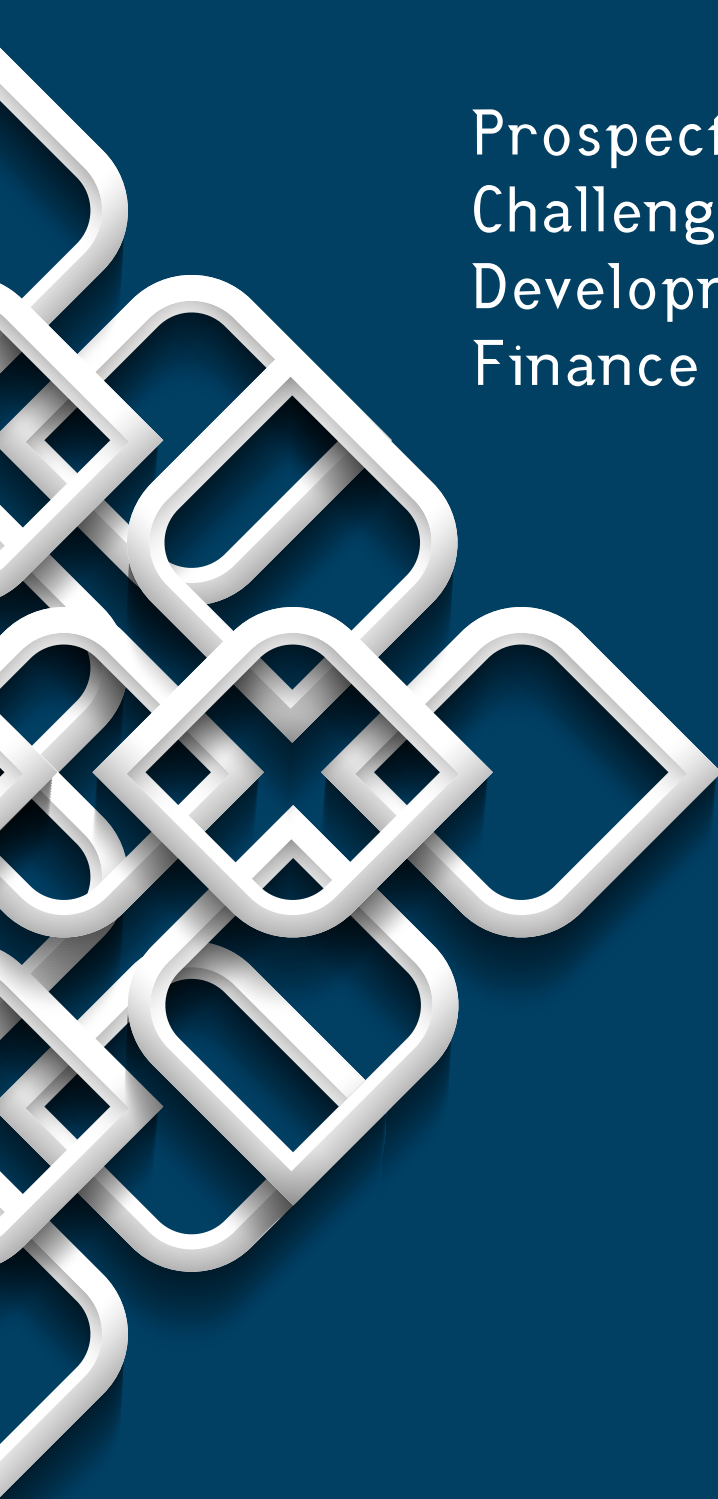


Prospects and Challenges in the Development of Islamic Finance for Bangladesh



ISLAMIC FINANCIAL SERVICES BOARD

PROSPECTS AND CHALLENGES IN THE DEVELOPMENT OF ISLAMIC FINANCE FOR BANGLADESH

The views expressed in this publication are those of the author(s) and not necessarily the views of the Islamic Financial Services Board.

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ABOUT THE ISLAMIC FINANCIAL SERVICES BOARD (IFSB)

The IFSB is an international standard-setting organisation which was officially inaugurated on 3 November 2002 and started operations on 10 March 2003. The organisation promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets, and insurance sectors. The standards prepared by the IFSB follow a lengthy due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which involve, among others, the issuance of exposure drafts, holding of workshops and where necessary, public hearings. The IFSB also conducts research and coordinates initiatives on industry-related issues, as well as organises roundtables, seminars, and conferences for regulators and industry stakeholders. Towards this end, the IFSB works closely with relevant international, regional, and national organisations, research/educational institutions, and market players.

For more information about the IFSB, please visit **www.ifsb.org**.

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SECRETARY - GENERAL'S FOREWORD

The rapid growth of Islamic finance during the last decade has drawn the increasing attention of national policy makers as well as of international institutions. At one level, there is growing recognition of the contribution that Islamic finance can make to the goals of economic and social development. At another level, the expanding size of the sector underscores the importance of a strong public policy stance to ensure that legal and regulatory frameworks are adequate to ensuring orderly growth and resilience. These two broad sets of issues have direct relevance to Bangladesh, which has a large and growing Islamic finance industry.

Islamic finance is an increasingly important means for the financing of physical and social infrastructure that supports economic development and job creation in an expanding group of emerging economies. Countries are seeing the increasing use of Islamic financial instruments to finance long-tenor public infrastructure investments using a variety of *Shari'ah*-compliant structures. These investments, and the use of *Sukūk* to finance them, now span a wide range of social and physical infrastructure and are becoming increasingly important to driving growth in both Asia and the Gulf Cooperation Council countries (GCC). These investments have been made possible by the development of Islamic capital markets, most notably in Southeast Asia and in the Middle East.

Similarly, Islamic finance is an instrument for reaching out to under-served segments of society, which include the poor as well as vulnerable non-poor, amongst whom are very significant numbers of people who have voluntarily limited their access to an interest-based financial system. With the strengthening of regulatory and public expenditure frameworks, an increasing number of countries are integrating Islamic finance into public spending and public financing decisions through issuance of sovereign Islamic securities that further helps to provide a benchmark for corporate Islamic securities. The countries where this is happening are those which have made a long-term commitment to developing a broad-based Islamic financial system, including of Islamic banks.

Islamic finance has proven to be resilient during the Global Financial Crisis. However, Islamic finance is not immune to change and countries that promote Islamic finance are visibly at different stages of economic, market and institutional developments. Reflecting these differences, these countries are also at different phases of regulatory development for Islamic finance. Despite these differences however, there is a common set of issues that each jurisdiction faces, and there is an international dialogue on good practices. Unity in principle, and diversity in practice, would be a good characterisation of the approaches to the regulation and supervision of Islamic finance.

There are in general four common issues that policy makers face in Islamic finance. The first is the legal framework. While some countries have opted to have separate laws for Islamic finance, and others have chosen to amend existing laws, clarity and transparency in the legal framework are vital to ensure a level playing field amongst financial institutions and to foster consumer confidence. The second is on regulation

and supervision for an environment where both conventional and Islamic finance co-exist. This task is complex, and is facilitated by an early recognition of the need to plan for, and develop, instruments for liquidity management and monetary policy control. The third is on the appropriate choice of distribution channel for Islamic financial products to reach consumers. Finally, there is the structure of *Sharī'ah* governance which also needs to be explicitly addressed, whether in a framework that emphasises centralisation, or in a more decentralised form. These are live issues today across jurisdictions and continents. Countries that have progressed furthest in terms of an orderly development of Islamic finance are those that have put in place roadmaps which recognize that time is needed to develop the legal framework, and to build broad-based capabilities. These countries begin by addressing these aspects first, while permitting financial institutions to provide a closely monitored set of products in the interim.

In almost all jurisdictions, there is the recognition that building risk management capabilities within financial institutions, and within the central bank at the economy-wide level, require a set of explicit priorities over the medium-term for the development of *Sharī'ah*-compliant markets and instruments. The most successful countries in terms of orderly development of Islamic finance are the ones which have prioritised the building of knowledge and capabilities within the central bank. Suffice to say that in Islamic finance there is no one size fits all, but there is greater appreciation today of differences, and their basis. There is also convergence through harmonisation and mutual recognition on an expanding range of issues. Cross-fertilisation is taking place as countries adapt and learn from their own experiences, and from the experiences of others.

The rapid growth of Islamic finance is contributing to the deepening and widening of the global financing system through the use of innovative, *Sharī'ah*-compliant, contractual forms that are introducing new financial instruments and a new and vibrant segment to the global financial system. In supporting the growth of the industry, a collaborative effort between the supervisory authority, policy-makers and market players is the key to maintaining the balance between strong regulation and the market's ability to grow. Priority must be given to the creation of an enabling financial infrastructure consisting of common international standards for supervision and regulation, as well as for transparency and disclosure. This will facilitate not only continuous development of a sound, resilient and stable Islamic financial services industry, but also one that promotes innovation and growth.

In line with the mandate of the IFSB to promote the development of the Islamic financial services industry in and among its member countries, this publication aims to share the prospects and challenges, initiatives and experiences, in developing Islamic finance, with specific focus on the Bangladesh experience. The chapter contributors have kindly shared their views and experiences, initially at a Seminar organised by the IFSB and hosted by Bangladesh Bank in Dhaka in September 2013, and the key ideas and discussions in the Seminar are now documented in this publication.

The publication has benefitted from the review of Professor Volker Nienhaus, and a team at the IFSB Secretariat, headed by Assistant Secretary-General, Zahid ur Rehman Khokher, and Members of the Secretariat, Kartina Md Ariffin, Siham Ismail and Rosmawatie Abd Halim. The latter two have been instrumental in the editing, designing and printing of the publication.

I would also like to thank the Asian Development Bank (ADB) for their support for the IFSB's initiatives in Bangladesh, and other common member countries, as specified in the ADB Technical Assistance to the IFSB in 2013.

Jaseem Ahmed

May 2014

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Chapter 1

INTRODUCTION

Professor Dr. Volker Nienhaus

Bangladesh has a long history in Islamic finance. The first Islamic bank – Islami Bank Bangladesh Limited (IBBL) – was established in 1983. Since then, Islamic finance has shown continuous strong growth, not only in terms of deposits and assets, but also in market share. Today, the central bank oversees seven stand-alone Islamic banks and 16 conventional banks with Islamic banking branches.

Two aspects of the Bangladesh economy are worthy of note. First, it has experienced sustained growth over the past decade in general, and in recent years in particular.¹ Especially noteworthy is the improvement in human development indicators.

- In spite of numerous external economic shocks and natural disasters, the real economy of Bangladesh has grown each year since FY1995 (July to June) by at least 4.4%. However, the annual growth rate has been 6% or above in all but one of the last ten fiscal years (with an increasing long-term trend).
- The robust economic growth combined with a reduction in population growth (from approximately 1.4% in 2000 to approximately 1.2% in 2012) has increased real gross domestic product (GDP) per capita and significantly reduced poverty. The share of the population living below the upper poverty line decreased from 52% to 35%, and the absolute number of people in poverty fell from 61.6 million in 2000 to 44.8 million in 2010. The current gross national income (GNI) per capita of around USD900 is approaching the middle-income threshold of USD1025.
- The sectoral diversification of the economy has progressed. Agriculture accounts for 19.3% of GDP, industry for 31.3% and services for 49.5%. The largest sub-sectors are manufacturing (19.0% of GDP), wholesale and retail trade (14.3%), transport, storage and communication (10.7%), and crops and horticulture (10.7%). The share of financial institutions is only 2.1%.
- Bangladesh's exports are dominated by ready-made garments (over 75%). This one-sided export structure is a concern – in particular, after several serious accidents and labour issues in the recent past.
- Macroeconomic management has been successful in recent years in stabilising the ratio of government debt to GDP at around 37%, containing inflation at around 8%, and stabilising the real effective exchange rate over the medium term in spite of external pressures.

¹ The figures quoted in the following bullet points are excerpted from the presentation "Bangladesh: Economic Challenges, Policies & Prospects, June 2013" by Hassan Zaman, chief economist of Bangladesh Bank and Annual Reports of Bangladesh Bank.

The second remarkable fact about Bangladesh's economy is the strong market position of Islamic banking in the country's private banking sector.

Table 1.1: Structure of the Banking System of Bangladesh (December 2012)

Bank types	Number of banks	Number of branches	Total assets (billion Taka)	Percentage of assets (%)
State-owned commercial banks (SCBs)	4	3478	1831.9	26.0
State-owned development financial institutions (DFIs)	4	1440	385.5	5.5
Private commercial banks (PCBs)	30	3339	4371.5	62.2
- of which only conventional	10			
- of which only Islamic	7			
- of which Islamic and conventional	13			
Foreign commercial banks (FCBs)	9	65	441.8	6.3
- of which only conventional	6			
- of which Islamic and conventional	3			
Total	47	8322	7030.7	100.0

Source: Bangladesh Bank, Annual Report 2012-2013, table 5.1 and p. 27.

Private commercial banks and foreign commercial banks hold 68.5% of the total banking assets. Two-thirds of the domestic private commercial banks (20 of 30) and one-third of the foreign commercial banks (3 of 9) offer Islamic financial services, either as stand-alone Islamic banks or as conventional banks in Islamic branches. Currently, no state-owned scheduled bank offers Islamic financial services.

Bangladesh Bank has calculated the market share of Islamic banks and branches as 18.9% of the deposits of the country's total banking system and 21.1% of total credit (Annual Report 2013 Bangladesh Bank, p. 37). If the deposits and assets of the state-owned banks are excluded from the calculation (roughly one-third of total deposits and assets), it is evident that Islamic banks have achieved an even more impressive penetration of the private banking sector.

A market share of 18–20% is above the global average, and on the same level as Malaysia and not much behind the United Arab Emirates (UAE) and Qatar. Only Kuwait and Saudi Arabia have much higher market shares (and Iran and Sudan, where the entire financial system has been Islamised so that Islamic banks have, by definition, a market share of 100%).

Bangladesh is one of those countries where Islamic finance markets have systemic significance. The Islamic Financial Services Board (IFSB) has assigned the top category of “systemic importance” (with a market share of Islamic banks of at least

15% of total banking sector assets) to the Islamic banking industry in Kuwait, Saudi Arabia, the UAE, Bangladesh and Malaysia.² The classification follows the “Indicator-Based Measurement Approach” of the Basel Committee on Banking Supervision (BCBS). According to the BCBS/IFSB criteria, one could even think of Bangladesh as one of the very few Muslim countries (if not the only one) where one Islamic bank – namely, the oldest and by far the largest Islamic bank with a share of roughly 50% of the Islamic market (IBBL, see also Chapter 6) – could be classified as a “domestic systemically important bank” (D-SIB).³ To determine whether a bank is systemically important, the regulators assess the impact of its failure on the domestic economy, taking into consideration the size of the bank, its interconnectedness, substitutability and complexity.

The larger policy issue in Bangladesh is the adequacy and scope of the legal and regulatory framework in providing an appropriate enabling environment for Islamic finance. The growth of Islamic finance in Bangladesh was driven for decades by a vigorous demand of the private sector without sustained and comprehensive support from the public sector. This is reflected in the absence of a specific legal and regulatory environment for Islamic finance. For about 25 years, Islamic finance has flourished in a conventional regulatory regime with only marginal adjustments to allow for its peculiarities. This is in a stark contrast to Malaysia, where Islamic finance started in the same year as in Bangladesh and has reached a similar market share, but with arguably the most elaborate legal, tax and regulatory system tailored to the needs of Islamic finance. This policy backdrop in Bangladesh is now undergoing change, initiated by Bangladesh Bank and coordinated with the policy authorities, and a vigorous agenda has emerged involving not only changes to the legal framework but also formal measures including the development of liquidity management capabilities.

