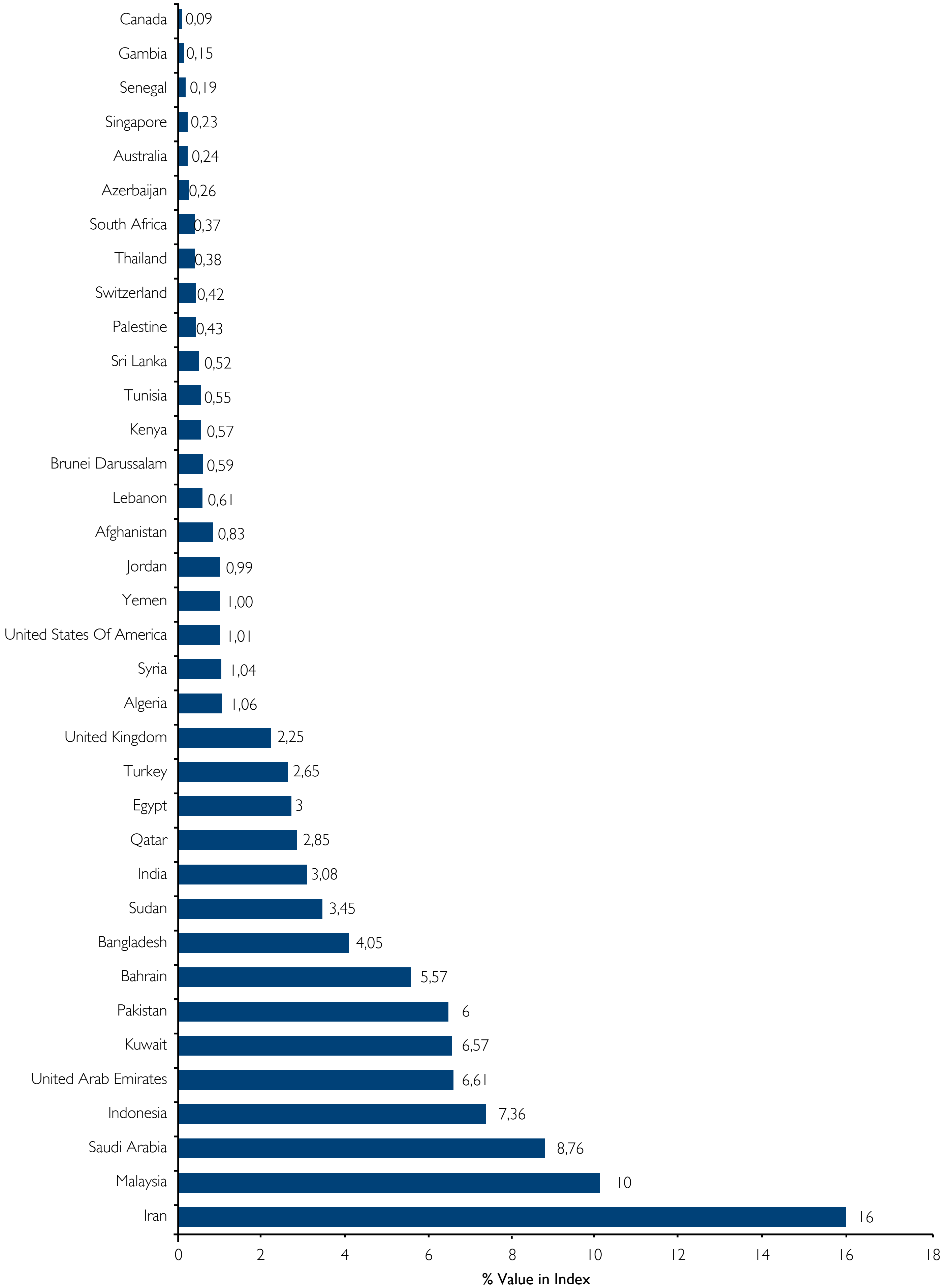
Another interesting case is that of **Pakistan** which has gone 7 steps the ranking from 14th position (based on size of Islamic assets only, for example) to 7th. This can be explained better knowing that Pakistan does exercise a Central Shari'a Supervisory regime – a factor which carries about 20% of the weight in the index construction. This is despite Pakistan deriving little advantage from having a higher Muslim population, a variable which has lower weight in the index.

A very attention-grabbing finding is the case of **India** for example, which has occupied 11th position in the overall ranking, leaving behind countries like Qatar (12th), Turkey (14th) and UK (15th). This is despite the current diminutive size of Islamic financial assets and the absence of a full-fledged Islamic banking institution, even though it is a country with the third largest Muslim population in the world. We would therefore like to take a cautious view on the standing of India and remind ourselves of the size of Islamic assets in Qatar, Turkey and UK which are far greater than India. In case of Qatar and UK, one explanation may be a smaller Muslim population. All said, in terms of % value of these countries in the index (Figure 2), India and Qatar stack very closely while Turkey and UK are not very far behind either.

While ranking data is presented for all 36 countries, we do not present dedicated discussion on countries ranked 16th to 36th because of their % value in the index which is either 1 or less. In fact, the first 15 countries represent about 88% of the total index position which is a good enough subset to limit plausible discussion on results.

Figure 1: Islamic Finance Country Index (IFCI)




Canada
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Singapore
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Australia
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Azerbaijan
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South Africa
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Thailand
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Switzerland
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Palestine
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Sri Lanka
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Tunisia
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Kenya
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Brunei Darussalam
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Lebanon
0,61
Afghanistan
0,83
Jordan
0,99
Yemen
1,00
United States Of America
1,01
Syria
1,04
Algeria
1,06
United Kingdom
2,25
Turkey
2,65
Egypt
3
Qatar
2,85
India
3,08
Sudan
3,45
Bangladesh
4,05
Bahrain
5,57
Pakistan
6
Kuwait
6,57
United Arab Emirates
6,61
Indonesia
7,36
Saudi Arabia
8,76
Malaysia
10
Iran
16
0
2
4
6
8
10
12
14
16
18
% Value in Index

IFCI ranking: 21

AFGANISTAN

October 7th 2011 will mark 10 years since the NATO led forces entered Afghanistan. The attack brought promises of liberty, hope, democracy, prosperity and women rights to a country long crippled by years of war from both within its borders and beyond. 10 years on, the Afghani people are still mulling over whether these promises have been met, while America and its' allies worryingly ponder as to how to withdraw their 13000 strong force in the face of a strengthening Taliban insurgency. A decade on, It is unlikely there will be cessation of hostilities in this war torn nation.

Opportunities in the rubble of war

Be that as it may, the rebuilding efforts continue in the midst of bombs and gunfire. It was hardly going to be a smooth transition from failed state to a flourishing democracy, though the building blocks are clearly visible. Afghanistan's government is limited to using short-term bills and international aid to finance development and have received more than USD 32 billion in international aid since 2001 to rebuild. The financial sector is slowly developing. Essentially, the banking system had to be created from a blank piece of paper with a complete overhaul of the banking sector in 2003. Local and international consultants, advisors, visionaries and practitioners gathered to setup a framework for the system with attempts to bring its banking standards up to those of its neighbours, Pakistan and Iran. At present, total deposits stand at USD 3.58 billion as of August 2010, according to a central bank report. But bankers estimate that there is close to USD 30 billion in circulation that remains untapped by the banking sector.

In 2009, the Central Bank of Afghanistan introduced a five year plan to enhance the banking framework. A pressing concern is how to attract a larger customer base. Currently, only a tiny proportion has a bank account with over 95% not having access to banking services. Poverty along with the threadbare number of banking branches across the country, contributes to this high figure. Additionally, potential customers have rejected conventional finance as it is antithetical to Islamic financial tenets. There is therefore a potentially significant captive market for Islamic finance.

Subsequently, the five year plan recognises the expediency of the Islamic finance market for Afghanistan's rejuvenation. The central bank has set up an Islamic finance division to work on Islamic finance and a Shari'a board. Currently, there is no specific Islamic finance legislation nor is there a fully fledged Islamic bank. But out of the 17 conventional banks that operate in the country, six of them have Islamic banking windows.

Afghanistan's central bank expects an Islamic banking law to be enacted by September and the inauguration of a fully fledged Islamic bank soon after. The central bank is planning to issue three banking licenses once the law has passed, and a number of banks have already shown interest. The government hopes that Islamic banks will tap into the giant reservoir of unbanked customers. In addition to establishing Islamic banks, the sector is looking at innovative means to draw customers. In this regard, mobile banking has significant attraction especially as the physical infrastructure of the banking system is at an embryonic stage.

Corruption in the elite

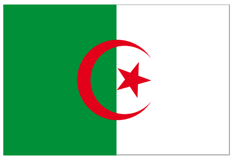
Unfortunately, the banking sector has taken a battering recently and suspicions are high about the industry. In the birth pangs of Afghanistan's banking sector, it should not come as a surprise that corruption has already inflicted damage to the integrity of the system. Early 2010 saw American investigators and their Afghani counterpart unearth opaque tributaries of money going from depositors' accounts at Kabul Bank – the country's largest private bank - into personal accounts of senior banking and government officials. It is estimated that

USD 900 million is missing from the bank, which for a country whose GDP is currently at a meagre USD 11.76 billion (World Bank 2008) staves a sizable hole in their rebuilding budget. Investigators believe that the USD 900 million includes failed loans and loans to fictitious organisations. It is hoped that Islamic banks and its already intuitive attraction to a country predominately Muslim and conservative, will galvanise the sector.

Third sector development

Moving away from banking, the third sector has seen Islamic finance play a crucial role in reaching out to the impoverished segments of society. Organisations such as FINCA Afghanistan have developed Shari'a-compliant microfinance products. It currently has 10000 clients with an average loan size of USD 385. The World Council of Credit Unions (WOCCU) program established the country's first national association for Islamic investment and finance cooperatives (IIFCs), or credit unions, which are intended to benefit small and medium-scale business owners, farmers and low-income households in underserved rural areas. In December 2009, The U.S. Agency for International Development (USAID) awarded WOCCU USD 60.5 million to expand financial services in southern and eastern Afghanistan.

As the anniversary fast approaches, the Afghani people have plenty of milestone events to deliberate over. Has the War on Terror in their country been a resounding success? The answer on the lips of most Afghanis would be no. But in the rubble of war, there are shoots of opportunity: opportunities that need to be taken quickly before they flounder. Islamic banking is present in Afghanistan, but nascent; demanded but not extensively supplied. 2011 could be another milestone year but it is for the Afghanis to take the right steps. Seemingly they are on the path but have to be careful not to trip up.



IFCI ranking: 16

ALGERIA

Algeria is a country situated in North Africa along the Mediterranean Sea. It boasts of a rich cultural heritage due to its unique history, as the country has been subject to various forms of occupation throughout its past. A mixture of Berber, Arab, Turkish as well as French influence has given the local populace much diversity. Algeria possesses natural resources in abundance such as oil and gas. However, there is high unemployment and poverty within Algeria leaving much of the youth disenfranchised. This is clearly evident from the recent demonstrations held against the government, with more expected, inspired no doubt by the success of similar protests in Egypt and Tunisia.

With the majority of the population being Muslim, one would expect Islamic finance to already be well established within the country. Unfortunately, the government of Algeria has been slow to facilitate the entrance of Islamic finance, stunting its growth. The scepticism and attitude of the Algerian government has no doubt been influenced by historical events in the country, i.e. the civil war in the 90's.

However there are signs that the government is warming towards Islamic finance. This change in attitude is due to the fact that the leadership of the country is keen to attract investment from the rich Gulf States and furthermore Algerians themselves, now want more access to financial services which are at par with their religious beliefs. Furthermore, as was mentioned earlier, there is much unemployment and unhappiness at the current regime, thus Islamic finance expansion will create much needed jobs and may ease some of the pressure on the government.

The year 2010 saw some crucial developments in the Algerian legislative framework, to facilitate the growth of Islamic finance within the country. After the government received much criticism for stifling the growth of Islamic finance, it responded by amending the Law on Money and Credit in May 2010. The amendment which was due to come into play this January (2011) aims to make it easier for banks to offer both conventional and Shari'a-compliant finance and enable them to establish their own respective Shari'a boards.

The law amendment will hopefully fuel the growth of Islamic finance within Algeria, as even though there are a few IFIs currently operating within the country, the market share held by Islamic banks is still insignificant. Besides retail and investment banking, there is also potential for Shari'a-compliant micro-finance, which has not escaped the attention of potential entrants to the market.

The clamour for Islamic finance is growing louder. Conferences were held in 2010 and MPs have started to promote its cause. Thus it is expected that Islamic finance will play a much greater role in future in the Algerian economy.

IFCI ranking: 31

AZERBAIJAN

Azerbaijan is a country which is strategically located near the Caspian Sea. It is rich in culture and resources possessing large reserves of both oil and natural gas. With the majority of its nearly 9 million strong Muslim population, it seems a ripe market for Islamic finance to enter.

The country gained independence from the Soviet Union in 1991, after years of occupation which had curbed religious activity. Islamic finance development was slow within Azerbaijan, as well as in other Muslim countries in the region. Gradually, a reawakening of religious values amongst individuals in the region has occurred and this, in turn, enabled Islamic finance to make some inroads into the financial system.

Due to an absence of appropriate legislation and regulation stemming from a lack of support from the government, much of the Islamic finance activities in the country had been informal and silently countenanced by regulatory bodies and government. However, it appears as though Islamic finance seems to be becoming more and more "official" in a sense.

Kovsar Bank has been offering Islamic financial services for some time now; but the bank was recognised by the government not as an official "Islamic" bank, but rather a bank which offers alternative or interest-free finance. The IDB was critical in changing the views of the Azerbaijani government towards Islamic finance. It was involved in the setting up of an Islamic investment fund known as the Caspian Investment Company (CIC), a joint-venture between the IDB and Azerbaijani government. By creating an amicable partnership, the government was exposed to the potential benefits of Islamic finance. Compounding this good will, the Islamic Corporation for the Development of the Private Sector (ICD) has been providing certain Azerbaijani Banks credit to use for "unofficial" Islamic finance offerings such as ijara.

Today, the largest bank in the country, the International Bank of Azerbaijan (IBA) has expressed its wish to introduce Islamic financial services. The bank is in the final stages of opening up an Islamic window, after a team worked tirelessly since 2009 to formulate a strategy and engage relevant stakeholders. The Islamic banking window is expected to begin operations in 2011. Other banks within the country which have been looking at setting up an Islamic banking window include Turan Bank. The ball has started to roll which could have lasting effects for Azerbaijan and impress the rest of the region.

The government however still needs to amend certain laws and do more to facilitate Islamic finance in the country. However the future of Islamic finance seems bright and the importance of Azerbaijan cannot be underestimated. This view is supported by IDB choosing to have its 35th annual meeting in the country in 2010.

IFCI ranking: 32

AUSTRALIA

The Ashes have returned to England, much to the dismay of the passionate Australian fans, who had been so used to their imperious cricket ticket team discarding rivals with their technical mastery, elegant deliveries and an unflinching ruthlessness that teams had already lost before walking on to the pavilion. Unfortunately, time waits for no man and the old guard, one by one, have left; it is up to the new guard to learn from their example and move forward.

Similarly, 2010 also saw the previous Prime Minister, Australian Labour Party's Kevin Rudd leave and hand over the reins of power to his Deputy, Julia Gillard. In the ensuing parliamentary elections, the Labour Party narrowly claimed victory, forming a minority government, and entered into its second term in power. Policies have therefore not altered significantly and the focus of developing Australia as leading financial centre still remains. This is good especially for the progress of Islamic finance in the country. The previous government had shown a great deal of enthusiasm for the establishment of an Islamic finance hub in Australia. This was ostensibly driven by former Assistant Treasurer, Senator Nick Sherry, who has set the groundwork in place for Islamic finance to flourish in Australia.

Demistifying Islamic finance

On May 27th, the Treasury launched a joint publication with Malaysian based law firm Zaid Ibrahim and Co, entitled 'Demistifying Islamic finance'. The booklet was a general introduction to Islamic finance intended to raise awareness and encourage growth. Furthermore, the publication hoped to dispel misconceptions regarding the link between terrorism and Islamic finance. At the official launch, Sherry was keen to point out the government's support on Islamic finance's ethical precepts stating, "The Australian Government works to foster competitive and efficient markets that promote consumer wellbeing, a secure financial system and sound corporate practices. This work supports a market system based on integrity, transparency and clarity — the same principles which are set out in the Quran and the Sunnah and which form the basis of Islamic finance".
It was an edifying comment, one which unfortunately brought the ire of the more prejudicial and contemptuous segments of Australian society. Nevertheless, it was a statement of intent, a culmination of months of discussions, networking and consultations.

To augment and develop their capacity in Islamic finance, Australia has sought the assistance of Malaysia and Middle Eastern nations with Sherry making a number of official visits of Islamic finance hubs such as UAE, Bahrain, Qatar and Malaysia. At the end of 2009, the Malaysian Islamic Finance Centre (MIFC) sponsored a roadshow which consisted of seminars and roundtable discussions with government officials on opportunities to be gained from Islamic finance. To strengthen the relationship, the Australian Treasury signed a Memorandum of Understanding with Bank Negara Malaysia in order to foster long-term strategic business development in conventional and Islamic finance between Malaysia and Australia. Zaid Ibrahim & Co became the first Asian law firm to open offices in Australia in 2009 with a focus on advising upon Islamic finance services. Concurrently, UAE expressed interest in developing commercial relationships with Australia. The Dubai Export Development Corporation has undertaken two Islamic financial services mission to Australia aiming to strengthen the export of Islamic financial services. The Corporation which consists of leading IFIs such as Noor Islamic bank have also been assisting the Australian government in potential changes in legislation to accommodate Islamic finance.

The year of the reports

The aforementioned booklet was not the first piece of literature issued by the government. In fact 2010 can be regarded as the year of reports and consultations, with three other publications being issued over the course of the year. The year began with the Australian Financial Centre Forum (AFCM) releasing 'Australia as a Financial Centre: Building on our Strengths', more commonly known as the Johnson Report. The AFCM was established in September 2008 to promote Australia as a leading financial centre. The Report was the result of in-depth analysis looking at ways Australia can boost 'financial services and improve the competitiveness of their Australia's (sic) financial sector'[210] and issued a number of recommendations. Recommendation 3.6 requested the Board of Taxation to see if amendments had to be made to Commonwealth taxation provisions in order for treatment of Islamic products to be on parity with that of their conventional counterparts, in terms of economic substance. Recommendation 4.8 called for the removal of regulatory barriers. The document highlights Islamic finance as a key growth area and one which would tap into the highly liquid Middle Eastern market as well as provide access to offshore saving pools. This was a pivotal document, signifying Australia's sincere interest in developing the regulatory framework for Islamic finance products.

The Johnson Report was followed by the Australian Government's trade and investment development agency, Austrade, launch of a booklet entitled *Islamic finance*. The booklet highlighted Australian market as strong market for investment and the development of an Islamic finance hub in the Asia Pacific. It would come as no surprise that the February 12th launch was in front of a high ranking delegation from the UAE. Moreover, the release of the booklet coincided with Westpac Banking Corporation creating a Special Interbank placement for Islamic institutions which facilitates commodities trade for Middle Eastern and Malaysian investors.

Regulatory bodies are responding to the increased interest in Islamic finance. The Australian Financial Markets Association (AFMA), the body representing wholesale banking and financial markets on regulatory issues, has formed the Islamic Finance Committee and is in regular dialogue with the Treasury regarding taxation matters. Senator Sherry has spearheaded a review of Australian tax laws in order that IFIs are not unfairly penalised. A working group at the Board of Taxation has been established to review and suggest amendments and it is expected that the report will be published June 2011. Senator Sherry hopes there will be legislative changes to accommodate Islamic finance more effectively by the end of 2011.

Following the change of government, the Board of Taxation released a discussion paper examining tax frameworks and identifying its limitations in accommodating Shari'a-compliant products. The paper focused on seven Shari'a-compliant products, looking at risk management strategies adopted by IFIs. An appraisal was made as to the tax ramifications of these products. The products analysed were murabaha, commodity murabaha, ijara wa iqtina, istisna, salam, diminishing musharaka and an ijara sukuk.

The report is to be followed by a series of consultations with stakeholders with an interest to developing Islamic finance. Submissions have been requested to assist in the process and consultation forums convened by the Board of Taxation have been planned in major Australian cities: Canberra, Melbourne and Sydney.

Islamic finance in Australia

Zaid Ibrahim & Co in Australia was not the first commercial organisation with a stake in Islamic finance to enter the country. In 2008, Kuwait Finance House was the first foreign Islamic bank to set up operations in Australia. The current focus of KFH is on developing and promoting wholesale markets which enable cross border transactions between Australia and Islamic finance hubs. In 2009, Australia's Macquarie Group Ltd and Gulf Finance House partnered together to establish a joint Islamic financial services platform in the Middle East. Terms of the agreement included planned placement of a USD 100 million convertible murabaha. But it is the grassroots organisations that build up a profile. Any changes in the regulatory framework will result in an improved financial environment in which to offer a range of Islamic financial products, thereby potentially increasing customer base. Indigenous Islamic finance is still in its infancy in Australia with only a few small initiatives, providing a limited number of services for the small but growing Muslim community within Australia. Recent figures show that Australia has a Muslim population of approximately 340,390. This population has expanded rapidly by more than 80,000 (or 28%) from 1996 to 2006. The Muslim Community Cooperative (Australia) Ltd (MCCA) was the first provider of Shari'a-compliant services, founded as cooperative in 1989. It offers Shari'a-compliant home loans and was the largest originator of Shari'a-compliant residential home loans in Australia. Over the last year few years, it has branched out into asset management. In 2009, MCCA Income Fund became the first Australian Securities and Investment Commission (ASIC) regulated Shari'a-compliant retail fund.

MCCA lobbying was a crucial factor that prompted the amendment of the Stamp Duties Act in the State of Victoria, which has the largest population in Australia. The State Parliament amended the Governing Act in 2004 so that sales/re-sales taking the form of "Cost Plus" arrangements would be treated as unitary transactions. This removed the double taxation problem on ijara mortgage arrangements, the main structure used in property acquisition. While Victorian state law has been amended to provide relief against double taxation, other states continue to levy stamp duties at each stage of the ijara transaction. This problem was addressed in the Board of Taxation paper.

The success of MCCA has lured other Shari'a-compliant organisations such as Iskan finance and Islamic Co-operative Finance. Iskan concentrates on home financing while the latter has a range of services including offering investment funds such as Zakat funds. The interest is not limited to Islamic finance organisations. In 2009, National Australia bank committed USD 15 million to introduce Shari'a-compliant loans. These are no interest loans provided to low income earners who have difficulty accessing credit. In the same year, LM Investment Management Ltd, a specialist income

[210] AFCM (2009) 'Australia as a Financial Centre: Building on Our Strengths'

funds manager issued Australia's first onshore Shari'a-compliant fund focusing on global property and business markets. The LM Australian Alif Fund is marketed via LM's international network of licensed financial advisers, intermediaries, wholesale platforms, private banks, pension funds, corporate and institutional investment consultants spanning beyond 32 countries. In September 2010, the Central Bank of Bahrain authorised formation and marketing of the Hyperion Australian Equity Islamic Fund, the first Shari'a-compliant offshore fund comprising of stocks on the Australian Stock Exchange which are deemed to be Shari'a-compliant. The fund is hoping to provide investors in the Middle East exposure to the Australian equities market

Oh no! No ball

The last two years there has been significant progress within the Islamic finance space in Australia. It has taken 20 years, but Australia is well on course to achieving an extensive and indigenous Islamic finance industry. La Trobe University is well aware of the zeitgeist and became the first university in Australia to offer master degree in Islamic banking and finance. The course also provides exemptions to part one of the Chartered Islamic Financial Professional qualification, thus showing a holistic approach adopted by La Trobe. They have further developed an E-learning masters course in partnership with Dubai's Ethica institute.

Yet not everyone is happy with the approach undertaken by Australia's government in supporting Islamic finance. Liberal Party member Cory Bernandi has voiced his opposition, arguing that Shari'a law is in opposition to Australia's western values. Fortunately, party colleagues have been quick to dismiss his criticisms, supporting the governments' efforts in removing barriers to integrate Islamic finance into the Australian system. It would seem then that there is a unity amongst the politicians on this most sensitive of matters. 2011 will prove how committed they are to the cause.

IFCI ranking: 8

BAHRAIN

As a small Island in the Persian Gulf, Bahrain has made significant waves in the Islamic finance sector. Its success has much to do with the free market policies of the government, who have encouraged international firms to enter the market. According to the Index for Economic Freedom 2011 published by the Heritage Foundation and the Wall Street Journal, it is the world's 10th most free economy and the only Middle Eastern nation in the top 20. By having an open economy, it has allowed the proliferation of ideas and innovation, thus encouraging private sector developments in Islamic finance. More so than this, the support of the government and the central bank has been crucial to Islamic finance's growth in Bahrain.

State of the industry

According to the Bahrain Economic Development Board (BEDB), the financial sector had contracted slightly in 2009. However, the shrinking output was marginal, at only 1%, suggesting that Bahrain had survived the financial crisis relatively well. Bahrain owes its success to its open market, liberalised policies and ongoing country marketing which has attracted foreign financial institutions to set up branches there and retain majority ownership. The IMF has stated that high initial levels of bank capital and sound prudential norms established by the Central Bank of Bahrain (CBB), ensured the resilience of the financial system. Recourse to extensive direct interventions seen in many countries has not been required. In addition, the CBB has endorsed Islamic finance and is keen to ensure transparency, efficiency and competitiveness, in order to boost the Islamic finance industry.

Bahrain's strength in the insurance and financial services sector has provided this island state a prominence in the Islamic finance market. According to Kuwait based Al Sabek, Bahrain has 20 Islamic funds investing nearly USD 1 billion. It has more IFIs than any other purported Islamic finance centre. According to the Oxford Business Report (OBS) it has 27 Islamic banks out of 140 banks operating in the Kingdom, representing USD 25.5 billion in assets –approximately 10% share of total global Islamic banking assets. Moreover the banker accords it a favourable statistic: four of the top five Islamic banks in the world are from Bahrain. The annual growth of the banking sector in the last five years has been remarkable since 2005, averaging approximately 48%. However, this has been impacted due to the global recession. While retail remains healthy, the wholesale sector requires a rethink in strategy. A major concern has been the concentration on real estate – Bahraini Islamic banks are rumoured to have 70% of their capital invested in the Islamic finance investment of choice. The CBB has attempted to put a cap on real estate exposure since 2006, but this has been met with a chorus of disapproval. However, due to the sluggish real estate market, a change of focus is needed for Islamic banks. Inertia will prevent an accelerated approach, but there are opportunities, for instance, in the local private sector. In November, BMI Bank and Tamkeen launched an Islamic financing scheme for local private sector companies. The scheme hopes to invest USD 13 million dollars for the development of local entrepreneurship.

Insurance has been vibrant in Bahrain. In 2009, it was the only segment of the financial sector to experience growth, having reportedly expanded by 6%. Bahrain also has 18 takaful operators – seven of which are fully fledged takaful providers - and one retakaful firm. Established conventional insurers such as Allianz and Chartis have bases in Bahrain where they offer both conventional and Islamic insurance. Bahrain remains a top choice for international insurers keen to set up takaful divisions to service GCC countries, and there are currently 177 insurance policy writers in Bahrain. This is a testament to the highly regarded regulatory centre Bahrain has created for insurance services. Gross premiums for takaful companies in Bahrain reached USD 72.54 million in 2008, representing a 73% jump from the previous year. By the end of 2008, takaful firms accounted for 42% of the paid up capital of Bahraini insurers. In 2009, the seven takaful companies had gross contributions of USD 87 million, representing a 22% increase from the previous year. Family takaful represents the largest sector. Gross premiums from retakaful registered 217.6% growth between 2008 and 2009 highlighting the growing importance of retakaful structures. In September, T'azur a regional takaful company headquartered in the Kingdom of Bahrain, signed of an Islamic reinsurance (retakaful) agreement with Hannover Retakaful, the Bahrain based Islamic subsidiary of Hannover-Re, one of the world's leading reinsurers. Consolidating resources between the Islamic and conventional sectors will be important in strengthening Bahrain's position as an insurance and takaful centre in the financial markets. These achievements have been recognised by the industry. At the annual International Takaful Summit it has been awarded Best Financial Centre three years in a row.

Standardisation in a world of diversity

Being the base of standard making bodies such as AAOIFI has provided Bahrain with a position to influence the direction of Islamic finance. AAOIFI, whilst a small body with few resources, has been active in setting out accounting, auditing and Shari'a standards for the Islamic finance industry. Its preeminent Shari'a board and committees are infused with prominent practitioners of Islamic finance as well as leading scholars. For an industry still finding its path, intellectual disagreement was likely to occur under the auspices of bodies such as AAOIFI, which is gradually becoming the most influential international fiqh body. Indeed, AAOIFI Shari'a board's chairman, Sheikh Taqi Usmani's 2008 criticism of the sukuk industry sent reverberations throughout the industry. Questions were being asked as to the nature of sukuks and whether they could be classed as Shari'a-compliant. Parallel to Usmani's criticism, the credit crisis ensued which was followed by the default of the Nakheel Sukuk. Combined, the sukuk industry took a beating, one that it is only now recovering from. Sukuks have generally been an important part of Islamic finance's product portfolio, not least because of its potential for innovation. But intermittent moments of reflection, where premises and postulates are questioned, are required for the health of any nascent industry, not least Islamic finance.

Thus AAOIFI's announcement in August pertaining to the limitation of a scholar's role on multiple Shari'a boards is seen as a positive means to ensure transparency and diversity on Shari'a boards, while at the same time increasing human resource capacity. They also called for the creation of a national Shari'a board to audit and clarify Shari'a products and reduce the incidence of disagreement amongst scholars. However, this has not been met with complete support, with many arguing that it would increase bureaucracy.

The announcement has also contributed to the ongoing polemic discourse regarding standardisation. In this regard, the International Islamic Financial Market (IIFM), a Bahrain based standards setting body for the Islamic capital and money markets, has been paramount for the pedagogy of Islamic finance. Its primary focus lies in the standardisation of Islamic products, documentation and related processes. The recent collaboration between New York's International Swaps and Derivatives Association (ISDA) and Bahrain based International Islamic Financial Market (IIFM) in the creation of the standardised Tahawwut hedging agreement, is an achievement in terms of the flexibility of Islamic finance to create Shari'a-compliant derivatives. The agreement hopes to counter the ongoing problem of risk management within the industry. The IIFM have also looked at drafting standardised documents for asset backed bonds and creating repos to manage funds. These initiatives affirm Bahrain's strong advocacy of international standards for the Islamic financial sector along with better risk management practices.

Liquidity Challenges

Another pervasive problem has been the lack of liquidity in the market, due to the absence of secondary money markets. Bahrain is the only GCC country to issue three and six month domestic Islamic bills. To address this challenge, Bahrain Financial Exchange (BFX) launched its Islamic finance division, the Bait Al Bursa, in October. It offers a multi asset exchange, the first in the MENA region, which acts as a platform for electronic trading of Shari'a-compliant securities. Part of the platform is E-Tayseer, a fully electronic platform for automating murabaha transactions. The automated system mitigates the problem of efficiency, transaction costs and Shari'a compliancy. A further initiative has been the collaboration between CBB and the Liquidity Management Centre (LMC) to facilitate greater liquidity by the opening of a secondary market, granting the platform for the trading and repackaging of sukuks, converting them into shorter term debt. Government sukuks will be utilised in short term debt structures. The LMC was set up in 2002 in Bahrain, to act as a conduit between banks looking to place surplus funds in traded investments.

Improving the framework

The CBB pioneered the development of a comprehensive regulatory framework for Islamic banks in 2001, followed in 2005 by a regulatory framework specific to Islamic takaful and retakaful companies. The CBB has published detailed guidelines for Islamic banking in the country, similar to those of conventional banks. However, there are two additional requirements: each Islamic bank must have an independent Shari'a board, and Islamic banks need to adopt AAOIFI standards for financial reporting.

The Waqf Fund for research, education and training has recognised the need to develop financial professionals who have knowledge of both Islamic and conventional finance. The Waqf Fund is an endowment capital fund that has the support of Islamic banks and conventional banks with Islamic windows. The fund supports and finances training, education, research and other developments in Islamic finance. It was set up in 2006 by the CBB, in partnership with 15 leading Islamic institutions and three conventional banks that also have units offering Islamic banking services. It unveiled plans to conduct training programmes in conjunction with the Scottish based Islamic Finance Council UK (IFC) for Shari'a scholars, auditors and compliance professionals, aimed at enhancing their understanding of global financial markets. The fund is also working with BIBF to increase the skills base for the sector through a graduate sponsorship programme. It provides support for graduate students from the banking, finance, accounting and economics streams of the University of Bahrain and other institutions to obtain diplomas from the institute, while also receiving work experience at selected banks. In March, the Waqf Fund announced it had just completed the selection process for the second batch of graduates for the programme.

International multiservice firms such as Deloitte are capitalising on Bahrain's position as an Islamic finance centre by the creation of its new Islamic Finance Knowledge Centre (IKFC). The IKFC is designed to help Deloitte's clients tap into the Islamic finance field by providing experts who will support the firm's Middle Eastern audit, tax, consulting, risk and financial advisory.

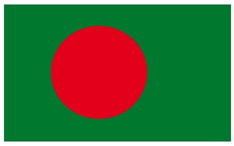
Expanding the industry

Bahrain Association of Banks (BAB), an umbrella body, which works closely with the CBB. At the World Bank/IMF meeting it launched The Handbook of Islamic Banking & Finance, an introductory text designed to explain Islamic finance products to non specialists. An initiative such as this, in the centre of capitalism, highlights Bahrain's intention to spread information and knowledge about Islamic finance to a wider audience. As the Islamic finance industry grows, a recurring need will be having expansive and high quality sources of information. In February, an Islamic finance directory was launched in Bahrain by Thomson Reuters. The directory consists of details of Islamic finance professionals and scholars, rating agencies, industry standard bodies, consulting firms and subsidiaries from 25 countries.

Industry analysts comment that Islamic commercial banks are sitting on a bed of liquidity and are unsure as to how to deploy the cash. The foreign markets are proving to be lucrative and many banks have sought to tap into international markets. Al Salam Bank, Bahrain's fastest growing lender by revenue, has been especially active in providing Shari'a-compliant financing for the investment in prime real estate in commercial hubs of the UK. They are also looking for USD 500 million in Asia Pacific markets such as Singapore, Malaysia and Indonesia, to profit from the flourishing markets within the region. Al Baraka Banking Group also plans to expand into the Asian market having finalised its merger with Emirates Global Islamic Bank in Pakistan, in October. These are just some of the latest developments and are a testament to the growing power of Bahrain's Islamic banks. More investment, especially in non-Muslim countries, will increase awareness of Islamic finance and diversify the product portfolio of Islamic banks.

Political upheaval

The recent protests in Bahrain revealed much discontent with the ruling elite. It starkly showed on the global stage the long-term fissures between the Sunni government and the Shi'a majority who make 70% of the population. For the Islamic finance industry in Bahrain, there is unlikely to be ramifications given that the industry is thriving and the foundations are truly set. Moreover, Islamic finance is fortunate as it encompasses Sunni and Shia schools of law. Ideologues such as Baqr al Sadr were Shi'a. But with mighty discontent, markets become mightily anxious. These will be testing times but Islamic finance in Bahrain is likely to remain resilient.



IFCI ranking: 9

BANGLADESH

Bangladesh's foray into Islamic finance has not been without ambivalence; a flux between avidity and vacillation. The Saudi Prince Faisal's vision for a pan-Islamic bloc naturally embraced the newly independent Bangladesh in the 1970s. Bangladesh ratified the IDB charter in 1974 and was, at one point, advocating separate banking systems though this never transpired. The Bangladesh Islamic Bankers Association, a voluntary organisation whose objective were to abolish riba from the Bengali economy, was an effective lobby group in the early 80s, encouraging Islamic banking to develop. Their efforts spearheaded the incorporation of the Islami Bank Bangladesh Ltd (IBBL) in 1983, which was not only the first Islamic bank in Bangladesh, but is also considered the first interest free bank in South East Asia. Islami Bank Bangladesh Limited (IBBL) started as a joint venture multinational bank with 63.92% of equity contributed by IDB and financial institutions like Al-Rajhi Company for Currency Exchange and Commerce of Saudi Arabia, Kuwait Finance House, Jordan Islamic Bank, Islamic Investment and Exchange Corporation of Qatar, Bahrain Islamic Bank, Islamic Banking System International Holding S.A, Dubai Islamic Bank, Kuwait Ministry of Awqaf and Islamic Affairs.

Legislative inertia

To the chagrin of Islamic finance supporters, legislation however was not changed. There were slight amendments made to accounts to fulfil the special requirements of Islamic banks. Necessary amendments were made in the Income Tax Ordinance (1984) which viewed both the profits paid on mudaraba as expenditure. This was hardly the absolution of interest from the economy, ardently desired by exponents of Islamic finance, but it provided a level playing field and enabled more Islamic banks to enter the market.

Democracy became the de jure political system in Bangladesh in 1991 after 20 years of dictatorship; and so began a debilitating rivalry between the two leading parties in Bangladesh - the Awami League and Bangladesh National Party - which is ongoing today. Power shifted hands between the two parties approximately every 5 years, affecting stability and the achievement of long term goals. Each party oversaw certain developments for IFIs in Bangladesh which has gradually improved the legal framework for Islamic banks, though in a piecemeal manner. However, one constant has been the power and authority of the Bangladesh central bank, Bangladesh Bank, who regulates' institutions engaged in financial activities and has the power to issue licenses to new banks.

Bangladesh does not have a bespoke Islamic Banking Act. A draft Islamic Banking Act, which would have been included in the authoritative Banking Act (1991), was discussed in Parliament but was not passed as law. Nevertheless, several clauses were incorporated in the Bank Company Act (1991) regarding the mechanism of Islamic banking. In 1997, the Bangladesh Bank sought suggestions from banks working in Islamic finance in order to facilitate a consonant environment to Islamic banking. It was hoped this would lead to an Islamic banking act. 14 years on, an act has not been forthcoming. In 2004, the government formed an eight-member expert committee to draft the proposed insurance laws, including a Takaful Act for Islamic insurance companies. The interim cabinet, however, turned down the proposal.

Show me the money

Arguably, Islamic finance could have been quite prominent with the right level of government support and focus. Practitioners in the field add that Bangladesh Bank is not doing enough to fully establish Islamic finance in the country. A lack of liquidity has been blamed on insufficient legal support from the central bank. Criticisms have also been made about a lack of expertise and a minimal portfolio of products. Islamic banks rely extensively on murabaha to generate profit. However, the wider socio-economic picture has to be considered. Bangladesh is one of the poorest countries in the world, with systematic corruption in all segments of society, low incomes, a widening gap between the rich and the poor, a sizable unbanked population, political instability, cronyism and weak legal enforcement.

Banks face excess liquidity issues due to a lack of response from good credit borrowers and the lack of adequate interest free financial instruments. Industry practitioners state that the central bank has not provided legal support which has accentuated the liquidity problem. Furthermore, there is a dearth of expertise to appraise, monitor, evaluate, and audit Shari'a-compliant financing projects. There has not been much success in devising an interest free mechanism that places funds on a short term basis. Profit sharing risk is seen as too high and therefore banks have resorted to debt financing structures such as murabaha. The central bank is attempting to resolve these issues and have encouraged foreign banks to roll out more Shari'a based products.

To date, there have only been two issuances of sukuk to generate cash flow: the IBBL 3000 million Taka Mudaraba Perpetual Bond (which has no maturity) and the government's Bangladesh Government Islamic Investment Bond, which also used mudaraba as an underlying structure. The objective of the latter was to maintain the SLR of Islamic banks, as well as providing an outlet for investment or procurement of funds. Aside from these instruments, Islamic banks are still heavily dependent on deposited funds. There is a need to develop primary and secondary markets as well as innovation and diversification of the product portfolio of banks.

Another challenge for Bangladesh Bank has been determining a suitable profit sharing mechanism for depositors and the banks with respect to mudaraba accounts. The profit sharing ratio under a mudaraba can be determined by the commonly used weightage system or the Investment Income Sharing Ratio (ISR). The differences are subtle but have caused much debate amongst adherents of Islamic finance in Bangladesh. The Central Shari'a Board for Islamic Banks of Bangladesh (CSBIB), a non-corporate body, registered in 2009, committed to the promulgation of Islamic finance in Bangladesh, have argued for the latter. The Bangladesh Bank has prescribed the weightage system as a standard for Islamic banks to follow to generate a rate of return. The central bank has granted some preferential provisions to develop Islamic Banking in Bangladesh including a lower Statutory Liquidity Reserve (SLR) as compared to conventional banks. Since 1983, the SLR for Bangladesh Banks has been fixed at 10% whereas for conventional banks it has hovered around 20% and is currently at 18.5%. Infrequent changes have been made over the years to conventional banks' SLR, in order to increase supply of funds thereby reducing interest rate differentials. The lower percentage takes into account the prohibition for Islamic banks to invest in interest bearing instruments, thereby reducing their liquidity. However due to the global economic downtown with the parallel increase in commodity prices, Bangladesh has suffered from increased inflation rates. In May 2010, the SLR was increased to 10.5% for Islamic banks.

Central Bank Guidelines

The Bangladesh Bank Governor, Dr. Atiur Rahman, in December 2010, reemphasised the commitment of Bangladesh Bank to develop Islamic finance in the country and publically called for Islamic banks to follow the Shari'a completely. Bangladesh Bank set up a research and Islamic economics division in 1990 under the Department of Research within the bank, to conduct timely analysis of the Islamic finance industry in Bangladesh.

In 2009, Bangladesh Bank issued guidelines through a circular on the operation and management of Islamic banks which supplement existing banking laws. The guidelines were a result of discussions between Bangladesh Bank, several Islamic banks in the country and the Central Shari'a Board.

The guidelines represent the first attempt to provide an operational framework for Islamic banks. The guidelines cover a number of points including corporate and Shari'a governance, product definitions and operational frameworks, alternative investment modes, and conversion of conventional banks into Islamic banks. However, guidelines are limited by a number of shortcomings and ambiguities. This has been admitted by Bangladesh Bank, though no amendments have been made. The guideline makes formation of a Shari'a board for Islamic banks optional, though this is contrary to global industry practice. There is also stringent criteria for a Shari'a board candidate to meet. Practitioners argue that a paucity of candidates who meet these criteria would deprive the Islamic banking industry of the necessary talent to go forward. They are therefore asking Bangladesh Bank for a relaxation in the stipulations.

State of the industry

It is a common lament that the level of Islamic finance expertise in Bangladesh is not sufficient for a robust Shari'a board, but this has not hindered Bangladesh's progress. Currently, Bangladesh has seven fully fledged Islamic banks and eleven Islamic finance windows with their own Shari'a boards. The banks are Islami Bank Bangladesh Ltd, Al-Arafah Islami Bank Ltd, ICB Islamic Bank Ltd, Export Import Bank of Bangladesh Ltd (EXIM), Social Islami Bank Ltd, Shahjalal Islami Bank Ltd and First Security Islami Bank Ltd. Exim Bank Limited and First Security Islamic Bank Limited were conventional banks who fully converted into Islamic banks in 2004 and 2009, respectively. There are just shy of 300 branches offering Islamic finance products. According to Bangladesh Bank, Islamic banking systems in the country account for 25% of all private bank deposits with 30% of investments made by banks concordant to Shari'a principles. In December 2010, HSBC launched HSBC Amanah in Bangladesh which offers a full range of products in the country for both retail and commercial customers. The Amanah service is only available in 8 countries and therefore reflects the opportunities available in Bangladesh.

Since the inception of the first takaful company in Bangladesh in 2000, the takaful industry has grown. As with banking, the absence of legislation pertaining to takaful has not presented obstacles for the formation of several more takaful companies. Today, there are as many as 62 insurance companies operating in Bangladesh, of which six are fully fledged takaful operators, and 13 have windows. As of 2008, total assets for takaful institutions were 9.7 million taka, constituting 7% of total assets of the insurance sector. Total premium was 5.7 million taka in 2008, constituting 12% of total premiums of the insurance sector. In March 2010, the government enacted the Insurance Act 2010, with a provision for the creation of an Insurance Development and Regulatory Authority. It was proposed that Shari'a consultants would sit on this board, but to date, the authority has not been constituted.

Islami Bank Bangladesh: an international success

The burgeoning Islamic finance sector in Bangladesh owes a considerable amount to the activities of the first Islamic bank in Bangladesh, IBBL. Since opening in 1983, IBBL has become a conglomerate which has branched out from its traditional focus of Islamic finance. IBBL created a Foundation which has established hospitals, schools and arts institutions. In August 2010, IBBL announced an initiative to award two years term education scholarship for 200 poor students, who were achieving high grades in their class. They have also been entreated by Nigerian based Jaiz International to set up the first Nigerian Islamic bank. An agreement was signed between the two organisations in December 2009. Under the agreement, the IBBL will help develop capacity building programmes for the training and development of the workforce and design and implement appropriate procedures for all processes, transactions and products to ensure smooth operations of the proposed Nigerian bank. IBBL have already deposited USD 35 million to the Central Bank of Nigeria. For their endeavours, Global Finance, the USA based financial magazine awarded IBBL best IFI in Bangladesh for the year 2010. It has previously won the award 6 times over the last decade.

What of microfinance?

Bangladesh is internationally known for being the birthplace of microfinance. It is also reputed as the NGO capital of the world, most of whom have a significant component dedicated to microfinance. Consequently, Islamic banks have entered into the microfinance space within Bangladesh, providing Shari'a-compliant products mainly based on Bai' Muajjal. The IBBL has offered products through its Rural Development Scheme (RDS) project and utilised its extensive network and presence in rural villages to develop a framework which encourages entrepreneurship and spiritual growth under an Islamic aegis. As a comparison with other larger and more widely known microfinance outfits such BRAC and Grameen, RDS has done remarkably well especially with a lower uptake. According to 2008 statistics, RDS has been offered by 129 IIBL branches and covers 10,000 villages across Bangladesh. The number of participants is just below a million.

Socio Islami Bank limited (SIBL), is one of the seven fully fledged Islamic banks in Bangladesh which is active in rural financing though does not concentrate on microfinance. It focuses on SMEs, agrofinance, remittance and alternative delivery channels. There is a shift of focus from high income transactions in a bid to bringing economic mobility to a high percentage of the low income earners and create adequate employment opportunities, income generation and poverty alleviation which will lead onto financing industrialisation.

To the future and beyond

There is an alterity in the approach of the Bangladesh government and the central bank to Islamic finance in the country. Their influence in driving the industry forward cannot be underestimated, but at the same time industry practitioners feel more can be done. They are certainly exasperated by the lack of legislative amendments needed to strengthen the industry. But even accounting for this backdrop, the private sector has done remarkably well in allowing a flourishing of the Islamic finance sector. They need to do more in developing human capital; a common bugbear for most IFIs and more efforts are required to educate the public about Islamic finance.

The talent is there but needs to be channelled appropriately. Unearthing charismatic and influential individuals has not been a problem for Bangladesh. Mohammed Yunus is the founder of Grameen Bank and winner of the Noble Peace Prize; Jaseem Ahmed a former director at Asian Development Bank, now succeeds industry heavyweight Professor Rifaat Abdel Karim as Secretary General of the IFSB. It was a surprise appointment due to his relative inexperience in the industry, but it is an achievement Bangladesh should be proud of. In the Islamic finance sector, they could be proud of more.

IFCI ranking: –

BOSNIA

Bosnia is a country situated in the Balkans, born out of the ashes of the former Yugoslavia. The country was the subject of a horrendous conflict among different ethnicities with some favouring independence and others favouring to remain with the Yugoslav federation. Tragically there was genocide committed against ethnic Bosnian (Muslims). After 10 years of relative peace, there is still tension between the different ethnicities and thus a rapid Islamisation of the financial landscape is likely to be met with strong opposition.