In July 2009, the Bangladesh Bank (the central bank of Bangladesh) issued instructions for the identification of risks relating to financing and investment contracts made by Islamic banks for capital adequacy purposes. This circular provided guidelines based on IFSB-2 (Capital Adequacy Standard for IIFS). Then, in November 2009, Bangladesh Bank issued its “Guidelines for Conducting Islamic Banking”. The Guidelines supplement the existing banking laws, rules and regulations and cover the following topics:

- the licensing of full-fledged Islamic banks and Islamic banking branches of conventional banks, and the conversion of a conventional bank into an Islamic bank;
- principles of *Shari’ah*-compliant deposits (*Waḍr’ah*-based current accounts and *Muḍārabah*-based savings, short notice and term deposits);
- investment principles and products (*Murābahah*, *Istiṣnā’*, *Ijārah*, etc.) in general and for imports and exports in particular;

.....} ² See IFSB (2013), Islamic Financial Services Industry Stability Report 2013 (Kuala Lumpur: IFSB), p. 9.

³ See Basel Committee on Banking Supervision (2012), A Framework for Dealing with Domestic Systemically Important Banks (Basel: Bank for International Settlements [BIS]); and IFSB (2013a), Revised Capital Adequacy Standard for IIFS [IFSB-15] (Kuala Lumpur: IFSB), Chapter 2.

- the maintenance of the cash reserve ratio (CSR) and statutory liquidity ratio (SLR) as prescribed by Bangladesh Bank;
- fit and proper criteria for members of the *Sharī'ah* board of an Islamic bank ("*Sharī'ah* Supervisory Committee");
- guidelines for accounting and reporting; and
- a standard framework for calculating the rate of return for profit-sharing deposits.

The Guidelines were an important step forward, but they do not address every issue and remain somewhat ambiguous in some cases. For example, they do not provide a comprehensive *Sharī'ah* governance framework, and they refer to the International Financial Reporting Standards (IFRS) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) for accounting and reporting but do not determine the priority in cases of conflicting principles. This may result in financial statements which are not fully comparable between banks that chose different priorities. On the other hand, the "fit and proper" criteria were criticised as being too "precise" and demanding, leading to a very limited pool of candidates qualified for *Sharī'ah* board positions.

The Guidelines were the beginning, not the end, of a process of legal, regulatory and policy reforms that may end in an Islamic banking Act and a more supportive environment for Islamic finance. For example:

- Bangladesh Bank launched the "Islami Interbank Fund Market" (IIFM) to enhance the liquidity management tools of Islamic banks (2011).
- The government considered the issuance of *Sukūk* for infrastructure financing (2013).
- The parliament debated an amendment to the Banking Companies Act 1991 in order to terminate the provision of Islamic banking services through conventional banks (2013). This amendment will inhibit the misuse and misappropriation of funds, and ensure the full *Sharī'ah* compliance of the Islamic banking sector, thus creating a more secure banking environment.
- The Bangladesh Bank launched a refinancing fund for the small and medium enterprises (SME) sector that provides funding for businesses in the rural areas through the intermediation of Islamic banks (October 2013).

Bangladesh also has a sizeable *Takāful* industry, with a market share of 26.0% of first-year premiums in the life and 4.6% of gross premiums in the non-life business lines for 2011/2012.⁴ By the end of 2012, 62 insurers were operating in Bangladesh, and 11

.....↓
⁴ For this paragraph and all figures on *Takāful*, see Kazi Md Mortuza Ali, "*Takāful* in Bangladesh – Seeking a Framework for Growth", www.meinsurancereview.com, December 2013, pp. 47–49.

more were allowed in 2013. Out of these 73 insurers, five are in family *Takāful* and three in general *Takāful*. In addition, 12 conventional life insurers operate Islamic windows. The total premiums of family *Takāful* have been nearly stagnant since 2009, while they are still growing in general *Takāful*. The premiums of family *Takāful* amounted to roughly ten times the premiums of general *Takāful* in 2012. Although the market share eroded from peaks of 33% and 5.2% in 2009/2010, the market penetration of family *Takāful* is still significantly above that in most other jurisdictions. This is remarkable, because *Takāful* has grown and is actually struggling in a non-conductive regulatory environment. For instance, there are no specific *Takāful* regulations in place; and the *Takāful* operators are regulated by the Insurance Act 2010, which does not pay sufficient attention to the specificities of Islamic insurance. Technical deficiencies and conflicts with *Sharī'ah* principles could be overcome by a specific *Takāful* Act. The Insurance Development and Regulatory Authority (IDRA) circulated draft *Takāful* rules in October 2013 which address, in particular, the operational models of *Takāful* operators (which should be a combined *Wakālah/Muḍārabah* model) and the segregation of funds in *Takāful* undertakings (into a Participants' *Takāful* Fund, a Shareholders' Fund and a Participants' Investment Fund in family *Takāful*), surplus sharing, solvency margin requirements, and the formation of a *Sharī'ah* Council and its approval by the regulator. While the draft rules could reduce anomalies for the *Takāful* industry that result from the Insurance Act 2010, other problems, such as the lack of attractive investment opportunities for family *Takāful* or the scarcity of qualified human resources, will persist. Islamic finance is demand-driven in Bangladesh, and a consistent and reliable regulatory framework would help to unleash the potential of Islamic finance and to create a thriving and more innovative industry.

In the aftermath of the global financial crisis the government and the central bank of Bangladesh have actively supported Islamic finance. The growing awareness of the systemic importance of Islamic banking and insurance has prepared the ground for the work of upgrading the existing Islamic banking guidelines and designing a more comprehensive and consistent legal and regulatory framework for the Islamic financial services industry in Bangladesh. The aim of the contributions in this volume is to support the analysts and decision-makers who are engaged in this process by providing insights into global trends and best-practice examples in other countries and outlining some contours of a roadmap for the further development of the Islamic finance industry in Bangladesh.

Chapter 2

GLOBAL OVERVIEW: ISSUES, CHALLENGES AND OPPORTUNITIES

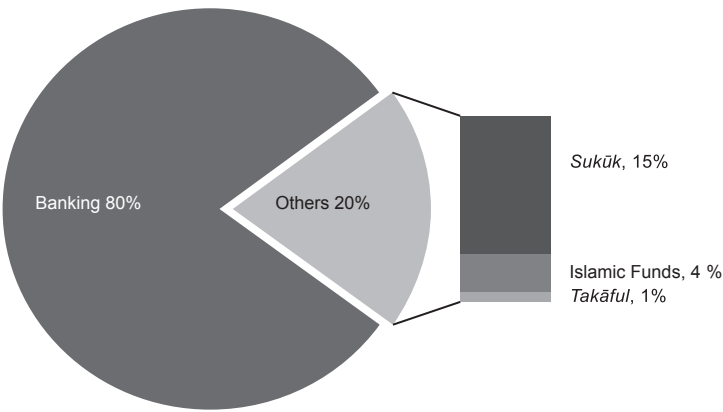
Baljeet Kaur

In its modern re-emergence, the global Islamic finance industry has entered into its fifth decade of existence. The industry is now viewed as an increasingly important financial development that is gradually making headway into mainstream finance. Though it constitutes only 1% of the total global financial assets, its growth during the past decade has been sustained. In 2005, the industry was worth approximately USD700 billion, but as at year-end 2012 its value had doubled to USD1.6 trillion. By 2020, total Islamic financial assets are expected to have a value of USD6.5 trillion at an estimated compounded annual growth rate (CAGR) of 19.15% during 2012–2020.

Strong growth

The Islamic banking sector has been the main driving force of the global Islamic financial services industry, with an estimated asset size of USD1.32 trillion as at the first half of 2013, representing 80% of the total global Islamic finance assets. Islamic banking assets have grown at a CAGR of 20.4% between 2007 and 2013. Alongside Islamic banking, Islamic capital markets have also developed significantly over the past decade in terms of their sophistication and size. The growth of Islamic capital markets is vital in facilitating better financial intermediation of the overall Islamic finance industry. The *Sukūk* market has become the second-largest asset class within the Islamic finance system, as corporations and public enterprises around the world are starting to diversify into alternative funding sources through Islamic financial instruments. The *Sukūk* sector is estimated to represent more than 15% of the global Islamic financial assets, and global *Sukūk* outstanding rose to USD270.1 billion as at year-end 2013, a 17.8% y-o-y growth (2012: 29.9% y-o-y). The Islamic funds sector is also growing quickly, with assets under management worth USD72.5 billion as at 20 December 2013 (8.4% y-o-y growth). In terms of the number of funds, there were only 285 Islamic funds in 2004, but by year-end 2013 this number had grown to 1049. Supporting the Islamic equity market are the four global Islamic indices, which encompass a large territory across regional and economic geographies. The smallest segment of Islamic finance is *Takāful*. As at year-end 2013, the global gross *Takāful* contributions are estimated to be USD19.87 billion (15% y-o-y growth).

Chart 2.1: Islamic Finance Assets by Sector (2013E)



Sources: Various, KFHR

Increasing number of players

Today, there are more than 600 Islamic financial institutions operating in more than 75 countries. In addition, the pool of Islamic financial institutions is expanding with the broadening of the range of Islamic financial professional services available worldwide. Many higher academic and training institutions around the world offer degrees in Islamic finance. Catalyst institutions, such as research and advisory houses that promote innovation, business advancements and sharing of resources, are also emerging to complete the value chain of the overall industry.

Diagram 2.1: Diverse Professional Services for Islamic Finance

Information, services, media, associations	Training, education, research	Consultancy – legal, commercial, Shari'ah	Rating agencies	Stock exchanges, commodity trading platforms, new financial centres
Dow Jones, FTSE, MSCI, Thomson Reuters, RedMoney...	BIBF, IRTI, KFHR Research, IBFIM, INCEIF, universities...	KPMG, E&Y, PwC, Deloitte, Yasaar, Amanie...	IIRA, Moody's, S&P, Fitch, RAM Ratings...	BSAS, IIFM, IILM, MIFC, DIFC...

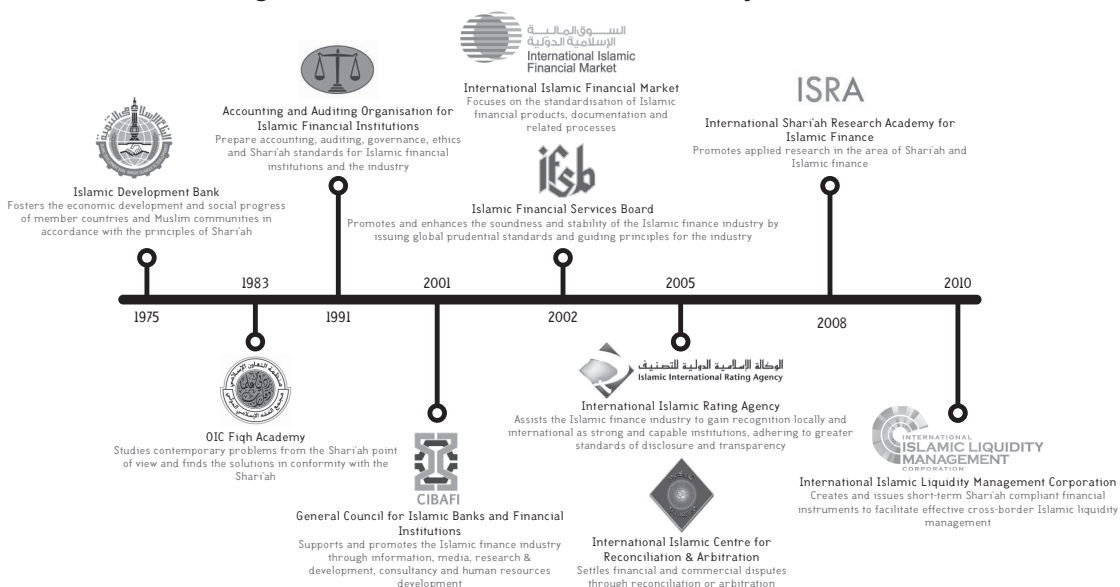
Global Islamic finance architecture and initiatives

The positive trends in Islamic finance are reflected not only in the increasing size or expansion of the industry and encouraging growth rates, but, importantly, in the level of commitment shown by regulatory bodies and governments as well as the efforts made by multilateral organisations and regional development banks. Efforts and initiatives

are being pursued at domestic, regional and global levels, aimed at maximising the significant growth potential of Islamic finance and enhancing its long-term resilience.

Among the notable multilateral bodies critically shaping the global Islamic finance architecture are the IFSB and the International Islamic Liquidity Management Corporation (IILM). The work of the IFSB complements that of the Basel Committee on Banking Supervision, the International Organization of Securities Commissions and the International Association of Insurance Supervisors. As at March 2014, the 184 members of the IFSB comprise 59 regulatory and supervisory authorities, eight international intergovernmental organisations, and 111 market players, professional firms and industry associations operating in 45 jurisdictions. Meanwhile, established on 25 October 2010, the IILM is an international institution established by central banks, monetary authorities and multilateral organisations to create and issue short-term *Shari'ah*-compliant financial instruments to facilitate effective cross-border Islamic liquidity management. On 27 August 2013, the IILM officially began its market dealings with a USD490 million *Sukūk* issuance; a second issuance of a similar size followed on 27 November 2013, and a third – valued at USD860 million – on 20 January 2014. The IILM aims to enhance cross-border investment flows, international financial linkages and financial stability by creating more liquid *Shari'ah*-compliant financial markets for Islamic financial institutions (IFIs).

Diagram 2.2: Global Islamic Finance: Industry Architecture



Source: GIFF Report 2012

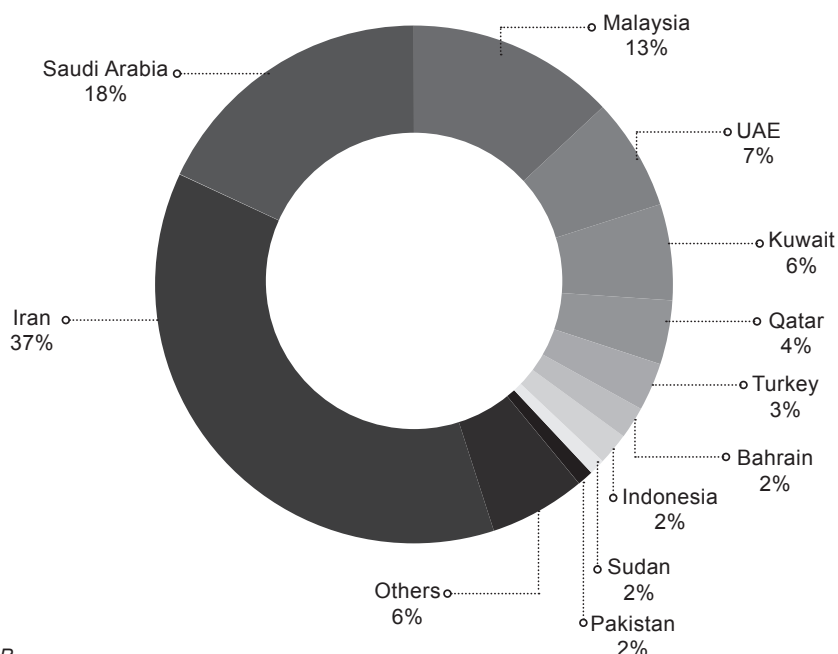
Although it is clear that the key components of the Islamic finance value chain have been firmly set in place, the industry is still facing various challenges at both regional and global levels given its nascent level of development. Many jurisdictions

that operate Islamic finance sectors and offer *Sharī'ah*-compliant financial solutions are yet to develop holistic regulatory frameworks and legislation that enable smooth functioning of the Islamic financial system. There is a critical need for regulatory support to drive the growth of Islamic finance. Pressing matters include the need for: (1) an appropriate supervisory environment that caters to the unique features of Islamic financial products; (2) a wider understanding of *Sharī'ah* practices, and of the differences between the Islamic financial system and the conventional system; (3) the adoption of accounting and auditing standards that recognise the unique features of Islamic finance transactions; (4) the introduction of *Sharī'ah*-compliant financial instruments to manage the excess liquidity of Islamic banks; (5) standardisation of products and other-related documents; (6) the drafting of clear rules and practices for dispute settlement in transactions; and (7) the development of human resources that are versed in both *Sharī'ah* matters and the dynamics of the financial industry.