Islamic finance entered Bosnia in 2000 with the setting up of the Bosna Bank International (BBI), which was supported by the IDB, Abu Dhabi Islamic Bank as well as Dubai Islamic Bank. The bank faced opposition from non-Muslims before its opening, but has been well received by the Muslim population. It has managed to offer some innovative Islamic financial offerings such as a Hajj and Umrah Investment account. Besides this, the Bank also offers other Shari'a-compliant financing products for home and vehicle financing amongst its service offerings.

Interest in Islamic finance in Bosnia is increasing according to insiders familiar with local sentiments. Around 40% of the population is Muslim, hence it is a location which can be lucrative for Islamic finance. Many Bosnian Muslims are studying Islamic finance abroad in places such as the International Islamic University Malaysia (IIUM) as well as Bank Negara Malaysia's University for Islamic Finance, INCEIF. Furthermore there are also undergraduate as well as postgraduate courses offered locally in Islamic finance by the International University of Sarajevo.

The Malaysian government has a strong affiliation with Bosnian Muslims, as it is one of the few countries which assisted them during the civil war. Furthermore many Bosnians who have studied or are currently studying in Malaysia have been given scholarships. BBI's CEO, Amer Bukvic, is an alumni of the IIUM. This strong relationship may prove vital in future as Malaysian interest could help propel the Islamic finance industry in Bosnia forward.

In 2010, a conference held in Bosnia under the auspices of the IDB, was attended by around 600 participants. The aim of the conference was to showcase Bosnia as an attractive place for investment as projects of up to USD 11 billion were showcased. The country is also trying to leverage on its strategic location to highlight the role it can play as a link between Europe and the rest of the Muslim world. Furthermore trade between Bosnia and the UAE is set to increase.

However much more needs to be done in Bosnia for Islamic finance to flourish. There are certain issues which need to be hammered out so that the country appeals to GCC investors; and motivates international institutions to set up Islamic windows in the country. Some have suggested that the government should issue sovereign sukuk. Additionally more effort needs to be undertaken to educate the government and the various regulatory bodies so that necessary amendments to legislation can be made in order to facilitate further Islamic finance development.

IFCI ranking: 8

BRUNEI DARUSSALAM

'To date, Brunei has not done much. We still have a lot more to do in terms of market capability, human capital development, international Islamic banking, international takaful. In terms of capital market, we are not yet ready', said Ethica Consultants' executive manager Sri Anne Masri, at an Islamic Finance News road-show in December. Her comments suggest that Brunei have an enervated Islamic finance market. This would seem to be a harsh assessment but reading between the lines, Masri was not mourning the ineffectualness of Brunei. Rather she was exposing the desire and ambition of Brunei to be an international market leader

In the beginning

Brunei's first official engagement with Islamic finance was in 1991 with the opening of Perbadanan Tabung Amanah Islam Brunei (TAIB), a trust fund created to assist local Muslims undertake Hajj in 1991. Two years later, the International Bank of Brunei Berhad, a commercial bank was converted into Brunei's first full-fledged Islamic bank, renamed as Islamic Bank of Brunei Berhad (IBB). A second conventional bank was transformed into an Islamic bank in 2000, the year in which the Sultanate established the Brunei International Financial Centre.

It was in 2006, that Brunei kick-started the industry with series of legislative changes beneficial to Islamic financial banking and insurance firms. Indeed, the year saw the constitution of a national Shari'a board and the merger of the two standing Islamic banks in Brunei to create Bank Islam Brunei Darussalem (BIBD). The government launched a rolling short term sukuk al ijara programme to boost liquidity for banks. The Sukuk Holding Properties Inc and Sukuk (Brunei) Inc were set up by the Ministry of Finance to issue sukuk. To date, the government has issued USD 2.1 billion worth of short-term sukuk al-ijara.

Through issuing the sukuk, the sultanate became the first sovereign nation to issue securities without previously setting up a conventional capital market. A beneficial outcome has been the curtailment of national debt. However, for further development, it is expedient for Brunei to develop an independent monetary policy. Currently, there is a reliance on Singapore to set interest rates, and though over the years this has worked well for both countries, any further developments in the capital market will require Brunei to step out on its own. The establishment of the Monetary Authority of Brunei in 2011 is a positive step in achieving independence as it will act as the central bank of Brunei, concentrating on the formulation and implementation of monetary policies, supervision of financial institutions and currency management

Towards an Islamic finance hub

With a small population, the need for numerous and manifold financial institutions in a country is limited. But as an offshore centre, a variety of financial services and institutions is necessary for an efficient, dynamic market; and Brunei has opened the markets to a number of international financial services companies to set up in the Sultanate. For Islamic banking, this has not been the case. Previous legislation for Islamic banking was narrower in focus, restricting foreign ownership which has meant that there is currently no foreign bank offering Islamic bank services. However, legislation was changed with the passing of the Islamic Banking Order 2008, which permits financial institutions licensed as offshore companies to undertake Islamic banking. By extension, international banks can partake in Islamic financial activities in Brunei. However, while paid up capital for a local Islamic bank has to be USD 100 million, for foreign banks, the figure rises to USD 500 million, which may prevent foreign banks in applying for the license. Nevertheless, in March, the Brunei government invited Malaysian Bank Rakyat, Malaysia's biggest Islamic cooperative bank to open a branch in Brunei. While there have been no further developments with Bank

Rakyat still considering its options, it shows the change of stance of the government.

The entry of another Islamic finance bank may have a positive impact in developing new products and services within the local markets. Islamic banks in the country do not have the incentive to foster innovative product development, because of the small population and also the need for loans from state run companies is limited. Financial institutions are known for their excess liquidity due in part to the abundant oil resources in the country but there isn't a pressing need to convert it into debt finance. Privatisation may alter this state of affairs and the Brunei government has shown interest in enabling the private sector to play a larger role in the development of the economy.

However, currently there are only two Islamic financial intermediaries: BIBD and TAIB. BIBD is the only bank to have a universal banking license. BIBD has more than 14 branches located in all Brunei's four districts and according to its website; BIBD has the single largest distribution of ATM networks in the country. BIBD also has two subsidiaries, namely Takaful BIBD Shd Bhd which primarily provides insurance coverage and BIBD At-Tamwil Berhad, a finance company, which provides hire purchase financing for vehicles and consumer products.

In 2009, BIBD arranged a USD 850 million international sukuk issues with IDB. BIBD was also the lead manager for GE's USD 500 million sukuk and lead underwriter of the only private sukuk issuance in Brunei, Brunei's LNG USD 68.7 million sukuk. BIBD's investment banking division is growing in stature after opening their investment banking division in 2008. Since then the number of services has expanded to cover fund management, treasury, risk management and security services.

The main concern for BIBD is retail, which has outpaced conventional banking over the last few years and has a higher participation of local consumers than traditional Islamic finance hubs such as Bahrain. It is estimated that Brunei's Islamic finance sector accounts for around one third of banking assets and more than 25 per cent of deposits while providing nearly 60 per cent of total financing. This is a reflection of the growing level of consciousness amongst Muslims in the country adhering to religious principles. According to Brunei's ministry of finance, Islamic banking assets in 2009 were about BND 6.3 billion (USD 4.81 billion) or 40% of the total banking sector in Brunei. Unofficial figures suggest that this has grown to 45% in the last year.

The second institution, TAIB, is also the oldest IFI in Brunei. It offers a range of products and services from retail based products - such as saving accounts and home financing – to corporate financing. TAIB offers all banking products except cheque facilities. A reflection of the growth of Islamic finance in the country can be inferred from the increasing uptake of their products. TAIB reports a steady growth of more than 50 per cent per annum for its Home Financing Portfolio. There has also been a 20% increase of their short term fixed deposit product. With a low minimum deposit of USD 100, as compared to conventional banks which charge USD 1000, this is spurring on people to save thereby realising a secondary aim. Part of TAIB's strategy is to inculcate a savings culture in a country with a high GDP per capita and they have been active in offering financial management education programs. This follows the general trend adopted by the Brunei government in encouraging prudential money management. The Brunei government issued tighter rules on credit cards in order to curb the increasing debt incurred by Bruneians.

On the institutional side, TAIB is a cornerstone investor in the Securus Fund, the world's first Shari'a-compliant data centre fund, which offers a long-stabilised cashflow and is managed out of Singapore. Data centres are purpose-built real estate facilities housing rack-mounted computer servers. Data centre demand has been driven by the rapid rise of e-commerce, social networking and file sharing. Supply of data centre space has been unable to match the growth in demand.

Takaful

In 2008, the Takaful Order was enacted ensuring a level playing field with conventional insurance companies. The Order required Takaful providers to be better capitalised. Official figures show that while assets at conventional insurance companies shrunk between 2008 and 2009, the takaful industry grew by 5.2% from USD 144.2 million to USD 151.8 million. General takaful has been the most successful segment of takaful; while family takaful has experienced slow growth. In November 2010, Takaful Islamic Bank of Brunei and Takaful Bank Islam Brunei Darussalam announced they would be merging. The new entity will be known as Takaful Brunei Darussalam. Merging facilitates a consolidation of resources and experience. Part of the problem for the takaful industry is that the expertise in this field is limited; though takaful companies have managed to increase their profile both within and beyond. In December 2009, Insurans Islam Taib became Brunei's first IFI to receive a rating from an international ratings agency, Fitch.

If it says its halal, it is halal.

The government's long term development plan, LKN 2007-2010, explicated Brunei's keenness in establishing itself as an Islamic finance hub. However, this is not the only avenue through which they hope to achieve long term growth. Part of Brunei's strategy is to diversify from oil and gas, which has been been key to the success of Brunei's economy. But an acquiescing to the gradual depletion of resources, Brunei has sort other means to vitalise its economy, namely the halal industry. By, creating products and financial services which are permitted under Shari'a, the government hopes that it will encourage trade in goods and services which is emblematically halal. Brunei has already hosted five International Halal Market Conferences (IHMC); the most recent convened in June. The IHMC organisers stressed that this event is not just food related, and companies and organisations that are involved in Islamic finance, economic policy, travel and tourism, hospitality, media and networking were encouraged to participate. To add to this, in 2009, the government owned Wafirah Holdings, unveiled the global halal brand, a trademark indicating comprehensively that a certain product is halal and has passed the vetting standings of the Shari'a. The brand is hoped to be a key diversifier for the local economy. Ghanim International Food Corporation holds the licence to manage the brand which it hopes will be taken up by companies from other Muslim countries. The company, a 50-50 joint venture between Hong Kong-based logistics firm Kerry FSDA and the Brunei government will be focusing on assisting export-ready SMEs. Ghanim is working with global manufacturers to make and then market them worldwide through Kerry Logistics supply chain, under the Brunei Halal brand. In October, the Brunei Halal range of products was successfully launched in Singapore and is now available at the Lion City's biggest supermarket chain, NTUC FairPrice Cooperative Ltd.

Challenges remain

Brunei hopes to build by combine the Halal brand with Islamic finance to bolster its international profile. However, there are number of challenges that need to be overcome if Brunei wishes to progress in Islamic finance. A pervasive problem is that even with a high percentage of consumers of Islamic banking services, there is a still a lack of understanding about Islamic banking products, which affects the development of human resources in this field. More education is required.

Universiti Islam Sultan Sharif Ali (Unissa), earlier this year, held an International Conference on Islamic Finance, where experts collectively agreed that, "human resource development is a key factor in helping boost Brunei's Islamic finance sector". Unissa offers a Bachelor Degree programme on Islamic finance, to introduce Islamic finance to the workforce. The Authority for Info-communications Technology Industry of Brunei Darussalam granted USD 151,600 to Crescent Sdn bhd for its 'Premier Global End-to-End Online Programme for Masters of Islamic Banking and Finance', which would allow the attainment of a Masters in Islamic Banking and Finance (MIBF) through an online program. The programme is scheduled to begin next year.

Human resources and product innovation and proliferation are two crucial issues Brunei need to tackle in order to compete with traditional Islamic finance hubs. But signs are good for Brunei. However, whether they can be forging a path like their neighbour Malaysia, remains to be seen though maybe they do not need to be like Malaysia; maybe they need to be like Brunei: a small nation with a big voice.

IFCI ranking: 36

CANADA

The Islamic finance market in Canada has yet to take off. The problem for the Islamic finance market is the low Muslim population and its localisation to Toronto, but even with this in mind, there is significant potential for a thriving Islamic finance industry. Providing the interest from policy makers remains and is sustained by organised and effective lobbying from market players both domestically and internationally, there is a bright future for Islamic finance in Canada.

2010 witnessed a number of encouraging developments. In March, the Usury Free Association of North America (UFANA) hosted the inaugural conference on Islamic finance which was well attended by industry players from across the globe. Senior representatives from four of the five big Canadian and representatives from the Ontario Ministry of Finance and the Federal Ministry of Finance were in attendance, highlighting the level of interest amongst the government and the financial fraternity. With over 30 speakers, discussions on retail banking and the capital markets dominated the agenda over the course of two days.

The conference provided the platform for the unofficial launch of UM Financial's - Canada's premier IFI offering Islamic financing and investment solutions – iFreedom Plus MasterCard. The official launch took place on Aug 15. Charging no interest, and no monthly or transaction fees, iFreedom will be the country's first Shari'a-compliant credit card. UM Financial reported that one thousand customers had already registered for the card, and they expect to deploy 10,000 cards in their first year. Card accounts will be managed by Mint Technology, which operates other prepaid card programs.

Continuing the series of firsts, Assiniboine Credit Union (ACU) launched the country's first of its kind Islamic mortgage based on diminishing musharaka as a pilot project for the local Muslim community in Winnipeg. The long term success of this project will depend on the response by the community over the coming year. The product has been in the works for four years since the company was approached by members of the local Muslim community led by Shaikh Hosni Azzabi, Winnipeg's Imam. This is the first mainstream financial institution in Canada to offer an Islamic mortgage directly to its members, allowing them to have a personal relationship with the financier. The structure was approved by the Canada based Islamic Finance Advisory Board, an independent, nonprofit organization, which provides and promotes Shari'a-compliant advisory and audit to the financial services industry.

Gowling Lafleur Henderson LLP prepared a report released in March for Canada Mortgage Housing Corporation, a government provider of insurance for housing, on the potential of Islamic home mortgages in Canada. The comprehensive report, which analysed the actions undertaken by other countries in implementing Islamic finance, such as the UK, concluded that there would not be any significant legislative hurdles in accommodating Shari'a-compliant financing in Canada. This is good, especially with the fall in prices of Shari'a-compliant mortgages since the first home financing instrument was offered in 1979. However, the report was quick to point out that no conclusive empirical research had been undertaken to assess the level of demand for Shari'a-compliant mortgages and Islamic retail products in jurisdictions where it is offered, including Canada itself. Most of the optimism about strong demand seems to be coming from anecdotal evidence.

Consequently, the termination of the frontier Alt Oasis Canada Fund in April, one of only two managed Shari'a-compliant equity mutual funds in Canada, could be considered ominous. A low number of unit holders and the costs associated motivated the decision. Arguably, one cannot infer too much from this as the product was designed for high net worth individuals. In fact, on the institutional side, there is a growing level of interest from international Islamic banks, especially from the cash-rich Gulf States, in Canada real estate. Kuwait Finance House (KFH) has established a joint venture with Killam Properties to acquire up to CDN 450 million (USD 447.5 million) of multi-family residential properties in Canada. The agreement is considered to be the first real estate investment for KFH in Canada. Following the signing of this agreement in November, the Canadian Minister of International Trade, Peter Van Loan, acknowledged that Islamic banks from Kuwait can play a key role in investing in Canada. Canada has also been strengthening trade relationships with Islamic finance centres such as Saudi Arabia and Qatar.

Some of the credit of drawing the attention of the government to Islamic finance has to be given to Toronto Financial Services Alliance, a public-private alliance dedicated to the promotion of Toronto as a financial centre. In 2008, they created the Islamic Finance Working Group (IFWG) to discuss and propose ways in which Islamic finance can enter the Canadian markets. In May a report entitled 'Making Toronto the North American Center for Islamic Finance: Challenges and Opportunities' was released by the IFWG. The report recommended productive ties between banks and Muslim owned businesses, clarification and amendments of the regulatory framework, strategic alliances with Islamic finance centres to advise, educate and promote Islamic finance; and increasing foreign direct investment from the Gulf. The IFWG hopes to undertake further research on the development of the Islamic retail sector, the issuance of sovereign sukuks, taxation of Shari'a-compliant products and education programs in Islamic finance.

As with most non-Muslim countries looking to accommodate Islamic finance, there has been talk in the Canadian financial sector about the issuance of sukuk with HSBC bank Canada and UM Financial indicating that they are in the process. Values of the sukuk could reach up to CDN 2 billion but since further details have not come out, for the moment, the market remains quiet. Unfortunately, for the Islamic finance industry in major non-Muslim centres (think UK); any talk of issuing sukuk is usually followed with disappointment. It will be a shame as Canada's economy has emerged from the recession faster than the other G-7 Nations. Low interest rates, low inflation and a stock market, - which according to statistics, Canada has increased 42 per cent over the past five years - paint a healthy picture for the Canada economy.

While the Big Five[1] banks have previously shown little interest in Islamic finance, there is a slow change in perspective. Representation in the UFANA conference was indicative but what has been more promising is their involvement in formulating academic courses in Islamic finance. University of Toronto's Rothman School of Management will offer MBA students an elective in Islamic finance in 2011. Toronto's Centennial College, a community college recognized as one of the most culturally diverse post-secondary institutions in Canada, launched an Islamic finance course in May. The online course is being offered in association with London's Security and Investment Institute (SII), providers of the accredited Islamic Finance Qualification.

Other academic institutions such as Ryerson University's Ted Rogers School of Management are showing interest in the growth of Islamic finance. In June, they hosted the G20 Islamic Finance Summit, in association with UFANA. A one day event, it was a series of panel discussions looking into the role of Islamic finance in the global markets. A small event with a grandiose name, it is an appropriate metaphor for the growth of Islamic finance in the world: a niche alternative with grand ambitions. In Canada, these ambitions have yet to be realised but the formative steps have been made.

[1] The big five banks are: Royal Bank of Canada, Toronto-Dominion Bank, ScotioBank, Bank of Montreal and CIBC

IFCI ranking: –

CHINA

China's economy continues to grow at an impressive rate. The confluence of a strong internal industry along with a diversification in the international economy has given China a global influence. But China is looking for a symbiotic relationship; for institutions to invest in China. There aren't many countries, who would deny this invitation, not least countries from the Middle East. The relationship is gathering strength following 9/11, as the Gulf States looked to the East to invest their windfall earnings and with China being an economic powerhouse, opportunities are not hard to come by.

The new silk road

According to global consultancy McKinsey in 2008, the Gulf has the potential of earning USD 4.7 trillion by investing into Asia. This not only includes China but also subcontinental Asian nations such as India. Nevertheless, through interpolation, the profits that could be earned from China alone are staggering. Already, the Middle East has shown keen interest, ploughing millions into the China through investments and capitalising on the capital markets. Reciprocally, China has invested billions into energy, technology and physical infrastructure in especially North African countries such as Libya, Mali and Sudan. In 2009, the two-way trade between China and the Arab states hit USD 107.4 billion, compared with USD 36.4 billion in 2004. China also has diplomatic ties with all 22 Arab League states.

Into this dynamic relationship, Islamic finance is making headway. In 2006, Shamil Bank partnered with a local Chinese partner, CITIC International Assets Management ("CIAM") - the asset management arm of CITIC Group, a major state-owned Chinese conglomerate - to launch the first ever mudaraba property fund for investment in selected Chinese properties. Across the Gulf there was a strong demand from investors which included high net worth investors and financial institutions. It was expected that the returns could be as high as 18% IRR.

Unfortunately, things have not been as successful as hoped. The 9th investors report released on September 2010, revealed that the IRR has been declining. Part of the problem has been the Chinese government increasing restrictions on currency conversions resulting in extensive delays when converting into dollars thus translating into a lower IRR. Other problems have been the inefficiencies of the district government and the property bubble which is likely to burst in China. There is an expectation that property prices will fall by as much as 10 – 20%. China has responded by adopting aggressive tightening measures. The fund is therefore looking to exit by the end of 2010. After years of double digit growth, a flattening out was bound to occur, but the Chinese machine is likely to weather the storm with the steely determination and focus that facilitated its expansion. Economists predict the downturn will be minimal.

This level of stability and economic expansion provides the attraction for Shari'a-compliant funds to invest in China and capitalise on growth sectors. Prudential Fund Management (PFM), a Malaysian based company launched a Shari'a-compliant fund Prudential Dinasti Equity Fund in 2009, which leverages on the anticipated consumption growth in China. PFM has also worked with Dow Jones to create the Dow Jones Islamic Market Greater China Index which it used as a benchmark for the fund. The index will measure the performance of companies in China, Hong Kong and Taiwan that have passed screens for Shari'a-compliance.

In 2010, Hong Leong Tokio Marine Takaful launched its new China Growth Income Plan (CGIP). The five-year capital preserved investment plan uses murabaha and wa'ad to invest in key growth sectors in China, which include information technology, telecommunications and commodities. Another example is the AIIMAN A20 fund, a USD 100 million Islamic wholesale fund that will invest into the 20 largest Shari'a-compliant

China companies, listed in Shanghai or Shenzhen stock exchanges. It was the first non-ringgit Islamic wholesale fund and the first to focus on China A-shares.

Looking to Malaysia

As Malaysia look for opportunities to progress economically, they are leveraging on their experience and success in Islamic finance. Building strong commercial relationships with China will act as a channel through which Malaysia can develop. Deputy Finance Minister of Malaysia, Donald Lim Siang Chai recognised this in his speech at the 15th Malaysian Capital Summit, held in December. He encouraged IFIs in Malaysia to set up joint ventures with Chinese intermediaries, transferring expertise for investment. How China reaction will respond largely depends on how they perceive the profitability of Islamic finance. But the signs are good.
These signs are not only evident by the number of funds that are investing into China, but also through the partnerships which are being formed between Malaysian and Chinese entities. The Liaoning Province Authority in China have signed a memorandum of collaboration with the Islamic Banking and Finance Institute of Malaysia (IBFIM), and the Kuala Lumpur Chinese Assembly Hall (KLCAH), to provide interested organisations in Shenyang, capital of Liaoning with Shari'a advisory and consultancy services as well as training in Islamic banking and finance. It has to be noted that in Malaysia, one of the key consumer groups of Islamic finance are the Chinese. Some commentators even believe that the Chinese are bigger consumers of Islamic financial products than the Muslims.

Ningxia: the site for the first Islamic bank in China?

Being a staunchly secular society, it is difficult to calculate the number of Muslims in China. Figures vary wildly with some estimates at 60-70 million while others approximate between 20 – 100 million! Either way, this is a sizable amount with high concentration of Muslims found in the northwest provinces of Xinjiang, Gansu, and Ningxia. Ningxia is China's only Muslim autonomous region with a 36% Muslim population. The region is hoping to develop a free trade zone with Muslim countries and has launched a plan to train more Arabic speaking professionals over the course of the decade. In September, Ningxia hosted a China-Arab economic and trade forum which was classed as a modest success by some commentators. Attendees included former Jordanian Prime Minister Nader al Dahabi.

As the proud Hui people of Ningxia seek to express their Muslim identity, Islamic finance is likely to play a greater role especially with regards to building up trade relations with Muslim countries. It is already attracting attention as the potential venue for the first Islamic bank in China. The Chinese government have launched a feasibility study into opening an Islamic bank, though details are scant and there are still deliberations as to the form the Islamic bank will take. Industry sources state that the Chinese government have drawn advice and technical assistance from a number of organisations with expertise in Islamic finance including the professional services firm, Deloittes. The whispers coming from behind closed doors are positive but still no real development has taken place on the ground. It remains to be seen whether an Islamic bank will be formed but the interest is there.

IFCI ranking: 13

EGYPT

At the time of writing, Egypt is under military rule. The Mubarak regime has been toppled leaving a void and a great deal of uncertainty as to who will take the reins of power. An array of candidates with divergent ideologies is seeking power. What their political and economic approach will be and how the international community will respond to the regime, is still difficult to ascertain. Hence, the future of Islamic finance in Egypt remains uncertain. But as a country commonly regarded as the birthplace of Islamic finance, aversion is unlikely.

History of Islamic finance

It has become gospel that the Mt Ghamr was one of the first IFIs in not only Egypt but the world. It is true that the practices of the bank were Shari'a-compliant but it never advertised itself as being an Islamic bank. Only after Islamic banking and finance became part of the financial nomenclature in the late 70s that Mt Ghamr became consensually regarded as the first IFI. In fact, the first self regarded Islamic financial provider was an Islamic window set up by Bank Misr. The first fully fledged Islamic bank to appear in Egypt was Faisal Islamic Bank in 1979. The appearance of these banks is owing to a special law enacted in 1977, which accorded many advantages over conventional banks. It was surprisingly supported by most Members of Parliament including leftists, who initially had reservations.

Thus, the creation of the Islamic finance industry in Egypt is partly due to the concerted efforts of the government, to create an alternative to the 'usurious' conventional system. This was buttressed by the widespread religious revival during this period accompanied with greater returns on deposits offered as compared to conventional banks, and a high proportion of Islamic deposits in foreign currency. Conventional banks opened more windows to capitalise on this growth which diluted the share of fully fledged Islamic finance banks but reflected market potential. This took a severe swing with the collapse of Islamic investment companies in the late 80s and early 90s. These fund management companies were created on the back of religious legitimacy as well as the offer of high returns, significantly better than those offered by competitors. Unfortunately, companies such as El Rayan and El Saad, were effectively setting up ponzi schemes that claimed to invest in Shari'a-compliant assets. Millions of Egyptians were affected by the schemes and the government had to confiscate the assets and shut down these Islamic investments companies. The move had a widespread effect on the Islamic finance industry as a whole. By dint of association, the fall of the investment companies discredited Islamic banks. Customers began to express doubts on Islamic banks and subsequently long queues of account holders looking to withdraw their money were seen outside Islamic banks. It was not only socioeconomic factors which adversely affected the Islamic financial sector. In terms of financial health, the devaluation of the Egyptian pound and the precipitous reduction of the rate of return on Islamic deposits to a level below conventional deposits further added to the woes. Islamic banks were also guilty of mismanagement, which was reflected by the high levels of bad loans. The failings of Islamic banks led Sheikh Mohammed Sayyed Tantawi, Mufti of Egypt (1986-1996) and Al Azhar (1996-2010) to issue a controversial fatwa in 1989, ruling that the type of interest charged by conventional banks was lawful. A few years later he supported his fatwa by stating that conventional banks were more Islamic than the nominal Islamic banks and they should be shut down or at least not be labelled Islamic.

Islamic finance in the 21st century

Tantawis' statements did not find much support from Members of Parliament who recognised that Islamic finance does play a part in meeting a specific demand within the country. But the strong political will of the 70s and early 80s has been replaced by caution and doubt. Experts argue there is tremendous potential for the Islamic finance industry to blossom but the political will is absent and consumers are still dubious about the efficacy and veracity of Islamic financial institutions after the debacle of late 80s. The government has not removed the tax obstacles which affect Islamic finance transactions. Islamic Banks are regulated by the Central Bank who has made it clear that they will regulate Islamic banks on the same terms and conditions as conventional banks. There is no secondary market for short term investors to sell Islamic products which will deter institutional investors. Furthermore, the weak infrastructure is compounded by the lack of available talent within this field.

Today, there are three Islamic banks in Egypt Al Baraka, Faisal Islamic Bank of Egypt and National Bank for Development. The government expressed desire to issue sovereign sukuks and enact enabling legislation. This is a positive step forward, arguably resulting from the success of its neighbours in the Islamic finance market. Moreover, lenders such as Abu Dhabi Islamic Bank and Bahrain's Al Baraka Banking Group have already bought large stakes in Egyptian banks which suggests the development of the Islamic finance market in Egypt can be driven by gulf based banks that have the capital and the expertise to invest into the infrastructure of the Islamic finance market.

In terms of takaful, Saudi Egyptian Insurance House was established in 2003 and was the first takaful insurance company in Egypt. The company has been followed into the sector by eight others companies that all started operating in mid 2008, with fifty percent of the capital coming from the Gulf countries. According to figures published by the Egyptian Financial Surveillance Authority in 2009, takaful companies in Egypt currently hold a 5 percent stake of the USD 1.45 billion Egyptian insurance market. There is an expectation that the takaful industry will grow dramatically over the next few years.

However, despite Egypt's long history in Islamic finance and its commendable developments in recent years, only 3 - 4 % of its total banking industry - valued at USD 193 billion - is involved in Islamic finance according to the consultancy McKinsey & Company in 2009. There is therefore room for growth.

That was last year

How Islamic finance will fare with the change of regime is conjectural. Islamic finance in Egypt has over the years endured fluctuations of popularity both in terms of demand as well as government support. Assuming the next regime continues the policies of the Mubarak government, it is likely progress will be slow with marginal developments spread out over a period of time. A more supportive government can build momentum in the industry utilising the support and experience of Islamic finance hubs in the region such as Saudi Arabia, UAE and Bahrain. But the bedrock for a thriving Islamic finance industry is already present in Egypt. Egypt has the 6th largest Muslim population, a legal system that affirms certain aspects of the Shari'a and home to the oldest seat of Islamic learning in the world, Al Azhar. Al Azhar operates the Saleh Kamel Center for Islamic Economic studies and has been the site for many conferences. The infrastructure is there; how the next government utilises this infrastructure to develop Islamic finance remains to be seen.

IFCI ranking: –

ETHIOPIA

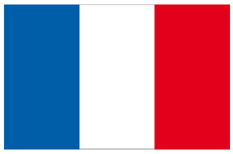
Ethiopia has had a strong relationship with the religion of Islam from the time of the Prophet Muhammad. It is one of the oldest independent countries in Africa only suffering a brief period under the occupation of Mussolini's Italy. Sadly the economic situation today is regrettable, as Ethiopia is one of the poorest countries in Africa and has been plagued by recurring famine and drought. It has one of the lowest GDP per capita in the world. Furthermore, the tolerance that existed between Muslims and Christians at the time of the Prophet has vanished and has been replaced by tension.

Muslims in Ethiopia make up about 33% of the population which is a sizable amount. Islamic finance has begun operating in other countries in East Africa; however there is scepticism among non-Muslims, as they are of the misconception that Islamic finance is solely for Muslims. Another misconception is that Islamic finance promotes terrorism. Thus much needs to be done to educate the local population within Ethiopia and other countries in the region as to the true nature of Islamic finance.

Due to a strong demand from local Muslims, the National Bank of Ethiopia (NBE) late last year approved a directive which will make it easier for banks in Ethiopia to have windows which will offer interest-free banking services based on profit sharing schemes as well as Shari'a-compliant financing. The establishment of Islamic finance in Ethiopia may greatly benefit the economy as more Muslims may be encouraged to use the banking system rather than informal channels. Furthermore, it will attract much needed investment from the other parts of the Muslim world. However, according to the prime minister, for the time being, foreign banks will not be allowed to be involved, and the shareholders will have to be from Ethiopia.

The first bank planning on setting up an Islamic bank is Zemzem Bank, which this year has sold shares worth 100 million birr. This surpassed the capital level required by the NBE by 25 Million birr. Zemzem was established in 2008 but had to wait to float shares until the RBE approved the directive on Islamic banking, which it took two years to do. Zemzem Bank is now gearing up to have its first general assembly, and it is expected that other banks will begin to offer Islamic financial services in the near future. Additionally as was mentioned earlier, Ethiopia is looking for increased investment from Muslim countries and has been actively engaged with the IDB, having a meeting with them in early 2010.

The response of the Ethiopian public to the share offering together with the warming of the government, are positive signs that the future of Islamic finance in Ethiopia is bright. Islamic finance may help recreate the atmosphere of tolerance among the different faiths, as it was at the time of the Prophet Muhammad (peace be upon him).



IFCI ranking: –

FRANCE

There has been an uneasy relationship between France and Islam, a country which has the largest population of Muslims in Europe. The furore over banning the niqab in public institutions has led to the question as to whether secularism can coexist with religious orthopraxy. The far right have exclaimed that permission to wear such a conspicuous religious symbol could lead to an islamisation of the country. It may be an extreme point of view but it is nevertheless a point of view that resonates amongst the general populace.

However, this level of trepidation does not seem to have affected the growing interest France has in Islamic finance. Undoubtedly, there are elements of the French parliament and society who reel in horror at the prospect of Islamic finance creeping into the country, but this is to be expected. But generally, a more salutary stance is taken towards this aspect of Islam, possibly because for the French, the niqab and Islamic finance two represent divergent perspectives. The niqab infers exclusion, Islamic finance suggests inclusion; the niqab is archaic, Islamic finance is modern; the niqab brings conflict, Islamic finance brings prosperity.

Du Finance Islamique

France's introduction to Islamic finance did not occur in the corridors of the French Parliament. French banks such as Societe Generale, Credite Agricole and BNP Paribas have long been active in the Islamic finance space and have bases in Muslim countries, such as Saudi Arabia and Bahrain. But now France are turning inwards, recognising that the potential size of the market for Islamic finance in France is large. The potential customer base however is far greater and it includes old French colonies such as Algeria, Morocco, Tunisia, Lebanon, Senegal and Mali; countries France still has strong trade links with.

In order to promote France as a market for Islamic finance, Minister of Economic Affairs, Christine Lagarde has been a leading figure. Her endeavours in creating working groups and pushing for legislative changes have been influential in advancing Islamic finance in France. Her efforts are coterminious with those of non governmental entities. Organisations such as the Invest in France Agency (IFA) have been proactive in building partnerships with countries and institutions that work in Islamic finance. In addition, non profit promotion bodies have been created such as the France Institute of Islamic Finance which is chaired by Mr. Hervé de Charette, former Minister of Foreign Affairs and Chairman of the Franco-Arab Chamber of Commerce. Their stated objective is to 'promote and help the development of Islamic finance in France and in the world' through lobbying, research and training.

Paris Europlace is another organisation whose remit is to promote Paris as a financial centre. It has since 2007 been a keen advocate of developing an Islamic finance market in Paris by establishing an Islamic Finance Commission. Paris Europlace reached an agreement in January 2009 with AAOIFI to promote the AAOIFI's Shari'a standards in France so as to encourage initiatives in asset management and the development of new bank and insurance activities. In December 2010, Paris Europlace convened a conference with Dubai's DIFC to discuss how France can partner with the GCC banking industry and become a key player in Islamic finance.

But France is not only looking to the Middle East for assistance. In October 2010, Banque de France and Bank Negara Malaysia signed a Memorandum of Understanding (MoU), to promote the advancement of the Islamic finance industry. The MoU states that the two banks will enhance their cross-border financial activities, including promoting and supporting Islamic finance transactions. The MoU called for mutual cooperation on human capital development, and development of the financial market infrastructure.

The government have shown enthusiasm in developing the market recognising the growth of Islamic finance in the last few years, especially in the Middle East. Also, the global recession stimulated a reassessment of values and methods of doing business. The quest for ethical practices in the financial market led Lagarde to declare that Islamic finance is inhered with those ethical principles. Thus it is not altogether a coincidence that the French interest in Islamic finance arose only in the last few years.

What do the Muslims think?

Salim Saifi, an investment advisor with IFA Middle East stated in June 2010 that France's Islamic finance sector registered a growth rate of 29 percent in 2009, compared to 6.8 percent for conventional banking. This has mostly been, unsurprisingly, in the real estate sector. In the three years to 2009, Islamic real estate transactions worth approximately 3 billion euros have taken place. But these have been high end transactions. For the average Muslim, France does not offer any Islamic financial services to cater to their religious requirement. A survey carried out by the French Institute of Public Opinion (IFOP) suggested that 55% of the Muslims would be willing to borrow even if they have to pay more for it. Unfortunately, there isn't the political nor the commercial will to offer retail services. At least for the time being, any developments will be occurring in the commercial markets.

Amending the law

The government, on the other hand, have been quite enthusiastic about the prospects of Islamic finance in France. The interest began in earnest from 2007. A Senate information report looked at how Islamic finance can be fostered through overcoming fiscal and legal obstacles and included five references to the need to encourage the emergence of Islamic finance in France. In July 2007, the French financial regulator, l'Autorité des Marchés Financiers ("AMF") laid down terms and conditions for setting up a fresh investment funds in line with the Shari'a, and noted in particular the importance of UCITS in developing Islamic funds.

It further clarified that the AMF treats Shari'a funds in the same manner as it treats other investment funds such as socially responsible funds, which use different criteria to build their portfolios. However, they emphasised that in the screening process for the funds, management has to be independent, with exclusive power over the final decision, though they can take advice and utilise Shari'a guidelines. A second point related to the purification of income that Shari'a funds have to undertake from time to time, which could negatively affect an investor's income. AMF stipulated that while this is permitted, references should be made in the prospectus about purification and the charities to which the monies will be donated.

The AMF statements were the first regulatory guidance issued, which expressly referred to Islamic finance. It represented a start in aligning Islamic finance tenets with the precepts of French law. The statement, however, was not the first example in which regulators mulled over Islamic finance. Loi no 2007-211 of 19 February 2007 brought the common law concept of Trusts into French legislation whose secondary effect was to lay the groundwork for the issuance of a French sukuk.

It is on sukuk and amending tax laws to accommodate Islamic finance that France has focused. The Sénat, the upper house of the French legislature, held a series of roundtable discussions on Islamic finance with key international players in May 2008. They looked at Islamic funds and amendments to tax laws that would have to be made in order to not unfairly penalise Islamic financial instruments. A government report published in 2008, estimated that France could tap into 120 billion euros in capital from Islamic finance, by making adjustments to its tax and banking law.

On 2 July 2008, the AMF clarified, through a statement published in French, English and Arabic, the criteria required to be followed for sukuks to be admitted into the French market. Primarily, the focus was on prospectuses which were required to adhere to EU regulations, in particular the Commission Regulation (EU) no. 809/2004 of 29 April 2004 implementing Directive 2003/71/EC (the Prospectus Regulation). After delineating the two categories of sukuk, namely asset backed sukuk and asset based sukuk, the statement goes onto elucidate that since the Regulation does not provide for any specific annexes that deal with sukuks, the prospectus will be required to be prepared according to the annexes which list comparable products. By way of example, Prospectuses for Asset backed securities will be prepared 'on the basis of the annex XIII with regards to the terms and conditions of the issue (in so much as the nominal amount of the bond is equal or greater than 50.000 euros), and the annexes related to "Asset Backed Securities", with regards to the issuer and the assets (annexes VII and VIII of the European Regulation'[212]. The AMF clarified further the drafting of prospectuses for sukuks in October 2010, with emphasis on the need for prospectuses to include the Shari'a parameters and the Shari'a board overseeing the product.

A point of interest is that the AMF in the July statement classified sukuks as bonds which is contrary to AAOIFIs opinion that sukuks are "certificates representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects". A subtle though controversial point, it is unlikely to raise too many brows as the AMF emphasised that it is not within their remit to regulate sukuks according to the Shari'a. However, the 2010 statement makes no mention to Islamic bonds, possibly as a deliberate attempt to appease potential issuers and investors. AAOIFI were certainly impressed by France's work in providing the infrastructure for the issuance and listing of sukuk approving the tax and regulatory changes made to issue sukuk.

Give me a tax break

Contrarily, for tax benefits, sukuks need to be structured as a debt instrument according to binding instructions issued by the Ministry of Economy and Finance in February 2009. Then, subject to compliance with

[212] AMF statement 02/07/2008

France's capitalisation rules, remuneration paid to the investors will be deductible from the taxable income of the borrower; and there will be no withholding tax if the investor is a foreign national. The instructions considered the fiduciary transfer of property between SPVs, and determined that VAT is exempt provided the fiduciary continues to use the property for an activity subject to VAT.

The investor should have no voting rights and in the event of default, investors will be given priority for repayment. There is no capital guarantee though investors could be reimbursed the full nominal value, but no higher, depending on the value of the underlying asset.

The instructions also clarified the approach to be undertaken for murabaha. As noted above, most of the Islamic finance transactions in France were in real estate. Parties relied on the Marchand de Biens statutory regime in which a company could buy property or acquire shares in real estate in order to resell them. The financier would be liable for reduced stamp duty on purchase from the seller. They would also be liable for VAT on the portion of profit directly related to intermediary services.

By using this regime, transactions could be structured using the murabaha model. However, there were several incongruent aspects to the regime including the possibility of speculation through the two operations of purchase and sale. It was also unclear how tax authorities would treat the murabaha profit, the portion which related to the opportunity cost of the deferred payment to the financier. The instructions determined that the profit would be considered interest and would be taxed on an accrual basis for the duration of the murabaha. The fees for the intermediary services would therefore have to be calculated on a lump sum basis. If the financier is a foreign entity, there would be no withholding tax.

The instructions also considered commodity murabaha, stating that VAT is exempt if there is no physical delivery of commodities within France. This was in line with French tax law.

Exciting times in Paris

The February 2009 instructions were updated in July 2010. At the same time, new tax instructions were issued on ijara and istisna transactions. The gradual progress made by France in Islamic finance has drawn approval and attracted leading Islamic banks. AAOIFI have praised France for their efforts to create the infrastructure necessary for the issuance of a sukuk.

In 2005, permission was sought for the creation of a Sharia compliant bank, Taysir, by Syrian born Investor Fehmy Saddy. Banque De France signed a MoU; however a clause in contract called for a French majority shareholding. This proved to be difficult as many of the clients approached were apprehensive of being involved in Islamic banking activity for political reasons. In 2009, Banque de France agreed to waive its restrictions and accept a reputable foreign bank. Bahrain's Al Baraka has said they are interested in opening five branches in France, while Qatar Islamic Bank signed a MoU with Banque Populaire Caisse D'epargne, emphasising cooperation and provides access to the French retail and SME market. The intricacies and details of the cooperation are still being hammered out but show the interest global Islamic banks have with developments in France.

In November 2008, AIDIMM (Association for Innovation and Economic Development and Real Estate) and IFAAS (Islamic Finance Advisory and Auditing Services) joined together to create of the ACERFI (Audit, Compliance & Research in Islamic Finance). This was regarded as the first Shari'a board in France and consists of a number of Islamic scholars. ACERFI will concentrate on research and ensuring Shari'a-compliance of products.

Additionally, a number of universities have started to offer Islamic finance masters. Paris Daulphine and the University of Strasbourg offer Masters' degrees, while business schools such as ESC Reims offer modules in Islamic finance.

The return of the unhappy right

The tax instructions are positive developments for Islamic finance in France but it has to be noted that they did not change the law, just clarified the fiscal application. Changing the law would be a tiresome undertaking not least because of the rigidities of the French civil law system. The looming shadow of laicite – the separation of state and religion- is a constant headache for exponents of Islamic finance in France. It is a gargantuan hurdle; to some extent explaining why the issuance of a sukuk has been delayed in France and why the government are dragging their heels in pushing Islamic finance forward. They can hardly be blamed for stuttering. On June 9th 2009, the French Senat passed a bill for the easy access of credit to SMEs. An amendment was made which effectively facilitated the issuance of sukuk. This was met with dismay amongst the right but the uproar was not large enough to derail the changes. Consequently, the French Socialist opposition challenged the legality of the new legislation on Islamic finance before the Constitutional Council. The Council ruled that the provision should not have been lumped into a broader bill on financing for medium and small businesses as it was a separate issue. Their justification was that the provision was challenged not on technical points but rather over the procedure followed in parliament. The socialists were simply content that it had been quashed.

And therein lays the problem for France and Islamic finance. The public space is a sacred, secular arena; the imposition of religious symbols whether it is in the form of veil or a bank which brazenly calls itself 'Islamique' is an anachronism. Balancing the sensitivities surrounding laicite and attracting investment, the 'Islamic' way, is imbued with difficulty. Nevertheless, the push to issue a sukuk continues with Thierry Dissaux, chief executive officer of the French Deposit Guarantee Fund, saying that a sukuk will be issued in 2011. The framework is there, the political will is in place, but then again, we cannot be too sure.

IFCI ranking: 35

GAMBIA

In the Muslim world, Gambia may not be typically associated with Islamic finance. Yet this West African nation which overlooks the Atlantic Ocean has made remarkable progress in the field, though largely under the radar.

There are currently fourteen banks within the local industry of which one is an Islamic Bank. The sole Islamic bank in the nation, Arab Gambian Islamic Bank Ltd (AGIB), was granted licence to begin operations by the central bank of Gambia in 1997, through the amended Financial Institutions Act of 1992. Although Finbank of Nigeria acquired 70% of AGIB in 2008, it has continued to be run on Shari'a principles.

Islamic finance has also made inroads in the Gambian Insurance sector. Takaful Insurance Company Gambia was established in 2007 and is now one of the 11 insurance companies which make up the sector. In 2010, the company disbursed 2 million dalasis to their customers, in addition to the setting up of a scholarship fund for needy students.

The Gambian government has been proactive in promoting Islamic finance, and has provided changes in regulation to facilitate the expansion of takaful. Local municipalities have even begun offering their workers takaful coverage through the Takaful Insurance Company Gambia. Furthermore the Gambian government has used salam sukuk as part of their liquidity management programs.

Due to the high population of Muslims within the country as well as the need to attract foreign investment, the government has been actively engaging the Middle East. In 2010, Gambia and the IDB signed four agreements to finance development projects in the country worth a value of USD 46 million. Part of the financing will go towards further developing the University of Gambia, and this may pave the way for possible courses in Islamic finance in future. The agreements signed in 2010 brought the total financing of the IDB in Gambia to USD 310 million, in various sectors of the economy.

The signs from the top level are positive and coupled with the rising demand from the local population, one can expect Islamic finance to continue to expand in Gambia.

IFCI ranking: –

GERMANY

Following the issuance of the first European sukuk by the Germany Federal State of Saxony-Anhalt in 2004, there was a lack of political will for an Islamic finance market within Germany. This is surprising as Germany has the second largest Muslim population in the EU of 4.3 million, the majority being Turkish. Moreover, German multinational financial institutions such as Deutsche Bank, Commerzbank, insurance giant Allianz, and others, have been active in the structuring and distribution of Islamic financial productions in the Middle East and Asia. The home market has not been as dynamic but with historical ties to Turkey, this may change.

German multinationals

German banks have a good reputation for product development in Islamic finance. Deutsche Bank introduced two sukuk, for Bahrain and for the Islamic Development Bank, into the market in 2009 and has become one of the major players in the Islamic banking business. In 2006, Deutsche Bank developed the DWS Noor Islamic Funds, through its mutual fund arm DWS investments. There are several funds under the DWS Noor Islamic Fund brand, structure to capitalise on opportunities in growth markets such as China and Japan. Dubai Islamic Bank is one of the distribution partners for the fund.

Structuring mutual funds has been one of the main products structured by German banks. They have been useful to tap into the home markets. Commerzbank structured the Al-Sukoor European Equity Fund on behalf of Al-Tawfeek Company for Investments, largely aimed at Turkish expatriates in Germany and the Benelux countries, and later marketed to Turkish retail investors in Turkey as well. But the Fund closed after four years.

Recently, Cologne-based Meridio AG launched the Meridio Global Islamic Multi Asset Fund, a Luxembourg-domiciled mutual fund, which the promoters claim is the "first approved, actively managed, international, ethically compliant, balanced mutual fund under European investment laws" and is aimed initially at retail and institutional investors in Germany and the Euro zone but hopes to be branched out to the East. The investment pool comprises Shari'a-compliant equities and sukuk. It is a dual currency (us dollar and euro) open-ended multi-asset mutual fund.

The Turkish connection

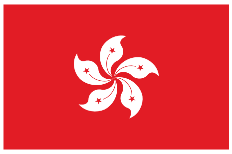
While the most of the activity in Islamic finance is occurring outside of Germany, this is not to say that there aren't attempts to raise awareness at home. Particularly prominent has been Institute for Islamic Banking and Finance (IFIBAF). As a promotion body, it has been active in raising awareness about Islamic finance throughout Germany. IFIBAF also provides consultancy and Shari'a advisory services to institutions seeking to provide Islamic finance products and services. The Central Council of Muslims, ZMD, a Muslim representative body commenced an initiative for establishing a program to certify the Shari'a-compliance of a product. However, ZMD is not recognized by all Muslims in Germany as their authorized representative. The Muslim community in Germany is not a homogenous group and therefore it is difficult to create a lobby to encourage Islamic finance in Germany.

The Turkish community however makes a sizable proportion of the German Muslim population; and there have been concerted efforts to offer tailor made financial products for the community. Deutsche Bank has set up a product line, Bankamiz, specifically targeting ethnic Turks that have been quite successful. However, Bankamiz products are not Shari'a- compliant but do reflect the potential of targeting ethnic groups. Indeed, the strong Turkish contingent has attracted Kuveyt Turk to set up a branch in Germany. The Federal Financial

Services Authority (BaFin), has issued a limited banking license to Kuveyt Turk Participation Bank. However, it is only permitted to collect funds that are transferred to accounts in Turkey that conform to Islamic rules. It is expected to start operations in the first quarter of 2011.

The role of BaFin

In 2009, BaFin organised a conference on Islamic finance in Frankfurt. The event was attended by 160 delegates from home and abroad and discussions centred on structuring Shari'a-compliant products and the prospects of Islamic finance in German. BaFin wishes to lay the legal and regulatory framework for Islamic finance, concluding that the German legislative framework can accommodate Shari'a-compliant products. However, since then there has been no real effort to facilitate Islamic finance in Germany.



IFCI ranking: –

HONG KONG

It would seem the enthusiasm for Islamic finance is petering out for the island state. Optimism was high two years ago for Hong Kong to be an Islamic finance hub outside of the Middle East and Malaysia, but things have not materialised that way. The 2010 budget speech was the first time that Islamic finance was not mentioned since 2007, and there have been few meaningful changes in tax law to facilitate Shari'a-compliant products. Even the prospect of issuing a sovereign sukuk has taken a blow when the Airport Authority announced that it would not be issuing a sukuk to raise money for a third runway even though they are still interested in building a runway. Thus, the question is how committed are Hong Kong to the development of Islamic finance in the country?

The Hong Kong Monetary Authority speaks

Very committed is the answer given by Hong Kong Monetary Authority Executive Director, Edmond Lau. The proof is in the pudding and Lau can point to a number of examples which show that Hong Kong is committed to Islamic finance. Hong Leong bank opened the first dedicated Islamic window which offers Shari'a-compliant wholesale and investment banking solutions. In 2009, CIMB Bank, another Malaysian bank launched its first Shari'a-compliant product in Hong Kong: a commodity murabaha with Hong Leong bank approved by the Hong Kong Monetary Authority. CIMB bank became the second bank in Hong Kong to have an Islamic finance window.

To build this embryonic industry, focus has been on education. The Treasury Markets Association (TMA) has provided education programmes and organised a series of workshops and seminars on Islamic finance. In September 2009, HKMA signed a MoU with Bank Negara to assist in the developing Islamic finance industry in Hong Kong through capacity building, facilitating cross-border transaction and human resource development. Later that year Malaysia Securities Commission (SC) and the Hong Kong Securities and Futures Commission (HKSFC) signed an MoU, allowing for the fast-tracking of local Islamic finance products into the Hong Kong market and vice versa. The MoU also states that the two institutions will share information and experience about the development of a legal and regulatory framework in relation to Islamic collective investments schemes. Hong Kong is also seeking the cooperation and expertise of Brunei to work together in putting Islamic finance on par with conventional finance. With these developments and recognising the long term importance of Islamic finance in the country, Hong Kong University of Science and Technology's Business School introduced an Islamic finance elective as part of its MBA programme in April 2010.

Acting as the conduit

As with most countries that have an interest in Islamic finance, the lure of tapping into Middle Eastern wealth has encouraged interest. Edmond Lau's opening speech at the Islamic Finance News road show in May highlighted the large pool of oil money which Gulf States are looking to invest and hope is for Hong Kong to have the right funds and products on offer to meet the Gulf investment needs. National banks such as Hang Seng Bank have created Islamic funds. Furthermore, there is a growing interest by Gulf States to invest in mainland China using Hong Kong as a platform.

Hong Kong has been a key fund raising centre for China. By the end of 2009, the stock market in Hong Kong was the 7th largest in the world with half of the stocks populated by Chinese companies in a range of industries. The two most prominent Islamic indexes, Dow Jones Islamic Titan Index and Hong Kong Islamic index have half of its constituent companies based in mainland China. According to recent market figures the Hong Kong Islamic index has outperformed the Seng

Index by 2% in the last two year and has outperformed the Seng Index by 17%, since its inception in late 2006.

In summary, we can see a number of developments in the market. Most of the activity is occurring in the private sector, especially with multinational behemoth HSBC playing an active role in Islamic finance. The conveyed quiescence may have more to do with the ravages of the credit crisis than to diminishing of intent. It is true sukuk had been a major focus for Hong Kong, and with the Airport Authority's announcement, intentions were questioned. But, the current discussions about amending the tax law as well as having three exchangeable sukuk on the stock exchange, indicates that the issue is far from being put to rest. Government affirmation of this is reflected through collaborations and discussions on amending aspects of the tax laws which may adversely affect the issuance of a sukuk and make it less competitive with conventional bonds. The focus is on four types of sukuk: ijara, musharaka mudaraba and murabaha; and it is hoped that legislation is passed in the next two years. The industry waits in anticipation.

IFCI ranking: 11

INDIA

2010 was a remarkable year for Islamic finance in India. There were at least half a dozen important developments but the two most conspicuous were the launch of the BSE TASIS Shari'a 50 Index and the court wrangling over the formation of an Islamic finance company promoted by the Kerala State Industrial Development Corporation (KSIDC) of the state of Kerala.

BSE TASIS Shari'a Index

Coverage for the launch of the BSE TASIS Shari'a Index has been prodigious. A lot has already been said and written about the Index. However what is worth highlighting is the methodology and performance of this index which in many ways is unique. In terms of methodology, the TASIS index has taken a strict line with Shari'a screening: less compromise with Shari'a means higher level of Shari'a-compliance.

Moving onto its performance, in the past few years the Indian economy has done very well, even during the recent global financial crisis. Consequently, a large number of Foreign Institutional Investors (FII) during, as well as after, the crisis invested in the Indian market.

This has taken the performance of Indian Indexes to higher levels. When looking at the performance of the Indian stock market from this perspective, it is highly satisfying that the Shari'a Index has outperformed India's bellwether Index (i.e. Sensex) by over 25%. Similarly the BSE TASIS Shari'a 50 Index has beaten the S&P India Shari'a Index by more than a 30% margin over the last two years.

The third notable feature of this index is the 8% cap assigned to its constituents. This is India's first cap weighted Index which should reduce volatility in the index, i.e. fall less when the market drops and rise gradually when the market appreciates. As Exhibit 1 demonstrates, it has been consistently outperforming the market. Perhaps this is an indication of the inherent relative strength of the shares which constitute its universe.

Kerala State Industrial Development Corporation (KSIDC) allowed to start Islamic finance operations through Al Barakah Financial Services Ltd

The second noteworthy occurrence involves developments in the state of Kerala. This news also generated domestic and international interest. However, some of the reports which appeared on this subject were out of context and sensationalized. Before exploring the significance, it is necessary to clarify the sequence of events:

1) KSIDC took an interest in starting an organisation that will comply with Shari'a rules and regulations.

2) One of the Big Four accounting firms was commissioned to advise on the appropriate structure and business model for the proposed organization, keeping in view Indian regulations as well as Shari'a requirements.

3) A feasibility study report recommended utilising a Non-Banking Finance Company (NBFC) model, regulated by the Reserve Bank of India (RBI). This was finalized keeping in view the presence of Islamic NBFCs in the country.

4) Al-Barakah Financial Services Ltd was incorporated on November 30, 2009 under the Indian Companies Act with the following objectives:

> To carry out the business of leasing and hire purchase of vehicles, home appliances, plant and machinery, aircrafts, ships, industrial and other equipments, properties and other assets; investment in assets, properties, shares and other securities; and to act as financiers, portfolio

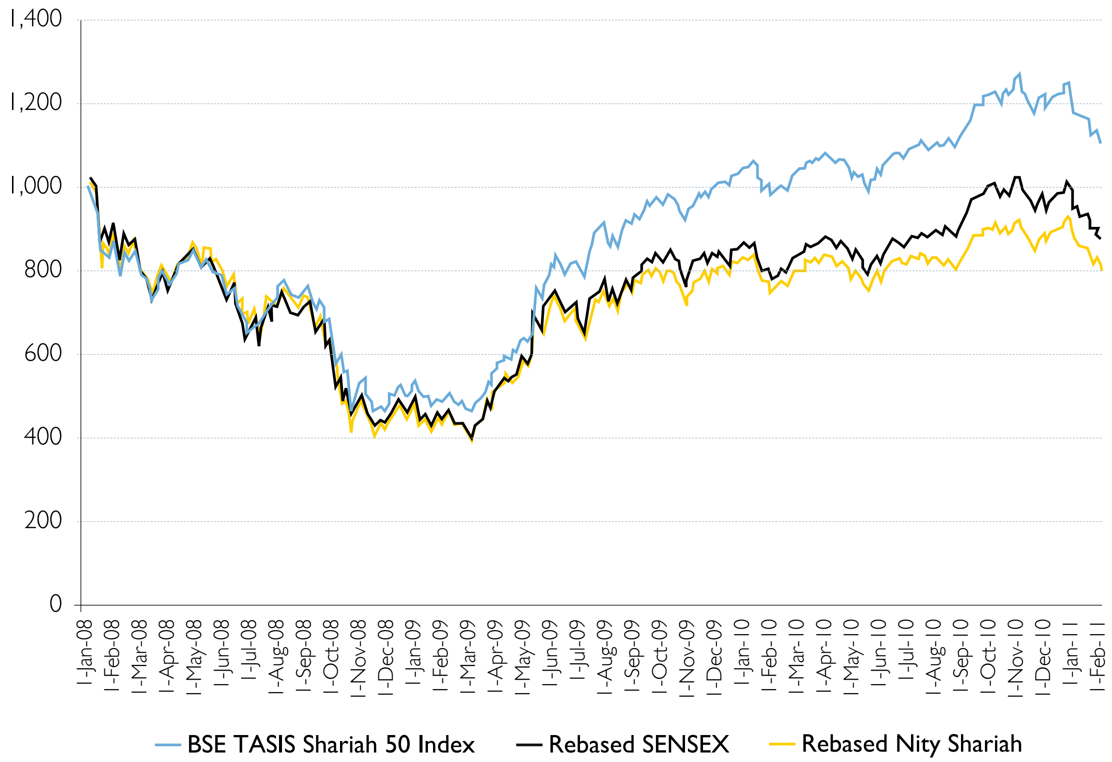


Exhibit 1: Comparison of performance of indices

managers, finance brokers and guarantors subject to Rules and Regulations issued by the Reserve Bank of India or such other government authorities from time to time. However, the Company shall not embark on or undertake any interest based financing.

5) It was also agreed that the state government would retain an 11% stake in the company and the remaining stake would be offered to businessmen drawn from various communities.

Once it became public, a Public Interest Litigation petition was filed in the court comprising the following contentions;

I. The forming of an Islamic Financing Company by KSIDC "is a clear instance of the State favouring a particular religion".

II. Formation of a Shari'a board composed of Muslim scholars "shows the identification of KSIDC with Islam, to the exclusion of all other faiths"

III. The prohibitions of interest, alcohol, eating of pig, etc. are against the constitution.

On January 5, 2010 a Division Bench of the High Court of Kerala, taking *suo mot* cognizance of the matter, ordered stay on the company's operations. The stay order was modified by an order dated April 8, 2010 which removed the stay on the company's operation, but the State was still prohibited from participating in the business of the company in any manner. The Court also requested submissions from a number of parties including the Union of India through the Ministry of Finance and the Reserve Bank of India (RBI)

After hearing the arguments of all the parties involved the High Court of Kerala dismissed all the petitions filed against the company in February 2011.

Some interesting aspects of the case

1) The Reserve Bank of India in its affidavit to the court submitted that with the current statutory and regulatory framework it is not legally feasible for banks in India to undertake Islamic Banking activities and the same holds true for Islamic NBFCs as well.

The High Court dismissed this assertion of the Reserve Bank. The Court in its order said that interpretation of the law is subject of the judiciary not the executive.

2) On the question whether an Islamic NBFC can function in India, the Court left the matter to the Reserve Bank of India on the pretext that the Court did not want to preempt the RBI from examining the matter. Many reports appeared in the media mistakenly reporting that the High Court had allowed Islamic banking in the country.

Other developments

1) The National Spot Exchange of India Ltd has received a Shari'a-compliance Certificate from TASIS for its platform for the electronic trading of gold, silver and copper on a spot basis. Considering the preference of a vast majority of Indian investors for investments in gold and silver, it is expected that the Shari'a-compliant trading of these commodities will further deepen the market in India.

2) Alpha Star Shipping LLC which has operations in

Dubai and other countries has started a short-term musharaka investment scheme. This is the first of its kind for an Indian company and will provide working capital to the company as well as provide Shari'a-compliant returns to a large number of investors.

3) The General Insurance Corporation of India has successfully completed its first year of its retakaful operation. The company has started retakaful operations in Malaysia and the UAE.

4) The Taurus Ethical Fund (TEF), India's first Shari'a-compliant mutual fund has outperformed India's best indices once again. On the 31st January 2011, the TEF gave an absolute return of 15.07% in one year, as compared to the return of 7.71% by the Benchmark Index (S&P CNX 500 Shari'a) and is ranked 20th out of 64 funds in the Open-end Equity Mid and Small cap category (Value Research) in a 1-year time frame. The fund also outperformed the Benchmark Index since its inception and has given a CAGR of 56.95%. During the FY 09-10, TEF declared 3 dividends amounting in aggregate to Rs. 4.50 per unit. During the FY 10-11 it declared a dividend of Rs.1.80 per unit on 10th Dec'10. Details of the dividends are as follows:-

Dates	Dividend Details
10th Dec'10	(18%) Rs. 1.8 per unit
19th Feb'10	(20%) Rs. 2.0 per unit
18th Sept'09	(10%) Rs. 1.0 per unit
31st Jul'09	(15%) Rs. 1.5 per unit

This can be graphically represented in Exhibit 2.

5) The Pure Stock Pension Fund (PSPN), is India's first Shari'a-compliant scheme regulated by the IRDA (Insurance Regulatory and Development Authority). This is the only scheme in India which is regularly audited by a Shari'a board. This scheme has performed very well. Its performance can be seen in Exhibit 3.

In conclusion, it is clearly apparent that Islamic finance has had an eventful year in India. With one of the largest population of Muslims in the world, India's government can no longer choose to ignore the industry. It is expected that this year, more hurdles will be crossed, facilitating the way for India to reach its potential to be a regional powerhouse in Islamic finance.

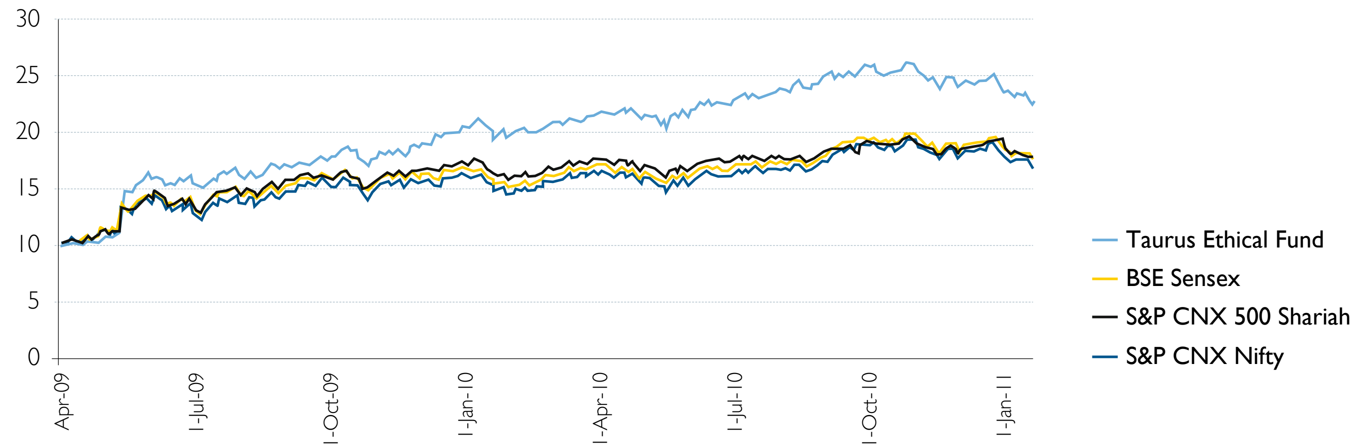


Exhibit 2: Dividend performance

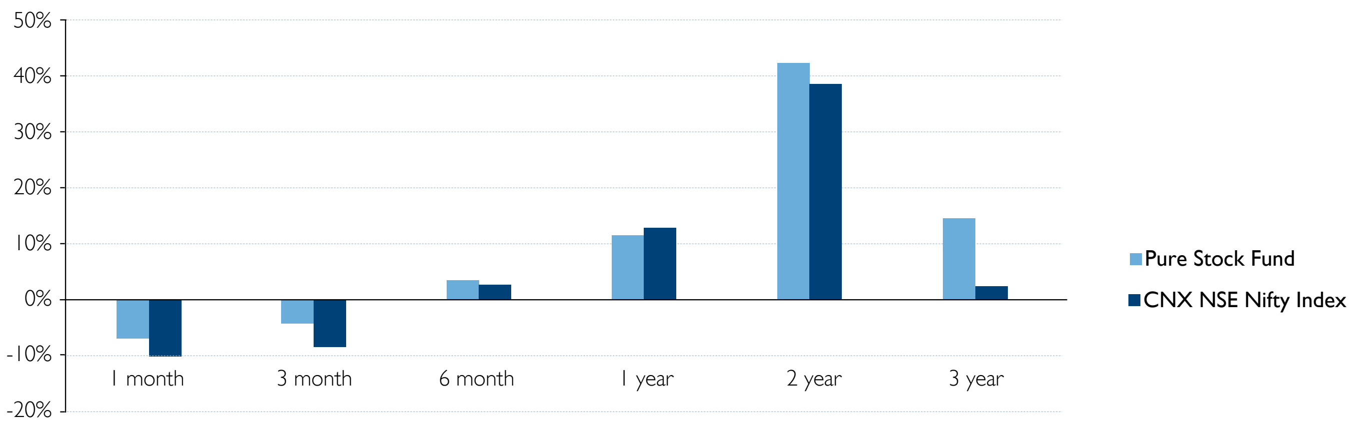


Exhibit 3: Comparative study of returns

IFCI ranking: 4

INDONESIA

Indonesia is the biggest economy in South East Asia, with the fourth highest population in the world. It is part of the G-20 countries. Indonesia has abundant natural resources and sustained GDP growth since 1998. Foreign investment is increasing. Indonesia is an archipelago of over 18,110 islands, of which 6,000 are inhabited. A tourist destination favoured by holidaymakers, Indonesia has the largest Muslim population in the world. But it cannot lay claim to being a leader in Islamic finance. This may change over the coming years depending on government and central bank commitment, which in the last few years has been present, though some say underwhelming.

Let's start at the beginning

It is thought that Indonesia's transformation into a Muslim polity was due to the integration of Muslim traders coming from Yemen. Anecdotal evidence suggests that the populace were impressed with the high standards exhibited by the merchants, scrupulous in transactions and ethical in nature. Whether apocryphal or not, the message should have moral ramifications for an industry which in 2011, will celebrate its 19th anniversary in Indonesia. In 1992, pursuant to the Banking Act no. 7, Bank Muamalat Indonesia commenced operations; the country's first Shari'a-compliant bank. In 1993, an arbitration forum was set up to tackle Islamic finance disputes, the Badan Arbitrase Muamalat Indonesia (BAUMI), initiated by the Indonesian Council of Ulema. The Council were pivotal to the creation of an Islamic finance industry after organising a conference on riba in 1990.

A number of legislative changes followed strengthening the legal framework, the most crucial being Act no.10 of 1998 which strengthened the legal foundation for Islamic banks to set up. The legislative framework was strengthened the following year with Act No.23. Indonesia's central bank, Bank Indonesia, was permitted to utilise Shari'a-compliant instruments as part of its monetary policy. Prior to these changes, there had been only one commercial bank and a number of Shari'a rural banks. A distinctive feature of the Indonesian financial system has been the proliferation of rural credit banks to serve, as the name would suggest, the rural sector. These are small outfits, broadly conducting microfinance transactions. Since the liberalisation reforms of 1988, these institutions have been increasing. Many of these banks offer Shari'a-compliant products to their customers. In addition, Islamic savings and loans cooperatives (Baitul Mal wa Tamwil) are also quite common.

After 1999, the Islamic finance infrastructure in Indonesia started to take shape. The Indonesian Council of Ulema set up the National Shari'a board, an independent body authorised to issue rulings on Shari'a products. The year 2000 witnessed the formation of the Jakarta Islamic index. Bank Indonesia created the Islamic Banking Bureau in 2001 to regulate, supervise and license Islamic banks. In 2002, Bank Indonesia released 'The Blueprint for Islamic Banking Development in Indonesia', a strategic plan segmented into three periods and detailing clear priorities to create in Indonesia, "A sound Shari'a banking system that is competitive, efficient and compliant with prudential practices, and capable of supporting real economic sector through the implementation of share based financing and trades with real underlying transactions in the spirit of brotherhood and good deeds to promote well-being for all society"

2011 will mark the end of the third period according to the Blueprint. At the end of the year, Indonesia can truly assess how successful it has been. However, from 2002 to 2008, the industry remained sluggish. Positive developments included the issuance of corporate sukuks, but the regulation created lags and innovation was stymied: critics argue due to the civil law system. 2008 proved to be a groundbreaking year. First there was Law No.19/2008 which effectively made it easier and cost effective for sovereign sukuks to be sold. This was followed by Law 21 of 2008, the authoritative law on Islamic finance in Indonesia. The law covers amongst other things: company formation, permissible and prohibited forms of Islamic transactions, corporate governance and dispute resolution. The act contained provisions which enabled foreign ownership of banks and pursuant to licenses being granted from Bank Indonesia, foreign Islamic banks being set up in Indonesia. The act proved to be the kick start the industry needed.

Current state of the industry

In 2007, Indonesia had three commercial Islamic banks; three years on, there are 11 commercial Islamic banks. According to Bank Indonesia, as of 2010 there are 28 Islamic windows operating in the country as well as 143 Islamic rural credit banks. There are three full fledged takaful firms, three retakaful firms and 36 Shari'a units of conventional insurance companies. Bank Indonesia has a Directorate of Islamic Banking, which is comprised of a number of departments involved in research, supervisory and licensing. Asset growth of Islamic banking has been more than double that of the country's conventional banking industry. According to the Directorate, Indonesia`s Islamic banks` assets grew 47 percent in 2010, reaching 100.26 trillion rupiah. The Islamic finance industry however still makes a small percentage of the total banking industry in Indonesia – 3 to 4 percent of total banking assets. But it has made credible progress over the last three years and is hoping to grow further. In the takaful sector, annual premium growth has exceeded 40% over the last five years. Once again, the sector itself constitutes only a small share of the overall insurance market. Notwithstanding the tiny market share, multinational insurance companies such as Prudential, Allianz and AXA have entered the Indonesian markets.

Bank Indonesia's 'Grand Strategy of Islamic Banking Development' released in 2008 is a bold vision, hoping that Indonesia will become a holistic and preeminent Islamic banking sector, a leader in the ASEAN (Association of South East Asian Nations). Since 2000, Bank Indonesia has issued over 25 regulations on Islamic banking from tax amendments to licensing requirements. Bank Indonesia is currently finalising its five year plan (2011- 2015) for local Islamic banks to boost the development of the Islamic banking industry. The plan will focus on seven main aspects – human resources development, arrangement and supervision, supporting infrastructure improvements, strategic alliances, customer empowerment and product innovations

But a constant criticism of the government has been their failure to quicken changes in legislation, especially with respect to tax. Only in the last two years has legislation been amended to remove double taxation on murabaha financing. National banks are pressuring the Indonesian government to match tax breaks offered by Malaysia as well as creating and promoting incentives for people to put their money into Shari'a banks.

There is also concern with the product approval process. Currently, Islamic banks have to get their products approved by the Shari'a board and then Bank Indonesia, which is regarded as being cumbersome and time consuming. Bank Indonesia, Indonesia Council of Ulema and the Indonesian Accountants Association has established a working group whose job it is to review new Islamic banking products. Once approved, banks will no longer need to go through the aforementioned process. IFIs are still expected to retain a Shari'a board to supervise and monitor.

Enhancing the rural sector

There is a large potential for growth in retail Islamic finance in Indonesia. One key avenue is through microfinance. According to estimates, more than 90 percent of Indonesia's 50 million small businessmen have no access to regular bank financing. Thus there is a capacious market for IFIs to capitalise on. Microfinance is attracting commercial banks because of its wider profit margins and lower defaults, according to the central bank, which estimates the industry accounts for 70 percent of Islamic lending. Significant growth has occurred in the Islamic rural credit markets, with Bank Indonesia licensing over 35 new Islamic rural banks over the last five years,

Rural banking is not limited to the rural credit banks. Commercial Islamic banks have been active in this sector, impressed by the greater customer base as well as the lower default numbers on loans. These are typically structured using the murabaha contract. Bank Muamalat Indonesia, the oldest Islamic bank in Indonesia, has a number of branches serving the banking needs of women, farmers and SME's. It helped establish 500 new cooperatives that provide micro financing in 2009, increasing to 2,500 the number of Shari'a-compliant cooperatives. Bank Syariah Mandiri is adding branches in Java and Sumatra to offer microfinance loans while Bank Syariah BRI aims to triple its business in the rural sector in 2011.

Developing the capital markets

According to the Debt Management Office of the Finance Ministry, the government has sold 57.34 trillion rupiah of sukuk since 2008, when the first sovereign sukuk was sold. However, challenges still remain especially within the domestic markets. Investors are demanding higher return from sukuks as there is no secondary market in which active trading can occur. The sukuk market is not sufficiently liquid enough which prevents the sale of new sukuks. Poor demand has resulted in a number of failed auctions. Indonesia is attempting to bolster demand by marketing to international investors and changing its sale practices. Rating agencies such as Moody's and Standard & Poor have raised the credit rating of Indonesia and expecting increases over the coming years. Moody's accounted Indonesia's economic resilience as a key factor determining their upgrade. In 2010, foreign holdings of Indonesian bonds – both conventional and Islamic – rose 79%. Thus a focus on international investors looks positive though more effort is needed to enhance the domestic markets. The corporate markets should also be a cause for concern. Analysts believe that there have only been 20 issues from corporates in the last five years, significantly lower than Malaysia.

On the other hand, Islamic funds based in Indonesia are doing well. Six of the 10 best performing Islamic funds in 2010 are from Indonesia. However, improvements need to be made to the Jakarta Islamic index. With only 30 Shari'a-compliant stocks, it is not sufficiently robust to create a thriving Islamic equity market. Indonesia has sought the assistance of UK regulators and industry players to improve the index as well strengthen their financial infrastructure.

Moving forward

Malaysian Islamic banks have a keen interest in Indonesia. Banks such as Maybank converted its Indonesia unit, PT Bank Maybank Indycorp (BMI), from a conventional bank into a fully fledged Islamic bank in October. Malaysia's Affin Bank purchased the Indonesian conventional bank PT Ina Perdana and converted it into an Islamic bank in April 2010. Close alliances with Malaysia will benefit Indonesia, not only in terms of transferring education, experience and increasing product offerings, but also acting as a distribution channel for Indonesian funds and sukuks.

It is incumbent on Indonesia to ensure the groundwork is in place; and Bank Indonesia has shown resolve and determination to ensure the requisite infrastructure needed. On the advice of the central bank, the University of Indonesia began offering a Master's in Islamic Banking in 2009, to help prepare students for the industry. The school also offers an Islamic banking specialization for MBA students and plans to offer a bachelor's in Islamic banking and a doctoral program.

However, government inertia and legislative hurdles will hinder Indonesia's progress. If it is to truly meet the goals set according to Bank Indonesia's strategic plans, Indonesia needs to be flexible and address challenges as they arise – sooner rather than later. The global Islamic financial market is on a precipitous climb upwards. Indonesia cannot afford to take small steps when its neighbours are taking giant strides.

IFCI ranking: 1

IRAN

Iran is one of the two countries (Sudan being the other one) in the world, which have transformed their economies and financial systems totally in accordance with Shari'a law. With a population of nearly 77 million and an annual GDP of about USD 826 billion (2009 estimates in terms of the purchasing power parity), Iran is an important economic player in the world. Its involvement and leadership role in Islamic banking and finance can be used for further strengthening the Islamic financial services industry world-wide, but surprisingly Iran features very marginally when it comes to the international power play in Islamic banking and finance. One obvious reason for this apparent marginalization of Iran in the global Islamic financial services industry is the economic sanctions imposed by United Nations, USA and the European Union. While this is an important factor that must have adversely affected the international engagement of Iran in Islamic banking and finance, it is interesting to look into some other factors that may explain the lack of leadership role played by Iran in the global Islamic financial services industry.

Islamic banking in Iran

Islamic banking was officially introduced in the country in 1983, with the passing of *The Law for Usury (Interest) Free Banking,* which requires all banks in the country to operate without engaging in paying or charging interest. It is, however, observed that the definition of the prohibited riba in Iran is rather based on an innovative concept. Although *The Law for Usury (Interest) Free Banking* does not explicitly define the prohibited interest, it seems as if the Iranian authorities follow a technical definition of riba, which states that a transaction involves prohibited interest only if it is between two *independent* parties. According to this doctrine of riba, the following conditions are found in any transaction that involves riba:

1. The existence of indebtedeness;

2. The existence of a debtor independent from the creditor;

3. Prior agreement (at the time of entering into transaction) between the two parties so that debtor must pay more than what he borrows; and

4. The actual receipt of the excess amount.

If any one of the above is missing in a transaction, it does not involve the prohibited riba. Consequently, it is acceptable for all the government-owned institutions and departments to carry on with their interest-based transactions and arrangements, when dealing with each other. As all the banks were nationalized after the revolution in 1979, borrowing from such banks by public sector corporations and institutions remained interest based, as it was deemed permissible for government-owned banks to lend to other government sector organizations. This actually meant that the Central Bank of Iran did not have to devise any new mechanism or develop any tools for the conduct of its monetary policy in compliance with Shari'a.

Similarly, banks are allowed to offer non-contractual non-fixed bonuses in cash or in kind to the holders of interest-free deposits (Article 16(A) of the Law for Usury (Interest) Free Banking). This is very helpful for the banks to keep on operating without changing their accounting standards and practices. Because of these types of provisions in the legal framework, Islamic banking in Iran is not very distinctly different from conventional banking practices.

A further anachronistic feature of Islamic banks in Iran is that they do not market their Shari'a-compliancy at all. For example, none of the Iranian banks adequately highlight their Islamic banking operations on their website or other marketing materials. On the contrary, some banks actually refer to certain Shari'a repugnant practices and concepts. For example, Saman Bank, a privately held Iranian bank, lists on its website "interest rates" on a number of deposit accounts it offers. This is obviously not in line with the internationally acceptable Shari'a and Islamic financial reporting standards.

Whatever be the view on Shari'a authenticity of Islamic banking in Iran, the country tops the list of countries in terms of Shari'a-compliant assets held by banks and other financial institutions. With nearly USD 315 billion Shari'a-compliant assets (as reported by The Banker), Iranian Islamic banks and financial institutions represent over 30.5% of the global USD 1.03 trillion Islamic financial market, according to figures by Edbiz Consulting. This is significantly higher than any other individual country, including the two most influential Islamic markets, namely Saudi Arabia and Malaysia (representing 13.4% and 10%, respectively). In December, Iran's Securities and Exchange Organization, joined the IFSB as a full member along with the Bank Eghtesad Novin, as an observer member

Bank Melli Iran ranks number one Islamic bank in the world, in terms of paid up capital (USD 5 billion) and assets under management (USD 57 billion). 7 out of the top 10 Islamic banks in the world happen to come from Iran. However, after the government's decision to ban daily withdrawals of above IRR 150 million (USD 15,139) in early 2010, there was concern that the Bank was going bankrupt. Bank Melli rubbished these concerns but with further rumours about the inevitable bankruptcy of two other banks, it suggests that the banking sector in Iran is far from healthy.

Worries in the banking system

According to industry figures released in January 2010, Iranian banks have USD 48 billion in bad loans according to industry figures released in January, which has led to a number of bank runs. In 2008, bad debts were at USD 15 billion, thus representing a 300 percent increase over the last two years. Iranian governments have often instructed state banks to provide low-interest loans to various sectors in order to boost the economy, saddling the banking system with non-performing loans. Unfortunately, who is to blame remains a vexatious point. A political tete a tete has ensued with the private sector accusing the government of corruption, nepotism and imposing too much bureaucracy. They further argue that money is given to government affiliated organisations who do not repay, which stifles entrepreneurship and growth. The government on the other hand, believes that private sector incompetence and malfeasance, along with the financial crisis have been key factors. Whatever the case may be, many factories have been built but are not functional making it difficult to pay loans back.

Another cause for concern has been the independence of the central bank. Since the inception of the central bank in 1960, the government has had significant control over central bank policies. With the passing of the Fifth Development Plan in 2010, this is changing as it curbs the power of the President in influencing monetary policy. Furthermore, the panel which decides on monetary policy used to comprise of government officials, but now the plan envisions a panel comprising seven economists. While they will be chosen by the government, parliament has to give a vote of confidence. This new system, still in its draft stages, hopes to reduce government control leading the way to less bias and the consolidation of vested interests.

Economic and trade sanctions

But while criticisms may be levelled at the Iranian government for monetary policy mistakes, it is difficult for the country to make comprehensive economic policies due to economic and trade sanctions from the USA, UN and the EU.

The crisis in the value of Iran's currency in late September and early October was a manifestation of uncertainty, speculation and fear that has been caused by the cumulative effect of sanctions. Iranian government officials have attempted to assuage public fears, but with growing inflation and unemployment, the public are rightfully indignant. While the rate of growth in Iran's real GDP in 2007 was 7.8%, the projected rate for 2010 was only 1.6% according to the IMF World Economic Outlook.

Sanctions have isolated the country from the international community and one obvious adverse effect of this is on Islamic banking in Iran. After the September 11 attacks in New York and the subsequent war on terror (and Iran being on the US list of the countries sponsoring terrorism), Islamic banks (like any other financial institution) would not like to engage themselves with the Iranian corporations and financial institutions.

It is unlikely that the sanctions will abate with the US accusing Iran of surreptitiously circumventing them through clandestine means. A case in point is the accusation that Iran is trying to set up a global network of banks in Muslim countries such as Iraq and Malaysia using dummy names and complex ownership structures. Consequently, pressure has been put on countries and institutions that are working with Iranian institutions to terminate their relationship. Lloyds, Credit Suisse and Barclays have been fined for processing payments by Iranian banks. The US has blacklisted 16 Iranian banks for allegedly supporting Iran's nuclear program. Others countries such as Australia have followed suit and have placed their own measures against Iran. South Korea temporarily closed the Seoul branch of Iran's Bank Mellat for two months and require it and other Iranian companies to get approval for future foreign exchange transactions.

Iran has therefore looked to build relationships with Muslim countries. At the Twenty-Sixth Session of the Standing Committee for Economic and Commercial Cooperation of the OIC (COMCEC) in Istanbul in October, Iran called for the creation of an Islamic fund and an increase in mutual trade among member states of the Organization of the Islamic Conference (OIC). In July, Heads of State and ministers from eight countries - Iran, Nigeria, Bangladesh, Egypt, Indonesia, Malaysia, Pakistan and Turkey - met in Nigeria to discuss developing business ties and reducing trade barriers. Trade between the eight Islamic nations is estimated to be worth about USD 68-billion a year, or about 3% of global trade. They intend to sign a preferential trade agreement by next year in an effort to double their trade with each other and strengthen economic co-operation and create an Islamic common market. Iran has also requested the IDB to increase its support of building the infrastructure in Iran and have appropriated a number of loans to invest in industry as well as physical infrastructure. In December 2009, it called on IDB to help sell Islamic bonds onto the international market. However, there has been little development since.

Lack of an Islamic financial policy in Iran

It appears as if the Central Bank of Iran and the government have failed to realize the potential of Islamic banking and finance in establishing Iran's leadership role in the Gulf region and the wider OIC-bloc. Although legislation in favour of Islamic banking and finance exist in the country, there is no clear policy framework for the conduct and promotion of Islamic banking in the country. It is fair to point out that Iran is not the only country that has failed to develop such a policy framework; apart from Malaysia most other countries fall under this category.

There is a definite need at the government level to have an Islamic financial policy in addition to its fiscal and monetary policy frameworks. The objective of the proposed Islamic financial policy should be to promote the use of Islamic banking and financial tools for the conduct of fiscal and monetary policies by the government. Furthermore, it must endeavour to establish Iran as a major player in the global Islamic financial services industry. In the absence of such a policy, some neighbouring countries, particularly the UAE, stand better chances of benefiting from the tremendous growth potential in Islamic banking, especially in the Middle East and North African (MENA) region.

Future of Islamic banking in Iran

The future of Islamic banking in Iran very much depends on how effective a role Iran can play in the global Islamic financial services industry. Malaysia provides an excellent example to emulate. By aspiring to be a global leader in Islamic banking and finance, Malaysia has not only developed a vibrant Islamic banking system at home but has also started exporting its model to neighbouring countries. Malaysia has undoubtedly started reaping the benefits of its investment in an Islamic financial infrastructure that it has created over the last 15-20 years.

Iran can play a similar role in the Gulf and Central Asian regions. In fact, Iran can have a competitive advantage over Malaysia, as the latter provides an example of dual banking system, while Iran has officially transformed its financial system completely in line with the requirements of Shari'a. Furthermore, it has the largest Islamic bank in the world, and of course it is located more central to the Islamic world as compared with Malaysia.

Iran can learn a lot from neighbouring UAE and Bahrain to bring-in the required flexibility to attract investments from the Gulf region. On another front, it must start positioning itself to export its Islamic banking expertise to the Central Asian countries like Azerbaijan, Kazakhstan, Uzbekistan and Tajikistan etc. In fact, by creating an Islamic financial alliance with the Gulf, Central and South Asian countries, Iran can play a lead role in banking and finance in the region. Given the strategic location of Iran (bordering Iraq, Afghanistan, Pakistan, Turkey, Azerbaijan, Turkmenistan and Armenia), it can play an instrumental role in the regional growth of Islamic banking and finance. Given that Iran has a number of uninhabited islands in the Persian Gulf, there is ample scope for developing an offshore centre of excellence for Islamic banking and finance.

As Iran has developed a very liberal Islamic financial regime, the Western countries must be led to buy in to the argument that islamic banking and finance can be used to bring socio-political reforms in Iran. For the west, this should be a more cost effective way of bringing Iran to the mainstream – an option that avoids heavy military and related expenditures associated with a more confrontational approach.

IFCI ranking: –

IRELAND

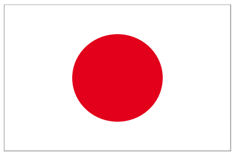
Although Ireland is home to a large Roman Catholic population and has experienced financial difficulty over the last year, to the surprise of many it has shown interest in facilitating Islamic finance. The country introduced legislation clearing the way for structuring certain Shari'a-compliant financial products. Islamic finance is not directly referred to in the legislation but comes under the umbrella term "specified financial transaction". Like the UK, the specified financial transactions will have to meet certain requirements and can be broadly categorised as credit transactions (like the murabaha), deposit transactions (akin to the mudaraba) and investment transactions (akin to sukuk). Under the Finance Bill 2010, which came into effect in January 2010, the Irish Ministry of Finance has introduced significant amendments to facilitate Islamic finance transactions in Ireland, especially the origination and issuance of sukuk.

The Explanatory Notes to Ireland's Finance Bill 2010 explains how legislation "is designed to extend the tax treatment applicable to conventional finance transactions to Shari'a products which are the same in substance as the conventional products." Shari'a-compliant instruments would therefore be taxed in the same manner as their conventional counterparts.

The Finance Bill 2010 also deals with UCITS management companies and introduced changes that are aimed at enhancing Ireland as a leading location both for UCITS and non-UCITS funds and which also came into effect in January 2010. The finance bill also extends Irish stamp duty provisions to provide for relief from stamp duty arising on the transfer of fund assets under fund mergers and reorganizations. These provisions facilitate the structuring of Islamic funds. Dublin has is trying to challenge other similar domiciles such as Luxembourg. Many significant Islamic funds are registered in Dublin such as the Oasis Crescent Global Equity Fund and the CIMB Global Islamic Equity Fund.

In October 2010, the Irish Revenue Service outlined the tax treatment of Shari'a-compliant products and structures for the funds, leasing and Takaful industries. A more in depth analysis can be seen in an earlier chapter. The Irish government has been actively involved in engaging Bahrain and signed a memorandum of understanding with the island state in December. Members of the Irish delegation were given expositions and more information on Islamic finance by the Central Bank of Bahrain.

Whilst the government has been proactive in changing its legislation, it remains to be seen as to whether or not Ireland can emerge as a player in the Islamic finance industry, as recent economic woes may curb their enthusiasm. Furthermore, as the initial focus of Irelands Islamic finance foray will be in wholesale banking, it will be competing with the UK, a country with a longer history in Islamic finance.



IFCI ranking: –

JAPAN

If articles on Islamic finance are anything to go by, it seems as though the interest in Islamic finance in Japan is diminishing. During the period 2000-2007 the number of articles appearing in Japan on the subject of Islamic finance steadily rose. However, after peaking out in 2007, there has been a sharp decrease.

Up until 2007, Islamic finance itself had been enjoying significant growth, partly backed by rising oil prices. The increased profile of Islamic finance led to greater awareness amongst the Japanese. In addition, Japanese firms such as Tokio Marine, Aeon Credit Services, Toyota Capital were conducting Islamic transactions. These three major factors lead to the significant increase of the figure in the period.

Looking at Exhibit 1 after 2007, the decline in reports is due to the following two factors; (1) the Islamic finance industry showed slower growth globally due to the sharp fall in oil prices and the global financial crisis, which affected the infant industry in Japan, and (2) Islamic finance was not something new anymore in Japan and thus only articles of significant importance would be deemed worthy enough to print.

Notwithstanding the decline in media interest, one can argue that Islamic finance in Japan is in a transition stage, moving away from just mere interest. We are seeing subtle developments in the market, which suggest that what you may or may not read in the paper does not exemplify what is happening in the markets.

1.) Developments in the private sector

i) Nomura

In July, Japan's biggest investment bank, Nomura issued USD 100 million sukuk with two years maturity, in the Malaysian market. It has been listed on the Bursa Malaysia. This is the first sukuk issuance by a Japanese entity. The Nomura sukuk is ijara backed, the proceeds of which are used for its subsidiary's aircraft leasing activities. Nomura also raised funds in Bahrain via a commodity murabaha amounting to USD 70million.

ii) Sumitomo Corporation

A general trading company, Sumitomo Corporation, showed its interest in Islamic funds. Although the details are to be disclosed in the future, this will be the first deal where a non-financial Japanese corporate utilizes Islamic finance. Sumitomo is quite active in Indonesia and other Islamic countries, so using Islamic finance models have the potential of enhancing relationships.

iii) Tokio Marine's Nile Takaful

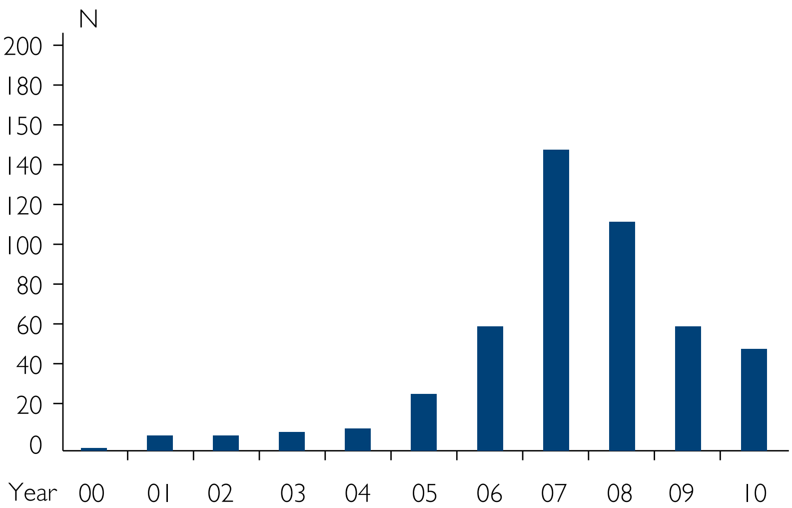


Exhibit 1
Source: Nikkei Telecom

In January 2010, Tokio Marine, Japan's largest non-life insurance provider, launched a local business entity in Egypt, known as "Nile Takaful". Tokio Marine is famous for its worldwide takaful network having retail presence in Saudi Arabia, Indonesia, and Malaysia. In Singapore, it has established a retakaful company. The opening of the Egyptian business is part of the company's continuous global expansion of takaful provision.

2.) Sukuk tax exemption

Prior to 2010, the only policy action taken by the Japanese government to accommodate Islamic finance was the Ordinance to the Banking Act 2008. The Act allowed a bank's subsidiary to offer Islamic financial products and services. In August 2010, the Financial Services Agency proposed a taxation change in sukuk transactions as part of comprehensive tax amendment proposals for the fiscal year 2011. The proposal was admitted within the budget authority.

The proposed change will exempt taxation on coupon profits for non-resident (i.e., foreign) sukuk holders'. The FSA also provided guidelines for structured finance products, from which sukuks can be formed under the Japanese legal framework.

The sukuk structure provided in the FSA's scheme, uses a concept called "Special Purpose Trust" concept which facilitates the creation of the ijara form as depicted in Exhibit 2. The issuer (the actual fund raising entity such as a corporate or soverign) transfers its asset to a Special Purpose Trust, and enters into a leasing (ijara) and trust agreement on the asset with the bank that manages the asset under this scheme. The profit rate is Shari'a-compliant as it is profit arising from the leasing activity, and is recognized under the Asset Liquidation Law of Japan.

Note that this scheme is not solely structured for sukuk: this is one of possible sukuk schemes using existing legal framework.

The scheme proposed by the FSA is sophisticated as it recognizes important features of sukuk. While sukuks are similar to bonds, its structure renders it unique primarily because the structure involves another entity as a cash flow generator. FSA stipulation of a Special Purpose Trust provides for the keystone required to structure a sukuk. However, this measure is based on "tax neutrality" between conventional bonds; it does not give preferable treatment to Sukuk. This is in line with the concept of policy actions taken by other non-Islamic countries.

The FSA measure is important for three reasons. First, it focused on the capital market which is one of the major growth drivers of Islamic finance. Second, it paid attention to foreign investors, who are key players in the market. Third, it shows Japan's positive attitude towards Islamic finance to Japan and to the rest of the world, after a lull period following the banking regulation change in 2008.

Looking ahead

In December 2010, the "IFN Roadshow Japan" organized by RedMoney came to Japan. Attended by renowned by international speakers, the event reflected the growing interest for Islamic finance in the private sector. The event was unique as many Japanese lawyers and accountants attended, with several Japanese lawyers taking the podium as panelists. This in the past was not common and reflects interest on Islamic finance is spreading to the cogs that run the financial markets. Hence Islamic finance looks set to play an important role in the financial landscape of Japan in future.