A. ISLAMIC FINANCE MARKET DEVELOPMENT BY SECTORS

i. Islamic banking

Global Islamic banking assets stood at USD1.32 trillion as at 1H13 and are estimated to have surpassed USD1.4 trillion as at year-end 2013. The Islamic banking segment continues to dominate the portfolio of Islamic finance and has produced strong growth, with a CAGR of 20.4% for 2007–2013E. Islamic banking has been the starting point for new jurisdictions that wish to respond to the needs of the people for faith-based finance and to address economic needs. The sector has started to grow beyond South-East Asia and the Gulf Cooperation Council (GCC) countries and has been introduced in Central Asia, Africa and Europe. Based on KFHR's 2013 estimates, Islamic banking assets in the Middle East and North Africa (MENA) (excluding the GCC) represent approximately 40% of total global Islamic banking assets, followed by the GCC (38%) and Asia (15%). In the GCC, Saudi Arabia led the Islamic banking assets portfolio with an 18% share of the total global Islamic banking assets in 2013E; and Malaysia led Islamic banking in South-East Asia with a 13% share of the global Islamic banking assets.

Chart 2.2: Islamic Banking Assets by Domicile (2013E)

Source: KFHR

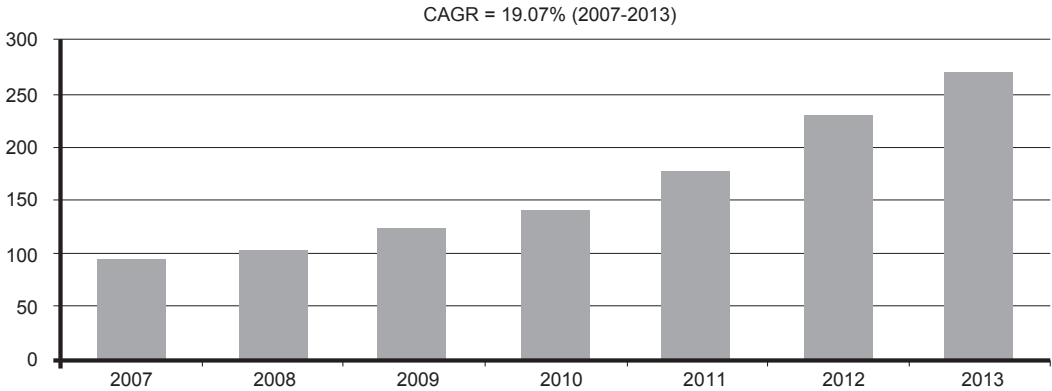
ii. Islamic capital market

That *Sukūk* are gaining greater acceptance as a mainstream financing instrument is evident from the increasing number and greater frequency of issuances coming to the market. In 2013, a total of USD119.7 billion of *Sukūk* issuances were recorded for the primary market, with sovereign *Sukūk* accounting for 62.3%. Malaysia accounted for 69.0% of total *Sukūk* issuances, or USD82.6 billion, in 2013; the GCC countries collectively contributed 22.0% of total primary market issuances in the same year. Following on from 2012's record primary market issuances of USD131.2 billion, 2013's performance recorded a decline of 8.77%. In the GCC, corporate and government-linked companies raising funds in US dollars made Saudi Arabia and the UAE the largest *Sukūk* issuers in 2013 (USD14.4 billion and USD7.2 billion, respectively).

The total assets under management (AuM) of Islamic funds has grown at a steady CAGR of 7.33% from 2007 to 2013, recording USD72.5 billion as at end December 2013. The growth of the sector's AuM in 2013 has been driven largely by net new asset flows into the sector, rather than by the rise in value of existing securities underlying Islamic funds' assets. The total number of Islamic funds stood at 1049 as at 20 December 2013, with 79 new funds launched in 2013. Islamic funds are highly concentrated in a few jurisdictions, with almost two-thirds of all Islamic fund assets in Saudi Arabia and Malaysia, followed by Ireland, the US and Kuwait. The sector is expected to continue

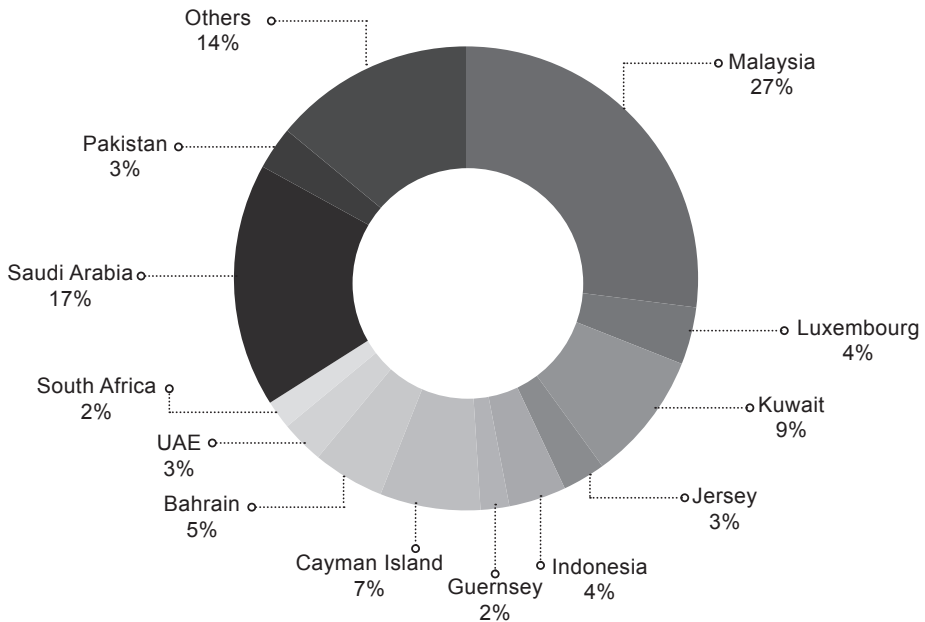
its growth, driven by deepening pools of wealth in the oil-rich GCC and increasing interest from conventional asset managers in investing in emerging markets.

Chart 2.3: Sukūk Outstanding



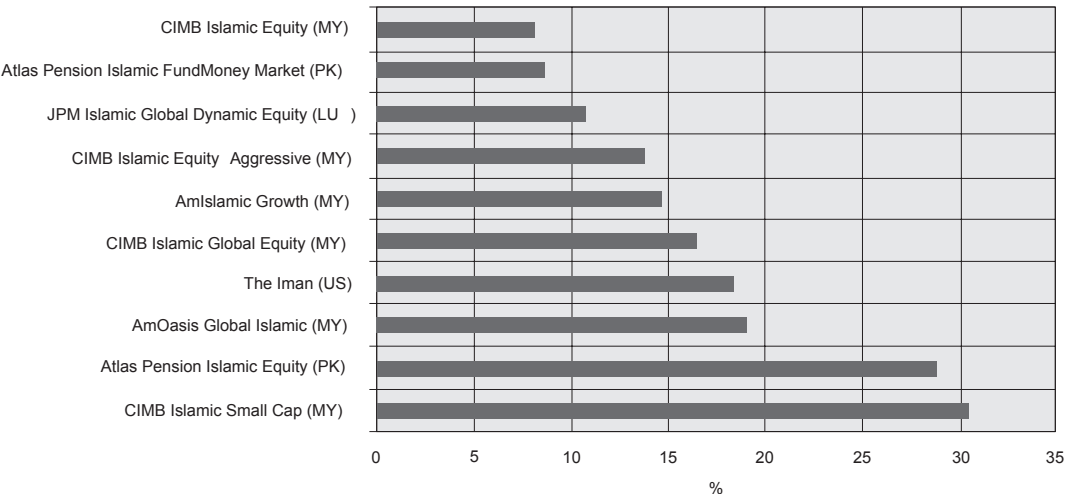
Source: Bloomberg, IFIS, Zawya, KFHR

Chart 2.4: Number of Islamic Funds by Domicile (1H13)



Source: Eurekahedge, KFHR

Chart 2.5: Top 10 Islamic Funds by Return (1H13)

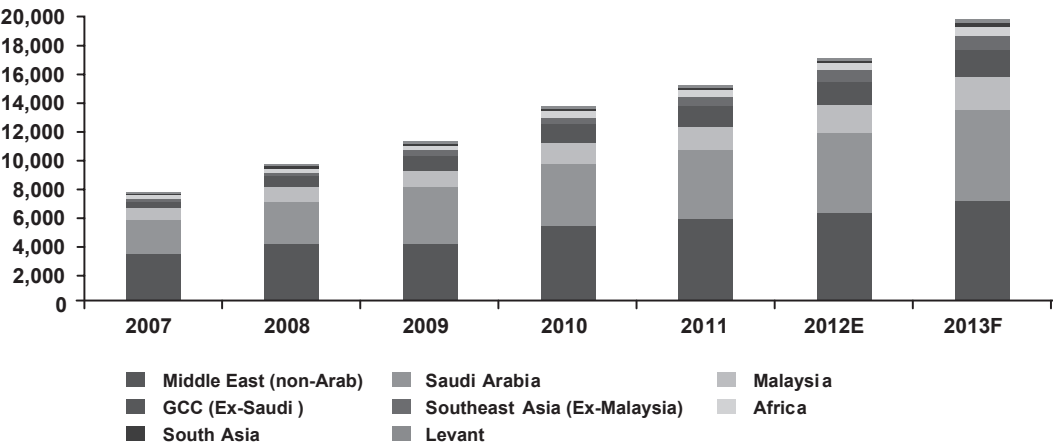


Source: Eurekahedge, KFHR

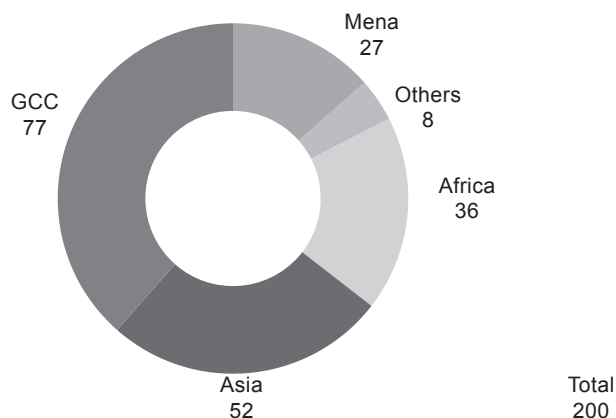
iii. *Takāful*

Takāful remains a nascent industry, with gross *Takāful* contributions globally of USD19 billion constituting only 1.1% of global Islamic assets as at year-end 2012. Key markets for this sector as at year-end 2013E are the GCC (USD8.37 billion) and South-East Asia (USD3.3 billion). In MENA and Africa, gross *Takāful* contributions amounted to USD7.1 billion and USD589 million, respectively. Moving forward, it is forecasted that the global *Takāful* industry will exceed USD25 billion by the year 2015.

Chart 2.6: Global Gross *Takāful* Contributions by Region (USD mlns)



Source: World Islamic Insurance Directory 2013, KFHR

Chart 2.7: Number of *Takāful* Operators by Region (2011)

Source: *World Islamic Insurance Directory 2013, KFHR*

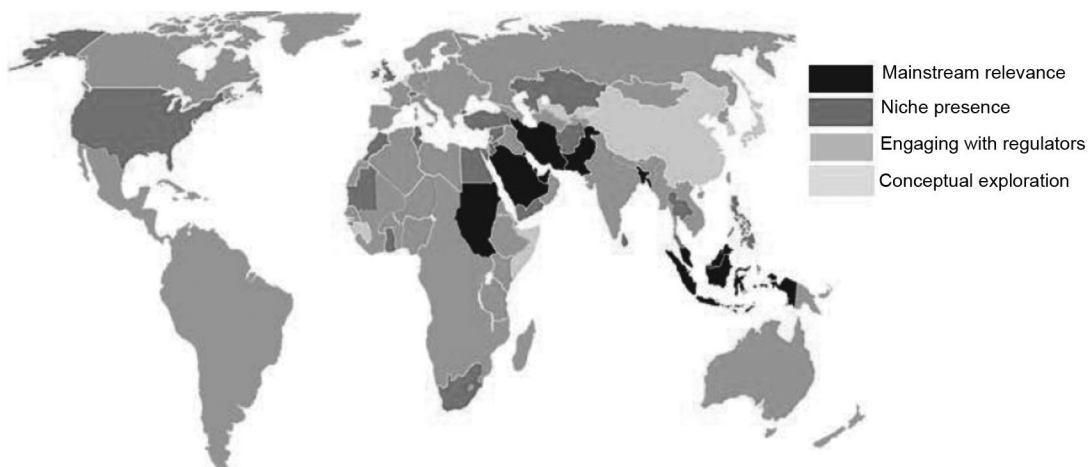
Against a backdrop of global macroeconomic challenges and financial pressures in the major markets, the expanding pool of global *Shari'ah*-compliant funds is becoming an increasingly attractive means for various jurisdictions to meet their financing needs. Faced with scarcity of funds in international markets, a growing number of new and emerging jurisdictions in Asia, Africa and Europe are seeking to attract Islamic finance investors, particularly from the oil-rich GCC countries. The overall global development of Islamic finance has therefore been reinforced by a number of factors, namely: (1) greater awareness and preference for *Shari'ah*-compliant financial solutions by the demographics in key Islamic finance jurisdictions globally; (2) an increase in affluence, which has led to growing economic participation of the Muslim population in Organization of Islamic Cooperation (OIC) countries; (3) strong regulatory support spearheading the momentum in the Islamic finance sector in various OIC markets and non-OIC jurisdictions – for example, the United Kingdom, Luxembourg and Hong Kong; (4) a liquidity crunch in the major Western banking institutions, particularly in Europe, which has allowed Islamic banks to emerge as alternative sources of funds; and (5) the growing global economic importance and trade linkages of the key Islamic finance jurisdictions, which have allowed Islamic financial institutions to expand their outreach by providing necessary *Shari'ah*-compliant financial support through, for example, Islamic trade financing products.

B. ISLAMIC FINANCE: SPANNING ACROSS GEOGRAPHICAL REGIONS

The geographical outreach of the Islamic finance industry, as well as the range of its product offerings, have been expanding rapidly as the critical growth drivers of the industry (as discussed earlier) are spearheading the industry's growth across various regions. The trend gained a firmer footing following the outbreak of the global financial crisis in 2008–2009 and the European sovereign debt crisis of 2011–2012, which had

a deep impact on the major conventional finance institutions while leaving the Islamic financial system relatively unaffected.

Diagram 2.3: Global Islamic Finance Industry Presence and Stages of Development (1H13)



Source: GIFF Report 2012

i. Asia

In Asia, Malaysia is leading on many fronts of Islamic finance. Other key markets are Pakistan, Indonesia, Bangladesh and Brunei. In terms of Islamic banking assets in the region, as of year-end 2012, Malaysia constituted 72.1% of the total, followed by Indonesia (10.8%), Bangladesh (5.4%), Pakistan (4.9%) and Brunei (3.4%). However, Islamic finance has the potential for further penetration of the domestic markets of these countries as, compared to the conventional finance segment, the Islamic finance sector is relatively small. For example, as at 1H13, Islamic banking assets represent 20.8% of the total banking industry assets in Malaysia, 21.1% in Bangladesh, 9.5% in Pakistan and 4.9% in Indonesia. Apart from the Islamic banking sector, rapid development is also seen across Islamic wealth management and *Sukūk* markets, while *Takāful* is growing somewhat slower but has a greater penetration capacity. Several Asian economies with sizeable Muslim populations, such as India, China and most of the Commonwealth of Independent States (CIS), remain largely untouched by Islamic financial services.