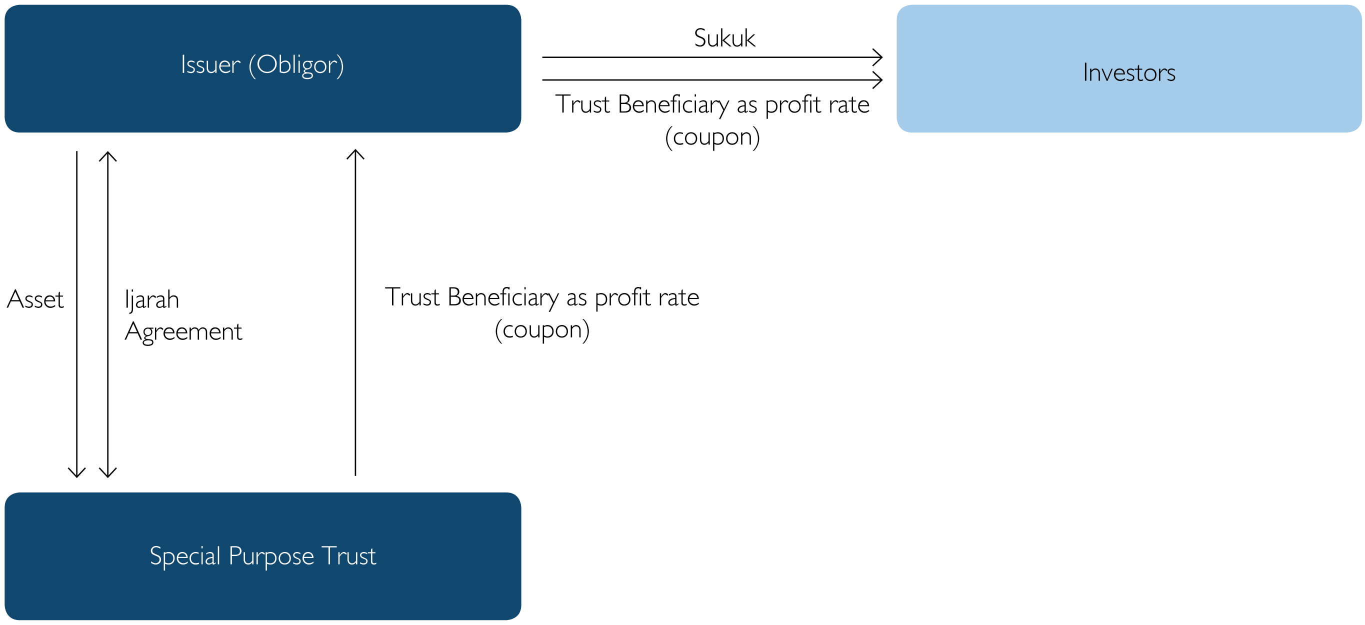


Exhibit 2: Sukuk structure under FSA scheme

IFCI ranking: 20

JORDAN

Although one of the smallest economies in the Middle East (with an estimated gross domestic product (GDP) of about USD 34 billion in 2010 and population of 6.5 million), Jordan is one of the most important markets for Islamic banking and finance, with the history of Islamic banking going back to 1978, when Jordan Islamic Bank for Finance and Investment (later renamed as Jordan Islamic Bank) was set up – only three years after the creation of Dubai Islamic bank, which is considered as the first successful experiment with Islamic retail banking. Since then, the country has gradually progressed in terms of development of Islamic banking and finance.

The socioeconomic situation in Jordan is not good, with GDP per capita of USD 5,300. Like in many other countries in the region, promotion and further development of Islamic banking and finance in the country is now being perceived as a tool for socio-economic reforms and for political management of the masses who have shown to be culturally aware of the role of Islamic banking in a modern society. In a country where economic turmoil is afflicting the country, with increasing prices and unemployment being symptoms of the problem, Islamic banking may be used as a tool for political management at least in the short run. Due to the global recession, economic growth halved at the beginning of 2010, and some political observers and economic analysts urge that the government of Jordan may consider the dual Islamic banking models as practiced by Bahrain and Malaysia.

Pioneering role of Jordan in Islamic banking and finance

Sami Hamoud, who is considered as one of the fathers of modern Islamic banking and finance, was a Jordanian who helped set up Jordan Islamic Bank. As one of the oldest players in Islamic banking and finance, Jordan has so far failed to capitalize on its pioneering role in initiating the global Islamic financial services industry. Friendly relations with the late King Hussain and Saudi Prince Mohammed Al Faisal and Shekh Saleh Kamel (founder and chairman of Dalla Albaraka Group) must be highlighted as an evidence of commitment of the government, to convince the major international Islamic financial players to invest in the country. It must also be highlighted that the government of Jordan was one of the very few governments in the region who were friendly enough towards Islamic banking to pass a special law enabling the creation of Jordan Islamic Bank in 1978.

Although the Jordan Islamic Bank received a lot of support from the members of the Muslim Brotherhood since the establishment of the second Islamic bank in Jordan, Arab Islamic Bank, the customers of Islamic banks come from a more diverse background. Islamic banking has a potential to replace an informal economy created by a coterie of families and neighbourhoods, friends and co-workers who believe in following Islamic principles in business and finance.

Criticism of Islamic banks has been levelled by Islamists who feel that banks could do more in terms of providing social and development services and promoting Islamic values. People have been critical of the high mark ups charged by the bank and the low bank returns provided to customers. Consequently, a burgeoning informal economy has formed: a coterie of families, neighbours, friends and co-workers who have created financial support networks which follow Islamic principles.

The formal sector

As mentioned above, Islamic banking in Jordan dates back to 1978. By the end of 2009, there were 23 banks operating in Jordan, two of which were Islamic banks. There were also 28 registered insurance companies, three of which are takaful operators. Assets of the two existing Islamic banks in Jordan alone amounted to around 12.5 percent of the total banking system and their financing accounts for over 15 percent of total credit. In 2010, two new Islamic banks were granted licences to operate in Jordan: Jordan Dubai Islamic Bank and Saudi's Al Rajhi Bank, pushing up the share of Islamic banking in the financial sector of the country.

Opening new Islamic banks alone will not stimulate the Islamic financial market. Jordan faces a number of challenges if it is to have a more robust system, including creating a secondary market for Islamic securities. A further problem is the shortage of qualified and trained personnel skilled in Islamic finance. Additionally, supervisory authorities are constrained by their own limited knowledge of Islamic finance which affects efficacious supervision of Islamic banks.

At present, the Central Bank of Jordan applies a single regulatory framework to govern both conventional and Islamic banks though allowances have been made to account for liquidity and credit risks that are unique to Islamic banks. Enacting legislation which accounts for the specificities of Islamic banks would strengthen their service provision. Legislation is already present relating to Islamic finance. Besides the 1978 act setting up Jordan Islamic Bank, the government passed a banking law in 2000 which restructured banking in Jordan and included a major section formalising the law regulating Islamic banks. With this act, provisions were made relating to the creation of investment accounts, corporate governance and the composition of the Shari'a board.

The Jordanian government have recognised that Islamic finance may provide access to funds which they are in need of to cut their current account deficit which currently stands at USD 1.5 billion. In November 2010, the government completed the issuance of USD 750 million in five-year conventional bonds on the international markets. This was the first time in the Kingdom's history that it has issued bonds on international markets, a sign of the growing need to acquire funds from abroad. Al Rajhi was hoping to issue a sukuk subject to the passing of a law which removed legal uncertainties regarding the issuance of sukuk, offered guarantees that protect investors, approved listing of sukuks on the local bourse and allowed a secondary market for Shari'a-compliant debt. The law was slated to be enacted by the end of 2010 but up to now, there have been no further developments.

Prospects

Throughout the Middle East there is a consistent kind of uncertainty about a number of things with a clear exception in favour of Islamic banking. Whatever be the changes in socio-political and economic aspects of the region in general and in Jordan in particular, Islamic banking is bound to prosper in the country. In Jordan, the conservative Muslims have always been in favour of modernizing Islam in the form of practices like Islamic banking. This has also translated itself into development of social projects. While there is a growing informal sector, Islamic banks have not been shunned and show potential for growth. Jordan's government has been far more proactive in supporting Islamic finance in 2010 as they respond to the growing need to tap into alternative sources of income. Further, activity in this field through the issuance of sukuk is likely to assist, but strong political will is required. However, political will is underpinned by a stable government.

IFCI ranking: –

KAZAKHSTAN

Prerequisites for Islamic finance development A necessary condition for effective socio-economic development is high investment activity, which allows the development of basic industrial sectors. This in turn maintains the social sphere, introduces new technologies and increases competitiveness of the country in international markets. In this regard, state economic policy needs to ensure strong support for investment activities and the creation of a favourable investment climate in the country. In Kazakhstan, total expenses for realizing the current State program of industrial development in during 2010-2014 would account to USD 43 billion. Most of these costs are planned to cover the expense of attracting foreign investments.

The recent global financial crisis has produced a negative impact on the development of investment processes in Kazakhstan. Inflow of FDI into the country has decreased which has compelled the country to look for alternative sources of funding. Consequently, Kazakhstan has welcomed Islamic financing as it has shown within the crisis, healthy sustainability and natural viability.

The post-Soviet Kazakh economy has been in transition. It initially encountered Islamic finance in the mid 1990s, when the country joined the IDB in 1995 and the Al Baraka Group opened its first branch in the country in 1994. Unfortunately, lack of familiarisation meant that the branch had to close.

IDB on the other hand has been integral in advancing Islamic finance in the country. In 2002, the President of the IDB met with high-ranking Kazakh officials to discuss the prospects of Islamic finance in the country. The meetings led to IDB's Annual Meeting being held in Almaty, the capital in 2003. Equally, Kazakhstan was quick to become a member of the IDB Group.

At the same time, the private sector was witnessing activity. In 2001 and 2004 banks like Lariba Bank and Taib Bank opened their Kazakh subsidiaries. It is worth mentioning that these enterprises provided few benefits to local people. In 2005-2008, there were several loan syndications by large Kazakhstan second-tier banks with overseas Islamic banks where short-term trade finance facilities based on the murabaha mode were used: Bank TuranAlem (2005-2006 – USD 50 million), Bank CenterCredit (2006-2007 – USD 38 million), then again BTA with Calyon Bank/Abu-Dhabi Islamic Bank (2006-2008 – USD 200 million), the Alliance Bank with Calyon Bank/Abu-Dhabi Islamic Bank (2007-2009 – USD 150 million) and BTA– Abu-Dhabi Islamic Bank/CIMB Bank (2007-2009 – USD 250 million).

MOUs between BTA and Emirates Islamic Bank (2007) and the sovereign wealth fund Kazyna with Qatar Islamic Bank (2008) were signed but never executed. The State Agency of Regulation of the Regional Financial Centre Almaty envisages Islamic finance will soon have 5% market share of the financial assets and even plans to issue sukuk in local currency. However, all these actions have been spontaneous, without preliminary analysis. Notwithstanding the haste, the need to introduce Islamic banking through official channels has gathered momentum and the initiative of preparing and adopting a new draft law has started albeit in tough financial times.

Legislation

Government interest in Islamic finance began in earnest in 2008. Internal assessments along with discussions with Islamic finance specialists led to the passing of the law "On the Introduction of Amendments and Additions to Certain Legislative Acts of the Republic of Kazakhstan Relating to the Issues of Organization and Activities of Islamic Banks and Organization of Islamic Financing" (the IF Law) on February 12th 2009.

The IF Law promotes the creation of a legal framework conducive to the introduction and development of

Islamic financial instruments in Kazakhstan. It eliminates certain restrictions obstructive to the entrance of Islamic banks into the local financial markets. The Law defines forms and methods of state regulation and supervision over Islamic bank activities, and addresses the operational environment of Islamic banks.

Pursuant to the IF Law, the government introduced a package of amendments and changes to the Civil Code, the Tax code, the Law on Banks and Banking Activity, the Law on Securities Market, the Law on Investment Funds, the Law on State Registration of Rights for Real Estate and deals thereupon, and the Law on Guaranteed Insurance of Deposits allocated at local second-tier banks

Articles 52 to 58 of the Law on Banks and Banking Activity pertain to trade financing activity and allow banks to own the assets. This amendment allows the creation of products which are Shari'a- compliant. These new acts have revised the concept of originator with respect to securities issuance and as to who could be considered such. Changes in the law have also made it incumbent on every local Islamic bank to form Shari'a boards (conventionally written as Councils on principles of Islamic financing).

President N.Nazarbayev is a committed supporter and the main exponent behind granting IFIs full legislative basis. He has been instrumental in the establishment of the first Islamic bank in Kazakhstan by ensuring an accelerated ratification process of Articles of Agreement between Abu-Dhabi Investment Council and Government of Kazakhstan. The bank will be constituted through licensing a Kazakh branch of Al Hilal Bank with offices in Almaty and Astana cities.

However, there are shortcomings with the IF Law. For example, in issuing sovereign sukuks, state bodies such as the Ministry of Finance is omitted from the list of potential Islamic security originators promulgated by the law; there are multiple taxation deficiencies that have hindered the first Islamic Bank to facilitate its local operations through commodity murabaha or ijara; and on Sharia-compliance, the Financial Supervisory Agency and National Bank are actively enhancing the secular and conventional nature of the domestic financial system thereby making it harder for Islamic banks to compete. Basic terminology for Islamic financial instruments is only partly described in Kazakh legislation. A fuller expression of Islamic finance products utilising their unique vernacular should be adopted in order to foster understanding by external partners, enhance their practical applications and identify correct regulation and risk management as per best international practices.

Obviously, Islamic finance legislation needs review and improvement. This will take time. Nevertheless, there are positive developments in the industry and salutary comments coming from the government. In the Annual Message to the People of Kazakhstan by the President Nazarbayev on January 29, 2010, he issued a directive to create a Regional Centrer of Islamic Banking in Almaty for CIS countries. The Presidential Administration is thus committed to developing an indigenous Islamic finance industry. This is complemented by their desire to re-consider legislation and offer a systemic approach to building up the industry.

On August 3, the Road Map on the Development of Islamic Finance was approved. It consists of 14 systemic measures on improving Islamic finance legislation, attracting Sharia-compliant investments from OIC countries, getting memberships in international associations like IFSB, AAOIFI, IIFM, IIRA, LMC, introducing Islamic financial reporting standards, creating a central training center and independent research center on issues relating to Islamic economy studies and current operational issues of global Islamic finances, establishing Shari'a-compliant institutions in microfinance, leasing and mortgage, opening a central Shari'a board, developing respective PPP instruments etc.

Domestic Islamic finance private sector

The Regional Financial Center Almaty was intended to be a leading coordinator in promoting Islamic finance activities in the country. However, this governmental institution pays more attention to general issues and gives less priority to the emerging private Islamic financial sector. Hopefully, the situation will change in 2011 when the theme of Islamic finance will gain more prominence in Kazakhstan due to the forthcoming chairmanship of Kazakhstan in the OIC (2011-2012). Add to this, there are several public events which will be held such as the Kazakhstan Islamic Finance Conference 2011.

The only domestic Islamic bank is Al Hilal Kazakhstan. It has planned to invest USD 250 million into the Kazakh economy in 2010 and expects the volume of investment to reach USD 1 billion in two years time. Al Hilal intends to finance large corporate projects utilising the murabaha contract (each contract not less than USD 5 million). There is reduced focus on the SME sector. Expectations are that a second Islamic bank will commence operations in the second half of 2011. Shareholders of this second bank, as announced in July 2010, plan to concentrate its activities in retailing and the SME sector thereby not competing with Al Hilal's high end focus.

In Kazakhstan, Islamic insurance services are provided by the Halal Insurance Takaful Company (HITC). Due to legislative restrictions, it was established as a 'Mutual Insurance Society'. The company has set the following targets and hitherto has been successful in meeting them:

1) Provide high-value Shari'a-compliant insurance products to local people. HITC provides three types of voluntary takaful insurance (medical insurance for travellers, including persons performing Hajj or Umrah; accident insurance; and property insurance.

2) Promote takaful to the public and spread knowledge on Islamic finance;

3) Lobby for changes into the Act on insurance activity in favour of creating fully fledged operations of takaful;

4) Prepare local specialists in takaful.

In the field of Islamic advisory and consultancy there are several private companies, one of them is the Istisna Corporation which within one year organized the following notable events: the first Kazakhstan Islamic Finance Conference, the first BIBF seminar in the region on AAOIFI standards, an intensive course on product development and Islamic financial engineering and an international conference on Islamic finance regulation issues in post-crisis period, Furthermore it has published an original of the Handbook of Islamic Banking in Russian to distribute within all CIS countries. The company provides Islamic finance consultancy services and investment intermediation with OIC countries. Another local Islamic finance training body is IBFTC. JSC Fattah Finance is a diversified Shari'a-compliant business in the field of asset management, education and is trying to develop a halal hub with the assistance of Malaysian partners. Furthermore it is also involved in a Hajj fund and will be involved in the setting up of the next Islamic bank, (together with Development Bank of Kazakhstan and Malaysian based Amanah Raya Co)

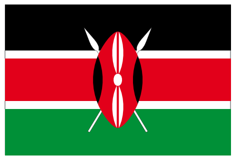
Overall, eight companies (which besides the above, also includes JSC Regional Financial Center Almaty, Almaty Financial Center Ltd., Al Hilal Islamic Bank, IFI Ltd. and Kausar Ltd.) are members of the Kazakhstan Islamic Finance Development Association (KIFDA), a self-regulating public body that acts to promote the huge potential of the Islamic finance industry in Kazakhstan and the CIS region. In this regard, the local Islamic finance private sector will play a leading role in further strengthening the institutional and operational capacity of the industry. Developments in Islamic finance can to be seen in parallel with the growth of the halal industry, which has grown over the last four years. It is likely that the preferred clients of Islamic banks will be halal certified businesses. Due to the lack of available Shari'a-compliant financing, they are forced to transact with conventional banks.

Issues

There are a number of challenges that confront the Kazakh Islamic finance sector. These include: 1) protecting investment depositors (probably through a takaful scheme) due to the absence of obligatory insurance of Islamic deposits; 2) development of Sharia-compliance procedures, coordination of corporate Shari'a boards as well as creation of a central Shari'a board by the Financial Supervision Agency; 3) consideration and monitoring of socially-oriented Islamic financial products such as zakat, sadaka, qard al hasan, waqf property funds that will manifest through the systemic development of Islamic financial market; 4) legal adaptation of AAOIFI and IFRS standards; 5) assistance to Islamic banks for solving issues of short-term liquidity in the absence of an Islamic interbank market; 6) new changes into the current legislation regarding Islamic securities market development, including amendments of state bodies' (Ministry of Finance) status as originator and further simplification of taxation regime for Islamic transactions; 7) launching a domestic Islamic fund market; 8) developing a research and analysis capacity (this is unlikely due to budgetary constraints and the absence of economists and thinkers with knowledge of both Arabic and English; 9) State bodies need to educate themselves about Islamic finance and take a more proactive role. Within this year, actions have not been undertaken by regulators (National Bank, Financial Supervision Agency, Ministry of Finance) to facilitate membership to IFSB, AAOIFI, IIFM, IIRA, LMC; 10) detailed study and practical application of all available Shari'a-compliant financial instruments, especially linked to PPP modes such as diminishing musharakah. The government should provide all administrative and operational support to local private Islamic finance institutions in their start-up stage.

Perspectives

Addressing the above issues will promote real improvements in public life and lead to diversification in the economy. It will strengthen ethical norms practiced by businesses. The active role of the government in developing a dual system where Islamic finance can co-exist, is imperative. Stability will lead to inflows of FDI, especially from the OIC. For this reason, it is necessary to study the process by which other countries manage to adapt Islamic finance into the local legal system. Understanding methods would enable the building up of a competitive national economy and establish effective mechanisms of regulation and supervision. According to RFCA estimates, in 2020, Islamic finance share in the financial markets will be approximately 10%. Of course, this is a very optimistic view. But the institutional capacity in Kazakhstan is gradually taking shape.



IFCI ranking: 24

KENYA

Islamic finance in Kenya has a short history but it is one that has seen much progress. With an affluent Muslim community, it has managed to create a burgeoning Islamic finance market in a short period of time. Barclays first availed the opportunities in 2005, with the setting up of the La Riba account. Their pioneering work spearheaded the establishment of two licensed Islamic banks within three years: First Community Bank (FCB) and Gulf African Bank. By 2010, according to the Central Bank of Kenya (CBK) in May, they had 1,570 loan accounts and 58,548 deposit accounts and control 0.8 per cent of banking sector's net assets within two years of operation.

Both banks have shown ambition to not only spread coverage of Islamic banking throughout the country but also to expand into other East African countries. With a growing number of branches – 29 from recent figures – their profile has grown which has allowed them to contribute effectively to the development of the industry in Kenya. Their success has stirred multinational banks such as Chase bank to offer Shari'a-compliant products through its subsidiary in Kenya. In July, the bank launched Chase Iman which offers accounts for individuals and asset financing for SMEs. Chase bank has been voted the fastest growing bank in 2009 and 2010. With the launch of Chase Iman, the bank has a wider vision. Barclays have continued to provide Shari'a-compliant products. The La-Riba Vehicle Finance and La-Riba Personal Finance products are seen as an answer to asset financing products provided by new entrants; and a means to serve the underserved Islamic community in Kenya.

FCB as the first fully fledged Islamic bank in Kenya has sought to be a trailblazer. It has sought to address the gaps that plague any nascent Islamic finance industry and in this respects it has achieved a number of milestones expedient for the industry. In October, it set up FCB Takaful Insurance to work in partnership with established insurance companies to offer takaful products. In February, they received approval to set up FCB Capital, an investment banking subsidiary and the first Islamic investment bank in Kenya. The bank's products and services will cover a wide range of Shari'a-compliant investment activities. FCB Capital hopes to be a conduit through which foreign direct investment will be channelled for financing infrastructural projects. The bank has also been active in the local community. They set up the Islamic Finance Training Centre to train staff in Islamic finance. The Centre will facilitate the development of financial professions with skills and knowledge in Islamic finance. They have registered the Centre with the Ministry of Education in one of their Nairobi branches. FCB were also one of the four banks chosen by the government to work with the Youth Enterprise Development Fund, a development initiative formed by the government to support youth orientated SMEs with capital. FCB's focus is on the Muslim community.

Gulf African Bank was set up a year after FCB and has experienced a difficult two years of consecutive losses. However, 2010 may prove to be a turning point as they have recorded profits for the first time. This bodes well for the overall strategy of the bank, which hopes to expand into other East African nations such as Uganda and Tanzania.

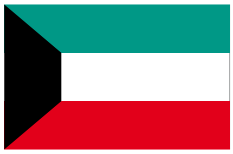
Its principal shareholder, GulfCap Investments raised KSH 1 billion as capital to launch Gulf Takaful Company. There is increasing interest for takaful in Kenya due to the growing middle class and the failure of conventional insurers to penetrate the market. Conventional insurers are therefore turning to the takaful markets. CIC insurance has invested sh120 million to create a subsidiary, Takaful Insurance of Africa. APA hopes to issues takaful products next year while Cannon Assurance has collaborated with FCB in joint venture to roll out takaful covers. FCB will develop and market the products; Cannon will focus on the financing. Morgan Stanley research suggests that takaful premiums in Kenya could potentially reach Sh20 billion in 2014, or 31 per cent of total insurance premiums last year.

The role of the government

The government and the CBK have been supportive of the development of the Islamic finance market in Kenya. The CBK have granted exemptions and provided leeway to Islamic banks in order to accommodate Shari'a-compliant products. The CBK hope to launch Shari'a-compliant treasury bills to boost liquidity and there are discussions regarding the issuance of a sovereign sukuk. However, this will be dependent on the support of the government who have, to date, shown commitment to building the industry. In his 2010/2011 Budget speech, Kenyan Finance Minister, Uluru Kenyatta spoke of 'the need to amend the law to accommodate Islamic banking products by introducing the concept of a return as opposed to interest', and announced plans to further amend the Central Bank of Kenya Act 'to facilitate Islamic transactions'. The current Banking Act has enabled Islamic banks to find alternative methods of deriving profits without recourse to interest. Article 16A (2) of the Banking Act as of January 2010 states: "An institution shall, in respect of a savings account, pay interest accruing, or a return in the case of an institution carrying out business in accordance with Islamic law, to that account as long as the minimum balance is maintained." Whilst the difference is subtle, it has enabled banks to conduct Islamic financial transactions within the full purview of the law.

A brighter future

At the second East and Central African Islamic Finance Conference in May, delegates gathered to discuss the prospects of Islamic finance in Kenya. There is a real desire to create an Islamic finance hub in the East African country and with such accelerated developments this is a real possibility.



IFCI ranking: 6

KUWAIT

In 2009, a report published by the US based Centre of Diplomatic Strategic Strategies declared that Kuwait has been one of the biggest centres for Islamic finance in the last 30 years. The industry has grown to become an important segment of the country's financial sector, sustained by increasing demand and a growing awareness in the domestic market of Islamic finance. Islamic banks have rapidly won market share from conventional ones and have become a successful substitute for traditional banking operations. This has led many domestic and multinational banks to seek a share of the Islamic financial market. Kuwait's success has not been due to extensive regulatory changes or active participation of the government; but rather the dynamic activities partaken by IFIs in the market. One institution stands prominent in the success and transformation of Kuwait into an Islamic finance hub, namely Kuwait Finance House.

Kuwait Finance House: a bank with many faces

Kuwait's association with Islamic finance dates back to 1977, when the Kuwait Finance House (KFH) was established. The Banks inception was a result of political manoeuvrings undertaken by the ruling Al-Sabah family in a bid to counter Arab nationalism. It was established with a 49% government share in capital and enjoyed certain perks for over 20 years such as freedom from central bank regulation and protected monopoly status as Kuwait's only Islamic bank.

KFH has been particularly instrumental in creating a unique brand of retail based finance. Being outside banking regulations gave it the freedom to participate in both banking and trading activities. In an attempt to keep finance linked to the real economy, KFH have kept large inventories of real estate, automobiles and other products which are demanded by Kuwaitis. This has made KFH a hybrid between a bank and a trading company. KFH has new and used car showrooms, as well representatives available at most car distributors in Kuwait who can advise on its financing packages. KFH has established a separate affiliate, KFH Trade, for its car financing business. The bank is also one of the largest owners of real estate in the country. It has a real-estate affiliate which provides Shari'a-compliant mortgages as well as an ijara service that provides an ownership option for clients. In the early 80s KFH took advantage of government subsidies in the land market and invested heavily in real estate. Its investments were so substantial that it was accused of driving up prices. KFH subsequently diversified into other asset classes.

Criticism has been levelled at KFH and the model it has created. Accusations include the encouragement of unhealthy spending habits which manifested itself in high levels of debt amongst Kuwaiti citizens. They have also been culprits of offering products which many regard as comparable to prohibited activities. In 2009, to attract customers to their credit cards, KFH issued an awards programme for its cardholders offering KD 100,000 in prizes, which was construed to be akin to gambling. Paradoxically, many believe that the increased level of Islamic consciousness in Kuwaiti society owes to the business practices of KFH, who have actively promoted an Islamic lifestyle.

Kuwait Finance House has USD 1.5 billion in assets under management (AUM), with investment in the US, Malaysia, China, and the Middle East. The real estate arm which started operations in the 1990s, has previously invested in property in the United States and Europe, including Britain though it sold property in the United States and Europe, in 2005 and 2006 after prices shot up. In recent years there has been a change of policy, with a reversion to US and European markets. In December 2009, it invested USD 242 million into residential properties in Chicago.

Due to its success and consistently high profits, KFH has expanded into other countries, most notably Turkey (where it is known as Kuveyt Türk Katilim Bankasi AS). It is Turkey's largest Islamic bank and has more branches there than in Kuwait. KFH started retail, commercial and investment banking operations in Malaysia in 2005 and it has opened representative offices in Singapore and Melbourne. KFH Malaysia helped develop a USD 1.3 billion real estate project in the country in 2005 as an Islamic equity property ventures. Five years on, the bank is embarking on its fourth building project in Malaysia using a similar equity concept. Unfortunately, few others in the industry have followed the same path, reflecting Islamic finance's slow and difficult shift away from debt instruments.

Moving away from the monopoly

For 25 years, KFH was the only Islamic bank in Kuwait and developed a degree of power and authority. The ruling establishment, while originally supportive, were looking to dilute their authority especially with fears that the bank was supporting Islamist activities. Kuwait Central Bank (KCB) was also keen to weaken KFH's stranglehold in order to increase competition with conventional banks. Subsequently, in 2003, amendments were made to the Central Bank Law 32 1968, which allowed more players to enter the market. As a result, conventional banks such as the Kuwait Real Estate Bank converted into being an Islamic bank, changing its name to Kuwait International Bank and new Islamic banks such as Boubyan Bank were formed.

Three more Islamic banks have set up in Kuwait since the passing of the legislation in 2003, namely: Al-Rahim Bank branch, Al Ahli United Bank and Warta bank. While the latter bank is indigenous, the former two are part of a banking groups originating from Saudi Arabia and Bahrain respectively and were formed in the last two years. Ties are therefore becoming stronger between Islamic finance hubs.

The five banks sit in a market dominated by conventional banks – 16 in total. However, they have managed to compete effectively and according to a McKinsey & Co, witnessed between 2003 and 2009, compound annual growth rates in Islamic banking assets of 23%. In addition, according to the recent KCB annual report, there are 54 bespoke Islamic investment companies out of 100, thus surpassing non-Shari'a-compliant investment companies. There are also 54 Islamic investment funds in the country out of 112. According to figures from 2009, the Islamic and Sharia-compliant companies make up 57% of the total Kuwait market capitalization.

Regulatory headaches and legal bellyaches

There has not been much in the way of enabling legislation for Islamic finance in Kuwait. This is a problem especially with regards to sukuk. Issuances of sukuk have been few, and much blame has been placed on the lack of appropriate legal mechanisms as well the government monopoly on all service sector projects. Previous mention has been given to the legislative act which enabled Islamic finance to operate. Most of the provisions of the act concern the mechanisms of an IFI. The Act, along with the amendments and additions made in 2003, creates a comprehensive framework addressing important aspects of Islamic banking. One important provision is on corporate governance which includes the stipulation that each institution should have a Shari'a board with three members. The Shari'a board is to report, not to the central bank, but the Ministry of Awqaf and Islamic Affairs. This is an interesting delimitation with KCB having no regulatory authority over the decisions of the Shari'a board, thereby separating the financial and Islamic aspects.

Islamists would like the government to do more. In March, Five Islamist lawmakers including the head of Kuwait's financial and economic committee, Barak Al-Muter, presented a draft bill to parliament for the full Islamisation of financial institutions in Kuwait. They argued that since the Kuwaiti constitution explicitly states that Islam is the religion of the state and is a major source of legislation, the Shari'a must be the de facto law. Separately, in March, the civil commercial department ruled that banks cannot collect additional interest on loans in accordance with Islamic regulations on which the state's laws are based. Thus it would seem that Kuwait is heading towards islamisation of the financial sector, but this would be presumptuous. The central bank has attempted to level the playing field between the banks and not pander to each and every request. In December 2010, KCB rejected a request by Islamic lenders to grant them exceptions from liquidity ratio requirements and allow for the withdrawal of excess liquidity. This was the second time the Gulf Arab state's central bank rejected such a proposal.

There have also been chinks in the Islamic finance armour, caused by the global recession. Declines affected Kuwait's real estate sector and stock market, which had a negative causation on Islamic banking profits. Merchant families and private sector organisations have also been affected by the recession. One notable example is Investment Dar. The Nakheel default in Dubai is commonly regarded as the moment Islamic finance structures began to be tested. However, prior to Nakheel, there was Investment Dar's default of USD 100 million of sukuk maturing in October 2010. In April 2010, a Kuwaiti Court granted Investment Dar legal protection from its creditors. Since then it has attempted to restructure its debt.

Sunlight on the horizon

Undoubtedly, the recession would have an impact on the Islamic finance industry in Kuwait but as the world economy picks up, Kuwait will follow. Indicators are good that Islamic finance will continue to have a sizable impact on not only the financial markets, but also on wider society. KFH has stated that there will be double digit growth in 2010 due to Kuwait's substantial oil revenue, increase competition in the market place and the development of new products on the market. Kuwait is also leading in terms of information technology. Path Solutions, the Kuwait based banking systems provider, has been achieving a great deal of success through the deployment of its iMal product. It was the first banking software firm to be recognized and certified by AAOIFI and has been adopted by leading Islamic finance organisations across the globe. The iMal software fills the gap of appropriate automated systems that accounts for the nuances of Islamic finance.

Kuwait also hopes to develop their research capacity in Islamic finance. Negotiations are underway for a Sabah Al-Ahmed Centre of Islamic Finance Research, an academic arena where researchers can devise Islamic finance solutions to problems arising in the financial markets. Thus, Kuwait is continuing their progress in Islamic finance with aplomb; slight obstacles are unlikely to wade it down.

IFCI ranking: 22

LEBANON

Referred to as the Las Vegas of the Middle East, Lebanon is a country of contrasts. Sadly, ethnic and sectarian tension alongside occasional war with Israel has caused much destruction and loss of life in Lebanon over the years. The instability in the country has caused it to economically suffer and has affected the growth of Islamic finance in the country.

Although the government enacted legislation on Islamic finance earlier this decade and made subsequent amendments, the industry has really struggled to gain a foot in the Lebanese economy. According to estimates, Islamic financial assets are less than one percent of the total banking assets in the country, even though there are currently four Islamic banks, with a fifth having received its licence.

The government has been looking at making further amendments to legislation, to try and spur on growth in Islamic finance and has been actively engaging local stakeholders for their input. A problem that is common to many Islamic banks not just the ones in Lebanon, is the issue of how to manage excess liquidity. Realising this problem, the Lebanese central bank is looking at introducing a new facility this year which will enable Islamic banks in the country to manage their excess liquidity.

Whilst issuing sovereign sukuk would enhance the profile of Islamic finance, currently there are no plans for such an issuance. This is due to the fact that such issuances may require amendments in the current law, and the government does not want to be seen as favouring Islamic finance over conventional finance, but rather wants to create equal chances for them.

Lebanon was one of the first countries to only allow Islamic banks to offer Shari'a-compliant products, closing the door on the possibility of conventional banks having Islamic windows. This policy was later adopted by Malaysia and more recently Qatar. However, Malaysia initially allowed conventional banks to offer Islamic finance through windows, and only after the industry grew, did they adopt the policy. Early adoption of this policy by Lebanon stifled the growth of Islamic finance in the country.

However, according to executives at the Central Bank of Lebanon, Islamic banks are also to blame for their poor performance so far, due to the fact that they have not done enough to raise awareness about the industry and therefore, although Muslims make up 60% of the population, many of them are still patrons of conventional banks. Hence more needs to be done to raise awareness levels.

In a nutshell, it can be said that both the Lebanese authorities as well as the local Islamic finance players need to do much more to raise the profile of Islamic finance. There is no doubt potential for the industry to grow in Lebanon, as the country is home to a well educated Muslim population with expertise in banking. However, slow changes in legislation coupled with a lack of initiative by Islamic banks will hinder any further growth. Political instability in the country is another big issue that needs to be addressed.

IFCI ranking: –

LUXEMBOURG

The last few years have seen a boost in the Islamic finance movement, with the rise of Islamic finance 'hubs' and western governments' willingness to give their Muslim communities access to financial services consistent with their religious beliefs. Luxembourg has played a key role in Islamic finance for a long time and pre-empted its growth by making available a whole range of Shari'a-compliant instruments – crucially, way before other western governments.

The importance of Luxembourg's prime position for offering Shari'a-compliant investment instruments and vehicles is all the more exemplified by the fact that in many non-Muslim countries, the majority of conventional financial instruments are not tailored to Islamic finance in their existing form.

Strong government support and a favourable regulatory environment are the main drivers for Islamic companies and financial institutions to set up operations – and Luxembourg has long gone the extra mile to elevate its status to that of a global hub for Islamic finance. While Luxembourg is recognised as a leading European centre for Islamic finance, this is not the result of a recent initiative; rather, the result of a long track record in the sector. The Luxembourg stock exchange was the first European stock market to launch a sukuk; the Luxembourg Central Bank has recently been admitted as the first European Bank of the Council of the IFSB; almost 40 Islamic funds are domiciled in Luxembourg, making it one of the world's largest non-Muslim fund domicile with a 7 percent market share of the global market. A business-oriented environment, a proactive financial supervisory authority, and a flexible and secure framework are factors that enable Luxembourg to maximise the tax efficiency of its Shari'a-compliant products and spearhead global Islamic finance transactions.

A prime platform for Islamic finance transactions

The Luxembourg financial centre and legal framework

Major steps have been taken by Luxembourg in recent times, to elevate its status to that of a global hub for Islamic finance offering the financial industry global opportunities.

As a pivotal holding location and the second largest investment fund centre in the world (over EUR 1,992 billion of assets under management as of May 2010[213]) after the United States,[214] Luxembourg is perfectly equipped to address the needs of Islamic finance investments in and through Europe. In addition, Luxembourg is a renowned private banking centre, a world leader in cross-border investment fund retail, and the largest wealth management centre in the Euro-zone. The Luxembourg financial centre has much strength, including a flexible legal environment, the pragmatic approach adopted by its financial supervisory authority, and the possibility to obtain certainty and security in advance from the authorities on a case-by-case basis.

One of many illustrations of Luxembourg's rapid ascent as a prime platform of Islamic finance is that transactions not only can abide by all the traditional limitations of the Shari'a, but also operate in a legal and regulatory environment accustomed to Islamic finance techniques. In particular, the efforts made by the Luxembourg financial supervisory authority are praiseworthy.

Luxembourg remains a global investment centre and its renowned political and economic stability are key assets. In 2008, the Luxembourg government set up a multi-disciplinary taskforce charged with identifying obstacles to the development of Islamic finance and ways to further support its growth. Working groups focused on Islamic finance were also formed by the Luxembourg Investment Fund Association (ALFI) and Luxembourg for Finance. These are also taking place outside Luxembourg, in locations such as Dubai.

[213] Association Luxembourgeoise de Fonds d'Investissement, http://www.alfi.lu

[214] Luxembourg for Finance, http://www.lff.lu

Luxembourg's multilingual and multicultural workforce –of whom a fair proportion is knowledgeable in the field of Islamic finance –constitutes a prime vantage point. The commitment of advisory firms, auditors, lawyers and bankers to the continued growth of Islamic finance in Luxembourg is of paramount importance. Islamic finance-oriented education initiatives have also flourished, with the Diploma in Islamic Finance (partnership between the Luxembourg Banking Training Institute (IFBL) and the ICMA Centre of the University of Reading) and a further partnership between Luxembourg School of Finance (LSF) and INCEIF, the leading University in Islamic Finance in Malaysia.

A year ago, the Al Miyar platform was established in Luxembourg by Deutsche Bank, with an aim to facilitate the listing of Shari'a-compliant securities. Other platforms are currently under development and shall contribute to the expansion of the country as a global hub for Islamic finance.

In November 2009 the Central Bank of Luxembourg (BCL) became –and still remains– the first European bank to become a member of the IFSB, the prudential and supervisory standard setting body for global Islamic finance. The BCL will be hosting the 8th IFSB annual summit in 2011 (the first time the summit will be hosted by an EU member state). Also, the BCL was among eleven central banks and two multilateral organisations that signed an agreement for the establishment of the

Luxembourg´s tax treaty network (1 Dec 2010)

In force		Signed-entry into force pending ratification	In negotiation
Armenia	Mexico	Albania	Lebanon
Austria	Moldova	Argentina	Montenegro
Azerbaidjan	Monaco	Bahrain	Pakistan
Belgium	Mongolia	Barbados	Serbia
Brazil	Morocco	Cyprus	Syria
Bulgaria	Netherlands	Kazakhstan	Uruguay
Canada	Norway	Kirghistan	
China	Poland	Kuwait	
Czech Republic	Portugal	Liechstenstein	
Denmark	Qatar	Macedonia	
Estonia	Romania	Ukraine	
Finland	Russia		
France	San Marino		
Georgia	Singapore		
Germany	Slovakia		
Greece	Slovenia		
Hong Kong	South Africa		
Hungary	South Korea		
Iceland	Spain		
India	Sweden		
Indonesia	Switzerland		
Ireland	Thailand		
Israel	Trinidad and Tobago		
Italy	Tunisia		
Japan	Turkey		
Latvia	United Arab Emirates		
Lithuania	United Kingdom		
Malaysia	United States		

International Islamic Liquidity Management Corporation (IILM) in Kuala Lumpur, on 25 October 2010.

To further boost its Islamic finance credentials, Luxembourg boasts a wide investment treaty network of over 80 countries (including Kuwait, Saudi Arabia, the United Arab Emirates, Malaysia, Kazakhstan, Uzbekistan, Turkey and India), and has concluded tax treaties with several Islamic countries (including the United Arab Emirates, Bahrain, Qatar, Malaysia, Morocco, Tunisia, Indonesia and Turkey).

A further impetus has been made to existing business relations and bilateral cooperation between Luxembourg and Bahrain and between Luxembourg for Finance and the DIFC with the signing earlier this year of an MoU. Luxembourg is also currently working on an MoU with several Central Banks established in Muslim countries.

The compatibility of the Luxembourg legal framework with Islamic finance requirements for the implementation of Shari'a-compliant products is of immeasurable importance. Luxembourg tax law is considered one of the most flexible and efficient within the European Union, and is constantly evolving to meet the needs of foreign investors. Islamic modes of finance such as mudaraba, musharaka, and diminishing musharaka; and Shari'a-compliant debt such as ijara, qard hasan, murabaha, or commodity murabaha, may be realised in a very tax-efficient manner. What's more, unlike in many other jurisdictions, yield paid on pure income participating financing instruments may be deductible for Luxembourg corporate tax purposes and not subject to domestic withholding tax – irrespective of the status or residence of the recipient.

Luxembourg has recognised this and has developed a wide range of regulated investment vehicles (e.g. the société d'investissement à capital variable or SICAV, the société d'investissement à capital fixe or SICAF), semi-regulated investment vehicles (e.g. the société d'investissement à capital risqué or SICAR, the specialised investment fund or SIF), and unregulated holding companies (e.g. the société de participation financière or SOPARFI, the société de gestion de patrimoine familial or SPF), all accommodating the requirements of Islamic investors.

Besides this, a Shari'a board may be appointed in any type of Luxembourg regulated vehicle, and the purification of income is commonly accepted by Luxembourg authorities and service providers. Indeed, the Luxembourg financial supervisory authority has become increasingly familiar with Shari'a-compliant investment structures and is currently working on a set of guidelines or best practices for service providers to Islamic funds.

Shari'a-compliant investment funds

As Europe's largest centre for investment funds, Luxembourg has extended its reputation throughout the Middle East and in many ways spearheads the domiciliation of Islamic funds. Luxembourg is currently ranked fourth in terms of market share of Shari'a-compliant investment vehicles in the world, after Malaysia, Saudi Arabia and Kuwait, and is followed by Bahrain. There are currently almost 40 Islamic funds domiciled in Luxembourg, making it one of the world's largest place of domicile outside of the Islamic world.

In recent years, Luxembourg has cemented its position as the most popular domicile for UCITS funds ("Undertakings for Collective Investment in Transferable Securities"). Originally created as a retail product, UCITS funds are widely sold both to the public and to corporate and institutional investors. Benefiting from a European distribution passport, UCITS funds may be marketed across the European Union, Asia, Latin America, and increasingly in the Middle East. Over 700 Luxembourg funds are registered in Bahrain (including Islamic Equity Funds, Shari'a-compliant Money Market Funds, Shari'a-compliant Exchange Traded Funds etc.), testifying to the suitability of all such funds to Islamic investors.

At the same time, Luxembourg has developed alternative structures, such as hedge funds, private equity and real estate funds. Structures such as the SIF (explained above) that allow a wide investment portfolio, are commonly used for Shari'a-compliant private equity and real estate schemes – be they aimed at institutional or high net worth individuals.

Sukuk

Beyond its particularly efficient investment vehicles, Luxembourg is a pivotal location for the listing of sukuk, especially due to its favourable legal framework allowing the issuance from all types of entities under various forms. The listing on the Luxembourg Stock Exchange is enhanced by limited administrative burden imposed by the Luxembourg financial supervisory authority – in stark contrast to many other jurisdictions. In Luxembourg, the issuance of sukuk may ideally be structured through a SOPARFI or a securitisation vehicle. Both vehicles provide significant flexibility and may issue sukuks in the frame of private placements or listings on the Luxembourg Stock Exchange. Sixteen sukuks are currently listed and traded –including issuers from Malaysia, Saudi Arabia and the United Arab Emirates – with a combined value of over USD 7.8 billion, the first ever European stock exchange to list sukuk.

Microfinance

Microfinance aims at alleviating poverty through the supply of banking and financial services to poor or low-income clients. Such services are generally provided by microfinance institutions (credit cooperatives, non-governmental organisations...). For investors, however, those services can be channelled through a microfinance investment vehicle (MIV) and this is where the Luxembourg investment funds sector comes into play.

The microfinance business is well-entrenched in the Luxembourg financial centre and enjoys strong government support. Almost 46 percent of global MIV assets are held by Luxembourg-domiciled MIVs,[215] testifying to the country's commitment for the continued growth and support of microfinance. Luxembourg provides a very attractive legal framework for MIVs which may be structured as UCIs, SICARs, SIFs or securitisation vehicles. As discussed previously, these vehicles can be used to build Shari'a-compliant MIVs. The choice of which vehicle will depend on the profile and requirements of investors. Luxembourg, as a leading European investment fund centre, offers all the flexibility and choice of MIV structures as well as recognised technical expertise.

The microfinance industry is gaining momentum by offering Shari'a-compliant investment products to Muslim communities that are reluctant to deal with conventional financial instruments, and Luxembourg ticks all the boxes to become a hub for Shari'a-compliant microfinance investment.

Charitable trusts

Luxembourg provides many advantages to companies and individuals willing to set up a foundation (or charitable trust) in Luxembourg.

This type of non-profit organization can donate funds, support organizations, or act as the sole source of funding for its own charitable activities.

There are broadly two types of foundations in Luxembourg:

- Individual (i.e. separate) foundation;

- Foundation as a "compartment" of the Foundation de Luxembourg, or sheltered foundation.

Major challenges facing the Islamic finance industry in Luxembourg

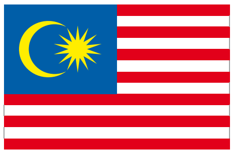
The magnitude of Luxembourg's efforts –ever since the country's emergence as an interesting holding and financing jurisdiction in the late 1980s– to elevate its status to that of a major international hub for Islamic finance is undeniable. But for all the efforts made, Luxembourg remains in the shadow of several other jurisdictions continuously favoured by Islamic investors. For all the cosmopolitism that characterises Luxembourg's workforce, the Muslim community in Luxembourg remains very small compared with its neighbouring countries. The hitherto arguably unforeseeable establishment of a retail Islamic bank in Luxembourg has, however, been mitigated by the two circulars of 2010. These were issued by the Luxembourg tax authorities in 2010 with an aim to cover and secure the domestic tax treatment of certain Shari'a-compliant transactions, that could pave the way for the marketing (on a European scale) of Islamic products issued by a Luxembourg-domiciled Islamic retail bank.

All players in the Luxembourg market are raising their game and are eager to show the Muslim world how essential Luxembourg can be for the future expansion of Islamic finance.

Looking ahead

Luxembourg has undeniably established a level playing field for all major Islamic products, and the factors underpinned in this article testify to its role as a global hub for Islamic finance. The flexibility, security and stability that Luxembourg offers, permit the availability of cutting-edge investment instruments and vehicles, Islamic products bearing exceedingly low effective taxation and the further expansion of Islamic transactions.

[215] Commission de Surveillance du Secteur Financier (CSSF)



IFCI ranking: 2

MALAYSIA

Malaysia is to Islamic finance, what America is to Capitalism: its indefatigable champion. Every limb and branch of the Islamic finance paradigm, Malaysia has a perceptible influence: from innovation in the capital markets to developing cogent education policies. Even with a dual market, where conventional and Islamic finance coexist, the government has shown more enterprise and boldness than any other self proclaimed Islamic finance hub to create an infrastructure which will fortify the domestic and global Islamic finance market.

No less a figure than the current US Secretary of State Hilary Clinton praised Malaysia's efforts for what she described as a 'creative approach' to Islamic finance. Speaking at the International Institute for Islamic Thought and Civilization (IIITC) in November, Clinton further commented that Malaysia could be a global 'thought leader' in Muslim affairs. This is quite a panegyric for a nation far from the traditional home of Islam.

But the statement is underpinned with evidential substance, especially with regards to Islamic finance. Over the last ten years, Malaysia has progressively built their Islamic finance industry, creating a unique and distinctly Malaysian approach. Not fettered by the idea that Islamic thought development belongs to the Middle East or to South Asian countries such as Pakistan, It has taken necessary steps to ensure that Islamic finance will thrive globally. According to market practitioners, Malaysia has an array of Shari'a-compliant products and an alternative for every conventional product available. In such an environment, Islamic finance is bound to prosper.

Industry overview

According to Central Bank figures from December 2010, Islamic banking assets totalled $109 billion according to the 2010-2011 Economic Report from the Ministry of Finance. There are 17 licensed Islamic banks, six of which are foreign owned; and 10 takaful operators, two of which are foreign owned.

The sukuk market has been particularly vibrant in 2010. The Bursa Malaysia has retained its position as the top sukuk listing destination. Malaysia's Islamic bond auctions drew record bids thus year. Demand for sukuk exceeded the amount offered. The excess demand was from Islamic banks in Malaysia as well from foreign investors. The government on the other hand borrowed less as the economy recovers from its first contraction in a decade; they are aiming to cut the budget deficit to 5.6 percent of GDP from a 22 year high of seven percent. That being said, the government have issued a number of sukuks this year including its first international debt issue since 2002. It is hoped that the five year dollar dominated ijara sukuks will set a new benchmark for pricing bonds in Malaysia. The government sold USD 1.25 billion after attracting orders of almost USD 5.5 billion. In June, the Government announced a five year plan indicating that annual development spending will rise by 2015, and it is expected that sukuk will account for much of the expenditure. This is surprising as the government to date have taken a diminutive approach to issuing sovereign sukuk, hence explaining the scarcity of said issuances.
Notwithstanding the general size of the sukuk market, total sales of the sukuk have dropped 24 percent to USD 15.3 billion this year. In order to reverse the fall, discussions are underway between Bursa Malaysia and regulators on enabling companies to issue sukuk affordable to the public thereby broadening the customer base. Even with the fall in the sukuk sales, this has been offset by the ringgits rally, spurring demand from foreign investors. Commentators highlight strong national growth along with low indebtedness making the ringgit attractive to investors.

Malaysian firms have been active in all aspects of sukuk issuance. In 2009, CIMB was the top global underwriter managing USD 4.4 billion worth of sukuk, beating the global giant HSBC. Bloomberg data shows that as of September 2010, three of the top five underwriters of sukuk are Malaysian based. Malaysia's dominance in the sukuk market, as compared to its Gulf competitors owes itself to the broader breadth of its capital markets. There is a far more active secondary market in Malaysia and investor choice differs. In the Gulf, investors buy and hold bonds until maturity. Bank Negara and Securities Commission have provided better regulation with detailed rules for sukuk issuance, while in the Gulf, the set of standards are not as comprehensive.

With respect to fund management, according to the Malaysia's Securities Commission, there are currently 152 Islamic funds registered with total Net Asset Value (NAV) of USD 7.1 billion. The Commission believe that the fund management sector is the fastest growing segment of Malaysia's Islamic capital market, with an annual compounded growth of more than 25% over the last five years. Part of Malaysia's success in the fund management industry is due its more innovative approach to product development as compared to the GCC countries that have based their fund structures largely to conventional models. Attractive tax incentives have been offered by the government contributing to the growth. Moreover, the Securities Commission has been active in collaborating with other important market regulators such as the DFSA and the Securities and Futures Commission of Hong Kong. These relationships have helped broaden the distribution network and promoted an exchange of ideas regarding the development of the fund markets. As part of Malaysia's liberalisation policies, the government has issued 14 licenses allowing international companies to form Islamic fund management businesses and companies.

Liberalising takaful

At approximately 8 percent of the total insurance assets in the industry, takaful in Malaysia is not as strong as it perhaps could be. As compared to Islamic banking, which holds 19 percent of the Malaysian banking sector, takaful firms has not been growing as fast over the last ten years. Part of the problem is that takaful firms have few investment opportunities as compared to conventional insurers. There has been a difficulty in developing products and increasing distribution channel and with over reliance on the regional equity and real estate markets, takaful firm are limited from enhancing their liquidity base. A more pervasive problem has been the lack of global uniformity of Shari'a standards hindering the increase of demand.

Malaysia plans to address these problems by issuing long term paper, including longer dated sovereign sukuks. In order to increase competition, and bring in increased capital, Bank Negara lifted the cap on foreign equity holdings of takaful operators and conventional insurers from 49% to 70%. This has been part of their liberalisation plan for the whole financial sector; and the cap has also been lifted for conventional and Islamic banks. At the same time, Bank Negara issued four new family takaful licenses. Notable companies to have procured the licenses included Netherlands based ING and Friends Provident from the UK.

Changing regulation

Malaysia is considered as having the most systematic approach to Islamic financial services regulation of which they are continuously improving. A major benefactor has been the government who have allowed innovations and developments and encouraged the creation of an institutional framework which could support Islamic finance. Foreign bankers have stressed that Malaysia's attraction as an Islamic banking hub is partly due to the government's active support.

Consequently, the Malaysian legal framework for Islamic finance is undoubtedly the most comprehensive compared to other interested jurisdictions and credit has to be given to the Government and regulatory authorities such as Malaysia's central bank, Bank Negara. Malaysia started with the passing of Banking & Financial Institutions Act (1983) which includes the Islamic Banking Act. This was followed swiftly with the Takaful Act 1984. In 2009 the government introduced two new updated acts — the Central Bank of Malaysia Act 2009 and the Capital Markets and Services Act (CMSA) 2009. A pivotal act has been the Central Bank of Malaysia Act 2009, which took effect in November of the same year. Two key pronouncements have been made in terms of regulation: 1) In Malaysia's dualistic financial system, conventional and Islamic financial systems will share parity; and 2) Dispute in Shari'a matters shall be brought to the Central Shari'a Board of Bank Negara, the Shari'a Advisory Council (SAC).

Cumulatively, what this effectively means is that legal disputes in Islamic finance will be adjudicated by judges who have the requisite skills and knowledge in the Shari'a and more specifically, Fiqh ul Muamalat. Malaysia has taken a systematic approach to Shari'a governance, ensuring a reduction of conflict of interest and a minimisation of Shari'a differences of opinion through the institutionalisation of a centralised Shari'a board at the Bank Negara, who by law acts as the authority of last resort. There is also a Shari'a board that advises the Securities Commission. The centralised Shari'a board's rulings are binding on courts and arbitrators. In the event of litigation, a dedicated judge has been placed in the commercial division of the High Court in Malaysia, who will preside over cases and will consult with the Shari'a board.

Bank Negara is in the process of changing Shari'a governance guidelines, which will set standards of Shari'a-compliance over the next decade. They plan to set parameters for murabaha, ijara, mudaraba, musharak, istisna and wadia contracts. In October, Bank Negara set up the Law Harmonisation Committee, a body tasked to seek ways of harmonising Shari'a laws with counterpart laws in the conventional system. The committee will gather the views and opinions of key stakeholders, deriving appropriate recommendations to strengthen the legal framework. The main objectives are to review existing Malaysian Islamic finance laws, propose necessary amendments to give legal recognition and develop the Malaysian legal framework as the law of choice for international financial transactions.

At Labuan International Banking and Financial Centre, Malaysia's offshore centre, there have also been amendments and enactments of legislation which will facilitate and strengthen Islamic finance. The Labuan Islamic Financial Services and Securities Act (2010) has made Labuan the first common law international financial centre to have specific legislation governing Islamic financial services.

Opening the markets

Much of Malaysia's success owes itself to impressive foresight in 2001, with the launch of The Financial Sector Master Plan (FSMP), a strategic plan consisting of a series of measures and a timetable for the liberalisation of the conventional and Islamic financial sectors. Kuwait Finance House was the first foreign Islamic bank to set up in 2004. In 2006, the Malaysia International Islamic Financial Centre (MIFC) was set up, whose core mandate is to promote Malaysia as a major Islamic finance hub. Since then, foreign ownership rules have been eased making it easier to trade in foreign currencies. The setting up of MIFC facilitated the issuing of International Islamic Banking Licenses (IIBL) to a number of foreign owned banks. HSBC, Citigroup, and Standard Chartered and Al Rajhi now have standalone Islamic banking subsidiaries in Malaysia. In April, Bank Negara authorised Deutsche Bank to conduct a full range of Islamic banking activities in foreign currencies out of Malaysia. Not content to ease into their stride, Deutsche Bank launched the Islamic Securities Services (SS-i) for both domestic and foreign Islamic fund providers. It is the first Islamic based custody and fund services product based in the country.

The IIB regime has a number of features salutary to foreign firms who wish to enter Malaysia. Some incentives include tax exemptions till 2016 on income earned from Islamic banking and takaful operations conducted in foreign currencies. The regime allows 100% equity ownership and removes immigration barriers thereby making it easier to employ international experts who can add value to the IFI's service provision. Malaysia has offered five licenses to international law firms to open dedicated Islamic finance branches in the country. This has proved less than successful with reservations coming from the Malaysian Bar Council and international law firms. The Council believe that this kind of deregulation will be detrimental to the local legal market, while the law firms argue that focusing on particular field would not be a profitable venture.

In November, Bank Negara announced that it would grant two licenses to foreign owned banks to establish Islamic megabanks in Malaysia. To be a megabank, the banks need to have USD 1 billion paid up capital and a global focus. Part of the objective of these megabanks will be to become an effective competitor with the conventional giants that dominate the market. Currently, there are discussions involving banks in Malaysia, Bahrain and Qatar but an element of secrecy surrounds the affair and details are scant.

But while there are concerted efforts to draw international financial institutions to Malaysia, domestic institutions are looking to regional markets. CIMB has a presence in 11 countries and is looking to expand further. Maybank, Malaysia's largest lender, has plans to expand its Islamic finance business in Singapore and Indonesia. Khazanah Nasional Berhad, the investment holding arm of the Government of Malaysia issued its largest sukuk in Singaporean dollars with a value of SGD 1.5 billion making in the largest SGD issuance by a foreign issuer in Singapore. BIMB is one of the stake holders of Sri Lanka's Amanah investments and is currently considering whether to raise its stake. In March, Asian Islamic Investment Management (AIMAN) partnered with Hwang DBS Investment Management Bhd to launch the USD 100 million Islamic Hwang DBS AIMAN A20 China Access Fund, which grants investors access to the lucrative Chinese A-Share market, one of the two types of stocks issued by the Shanghai or Shenzen stock exchange. The AIIMAN A20 will invest into the 20 largest Shari'a-compliant China A-share companies, in terms of their market capitalization. It is the first non-ringgit Islamic wholesale fund and the first to focus on China A-shares.

Focus is not limited to neighbouring countries. Working relationships have been established with indigenous IFIs and regulatory bodies in Gulf States and beyond. AmanahRaya Investment Bank partnered with Bahrain's Capital Partners Holdings to launch the Global Halal Ventures Fund in May. The fund has been created to invest in halal related businesses in Muslim countries to tap into the huge demand available. Another example is the collaboration of Malaysian Islamic banks with their UK counterparts to stimulate cross border transactions between countries. We are seeing manifestations of partnerships between the two countries already. UK's Standard Chartered and BIMB plan to offer Shari'a-compliant derivatives in Malaysia, commencing from the first quarter of 2011. The derivatives will provide protection from fluctuations in price of basic commodities.

Ensuring protection for investors and creating an effective risk management framework is a key concern for Malaysian regulations. The Securities Commission have been proactive in securing ties with capital market regulators and has signed 29 MoUs since 1994. In December, Malaysia's Securities Commission signed an MoU with Qatar Financial Markets Authority (QFMA) to strengthen cooperation, with a focus on enhancing investor protection.

To enhance the global framework for Islamic finance, Malaysia has ambitious plans to develop a space in which there will be co-operation between leading institutions and regulators. In October, sovereign wealth funds from Malaysia and Abu Dhabi signed an agreement to build a USD 8.4 billion international financial district in the capital, Kuala Lumpur. It will be a 34 hectare site for banks, professional service firms, regulations and financial institutions to co-locate. Construction is expected to commence in 2011 and highlights Malaysia's ambition as well as need to bring in foreign investment to build the physical infrastructure necessary for Malaysia to achieve developed nation status by 2020. Leveraging on their Islamic credentials, Malaysia has attracted Gulf institutions to assist in the development of real estate, energy capabilities, communication facilities, amongst other things. It is envisioned that sukuks will be a common source of raising finance.

Strengthening the markets

Malaysia's progressive development of the Islamic finance industry is not parochial in outlook and delimited to within the borders of Malaysia. Multinational organisations such as the IFSB are based in Malaysia. IFSB has been prominent in the market for issuing international standards to ensure soundness, stability and transparency in the Islamic finance industry. In October, IFSB set up the International Islamic Liquidity Management Corporation (IILM). The primary objective of the IILM is to issue Shari'a-compliant instruments to facilitate liquidity management solutions for IFIs. This has been a particular problem for IFIs who are prevented from accessing conventional liquidity markets due to Islamic prohibitions. Through developing instruments and procedures to, and encouraging cooperation between member countries, it is hoped that this pervasive problem will be solved. Malaysia had already created the Bursa Suq al Sila in 2009, an electronic platform, that enables banks and companies to buy and sell basic commodities that are used as assets to back Islamic loans thereby managing short term liquidity. But the IILM represents a source organisation through which Shari'a-compliant instruments will be issued.

There were 11 central bank signatories to the agreement from Indonesia, Iran, Luxembourg, Malaysia, Mauritius, Nigeria, Qatar, Saudi Arabia, Sudan, Turkey and the United Arab Emirates. Multilateral organisations such as IDB and the Islamic Corporation for the Development of the Private Sector (ICD) are also signatories. The Malaysia parliament is currently drafting legislation for a special enabling act which will accord the IILM a diplomatic status granting it privileges.

The knowledge economy

Boasting a vibrant and dynamic market, Malaysian institutions and thinkers are highly sought after by countries wishing to develop their own Islamic finance capacity. China, Hong Kong, South Korea, Singapore, Indonesia, Australia, Brunei have all garnered assistance. It would suffice to give a few examples. In 2009, Bursa Malaysia and Korea Exchange (KRX) co-organised an Islamic capital market conference in South Korea to stimulate interest in the trading of Shari'a-compliant products. South Korea was looking to issue a sovereign sukuk, and sought advice from leading Islamic finance scholar, Dr Mohd Daud Bakar, of Amanie Business Solutions. Amanie set up in Dubai in 2008 to provide Shari'a advisory services, as well as offer a range of training and education programmes in Islamic finance.

Amanie's expansion into Dubai attests to Malaysia's pre-eminence in the field of education and training in Islamic finance, though many would argue that Malaysia's more liberal approach to Islamic finance dilutes its authority on the subject matter. Nevertheless, as a leading market, it still holds credibility and value especially to those who are not well versed in this field; and with a mature academic system in Islamic finance, people are flocking to Malaysia.

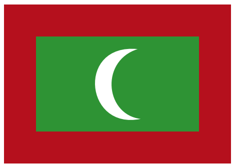
Hitherto, Malaysia's International Centre for Education in Islamic Finance (INCEIF), set up by the central bank in 2006, has been a leading provider of Islamic financial qualifications. These include the Chartered Islamic Financial Professional (CIFP) qualification, a Masters and a PhD. INCEIF have partnered with universities, such as Reading University UK, to offer Islamic finance programmes. In 2010, they have sought collaboration from three institutions in Jordan, the University of Luxembourg, Chinese University of Hong Kong and the Reims Management School in France. A wider network is part of INCEIF's desire to be a truly global university.
Returning back to the private sector, an important organisation in terms of producing ground breaking research and producing recommendations to strengthen the framework of Islamic finance has been the International Shari'a Research Academy (ISRA). ISRA has developed a global reputation for their research into Islamic finance, which has led to collaborations with local and international bodies to enhance Islamic finance thought leadership. In November 2009, they signed three memorandums with Affin Islamic Bank, IRTI and KFH Malaysia. The latter collaboration has resulted in translating to English, Shari'a resolutions from the fatwa and Shari'a supervisory board meetings of KFH held from its inception in 1977 up to 2009. The material will be source material to non-Arabic speaking Shari'a boards across the world.

Malaysia has also taken serious steps in ensuring there is more female involvement on Shari'a issues. There are currently 10 women Shari'a advisers in Malaysia. Anecdotal numbers suggest that there are no female advisers in the Middle East. Women are also chief executives of major financial institutions such as EONCap Islamic.

A quiet 2011?

It would be fair to say that ongoing growth of Islamic finance in Malaysia will continue with aplomb. Malaysia does have a dual system and the conventional system is still dominant; but the strong government support has given Malaysia a leading position in Islamic finance. So much so that regions in Malaysia can experiment - to some extent- with their financial systems. In August, Kelantan, one of the 13 states of Malaysia situated to the North East introduced gold dinars and silver dirhams as currency. Within a few months, gold dinars were sold out. However, the Bank Negara has warned that the currency cannot be used as legal tender; only the ringitt is permitted. The currency can however be used as investment.

This may have been a local occurrence but the audacity suggests the openness of the Malaysian market and willingness to countenance new, slightly controversial, projects. In many respects, Malaysia's Islamic finance market has grown due to the flexibility and space granted to it. Provide the space and it is unlikely growth and innovation will be unabated.



IFCI ranking: –

MALDIVES

Honeymoons are often instinctively associated with this idyllic island lying close to the Indian peninsula. The prospect of white sands and sky blue seas tempts and tantalises couples beginning their journey into married life. Tourism is therefore a major source of income, as thousands flock to experience what the Maldives call the 'sunny side of life'. Ibn Battuta, the intrepid 14th century traveller commented that these 'islands are to be reckoned as one of the wonders of the world'. He was also impressed by piety and religious uprightness of its inhabitants.

Seven centuries on, Ibn Battuta would have been quite intrigued with the culture and activities of its inhabitants and migrants. He would also have been impressed that the state religion of the Maldives is Islam. This is hardly surprising considering 99% of the Maldives' 400 000 population is Muslim. What may have beguiled him is how 3000 people from the Maldives suddenly lost their citizenship due to amendments in the constitution. In 2008, a revision was made in which it states under Article 9d, 'a non-Muslim may not become a citizen of the Maldives'. Islam is uncompromisingly a mainstay for the Maldives.

2008: a milestone year

2008 seems to be a milestone year for all things Islamic in the Maldives. An Islamic Finance Unit was established in the Maldives Monetary Authority to facilitate the setting up of an Islamic bank. This project was initiated with a USD 4 million grant as investment equity from the Islamic Corporation for the Development of the Private Sector (ICD). Work was carried out to develop a suitable regulatory framework and partners such as the IDB were called to assist in the setting up of the bank. In 2009, CIMA in Sri Lanka launched the CIMA Islamic finance qualification in the Maldives, anticipating the need to develop the human resource capacity in Islamic finance. There was yet an Islamic bank in the Maldives.

2010: so commences Islamic finance

It was only in August 2010 that the Maldives Monetary Authority issued a licence to Maldives Islamic Bank Private, establishing the country's first IFI. The ICD holds a 70% stake in the bank and the remaining is held by the government of the Maldives. To develop the institution, the Maldives Islamic Bank (MIB) and the Islamic Banking and Finance Institute Malaysia (IBFIM) signed an agreement in November 2010 in which IBFIM will assist MIB develop their Shari'a-compliant banking products. There had already been Islamic finance activity in the Maldives since 2005. Amana Takaful (Sri Lanka) had been offering takaful services in the Maldives through agents. To consolidate, they received a general insurance license in March 2010 and have a branch in the capital Malé. To support the activities of the bank, the Maldives parliament sanctioned the Maldives Banking Bill which includes a chapter on the practices of Islamic banking.
Maldives Islamic Bank enters a banking sector consisting of five banks, only one of which is a local bank. Opportunities therefore abound but just like those absorbed couples that come every year, Islamic finance in the Maldives is still in its honeymoon period.

IFCI ranking: –

MAURITIUS

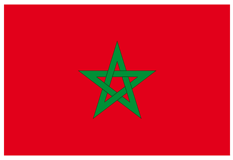
The ground work is being laid for Islamic finance to flourish on this island state. It is already recognised as an attractive location for structuring Islamic funds, due to the taxation regime of the country. Taxation agreements with over 30 countries mean funds domiciled in Mauritius, do not incur any capital gains tax on shares in a company based abroad. Now, Mauritius is considering issuing a sukuk in order to draw investment from the gulf and the Far East.

For this to transpire, there have been several regulatory changes. Specifically for sukuk, an amendment was brought in the Public Debt Management Act 2008 that modifies the definition of government securities. Sovereign sukuks have now fallen under the definition. Consequently, there is an expectation that a sovereign sukuk will be released in 2011, which will facilitate the creation of an Islamic interbank money market. In turn, it is hoped that the money market will cater to the liquidity requirements of Islamic financial services that are present in the country.

A pivotal moment for Islamic banking in the country was the passing of the Finance Act 2007, which brought in amendments to the Banking Act 2004. The Act stated that banks incorporated under the 2004 Act were permitted to provide Islamic finance services, subject to the granting of a licence by the Bank of Mauritius. The first Islamic banking licence was granted in October 2009, with HSBC opening an Islamic window to provide basic Islamic finance services such as current accounts and term investment accounts. There haven't been any significant enhancements in the product portfolio of HSBC. The Bank of Mauritius also published guidelines for Islamic banking which cover governance, risk management, capital adequacy and auditing standards. The Bank has made it clear that banks are obliged to set up a Shari'a board or have a Shari'a advisor while there will not be any central Shari'a advisory board as such. The Bank of Mauritius will however have an honorary Shari'a advisor who will play a supervisory role over Islamic banks, ensuring Shari'a-compliance. It is not the responsibility of the bank to conduct an ex ante review of the products which will be left to the individual banks Shari'a board.

The regulatory framework has therefore been set. Consequently, the recent announcement that an Islamic bank will be set up by the end of 2011, commenced phase two of the Mauritius progress in Islamic finance. Phase one comprised of building relationships with IFIs and centres. Mauritius has drawn guidance from the experience of other countries that have Islamic finance operations, particularly UK, Singapore and Malaysia. They have also become a full member of the IFSB in 2009 which has assisted Mauritius to develop their liquidity management capacity. Moreover, the Bank of Mauritius was one of the ten other central banks that signed the Articles of Agreement of the International Islamic Liquidity Management Corporation (IILMC) in October 2010.

Phase two will involve further developments of the financial markets in Mauritius. The setting up of an Islamic bank will lead to the proliferation of Shari'a-compliant securities. Bank of Mauritius has already organised a seminar on Islamic capital markets in June 2009; and along with their membership to the IILM, there are signs that Mauritius are keen to enhance their own capital markets. The launch of the Islamic bank will act as a catalyst and accelerate the already impressive progress made by the island state.



IFCI ranking: —

MOROCCO

The Kingdom of Morocco is a popular tourist destination for many holidaymakers from Europe and beyond. It has a rich culture stemming from Arab, Berber, French and African traditions. The country is situated in the north of Africa and strategically located along the coastlines of the Atlantic and Mediterranean coastlines. With the majority of the population Muslim, Morocco would seem a likely destination for Islamic finance. However the government has been slow to encourage its development, due to the fear that it may back the Islamist opposition. Furthermore, terrorist attacks in Morocco have contributed to this stance.

The Moroccan government has started to allow banks to offer Shari'a-compliant products following much demand for them. Initially, only conventional banks were allowed to offer some Islamic financial products such as ijara based products. Stand alone Islamic banks were not allowed in the country. Furthermore, even though conventional banks were allowed to offer Shari'a-compliant products, the cost was much higher due to higher tax, and they were known as alternative financing products.

The years 2009 & 2010 saw significant regulatory changes in the tax structure in Morocco to facilitate the entrance of the IFI. In the Financial Act of 2009, steps were taken to remove the double imposition of registration fees on property financed by murabaha, and in January 2010, the VAT on alternative banking products such as murabaha and ijara was reduced to 10% from the previous 20% levy. This change created a more level playing field for Islamic banks to compete with their conventional counterparts.

Additionally, the Moroccan Central Bank gave its approval for an Islamic finance subsidiary to be launched by Attijariwafa, in May 2010. The subsidiary known as Dar Assafaa Littamwil announced its fund launch in July 2010, and is 100% owned by Attijariwafa Bank with a capitalisation of around USD 5.7 million. Although the start up capital was not so high, the Bank is willing to consider partners in capitalising the company.

Dar Assafaa will offer a whole range of Shari'a-compliant financing through 9 branches such as vehicle financing, personal and consumer financing. The products will be marketed under the term "alternative" financing, the official term for Shari'a-compliant financing.

Whilst the government seems to have changed its attitude towards the development of Islamic finance within Morocco, a lot more needs to be done so that the industry can make more inroads. Failure to do so will see Morocco loose the opportunity to capitalise on the benefits of Islamic finance for its economy and citizens.

IFCI ranking: –

NIGERIA

Elections will be held in 2011 in Nigeria and it is likely that the current ruling party, the Peoples Democratic Party (PDP) will regain power once again especially since they have managed to hold onto power for the three previous elections (1999, 2003, and 2007). Some political analysts believe another term for the present incumbent, Goodluck Jonathan, will be good for the financial health of Africa's most populace nation as he is known by the international community.

Possibly. But there are worrying signs that the economy is in the doldrums. In 2009, the Central Bank of Nigeria (CBN) bailed out 10 banks last year with 620 billion naira (USD 4.1 billion) to prevent a collapse of the financial system. Increasing inflation rates, depletion of currency reserves coupled with the foreign flight of oil income has led to questions regarding the management of the economy by the government. However, Goodluck Jonathan's tenure as president began only in May after the death of the previous president. A year in power leading up to the elections may not be enough to give a proper appraisal of his rule.

Should he win the elections in April, part of Mr. Jonathan's mandate will be to continue Nigeria's aspirations of becoming a financial hub in Africa by 2020. The Financial System Strategy (FSS) 20: 2020 is a strategic economic plan launched in 2007 which aims to engineer Nigeria's transformation into one of the 20 largest economies in the world by 2020. Part of its strategy to strengthen the domestic financial markets is improving finance access for the large unbanked sector and integrating the informal sector into the formal financial sector. In this regard, Islamic finance plays an important role.

Building relationships

It has been in the last few years that a concerted effort to bring Islamic finance into Nigeria has manifested. But recognition of Shari'a-compliant products has been inhered in Nigerian legislation. Non-interest banking is provided for in the Financial Institution Act 1991, in which profit and loss sharing is recognised; though the Act proscribes the use of religious terminology in the registration of a bank's name. Following the passing of this Act, Habib Bank was given a licence to operate an Islamic banking window which is still operational today, but under the name of Bank PHB. In 2007, Bank PHB designed products to encourage Islamic banking in Muslim communities. However, this attempt did not achieve significant success or growth.

Material developments have occurred from 2009 onwards. Nigeria has sought to establish relationships with multilateral organisations such as the IDB, becoming a member in 2009. The IDB approved a Technical Assistance program to build capacity and create awareness on Islamic banking in Nigeria. Nigeria is hoping that IDB will assist in enhancing the physical infrastructure of the country, including construction, transportation and power. According to the Government, Nigeria does not need aid, but financial support, and will be looking for investment in order to reach their goals under the FSS. They also joined the IFSB in 2009. In April 2010, the IFSB agreed in principle the establishment of an inter-governmental special purpose entity to help in building liquidity management infrastructure. Along with membership with Islamic multilateral organisations, CBN has signed MoUs with other central banks such as Bank of Sudan and Malaysia's Bank Negara to educate on the regulatory aspects of Islamic finance.

A portentous event occurred in July with the gathering of state officials in Abuja from eight Muslim countries: Iran, Nigeria, Bangladesh, Egypt, Indonesia, Malaysia, Pakistan and Turkey. Delegates sat to discuss the prospect of developing business ties and reducing trade obstacles thereby creating an Islamic common market. Trade between the eight Islamic nations is estimated to be worth about USD 68 billion a year, or about 3% of global trade. Further, cooperation will increase trade and with Islamic finance being an important constituent of the financial markets for five of these countries, Nigeria's Islamic finance market could benefit significantly.

EFInA (Enhancing Financial Innovation and Access), an independent non-profit organisation funded by DFID and the Bill & Melinda Gates Foundation was set up in late 2007, with a mission statement to promote Financial Sector Development and Financial Inclusion in Nigeria. It has taken a proactive stance towards Islamic financing, co-opting stakeholders and international market operators in Islamic finance to create a strategy to disseminate Shari'a-compliant products.

Amending legislation

Up to 2009, the regulatory framework was not sufficient for Islamic finance to prosper. Things changed with the passing of the law governing the operation of Islamic banks in March 2009. This was followed in January 2010, with the establishment of a non interest banking unit in the Financial Policy and Regulation Department of the Central Bank. In September, the Nigeria Deposit Insurance Scheme (NDIC) released its draft framework for a non-interest Deposit Insurance Scheme for discussion. NDIC had sent six of its personnel to Malaysia to acquire the necessary knowledge on Islamic deposit insurance thereby assisting them in creating an appropriate framework. In addition, the Debt Management Office (DMO) set a tentative timetable for the development of the first sukuk to be issued from Nigeria.

The CBN has strengthened the Islamic finance regulatory framework with the publication of "Guidelines on Shariah Governance for Non-interest Financial Institutions in Nigeria" (The Guidelines) and the "Framework for the Regulation and Supervision of Institutions Offering Non-interest Financial Services in Nigeria" (The Framework) released in Dec 2010 and Jan 2011, respectively.

The Guidelines clarifies that the CBN will set up a National Shari'a Advisory Board, to be called CBN Shari'a Council. The Guidelines contain details on the fit and proper criteria for scholars on boards which are to be set up for every IFI. The Shari'a Advisory Committee, as it will be known, will operate as an independent body for the bank.

The Framework does not make reference to Islamic banks instead defining them as non-interest financial institutions (NIFI) which, "transacts banking business, engages in trading, investment and commercial activities as well as the provision of financial products and services in accordance with Shari'a principles and rules of Islamic commercial jurisprudence". In August, CBN had released information on the banking model in Nigeria. It defined non interest banks as specialised banks which can be divided into two, namely: national non–interest bank which shall have a capital base of 10 billion naira's and will operate in every state; and regional non-interest bank, which shall have a capital based of 5 billion naira's and operating in fewer states.

The Framework provides detailed information on the type of NIFIs that can be created, licensing requirements and the Islamic instruments that an Islamic bank can transact in. Further information is given with regards to subsidiaries and branches.

The market blossoms

The CBN publications were an important step in developing the regulatory framework for IFIs to operate in. Currently in the market, there are institutions deploying Shari'a-compliant products but with the new publications, it provides legal clarity thereby increasing the prospects of supplying more Shari'a-compliant products onto the market. Conventional Nigerian banks such as Fin Bank and microfinance banks such as Integrated Microfinance Bank have Shari'a-compliant products in their product offerings. Lotus Capital is a full-service, halal investment management boutique specialising in Shari'a-compliant asset management, private wealth management advisory services and financial advisory services. Halal Takaful Nigeria was the first (and currently only) takaful provider in Nigeria. It was a segregated division of Cornerstone Insurance set up in early 2010 and offering family and general takaful. In May, Al Barakah Microfinance Bank became the first Islamic microfinance bank in the country.

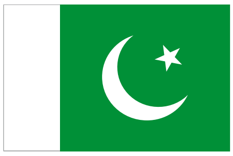
However, there is currently no fully operational Islamic bank. Jaiz International hope to set up a bank by 2011 and have brought in the technical assistance of Islami Bank Bangladesh Limited (IBBL) to help set up the infrastructure of the bank. Jaiz was incorporated in 2003 and set up to be an international holding company committed to setting up non-interest institutions such as Islamic banks. Since their formation, they have lobbied the government for an Islamic bank license in Nigeria but have been hindered by the then stringent capital requirements, a lack of committed investors and the global economic crisis. However, with the CBN publication and the lowering of the capital requirements, there is a greater sense of opportunity.

To encourage Islamic capital markets, the demutualisation of the Nigerian Stock Exchange (NSE) will allow foreign investments and create a trading platform on which Islamic securities can be traded. Currently, the NSE is in its early stages of demutualisation, but with the fall of investor confidence, the time is ripe for increasing the amount of tradable securities.

Challenges ahead

The CBN publications have not been met with resounding support. Accusations have been levelled against the CBN governor, Sanusi Lamido Sanusi, of having a 'Northern Agenda'. Nigeria has been suffering from internecine strife between Muslims based in the North and the Christians in the South. The PDP have attempted to reconcile the two parties by having Muslim and Christian leaders alternating terms in power, but frictions still remain. For the spread of Islamic finance, there needs to be support from both sides. Thankfully, certain Christian groups have shown interest in operating a NIFI.

A more grievous problem is the economic situation and the underdeveloped infrastructure in the country. Nigeria is a dependent economy which is a major factor behind the depletion of reserves. Lack of investment in the infrastructure has made it difficult for the country to create a vibrant manufacturing sector though their oil reserves have been a sufficient substitute. The West African country holds the eighth-highest crude oil reserves among OPEC members but is seeking to diversify the economy by developing its finance industry. This will be a tough task. According to EFInA's Access to Finance 2008 Survey, it showed that 68 million Nigerians representing 79 per cent of the adult population were unbanked. In addition, rampant corruption, imprudent management and the uneven distribution of wealth in the country have weakened the country's economy. If Goodluck Jonathan is to succeed as President, he needs to find effective strategies in dealing with these issues. And whilst Islamic finance is unlikely to be priority in his policy agenda, it will certainly be a critical aspect in developing a much more robust and wide ranging monetary policy. The CBN have laid the framework; it is time for IFIs to seize the opportunities.



IFCI ranking: 7

PAKISTAN

The desire for an Islamic economic system in Pakistan is as old as its independence. The Pakistan movement in British India during the first half of the last century was aimed at obtaining a separate country for the Muslims where they could lead their lives according to Islamic principles. This ideology necessitated every government, since independence in 1947, to take steps towards islamisation of the economy, especially the financial system. The founder of Pakistan, Muhammad Ali Jinnah, also emphasized the need for an economic system based on the Islamic principles of equity, justice and broad based distribution of economic gains while inaugurating the country's central bank, the State Bank of Pakistan (SBP) in 1948[1]. Mr. Jinnah in his speech said:

"…I need hardly dilate on the important role that the State Bank will have to play in regulating the economic life of our country…I shall watch with keenness the work of your Research Organization in evolving banking practices compatible with Islamic ideas of social and economic life... The adoption of Western economic theory and practice will not help us in achieving our goal of creating a happy and contented people. We must work our destiny in our own way and present to the world an economic system based on true Islamic concept of equality of manhood and social justice. We will thereby be fulfilling our mission as Muslims and giving to humanity the message of peace which alone can save and secure the welfare, happiness and prosperity of mankind. "

Further, all three constitutions the country has had since independence i.e. constitutions of 1956, 1962 and 1973, had preamble clauses that no law repugnant to the injunctions of Islam shall be enacted in the country. The 1962 and 1973 constitutions provided for the creation of the Council of Islamic Ideology (CII); the 1973 constitution (the existing constitution of Pakistan) also required the Government to ensure earliest possible elimination of riba from the country's economic system as one of the principles of the state policy. The riba free economic system is thus a constitutional obligation of the government of Pakistan.

Evolution of Islamic banking in Pakistan

The Council of Islamic Ideology (CII) report[2] on the transformation of the economic system to one based on Shari'a principles in 1970s, was the first serious attempt by a state institution to provide a strategy culminating in elimination of riba from the country's economic and financial system. The report gave the necessary conceptual framework and time-frame for islamisation of the financial system, encompassing government debt and monetary policy. The report, prepared by a panel of Shari'a scholars, economists and bankers covered the islamisation of (a) government transactions for financing fiscal deficit, (b) State Bank of Pakistan's domestic transactions and monetary policy, (c) bank deposits, (d) loans for fixed investment in industry, agriculture, construction, etc, (e) financing of working capital requirements, and (f) co-operative credit systems. The report recommended the government to complete the process of elimination of riba by July 1982.

The government started implementing the CII recommendations in the late 1970s with the conversion of operations of specialized financial institutions like House Building Finance Corporation (a government owned mortgage finance company with focus on low income clientele) to a riba free mode. It further demonstrated its strong resolve to eliminate riba in line with the recommendations of CII in early 1980s, by introducing significant changes in the legal framework including the introduction of Zakat and Ushr Law, amendments in the Banking Companies Ordinance and the Code for Civil Procedures, establishment of banking tribunals with civil and criminal powers and obligation to decide the recovery suits within 90 days. Further, the Mudaraba Companies Ordinance was promulgated to allow for establishment of mudaraba companies

[1] http://www.sbp.org.pk/ibd/bulletin/2009/Bulletin-Apr-Jun-2009.pdf

[2] http://www.cii.gov.pk/publication.asp

and issuance of mudaraba certificates for raising funds to finance different ventures/projects. Also necessary amendments were made in the company law/securities regulations to allow corporates to raise funds by issuing Islamic instruments like Participation Term Certificates (PTCs) and Term Financing Certificates (TFCs).

In line with government policy, SBP also issued comprehensive instructions to banks to shift to a riba free banking system[3]. The banks were advised to mobilize all remunerative deposits, i.e. all deposits other than the deposits in current accounts, on a Profit and Loss Sharing (PLS) basis. All local currency financing to industry and the business community was also required to be made through Shari'a-compliant modes. SBP gave twelve modes of Shari'a-compliant financing which the banks could use to extend financing to the industry. The twelve modes given by SBP included trade related modes of murabaha, ijara, salam, istisna; and investment type modes of musharaka and mudaraba. Qard hasan and loans based on service charges were also part of the modes given by SBP.

While sincere efforts were made by the government in the early 1980s to eliminate riba, the commitment of other stakeholders faded with time; which could partly be blamed for the limited success of the extensive efforts made to convert into an Islamic banking system. Further, it was presumed that the transformation would take place by making necessary changes in the legal and regulatory framework. But failure to consider mechanisms to ensure Shari'a-compliance in banks' operations stunted such transformation.

The absence of a Shari'a-compliance framework grossly weakened public trust and confidence in the Islamic banking model. Consequently, a number of faith sensitive persons filed suits in the Federal Shari'a Court (FSC), a court established in 1980 to hear and decide cases/suits related to Shari'a. Interestingly, the FSC was not authorized to hear suits related to the economic and financial system during its first 10 years of establishment. In 1991, the court passed a famous judgment that declared a number of financial laws and practices in vogue at the time as repugnant to the injunctions of Islam. The court also decided that all such laws shall cease to be effective from 1st July 1992.

Paradoxically, the government, who had formed a commission to review the existing financial laws and practices in order to bring them in conformity with Shari'a, appealed against the FSC decision to the Shari'a Appellate Bench (SAB) of the Supreme Court of Pakistan[4]. The case remained pending in the SAB for more than 7 years and was decided in December 1999 whereby the SAB upheld the FSC decision by rejecting the appeals and directed that laws involving interest would cease to have effect. In the judgment, the SAB concluded that the present financial system had to be subjected to radical changes to bring it into conformity with the Shari'a. It said, *'all prevailing forms of interest, either in banking transactions or in private transactions falls within the definition of riba. Further, the interest stipulated in government borrowings either acquired from domestic or foreign sources, is riba that is clearly prohibited by the Holy Quran'*. The court also directed the government to bring the system in conformity with Shari'a by June 2002 and constitute a commission for transformation of financial system (CTFS) to guide the government on the transformation.

The CTFS, constituted at the SBP in January 2000 in compliance with the court directive, in its report on the elimination of riba suggested the government to: a) introduce a law to prohibit interest, b) reinforce the system of corporate audit to improve banks' comfort level about operating results of corporates/SMEs, c) make thorough reappraisal of the tax system to allow for provision of financial services based on musharaka and mudaraba, d) make recovery laws more effective and stringent, e) take steps to create mass awareness about the new system, and f) develop mechanisms for the training of banks' staff in Islamic finance. The commission also recommended the government to constitute a permanent committee of Shari'a scholars, bankers and economists to advise the government on strategies required to islamise the banking and financial system.

While the CTFS had finalized its recommendations for eliminating riba from the banking system, the SAB accepted the review petition against its earlier judgment on 24th June 2002 and set aside its December 1999 judgment whereby the government was required to eliminate riba from the economy by June 30, 2002. The case was referred back to the FSC for a fresh hearing; the case has been pending in the FSC ever since. The CTFS was also dissolved in June 2002; however most of its recommendations were adopted by the SBP after it re-launched the Islamic banking initiative in 2001.

Current Islamic banking scene

While the earlier attempts to transform the banking system as a whole met with only limited success, the current approach is to allow and promote Islamic banking in parallel to the conventional system to enable the masses to do banking according to their preferences. The existing framework allows three types of Islamic banking institutions (IBI): i) full fledged Islamic banks, ii) Islamic banking subsidiaries of conventional banks and iii) Islamic banking branches (IBBs) of conventional banks. The conventional banks having IBBs can also have Islamic banking windows in their conventional branches and can convert their conventional branches[5] into Islamic banking branches as well. An elaborate Shari'a-compliance framework was also introduced that comprises the Shari'a board at the central bank which is the apex Shari'a body in the country for IBIs; the Shari'a advisors at banks' level appointed based on SBP's Fit and Proper criteria; internal Shari'a audit at IBIs level, and periodic Shari'a inspections by the SBP to assess Shari'a-compliance levels in IBIs. The composition of SBP Shari'a Board is unique as it includes a blend of Shari'a scholars, legal experts, accounting professionals, and professional bankers.

The introduction of a dual system in 2001 has so far been a success as the Islamic banking industry has grown since then and presently constitutes about 6.5% of the banking system in Pakistan. Starting from almost scratch the industry now has five full fledged licensed Islamic

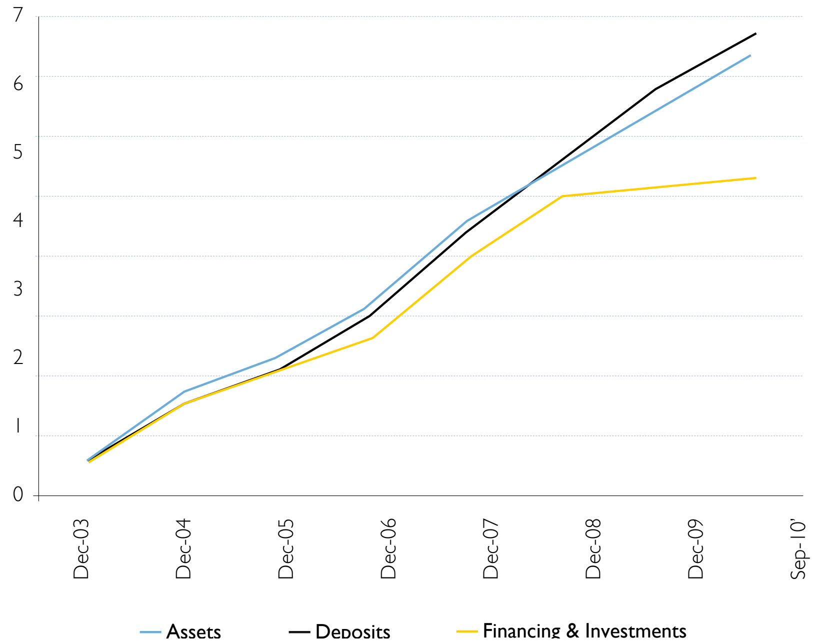
[3] http://www.sbp.org.pk/departments/pdf/IBD-OldCircular/BCD-cir13-1984.pdf

http://www.sbp.org.pk/departments/BCDC_Cir.htm

[4] The FSC decisions could be challenged in SAB of Supreme Court, which is the highest adjudicating body in the country.

[5] http://www.sbp.org.pk/ibd/2010/C2.htm

Share of Islamic Banking (%)



banks[6] and 13 conventional banks having IBBs with a network of more than 700 branches and presence in more than 80 cities and towns across the country. The industry has been growing 30% annually for the last five years and is likely to increase its share to 10-12% in the country's banking system during the next 2-3 years. During the calendar year 2011, more than 150 branches is expected to be added in the IBIs network which is indicative of the enduring demand of consumers for Islamic banking services in the country and interest of the banking community in capitalising on this market.

Issues and challenges

Notwithstanding the impressive growth during the last 6-7 years, the Islamic banking industry in Pakistan is still facing some major challenges, which if not prioritised, may have serious implications on sustaining growth.

First, the blurred distinction between Islamic and conventional banking products may weaken the very appeal of Islamic banking. The existing paradigm is based on developing Shari'a-compliant structures of conventional banking products, with only limited focus on the economic results they produce. While things are relatively better in Pakistan with respect to Shari'a ratings and acceptability of Islamic finance products, there have been demands particularly from conventionally trained Islamic bankers for liberalizing the Shari'a framework to bring it on par with Gulf and East Asian Markets. The excessive use of instruments like commodity murabaha (CM) particularly in the Gulf and East Asia, not only for liquidity management but also for extending personal loans to consumers, has received wide spread criticism. Although the use of CM in Pakistan is limited to only liquidity management, Shari'a scholars of some of IBIs have not allowed its use even for liquidity management. An objective assessment of the current paradigm is thus needed to see whether it is sustainable in its present form or needs some key changes. Options include a gradual movement towards risk and reward sharing modes.

Second, the business community and public at large need to be convinced about the utility and effectiveness of the Islamic banking initiative. Part of the problem is a lack of awareness, but the existing Islamic banking paradigm itself is also responsible for its limited acceptability as a distinct and viable system to cater to the financing needs of the real economy. There is thus not only a need for initiating a mass awareness campaign but also an expediency to design competitive Islamic finance products, clearly distinctive to conventional counterparts to serve the financing/banking needs of the masses.

Third, the present scope of IBIs is generally confined to cater to the short term financing needs of the real economy. While this scope is in line with the business model and deposit streams of conventional banks, it is not sufficient for Islamic banks. With this narrow scope, the Islamic banks will find it increasingly difficult to compete with conventional banks, which not only enjoy economies of scale but are also highly efficient and flexible when compared to Islamic banks. There is thus a need for Islamic banks to expand the scope of their business to areas and products where conventional banks have limited appeal, experience and skill set. One of the options could be to provide both commercial and investment banking services to be financed by different stream of deposits: current and PLS deposits for financing the short term trade based activities and restricted investment accounts (on the balance sheet) for financing the longer term investment banking business. The economies of scope so achieved will be instrumental in increasing the viability of Islamic banks, improving financial inclusion, augmenting entrepreneurial culture and significantly enhancing the returns to the depositors.

Fourth, despite some improvement in the recent past, the availability of suitably qualified and trained Islamic bankers still remains a key challenge for the industry not only in Pakistan but in almost all jurisdictions having Islamic finance. A large majority of Islamic bankers, particularly those interacting with the clients, do not have adequate understanding of Islamic finance and thus find it difficult to fully convince potential customers about the utility of Islamic finance and its distinction over conventional finance. They try to sell their products primarily on religious considerations rather than highlighting the business and economic utility of their products. The excessive use of 'halal' and 'haram' phrases for Islamic and conventional products respectively is limiting the target market of IBIs to faith sensitive clients. If Islamic finance lacks competitive solutions to conventional finance, there is no rationale to the market and promoting a system that gives sub-optimum solutions for meeting the financing needs of the real economy. Obviously, this is not the case; it is the limited capacity and understanding of existing Islamic bankers that create such doubts about the utility of Islamic finance. It is therefore, important that all stakeholders join hands to address the human resource capacity issue in Islamic finance.