Asia – in particular, Malaysia – is the most developed market for *Sukūk* at both the primary and secondary market levels. As of mid-2013, Malaysia was responsible for USD148 billion of outstanding *Sukūk*, or 60.4% of the total global value. Other jurisdictions in Asia that are active *Sukūk* issuers include Indonesia, Pakistan,

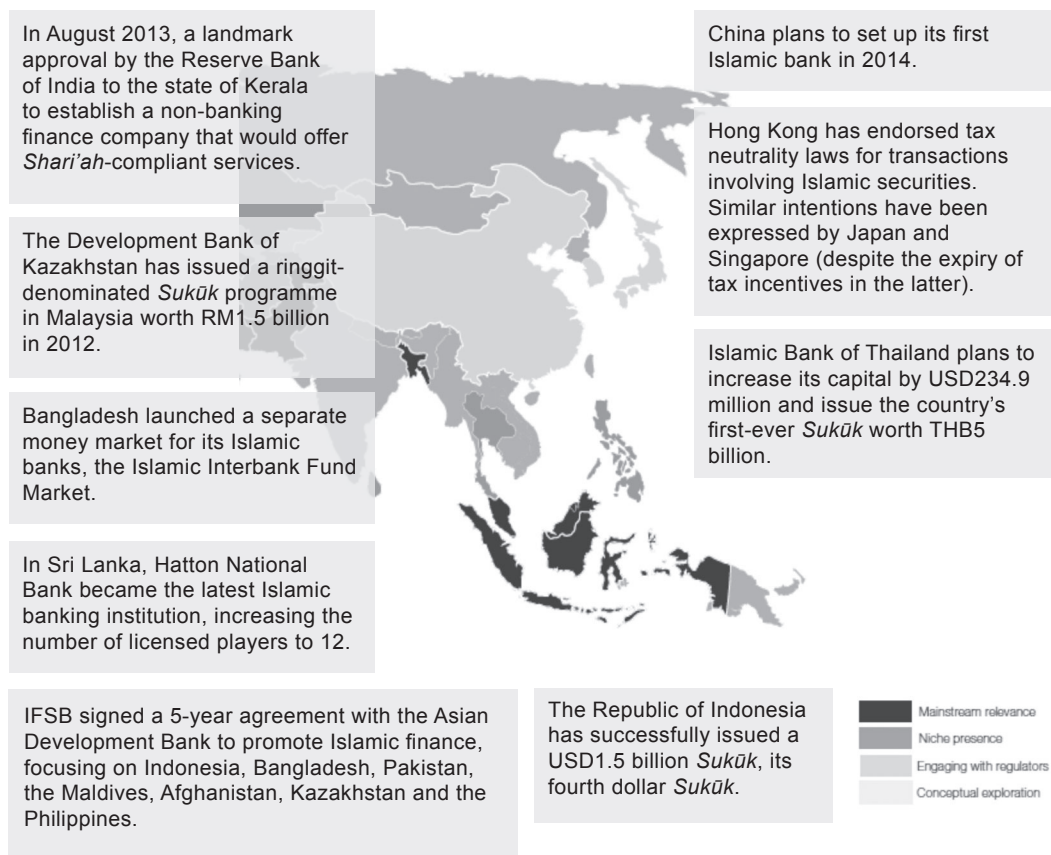


Singapore and Brunei. In 2012, Indonesia accounted for 7.0%, and Pakistan for 1.5%, of global issuances.

Malaysia is also leading the Asian region in asset management, with 80.7% of Islamic fund assets under management and a total of 188 funds worth USD13.1 billion in 2012. Next is Indonesia, with USD1.4 billion under management spread across 54 funds. Other Islamic fund markets in the region include Pakistan, Singapore, Bangladesh, Hong Kong, Thailand and Sri Lanka.

The development of *Takāful* in South-East Asia is concentrated only in a few countries, with Malaysia being the central market of expertise in the field. Indonesia and Brunei, together with Malaysia, account for USD2.1 billion in gross *Takāful* contributions. *Takāful* services are also available in Pakistan, Bangladesh and Sri Lanka.

Asia is a pivotal part of both the global economy and the Islamic financial system, operating as a driving force of world economic growth. Growth of Islamic finance in this region is expected to further support the area's economic expansion. However, much more needs to be done to facilitate an enabling environment that supports smooth functioning of the Islamic finance industry in new jurisdictions, as well as to advance developed Islamic financial markets to the next level. An enabling legal and regulatory framework, a competent talent pool, and greater product innovation to cater for the diverse demographic needs of the region's population and awareness are among key areas for improvement.

Diagram 2.3: Islamic Financial Markets Developments in Asia (2012-2013)

Source: KFHR

CASE STUDY: Islamic Finance in Bangladesh

Bangladesh is an important jurisdiction for Islamic finance, being the third-largest Muslim country in the world, with a population of 160 million Muslims forecasted at year-end 2013 (Pew Research). The popularity of Islamic banking is growing at a rapid pace in Bangladesh. The number of Islamic banks has grown steadily in the 30 years since the establishment of the first Islamic bank in the country in 1983 as a “niche offering”. Islamic banking is now a well-established industry in Bangladesh, with 21.1% of market share, and plays a vital role in the country’s economic growth.

At present, there are eight full-fledged Islamic banks in Bangladesh. In addition, 17 regular commercial banks and one foreign bank are offering Islamic products through their Islamic banking branches/windows. A significant milestone was achieved at the end of 2012 when the Islamic banking industry crossed the Bangladesh Taka (BDT).

1 trillion mark in assets and liabilities. The industry has higher capital adequacy ratios and low non-performing loans compared to conventional banks. It has also witnessed faster financing growth than has conventional banking.

Bangladesh Bank, the country's central bank, is the ultimate authority that regulates the Islamic banking industry. For capital market activities, the Securities and Exchange Commission (SEC) has full regulatory mandate, while the Insurance Development & Regulatory Authority Bangladesh oversees the insurance and *Takāful* sectors.

Diagram 2.4: Financial Regulatory Bodies in Bangladesh



Source: Regulatory authorities, KFHR

Although there is no dedicated Islamic banking act or legislation to control, guide and supervise Islamic banks in Bangladesh, some Islamic banking provisions have already been incorporated in the amended Banking Companies Act of 1991 (Act No. 14 of 1991). Bangladesh Bank inspects and supervises Islamic banks' operations according to the regulations set down for conventional banks. The *Sharī'ah* councils of individual banks are responsible for ensuring *Sharī'ah* compliance within their own organisations, and the central bank examines only their reports.

More efforts are needed, however, to enhance the legal and regulatory framework of the banking system in general. Notably, the state-owned banking corporations (SOBCs) in Bangladesh suffer from low capital and high non-performing loan ratios. According to the International Monetary Fund's (IMF's) Article IV Country Consultation Report, SOBCs' weak balance sheets represent a tangible fiscal risk (with potential recapitalisation needs of between 1 and 3½ percentage points of GDP as of June 2013, depending on assumptions). In this regard, the IMF notes that recent banking law amendments strengthen governance in the banking system and enhance the supervisory powers of Bangladesh Bank to safeguard financial stability. Amendments to the Bank Companies Act (BCA) were approved by Parliament in July 2013, after which (in September 2013) Bangladesh Bank issued an order limiting banks' capital market exposure to 25% of their capital, as set out in the newly amended BCA.

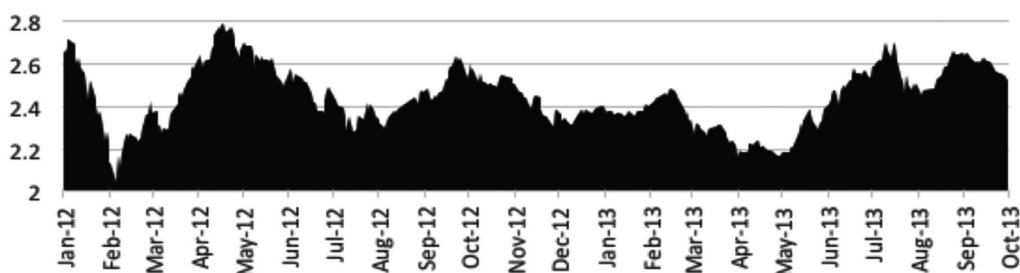
The Islamic finance industry in Bangladesh has a promising banking and *Takāful* segment with a number of active players serving the domestic markets. In order to further encourage growth of the Islamic banking industry in the country, Bangladesh Bank has granted some preferential provisions for the smooth development of Islamic banking in Bangladesh. They include the following measures:

- Islamic banks in Bangladesh have been allowed to maintain their statutory liquidity requirement (SLR) at 10% of their total deposit liabilities, instead of the 20% set for conventional banks. This provision enables Islamic banks to use more liquid funds for investment, and thereby generate more profit.

- Under the indirect monetary policy regime, Islamic banks have been allowed to fix their profit-sharing ratios and mark-ups independently, in accordance with their own policy and banking environment. This freedom in fixing profit-sharing ratios and mark-up rates provides scope for Islamic banks to follow the principles of *Shari'ah* law independently.
- Islamic banks have been permitted to reimburse 10% of their proportionate administrative cost on a part of their balances held with Bangladesh Bank. This facility has given some scope for enhancement of a bank's profit base.

One major area of the Islamic financial market in Bangladesh that needs further attention is the Islamic capital market and instruments such as *Sukūk*, which have proven to be a vital fund-raising tool for corporates and governments throughout the world. At this juncture, the Bangladesh government is looking into introducing *Sukūk* as an instrument for managing liquidity at Islamic banks. As such, an Islamic Treasury bill is awaiting government approval before proceeding with issuance to the market. Similarly, the equity market in Bangladesh remains small relative to its regional peers. The Dhaka Stock Exchange is one of the two main stock exchanges of Bangladesh, the other being the Chittagong Stock Exchange. In January 2014, the Dhaka Stock Exchange unveiled plans to list an Islamic equity index that would track *Shari'ah*-compliant stocks. As at 1 October 2013, the combined market capitalisation of listed companies on the Dhaka bourse stood at BDT2.5 trillion, or USD32.6 billion. This is compared to the USD1 trillion capitalisation of the National Stock Exchange of India, USD394.8 billion of the Stock Exchange of Thailand and USD48.7 billion of the Karachi Stock Exchange.

Chart 2.8: Dhaka Stock Exchange: Market Capitalisation



Source: Dhaka Stock Exchange, KFHR

Overall the Islamic finance industry in Bangladesh has significant room for growth, particularly in the capital market space. Despite the tremendous growth of Islamic banking in the country, a large portion of the population remains unbanked; thus, the full potential of the budding industry has yet to be unlocked.

Growth Areas of Islamic Finance in Bangladesh

Undoubtedly, one of the main growth areas of Islamic finance in Bangladesh is the availability of microcredit and its accessibility by lower-income groups and small to medium-sized businesses. Bangladesh was one of the earliest countries to adopt microfinance with the establishment of the Grameen Bank in 1976. The country is also regarded as one of the first to embark on Islamic microfinance, with more than 100,000 clientele. The largest Islamic bank in Bangladesh, Islami Bank Bangladesh Limited (IBBL), is also the largest provider of Islamic microfinancing. In 1995, IBBL launched its Islamic microfinance programme called the Rural Development Scheme (RDS) with the objective of eliminating rural poverty through small and microcredit products or schemes. Since 1995, IBBL has distributed USD504.9 million in microfinancing.

Although only roughly 8% of IBBL's assets are dedicated to microcredit activities, the bank has innovated ways to further expand its activities to a larger number of lower-income groups and small businesses. Initiatives include the following:

- deposit accounts for nominal amounts;
- welfare deposit schemes for cash *Waqf* and *haji*;
- selected saving schemes for the empowerment of women; and
- introduction of accounts for farmers and students.

The principles of Islamic finance strongly support the growth of Islamic microcredit through the sharing of values and objectives in which the empowerment of people towards achieving better living conditions is encouraged. Growth is likely to continue as the Bangladesh economy develops in line with both the economic and religious needs of the Bangladesh population. And, indeed, the Islamic microfinance sector may take the opportunity to prove itself as a successful financing tool and produce results that can be replicated by other regions around the world.

Other growth areas include the Islamic banking industry. Despite the lack of a regulatory framework for Islamic finance, as is the case in countries such as Malaysia, Islamic banking in Bangladesh has been able to muster a significant portion of the overall banking system, anywhere between 20% and 25% according to government sources. This makes the country one of the top five jurisdictions in the world in terms of market penetration, a remarkable feat for a country without a legal or regulatory framework for Islamic finance. This shows the significant demand among the Bangladeshi population.

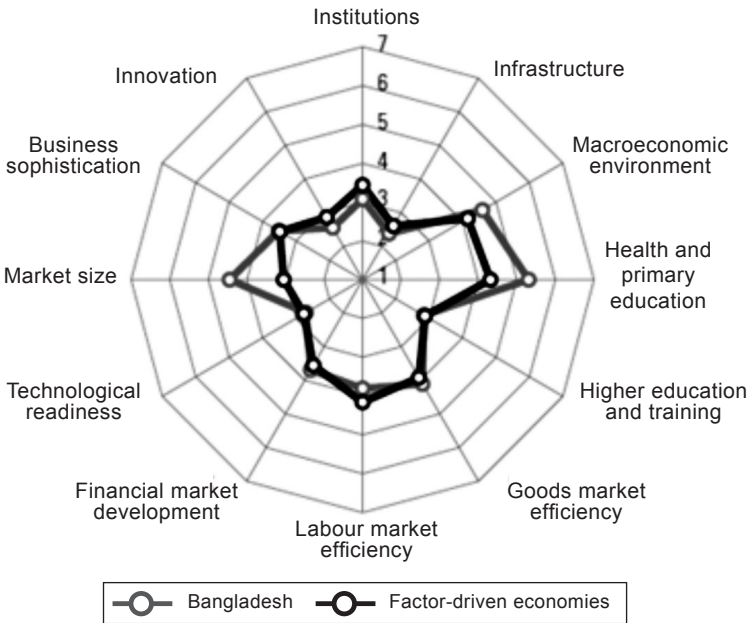
Opportunities and Challenges in Bangladesh

While fiscal management and debt sustainability issues act as constraints on sovereign debt issues by low-income countries, in the medium to long term, there are potential benefits to emerging markets that have strong macroeconomic balance sheets in developing the legal, tax and regulatory frameworks needed for *Sukūk* issuance.⁵ *Sukūk* have been utilised in various regions for funding infrastructure projects and

⁵ An assessment of the prospects of conventional sovereign bond issues in Bangladesh is provided in Hamid Rashid (2012), "A Sovereign Bond Issue for Bangladesh?", *Bangladesh Bank Training Academy Journal*, vol. 1, issue. 1, July - December 2012

financing government deficit spending. According to the World Economic Forum's Global Competitiveness Index 2013–2014, Bangladesh ranked 132nd out of 148 countries in terms of infrastructure.

Diagram 2.4: Bangladesh Stage of Development



Source: WEF, KFHR

As part of its “Vision 2021”, an economic and social vision for Bangladesh to become a middle-income country, the government has undertaken the following with regards to infrastructure:

Road, rail, river and air transport and telecommunication systems will be expanded. Construction of bridges and tunnels for Padma and Karnaphuli rivers, connecting Bangladesh with the Asian highway and Asian railway, improvement of port facilities, building of a deep sea port to open up Bangladesh's ports to countries of Asia will be implemented. In Dhaka, construction of a metro tunnel, elevated rail and circular rail to remove traffic jams and to solve public transport problems will be studied forthwith in order to undertake a feasible project. The project will then be implemented on a priority basis.

Source: Vision 2021, KFHR

Infrastructure, then, is an important funding area that will need to see significant investment over the coming years to ensure that the above goals are met. Internationally, *Sukūk* have played a crucial role in the infrastructure sector over the past decade. The very nature of *Sukūk*, combined with their flexibility, allows them to be structured in

various ways that have attracted corporate and sovereign entities to choose Islamic bonds as a viable alternative financing instrument. The infrastructure sector has seen a large portion of the raised *Sukūk* funds directed to development projects around the globe.

Sukūk are also a crucial tool for managing liquidity within the Islamic finance space. Their fixed return and tenure characteristics make them a useful tool for hedging against risks and managing short-term liquidity needs, and give them the ability to act as a long-term investment instrument for *Takāful* operators and pension funds. Given that the Islamic banking system in Bangladesh is consistently growing at a rapid pace, there is a pressing and ongoing need to find liquidity tools for interbank transactions.

Public-sector investment has been an important factor supporting Islamic financing of infrastructure in the Middle East and Malaysia. While there are formidable legal and regulatory pre-conditions for successful *Sharīʿah*-compliant financing of infrastructure, with public-sector involvement, there are potential benefits from having a higher credit rating relative to the rating of the conventional sovereign issue.

Despite some level of success in providing access to finance among the Bangladesh population, there is still significant room for growth. In 2010, Bangladesh Bank observed that financial inclusion had increased to 56.43% of the population, from 39.76% in 2004. According to a recent study by the Institute of Microfinance (InM), around 66% of households in Bangladesh now have access to services including credit, savings and insurance from banks or microfinance institutions (MFIs) and cooperatives.

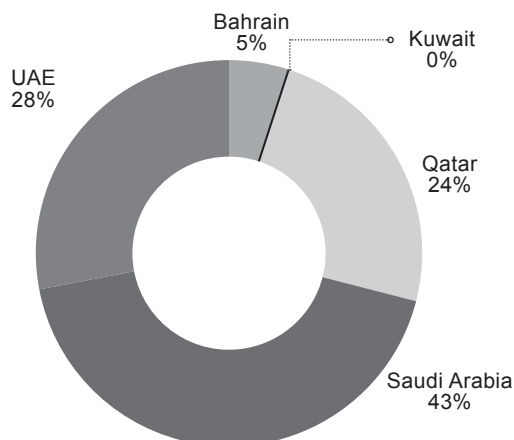
Islamic banking in Bangladesh has evolved despite multi-dimensional challenges, including the absence of a legal framework. Since its introduction in Bangladesh in 1983, no comprehensive law has been enacted to regulate Islamic banking, with the exception of the “Guidelines for Conducting Islamic Banking” issued in 2009 and a few amendments to the application of the existing laws by the government and the central bank. Malaysia also introduced Islamic banking in 1983, but it had enacted an Islamic Banking Act even before the commencement of the Islamic banking business.

ii. MENA (incl. GCC)

In MENA, the most advanced Islamic banking markets are in Saudi Arabia, Bahrain, Kuwait, Qatar and the United Arab Emirates. These GCC markets are home to several of the largest Islamic banks in the world. Oman is relatively new to Islamic finance, but the pace of financial reforms is accelerating. Omani financial regulatory bodies have finalised the amended regulatory framework for Islamic banking in the Sultanate. Alongside the GCC-based Islamic finance favourites, the reformed Islamic financial jurisdictions of MENA are entering into the limelight. Other regional developments in non-GCC countries in MENA include the Iraqi government, which has approved the establishment of the country’s first state-owned Islamic bank, the Two Rivers Islamic Bank, with an initial capital of USD21.5 million. Iraq and Libya are in the midst of designing Islamic banking legislation. Tunisia’s Islamic finance industry is expected to

grow further with the efforts undertaken by that country's government. Meanwhile, the Government of Yemen is structuring a *Sukūk* programme for 2014.

Chart 2.9: *Sukūk* Outstanding (1H13)



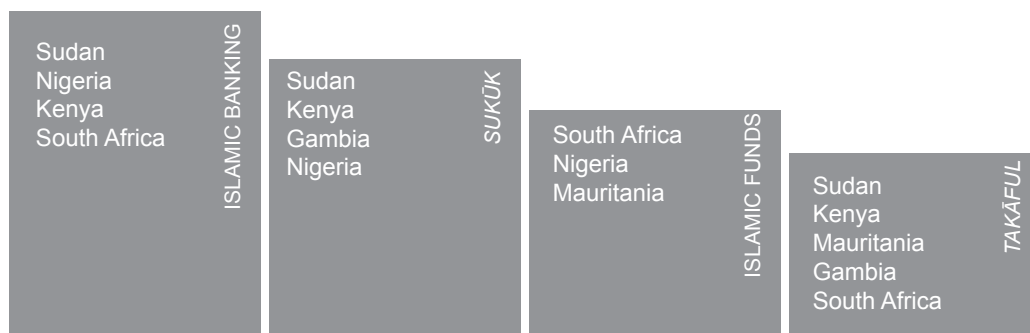
The region is home to a diverse range of *Sukūk* market players, from financial institutions to real estate developers, and construction companies to energy producers. The market is dominated by the GCC countries whose corporations issue mainly in both local and foreign currencies. In the first half of 2013, Saudi Arabia was the largest regional market for issuances with a total of USD7.5 billion placed. This was followed by the UAE (USD5.2 billion), Bahrain (USD889.7 million), Qatar (USD549.4 million) and Kuwait (USD43.7 million).

Within MENA, the GCC is the largest *Takāful* market, with gross *Takāful* contributions of USD8.3 billion. The region holds 72% of the global *Takāful* industry in 2013E.

Key challenges in this region are the growing competition on the global stage, the shortage of Islamic financial instruments for effective liquidity management and limited qualified human capital. Constant enhancement of the supervisory and legal framework is one key factor that will help maintain the GCC countries' momentum in responding to the rapidly changing financial landscape.

iii. Africa

Thanks to the growing national economies in need of alternative investments and financing, and a large Muslim population of about 250 million (in Sub-Saharan Africa), the region is a budding market with new Islamic finance opportunities. Behind the regional pioneer Sudan, leading the pack of fresh entrants is Nigeria, followed by Kenya and South Africa. While the former two countries have already made considerable strides in regulatory reforms (for Islamic banking, *Sukūk* and *Takāful*), South African tax regulators are expected to put the finishing touches on their rules later this year.

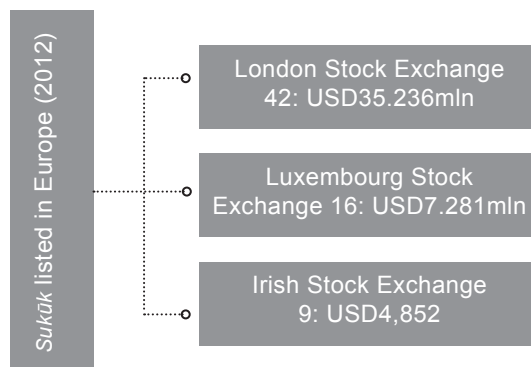
Diagram 2.5: Islamic Financial Market in African Countries

Source: KFHR

There are currently 38 Islamic banks operating within the African continent. Sudan accounts for a significant 81.5% of Islamic banking services in Africa. A number of African states have introduced new measures to make way for Islamic financial markets, one of them being Nigeria. The Central Bank of Nigeria recently issued guidelines accommodating *Shari'ah*-compliant banking and has approved a banking licence to launch the country's first Islamic bank. In Kenya, a new market player, Equity Bank, has started to offer *Shari'ah*-compliant products and services in an effort to grow its customer base. On the Islamic capital market scene, the countries that have so far issued *Sukūk* include Sudan, Kenya and Gambia. South Africa and Nigeria are expected to be the next sovereign issuers in the region. Senegal plans to move into the Islamic capital market space through draft regulations in 2015. With regards to Islamic asset management, South Africa has witnessed a number of Islamic funds launched over the years. Other countries that have set up Islamic funds are Mauritania and Nigeria. Finally, *Takāful* services are available today in Mauritania, South Africa, Gambia and Kenya.

iv. Europe

Islamic banking activities mainly take place in Turkey, the UK and France, and are considered a low penetration of retail Islamic banking compared to the relatively large number of potential Muslim retail customers. *Takāful* is available today only in Turkey, the UK, Ireland, Luxembourg and Germany. Islamic funds, on the other hand, are more widespread and are domiciled in Ireland, Luxembourg, Jersey, Guernsey and France. In 2012, European Islamic funds comprised 8.3% of the global total Islamic funds. Luxembourg and Ireland are creating niche markets in this segment to expand their range of services as international financial hubs. Europe has been able to position itself as a popular destination for *Sukūk* listings with volumes as shown in the diagram below.

Diagram 2.6: Sukūk Listings in Europe (2012)

Source: KFHR

Among recent developments are Banque Chaabi's concluding of inaugural *Murābahah* mortgage contracts in France (under the *Murābahah* tax regulation FE4/SE1/02) and Société Générale's plans to issue USD300 million worth of *Sukūk* through the Malaysian jurisdiction. In neighbouring Germany, Kuveyt Türk Katılım Bankası, the Turkish arm of Kuwait Finance House, aims to begin local operations in a bid to establish the first Islamic bank in the country.

Several financial centres in Europe are already on the radar to compete as regional Islamic financial hubs. This positive development is expected to generate greater intensity and activities of Islamic finance in the region. Notwithstanding this, regulatory and accounting frameworks that cater for features of Islamic financial products need to be developed as the industry grows further. A shortage of *Sharī'ah*-compliant highly rated instruments is also a key challenge for Islamic banks in the region.

v. Oceania

Among the Australian government's recent initiatives is a report by the Australian Board of Taxation on tax treatment agreeable with Islamic finance. Australia also has three Islamic funds domiciled in the country.

vi. North America

Riba-free financial services are offered today by more than 15 institutions in the United States. The *Takāful* market, however, is served by only one *Takāful* operator. Corporate *Sukūk* issuances have taken place in the US since 2004. Islamic funds similarly abound and make the US the fourth-largest market with assets worth USD4.4 billion as at year-end 2013, which has been boosted by the introduction of US-based Islamic indices, namely the Dow Jones Islamic Market Indices and Standard & Poor's *Sharī'ah* Indices. The key challenges in North America are the absence of a legal and regulatory framework to support the industry's prospects and growth, as well as a lack of public awareness and understanding.

C. CROSS BORDER AND CROSS-SECTORAL PERFORMANCE OF THE INDUSTRY

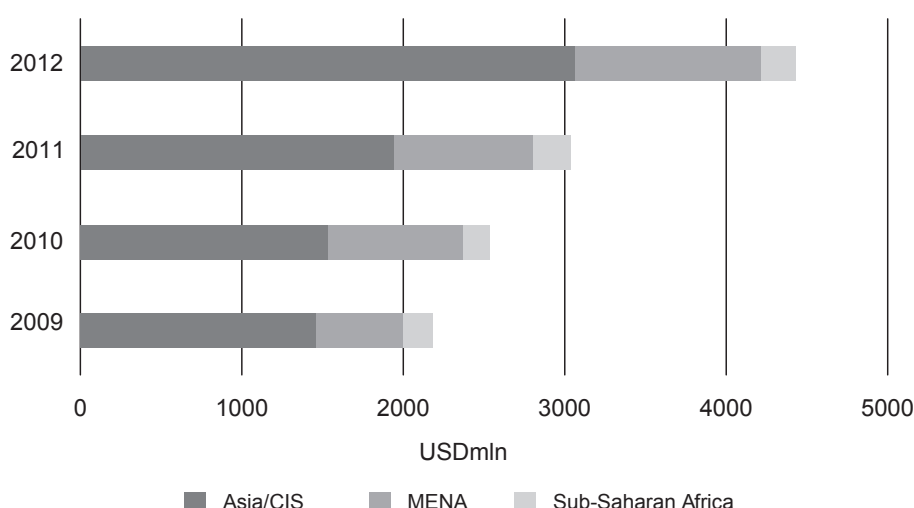
During the initial three decades of Islamic finance inception, the industry has mainly been domestically driven with growth originating from local markets of the key Islamic finance jurisdictions. However, in recent years, the Islamic finance industry has been gaining traction on global markets. Among the various sectors of Islamic finance, the *Sukūk* market has progressed as a main driver for Islamic finance to go beyond domestic borders into the international financial market, becoming a pivotal avenue for international fund-raising and investment activities.

As the overall Islamic finance industry is still a small segment within the entrenched conventional finance system, internationalisation of the industry is expected to contribute to efficient and effective funds mobilisation and allocation across regions. This effort will strengthen and enhance the international financial and economic linkages between jurisdictions, mutually benefiting all stakeholders. For instance, with the internationalisation of Islamic finance through *Sukūk* issuances, issuers will have access to a new source of funds and liquidity. Meanwhile, investors will gain from new investment opportunities and a diversification of portfolios. The *Sukūk* market has also emerged as an important intermediary in Islamic finance and has been instrumental in facilitating Islamic cross-border and cross-sectorial financing in supporting a variety of projects and investments such as infrastructure sectors, utilities sectors, services sectors, education, healthcare and transportation. GCC countries, such as Saudi Arabia and Kuwait, have recently introduced a number of infrastructure development projects that are aimed at steering their economies away from dependence on oil and gas. *Sukūk* are expected to offer the necessary long-term cross-border and cross-sectorial facility for such projects in the region and in other countries in Asia. Contracting projects currently under way in the GCC are estimated to be worth more than USD900 billion.

Trade among the expanding emerging economies continues to grow and accounts for more than half of world trade. In this regard, Islamic finance has an important potential to facilitate trade and investment flows that will be mutually reinforcing. Encouragement and support from the OIC and the Islamic Development Bank (IDB) in promoting intra-regional and generally intra-OIC trade is further expected to boost demand for Islamic trade financing products. Total trade financing among the OIC member countries, including Malaysia, Saudi Arabia and Turkey, was estimated at just under USD4 trillion at year-end 2012. The Islamic trade finance sector, particularly in the OIC, has been supported by the IDB, especially after the setting up of the International Islamic Trade Finance Corporation (ITFC), an organisation which brings the trade financing activities previously conducted by the various windows of IDB under one roof. The ITFC approved Islamic trade transactions worth USD4.446 billion in 2012, recording a 47% increase from USD3.033 billion in 2011. Moreover, the Asian and Commonwealth of Independent States (CIS) regions held the highest share (69%) of the total approvals given in 2012, followed by MENA (26%) and Sub-Saharan Africa (5%).

The future of trade financing and Islamic finance remains promising, underpinned by several initiatives executed by a number of market players and organisations. For instance, GCC countries recently planned to sign collective free trade agreements (FTAs) with several countries and economic blocs, boosting foreign investment and opening new employment opportunities. The suggested agreements are expected to be signed with Japan, the European Union (EU), ASEAN, South Korea, China, India, Turkey, Russia and Australia. In addition, in early 2014, the Dubai Financial Services Authority (DFSA) entered into 26 supervisory cooperation agreements with EU and European Economic Area (EEA) securities regulators. The agreements under the memorandum of understanding were meant to allow fund managers in the Dubai International Financial Centre (DIFC) to manage and market Alternative Investment Funds (AIF), which includes Islamic finance funds and facilities, to professional investors in the EEA under the rules of the Alternative Investment Fund Managers Directive (AIFMD).