[6] The number reduced to 5 from 6 full-fledged Islamic banks due to recent merger of two Islamic banks

Fifth, the lack of suitable liquidity management instruments has been a key issue particularly in Pakistan, where instruments like CM have limited acceptability. Issuances of the sovereign ijara sukuk since 2008 partly addressed the problem. However due to limited availability of the sukuk (due to buy and hold strategy) and their infrequent issuance, these sukuk are not frequently traded in the secondary market, reducing their utility as a liquidity management instrument. Further, sukuk are being issued to raise public debt, which coupled with use of conventional benchmarks (T-Bills rate) for pricing, increases its resemblance with fixed rate conventional bonds. While the variable rate sukuk (based on musharaka/mudaraba) may be a longer term industry objective, in the short to medium term, sukuk for financing specific infrastructure projects of the government could significantly improve their Shari'a repute besides bringing greater discipline and transparency in selection and financing of infrastructure projects. Further, the frequency of their issuance will also have to be increased significantly to improve their tradability in the secondary market. The recent establishment of the International Islamic Liquidity Management Corporation (IILM) in Kuala Lumpur, Malaysia is also a very important development that will have far reaching effects on the growth of Islamic finance globally. The IILM would enable institutions offering Islamic financial services to invest surplus liquidity and provided an important avenue to member countries to raise public debt from international markets at competitive rates.

Sixth, significant steps have been undertaken regarding legal and regulatory infrastructure to provide necessary support for Islamic banking; however, there is still a need to have a thorough review of the existing legal and regulatory framework to incorporate necessary amendments to draw full support for Islamic banking, especially in case of insolvency of an Islamic banking institution.

Seventh, the varied Shari'a practices in the Islamic banking industry remain a challenge affecting public perception. AAOIFI has provided immense support in harmonising the Shari'a practices; nevertheless, there still remain some areas where conflicting Shari'a practices prevail in the market. Respective jurisdictions are working to bridge such gaps; however, efforts at an international level to synchronize Shari'a practices would have a significant, beneficial impact on the industry.

Eighth, the research and development in the Islamic banking industry is slow-paced. The industry needs an ongoing system of research and development which may serve towards broadening the scope and appeal of Islamic banking industry across the masses. This would also facilitate the enrichment of the product mix and help resolve the issues faced by the industry.

Future Outlook

Despite the issues and challenges highlighted in the above section, the future outlook of the industry in Pakistan is positive. The industry is likely to keep its growth momentum and continue to increase the depth and breadth of its services in the medium term. The geographical outreach presently concentrated in a few big cities is likely to expand to second and third tier towns and cities. This would provide the much needed penetration and a platform to further increase the pace of growth and diversify deposits and financing portfolios. Presently, the IBIs have no exposure in the agricultural sector, which besides high risk perception of the sector is also attributable to absence of IBIs in rural/semi rural areas. With the central bank encouraging banks including IBIs to increase their exposure in the agriculture sector[7], both through regulatory and promotional measures, it is highly likely that IBIs will develop a significant agricultural portfolio in the medium term (next five years). Similarly, some improvement in the IBIs exposure to SMEs is expected; presently IBIs have approximately two percent share in the number of SMEs accessing financial services from the banking system. The large un-banked population[8], estimated at more than 95% Muslim, also provides optimism about sustaining growth momentum particularly on the liability side. Further, the improved avenues for managing surplus liquidity through initiatives like IILM are likely to encourage IBIs to launch aggressive deposit mobilization drives.

While the growth is likely to continue at a reasonable pace, the dissenting voices and concerns about Shari'a permissibility of various products will stimulate discipline, transparency and maturity in the industry and overall Shari'a-compliance would further improve. This would however require strong commitment by the government and policy makers. The central bank has been demonstrating its strong resolve to help develop the sector through supportive legal, regulatory and Shari'a-compliance frameworks and capacity building and awareness creation initiatives. The commitment and ownership by other state institutions including Securities Commission, Taxation and Government Debt Management Departments/agencies however needs to be improved to develop a strong and vibrant Islamic finance industry in the country.

[7] The present exposure of banks in agriculture sector is less than 5% with IBIs having no exposure at all

[8] Only about 11% of the adult population is banked as per World Bank access to finance survey 2007

IFCI ranking: –

PHILIPPINES

The Philippines is made up of 7000 islands and famed for its culture and of course boxing sensation Manny Pacquiao. It has a population of roughly 93.6 Million inhabitants. The dominant religion is Christianity which was spread during time the Philippines was a colony of Spain. Muslims make up 5%-10% of the total population and thus provide a sizable market for Islamic finance.

Before the establishment of the first Islamic bank, Dubai Islamic Bank, there was Philippine Al Amanah Bank founded in 1973. The mandate of the bank according to the Presidential Decree 264 was 'to provide credit, commercial, development and savings banking facilities at reasonable terms to the people of the preliminary Muslim provinces of Mindanao, principally, the provinces of Cotabato, South Cotabato, Lanao del Sur, Lanao del Norte, Sulu, Basilan, Zamboanga del Sur, Zamboanga del Norte and Palawan for the establishment, acquisition, development and expansion of agricultural, commercial and industrial enterprises, there is hereby created a body corporate to be known as the Philippine Amanah Bank, which shall have its principal place of business at Marawi City and shall exist for fifty years.

However, it was not an Islamic finance bank; rather a bank serving the Muslim community but offering conventional finance. Things did not change, even after a decree was passed changing the name of the bank to Al-Amanah Islamic Bank of the Philippines (AIBP) in 1990. The bank failed to take off the ground mainly because of a lack of public awareness and limited expertise in Islamic finance amongst staff. In 2006, the central bank allowed the bank to operate as conventional bank in order to stem the losses and to make it easier for the bank to be sold, which eventually occurred in 2008. Prior to the acquisition by Development Bank of the Philippines (DBP), efforts were made to attract investment from the Gulf and Malaysia. Currently the bank offers both Islamic and conventional products but it is hoped that by the end of DBP's five year development plan in 2013, it will be a fully fledged Islamic bank. Amanah has USD 21 million of Islamic banking assets.

An overwhelming concern for the Philippines government has been the activities of the Abu Sayaf and Moro Islamic Liberation Front militants who operate from the predominately Muslim area of the Autonomous Region of Muslim Mindanao (ARMM). The region gained autonomy in 1989 and has its own government. However, the region is severely impoverished. According to the government's National Statistical Coordination Board, per capita income in Muslim Mindano is USD 78, the lowest among the 17 regions in the Philippines. The poverty strengthens the militant cause and the government are looking at means of alleviating the poverty. It is therefore no coincidence that eight of the nine AIBP branches are based in the ARMM.

The Development Bank of the Philippines (DBP) has been sending executives to Malaysia for courses on Islamic finance. Furthermore Al-Amanah Islamic Bank is planning on offering more innovative services, such as making it easier for Muslims working abroad to send money back home. Executives at Al Amanah Bank feel that the Bank is currently doing well and may even post a profit in 2011, before the 2014 deadline. As a sign of intent the bank recently appointed Enrique D.Bautista, Jr as its chairman and CEO, who brings with him much experience. The bank even has ambitious plans to expand to other countries such as Malaysia in the future.

Islamic finance can facilitate further improvements in relationships between the government and the Muslims but the legal framework requires changing in order to drive the industry forward. The regulatory system is not germane to the growth of Islamic finance in the country and without proper changes in the regulatory infrastructure; there will be few developments in the next few years. The government had toyed with the idea of issuing a sukuk but decided against it. However, they are currently in the process of drafting a bill to facilitate the expansion of the Islamic finance industry in the Philippines. The central bank hopes that by doing so, this will open the country for investment especially from the Gulf States. Optimism is not high, however, as the central bank had alluded to changes in legislation in 2009.

IFCI ranking: –

PALESTINE

It is difficult for Palestine to embark on a course of economic development without having mind to the actions and strategy of Israel. Their looming presence is a constant source of concern for the newly formed Palestinian state, with sanctions and blockades offering little room for self determination. What space there is however grants the Palestinians some measure of opportunity, but with political divisions between the two constituent territories of the Palestinian state, Gaza and the West Bank, there is unfortunately an economic disparity which has adverse effects for the state as a whole.

Demographics and economics

As of 2009, less than 4 million people live in Palestine of which roughly 62% live in the West Bank and East Jerusalem and the remainder in the Gaza strip. The size of the economy is approximately USD 6 billion. GDP has been increasing since 2006 (with a bumper year in 2009) and according to the IMF, the Palestinian economy will grow by 8% in 2010. The Palestinian Monetary Authority (PMA), the central bank in Palestine, put this down to private sector confidence, ease of movement of goods to the Palestinian regions and finally donor aid. The World Bank has commented however, that Palestine's reliance on donor aid maybe precarious for the economy in the long run. Average annual donation since 2008 has been USD 1.6 billion. The World Bank advised increased focus on private investment to remove dependence. In this regard, the work of the Palestine Investment Fund in bringing private investment into the Palestinian state is a positive achievement. Recent figures suggest that it has USD 800 million AUM. The fund holds a 47 percent stake in Wataniya Telecom of Kuwait. The fund is also a partner in the Ersal financial centre, a planned 13-tower project in the West Bank with Riyadh-based Land Real Estate Investment and Development Co. As the name would suggest, the Palestinian Authority hopes that the centre will become a financial hub drawing in foreign investment and increasing commercial activity in area.

According to the PMA, there are currently 19 banks in the Palestinian territories, comprising of 17 commercial banks and two local Islamic banks: Palestine Islamic Bank and Arab Islamic Bank. There are currently two takaful companies in Palestine: Al-Takaful Palestine Insurance Company PLC and Palestine Takaful Insurance Co. The Palestinian Authority is looking to Islamic finance to bolster their economy and remove dependence on foreign aid. Consequently, the Palestinian central bank is attracting local banks to its first sale of sukuks, intended for 2011. It hopes to sell as much USD 50 million of sukuk. The Islamic notes are likely to be dollar dominated as the territories do not have a single currency.

Political division

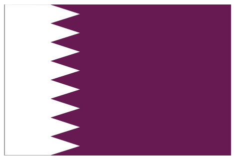
Unfortunately, the prospect of Islamic finance in Palestine is likely to be hindered by political discord. After the 2007 elections, political power became divided. The West Bank remained under the jurisdiction of the Palestinian Authority, while Hamas took control of Gaza. This had adverse repercussions for the Palestinian economy especially for Gaza with tightening of sanctions by the international community and Israel. According to the PMA, GDP growth in the West Bank was 8.5% while Gaza registered 1%. Gaza also suffers from high unemployment (38.6%). Recent estimates in 2007 made by UNCTAD estimate that 80% of Gaza are under the poverty line whereas in the West Bank, the figure is 45%.

The economic disparity is further compounded by conflicts between the Palestinian Authority and Hamas. After Hamas seized control of Gaza in June 2007, Israel increased monetary restrictions against Hamas. Concurrently, the PMA tightened its money-laundering rules, making it harder for funds to flow into Gaza. As mentioned, the PMA recognise only two local Islamic banks. They do not take into account Islamic National Bank, an Islamic bank set up in Gaza which the PMA and the International community believe to be a proxy for Hamas to channel investments to fund militant activities. The bank claims it is not politically affiliated with Hamas and has set up the bank to bring in foreign investment. However, by falling out of the purview of the PMA and the regulatory infrastructure, international banks are unlikely to deal with a bank which is believed to be affiliated with Hamas. In March, the US treasury put the bank (as well as a television station based in Gaza) on its terrorist financing list.

Conversely, Hamas does not recognise the PMA, arguing that a self styled central bank works within the parameters set out by the international community, and runs against Palestinian interest. By not recognising the PMA, Hamas have effectively set themselves up as a de facto regulatory authority in the Gaza strip. Hence, the raids on two PMA regulated banks, one being Palestine Islamic Bank, in March and June, emphasise the uneasy relationship Hamas has with the PMA.

Progressing through uncertainty

Islamic banks have been in Palestine for over 15 years and have done moderately well. The largest Islamic bank in Palestine, Palestine Islamic Bank, has over USD 350 million of assets. In a volatile economy, this is quite impressive. But the success of Islamic finance, and for that matter, the economy of Palestine will largely depend on political wrangling between Israel, the Palestinian Authority, Hamas, the EU Quartet and the USA. This creates a level of uncertainty for a nation that is still reeling from what they see as 70 years of oppression. While economic indicators are improving, the instability of the region could reverse progress and thus predicting the future for Islamic finance will be as difficult as achieving amity between Israel and Palestine.



IFCI ranking: 12

QATAR

It has been a good year for Qatar. The economy is good, neighbouring Gulf States are stumbling and the world's leading footballing nations will be coming to Qatar to kick a ball for the FIFA World Cup Trophy in 2022. One cannot be but impressed by Qatar's more measured growth – as compared with the garish Dubai – from the desert tents to gilded heights of Al Fardan Residences in such a short period of time. It has built an economic infrastructure developed largely through returns from their sizable oil and gas reserves that is still driving the economy forward and represents 50% of the country's GDP.

Qatarisation

Yet Qatar is well aware that for long term prosperity, reliance on hydrocarbon industries has to decrease and economic diversification is imperative. The Qatar National Vision 2030 (QNV) policy document launched in 2008 is a blueprint to achieve economic and social goals. The vision is based on four pillars and broadly represents the overarching focus of Qatar.

- human development
- social development
- economic development
- environmental development

On the path to achieve this goal, Qatar has embarked on a number of programmes including a policy of Qatarisation. This program is designed to increase the number of Qatari nationals in public and private sectors. Qatar has a population of only 1.6-1.7 million, of whom only 20% are nationals. In order to control the influx of expatriate workers, Qatar has tightened the administration of its foreign manpower programmes over the past several years. Growing numbers of foreign-educated Qataris, including many educated in the United States, are returning home to assume key positions formerly occupied by expatriates.

A leading exponent of Qatarisation has been Qatar Islamic Bank. It was honoured at the 27th session of the GCC Ministers of Labour Assembly in November for its initiatives in integrating Qataris into the local economy. QIB has signed an agreement with the Ministry of Labour to sponsor and support 30 Qatari students for three years during their studies. Last October, the institution signed another agreement with the ministry to send 13 Qatari students to the College of North Atlantic-Qatar for one year. The number of Qatari students sponsored by QIB will reach 43 by 2011, and will be well equipped to assist in QIB's different departments especially banking services and corporate banking. Similarly, other Islamic banks are following suit. Masraf Al Rayan claim to have one of the highest Qatarisation rates in the country's banking sector. The bank reports that the percentage of Qatari nationals working in the bank till July 2010 is approximately 35.5 per cent of 308 employees. Islamic bank Qinvest, Qatar's largest investment bank designed and launched the "Qatari Development Program", a 12 month intensive program to train Qatari nationals.

But the Qatar National Vision is more than just building up the local labour force. The aim is to be a market leader, independent and globally renowned. Policy makers understand that increasing global competition requires Qatar to create the right foundations and adapt in order to stay competitive. To this end, Islamic banks in Qatar are strongly committed to the initiative.

Growth and saturation

The IMF projects Qatar to have the world's fastest growing economy in 2011. Signs are good. The Qatar Index has jumped to a two year high in December 2010. Qatar's domestic and overseas investment portfolio is growing and the country is expected to spend tens of billions of dollars in the year ahead as it expands its investments around the world. Qatar Islamic Bank (QIB) signed an istisna agreement in May for the financing of a QAR 300 million (USD 82 million) residential project to be built in Al Khor. This real estate project at Al Khor is one of the biggest in Qatar since the economic downturn. At the beginning of the year, Qatari Diar Real Estate, a subsidiary of Qatar Investment Authority, raised USD 1.1 billion through a murabaha, making it the largest syndication in Qatar. QIB was appointed as the sole initial mandated lead arranged and book runner – the first time that a local bank has assumed such a role.

However, the government have expressed concern at the large number of banks given the small size of the market and therefore has encouraged mergers between banks. There are 18 banks operating in a nation with a population of only 1.6 million, including four Islamic banks – Qatar Islamic Bank, Qatar International Islamic Bank (QIIB), Masraf Al Rayan and Barwa Bank - a number of Islamic investment banks and seven foreign-owned lenders. The country is overbanked, and this has already led to a few mergers and acquisitions in the sector since the beginning of 2010. Barwa Bank acquired First Finance Company and The First Investor in a bid to become a universal Islamic banking group. It is an ambitious aim for a bank that started in 2007 but in the last three years, Barwa bank has grown in assets and product portfolio. Their growth highlights that the potential Islamic banking market is huge in Qatar. Thus, in July, HSBC Amanah opened the first dedicated Islamic banking branch in the MENA region outside of Saudi Arabia; and will serve both retail and corporate customers.

Competition in the Islamic banking market is intense. Major commercial banks such as Qatar National Bank, the Commercial Bank of Qatar and Doha all have Islamic banking subsidiaries. Increasing competition has compelled Islamic banks to look abroad. In August QIIB injected £20 million into the Islamic Bank of Britain, in order to stimulate growth in the foundering Islamic retail bank. It is also the founder of Syrian International Bank. Qatar First Investment Bank partnered with Dubai based asset management Gulfmena, to establish a unique, one-stop Shari'a-compliant asset management company. It will be the first of its kind in the region offering a range of Islamic investment products and services. QIB, the largest Islamic bank in Qatar, has a base in the UK and is a majority shareholder of Asian Finance House in Malaysia. Qinvest, QIB's investment banking arm, partnered with India's leading financial services provider, to create Ambit Qinvest India Fund. The fund is the regions first Shari'a-compliant fund. Qinvest also acquired a 25% stake in Ambit Corporate Finance Pvt Ltd, an investment bank. Qinvest also has a 47% stake in Pamure Gordon PLC, a 130 year old stockbroker and investment bank from the UK.

QIB certainly has a leading position in the market. Its network and portfolio make it one of the largest Islamic banks in the world. With such a stature, QIB has been able to stimulate innovation and market growth and has led other banks to follow. In September, QIB issued an international sukuk, the first to be offered by a Qatari financial institution. It was oversubscribed eight times, with demand reaching USD 6bn. After global downturn of the last two years, it is hoped that the sukuk will galvanise the market and now encourage corporates to issue sukuks,

Takaful begins to boom

In the Middle East, while banking is booming, insurance penetration remains low. This is slowly changing with Bahrain taking a leading role. Qatar hopes to capitalise, with the aim of becoming a regional insurance powerhouse by 2013. Latest figures show that insurance penetration as a percentage of GDP is just 1.1%. Of that small percentage, takaful has accounted for 25% in 2010, according to a survey released by Ernst & Young. The market is dominated by Qatar Islamic Insurance Company, which has long been the only dedicated takaful company. However, 2010 has seen the entry of a number of companies into the takaful market. Leading conventional insurer, Al Khaleej Insurance and Reinsurance company converted its operations fully into takaful in January. Damaan Insurance Company (Beema) also joined the market in January. Shareholders in the company include Islamic banks QIB and Masraf al Rayan, as well as Barwa Real Estate, Barwa's parent company. Additionally, foreign takaful companies are coming into the market. In October, Doha Bank and Allianz Takaful announced a partnership to promote Islamic insurance products in Qatar, while in the Qatar Financial Centre (QFC), Bahrain based takaful operator, T'azur, became the first general takaful company to undertake business in the QFC in 2009. The Qatar Financial Centre Regulatory Authority (QFCRA) had also authorised Allianz takaful to operate in the QFC in 2009.

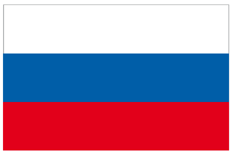
Regulatory consolidation or attenuation?

Of late, Qatar regulatory authorities have taken an uncompromising stance towards the development of Islamic finance in the country, which has positive ramifications for full fledged Islamic banks but adverse consequences for conventional banks with an Islamic component. In August, the central bank issued new regulation which prohibited conventional banks allocating more than 10% of issued capital to Islamic banking operations and from opening additional branches for Islamic banking. In February of this year, the central bank issued a directive stating that conventional banks are required to close their Islamic banking units by the end of 2011. These moves are directed at ensuring a complete separation of the two systems and the avoidance of comingling of funds. But it has left conventional banks with Islamic banking units - including HSBC, Qatar National Bank, Commercial Bank of Qatar and Doha Bank – in a confused position. Options are available including acquiring a license from the QFCRA, the country's second regulatory authority, but this will lead to a diminution of service offerings with more focus on corporate activities. The prospective closure of these units will be a positive impact for the Islamic banks in the country. Already, following the announcement, share prices for Islamic banks have increased. It will also ease the central bank's supervisory responsibilities. However, since the directive was issued without extensive consultation, there is arbitrariness behind this move.

A strong base equals growth

The central bank's move indicates the growing importance of Islamic finance in the economy.

Removing competition serves to increase the prominence of domestic Islamic banks in the market. Moreover, the country is overbanked especially with respect to its comparatively low population, and less service providers, will equal greater concentration leading to higher profits for domestic Islamic banks. The Islamic banks in the country are also quite active in their communities. Each bank has embarked on projects to develop community solidarity. Therefore, the central bank's move may not be as great a surprise as initially felt. With a national policy directed to invigorating the local markets, a greater market share for Qatari banks can only be a good thing to achieve objectives. In the long run however, this is debateable.



IFCI ranking: –

RUSSIAN FEDERATION

The Russian Federation is a vast swath of land covering nine time zones. One could travel from Moscow, on land, through Russian territory and end up in China; and if they really feel adventurous, they can continue on into Alaska, USA, and enter the western hemisphere. There are an array of peoples coexisting as Russians but differing dramatically in their cultures and beliefs. 83 federal states constitute this leviathan nation, including 21 republics, with their own constitution and government. Cumulatively, the Federation is the 8th largest economy in the world and is home to some 150 million Muslims dispersed and scattered across the width and breadth of the nation. Eight of the 21 republics boast a majority Muslim population which would suggest that Islamic finance could play a major role. However, nothing is ever that simple with the ex-Soviet Union.

Moscow looks to the east

Russia has felt the pinch of the credit crisis and is exploring opportunities to boost their economy. A number of Islamic finance experts from across the world have visited Russia, discussing with senior officials and leading bankers the potential of Islamic finance for the country. This seems like a natural outcome of an ongoing interest in Islamic finance over the last few years. In May, members of the financial community gathered for the 3rd annual Moscow Forum on Islamic finance and investments: a platform on which Russian regulators and bankers would be able to brainstorm and collaborate with international experts in Islamic finance. At the end of the year, the Moscow Times, an English daily, hosted their second annual conference in Islamic finance whose rota of speakers were primarily Russian nationals working in domestic and international organisations acquainted with Shari'a-compliant transactions. While Vladislav Kudryashov, Deputy Director, Legal Department, Ministry of Finance of the Russian Federation may have spoken about the problems of accommodating Islamic finance products in a non-Islamic jurisdiction, his presence indicates an interest from the Kremlin.

Growing interest has led to the formation of groups dedicated to the promotion of Islamic finance in Russia. In February, a meeting was convened in Moscow between the members of the newly formed Russian Association of Islamic Finance Experts. The Association's task is to explore ways in which Islamic finance can be harmonised into the Russian financial markets. It was set up by members of the Working Group on Alternative (Islamic) financial institutions and products, a task force set up in May 2009. Their mandate is to come up with a legal and regulatory framework which would facilitate Islamic finance. To this end, a Coordination Council consisting of senior members of the Union of Muftis of Russia (SMR), international tax experts, lawyers and bankers will oversee the work of the Association.

The small but growing cabal of bodies interested in Islamic finance has brought in the support of Islamic finance organisations such as AAOIFI to lend assistance if required. AAOIFI have translated key AAOIFI Shari'a standards into Russian; including sukuk, murabaha, Islamic insurance, ijara, mudaraba and musharaka. In October, the Secretary General of AAOIFI, Dr. Mohamad Nedal Alchaar, met with members from the ministry of finance, the central bank, the Grand Mufti of the Shura Council of Russian Muftis, and the Russian Association of Experts in Islamic Finance in Moscow, to discuss prospects in Russia and to affirm their support to those interested in Islamic finance.

In October 2009, Moscow International Higher Business School, Mirbis, became the first Russian academic institution to introduce a short term course in Islamic finance.

The role of the private sector

Islamic finance is not alien to Russian banks who have conducted Islamic finance transactions though mainly outside their borders. The German subsidiary of UK trade finance group, CCH International, arranged the first Islamic trade finance facility for a USD 20 million murabaha for Globexbank of Moscow, on behalf of a client of the bank in 2006. Major Russian banks such as VTB (Vneshtorgbank) and Gazprombank have worked on Shari'a-compliant products. VTB Capita, a wholly owned subsidiary of VTB, has set up a branch in Dubai, channelling liquidity from cash-rich Gulf investors to Russia. They are looking to issue a sukuk and by signing an MoU with Liquidity Management House (a wholly owned subsidiary of Kuwait Finance House) to develop sukuk and other Islamic products for Russian corporate, the building blocks are in place. It was only due to the fallout following the default of the Nakheel sukuk, that the anticipated sukuk arranged by VTB Capital was put on hold.

But while these are conventional financial institutions with an interest in Islamic finance, Al Shams Capital is a fully fledged Shari'a-compliant investment vehicle. Its mission statement, according to their home website is to 'to promote and support the development of Shari'a-compliant, ethical, value investments into CIS and Eastern European countries, and contribute to establishing and developing the Islamic financial infrastructure as a new reality in this region'. The company is in the process of launching its first Islamic private equity fund for the CIS & Eastern Europe which will invest in regional IFIs, halal food industry and other Shari'a-compliant sectors. The fund, which is likely to be launched in first quarter of 2011, is a joint project with Luxembourg entities Thiessen Law and Lux Global Trust Services.

Going through the back door

In 2006, the Russian central bank set up an Islamic finance advisory committee comprising representatives from the government to familiarize the various departments of the state with Islamic banking and finance. With no further development, the initiative can be regarded as a resounding failure. The government have expressed an interest in issuing a sovereign sukuk, but the legislative framework is not in place and currently there does not seem to be any signs that there will be a change in outlook.

At the end of 2006, the central bank revoked the license of Badre Forte, Russia's first Islamic bank on the grounds of nefarious unconscionable activities undertaken by the bank including money laundering. The bank was founded in 1991, and offered customers deposit accounts, interest free debit cards and halal money transfers but it was limited. A small portfolio of products, outlet branches, a small customer base, and ignorance by most of the Muslim community gave the bank little credence. However, its major stumbling block was the mandatory deposit insurance scheme imposed by the central bank. Badre argued that the scheme flew against the tenets of the Shar'ia, but the central bank was unyielding. Justifying Badre's demise, the central bank argued criminal activity whereas shareholders of Badre Forte inferred a hidden agenda.

One thing that the Badre Forte incident revealed is that with a lack of enabling legislation, IFIs, especially banks, will have to compromise. Lobbying the government to amend legislation will take a more confident and integrated Muslim community. The Muslim community are finding their voice in Russia, though it is intermittently subdued with every fresh incident of belligerence conducted by Muslim separatists in one of the Muslim majority republics. There is suspicion amongst certain members of the government and the central bank, that Islamic finance will be a means to fund militancy. However, the opening of the Arab Banking Corporation (ABC) branch in November made ABC the first Arab bank to open in Russia. Their move gives an opportunity for Islamic banks to eventually enter but this will rest on how facilitative the Russian government wish to be with Islamic finance.

The roaring republic

Government sluggishness on Islamic finance is countered by the dynamism of Russian federal states in bringing Islamic finance into their regions. The most active has been the Republic of Tartarstan, a Muslim majority republic who has been given presidential blessing to encourage an Islamic finance sector. In March 2010, several Islamic organisations gathered to create an Expert Council on Islamic Economy: an advisory body regulating the problems of Islamic finance, business, law etc. Scientific and practical assistance will be rendered by Non-profit Fund for the Development of Islamic Business and Finance (IBFD Fund), Russian Islamic University and Non-profit partnership of Muslim entrepreneurs known as the Tartan group. Tartarstan has hosted two major Islamic finance investment symposiums in the last two years. The international event attracted more than 500 representatives from South-East Asia, the Middle East, Europe, the CIS countries and Russia. This year, the keynote speaker was ex Malaysian President and keen exponent of Islamic finance, Mahathir Mohammed.

The conference was an indication of the strategy that the Republic of Tatarstan has adopted: attracting foreign investments. Delegations have been sent to Singapore, Malaysia, Hong Kong and South Korea to build productive ties with governments and institutions. According to Tartarstan's President Rustam Minnikhanov, Tatarstan has built extensive contacts with Kuwait, Saudi Arabia, the United Arab Emirates and Egypt. In December 2010, the republic signed an MoU with Malaysian IFIs, Amanah Raya Berhad Group and Kuwait Finance House Malaysia, on deriving assistance in arranging the issuance of a sukuk originating from Tartarstan.

Yet, Tartarstan has a grander vision with Islamic finance being only a component. It wishes to promote halal industries and products. In November, the first Russian halal industrial park, Baltach, was launched in Kazan. The park will house small and medium-sized enterprises (SMEs) involved in the halal business industry. The main goal of the project is the processing and distribution of agriculture and livestock products produced by local farmers. The initial investment in the Baltach project is 150 million rubles and the project is managed by the holding company NHIDC, whose financing and investment activities of local companies and other partners will be exclusively under Islamic financial contracts.

For the project to get off the ground, a pivotal part was played by IFC Linova, an Islamic finance consultancy advising and promoting the industry. It became an observer of the International Islamic Financial Market (IIFM), granting it access to major IFIs across the Islamic world. IFC Linova has been instrumental in major projects which have contributed to the growth of an 'Islamic' sector in Tartarstan. This includes the development of guidelines for Islamic finance; the establishment of the Russian Centre of Islamic Economics and Finance at the Russian Islamic University based in Kazan; the founding of the non-profit Foundation for Development of Islamic business and finance; Islamic Investment Company of Tatarstan (IICT) and advising companies on conducting Shari'a-compliant transactions.

IFC Linova has been a luminary within this field and has drawn upon its network of partnerships to encourage investment into Tartarstan from multilateral organisations such as Islamic Development Bank. IDB has a USD 1 million equity stake in the Islamic Investment Company of Tatarstan. IICT hopes to act as a conduit between SMEs and the IDB, who will channel investments from member countries.

With Tatarstan actively promulgating Islamic finance, other federal subjects of Russia are showing interest in Islamic finance. The Republic of Ingushetia is looking to cooperate with Bahrain. A high level economic delegation led by the Deputy Prime Minister and the Minister of Economy went to Bahrain to discuss cooperation in Islamic finance. Moscow may wish to take note.

IFCI ranking: 3

SAUDI ARABIA

To which country can the credit of creating Islamic finance as an alternative paradigm be accorded to? Egypt has a strong case, so does Pakistan, and one cannot forget to mention Iran. But they would all agree that the spiritual home of Islamic finance lays in Saudi Arabia, not only because it was the birthplace of Prophet Muhammad (peace be upon him). Rather, the efforts of King Faisal, ruler of Saudi Arabia between 1964 and 1975, and his son Prince Muhammad Al Faisal set the foundations on which the industry is built upon. After the embarrassment of the Six Day War and the perceived failure of Egypt's General Nasser's Pan Arabism, the Muslims of the Middle East looked towards Islam as a unifying force. King Faisal became the obliging leader, buoyed by the oil windfall his country had secured. Under his leadership, the Organisation of the Islamic Conference (OIC) was formed in 1970, bringing together Muslim countries committed to the preservation and promotion of Islamic social and economic values. From the OIC, two critical organisations in the Islamic finance narrative materialised: Islamic Fiqh Academy and IDB. The former has contributed to the intellectual framework of Islamic finance while the latter has been a vehicle for the spread of Islamic finance concepts and models throughout the Muslim world. Saudi Arabia therefore may have a basis to boast of being a progenitor of Islamic finance.

Domestic paradox

Yet, while Saudi Arabia has been proactive internationally, its domestic market has been comparably muted over the years, especially when compared to its Gulf neighbours and Malaysia. No reference is made to Islamic banking and finance in legislation and there have been very few, if any, guidance issued by the Saudi central bank, Saudi Arabia Monetary Authority (SAMA). For a long period of time, Saudi Arabia was not particularly supportive of the domestic Islamic finance market and it is notable that of the four licensed Islamic banks, none of them have the term 'Islamic' in their name.

SAMA, as regulator, makes no distinction between conventional and Islamic banks in terms supervising their financial activities. Equally, the Capitals Market Authority (CMA), even as regulator of the capital markets does not scrutinise the Shari'a credentials of a product, Shari'a governance is therefore upon the bank itself and thus classification can only be made if a particular bank has a Shari'a board or a product has gone through the necessary checks. The approach differs from other Islamic finance hubs but it is a system that has by and large operated without any significant glitches.

However, without a national Shari'a board or a binding set of rules, besides ruling legislation relating to conventional banking, it creates a plethora of opinions. Thus it is difficult to harmonise conflicts, weakening the veracity of Islamic finance transactions. IFSB and AAOIFI standards are used by Saudi Arabian Islamic banks, but they act as guidance as opposed to a binding set of laws. Saudi Islamic banks are in a position to map out their own individual path relating to Islamic finance.

Demand is increasing for Shari'a-compliant products in the Kingdom. Retail banking has become more or less Shari'a-compliant with many conventional banks offering Islamic finance products through. Corporate banking has also seen a rise of Shari'a-compliant financing, with estimates of 60-80% of transactions being undertaken according to Shari'a principles. Latest figures show that Saudi Arabia tops the chart for Islamic loan volumes, exceeding USD 5.66 billion as of May 2010.

Cooperative insurance

Takaful is also fettered by a lack of guidance, though there is legislation which places it on a different footing to banking. Prior to 2003, the insurance sector was unregulated. Insurance was considered impermissible under the Shari'a and therefore conventional insurance companies were excluded from Saudi Arabia. The void was filled by offshore companies offering insurance that was unenforceable under Saudi law; and cooperative insurance provided by former state monopoly provider, the National Company for Cooperative Insurance.

In 2003, the Cooperative Insurance Regulations were passed providing the basis for insurance companies to operate. However, the insurance has to be conducted on a cooperative basis 'in accordance with Islamic Shari'a'. Unfortunately, there was no detailed guidance as to what constitutes cooperative insurance though it is accepted that there are differences to the takaful model. Consequently, some scholars in Saudi Arabia have deemed several takaful products to be Shari'a repugnant, making certainty elusive and setting barriers to entry into the market. This is a shame as there is huge potential for takaful in the market. But even with ambiguity in the law there are 29 insurers in the Kingdom, both local and international. According to Swiss Re, a leading international insurer, premium income in life insurance soared 61 percent last year while non life grew 25 percent. Such growth indicates a strong demand for insurance products.

Legal changes needed

The growth of the Islamic finance market in Saudi Arabia is impressive given that there is an absence of enabling legislation. Strong demand buttressed by excess liquidity derived from oil wealth has driven the market forward, but there is a general feeling that the industry could have been far bigger provided legislative changes were made. The problem however, is that the legal system in Saudi Arabia is plagued with inefficiencies, which makes the passing of law somewhat of an ordeal.

No better example can be given than the protracted passing of the mortgage law. In Saudi Arabia, it is estimated that less than a third of Saudi nationals own their own home, partly because of wealth constraints. Finance is difficult to secure with some applicants for loans having to wait years on end. Islamic banks have attempted to fill this gap through Shari'a-compliant financing, but this is mainly for newly built houses and not for existing housing. Saudi Home Loans (SHL) on the other hand is the first specialised Shari'a-compliant home financing company in the Kingdom and has financed over 2500 units. The problem is that the Saudi property market is suffering from a shortage of housing units, which while shielding Saudi Arabia from the real estate corrections seen in neighbouring Gulf States, has put an upward pressure on Consumer Price Inflation. Inflation has been further compounded by high rental rates. In order to address this problem, Deutsche Bank estimated that Saudi Arabia needs 1.2 million additional houses by 2015. The potential housing boom has attracted several international companies to enter the market.

High inflation, low incomes, lack of houses and high initial outlay for mortgages has meant that a high proportion of the Muslim population is being excluded from owning homes. It has therefore become imperative for a mortgage law to be enacted. Expectations are that with a mortgage law, there will be a boost in the real estate industry and a diversification in a bank's balance sheet. It will also give opportunities for the issuance of sukuk. However, a mortgage law has yet to be enacted, victim of filibustering in both the Shura council and the cabinet. Two years on, the mortgage law has yet to be passed.

Expectation for the imminent passing of the law has attracted investment banks and real estate companies to Saudi Arabia. The Islamic Corporation for the Development of the Private Sector (ICD) wishes to establish a real estate company, a finance company and a mortgage finance company. But delays in the enactment of the mortgage law have left the ICD and the rest of the market perplexed and wanting.

Expansion and growth

In 2005, Saudi Arabia joined the World Trade Organisation (WTO) which placed conditions of membership on the Kingdom. One was to affect an efficient legal system; another was to open up the financial markets. The latter objective has proven to be a more successful endeavour. International institutions have come into Saudi, which has benefited the Islamic finance industry. At the end of August 2010, Tadawul, the Saudi stock exchange registered 153 Shari'a-compliant funds in 15 fund categories including international trade funds and real estate funds. Saudi based NCB Capital has claimed a 33% share making it the world's largest Shari'a-compliant asset manager.

In March, the CMA approved the Kingdom's first Exchange Trade Fund (ETF), both conventional and its Shari'a-compliant variant. The CMA approved the listing of Falcom Saudi Equity ETF which will invest in listed Saudi equities. ETFs have been slow to take off in the GCC due to the nascent financial markets, but it is hoped that this will lead to more interest. The creation of the fund and its tapping into the Saudi markets shows the opportunities available in Saudi Arabia. Being the world's largest oil producer, Saudi Arabia is flushed with liquidity which makes it attractive for foreign investors.

High liquidity is stimulating the sukuk markets. In 2010, Saudi Arabia led the GCC in the issuance of sukuk and is only second to Malaysia in the global sukuk market. Saudi Arabian real estate and energy companies are leading sukuk sales in the nation, which has the secondary objective of spurring economic growth in order to meet the objectives of Saudi's five year USD 400 billion stimulus plan for the economic growth of the country, and the financing of the construction projects. Increased issuance of sukuk enables local banks to tap into much needed liquidity, which they would be unable to get from conventional markets. Saudi Arabia does not have a Shari'a-compliant money market which hinders banks in managing their liquidity. The foundation of the IILM in Malaysia is a positive step in filling that void. Saudi Arabia has also issued innovative sukuks. Saudi Electricity Co.'s USD 1.87 billion sukuk sold earlier in 2010, is underwritten by the company's income from fees, such as connection charges.

However, the sukuk market did take a turn for the worse after the credit crisis. Last year, Saudi based companies such as Saad Group defaulted on their sukuk.

Eighty banks, including BNP Paribas SA and Citigroup Inc., are owed at least USD 15.7 billion, sparking a flurry of litigation.

Domestic banks

Stringent bank rules have not hindered local banks. There are currently four Islamic banks in Saudi Arabia: Al Rajhi Bank, Bank Albilad, Alinma Bank and Bank Al Jazira. They offer a full range of retail, corporate and investment products and have benefited from the strong demand for Shari'a- compliant retail and business products. Al Rajhi remains the biggest, the most ubiquitous as well as the most innovative. It has adopted a similar model to Kuwait Finance House, blurring the lines between financing and trade. In 2009, it was reported that it had eleven car show rooms offering cars to be financed by Shari'a-compliant products. They have also expanded into Singapore, Malaysia and Indonesia, hoping to tap into the East Asian Markets.

As for IDB, they have continued their remarkable progress in both the commercial and development sectors. In 2009, they issued 3 sukuks and have issued a USD 3.5 billion sukuk under its Trust Issuance Program which is listed on the London Stock Exchange and also the Bursa Malaysia where it is listed in ringgit. The four offerings have totalled USD 2,750 million, making it the largest volume of sukuk issuance by a multi lateral company. But it is on the development side that the IDB has been particularly impressive. With 54 shareholding member states, the IDB has assisted in micro and macro economic development in most of these member states. From textile projects in Syria, to road building in Uzbekistan, the IDB is growing in stature as a multilateral development organisation.

The dream of King Faisal

With over 40 years experience in Islamic finance, Saudi Arabia has accomplished much. But there are still improvements that could be made. Commentators constantly allude to the untapped potential of Saudi Arabia and its failure to capitalise on opportunities. The government and the regulatory authorities need to be more proactive in building the necessary infrastructure for Islamic finance but hitherto there has been a general reticence. Opening the markets in 2005 attracted multinational organisations into the country, thereby creating value and efficiency in the private sector; but the private sector in general has been the pioneering force in creating a vibrant Islamic finance sector. It has worked so far but it could work so much better with ostensible government support. 40 years ago one man certainly stood up to the task.

IFCI ranking: 34

SENEGAL

Senegal is one of the few countries in Africa which has been relatively stable despite having a high incidence of poverty and unemployment. Unlike other countries in the continent in which dictatorships are the norm, Senegal has had relatively peaceful transfers of power. The country has a population of around 12.8 million, 95% of which is Muslim.

With the country being majority Muslim, together with the fact that the majority don't have access to formal banking services, the country may prove to be a fertile ground for Islamic finance in the future. The leadership of the country has not failed to spot the potential and has thus begun to change legislation that would make it easier for banks to set up Islamic units. There is one Islamic bank in Senegal which was established in 1983, the Islamic Bank of Senegal. However with Islamic finance growth continuing to increase, more can be expected to open in the country.

According to IMF economists in the region, profit & risk sharing instruments would be useful for Muslim entrepreneurs within the country as they would be able to undertake projects which they would not normally consider. The country is also interested in issuing a sovereign sukuk this year with the input of Citibank. As was mentioned earlier, Senegal is relatively stable when compared to other countries in the region so this factor may see it emerge as a preferred destination for investors from the Gulf.

If Senegal manages to issue sovereign sukuk, it will pave the way for increased investment from the Gulf and elsewhere, which is something the leadership is keen to capitalise on. Dubai Ports World has already invested in a major Senegalese port and there has been investment from both Kuwait and Saudi Arabia in other sectors of the economy. Entrance of Islamic finance would no doubt help increase this investment.

One potential bottleneck is the lack of qualified personnel with the necessary knowledge of Islamic finance principles. However the Senegalese have realised this and begun taking steps to address the situation; a high ranking delegation of Senegalese visited Bahrain to learn more about Islamic finance and members of the delegation are going to be awarded diplomas in Islamic finance from the Bahrain Institute of Banking and Finance, after undergoing intense training. This continues Senegal's tradition of engaging the Islamic finance industry in Bahrain for guidance due to its expertise. Furthermore Senegal would be an attractive place for Islamic banks in Bahrain to open branches as it could serve as a platform for them to penetrate other countries in the region with sizable Muslim populations. Thus we see that Senegal is another country in which there is huge potential for Islamic finance to expand. The signs are positive and we may expect Islamic finance to play a key role in Senegal's future and hopefully help address the issues of poverty and unemployment within the country.

IFCI ranking: 33

SINGAPORE

For 17 years, Bahrain has been the home of the World Islamic Banking Conference (WIBC), the largest congregation of market leaders, practitioners, thinkers and interested parties in Islamic finance. It has been a platform on which developments and challenges facing the industry can be discussed, appraised and resolved. In 2010, 1200 delegates attended the event in Manama, an impressive figure especially when one considers the first WIBC had only 120 delegates.

Even with the litany of conferences, seminars and lectures that prevail within the industry, the WIBC is still unrivalled with Bahrain being regarded as home. But the tide is changing. The WIBC brand is expanding to the Far East; and if it can be considered as a weather vane for the industry, the inaugural conference of the World Islamic Banking Conference, Asia Summit, in Singapore, shows that the Asia Pacific region is as integral to the success of the Islamic finance industry as are the Gulf States.

Certainly, Malaysia has been at the forefront of Islamic finance for the last decade, but its gargantuan presence has overshadowed the subtle developments that have been occurring in Thailand, Brunei and of course Singapore. While nowhere near the size and influence of Malaysia, the next 10 years will be a formative period for the other Asian tigers.

Small but vocal

Speaking at the 16th WIBC in Bahrain in December 2009, H.E. Heng Swee Keat, Governor of the Monetary Authority of Singapore stated that "Islamic finance will provide an increasingly important bridge in the growing connectivity between the Middle East and Asia. Singapore is pleased to help catalyse deeper relations between these two high-growth regions ". Islamic finance therefore plays an important part in creating trade linkages, with Singapore looking to capitalise on the opportunities.

But its precocity will preclude this former British trading post to simply act as a conduit. Singapore is a small island but has a big voice. It has waded into debates assailing Islamic finance with Assistant Managing Director of the Monetary Authority of Singapore, commenting Ng Nam Sin at the WIBC in Bahrain on the issue of risk management and corporate governance standards and called for Shari'a-compliant banks to improve standards. Not content in simply commenting on the industry, Singapore have recognised that for mature and consolidated growth, there is a need to develop human resources. MAS said that it will sponsor eligible students for undergraduate courses in Islamic finance at the Singapore Management University (SMU). SMU has set up the Islamic Law and Finance Centre, a pioneering institution and the first of its kind to combine Islamic law, banking and finance programmes in a single, multi-disciplinary university centre. Anticipated to being in the first quarter of 2012, SMU Law School will launch a post-graduate Masters programme in Islamic law and finance, which will be open to both lawyers and non-lawyers interested in pursuing a career in this field.

The zeitgeist has not escaped grass root Muslim organisations, whose traditional focus has been to cater to a Muslim's spiritual and social requirements. The encroaching purview of finance and the flourishing of Islamic finance has encouraged the Singapore Islamic Scholars and Religious Teachers Association (PERGAS) to develop a body of scholars that can consult on Islamic finance. They set up the Islamic Finance Consultation Unit (UKKI) in 2009, to advise Muslims on wealth and asset management and it is hoped that this unit will expand its focus. Thus, to develop further their capabilities in other aspects of Islamic finance, industry players are assisting. HSBC Insurance has start training members of PERGAS on the technicalities of takaful. The takaful training programme began in December, with between 20 and 30 students in the first batch.

The role of the MAS

Islamic finance in Singapore has been commendably supported by Singapore's de facto central bank, the Monetary Authority of Singapore. MAS joined the IFSB in December 2003 as an observer member and became a full member in April 2005. Singapore is the only non-Muslim country to be a full member of the IFSB. MAS currently participates in the Islamic Money Market Taskforce, the Supervisory Review Process Working Group and the Special Issues in Capital Adequacy Working Group.

While they have been clear that there will be no separate banking regulatory framework for Islamic finance, MAS have attempted to ensure that Islamic finance and conventional finance compete on the same plain, without any hindrances due to Islamic finance's more peculiar features. In 2006, the Monetary Authority of Singapore (MAS) approved banks engaging in non-financial activities, such as commodity trading, to facilitate murabaha transactions. Tax treatments of Islamic contracts have been aligned with the treatment of conventional financing contracts that are economically equivalent. Double stamp duty has been removed on Islamic finance products. Further initiatives include granting a 5 percent concessionary tax rate for income derived from Shari'a-compliant fund management, lending and takaful; and clarifying the Capital Adequacy Ratio requirements in relation to Islamic finance products. MAS are now considering insuring murabaha deposits (which has been classed as a deposit according to Singapore's Banking Act). The Deposit Insurance Scheme already insures principal guaranteed deposits such as wadia. In April, MAS issued guidelines on the application of banking regulations to Shari'a-compliant products which included murabaha products (deposits, financing, interbank placements, spot transactions), ijara wa iqtina, diminishing musharaka, istisna and sukuk. Gradual amendments to regulations since 2005 have removed the costly barriers which had the potential to impede the growth of the industry.

Developments on the ground

The first Shari'a-compliant pan-Asian equity index was launched in Singapore in February 2006. This index served as a benchmark for Shari'a-compliant funds investing in Asian equities and paved the way for Islamic funds to be set up in Singapore. As of 2008, there were SGD 500 million takaful funds under management and approximately SGD 2 billion Shari'a-compliant real estate funds managed out of Singapore. In 2008, Daiwa Asset Management Co. Ltd.'s listed the first Shari'a- compliant exchange trading fund which offers an investment channel into Japanese companies that fully comply with Shari'a investment principles.

Singapore has been involved in a number of innovative transactions including several sukuk. The government started a SGD 200 million reverse enquiry Ijara sukuk issuance program in January 2009, which was set up to provide "regulatory assets" to institutions offering Islamic services. The sukuk was designed to address concern relating to the lack of Shari'a-compliant products and brings stability to the Islamic finance system. The ijara asset happens to be the MAS building, regarded as first class real estate and consequently the sukuk marked the first issuance of a sukuk in the market by a triple A rated sovereign entity. With the issuance of this sukuk, Singapore became the first non-Muslim-majority country to establish a local currency sovereign sukuk.