Chart 2.10



Source: ITFC 2013, KFHR

In Islamic cross-border financing, taxation remains the critical challenge since transactions utilise underlying assets and contracts of sale, purchase or lease. This could trigger capital and value added tax (VAT) in certain jurisdictions, and some countries require a stamp duty for real estate transactions, which is an obstacle for the *Shari'ah*-compliant financing of property acquisition. For such reasons, one of the challenges in Islamic finance, particularly trade finance, is tax certainty in each country, as well as provisions for Islamic modes of financing in the applicable tax treaties to ensure a level playing field. Moreover, there is also a need for standardisation and harmonisation of the legal implications of Islamic finance in different jurisdictions, with respect to both *Shari'ah* rulings and legal enforceability.

D. CONCLUSION

Total global Islamic financial assets are estimated to reach USD6.5 trillion by 2020. The industry is expected to chart positive growth underpinned by the following factors:

- government spending on infrastructure projects financed by Islamic finance;
- growing interest in Islamic finance and supply-side dynamics by financial institutions;
- active role played by government and regulatory agencies, multilateral bodies and industry players to promote the development of Islamic financial markets in their respective countries and globally; and
- the increase of global trade flows in MENA and OIC countries.

Another important aspect moving forward is the potential role of Islamic finance in supporting financial inclusion.

Sovereigns are expected to tap *Sharī'ah*-compliant global pools of savings through *Sukūk* issuance in both Asia and GCC. The participation of corporates in *Sukūk* and other Islamic finance instruments has grown significantly in 2012, and this is set to continue. Many Islamic banks and financial institutions plan to raise funds in support of capital structures, for refinancing and to fund additional activities. The prospects for the *Sukūk* market remain bright. The sovereign *Sukūk* sector will likely continue to stoke stakeholders' interest, as sovereigns – including the United Kingdom, Ireland, South Africa, Tunisia, Mauritania, Luxembourg, Senegal and Oman – are expected to debut sovereign issuances in 2014.

Chapter 3

LEGAL, REGULATORY AND ENABLING FRAMEWORK

Dr. Akram Laldin*

A. INTRODUCTION

Islamic banking and finance is a developing industry that is viewed widely as a viable alternative to conventional finance. It has been adopted across the globe and has a lot of potential for growth (as the previous chapter has shown). Islamic banking and finance, like the normal finance industry, is a regulated industry. However, the operations of Islamic banking and finance are unique insofar as they are regulated not only by the national law, but also by the *Sharī'ah* law.

The growth opportunity as well as the challenges facing the development of the Islamic financial industry in the global market have raised public policy issues in the jurisdictions in which the industry operates, and internationally these have led international organisations, international standard setters, national regulatory authorities, policy-makers and academia to examine various aspects of Islamic financial intermediation each from their own perspective (World Bank Policy Research Working Paper No. 3227, 2004).

In most jurisdictions, the legal and regulatory framework of the Islamic financial industry has been formed in line with international standards and best practices while taking account of its distinct characteristics inspired by *Sharī'ah*. The regulators in those countries have to produce general and specific rules and guidelines for the industry which are in line with the *Sharī'ah* framework, the domestic legal and regulatory framework, and international standards issued by international standard-setting bodies.

In conducting its business, Islamic finance has to address a number of problems, including those matters relating to credibility, regulatory enforceability and uniformity (including *Sharī'ah* issues). A legal, regulatory and enabling framework is expected to accommodate them in a proper and comprehensive perspective. Likewise, a proper *Sharī'ah* governance framework is expected to be included in the legal and regulatory framework in order to ensure that the entire operations of Islamic financial institutions are *Sharī'ah* compliant.

B. SHARĪ'AH AND ISLAMIC FINANCE

Islamic finance operates on the basis of *Sharī'ah* principles by observing the pillars and conditions of contract in the operational mechanism. Its grounding principles are the objectives of *Sharī'ah* (*Maqāṣid al-Sharī'ah*): to realise human well-being (*Maṣlaḥah*) and to repel harms and difficulties (*Mafsadah*) in people's lives (Laldin & Furqani, 2012).

* The author acknowledges the valuable assistance of Dr. Hafas Furqani, Researcher, ISRA.

Sharī'ah is the backbone of the system as well as its main driver. *Sharī'ah* not only contains the principles and foundations upon which the financial system from an Islamic perspective is established, but also provides guidance and a framework for the future direction of the industry.

Sharī'ah envisages value propositions that Islamic finance is expected to deliver:

- Islamic finance integrates ethics into finance by prohibiting unethical investment practices and activities such as *Riba* (usury), *Gharar* (uncertainty), *Maisir* (gambling), *Zulm* (oppression), *Tadlis* (cheating) and others, while emphasising justice and fairness (*`Adl*) and equality (*Musawah*) in financial transactions.
- Islamic finance should work on the basis of partnership and cooperation among the financiers and investors/entrepreneurs, with risk and reward sharing, which will ensure greater market discipline.
- Islamic finance requires greater transparency and disclosure, and greater fiduciary duties and accountability, for the benefit of both the financiers and the customers.
- Islamic finance ties financial transactions to real economic activities, since it prohibits that money becomes a commodity or an end in itself. Islamic finance bans excessive leverage that has no direct link to real economic activities.

These value propositions take effect in the practical realm through observance of the propositions of “*Sharī'ah* compliance”. *Sharī'ah* compliance is an instrument to keep the development and direction of the Islamic finance industry on the right track, but it is at the same time an epitome of the comprehensive values and final objectives of Islamic finance.

A firm commitment to *Sharī'ah* compliance by all stakeholders in the Islamic finance industry is strongly expected. The legal and regulatory framework has to be developed accordingly. To achieve that purpose, a proper *Sharī'ah* governance framework should be in place. A strong *Sharī'ah* governance framework should be in place to manage, and ideally eliminate, the *Sharī'ah* non-compliance risk that arises from non-compliant processes in product structuring or from insufficient legal documentation, but also to establish structures and practices that would assist the development of the industry in accordance with the purpose of *Sharī'ah* itself.

C. LEGAL AND REGULATORY FRAMEWORK

Islamic finance is a new sector of the contemporary financial system. The setting up of Islamic finance organisations in a large number of different jurisdictions has led to a diverse legal and regulatory landscape. In general, the countries that have shown commitment to developing Islamic finance can be categorised into three types:

1. countries that claim to have fully *Sharī'ah*-based legal systems, such as Iran, Saudi Arabia and Sudan;
2. countries with partially *Sharī'ah*-based legal systems, such as Bahrain, Malaysia, Indonesia and the United Arab Emirates (UAE); and
3. countries with completely secular legal systems, such as Singapore, the United Kingdom (UK) and the United States (US).

The prevailing legal and regulatory system of a country determines the structure and type, as well as the means of implementation, of its legal and regulatory framework for Islamic finance. Two distinct approaches have been observed (NikThani & Othman, 2008):

1. setting up a comprehensive, separate legal and regulatory framework for Islamic finance that is parallel to and compatible with the existing laws and regulations for conventional banking and finance; and
2. retaining the existing conventional financial framework and taking incremental steps to accommodate the specificities of Islamic finance, which leads to a gradual extension and differentiation of the legal and regulatory system over time. This process can also factor in the experiences of other jurisdictions.

Most jurisdictions have adopted the second approach: they have retained the existing conventional legal and regulatory framework and made necessary adjustments for the integration of *Sharī'ah* principles in the financial practices.

The adoption of a gradualist approach, however, poses some challenges to the Islamic finance industry, as a number of the existing legal and regulatory provisions are not in line with *Sharī'ah* principles, while Islamic financial institutions are bound to follow the *Sharī'ah*.

Research by the World Bank (2004) observed factors specific to Islamic finance that may become hurdles in developing a legal and regulatory framework for Islamic finance:

1. There is a divergence between the paradigm of Islamic finance, or its theoretic conception, and the way it is practised in many instances.
2. Actual Islamic financial institutions have to adapt to their environment where they have to compete with conventional financial intermediaries but do not have access to the same money market instruments for liquidity management purposes.
3. Each Islamic financial institution's (IFI's) *Sharī'ah* board and prevailing local legal traditions and interpretations combine with the market's competitive pressures to shape each institution's activity.

4. In most jurisdictions, IFIs are still required to comply with the regulations governing conventional financing and to use accounting standards that may not be fully adapted to the substance of their business activities.
5. There are variations within the paradigm reflecting four schools of thought in Islamic jurisprudence whereby each provides its own interpretation of the nature of financial transactions and products that may or may not be compatible with *Sharī'ah*.

Since the Islamic doctrinal system is not completely rigid, a gradual reconciliation of the two systems is possible. Further deliberations to reconcile *Sharī'ah* requirements with the provisions of the existing legal and regulatory system can be attempted to support financial institutions operating within a *Sharī'ah* framework. Efforts to establish an orderly and harmonised interface between the existing legal and regulatory framework and the *Sharī'ah* principles that underlie the Islamic financial contracts have been attempted in various jurisdictions as well as at the international level. A number of institutions have been established to become focal points on major issues – in particular, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the International Islamic Rating Agency (IIRA), the IFSB and the Liquidity Management Center (LMC) (World Bank Policy Research Working Paper No. 3227, 2004).

To achieve that objective, efforts should be made to broaden and deepen the understanding of Islamic specificities by providing supporting services to the legislature and the judiciary in a cost-efficient and timely manner. It is of the utmost importance that legislators and judges come to well-informed decisions because of the possibly of a far-reaching impact of a single decision on the rest of the Islamic finance industry (“public interest”/*Maslahah* consideration). Furthermore, it is important to set up a legal harmonisation committee or a working group to scrutinise a country's legal and regulatory framework and propose solutions for identified legal conflicts between the Islamic and secular systems.

D. ADOPTING SHARĪ'AH IN THE LEGAL AND REGULATORY FRAMEWORK

The direction of the Islamic financial industry is very much determined by the certainty of the legal and regulatory framework. The framework should take into account the value propositions and principles promoted by *Sharī'ah*, which are the backbone of the industry. In this regard, there are some challenges in adopting *Sharī'ah* in the legal and regulatory framework that require solutions from the regulators and other stakeholders in the industry.

i. Harmonisation between the *Sharī'ah* principles and the existing legal framework

The existing legal definitions of banking and financial services often do not recognise Islamic financial transactions, due to their nature as trade and investment vehicles.

Many constraints are to be expected if a country's general laws are to be applied directly to Islamic financial transactions, resulting in potential conflicts and adverse legal effects.

Considering the fact that Islamic financial institutions are not only operating in purely *Shari'ah*-based jurisdictions but also in non-Islamic, largely Western legal systems, the adjustment and management of tensions between Western and Islamic legal principles are a persistent challenge.

A mechanism is needed to ensure that Islamic finance is treated on a par with conventional finance, and that *Shari'ah* laws and a country's jurisdiction are harmonised and become converged. The target is to ensure that the commercial law in the country can integrate the Islamic commercial law.

ii. *Shari'ah* Standards for Islamic Financial Transactions

Shari'ah certainty for the business of Islamic financial institutions is considered to be one of the most important requirements for the Islamic finance legal and regulatory framework. The legal and regulatory framework should acknowledge the wider nature and characteristics of business and transactions of Islamic banking and finance. Like conventional banks, Islamic banks accept deposits for transactional and savings purposes; however, unlike conventional finance, Islamic banks do not use loans for their financing business but, instead, other types of contracts and transactions such as sale, leasing, joint ventures and business partnerships.

In addition, a *Shari'ah* standard for various approved contracts in Islamic financial products has to be spelled out to solve the problem of a lack of consensus among *Fiqh* scholars on contractual rules governing financial transactions which might raise Islamic banks' exposure to counterparty risks arising from the unsettled nature of contracts, and may lead to potential litigation problems. A related issue is the general confusion created by the heterogeneous interpretations of the fundamental *Shari'ah* rules resulting in differences in financial reporting, auditing and accounting treatments by Islamic banks (World Bank Policy Research Working Paper No. 3227, 2004).

Shari'ah standards for Islamic financial contracts would streamline practices and products of Islamic financial institutions. *Shari'ah* standards would serve as a guide for product development as well as for *Shari'ah* reviewers, *Shari'ah* auditors and external auditors when they review and audit the operations of Islamic financial institutions.

iii. A Source of Reference for Courts and a Dispute Settlement System in Islamic Finance Related to *Shari'ah* and Legal Issues

The *Shari'ah* standards would also serve as a reference for courts and arbitrators in resolving cases and disputes brought to the courts. The legal and regulatory framework should take this into account whenever it provides schemes for the settlement of disputes arising from Islamic financial transactions.

There is a high potential for anomalies in the interpretation or even contravention of *Sharī'ah* principles when civil courts apply Western-inspired laws instead of Islamic law, due simply to the lack of appreciation or varying competence on the part of legal and judicial personnel. The absence of a comprehensive codification of substantive laws governing Islamic financial institutions can exacerbate this situation.

An appropriate courts and dispute settlement system for Islamic finance is therefore important. It is also important to ensure that a country's judicial system is capable of dealing with Islamic disputes or arbitrations, and that the relevant authorities have a good understanding of how to handle Islamic finance disputes brought to courts by financiers, consumers and other stakeholders.

iv. *Sharī'ah* Governance Framework

As *Sharī'ah* compliance is the paramount objective of Islamic financial practice, the existence of a *Sharī'ah* governance framework is necessary. *Sharī'ah* governance essentially refers to structures and processes adopted by Islamic financial institutions to ensure compliance with *Sharī'ah* rules and principles. It is a very critical area in Islamic finance, and is of no less importance than corporate governance to any institution. However, *Sharī'ah* governance is particular to Islamic finance, as it is the mechanism which determines the “Islamicity” of any particular Islamic business or financial institution as well as of the system as a whole. *Sharī'ah* governance ensures that the industry is at all times in accord with the *Sharī'ah* by ensuring the legitimacy of the products offered and supervising the products sold and applied in the market (Hasan, 2011).

Sharī'ah governance is indispensable for ensuring confidence in the Islamic finance industry in the eyes of the public. A proper *Sharī'ah* governance framework would ensure strict *Sharī'ah* compliance in all practices of the industry. This would give credibility to the industry and instil public confidence. It would also promote operational and financial stability, since it would ensure that the value propositions of Islamic finance are implemented in practice (Abu Ghuddah, 2008).

Effective *Sharī'ah* governance requires the setting up of a clear and comprehensive framework within the legal and regulatory system to regulate the Islamic finance industry and guide its development. Fundamental to this process is the definition of all its actors – in particular, the *Sharī'ah* committee, the board of directors, managers, *Sharī'ah* reviewers, *Sharī'ah* auditors, etc. Their roles and responsibilities for the progress of the whole Islamic finance sector have to be spelled out. Other aspects of *Sharī'ah* governance are supporting initiatives to enhance a *Sharī'ah* adviser's performance, such as a legitimate mandate, the establishment of a *Sharī'ah* secretariat, *Sharī'ah* research capacities and others.

v. Legal and *Shari'ah* Framework for Lender of Last Resort and Deposit Insurance Facilities

This chapter so far has dealt with steps that should be taken to ensure the *Shari'ah* compliance of the legal and regulatory environment of Islamic financial institutions. Legal and regulatory reforms and adjustments are priority areas from a *Shari'ah* point of view. However, the central bank may have a somewhat different priority. The basic financial intermediation through banks always implies a stability risk and a consumer protection concern. Bank intermediation is based on the collection of short-term deposits for medium- to longer-term financing operations. Hence, there is an inherent liquidity problem in bank intermediation with the potential to escalate – under adverse circumstances – into a bank run, which could then lead via contagion effects to a systemic crisis. It is a top priority for central banks to have instruments at their disposal that can prevent the proliferation of individual liquidity problems to the point of initiating a systemic crisis. Two widely used instruments are lender of last resort (LOLR) facilities and deposit insurance schemes. From a central bank's perspective, it is of utmost urgency to implement such instruments also for the Islamic banking sector, even if a general consensus on a *Shari'ah*-compliant arrangement has not been reached and several approaches are still subject to debates among *Shari'ah* scholars.