In 2010, Singapore saw the launch of the first Shari'a-compliant REIT in Singapore. Sabana REIT is world's largest Shari'a-compliant property trust which has raised SGD 664.4 million in its IPO through attracting local and foreign investors. The REIT is listed on the Singapore exchange with Bahrain being the cornerstone investor. The developments in Singapore have attracted the attention of Gulf based IFIs looking to diversify. Saudi based Al Rajhi bank is a majority shareholder of AEP Investment Management, a Shari'a-compliant investment advisory firm which hopes to tap into the opportunities in the Asia Pacific region. In June, AEP Investment Management and Keppel Telecommunications & Transportation Ltd (Keppel T&T), as Joint Investment Managers, announced the initial closing of Securus Data Property Fund Pte. Ltd. (Securus Fund), the world's first Shari'a-compliant data centre fund. Securus Fund's initial closing was achieved at USD 100 million.

Progress will be slow...

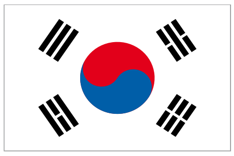
In 2007, the Islamic bank of Asia, Singapore's wholly owned fully licensed Islamic bank was set up to focus on capital markets, direct investment and corporate banking services. After the pomp and the fanfare of its establishment, the bank has suffered losses over the years, reporting a USD 77.1 million loss in June. DBS group, IB Asia's majority shareholder has publically stated their commitment to Islamic finance but unconfirmed reports suggests that they may downsize IB Asia. Even leaving this aside, IB Asia is set to reduce its work face. Along with Kuwait Finance House, Singapore's cut of its workforce – citing internal structuring – these developments do not bode well for Islamic finance in Singapore.

Market commentators are circumspect about the growth of Islamic finance in the next few years. Even though Singapore have issued sukuks, issuances have been sporadic and compared to its neighbours, it has been a trivial amount - Singapore saw USD 123.6 million of sukuk issuance in 2009, compared with USD 8 billion for Malaysia and USD 1.2 billion for Indonesia, its nearest Islamic banking competitors, according to Thomson Reuters data. Most of the developments will occur in the wholesale sector as opposed to retail but progress will be slow and there is a pressing need to have a critical mass of trained professionals in Islamic finance, which is currently lacking.

...but growth will prevail

However, with the support of the MAS and growing economic strength of China, Malaysia and Indonesia, Singapore is perfectly placed to seize opportunities available within the Islamic finance market space. In 2010, there were a number of transactions which indicate in the horizon that there will be significant developments. Maybank, Malaysia's biggest lender, set up a dedicated Islamic banking hub in Singapore, a 3720 sq ft refurbished branch, offering Shari'a-compliant services to Muslims and to non-Muslims – who form the bulk of the branch's customers. Maybank launched an Islamic finance package for small and medium enterprises (SMEs) seeking financing. So while retail is limited, with few products on offer, there are signs of development.

On Singapore's Islamic finance journey, Malaysia's role will be crucial. Geographical proximity along with their historic and cultural tie will play a major part in building productive relationships and structuring Shari'a-compliant transactions. Khazanah Holdings, Malaysia's sovereign wealth fund, undertook a hostile takeover of Parkway Holdings, a Singapore-based health care firm. The takeover took place in June. In October, Parkway Holding concluded the largest Islamic financing deal in Singapore thus far entering into an SGD 750 million murabaha facilities agreement, which will be used to pay off other existing loans. It will be intriguing to see how much stronger the relationship will become at the corollary effect on Islamic finance. But presently, signs are encouraging.



IFCI ranking: –

SOUTH KOREA

South Korea has had strong trade links with the Middle East for four decades which has invariably meant working on Islamic finance structures. Since the early 1980s, Korean companies such as Lucky Goldstar, Hyundai and Daewoo have been accessing Islamic trade finance facilities, processed mainly through the London market. However, there is now a push to open up the domestic Islamic finance market. This is not necessarily for the domestic Muslim population. With less than 1% of the population being Muslims, the idea of a Islamic retail market is implausible for South Korea. There is no real desire to offer any Islamic finance retail products. The drive is rather to attract foreign investment especially when neighbouring countries such as Singapore and Hong Kong have expressed a desire to be an Islamic finance hub in the region. A more pertinent reason is the USD 38 billion trade deficit South Korea has with GCC countries arising from the trade of oil. Figures suggest that 68% of the South Korea's oil and 53% of natural gas was pumped by GCC countries. By embracing Islamic finance, and therefore tapping into Middle East wealth, they hope to reduce the deficit.

Building the relationship

The Middle East supplies the energy; South Korea manufactures the goods. It is a convenient relationship that has worked well over the years and seems to be going strong as we head into the second decade of the 21st century. The rise and rise of the Gulf States from the desert plains to sporting high rise skyscrapers with the latest technologies supporting the associated glamour and sparkle, owes a considerable debt to South Korea's preeminent role in the manufacturing and electronics industry. Samsung C&T Corp., the second-biggest contractor in South Korea, built the world's largest tower in Dubai. In 2010, Gulf States continued to procure the engineering expertise of the South Koreans. Korea Electric Power Corp., the nation's biggest supplier, won a USD 20 billion contract to build nuclear power plants in the UAE in December, Samsung Engineering Co., South Korea's biggest engineering company, won a USD 1.5 billion contract in April to build utility and offsite facilities for a gas project in Abu Dhabi.

With more transactions likely to occur between South Korean companies and the Middle East, Islamic banks will have greater opportunities to act as a financier and advisor. Cross border transactions will require Islamic banks to cooperate with their South Korean counterparts. Already we are seeing relationships forming. In March, Woori Investment & Securities Co, a unit of South Korea's third-largest financial company, signed an MoU with Qatar Islamic Bank to cooperate in investment banking services and according to QIB, facilitate 'mutual cooperation between the two parties in the search for suitable financial and investment opportunities in the Korean, Asian and Qatari markets'. The South Korean market offers investment opportunities in Korea's high-tech sector with companies more than likely to pass the first stage of the Shari'a screening process, namely ensuring that activities undertaken are Shari'a-compliant. Investment into South Korea will fuel innovation and increase the product portfolio. South Korean financial regulator, Financial Supervisory Service (FSS) are keen to encourage strong relationships with Islamic banks and help the environment for Islamic finance to flourish. In May, the South Korean Financial Services Commission approved the country's first Islamic investment fund, the Yurie Shari'a-compliance Korea Index which invests in 78 local Korean blue chip companies. This builds on successful Islamic funds such as STIC Pioneer Fund 2 (USD 200 million), Oryx/STIC Korean Technology Fund (USD 150 million), and the Private Equity Pre-IPO Buyout Fund by STIC Investment, a venture fund.

Proactive and vibrant relationships in the building up of South Korea's capabilities extend to near neighbour Malaysia. Malaysia sought the assistance of the Korea

Exchange (KRX) in the development of the Bursa Commodity House system for Bursa Malaysia. Two years later, Bursa Malaysia and KRX hosted the inaugural KRX-Bursa Malaysia Islamic Capital Market Conference in Seoul. Discussions centred on the growth of Islamic finance and the liberalisation of Islamic financial markets. South Korea has been mulling over the issuance of sukuk for a few years now and have gathered assistance from Kuala Lumpur based consultants Amanie Business Solutions, led by the reputed Shari'a scholar Dr. Daud Baker.

Legislative hurdles and the Christian dismay

Typical of any country looking to issue a sukuk or to develop their Islamic finance capacity, legislation has proven to be a stumbling block for South Korea. The government would like to remove impediments and ensure tax neutrality. Major South Korean companies agree, throwing support into the government's plan to issue sukuks. But things are not so simple, with opposition to the prospect of legislative changes to account for Islamic finance nuances gaining credence.

The tax subcommittee had already approved the bill for tax breaks for sukuk earlier in the year but in December 2010, The Strategy and Finance Committee of the National Assembly rejected the bill. Vocal opposition came from the church that represents approximately 30% of the population and fear is that the funds will be used for terrorist funding and money laundering. It is no secret that some National Assembly parliamentarians have been aggressively lobbied to reject the bill by powerful Christian evangelical groups such as the prominent Korean Association of Church Communication. This is a shame. The amendments to the tax law would have given tax neutrality to a sukuk issue while exempting foreign sukuk investors from paying withholding income taxes subject to a number of conditions.

According to the Korean Muslim Federation, there are approximately 35,000 Muslim residents in South Korea and more than 100,000 Muslim foreign workers. In a country which has a population of about 49 million, any prospect of being an effective lobbying group and a countervailing force to strong Christian lobby, is inconceivable. The support for Islamic finance is coming from the government and the business community. Any pressure for the bill to be approved will depend on them. Judging by the positivity thus far shown, the current impasse seems to be a bump rather than a barrier to bringing in legislative changes to enable the issuance of sukuk.

IFCI ranking: –

SPAIN

On 17th June 2010, at the Palacio de la Bolsa de Madrid, it was time for introspection for the Spanish. Key figures from the Spanish government, banks and financial institutions gathered to discuss with leading figures from the world of Islamic finance, whether Shari'a-compliant financing could assist Spain in recovering from the tumult caused by the global recession. The conference tackled issues such as financing public and private projects, regulatory amendments, tax, Islamic banking and insurance; and of course, the financial crisis over the course of three days. The outcome of this conference has yet to be felt, but this may represent a beginning for a country that has so far shied away from Islamic finance.

If Islamic finance should grow in Spain over the coming years, then 2010 will be looked back as the year the ball started rolling. The experience of European countries such as UK and France in bringing in Islamic finance models has presented Spain with a learning curve, one which they are taking notes from. In order to grow, expertise is required to educate and navigate through the hurdles that may be present on the journey. Consequently, Madrid Centro Financiero, (MCF), an association committed to promoting Madrid as an International financial centre, signed a MoU with Dubai International Financial Centre (DIFC) to support bilateral relations and encourage investment. Also addressed was fostering Islamic finance activities in Spain and amending legal and regulatory frameworks which will reduce cost barriers for Shari'a-compliant products.

The MoU followed another Memorandum signed in April between the UAE's Securities and Commodities Authority and its Spanish counterpart, Comisión Nacional del Mercado de Valores (CNMV). The parties envisage extensive cooperation between the two regulators in opening up capital markets for joint listing, development of Islamic finance products, the sharing of experience and unlocking other opportunities within the securities market. The two MoUs are thus tentative steps forward in bringing Islamic finance into the country.

Time will tell how committed Spain is to incorporating Islamic finance into the country and it is difficult to make any clear predictions. However, there are signs of optimism especially as Spain looks eastwards to bolster their economy. Spanish financial institutions are also taking the opportunities available. Allfunds bank, jointly owned by Spanish financial groups Santandar and Intesa Sanpaolo is a leading business to business fund platform. It launched an Islamic Services unit in September 2010. Clients would have direct access to the largest available range of Islamic funds through an automated platform. This was not the first venture into Islamic finance made by Allfunds Bank. It already offers more than 80 Shari'a-compliant funds, sourced from 15 fund promoters based in Luxembourg, Ireland, UAE and Saudi. In November, leading UAE takaful company, Salama-Islamic Arab insurance, partnered with Allfunds Bank to offer takaful and Shari'a-compliant funds across the Middle East through their automated platform.

It is however a mistake to assume that Islamic finance had not entered the Spanish shores earlier to 2010. Leading Islamic investment bank, Gulf Finance House (GFH) had opened a fund in 2005, aptly titled Al-Andulus House, to invest in residential real estate development projects along the Costa del Sol. The fund was structured according to the Shari'a and leveraged on the experience of local professional advisory firm, Aguirre Newman. In 2008, KFH was invited by members of the Spanish business and finance community to Barcelona to discuss Islamic finance: its growth and opportunities it provides. There were no immediate results but the interest was there. It remains to be seen how far this interest will go.

IFCI ranking: 26

SRI LANKA

For some countries, Islamic finance is an alternative choice to meet an individual's financing needs; for others Islamic finance is a tool to rejuvenate an economy. For Sri Lanka, Islamic finance represents a bit of both.

Sri Lanka is emerging from a 26 year civil war which officially ended in 2009. During this period, Sri Lanka showed strength and resilience which was reflected by a strong economy even in the face of weak investor confidence. The end of the war has improved confidence and provided opportunities for Sri Lanka to grow, and with it Islamic finance is playing a marginal, though increasing role.

Closing the loophole and opening the coffers.

Sri Lanka has 1.6 million Muslims which represents 7% of the nation's 23 million population. There are many informal entities that offer Islamic financial products though in local areas with a high Muslim population. Various unregistered firms are taking deposits due to a loophole in Sri Lanka's laws relating to finance businesses but this is expected to be closed with the Sri Lankan government presently discussing suitable legislation.

The black economy in taking deposits will whittle down and recognised IFIs will be sought by individuals in order to save. There are already a number of financial institutions offering Islamic products and services. There is yet to be a fully fledged Islamic bank, but this is likely to change in 2011 mainly due to the praiseworthy efforts of Amana Investment ltd. The official story of Islamic finance in Sri Lanka begins with this company.

Amana Investment Ltd: pioneers of Islamic finance in Sri Lanka

In 1997, Amana investments Ltd was established, whose mission statement was to offer Islamic finance solutions. The company offers a range of products including amongst others, home musharaka, ijara vehicle leasing, mudaraba investment accounts and musawamma. Figures show that customer deposits in the company are over LKR 7.8 billion (USD 70 million), an impressive figure when considering the short time period of its existence and the broader conditions in the country. Since its inception, they have branched out into Takaful (Amana Takaful Ltd) and the Securities and Capital Markets (Amana Securities, Amana Capital and Amana Asset management). In the capital markets, Amana were instrumental in creating the Dow Jones Islamic Market Amana Sri Lanka Index, which tracks the performance of Sri Lankan companies that comply with Shari'a based investment principles. Along with Namal unit trust, they formed Namal Amana Equity Fund. The fund has been successful over the last year, rising 71 percent and beating all the other 299 funds tracked by Bloomberg.

Amana Investments have also been instrumental in pushing for legislative changes. An amendment was made to the Banking Act 1998 in 2005. In the Act, banks are classified as Licensed Commercial Banks (LCBs) and Licensed Specialised Banks (LSBs) with Schedules known as Schedule II and Schedule IV detailing the permissible forms of businesses that could be undertaken by such banks. The amendment ensured that LCBs and LSBs were permitted to offer Islamic banking products. Additionally, there was an amendment to the definition of deposits in the act, recognising Islamic banking products.

In 1998, Amana Investment requested the Central Bank of Sri Lanka (CBSL) for a licence to set up a commercial Islamic bank, Amana Bank Ltd. 11 years later, CBSL granted a Letter of Provisional Approval which stipulated, *inter alia,* that the bank is required to have start up capital requirement of LKR3.2 billion (US 28.6 million). Over the course of the next two years, Amana Bank Ltd said it had raised 3.2 billion in capital through a private placement by selling 631.9 million

5.00 rupee shares to both foreign and local investors. In January 2011, the license for the first commercial Islamic bank in Sri Lanka was granted by the CBSL. According to Amana investment website, shareholders include Bank Islam, Malaysia Berhad (20%), AB Bank, Bangladesh (15%), IDB, Saudi Arabia (10%), and Sri Lanka's leading tea exporter Akbar Brothers (10%). Amana bank hopes to attract funds from the cash-rich Middle East which is looking for investments for its surplus cash generated from oil to fund infrastructure projects on the island.

Success brings in the competition

On the back of the success of Amana, a number of other companies, both national and international have entered the market to varying success. Conventional banks such as Muslim Commercial Bank and the Bank of Ceylon have Islamic windows. The eponymously titled Peoples Leasing Company has rebranded their Islamic finance services unit to Al-Safa to reflect the growing interest in ijara services. Another leasing company, the LOLC group, was the first of its kind in Sri Lanka. In the mid 90s, LOLC experienced a reduction of their Muslim customer base as Muslim sought more Shari'a-compliant options. In order to recapture this market, LOLC set up its own Islamic business unit Al-Falaah in 2007. Al Falaah opened its 3rd Islamic Financial Services Centre in 2010 and offers Shari'a- compliant profit sharing and investments, leasing, trade financing and property/project financing.

However, it has not all been smooth sailing for the Islamic finance industry in Sri Lanka. ABC Baraka Investments entered the market in 2007 and was relatively successful. However, the global financial crisis had adverse ramifications for the investment management company. Depositors were entitled to a minimum of Rupee 50000, but as of 2010, the management has failed to make payment though they are planning to do so in 2011.

A more egregious case is the dissolution of the Islamic finance subsidiaries of Sri Lanka's oldest and largest conglomerate, Ceylinco Group. Ceylinco had, in the early 2000s set up Ceylinco Takaful Ltd to capture the untapped takaful market, and also Ceylinco Profit Sharing Investment Company Ltd. Moreover, an Islamic finance faculty at Ceylinco Sussex Business School was established. In 2006, they signed a partnership agreement with Malaysian based INCEIF to develop human capital needs and the Islamic finance industry in Sri Lanka. In 2009, nearly 12,000 depositors with a total of Rs.800 million funds demanded their money back from Ceylinco Profit Sharing Investment Company Limited (CPSICL). Depositors of Ceylinco Profit Sharing had not been paid their profit shares nor were they able to withdraw their deposits. Investigations into the organisation resulted in the suspension of operations by Ceylinco Takaful Ltd in 2009. It was meant to last only a few weeks but the company never reopened. In November 2010, the Insurance Board of Sri Lanka (IBSL) called for quotations from persons with financial or legal background with insurance experience to be appointed as an administrator.

The cause of the crisis was the failure of an unregistered firm under Ceylinco group which had adverse ramifications on the whole group. Ceylinco Development Bank, a community finance entity, has recently changed its name to Citizens Development Business and has announced in December 2010, that it will offer Islamic financial services. As for the beleaguered depositors, they arrived to a mutually accepted repayment plan at the end of 2010.

Education, Education, Education

The precipitous fall of Ceylinco has not had a major impact on the Islamic finance market in Sri Lanka. Market commentators believe that the Islamic finance market in Sri Lanka is just below 5% but growing. To move forward a number of challenges need resolution. Under statutory regulations, Islamic institutions and conventional institutions have to invest 50% of their finances into treasury bonds which are not Shari'a-compliant. This is something that legislators need to address, especially with the forthcoming establishment of an Islamic bank. The government are not yet savvy to Islamic finance but are supportive and have been training officials in Islamic finance. There are number of Islamic finance training providers in Sri Lanka as well as Islamic finance promotion bodies. A number of them are accredited training providers for UK based Chartered Institute of Securities and Investment's (CISI) who offer the Islamic Financial Qualification (IFQ). Additionally, it is notable that each Islamic finance entity has a Shari'a board which is comprised mostly of local scholars who have been educated in Sri Lankan madrassas. The strong scholar community facilitated the creation of All Ceylon Jami'yyatul Ulama, the governing body for certifying compliance with Islamic law in Sri Lanka. The body deals with all aspects relating to the Shari'a including finance, though it is not a central Shari'a board. Islamic finance in Sri Lanka is still in its infancy; maybe in the future it will be considered, but not now.

IFCI ranking: 30

SOUTH AFRICA

If proof was needed that Islamic banking is being viewed as an important contributor to the South African economy, it came in the 2010 budget speech of Finance Minister Pravin Gordhan, who said, "As an ongoing part of the process of simplifying our tax system, the government proposes further measures to reduce red tape and enhance our attractiveness as a viable and effective location from which businesses can extend their African and other worldwide operations. We will also review the tax treatment of financial instruments to ensure appropriate accommodation of Islamic-compliant finance."

Minister Gordhan was true to his word and, in May 2010, the proposed tax amendments were issued. These were based on two years of collaboration by the National Treasury with a broad cross-section of Islamic finance sector stakeholders. The proposed amendments are undoubtedly the most important development in Islamic finance for the period under review.

The reason for the proposed amendments is that, under the current tax laws, the concept of form in Shari'a-compliant products works against taxpayers, who lack the full freedom of control because of their adherence to religious principles. Thus tax is currently a hindrance to a vibrant and growing Islamic finance market.

The proposal is that specific provisions be added to the current tax legislation so that Islamic finance is placed on an equal footing with conventional finance. The first three underlying structures that are to be accommodated from a tax perspective are mudaraba, murabaha and diminishing musharaka.

Mudaraba

Under current legislation tax payers are exempt from paying tax on the first R22 300 they earn in interest (this increases to R32 000 for people over 65 years). Investors who use the Shari'a-compliant mudaraba option don't enjoy this tax exemption as they are earning a profit share rather than interest. The amendments propose that profit earned by individuals in terms of a mudaraba arrangement will be treated in the same way as interest for tax purposes, thus ensuring that the same tax exemptions apply to mudaraba investments.

Murabaha

The amendments propose that, for income tax, value-added tax and transfer duty purposes, the bank will be deemed not to be involved in the purchase or sale of assets/property but rather that the client will be deemed to be acquiring the assets/property directly from the seller. The outcome will be that the additional indirect taxes, which would not apply to conventional financing deals, will also not apply to murabaha financing. From a tax perspective, the mark-up applied by the bank will also be treated in the same way as interest.

Diminishing musharaka

For the purposes of income tax, value-added tax and transfer duty, the bank will be deemed not to be involved in the sale of the property. The client will be deemed to be acquiring the bank's proportionate interest in the property directly from the seller. The rent paid is deemed to be a 'premium payable.'

Industry stakeholders, through their specific industry bodies, have all given their comments on the proposed amendments and a revised version of the amendments, which takes this input into account, is being finalised.

Islamic private banking

Until 2010, Islamic banking was regarded as a segment and all Islamic banking customers were treated similarly and offered the same products. Absa Islamic Banking and FNB Islamic finance both launched Islamic private bank offerings during 2010, thus enabling a level of segmentation within the Islamic finance sector based on income. This development ensures that affluent Islamic banking customers receive the same levels of service as affluent people who choose the conventional banking offering. This is a further indication of the contribution of a relatively small sector of the South African population (Muslims are estimated to constitute 2% of the overall population) to the economy as a whole. The intention is to provide affluent Islamic banking customers with a private banking service that can compete with the best in the world. The next stage of the segmentation process will be the development of an Islamic wealth offering for affluent clients. This would extend to the weighting of portfolios according to Shari'a principles and Shari'a-compliant estate planning.

Product development

In addition to the private bank offering, new product development has continued to be a focus of local Islamic banks due to the demand from customers wanting to conduct the full spectrum of their financial affairs according to Shari'a. The development of products for the business market has received particular attention. It can be confidently expected that, once the proposed tax amendments are passed into law, this product development process will increase.

Once the proposed tax amendments mentioned above are implemented, they will enable the development of more products such as a long term home finance that is competitively priced in comparison to a conventional home loan. Other products that will be enabled include Commercial Property Finance and Commercial Property Investments.

Launch of the BankSETA training material

South Africa shares a similar shortage of Shari'a finance skills to that experienced by many other countries. The Banking Sector Education and Training Authority decided to fund an intervention to address this skills shortage. They commissioned the development of a training programme to be used by all Islamic banks in South Africa. This programme covers all of the most commonly used structures in Islamic finance. Senior Shari'a scholars from Islamic banks in South Africa in consultation with the Shari'a Financial consultancy were involved in reviewing the content of the training programme. BankSETA has attracted a great deal of recognition for being one of the first national training authorities in a country not governed under Shari'a, to develop comprehensive Islamic banking training material of such a high standard.

Current South African Islamic finance landscape

There are 6 Islamic banks in South Africa that offer Islamic finance, one of which is a niche bank. They offer a wide range of Islamic retail banking products as well as Shari'a-compliant investments.

South African investment houses offer Shari'a-compliant investments including:

• Islamic Equity Funds - Shari'a-compliant, equity-linked exchange traded fund that tracks the FTSE/JSE (Johannesburg Stock Exchange) Shari'a Top 40 Index, reflecting the Shari'a-compliant companies listed among the top 40 companies on the main board of the JSE, as measured by market capitalisation

• Retirement funds

• Pension annuities

• Unit trust funds

• Endowment policies

Shari'a-compliant insurance is offered for motor, household and business needs in accordance with Shari'a.

Islamic finance is really about community development
The Banking Association of South Africa is working hard to build a culture of saving in the country. The "Teach a Child to Save Campaign" is an important part of this initiative. Teach a Child to Save encourages staff members of South African banks to give up a few hours to go into a local school to teach one of the carefully prepared lessons provided by the Banking Association. These lessons are designed to encourage children to understand the key elements of managing money and the importance of saving. Although Islamic banking has been part of this programme since 2007, the Banking Association established an Islamic Chapter of Teach a Child to Save in 2010, with a formal launch taking place at the Central Muslim School in Laudium, near Pretoria. Representatives from all levels of employment in South African Islamic banks went into their local Muslim schools to deliver lessons on how to draw up a budget and to manage and save money. This will be an annual activity that encourages banking employees to contribute their time and talents to the development of a culture of saving in the country.

The Head of Operations of Absa Islamic Banking has become a local champion of the global Pink Hijab Day initiative and 2010 was the third year of involvement. The focus is on raising awareness of breast cancer. During October of each year, pink hijabs are distributed to women of all faiths as part of developing a sisterhood who take responsibility for awareness of their own health. The focus for distribution of pink hijabs has been in schools and charitable community organisations, and business women's organisations have also been reached. Another wide-reaching outreach programme is the recognition of the Fast during Ramadan. Absa Islamic banking provides bottled water to some mosques in poorer areas nationally for people to break their Fast at sunset.

Work is also done with Muslim charitable organisations that support needy people of all faiths. The focus is on supporting organisations that have a broad reach across many areas of need.

Launch of Islamic banking in Tanzania

In May 2010 NBC (National Bank of Commerce) of

Tanzania, which is 55 % owned by Absa Bank Ltd, launched an Islamic banking offering in that country. This made NBC the first major Tanzanian bank to offer products designed to meet the needs of Muslims, who form approximately half of the Tanzanian population. The initial product take-up has driven plans to grow the offering to meet the business needs Muslims of Tanzania.

Looking Ahead

One of the other Islamic financial structures attracting attention is the sukuk. It is strongly believed that there is great scope for the development of sovereign sukuk in South Africa. South Africa has large infrastructure projects requiring the kind of funding for which sovereign sukuk could prove to be an ideal financing vehicle. The scope for introducing an alternative to existing conventional government debt by introducing instruments enjoying Shari'a acceptability is significant. This would be one of the first sovereign sukuk to be launched in Africa. This would support government infrastructure funding requirements, such as the need to extend the country's power generation capacity and would position South Africa as a centre for Islamic banking on the African continent.

In summary, 2010 was a landmark year for Islamic finance in South Africa. The developments taking place will change the Islamic finance landscape permanently and will drive growth and development of the sector; hence we can expect more progress in 2011. It will also position South Africa powerfully as a financial hub on the African continent, as it becomes the incubator for Islamic financial product development for Africa.

IFCI ranking: 10

SUDAN

Sudan is in a transition period; or rather Sudan has been in a violent transition period since it gained independence in 1955. The conflict between the Muslim north and the Christian south has raged on for over 50 years in some form, resulting in massive casualties, a foundering economy, famine, poor infrastructure and deep antagonism between the North and South, Muslim and Christian. Secession of the South had to occur and in early 2011, thus began a new dawn for Sudan. Southerners voted overwhelmingly for independence and a break from the North. Independence will be declared formally in July, making Sudan the world's 193rd state.

It will be a truly momentous occasion for a country long ravaged with civil war. The North had held a tight grip on the South, attempting to impose its vision upon a less than open South. Politics in the North can be characterised by strong Islamist agendas. One policy was the islamisation of the economy.

Islamisation not for all

The Shari'a has been the de facto law in Sudan since 1983. However, it took just shy of 10 years for transformation to a totally Islamic based financial system, with the Banking Law of 1992 marking its completion. After Iran, Sudan was the only country who had attempted to convert its entire financial system into an Islamic but the jury is out as to whether this has been entirely successful. In the North, Islamic banks remain small reflecting the limited size of its economy and its low living standards.

The transformation certainly had little support from the south, by and large compelled to accept the dictates of its Northern superiors. The context changed after the signing of the Comprehensive Peace Agreement (CPA) in 2005 marking the end of the second Sudanese civil law. Under the terms of the agreement, it was stipulated the North would still govern according to the Shari'a but the South were permitted to created their own representative government. These terms had an impact on Islamic finance. In 2007, all banks were told to convert into conventional finance or leave. Most Islamic banks chose to leave resulting in capital outflow from the South. Conventional banks have been set and several banks from neighbouring countries have entered the markets. There are currently around 10 conventional banks in the South. The Central Bank of Sudan, based in Khartoum in North, created the Bank of Southern Sudan as a branch to regulate the financial markets in the South.

Well established system

Islamic finance in the North remains entrenched. While it was only in 1992 that there was complete transformation, Islamic finance had presence in the country since the late 1970s. Faisal Islamic Bank of Sudan was the first bespoke IFI set up in 1977 by a special Act of Parliament. Strong government support and valuable concessions resulted in dramatic growth in a short period of time. More Islamic banks entered the market. But due to corruption and bias amongst the management of banks to certain customer groups as well as an abuse of Islamic principles to circumvent payment, banks began to experience high default rates. Tighter restrictions on loans resulted. Moreover, in the period of 1999 – 2002, Sudan introduced Basel requirements and aligned them with Shari'a principles.

Faisal Islamic Bank was also pioneers of takaful in Sudan. They set up the Islamic Insurance Company of Sudan, which was given tax exemption on all assets and profits. Legislation took time to follow. After a series of insertions, amendments and decrees, it was only in 2003 that the government passed the Law of Insurance and Takaful.

With the islamisation of the financial system in 1992, the state established the High Shari'a Supervisory Board to oversee compliance. The body comprised of Islamic scholars, bankers and economists. The Board has eleven members. While the Bank of Sudan sets rules for all Islamic banks, and the Shari'a boards of banks acts as a day to day monitor, the Board remains the authority on Shari'a matters. It is also the appeal authority for disputes relating to Islamic finance. Institutional Shari'a boards, in addition to their supervisory roles, act as in house law departments dealing with legal issues.

Capital Markets

In 1994, Khartoum Stock Exchange (KSE) was set up and comprises of shares of over Sudanese companies a number of investment funds and issues of government sukuk. The stock exchange has its own Shari'a board, which screens and approves products prior to their trading, thereby limiting speculation. In 2003, the KSE launched the Khartoum index which was developed with the assistance of the IMF. It is one of the top five exchanges in Africa.

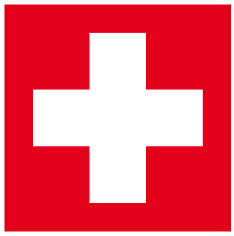
Sudan is quite active in the issuance of sukuk. Shahama bonds, short term securities which are structured utilising the musharaka model, is used by the state to borrow money in domestic markets. The bonds are backed by shares of companies owned by the Ministry of finance. Thus, profitability is dependent on the success of the companies which produces volatility in returns. The government issues these bonds on a quarterly basis with revenue going to administration costs and little being funnelled for development purposes. Sudan issued its first sovereign sukuk of USD 147 million in 2008. It had planned to offer a USD 300 million sukuk by the third quarter of 2010. But the issuance failed due to investor concerns about the precarious political situation in Sudan.

Foreign Relations

Another problem for Sudan in issuing sovereign bonds has been its pariah status according to the International community. It has been classified as a sponsor of terrorism by the US and has been subject to economic sanctions. Sudan has however attempted to seek assistance from Arab nations such as Egypt, Kuwait and Saudi Arabia. Sudan central bank was also one of the signatories to the establishment of the International Islamic Liquidity Management Corporation (IILM) in Kuala Lumpur in October. The central bank is a full member of the IFSB. They have also been beneficiaries of IDB loans including a USD 120 million loan to help Sudan with the development of Khartoum New Airport. IDB have also stated that they would assist Southern Sudan with construction efforts.

A new dawn

Sudan's foray into Islamic finance has been a long and productive one but one which is riled by internal and external conflict. Intentions were good and there have been a number of noteworthy achievements. But without political stability and crippling conflict, Sudan has been unable to reach its potential. This may change following the separation and dependent on whether gun totting militia harbour for peace. With years of violence marring opportunities for long standing peace, there is always that uncertainty which will prevail. But with the division, and with North Sudan coming out of the cold on the political arena, there are opportunities to grow. Sanctions may be lifted and this will serve to bring investment. It is just dependent on that delicate rope of peace to hold.



IFCI ranking: 28

SWITZERLAND

Switzerland is one of the most popular financial hubs in the world. It is known for its strict code of conduct with regards to confidentiality and its world class private banking services. Hence it has been a location of choice for wealthy individuals seeking to benefit from protection and secrecy offered.

With oil wealth creating more wealthy individuals in the Middle East, Switzerland has been quick to capitalise. Players in the country have been promoting Switzerland as a destination for high net worth individuals from the Muslim world to experience world class banking services However, there have been very few conventional private banks offering Islamic finance products. Bank Sarasin is one of the few conventional private banks which have fully fledged Islamic finance offerings which, is somewhat surprising given that private bank Pictet & Cie launched Islamic services way back in 1998. Notwithstanding this, Bank Sarasin is one of the few conventional private banks that have a complete set of Islamic finance offerings. In addition to Bank Sarasin, the first Islamic private bank to open in the country was Faisal Private Bank, opened in Geneva in 2006. The bank has not been doing as well as expected and recently went through a change in management.

One problem which has hindered the progression of Islamic finance in Switzerland according to insiders is the terminology. Many non-Muslims feel threatened when they hear the terms 'Islamic' and Shari'a, believing that Islamic finance is the initial step to the emergence of Shari'a law in Switzerland and Europe at large. This view was clearly indicated by the Swiss public's view on banning minarets in the country.

However analysts are of the opinion that it is only a matter of time before Islamic finance makes further headway into the Swiss landscape as the industry continues to gain momentum globally.

IFCI ranking: 17

SYRIA

Since the coming to power of Bashar Al Assad in 2000, Syria has embarked on a series of political and economic reforms. In the last five years, focus has moved towards just economic reforms, with liberalisation and the opening up of the markets being a broad based policy goal. His moves are a departure from the centralised planning which characterised his father's regime; and has had important consequences for the banking industry and specifically Islamic finance.

A new phenomenon

After many years of a centrally planned socialist economy, it was unlikely that there would be a rapid move towards a market economy. Hope was high for there to be wholesale changes made to the Syrian economy, especially with President Bashar's more liberal rhetoric. But today industry remains highly centralised and steady introduction of market reforms since 2005 has yet to make significant difference.

But in the financial sector there have been significant changes. Long populated with state owned banks, in 2004 Syria welcomed its first private bank. From there a number of private banks have formed thereby increasing the quantity and quality of financial products on offer leading to an increase in the customer base. Concomitantly Islamic banking also took shape, which has made Syria unique in the Islamic finance markets. Rather than edging into the market and competing with established players, Islamic banks were starting operations at the same time as their conventional counterparts.

The passing of Legislative Decree 35 in 2005 provided the legal footing for Islamic banks. The law is wide ranging addressing issues such as Islamic bank operations, Shari'a governance, capital adequacy, tax policy and a host of other concerns. Interestingly, the law directly mentions compliance with AAOIFI standards, a positive step in ensuring some level of standardisation within the domestic markets. Syrian authorities have also granted Islamic banks a range of investments activities including being able to enter as partners in a commercial transaction. Being able to act as an investment partner opens up a wider market for Islamic banks.

When compared to conventional institutions, these allowances grant Islamic banks competitive advantages. However at the same time, the capital requirement to establish an Islamic bank is higher than a conventional bank. In January, Decree No. 3 of 2010 was passed which increased the minimum capital requirement for conventional banks to 10bn Syrian pounds and 15bn Syrian pounds for Islamic banks. The government said the move was necessary in order to comply with Basel II standards and hedge against the risks posed by the growing integration of local banks into global markets. The higher capital requirements for Islamic banks acknowledge the liquidity problem which affects Islamic banks.

A growing market

There are currently 14 private banks operating in Syria. The first Islamic bank in Syria, Al Sham Islamic Bank started operations in 2007. It was followed by International Islamic Bank (an affiliate of Qatar International Islamic Bank). In 2010, Al Baraka bank started operations. Kuwait Finance House has plans to open an Islamic bank in Syria in the near future and has partnered with number of prominent local Syrian business men. A key attraction of the Syrian market is the excess liquidity in the market. According to central bank figures deposits amounted to 41% of GDP in 2009. Consequently, analysts believe that there is a potential for more banks.

Recent estimates suggest that, as of April 2010, assets at Islamic banks stood at SYP 75.8 billion, making a 40% increase from the year before. Islamic banks hold approximately 4% of all banking assets. Public banks still dominate while private banks hold just over 20%.

While Syria has two Islamic insurance companies, Al-Aqeelah Takaful and Syria Islamic Insurance Company, the market for insurance is not as conducive as it is for banking. Takaful companies are subject to the same regulatory guidelines as conventional insurance companies though the Syrian Insurance Supervisory Commission (SISC) has indicated that separate guidelines will be issued. Furthermore, SISC are looking to set up a Shari'a board to oversee takaful companies and to cooperate in drafting guidelines.

A key challenge for Syrian takaful companies is building up a strong consumer base. In a conservative Muslim country such as Syria, there are religious scruples over insurance. Thus we see that most premiums are generated from companies and not individuals. But takaful companies are seeking to build out their personal policy service lines, highlighting Islamic credentials. They have managed overtake a number of conventional insurers in terms of income and there is general positivity that this success can be continued. However, the dissolution of a third insurance company, Noor insurance, indicates that the industry is still experiencing growing pains.

Challenges

However, for Islamic banks to prosper there needs to be a change in consumer perception. According to the Syrian Banking Monitor 2009, a survey on attitudes to banking in Syria conducted by local research firm Acumen, Syrians are generally cautious about the banking sector. Only 16% of urban Syrians have a bank account. As mentioned above, liquidity is high in the market but many are dealing with conventional institutions. However, the survey revealed that most respondents had a preference for Islamic banking services but choose a bank according to reputation and credibility. At the same time most depositors in Syria are not keen on long term deposits, narrowing the product portfolio for Islamic banks.

On the institutional side, Decree 35 of 2005 ensures that contracts concluded by Islamic banks are exempt from taxes on profit and stamp duty. Unfortunately, there have been complaints by Islamic banks that tax authorities are charging stamp duty and transfer fees on purchases, which add to the cost of the transactions. There is also the problem of a lack of qualified people in the industry. Support is required to educate and train staff.

The future looks good

The banking sector is doing well in Syria though there has been a slight slowdown in growth in the last year. Liberalisation of the markets is ongoing. Decree 3, mentioned above, permitted foreign companies to take majority ownership of Syrian banks for the first time, with ownership cap rising to 60%. At the end of July, Decree 56 of 2010 was issued allowed international investment banks to enter the market. With these moves, Islamic bank heavyweights such as Abu Dhabi Islamic Bank have expressed desire to open branches in Syria. The government and the central bank are also interested in issuing sukuks. This is likely, especially after the central bank of Syria began selling government debt for the first time in decades, only this December. An open market will benefit the Islamic finance industry. It is still in its nascent stages in Syria but all indicators suggest the sector will grow further in the next few years.

IFCI ranking: –

TANZANIA

Tanzania like many countries on the African continent is plagued by poverty. However, unlike other nations, the country has been relatively devoid of strife and internal conflict. Modern day Tanzania is made up of the mainland (former Tanganyika) and the idyllic island of Zanzibar. The population of Tanzania is estimated to be 45 million and what is interesting to note is that the populace of the island of Zanzibar is 99% Muslim. Whereas on the mainland Muslims make up 35% of the population.

With a sizable Muslim population, Tanzania may be the next frontier for Islamic finance to spread. Furthermore, there is a strong historical relationship between the Muslim Tanzanians and Arabs as Islam spread to the country through Arab traders from Yemen and Oman, and thus many Muslim Tanzanians are of Arab heritage as the traders intermarried with local women. Another reason why there is huge potential is that much of the population is under-banked, so Islamic banks can fulfil this gap.

In 2010, Islamic finance began penetrating Tanzania, with South African banks at the forefront. The response so far has exceeding expectations. Stanbic Bank Tanzania, under their Islamic finance window, had 5000 new customers opening bank accounts during the first three months of offering Shari'a-compliant financial services in 2010. The bank aims to provide more facilities this year due to the positive response and has submitted a proposal to the central bank outlining their future plans. Absa bank of South Africa also began offering Shari'a-compliant services in 2010, through its subsidiary, the National Bank of Commerce (NBC). The bank has been offering cheque accounts as well as savings accounts with innovative features such as an imbedded funeral plan. Furthermore the bank plans to offer other innovative products such as a Hajj and Umrah savings facility in future. However, the two windows were not the first to offer Islamic banking facilities, as Kenya Commercial Bank (KCB) also got the licence to offer Shari'a-compliant banking services back in 2008.

2011 could prove to be an eventful year for Islamic finance in Tanzania. There are rumours that a group of private investors have approached the Central Bank looking to establish an Islamic bank. Hence we may witness the birth of full fledged Islamic banks in Tanzania. However there are certain issues that need to be dealt with according to industry insiders, such as a general lack of awareness and capacity. If these issues can be effectively dealt with, Islamic finance will no doubt establish itself in Tanzania in the coming years.

IFCI ranking: 29

THAILAND

It has become axiomatic that the ideologues of Islamic economics envisioned a holistic system which would eschew capitalist precepts in favour of an altruistic and ethical normative. Society would be lifted out of the mire of its own self indulgence and poverty will be alleviated giving opportunities to the less fortunate of society. Debates have erupted amongst academics and social commentators as to whether Islamic finance has realised such noble aims. Many non-Muslim countries have embarked into Islamic finance, not for philanthropic purposes, but for monetary gain and this fuels the arguments of the naysayers who opine that Islamic finance is underscored by the same motives as capitalism. However, certain non-Muslim countries would contest this opinion. One such country is Thailand.

Assisting the poor

The primary motives to develop Islamic finance in Thailand were to serve the economically weak Muslim community and to attract petrodollars from the Gulf. The community is mostly based in the South and consists of 9.5 million Muslims, over 10% of the population. It is the second largest religious group in Thailand but is burdened by the high incidence of poverty that pervades. The government have advocated more development aid for this region, hoping that increased affluence will scupper the intents of separatists who are fighting for an independent state. Political turmoil resulting from this conflict has had a negative impact in drawing in foreign investors.

Islamic finance in Thailand has its antecedents in the Pattani Islamic Saving Cooperative, a Shari'a- compliant saving cooperative set up in 1987. Since then a number of other saving operatives have been established in Southern Thailand which have successfully managed and mobilised Muslim funds in the region. The first Islamic window was established by Government Savings Bank in 1998. In 2001, Krung Thai bank set up an Islamic branch.

Pursuant to these developments, the government passed the Islamic Bank of Thailand Act in 2002 which led to the creation of the first Islamic bank in Thailand the following year, the Islamic Bank of Thailand (IBT). In 2005, in line with government policies, IBT acquired from Krung Thai Bank its Islamic branches. In 2008, IBT partnered with Muang Thai Group, a Thai Insurance company. Today the bank has over 60 branches spread across Thailand and is enjoying healthy profits with annual increases, including a bumper year in 2010, when net profits increased sharply from 355 million baht to 1.2 billion baht. This is largely due to the aggressive marketing adopted by the bank over the last few years. It has 131.32 billion baht worth of assets and is planning to open over 20 branches in the coming year.

IBT plans to set up the country's first Islamic property fund worth 1.4 billion baht. It has already signed an MoU with Finansa Asset Management, a leading wealth management company based in Bangkok, and hopes to start the fund by early 2011. While it would suggest that the bank has the objective of profit maximisation, the government would demur. IBT has been assigned to provide financial aid to Thailand's southernmost provinces, areas with the highest concentration of Muslims. Consequently, the bank's plan to list on the local bourse has been rebutted by the government as it runs contrary to the government's strategy for the bank. However, strategies may have to change especially after Malaysia's CIMB acquired Bank Thai in 2009. CIMB plans to open Islamic windows through its 125 windows, thereby acting as a direct competitor to IBT.

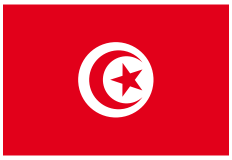
Building the infrastructure

On the other hand, the government is aware of the need to have a strong capital market to cater for the increasing demands of Thai Muslims. There are a few products on the market which serve this purpose. One such product is the Shari'a-compliant retirement fund created by Krung Thai Asset Management in 2006. But it is in the stock markets that we are seeing a great deal of success for Islamic finance. In April 2009, the Stock Exchange of Thailand (SET) and the FTSE created the FTSE SET Shari'a Index, created for both domestic and international investors. The index can be used for an array of Islamic products. In 2010, Islamic stock funds provided higher returns than their counterparts. In December, the Securities and Exchange Commission (SEC) green lighted the sale of sukuk funds to be sold directly to investors. IBT is expected to be the first issuer, In order to create a robust capital market, the Thai government is currently reviewing legislation with the intention of issuing a sukuk. The government has already drafted regulation which will provide tax exemptions on the transfer of assets but have yet to release it. Currently, sukuks would be subject to high tax costs due to double transfers of assets. Thai Securities Commission is assisting by drafting regulation which permits both domestic and international issuances of sukuk. Ongoing drafting of regulation has delayed the issuance of a sukuk. IBT had hoped to issue sukuks worth 5 billion baht but have been thwarted by the sluggishness of the government in passing appropriate legislation.

Yet as the government delays, the private sector has moved forward. Trans Thai-Malaysia (Thailand) (TTM) raised USD 190.2 million through a sukuk murabaha. The proceeds will be used to fund capital costs and working capital for the Trans-Thailand Malaysia natural gas pipe line which has been operational since June 2010. The sukuk represents the first issued by Thailand. The Malaysian Rating Corporation (MARC) awarded it the highest rating due to the predictable cash flow and TTM's low financial and operating risk profile. TTM is a mutually owned project company between the Petroleum Authority of Thailand and Petroliam Nasional (PETRONAS), Malaysia' national oil and gas company.

Rebels with or without a cause

Islamic finance in Thailand looks good. A relatively supportive government, a vibrant domestic market and strong ties with Malaysia can only bode well for the future. Ongoing insurgency in the South may provide obstacles, especially if the conflict intensifies. The government are keeping a close eye on developments but there is a hope that with increased affluence, it will pacify the rebels. In this regard, the IBT provides a medium through which conscientious Muslims can transact according to their beliefs. Government support for such endeavours may endear the rebels. At least this is the aim. But, at the same time, IBT is not relying on a change of heart. Its growth signifies that it has a greater ambition.



IFCI ranking: 25

TUNISIA

Tunisia is a country situated in North Africa, near the Mediterranean Sea and is bordered by Algeria and Libya. It has a population of between 10-11 million, the majority of whom are Muslim. The country has been in the news recently as the government was toppled when Tunisians took to the street to demonstrate their unhappiness with the Prime Minister Ben Ali, earlier this year. These events have had a direct impact on Islamic finance in Tunisia, but before discussing this, a history of Islamic finance in Tunisia will be given.

The entrance of Islamic finance into Tunisia has not been recent. In 1983, Tunisia saw the opening of the first, and for over 20 years, sole IFI. Known as BEST Bank (Beit Ettamwil Saudi Tounsi), it failed to capture a robust market share. Arguably, this has as much to do with the lukewarm approach afforded to BEST Bank as it is due to poor strategic planning on the part of BEST. Part of the problem lay with fears of creeping islamisation and the encroachment of political Islamists. Subsequently, the bank was formed with the government having partial ownership of the bank and officials playing an intrinsic role in the day to day operations of the bank. BEST was constituted as an offshore institution and therefore could not do business in Tunisian dinars – thus denying a customer base of indigenous Islamic investors and savers. This law was amended in 1985, thereby allowing offshore institutions the legal right to attract onshore deposits with a 1.5% total deposit ceiling.