Islamic banks, unlike conventional banks, are actually even more vulnerable to the liquidity problem due to, among other reasons, the limited availability of liquidity management instruments. *Shari'ah*-compliant interbank markets are often shallow and the range of liquidity management tools is rather limited.

A *Shari'ah*-compliant LOLR facility could be based on a central bank guarantee (*Kafalah*) to Islamic banks under liquidity distress, where the central bank provides liquidity against certain collateral. The guarantee itself is not eliminating banks' liquidity risk, but rather helps banks to fulfill their obligations to third parties when there is an unexpected liquidity mismatch. As such, LOLR from the central bank is not intended to shield banks from risks of their normal business operations. Rather, it is a facility for banks that face an unusual liquidity distress due to depositors' unscheduled liquidity withdrawals. Hence, LOLR can hopefully maintain the continuity of Islamic banking operations. Yet, due care is needed to prevent moral hazard arising from the nature of insurance that is inherent in the LOLR (Alamsyah, 2011).

One way to create a kind of insurance mechanism against systemic risks would be the formation of a systemic risk fund as a *Takāful* scheme to which banks with systemic relevance will contribute. This fund needs to be stipulated and coordinated by the central bank, as contributing banks normally do not want to hold securities until maturity for the purpose of maintaining market stability. But the central bank has the power to instill a cooperative attitude among banks that otherwise are competitors (Alamsyah, 2011).

In addition to the LOLR, systemic stability and depositor protection should be achieved by a *Shari'ah*-compliant deposit insurance scheme. A scheme designed to protect

depositors when an Islamic banking institution fails instills confidence among the general public in the safety of deposits, promotes the stability of the financial system, and preserves the competitiveness of Islamic deposits.

The Islamic deposit insurance system is an arrangement to protect insured depositors against the loss of their deposits placed with Islamic banking institutions in the event of the failure of the bank. Establishing an Islamic deposit insurance system could be beneficial to a country that practises Islamic finance. A comprehensive safety net within the Islamic financial industry would contribute to the strength of the system (Arshad, 2011).

A number of different approaches are used to implement a *Sharī'ah*-compliant deposit insurance system: government regulation, *Sharī'ah* contracts, or a combination of both.

Under government regulation, the government's efforts to set up an Islamic deposit insurance system are regarded as being in line with the Islamic concept of *Siyāsah Shar'iyyah*. *Siyāsah Shar'iyyah* refers to any action taken by the government in the interests of the public, or *Maslahah*. Some *Sharī'ah* contracts are available which could be examined and assessed on their suitability for an Islamic deposit insurance system, such as *Kafālah bil 'Ujr* (guarantee with fee) and *Takāful* (mutual guarantee) contracts. Islamic deposit insurance systems have been implemented in several countries, and further studies are needed to put forward best-practice recommendations.

vi. The Functions of Regulators in Macprudential Surveillance

Prudential supervision of the banking and financial industry is necessary to ensure the soundness of the financial system and enhance banks' role as active players in the development of the economy. According to a study by the IMF (1998) on banking supervision in an Islamic framework, prudential supervision of the Islamic banking industry is important to prevent insolvency risk, and risk of economic losses as a result of poor investment decisions, and also because weak banks may detract from the achievement of fundamental macroeconomic objectives, such as the efficiency of the payment system and effectiveness of monetary policy.

Financial crises, which reoccur over time, signal the need for means to identify and assess system-wide risks and to modify the regulatory and supervisory framework in order to mitigate risks and contain them within manageable dimensions. The recent crisis has highlighted the limitations of supervisory and regulatory frameworks in preventing the build-up of imbalances in the real sector with resulting adverse impacts on financial systems. It has also underscored for regulators the importance of monitoring and supervising from both the microprudential and macroprudential perspectives to ensure the stability of the financial system (Kardar, 2011).

At present, there is an emerging consensus on the need for a supervisory framework that would ensure prudence, discipline and transparency in individual financial institutions as well as in the macrofinancial system.

The overall objective of macroprudential surveillance is to limit the incidence of financial crisis and minimise the related costs to the country's economy. The key components of a viable macroprudential framework would comprise the following (Kardar, 2011):

- a system-wide review of the threats to the stability of the financial system, and the identification and analysis of risks posed by the interconnectivity of financial institutions and markets;
- an analysis of business cycles to identify and address the risks from procyclicality and herd mentality tendencies in the financial system;
- the identification of market failures that could result in financial crisis; and
- definition of the specific roles of all key stakeholders, regulators and parallel institutions, governments, central banks and regulators of banks, and non-banking finance companies (NBFCs) in maintaining financial system stability on an ongoing basis.

An effective macroprudential framework with the capacity to pre-empt risks and put in place an adequate set of instruments and mechanisms to mitigate them requires that all regulators and financial managers coordinate and engage actively under some formal institutional setting (Kardar, 2011). This could be done by having the following:

- Prudential regulations and other instructions to keep a close watch on the performance and stability of the banking system as a whole.
- Off-site surveillance and on-site supervision of Islamic banking institutions.
- Financial soundness indicators (FSIs) such as the advances-to-deposit ratio to assess the liquidity risk of banks. This gives a sense of any accumulation of risks on the balance sheets of individual banks and of the banking sector as whole. It can also help in the early identification of systemically important financial institutions (SIFIs) in difficulty and their role in attaining or threatening the overall stability of the financial system.
- Stress testing to assess overall risk exposures such as credit risk, real estate price risk, equity price risk and exchange rate risk, as well as the structural vulnerabilities of banks that could have contagion effects.
- Early warning systems (EWS) with early warning indicators for banking crises and a forward-looking assessment of the financial system.
- Consolidating and increasing the scope of supervision to achieve financial stability. This is in line with an increasing trend of consolidation in the financial sector in all markets. In the mid-1990s only 40% of the world's 500 largest financial firms were conglomerates, but that number has now increased to 70%. The supervision of conglomerates is important to protect banks from contagion risks, especially if the capital of the bank has been over-leveraged indirectly.

- Reducing procyclicality and strengthening bank capital buffers to improve the global banking industry's ability to absorb shocks arising from financial and economic stress, thus limiting the risk of spill-overs from the financial sector to the real economy as mandated by Basel III.

E. EFFECTIVE LEGAL AND REGULATORY FRAMEWORK

A legal and regulatory framework in general aims at laying down the operational framework for an Islamic financial system. It involves all dimensions of Islamic financial practices from product structuring, issuance and marketing, to dispute settlement.

A solid legal and regulatory framework for Islamic finance should be built on concepts and rules as defined by *Sharī'ah*, as the entire operation of the Islamic finance industry is based on *Sharī'ah* and tied to *Sharī'ah* rules. An effective legal and regulatory framework also requires readable, reliable signals of the risks that a financial institution faces resulting from its own behavior or from events external to it, as well as risks that may affect the financial system through contagion, or infrastructure failure. It also requires an ability to process these readable signals and to introduce the appropriate corrective actions as needed (World Bank Policy Research Working Paper No. 3227, 2004).

Furthermore, in practical terms, an effective legal and regulatory framework for Islamic finance also requires the following dimensions to be prepared and established.

i. Legally Binding Rules which are Promulgated in Advance in a Clear, Stable and Consistent Manner

An effective legal and regulatory framework requires clear formal, institutional and procedural criteria for the rule of law with appropriate processes for making, enforcing and changing rules. The legal and regulatory framework needs to be developed with the mission to become the procedural framework for efficient transactions. In this regard, there should be clear procedures on how laws and rules are being enacted, enforced and changed. This should also take into account how the *Sharī'ah* laws in the field of financial transactions can be adopted as part of a country's laws and rules.

In addition, the existence of well-functioning public institutions applying the laws fairly and independently is important in ensuring the credibility and sustainability of the finance industry. The rule of law should therefore also be upheld by all stakeholders: the regulators, industry players and customers.

ii. Specific Legal Framework Dealing Exclusively with Islamic Finance

To accommodate the development of the Islamic financial industry, a specific legal framework for Islamic finance is needed. A study by the IMF (1998: 15) recommends that "in order to provide the legal foundations for the supervision of Islamic banks, it

is necessary that either the general banking laws or specific laws pertaining to Islamic banks define in detail the nature of these banks and their specific operating relationship with central bank and other conventionals, if applicable”.

Such a legal framework should contain provisions relating to licensing, and permissible modes of financing, and state clearly the powers available to address compliance with laws and regulations. The legal framework would also function as a regulatory basis for the Islamic financial industry that would promote financial stability and development in compliance with *Sharī'ah*.

Malaysia, for example, has recently published a new law governing Islamic banking and *Takāful*, namely the Islamic Financial Services Act 2013 (IFSA). The IFSA will replace two existing Acts: Islamic Banking Act 1983 and *Takāful* Act 1984. The IFSA aims to introduce a more risk-focused and integrated approach to the regulation and supervision of financial institutions to safeguard financial stability; provide a comprehensive *Sharī'ah*-compliant legal framework in all aspects of regulation and supervision; and ensure effective functioning of the money market, foreign exchange market and payment system.

The enactment of IFSA brought about regulatory changes in three areas of the Malaysian financial sector, as follows:

- It imposed more extensive and intrusive regulation in the areas of capital, liquidity, incentive systems, governance, consumers and accounting, and hence enhanced the scope of regulation for systemic institutions.
- It strengthened institutional arrangements to avoid gaps and clarify accountability by having a more formalised arrangement for coordination and cooperation.
- It improved the international financial architecture by reforming international institutions to reflect the enhanced role of Islamic finance, to broaden the representation of Muslim countries, and to allow for more diversity in financial matters and their regulation.

iii. An Enabling Environment that Accommodates and Facilitates the Development of the Industry

Clear policy decisions and directions from the Islamic finance authority are important in ensuring an effective legal and regulatory framework. A country that adopts a dual banking system should have directions on Islamic finance in its policies and regulations. It should also have a clear roadmap indicating the envisaged future development of Islamic finance. The Islamic finance industry, while being recognised as a distinct system, has to be considered as part of a country's financial system, which affects the country's development and growth. Therefore, legislation to regulate and supervise Islamic financial institutions is also important.

Mechanisms must be in place to ensure that *Sharī'ah* compliance is observed in a comprehensive and rigorous manner. This could be done via a proper *Sharī'ah* governance framework instituted by the regulatory authority responsible for Islamic finance. The *Sharī'ah* governance framework would provide guidelines for the structural operation and mechanisms of Islamic financial practices. The framework would ensure the end-to-end *Sharī'ah* compliance of the Islamic finance industry.

Supporting infrastructures such as accounting standards and human resource development and other non-fiscal initiatives will help to ensure that the industry develops in the direction intended. This should be taken into account in the grand design of a country's Islamic finance development plan. A bright future for Islamic finance in the country requires a solid approach and comprehensive agenda in developing the necessary supportive infrastructure.

Participation in global initiatives such as the IFSB is also important. The Islamic finance industry is a global phenomenon that is attracting interest from people all over the world. With various countries having shown an interest in and commitment to Islamic finance, the next step will be to come up with a global standard that harmonises the legal and *Sharī'ah* dimensions of Islamic finance practices. The IFSB is an institution that attempts to develop global standards on Islamic finance to be adopted by various jurisdictions.

iv. A Clear and Efficient System that Preserves Enforceability of Islamic Finance Contracts

The legal systems in most of the countries that apply Islamic banking and finance are bifurcated. For example, Malaysian law comprises a hybrid of English common law, *Sharī'ah* law and native customary laws.

The interaction between two or more sets of laws has led to the existence of legal pluralism, affecting the certainty, predictability and enforceability of legal transactions and procedures, which, if not managed carefully, may impair the smooth functioning of a banking and financial system. Therefore, efforts to harmonise *Sharī'ah*, regulatory and national law are important in order to have a clear and efficient system that preserves the enforceability of Islamic financial contracts and creates a conducive legal system that facilitates and supports the development of the Islamic finance industry.

To further strengthen the legal system and infrastructure to cater for the growing development of Islamic finance, Malaysia has set up a Law Harmonisation Committee. This special task force was established by the Central Bank to ensure *Sharī'ah* compatibility of the laws of Malaysia that are relevant for Islamic finance. This requires existing laws to be reviewed and harmonised and new laws to be assessed with regards to their *Sharī'ah* compatibility.

v. A Credible and Reliable Forum for the Settlement of Legal Disputes Arising from Islamic Finance Transactions

An effective legal and regulatory framework in Islamic finance requires special courts, benches or committees within the judicial system comprised of judges who are well versed in *Sharī'ah* principles, especially in the area of *Mu'amalat* (commercial transactions).

Such bodies must have access to relevant authoritative *Sharī'ah* resolutions. Of prime importance are resolutions by a National *Sharī'ah* Council if such an institution has been established. Other *Sharī'ah* decisions (*Fatāwa*) issued by international fatwa bodies such as the OIC Fiqh Academy and the *Majma' Fiqh al-Islami Rabitah Alam Islami* are also important and should be taken into consideration for a better understanding of the subject matter and as guidance for wise decisions. Furthermore, the courts and the judiciary system should make efforts to publish high-quality law reports to record and facilitate access to precedents.

Likewise, the Islamic finance industry should ponder whether arbitration (*Tahkim*) and mediation (*Sulh*) by *Sharī'ah* and Islamic finance experts who qualify as arbitrators could be used more extensively to adjudicate cases of dispute. Other methods, such as mini-trials and hybrids of arbitration and mediation (arb-med), could also be explored.

Globally, it is important to set up an internationally recognised adjudicating body (e.g. an International Islamic Arbitration Tribunal) to settle disputes that arise in cross-border Islamic finance transactions.

A comprehensive set of laws and regulations should be put in place to provide the legal infrastructure for a satisfactory resolution of disputes, but also to provide general guidelines for Islamic financial institutions.

vi. A Neutral Tax Regime for Islamic Financial Services

It is now widely realised by industry players as well as investors that in most jurisdictions taxation laws have adverse effects for Islamic finance. If activities which are commonly adopted as Islamic financing modes, such as sale and purchase, leasing and profit-sharing investments, are not recognised as financing, they may be burdened with taxes and stamp duties which are not levied on conventional modes of finance such as lending and borrowing.

The structuring of Islamic financial instruments often comprises multiple transactions and additional parties compared to conventional instruments, and the instruments will therefore initially almost always be exposed to higher taxation. This also means higher costs of operation for Islamic finance players, making it difficult for them to compete on an equal footing with conventional ones. Moreover, this system unfairly penalises the consumers of Islamic financial products, who simply wish to meet their financial needs while complying with certain ethical principles to which they subscribe.

A neutral tax regime that would take into account the nature and characteristics of Islamic finance is therefore important in developing a conducive legal and regulatory framework for Islamic finance, to ensure the sustainability and competitiveness of Islamic finance as a business. It has to be acknowledged that an Islamic financial institution is, like other financial institutions, a business entity. For such an entity to continue to be sustainable, it must provide services more efficiently, expand its customer base and increase its competitiveness.

F. CONCLUSION.

In general, the aim of a legal and regulatory framework is to lay down the guidelines and operational framework for an Islamic financial system. It involves all the stakeholders in Islamic financial operations and covers all aspects of Islamic financial practices, from product structuring, issuance and marketing, to dispute settlement.

As *Sharī'ah* is the backbone of the industry, a solid legal and regulatory framework for Islamic finance should be built on concepts and rules as defined by *Sharī'ah*. Bangladesh may move forward via an enhancement of the *Sharī'ah* framework for Islamic finance. This would include all necessary aspects, such as *Sharī'ah* standards for Islamic financial products, a *Sharī'ah* governance framework, and a comprehensive *Sharī'ah* compliance framework for all operations of Islamic financial institution to preserve the integrity of the Islamic finance industry. It would also include support for the court system and institutions for arbitration (*Tahkim*) and mediation (*Sulh*) as alternative schemes for dispute settlement in Islamic finance.