Unfortunately, this pre-empted any real impact the bank might have on the financial sector. Additionally, the government's hard-line stance on Islamist activity commuted into a raid by security forces searching for evidence of links to the Rachid Gannouchi led Mouvement de la Tendence Islamique (MTI). This negative publicity corresponded to a decrease and stagnation of saving accounts from which BEST Bank has failed to recover. BEST Bank, in face of an intrepid government, diversified its operations and played down its Islamic character. Throughout the 90s, this has been a successful strategy though market growth has not been particularly astounding.

However the year 2010 showed that the government was becoming more open to Islamic finance. The primary reason for this policy shift was due to the fact that the government was looking to attract funds from the oil rich Gulf States. Furthermore the domestic clamour for Shari'a-compliant financial services had grown louder. Hence the year 2010 was quite eventful in terms of Islamic finance development in Tunisia, with the opening of an Islamic bank as well as a major project with a Bahraini Islamic Investment Bank.

GFH, an Islamic investment bank based in Bahrain and the Tunisian government announced the launch of a USD 3 billion offshore financial centre, the first one of its kind in North Africa. The project will facilitate trade with the EU bloc and the Tunisian economy as well as other economies within the region. This showed that the Gulf countries were becoming more interested in Tunisia, as even before this, Noor Islamic Bank from the UAE opened an office in Tunisia to be used as a platform to expand into the North African market.

Azzitouna, the first fully fledged Islamic bank was opened in May 2010 by the son-in-law of the now former president, Ben Ali. Azzitouna offers Shari'a-compliant savings and financing facilities for businesses as well as individuals. The bank was started with a capital of USD 30 million and was expected to grow to USD 71 million in 2011. Princesse Holding contributed 51% of the start up capital with the remainder shared by local partners. Azzitouna started with 9 branches and the management expected it to grow to 20 this year (2011).

The year 2010 also saw Azzitouna implement Instant Issuance Solutions from the Dutch security specialist firm Gemalto. The implementation of such a service made Azzitouna, the first bank within the country to offer Instant Issuance and on-the-spot delivery, which allowed the customers to use their new payment cards immediately.

News reports had shown that the executive level management of Azzitouna were planning ambitious expansions outside of Tunisia. At the recent French Forum on Islamic Finance, the chairman, Sakher El Materi stated how the bank planned to expand to other African countries and into the euro-Mediterranean region. Furthermore Azzitouna Takaful with a future subscribed capital of 15 000000 dinars, was opened to provide takaful and retakaful services.

Sadly, the recent political events in Tunisia may put a damper on Islamic finance in the country. As was mentioned earlier, the majority shareholders in Azzitouna bank are connected to the now disposed former prime minister. Thus the bank has been placed under the supervision and control of the central bank as the assets of the former regime are under investigation. There are reports that the bank has been losing 700 000 dollars a day since Ben Ali was toppled, due to a crisis in confidence. Hence Islamic finance in Tunisia seems to have taken the initial step forward and then two steps back.

IFCI ranking: 14

TURKEY

On the 23rd July 1924, sovereign Turkey was recognised by the international community. The Treaty of Lausanne sealed the fate of the caliphate, which had lasted over 600 years; and with a few signatures, the once great Ottoman Empire was consigned to history. The 'sick man of Europe' was finally cured: and its cure was secularism. The aftermath resulted in a pathological desire to ensure secularism triumphed, with efforts undertaken to push Islam and the Shari'a to the wayside.

In some respects this has been quite successful but with a majority Muslim population, the spectre of Islam would always remain. Balancing the secular intents of the Turkish constitution and the religious needs of its people has not been easy. There have been recurring moments of self-reflection, when Islamic ideals and practices would assail policy makers. Thus Islamic finance has been a peculiar case of acceptance and caution in Turkey.

Fighting with words

The first Islamic bank in Turkey, Al Baraka Financial House, was established in 1985. It was given the status of 'special finance house' to distinguish it from conventional banks operating in Turkey. Thus from the onset of Islamic finance in Turkey, the dichotomy was embraced. Allusions to Islam disturbed ideological sensibilities. In 2005, the banking law legislated that Islamic banks should be known as 'participation banks', a subtle reference to the desired form of Islamic finance, i.e partnership contracts. But even though the 'participation banks' in the country operate according to the Shari'a, the Islamic aspect is not officially recognised. Today products do not have 'Islamic' names and no bank has a Shari'a board to oversee compliance. They are not considered as full banks and are not part of the Turkish Association of Banks, thereby reducing complete recognition. Thus, the Participation Banks Association of Turkey (TKBB) was created but this is a trade body set up to promote Participation banks.

Participation banking in Turkey

There are currently four participation banks in Turkey, three of which are foreign owned. Kuveyt Turk is the most proactive of Turkey's four Islamic banks and is owned by Kuwait Finance House; Turkiye Bankasi, whose majority shareholder is Saudi Arabia's National Commercial Bank (NCB); and Albaraka Turk Participation Bank, which is a subsidiary of the Albaraka Banking Group, which in turn is majority owned by Saudi Arabia's Dallah Albaraka Group. The fourth bank is Asya Bank, set up in 1996 by over 200 businessmen from various industries. Many of these banks are branching off internationally into countries and areas such Kazakhstan, Germany and North Africa.

UniCredit Group has called Islamic banks the fastest growing segment in Turkish Banking. Credit volume grew by 9.7% between August 2008 and January 2010. However, the share in terms of overall credit volume is still low at 3.9 %. Participation banks hold only 4% market share of total banking assets in the country. However, financial indicators suggest that there has been consistent and constant growth. According to the TKBB, net income went up 11% and total assets volume increased 34% in 2009. The four participation banks are in the top 65 of the top 500 IFIs compiled by the banks and for a number of years, participation banks have outperformed conventional banks.

There has also been significant activity within the Islamic finance markets. Bank Asya's one year USD 255 million dual currency murabaha facility in 2010 was the largest ever in Turkey, and was subscribed by a consortium of 24 banks from 16 countries. The facility was more than three times oversubscribed at USD 255 million against the launch amount of USD 75 million.

For many years there has been talk of issuing a sukuk in Turkey but it has been tempered by the purview of secularism which overshadows anything ostensibly defined as Islamic. This conundrum seems to have been avowed with the issuance of Kuveyt Turk Bank's three year USD 100 Million sukuk in August. It was the first sukuk offered by Turkey as well as being the first bank sukuk offered by any financial institution based in Europe. The coupon rate was 5.25% and was oversubscribed. It is a mix of ijara and murabaha structures. The sukuk deal won three awards from Islamic Finance News Magazine for Deal of the Year, Best Sukuk Deal in the world and Best Deal in Turkey in 2010.

The government is considering changes to its taxation laws to encourage more sales. Currently under existing rules, companies selling Islamic debt are taxed twice, and amendments to legislation are required in order to develop more sales of sukuk. The government do not have immediate plans to issue a sukuk – though Kuveyt Turk have expressed interest in issuing more – but they have recognised that to encourage more investment into the country, a sovereign sukuk would be beneficial.

In January 2011, the Istanbul Stock Exchange (ISE) launched a participation index to track 30 Shari'a-compliant companies in an effort to further develop the Islamic finance sector. The new participatory index is intended to bolster trade with the Gulf and MENA regions. Bizim Securities, a Turkish fund management company, will monitor the index, ensuring Shari'a-compliance.

Approaching the century

Thus there seems to be a growing interest in Islamic finance from the government. Participation banks are certainly attempting to lobby the government to address the regulatory obstacles that hinder Islamic finance in the country but they have not rested on their laurels and have sought to increase their profile. Kuwait Finance House (KFH) has grand ambitions of making Kuveyt Turk its hub for its takaful operations. Kuveyt Turk entered Turkey's insurance sector by establishing Neova Insurance in its non-life branch in 2009. KFH is now looking to establish a life insurance and pension company in Turkey.

There has been a growing interest in Islamic finance in Turkey over the last few years. While Islamic banking started over 20 years ago, interest is building primarily to access the wealth in the Gulf regions. This is not a bad thing as it is has bolstered the industry. However, the ongoing conflict between secularism and Islamic normative still remain; and there is always a fine line on which participation banks walk. In 1997, Turkey's National Security Council (NSC) banned the coalition government due to the fundamentalist stance adopted by one of the parties, the Welfare Party. This, in turn, lead to legal measures against Islamic banks – then known as special finance houses – in which the banks could no longer open new branches. The decree was reversed soon after, with legislation issued in 1999 recognising Islamic banks as part of the financial system. But this incident exemplifies the fine balance that has to be undertaken by Islamic banks, or rather participation banks. In 2024, Turkey will celebrate 100 years. From now until then, Islamic banks are likely to grow in size and stature in the country though hopefully not to the chagrin of the die hard constitutionalists.

IFCI ranking: 5

UAE

It is difficult to generalise with the UAE. An agglomeration of seven states (or emirates), each emirate is distinctive with its own set of policies and perspectives. Over the last decade, most of the world's focus has been on Dubai for its incredible growth and determination to become a financial centre, competing with the likes of London, New York and Tokyo. Other emirate states were playing catch up to Dubai's enviable precocity, slowly building their own infrastructure but unable to directly compete with its breadth of influence.

Things changed with the global downturn. Dubai faltered, unravelling on the global stage, revealing the level of unbridled risk taking, fostered by individuals and institutions looking to profit from the flow of funds coming into Dubai. The bubble had burst. Today, half built buildings stand as a testament to the collapse of an over- heated economy, derelict and dissolute.

But while Dubai suffered, other emirates in the UAE were less affected. Crucially, Abu Dhabi withstood the economic crisis, largely due its oil reserves and more measured financial and economic management. When Nakheel defaulted on its sukuk, the Abu Dhabi government agreed to fund USD 10 billion to the Dubai Financial Support Fund that was used to satisfy obligations on Nakheel's parent company, Dubai World. The bailout eased the anxiety of many investors but brought questions as to the strength and stability of the Dubai economy. It also represented a watershed moment for the Islamic finance industry. Sukuk structures were now under the spotlight and questioned as to whether they were secure for investors.

From the ashes

This question has not been sufficiently answered though drafting of contracts for sukuks contain more stringent clauses. This is natural, in order to counter future problems. Investors are seeking more security, ensuring that sukuks are asset backed, giving them ownership and a buttress in the event of default. Prior to the default, only 4% of Moody's rated sukuks contained such provisions.

After the start of the global recession, demand in the global sukuk market fell and was compounded further in 2010 following the default. It was hoped that following Dubai World's announcement in May, that it had reached an agreement with its main creditor to restructure its liabilities, apprehensive investors would return to the market. But falling property prices has inhibited investor appetite. Experts believe that sukuk demand is inextricably linked to property prices, especially as the underlying asset of a sukuk tends to be property. Moreover, with conventional bonds rebounding faster than sukuks, many Gulf issuers are choosing to sell the former to capitalise on the abundance of liquidity in the market. With the greater enforceability in the event of default and the higher cost of drafting sukuk documentation, cumulatively, conventional bonds hold greater appeal. Standard & Poor have confirmed that the costs of structuring and issuing sukuk remain high, relative to conventional bank loans and bond issuance. The DIFC are looking to reduce the costs of documentation and to promulgate a more efficient Islamic finance industry. It has started to create 'Dubai docs', a standardised document for anyone who wishes to list or raise a sukuk from the centre, a move that is aimed to reduce the cost of sukuk documentation.

With the quiet domestic sukuk markets, UAE banks are looking to outside markets such as Malaysia to issue sukuk. The National Bank of Abu Dhabi issued a 500 million ringgit sukuk in December. The issue was oversubscribed providing a way for Asian investors to diversify their portfolios. In fact Abu Dhabi is advancing in the market as its neighbour finds its feet. It too was affected by the credit crisis and property prices fell significantly, though not as sharply as Dubai. In any event, Abu Dhabi Islamic Bank's (ADIB) announcement that it would be issuing sukuk under its USD 5 billion trust programme established in November 2006. Fitch ratings assigned a rating of A+ to the issuance which suggests that vestiges of resurgence of the sukuk market are evident in the region.

State of the market

With the negative publicity resulting from the Nakheel default, less focus has been given to the Islamic banking industry as a whole in the UAE. However, generally, the Islamic banking industry is doing well. At the end of 2009, UAE's eight Islamic banks held USD 49.8 billion of deposits at the end of 2009, or about 19 percent of the total, according to the central bank. UAE Islamic banks have not rested on their laurels and are continually improving their product portfolio. Sharjah Islamic Bank signed a strategic agreement with MasterCard Worldwide to issue debt and credit cards. DIB launched the world's first Shari'a-compliant personal liquidity solution, Al Islami Salam Finance, allowing customers to take between DH 25000 and DH 1million. ADIB is the official bank of the UAE football league and has launched a football fan visa card, which offers a number of benefits for the fan.

UAE Islamic banks also have presence in neighbouring countries. The oldest Islamic bank, Dubai Islamic Bank, has expanded its branch network to Pakistan. It has stakes in a number of foreign banks including Bosnia International Bank and Yemen's Saba Islamic Bank. DIB has a wide ranging portfolio with investments in real estate companies in Turkey and United Kingdom. Equally, ADIB have expanded into Egypt, acquiring National Bank of Development and transforming it into an Islamic bank; there were also plans to open branches in Iraq following acquisition of licences from Iraq's central bank.

It is not only service provision that Islamic banks are thriving but also in service quality. In January, Ethos Consultancy released its 5th Annual UAE Service Quality Bank Benchmarking Study, which revealed that Islamic banks were outperforming non Islamic banks in all three service quality channels: branch services, call centre performance and website facileness. This was the first year that Islamic banks outperformed conventional banks and is a reflection of the improvement in services provided by Islamic banks.

In terms of takaful provision, there are six takaful firms in the UAE. Like other Gulf States, insurance penetration is quite low, with only 1% of per capita expenditure utilised. However, several applications for licenses have been given to the Securities and Commodities regulator for assessment and it is expected that five new takaful companies will be set up in 2011. Takaful coverage in the UAE is growing and according to a Booz & Company report, the growth rate between 2005 -2008 was 135 percent.

In September, the UAE Insurance Authority Board issued the Takaful Regulations, which for the first time in the UAE provides bespoke regulations for takaful operators (Resolution 4 of 2010). The Regulations are required to be read and complied in conjunction with the authoritative Insurance Law, Federal No. 6 of 2007, and the regulations pursuant to it. The Takaful Regulations provide guidance to structuring takaful products and corporate governance. A significant provision is that it expressly prohibits conventional insurers from offering takaful products through an Islamic window. Also, the regulations promulgate the creation of the Supreme Committee for Fatwa and Shari'a Supervision, i.e. a national Shari'a board for the takaful industry.

There have also been developments in the money markets which will assist Islamic banks in the UAE manage their liquidity. The central bank of UAE's announcement in June to issue the first Shari'a-compliant Certificates of Deposit (CoD) in the Gulf, represents a move to create a dynamic and accessible money market. The Shari'a Coordination Committee, established two years ago to help standardize the industry in the Gulf nation, has worked closely with the central bank of the UAE to create Shari'a-compliant CoD. In December, it was reported that Islamic banks had invested some 3.5 billion dirhams in Shari'a-compliant CoDs that were issued by the central bank in December. The CoDs are based on murabaha and are designed to soak up the excess liquidity in the market.

Dynamism in an anxious market

An insipid sukuk market and a downturn in property prices convey the impression that the UAE economy is faltering. Investor confidence is low and creditors are still knocking on the doors of impecunious companies. In November 2010, financial services firm Dubai Group missed payments on separate loans and a murabaha facility suggesting Dubai's debt troubles are far from over.

But shoots of recovery are evident especially with the level of activity happening within the financial markets, as financial institutions – both conventional and Islamic- seek new opportunities to boost the economy. In November, DIB launched the first Shari'a-compliant REIT, in collaboration with France's Eiffel Management, to lift the country's real estate sector. The REIT will allow DIB to draw in foreign liquidity, thereby reigniting the property market. The REIT will be listed on the NASDAQ Dubai. DIB has also increased its stake in the debilitated property giant Tamweel and has enabled it to re-launch its financing activities after a two year absence.

It is unlikely that property will cease to be an important asset of choice but the last two years have emphasised the need to diversify away from property and to look at other ventures. Acknowledging this, there have been a number of interesting and innovative transactions. The private equity firm TVM Mena, specialising in health care, invested utilising Shari'a structures, into UK based Bourn Hall International. Bourn Hall was the world's first in vitro fertilisation clinic. Its founder was awarded the 2010 Nobel Prize in Medicine for his pioneering work. This investment is only one example of the slow diversification of Islamic finance into broader activities. A more cosmic example of diversification took place in the takaful industry. Al Yah Satellite Communications (Yahsat) secured the first ever space takaful policy. Methaq Takaful is one of the providers of the insurance coverage for Yahsat satellites scheduled to be launched in 2011. Technology, health care and energy are sectors offering lucrative opportunities for structuring Shari'a-compliant products. More focus on these areas will bring innovation and creativity into the industry.

Improvement in time is likely

Parochialism and comfort with property as the asset of choice proved to be a flawed strategy for the UAE. Diversification is integral to the success of any portfolio and Islamic banks have to look into innovative projects going forward. In the UAE, there is a move towards branching out and exploring wider opportunities. To sustain momentum however, they need to also be aware of human resource capacity. Building a broad, talented labour force, with a mix of skills and perspectives can invigorate this industry. Thus, Islamic banks in the UAE are looking to create a talent pool. ADIB has signed several MoUs with universities such as American University in Dubai and Abu Dhabi University in order to increase cooperation in strengthening their recruitment drive. The relationship allows increased networking and the exchange of knowledge, opinions and expertise. Ajman bank launched the "Sheikh Ammar Banking Excellence Program", a UAE wide education program, which offers a select group of graduates to undertake rigorous training and expose them to the mechanisms of a bank. The programme will be a mix of classroom learning and departmental rotations.

These are positive steps which supplement academic qualifications offered by universities and private sector providers such as Ethica Institute. After a turbulent two years, the UAE, and especially Dubai, need to recapture the spark that catapaulted them onto the world stage. This will take time as industry players learn from past mistakes. Equally, Islamic finance in the UAE is going through a rite of passage but has shown an admirable resilience to the tumult.

IFCI ranking: 15

UK

The UK has been leading the way amongst western nations in developing an indigenous Islamic finance market. It has 22 banks including five that are fully Shari'a- compliant, more than any other western country; 20 sukuk issues raising USD 11 billion listed on London Stock Exchange exceeded only by Dubai Nasdaq; seven Shari'a-compliant exchange-traded funds (ETFs); 20 law firms supplying services in Islamic finance; advisory services provided by Big Four professional service firms; institutions offering educational and training services in Islamic finance and an active presence on the London Metal Exchange which dates back to the 1980s. According to the International Financial Services London, UK has USD 19 billion of Islamic assets ranking it 8th among Islamic financial markets in the world.

Yet, all is not well in the country former Prime Minister Gordon Brown hoped would become a gateway to Islamic finance. The recession sapped some of the zest the Labour government had for Islamic finance; and with the new Conservative government at the helm and their accompanying mantra of cuts, more cuts, and even more cuts, there is an uncertainty as to their commitment to Islamic finance.

Public sector leaves; private sector bereaves

An announcement by the government in January 2011 has left practitioners in the industry disconcerted. There was an expectation that the Labour government would issue a sovereign sukuk, thereby stamping their commitment to Islamic finance. It was not to be during Gordon Brown's tenure and seemingly it will not be during the current Prime Minister, David Cameron's residency at no.10 Downing Street. The Treasury revealed that the government will not issue a sovereign sukuk as it was not value for money. It would however 'keep it under review'.

A collective sigh of disappointment was exhaled in the industry; frustrated by the fact that after three years of indicating that a sukuk was imminent, the matter had been so casually pushed aside. It potentially sent negative signals to neighbouring countries like France, who were looking to the UK for guidance. There was an expectation that the UK would lead the Islamic finance markets forward in Europe but it seems the UK has coiled into the corner.

On closer inspection of the Islamic finance market in the UK, maybe this is not surprising. The Islamic finance retail markets have not been as successful as was expected in the halcyon days of 2004, when Islamic Bank of Britain opened its first branch. Lloyds TSB have cut back offerings of Shari'a-compliant mortgages and HSBC Amanah has moved focus away from the UK towards the Middle East and Asia.

More worryingly, injection of GBP 20 million by Qatar International Islamic Bank in September exposed the fragile state of IBB, which had increased its customer base since the start of the recession in 2007, but had failed to attain profitability. Losses are currently at GBP 9.4 million: a sizable sum when considering the bank's low customer base. Figures show that IBB has 50000 customers, mostly Muslim. This is far too low a figure relative to the size of the Muslim population in the UK, which according to Pew Research Center's Forum on Religion & Public Life, is currently at 2.9 million,

Commentators are not at a loss to explain IBB's failure to attract more customers. The U.K. Islamic mortgage market amounts to GBP 500 million, 0.3 percent of total home loans suggesting low demand. Sufficient work has not been done in attracting new customers. The range of products are limited and with eight branches located in predominately Muslim areas, IBB's coverage is relatively narrow as compared to its conventional rivals. Additionally, capital constraints such as the FSA's requirement for banks to increase their capital ratio, have restricted its ability to fund growth. It is also hampered by the weak Islamic interbank market preventing adequate liquidity.

With financial markets faltering due to the recession, both conventional and Islamic, the inevitable downturn has had an adverse effect on an industry still trying to find its feet. Thomas Cook, a leading travel company, was expected to issue a USD 50 million sukuk in July but pulled out due to the weakness of the sukuk markets. A more pertinent example of the effect of the recession on consumer spending is the closing of Principle Insurance, the UK's first independent takaful company authorised by the FSA. Opened in 2008 to a fanfare of optimism, a year later it stopped taking new business due to running out of funds. In April 2010 it sold its subsidiaries, Principle Insurance Company Ltd and Principle Marketing Services Ltd to its largest shareholder, Al Salam. Currently, the only available takaful services in the UK are restricted to HSBC Amanah and Muslim Insurance Services (MIS). The latter has been particularly controversial with many industry players questioning its credentials of being Shari'a-compliant.

It was going all so swimmingly

The previous Labour government stated that they wished to be fair, collaborative and committed to the development of Islamic finance in the UK. Their measured approach to legislative changes has created an unencumbered regulatory environment in which Shari'a-compliant products could compete effectively with their conventional counterparts. A series of legislative changes have been enacted since 2003, which have removed double stamp duty land tax and have recognised the unique features of Shari'a-compliant products. Admittedly, the nomenclature within legislation makes no reference to Arabic terminology, preferring to lump the products into one umbrella group, labelling them 'Alternative Financial Arrangements'; but the desired outcome has been achieved with more regulatory recognition of murabaha, ijara, diminishing musharaka, wakala and sukuks. Government organs such as the Treasury and the FSA were issuing guidance notes on Islamic finance as well as promoting the UK markets and their capacity within Islamic finance at international conferences.

The supportive approach of the government stimulated the industry with the setting up of an Islamic retail bank and four wholesale Islamic banks – Bank of London and the Middle East, European Islamic Investment Bank, European Finance House (who have now adopted their parent company name, Qatar Islamic Bank (QIB)) and Gatehouse Bank. A number of high profiled transactions had also taken place including Kuwait's Investment Dar's acquisition of Aston Martin; and QIB's financing of the Shard of Glass, a commercial property currently being built at the heart of London's financial district.

To supplement the growing market, a number of bespoke Post Graduate Degrees in Islamic finance were offered, a first for a non-Muslim country. Durham and Loughborough were forerunners, offering degrees even before Islamic finance had taken off in the UK.

It is not all bad

Ultimately, the recession-stimulated government apathy has slowed the pace of Islamic finance in the UK. But there is still cause for optimism. In February, Parliament passed the Financial Services and Markets Act 2000 (Regulated Activities)(Amendment) Order 2010, which ensures that alternative finance investment bonds, such as sukuk, are broadly treated in a similar manner to conventional debt securities. The Order provides clarity on regulatory treatment of corporate sukuk, reduces legal costs and removes unnecessary obstacles to their issuance. By September, the UK witnessed the issuance of the first corporate sukuk within its jurisdiction. Issued by International Innovative Technologies Ltd, a milling design company, the musharaka sukuk pays 10% a year and will expire in 2014.

The previous government created a number of internal working groups to advise, appraise and promote UK's Islamic finance capabilities. The Treasury had created the Islamic Finance Experts Group (IFEG) while the UK Trade and Investment (UKTI) had created the Islamic Finance Sub Group (IFSG). In March, these groups effectively merged, to create the UK Islamic Finance Secretariat (UKIFS), the UK's first Islamic finance trade body, whose remit is to 'coordinate and promote alternative finance in the UK' and 'to act as a primary contact point for UK government bodies'. The body will include experts from banks, law firms, accountants and those with extensive experience and knowledge in legislative, fiscal, regulatory and political matters. While the intention is good, there is doubt as to how successful the trade body will be, given government bureaucracy. The UKTI will be funding the UKFIS for one year, after which it will have to survive on its own membership and revenues.

Over the years, establishment stalwarts such as ex-Bank of England Governor, Eddie George, the Lord Mayor of London and of course the previous Prime Minister have lent support to the development of Islamic finance in the UK. In May at the World Islamic Economic Forum, Prince Andrew, the Duke of York, along with UK's Special Representative for International Trade and Investment, commented that London was set to play a major role in the growth and further progress of the Islamic finance sector. Support from establishment representatives lends credibility to a nascent industry such as Islamic finance.

The Scottish government are expressing interest in employing Islamic finance to prop up the local economy. In 2008, Alex Salmond looked to Qatar for investment during the recession; even now Scottish enterprise and Scottish Development international are paying a close interest to Islamic finance. While no definitive move has been made to develop an Islamic finance market, a series of round table discussions and conferences over the last few years have alluded to the possibility that the Scottish government are taking a serious interest. The Scottish law firm Tods Murray LLP and the IBB created and launched an innovative Islamic mortgage model in 2009 to meet Scottish legal requirements while organisations such as the Islamic Finance Council UK (IFCUK) - quoted as being the 'most proactive entity in Islamic finance in the UK' by Arab News - are collaborating closely with the UK government and the private sector to promote and strengthen the global Islamic finance market. In 2008, they partnered with CISI to launch the Shari'a Scholars Continual Professional Development Program. The programme intends to enhance and build upon the Shari'a knowledge of scholars, providing them with knowledge of the financial markets taught by leading practitioners and academics. The programme has branched out to Bahrain and Kuala Lumpur. Scottish Universities such as the University of Glamorgan and the University of Dundee are offering post graduate degrees in Islamic banking and finance; and Islamic accounting and finance, respectively.

Optimism in the private sector

Mixed signals are coming from the four Islamic investment banks. On the one hand, certain banks have suffered losses in the last few years, affected by weak demand: European Islamic Investment Bank (EIIB) has posted end of year losses in March of GBP 22.2 million. On the other hand, over the last few years, all four have been involved in profit generating and occasionally ground breaking transactions.

The Bank of London and the Middle East (BLME) launched a Shari'a-compliant money market fund, the first of its kind to be launched in Europe. BLME also launched its online Shari'a-compliant Premier Deposit Account, the first of its kind in the country. It unveiled BLMEFX, a Shari'a-compliant web-based FX trading platform to provide clients with direct access to multiple currencies for overseas transaction. Through BLMEFX, the bank's corporate and private clients have instant access to a large number of currencies as easily as if they were using a conventional system, thereby making the process much simpler and more cost effective. Qatar Islamic Bank launched its Global Sukuk Plus Fund and formed a strategic partnership with Eden Rock Capital Management to scout for investment opportunities, especially in the small and medium (SME) enterprises in the UK. Gatehouse Bank and DDCAP announced the launch of a fund in early 2010 to invest capital in structured trade finance transactions. DDCAP is a wholesale Islamic market intermediary company. Gatehouse bank has reportedly seen an increase of transactions in the final two quarters of 2010, more than the cumulative number of the transactions in the previous three years. As of November 2010, their aggregate Real Estate portfolio was valued at USD 160 million. These are only a few of the developments within the wholesale banking sector but the four banks are strengthening their infrastructure, acquiring the necessary talent and entering new markets. As these banks have only started in the last few years, this is to be expected but after a fallow period following the global recession, the activity and the infrastructure building indicates progression rather than regression.

As for IBB, they are attempting to build up demand through increasing coverage of their Home Purchase Plan (HPP). They partnered with Legal and General, provider of risk, savings and investment management products in the UK, through their tailored mortgage club. IBB have also partnered with Independent Financial Advisors (IFAs) such as Alliance of Mortgage Packagers and Distributors to capitalise on their network. In December, IBB joined forces with Præmium, the investment management platform provider, to launch what they claim is the UK's only Sharia compliant retail Discretionary Portfolio Service (DPS). Discretionary Portfolio Services offer investors the chance to set up and interact with their investments through their Independent Financial Advisors (IFAs). IFAs can register for free to use the service and promote a wider range of investment options for their clients. IBB believe it will appeal to group pensions and employers with Islamic employees. The product will give investors the chance to set up Shari'a-compliant investments through IFAs.

UK based institutions are also contributing to the development of the global Islamic finance industry. Barclays Capital, the investment banking arm of London-based Barclays Plc, launched Shari'a- compliant repurchase agreements (Repos) in August, to assist liquidity management for Islamic banks and investors. UK Based Standard Chartered Bank, renowned for working within emerging markets, has introduced commodity derivatives in the Middle East and South East Asia as means to develop the risk management capacity within the Islamic finance market. Legal & General Gulf Takaful, a wholly-owned subsidiary of Legal & General Gulf (a joint venture between UK-based Legal & General Group and Ahli United Bank Group), set up in Bahrain in January offering life Takaful products through Ahli United Bank branches in Bahrain.

English law prevails

Undoubtedly, key to the development of the global Islamic finance markets has been English law firms. With most Islamic finance contracts drafted under English law, this should not come as too much of a surprise. Several of the so called Magic and Silver circles have divisions dedicated to Islamic finance which are based in London and Islamic finance hubs such as Dubai and Saudi Arabia. These include Norton Rose and Clifford Chance.

The growth of Islamic finance has led to several court cases being heard in court. Of the few Islamic finance cases that have been heard, a number of principles can be ascertained. Judges have conceded that it is not expected, nor should it be expected, that they should judge the case from a Shari'a standpoint. English law therefore triumphs over Shari'a law and consequently disputes shall be judged according to English legal principles and the facts at hand. Any reference to Shari'a only indicates that the bank will conduct their business following Sharia precepts but this does not elevate it to the governing law of the contract. According to seminal case of Beximco, courts will judge according to the literal meaning of the words within the contract, without having recourse to the Shari'a.

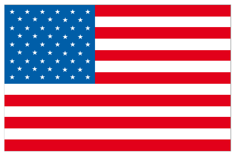
Interestingly, though courts have avoided adjudicating upon Shari'a principles when related to the contract, they seem willing to explore questions of Ultra Vires (i.e. a company working over and above what they have set out to do as according to their Articles of Association) according to the laws of the country in which the company was incorporated. Whilst in litigation cases courts will not delve into Shari'a matters, they countenance arbitrations which have been based on Shari'a law and are willing to uphold the awards, provided parties are not disputing a point on English law or that the arbitration agreement itself (as opposed to the law applied by the arbitration) is not governed by English law.

Educating the interested

Aside from developments within the marketplace, the UK has been leading the line with regards to education initiatives in the western world. There is an overwhelming demand for Islamic finance courses, and several UK universities have offered MSc and PhD programmes, usually with the assistance of international investors from the Middle East and Malaysia, who have set up centres dedicated to Islamic finance. The CEO of Dubai based Surgi Tech Group endowed the El Shaarani Islamic Finance and Business Centre, the first dedicated Islamic finance centre in Europe. It will provide a suite of qualifications on Islamic finance, including undergraduate, postgraduate, PhD and executive programmes and conduct research into Islamic finance and Shari'a-compliant business. Reading University offers an MSc in Islamic Banking and Finance, which is to be jointly taught with the Malaysian based International Centre for Education in Islamic Finance (INCEIF). Cass Business School offers the Executive MBA Dubai which has a component in Islamic finance. The DIFC offers scholarships to students interested in the course. Surrey University has a PhD program largely concentrating on accounting and auditing issues in Islamic finance and in 2010). In September, the University of Bedfordshire offered two new courses: The MSc in Islamic Banking and Finance and the LLM in Islamic Commercial Law.

Upwards and onwards

So whilst there has been a growing chorus of discontent about the Islamic finance market in the UK, things are not as bleak as sometimes assumed. The UK regulatory system has been congenial to the growth of Islamic finance and the government have in the past shown a great deal of support. By not issuing a sovereign sukuk, this undoubtedly reflected a weakening of resolve, but this can be strengthened provided the private sector stimulates critical growth. In many respects, the groundwork has been set up and it has committed IFIs to capitalise on opportunities. Too much reliance on the government will be counterproductive. They have done their bit; it's now up to private institutions to theirs.



IFCI ranking: 18

USA

These are strange times for the United States of America. Riding on the wave of optimism with slogans of change, the Obama administration has stuttered and staggered over the course of the last two years, finding their hands increasingly tied by the legacy of their predecessors. The deficit remains unmanageable; the economy is convulsing painfully; reforming the healthcare system has proved difficult and filibustering remains endemic in the corridors of power. Iraq and Afghanistan still rages on, Guantanamo is still open and peace in the Middle East is still about as elusive as garnering the support of an increasingly belligerent Right. Change is not as easy as the rose tinted, wide eyed, Obama enthusiasts had hoped for.

To change a point of view and a culture requires time and support with small steps leading forward. As the Irish Catholics, the Jews, the Italians and more controversially, the Afro-Americans, can attest minorities in America face a long and turbulent path to achieving assimilation. However, Muslim migrants have generally endured a painless transition into American society and have enjoyed relative success. But post 9/11, there has been a growing undercurrent of suspicion about all things Islamic, which has had an effect on the growth of Islamic finance in the USA. The prospect of Islamic finance making significant inroads into the US financial markets has by and large been curtailed.

Shari'a in the USA

The 2007 Pew Research Center survey on Muslims in America entitled 'Muslim Americans: Middle Class and Mainstream' revealed an integrated Muslim community. The community were generally educated to a high level and enjoyed a good standard of living. The survey concluded that Muslims were identified themselves as both Muslim and American They did not see a conflict between the value systems of the two. However, over 50% of Muslim Americans say that since 9/11 it has become difficult to be a Muslim in the United States. This point of view was especially prevalent in the wealthier segments of the Muslim community. The report did not delve into underlying reasons but anecdotal evidence provides sufficient evidence: the most ostensible being protests against the transformation of an old coat factory near the site of the Ground Zero into a mosque. Irascible protests erupted, conveying a worrying invective in which protestors conflated terrorism with the establishment of the mosque.

The Center for Security Policy, a US think-tank, issued a report in September titled "Shariah: The Threat to America", which said that practices promoting Shari'a were "incompatible with the constitution" and should be "proscribed." The report contains an appendix focusing on Islamic finance, referring to it as a 'stealthy jihadist practice'. The report was endorsed by some Republicans including former Speaker of the House of Representatives, Newt Gingrich, who has been calling for a federal law to ensure Shari'a, and by extension Islamic finance, is not recognised by any US court.

The move is extreme but it highlights the sensitivities that surround Islam in the USA; something the government and the US regulatory authorities has to be circumspect about. Too committed an approach, resulting in legislative changes to accommodate the peculiarities of Islamic finance products, is likely to lead to an impassioned outcry.

Far from suggesting that the government has not taken an interest in Islamic finance, it has maintained a measured approach to Islamic finance. A significant and lasting step undertaken by the government in Islamic finance occurred in the 1997, when the Bank of Kuwait requested interpretive letters from the Office of Comptroller of the Currency (OCC) on the ijara mode of house financing. This was followed by a second request by the bank on murabaha house financing in 1999. Both products, viewed by the OCC, were legislatively recognised and permitted for banks to offer because the structure of the products was economically identical to its conventional counterparts. In 2002, the Treasury held an in house session on Islamic finance in order to raise awareness amongst the state department officials. In 2004, the Chair of the Islamic Economics, Finance and Management at Rice University, Mahmud El Gamal was appointed as scholar in residence to advise on Islamic finance. In November 2008 the Treasury convened another training session on Islamic finance to familiarise officials with what the Treasury termed "an increasingly important part of the global financial industry".

Look to the private sector

Islamic finance's 'importance' has been widely accepted by US financial institutions who have transacted with Shari'a-compliant products, though most of the investments and deals have occurred outside of the USA, mainly in the Middle East. As the economic recovery continues, the Middle East offers investors a lucrative market. Wall Street lynchpins such as Citigroup and JP Morgan Chase have Islamic banking divisions while other multinational banks including Goldman Sachs and Merrill Lynch have worked upon Islamic financing transactions. Citigroup arranged the USD 500 million GE capital sukuk in 2009.

AIG's recent court appearance, mentioned earlier in this report, owes this dubious honour to their takaful division set up in 2006 in Bahrain. The insurance component of AIG is now known as Chartis with takaful remaining an important part of their product portfolio. In the UAE, Dubai Islamic Insurance and Reinsurance Company (Aman) and American Life Insurance Company (ALICO) reached an agreement in May, under which Aman will offer Alico's Shari'a-compliant products to its customers in the UAE.

Islamic mutual funds in the US are looking to diversify into emerging markets and have earmarked Malaysia as offering significant growth opportunities. Saturna Capital is the most prominent. Since 2005, it has won eight Islamic investment awards from Failaka Investors in Dubai. The company looks after USD 3 billion in assets via Amana Mutual Funds Trust, which includes Amana Growth Fund, Amana Income Fund and Amana Developing World Fund. Amana Income fund and Amana Growth fund are two of the largest Islamic equity funds in the world. It started the Amana Developing World Fund in the U.S. in September to invest in global emerging-market Islamic assets. The company bought Malaysia's Alpha Asset Management in March and changed its name to Saturna Sdn.

Thus, the private sector has and continues to play a meaningful role in the global Islamic finance markets. Multilateral organisations such as the World Bank and IMF have recognised the importance of Islamic finance to the development of the global financial markets. The International Financial Corporation, a World Bank Group member focusing on private sector development, opened its Islamic finance working group in 2008 to conduct research and formulate an Islamic finance strategy. Consequently, in 2009, it listed the IFC Hilal sukuk on the Dubai and Bahrain stock exchanges. The USD 100 million denominated sukuk was intended to raise funds for infrastructure projects in Yemen and Egypt.

The domestic market

Broadly speaking, the Islamic finance industry within the US has remained focused on retail and fund management, two segments from which Islamic finance started from. The story of Islamic finance at the community level begins in the 80s with the establishment of Amana Funds, a mutual fund company in Bellingham, Washington and LARIBA in Pasadena, California. Both institutions remained small until the 2000s, after which they have grown remarkably.

A pivotal event for the Islamic retail markets, and more specifically home financing, occurred in 2001 with LARIBA partnering with the Federal Home Loan Mortgage Corporation (better known as Freddie Mac) to offer mortgages. It provided a huge source of liquidity for home financing transactions and enabled LARIBA to become the only IFI to offer riba free mortgage securities. From virtually nothing in 2000, it is estimated that Islamic home loans will reach USD 5 billion by the end of 2010. A secondary development has been increasing efficiency, as customers do not have to wait several years to obtain financing due to a lack of capital, which had been the case prior to the entrance of Freddie Mac (and to a lesser extent Freddie Mae).

HSBC Amanah, offered Islamic home finance products in New York State in 2002. In their first year of operating, they financed home purchases worth USD 20 million. However, they left the Islamic finance market in the US in 2006 citing insufficient demand. Citigroup has also curtailed their Islamic finance retail provision and are moving towards corporate transactions. This has left grassroots organisations to fill the void. Currently, there are four main institutions that offer Islamic finance retail products namely LARIBA, Guidance Residential, Devon Bank and University Islamic finance corporation. The LARIBA system consists of a finance company and a national bank, Bank of Whittier. It serves all 50 states and has USD 400 million worth of assets. Devon Bank is a conventional bank with an Islamic finance window offering home and commercial financing while University Islamic Finance Corporation is a fully owned subsidiary of the Michigan based University Bank. Along with home and commercial financing, it also offers deposit products. The subsidiary was opened in 2005 and was the first of its kind in the USA Guidance Financial is a home finance provider and according to the company, have provided USD 1.9 billion in Shari'a-compliant financing to more than 6,000 Islamic households since the company was started.

Domestic Islamic finance activity has mostly been in areas with a high percentage of Muslims. North Jersey has been particularly dynamic in this market due to the larger proportion of Muslims that reside there. North Jersey Federal Credit Union (NJFCU) opened an Islamic banking division in June. It claims to be the first credit union in the nation to offer Shari'a-compliant mortgages in order to serve low income families. The mortgage loans are offered through Guidance Residential who also acts as the underwriter. NJFCU also offers Shari'a-compliant mutual funds and deposit accounts.

There has also been an increase in the number of smaller Islamic home finance companies that operate in different areas, targeting specific cultural groups. One provider that has grown rapidly since its founding in 2003 is the African Development Centre in Minneapolis. The Centre supports American Muslim immigrants, mostly Somalians, through offering a number of retail products including mortgages. The African Development Center, with support from the state's housing agency, offers Islamic mortgages to low income families. In May, the ADC partnered with the Minneapolis City Administration to provide Islamic financing through an alternative finance program to Muslim business owners. Unfortunately, as Islamic finance still remains a small, niche industry serving the needs of the Muslims, it has the potential to be exploited. In Chicago, a local investment scheme defrauded hundreds of Muslim investors out of USD 30 million fraudulently misrepresenting the products as being Shari'a-compliant. In court it was revealed the scheme was a ponzi scheme which affected more than 300 investors. Intriguingly the majority shareholder was a member of the Shari'a board of America, a group of Islamic clerics that advises Muslim investors and certified that Sunrise Equities was Shari'a-compliant. Tighter regulation is required along with better education and information.

Behind closed doors

The history of Islamic finance will lay testament to the monumental role played by the Dow Jones Islamic Market Index created in 1998. It revolutionised the asset and wealth management sections of Islamic finance, making it easier for funds to invest and paving the way for the formation of other indexes. An honourable mention will be given to the Harvard Islamic Finance Project, founded in 1995, for its work on the legal aspects of Islamic finance. Yearly symposiums brining in esteemed figures from the Islamic finance world has granted this initiative prestige and prominence and platform to discuss the issues assailing Islamic finance. One such issue was creating derivative like products which are Shari'a-compliant. This has been partly resolved with the collaboration between New York International Swaps and Derivatives Association (ISDA) and Bahrain's International Islamic Financial Market (IIFC) to develop the Tahawwut hedging master agreement. This standardised agreement allows trade of Shari'a-compliant derivatives.

So while the Shari'a may evoke apprehension, suspicion and prejudice amongst certain groups, Islamic finance has been recognised by major multinational US financiers as a respectable and profitable form of conducting business. Some people may be aghast at such a statement, unable to see beyond a brutal and primeval version of Islam, but as the Muslim population grows and the private sector continues their involvement in Islamic finance, a change of opinion will surely come.

IFCI ranking: 19

YEMEN

Yemen is a country steeped in tradition. It has one of the oldest civilizations and is home to a rich culture. The people of Yemen have been mentioned in numerous sayings of the Prophet Muhammad, and they are also known for their kindness. Sadly, the country has relatively high levels of poverty and unemployment. This has led to many of the Yemeni population being disenfranchised, causing tension between the north and south of Yemen as well as battles with Al Qaeda and the occasional Shi'a uprising. More recently there have been demonstrations in Yemen calling for the ousting of the President, caused by the sweeping wave of protests currently being experienced elsewhere in the Arab world.

An industry that exhales

Yemen has 17 banks, including four Islamic banks, Saba Islamic Bank, Tadhamon International Islamic Bank and Islamic Bank of Yemen for Finance and Investment, according to central bank data. Shamil Bank of Yemen and Bahrain is a subsidiary of Bahrain's Shamil Bank, and provides Shari'a- compliant products. There is also one insurance company: Yemen Islamic Insurance Company. The four banks accounted for 31% of the total assets held in the Yemeni banking sector in 2008 as well as 27% of the deposits and 40% of total financial facilities. There are approximately 44 Islamic financial branches distributed across the various governates in Yemen. The focus of most Yemeni banks has been the domestic markets. To a large extent, this focus has insulated the financial system from the ravages of the global recession. Tadhamon International Islamic bank has a far more international exposure particularly in markets such as the UAE and Saudi Arabia. It set up a branch in Indonesia in 2009. However, the greater coverage has produced a downward pressure on asset quality, compounded by the general economic turmoil within Yemen, resulting in an increase of non performing finance. However, the bank has coped remarkably well, increasing liquidity through a rise in unrestricted investment and saving accounts. It is currently the biggest Islamic bank in Yemen.

Tadhamon set up Tadhamon Capital in Bahrain, gaining a licence from the Central Bank in 2009. Tadhamon Capital is the first investment company in Bahrain to be fully owned by Yemeni shareholders. The Company aims to structure, launch and manage new investments and products across its main business lines which include asset management, private equity, real estate, treasury and wealth management.

Besides the four commercial Islamic banks, Yemen is home to the first micro finance bank to offer only Shari'a-compliant products in the Arab world. Al Amal microfinance bank has captured an estimated 25% of the Yemeni microfinance market even though it has been in existence for a relatively short period of time. The bank was recently awarded USD 104000 for winning the Islamic microfinance challenge 2010, which was jointly sponsored by CGAP, Deutsche Bank, Grameen-Jameel Pan Arab microfinance and the IDB.

There have however been criticisms that Islamic banks have not done enough to support development and alleviate the socioeconomic problems that are endemic to Yemen. Small businesses have expressed difficulty in accessing loans due to tough and inaccessible regulations. The banks counter that central bank regulations are exculpatory for this as they draft stringent regulations which are required to be followed. Accusations of nepotism have been levelled against Islamic banks. The four banks are family owned business which affects loan approval and precludes disbursement of funds to more efficient projects.

Balancing the budget

In 2009, an IMF study on Yemen concluded that the environment was conducive to the issuing of Islamic instruments. In March 2010, participants at a conference entitled "Yemeni Islamic Banks: Reality and Future Prospects" discussed the need to develop a regulatory infrastructure for the promulgation of Islamic finance industry in Yemen. Recommendations included a national Shari'a board, and the establishment of a payment fund to address liquidity needs of banks. Participants also suggested harmonising standards for the issuance of Islamic instruments because of the benefit to community development.

An Islamic finance industry in Yemen would be a means to tackle the growing economic problems within Yemen and tap into the excess liquidity. This is imperative for Yemen who has the largest budget deficit in the Arabian Peninsula, one that the government have made a priority to tackle. The government plan to fund the gap through domestic borrowing, utilising conventional bonds, sukuk and international loans.

Subsequently in February 2011, the first sukuk was issued in the country in February this year. The sukuk was issued by the central bank of Yemen which was the first part of a one year program aiming to issue sukuk worth YR 100 billion by the end of the year. Asides to contributing to the deficit, sukuk proceeds will be used to fund oil and road projects within the nation. A recurring problem is the weak infrastructure that plagues the country and more funding is required for public infrastructural projects. In addition to the sukuk, and the other forms of government spending, the IDB have been active investors.

In 2009, it was reported that IDB had provided USD 700 million to Yemen. Over the years, IDB have contributed to a number of development initiatives from improving literacy to enhancing the private sector. In November, the cabinet approved of a USD 12.5 million loan from the IDB to support rural development opportunities. The project hopes to increase the income of the impoverished men and women who work within the agricultural sector. The Islamic Corporation for the Development of the Private Sector (ICD) signed a MoU in May 2010 to promote and develop industrial and economic zones in the country.

Pesky politics

Yemen's economic woes are compounded by domestic tension and militancy. Aside from the recent protests against the incumbent government, the US has been pressuring Yemen to crack down on Al- Qaeda operatives in the country. In addition, there is a north – south divide and occasional unrest from the minority Shi'a population. Cumulatively, this serves to weaken the economic potential of the country, with investors expressing anxiety.

Whilst there is no doubt that the Islamic finance industry in Yemen is making headway and contributing to the Yemeni society, the fact of the matter is that due to the instability, corruption and economic woes that are currently inherent in Yemen, there is still a long way to go before Islamic finance can make a significant impact.