Furthermore, the central bank should establish a central *Sharī'ah* advisory body in order to harmonise different *Sharī'ah* views issued by the different *Sharī'ah* boards at the bank level. The central bank should also have a dedicated department to deal with Islamic banking issues and, from time to time, issue guidelines and regulations related to Islamic banking. To address the problem of liquidity, the central bank should establish Interbank Islamic Money Market instruments for the purpose of liquidity management for Islamic banks, LOLR facilities and a *Sharī'ah*-compliant deposit insurance.

Finally, it is important to note that an Islamic financial system is not just banking. Therefore, the Government of Bangladesh must establish a comprehensive capital market and *Takāful* framework for the country in order to strengthen its Islamic finance infrastructure.

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Chapter 4

ISLAMIC CAPITAL MARKETS AND LIQUIDITY MANAGEMENT: FACILITATING *SHARĪAH*-COMPLIANT FINANCING AND INVESTMENT

Zainal Izlan Zainal Abidin

A. ISLAMIC CAPITAL MARKET

“Capital markets” refers to markets where securities such as shares and bonds are issued to raise medium- to long-term financing and where the securities are traded by matching the users of capital (for fund-raising) with the suppliers of capital (for savings and investments). Capital markets consist of the primary market for new issuances and the secondary market, where transactions in previously issued financial instruments are carried out through an exchange or in the over-the-counter (OTC) market.

The Islamic capital market (ICM) is a capital market where the products and services, as well as practices, comply with *Sharī'ah* principles. The products include *Sharī'ah*-compliant equities, *Sukūk* and Islamic indices, to name a few, with early developments in these areas being the issuance of the Shell MDS *Sukūk* in 1990, the introduction of the list of *Sharī'ah*-compliant securities traded on the Kuala Lumpur Stock Exchange by the Securities Commission Malaysia in 1997 and the launch of the Dow Jones Islamic Market Index in 1999.

i. Background

The steady development of the ICM over the past several decades has enabled it to become an increasingly viable alternative to the much more established conventional capital market as a source of financing and an avenue for savings and investments. The ICM has expanded its breadth and depth in many aspects, including its range of products and services, the number and diversity of market participants, its infrastructure and capabilities, and its geographical reach. For instance, a growing number of multinational conventional-based financial institutions have embarked on ICM activities such as Islamic fund management and *Sukūk* advisory, and *Sukūk* are increasingly being recognised as a new asset class and being used by conventional financial institutions as a way to diversify their portfolios. Furthermore, several jurisdictions have introduced legislative and tax changes to provide a level playing field for ICM transactions vis-à-vis the conventional market.

Authorities and regulators have taken different approaches in facilitating the ICM within their respective jurisdiction. One approach is for the ICM to operate alongside the conventional capital market with specific ICM-related regulations and requirements adopted in addition to those in the conventional market, as in the case of Malaysia. Another approach is to allow ICM activities to be undertaken within the existing (conventional) capital market regime without any additional specific regulations or

requirements, as practised in many jurisdictions presently. Both these approaches are usually prevalent where the conventional capital markets are already established. Another approach is to develop the entire capital market (and the financial industry) as being wholly Islamic, as in the case of Iran and Sudan. This approach typically requires a policy decision at the highest level.

ii. Types of ICM Products

ICM products that are currently available in the market include the following:

Sharī'ah-compliant Stocks/Equity Securities

Sharī'ah-compliant equity securities are typically ordinary shares of listed companies which have been classified as *Sharī'ah* compliant for investment, based on the companies' compliance with applicable *Sharī'ah* screening criteria. Equities are risk-sharing in nature, where investors participate in the potential for capital appreciation and dividends as well as the risk of loss.

Islamic Unit Trust/Mutual Funds

An Islamic unit trust fund is a collective investment scheme that offers investors the opportunity to invest in a diversified portfolio of *Sharī'ah*-compliant equity securities, *Sukūk*, Islamic money market instruments and other *Sharī'ah*-compliant asset classes. The majority of Islamic unit trust funds invest mainly in equity securities.

Islamic Real Estate Investment Trusts (REITs)

A REIT is an investment vehicle that invests the majority of its total assets in real estate, whether through direct ownership or a single-purpose company whose principal assets comprise real estate assets. REITs typically offer competitive dividend yields, low correlation with common stocks and a potential hedge against inflation. The key difference between a conventional and Islamic REIT is the requirement for the income of the latter to be sourced from *Sharī'ah*-compliant rental and related activities. The operation of an Islamic REIT must also comply with the *Sharī'ah*, including its deposit and financing activities, as well as the acquisition and disposal of real estate.

Islamic Exchange-traded Funds (ETFs)

An ETF is a collective investment scheme that tracks the performance of a benchmark index usually by investing in the constituent securities or instruments of the index. Some ETFs achieve this objective through swap arrangements or synthetic replication. For an Islamic ETF, the benchmark index consists of *Sharī'ah*-compliant constituents and the fund therefore invests in these index constituents and, where permissible, other *Sharī'ah*-compliant instruments.

Islamic Private Equity

Islamic private equity focuses on investments in privately held *Sharī'ah*-compliant companies. Where the investment size is significant, investors may be able to seek board representation in the investee company. A private equity investment provides investors with potential for relatively high returns as they also would assume higher

risks due to the higher probability of failure. One exit mechanism for investors when the company performs well is through a public listing.

Sukūk

Sukūk are an alternative to bonds as long-term debt instruments. They are structured based on a *Sharī'ah*-compliant contract of exchange of assets or services, or a contract of participation or partnership. Such contracts can be made through the sale and purchase of assets based on deferred payment, leasing of specific assets or participation in joint-venture businesses. Hence, the issuance of *Sukūk* is not an exchange of paper for money with the imposition of interest but, rather, an exchange of *Sharī'ah*-compliant assets for some financial consideration applying various *Sharī'ah* principles, such as *Mushārah*, *Mudārah*, *Ijārah*, *Murābahah* and *Wakālah*, that allow investors to derive profits from the transactions. Diversity of structures and Islamic financial contracts used for the issuance of *Sukūk* provides flexibility to issuers in managing their distinct financing requirements – for example, for expansion of business, working capital, refinancing or project financing. *Sukūk* issuers may include governments, quasi-governments, public listed companies, private corporations and multilateral organisations.

Other Products

The development of structured products has been limited, due in part to the relatively narrow range of underlying ICM instruments compared to the conventional space and also *Sharī'ah* acceptability. Similarly, derivatives have generally attracted concern, as they are viewed to have *Maisir* and *Gharar* elements. Nevertheless, there are instances where derivatives may be used if the goal is risk mitigation rather than speculation.

B. GLOBAL OVERVIEW ON ISLAMIC CAPITAL MARKET

i. Recent Developments of ICM Products and ICM Regulations

The recent developments in the ICM signify the efforts taken by some jurisdictions to institute structural changes in the markets as well as the industries' drive towards innovation.

Sharī'ah-compliant Equities

As a proxy for the size of *Sharī'ah*-compliant equities globally, the market capitalisation of the Dow Jones Islamic Market World Index component stocks amounted to USD20.5 trillion as at end February 2014. While the size of *Sharī'ah*-compliant equities is typically not included in the quoted global size of the IFSI, the substantial market cap of these component stocks provides an indication of the significant potential for Islamic equity investments and fund management, including further development of Islamic collective investment schemes such as unit trust or mutual funds and ETFs.

Furthermore, initiatives in 2013 in the area of *Sharī'ah*-compliant equities reflect responses to investor demand and preferences for *Sharī'ah*-compliant products as

well as continuing efforts by regulators to facilitate further development of the ICM, which include the following:

- introduction of a new *Sharī'ah* screening process for listed companies by the Philippine Stock Exchange (and possible launch of an Islamic sub-index in 2014);
- introduction of a broad-based Islamic equity index by Bombay Stock Exchange in India;⁶
- listing in Malaysia of the world's first *Sharī'ah*-compliant stapled securities, comprising REITs and ordinary shares; and
- implementation of revised *Sharī'ah* screening methodology for equities in Malaysia.

Islamic Funds

Islamic funds have grown significantly and are now available in over 75 countries worldwide. From only 283 funds in 2000, the number reached 1049 in 2013, equivalent to an average annual growth of 10.6%. Over the same period, Islamic funds' total assets under management recorded average annual growth of 57.4%.⁷ Malaysia and Saudi Arabia lead the size and number of Islamic funds globally, although most of these funds serve domestic demand. Luxembourg remains the preferred global Islamic funds centre.

Sukūk

Sukūk have become an increasingly popular mode of raising financing through the ICM as they have enabled governments and corporations to tap a new source of funding while providing a new asset class to investors. *Sukūk* have played a significant role especially in financing the development of the infrastructure sector in various jurisdictions over the past decade, as many infrastructure assets are inherently *Sharī'ah* compliant.

Growth in *Sukūk* issuances has been exponential, despite a decline in 2008, charting a compounded annual growth rate of 50.5%⁸ between 2008 and 2013. *Sukūk* outstanding globally stood at USD270.1 billion as at year-end 2013. The cumulative infrastructure projects and funding needs in both the GCC and Asian regions have supported the growth of the *Sukūk* market. Traditional bond issuers have also looked to issuing *Sukūk* to capitalise on rising investor demand for *Sharī'ah*-compliant products.

In the case of Malaysia, which is the third-largest bond market in Asia relative to GDP, growth of its *Sukūk* market can be attributed to the government's support by ensuring its agencies prioritise *Sukūk* issuance (as opposed to conventional bonds) and providing tax incentives, the presence of facilitative regulatory and *Sharī'ah* governance frameworks, and the deep pool of investors seeking *Sharī'ah*-compliant instruments as well as issuers preferring to operate their businesses in a *Sharī'ah*-

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⁶ www.reuters.com/article/2013/05/01/islamic-finance-india-idUSL6N0DI02R20130501

⁷ KFH Reports: Islamic Fund Review 2013 and Islamic Finance Outlook 2014.

⁸ KFH Reports: Global *Sukūk* Market 2010/2011 and Islamic Finance Outlook 2014.

compliant manner. *Sukūk* issuance in Malaysia is also yield-competitive for the issuers given the strong demand arising from the larger investor base.

Some of the Gulf countries such as Saudi Arabia, Qatar and the UAE have also undertaken significant *Sukūk* issuances as they seek to develop their respective *Sukūk* market while rolling out their economic development projects. At the same time, there have been recent entrants into the *Sukūk* market, including the Development Bank of Kazakhstan and the Osun State of Nigeria, reflecting the wider acceptability of *Sukūk* in various parts of the world as an effective means to raise financing. Multilateral organisations have also continued to be a significant category of *Sukūk* issuers, with the Islamic Development Bank (IDB) and the International Islamic Liquidity Management Corporation (IILM) being recent entities to offer *Sukūk* in the market for different objectives – that is, to finance medium- and long-term projects and to facilitate short-term liquidity management for Islamic financial institutions, respectively.

Non-traditional jurisdictions have also begun to take concrete steps to tap the *Sukūk* market. Hong Kong recently passed bills to provide tax neutrality for *Sukūk* issuance as well as to enable the government to issue *Sukūk*. The UK Prime Minister announced in October 2013 that the UK government would issue a sovereign *Sukūk*, in part to demonstrate its seriousness in positioning the country as an Islamic financial centre.

ii. Current Issues in ICM

In spite of recent progress, the ICM – from a global perspective – is still at a nascent stage. For sustained development, it is essential to have breadth and depth in the ICM where there is variety and diversity of products being offered that would appeal to the different cross-sections of the market and also ample primary and secondary liquidity as well as active participation by players and investors.

At the same time, some issues that are affecting the ICM development agenda, such as higher transaction costs, need to be addressed, which is partly due to the relatively small scale/volume of ICM transactions and the low familiarity with ICM structures among service providers. Another key challenge for the further development of the ICM is in achieving greater universal acceptability to the extent that its value proposition should be viewed from economic and commercial perspectives and not just from a religious standpoint. Furthermore, full-fledged ICM product issuers and service providers still largely operate on a small scale, relative to their conventional counterparts. In order to sustain the growth that has been achieved thus far, there is a need to build scale in the various segments of the ICM, among others through the strengthening of service and operational infrastructure, including distribution channels, promoting greater product innovation and development, and enhancing international collaborations.

Variations in *Shari'ah* interpretations, though limited to only a few areas, also pose a challenge, particularly in spurring more cross-border activities. Nevertheless, certain

standards⁹ for the Islamic finance industry have been put in place to catalyse its development and facilitate cross-border practices.

iii. Infrastructure and Institutional Development

In supporting the development of Islamic finance globally, several Islamic multilateral organisations and entities have been established. In respect of the ICM, they include the following:

International Islamic Liquidity Management Corporation (IILM)

IILM is an international institution that was established with the objective of creating and issuing short-term *Shari'ah*-compliant financial instruments to facilitate effective cross-border Islamic liquidity management. In August 2013, IILM launched its inaugural *Sukūk* certificates valued at USD490 million. The three-month Islamic bonds were denominated in US dollars and were fully subscribed, receiving an A-1 rating from S&P. The *Sukūk* issuance aims to address challenges that Islamic financial institutions have been facing with respect to the availability of short-term financial instruments.

International Islamic Financial Market (IIFM)

IIFM is an international organisation that focuses on the ICM and money market segment of the Islamic finance industry. Its primary focus is on the standardisation of Islamic financial products, documentation and related processes at the global level.

IIFM aims to assist in the development of the Islamic finance industry by addressing its product and documentation standardisation needs, providing a universal platform to market participants through “Global Working Groups” for the development of the ICM and money market, and promoting *Shari'ah* harmonisation in documentation, products and processes.

Islamic International Rating Agency (IIRA)

IIRA is a rating agency established to provide Islamic capital markets and the Islamic banking sector with a rating spectrum that encompasses the full array of capital instruments and specialty Islamic financial products, and to enhance the level of analytical expertise in those markets. Its rating system recognises and incorporates the unique features of Islamic finance.

The primary objective of IIRA is threefold:

- i. rating Islamic financial institutions differently from conventional financial institutions, recognising their unique features;
- ii. facilitating the development of the *Sukūk* market through National Scale Ratings; and
- iii. mapping of ratings by IIRA and cross-border transactions.

⁹ Such as the IFSB Standards; Tahawwut Master Agreement by International Islamic Financial Market and International Swaps and Derivatives Association, Inc.

iv. Regulatory Framework for ICM

Having in place a sound regulatory framework that is developed in accordance with relevant standards is imperative in ensuring an ICM that is orderly, fair and transparent. Standard-setting bodies and initiatives in respect of the ICM include the following:

Islamic Financial Services Board (IFSB)

The IFSB, which commenced operations in 2003, is an international standard-setting organisation that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors.

The standards prepared by the IFSB follow a lengthy due process as outlined in its “Guidelines and Procedures for the Preparation of Standards/Guidelines”, which includes the issuance of exposure drafts, the holding of workshops and, where necessary, public hearings.

The IFSB also conducts research and coordinates initiatives on industry-related issues. It organises roundtables, seminars and conferences for regulators and industry stakeholders. The IFSB works closely with relevant international, regional and national organisations, research/educational institutions and market players. By November 2013 the IFSB had published 13 standards and six guidance and technical notes, with one standard relating specifically to the ICM: Guiding Principles on Governance for Islamic Collective Investment Schemes.

International Organization of Securities Commissions (IOSCO)

IOSCO, established in 1983, is the acknowledged international body that brings together the world’s securities regulators. It is recognised as the global standard setter for the securities sector. IOSCO develops internationally recognised standards for securities regulation, promotes their implementation in the various jurisdictions, and works intensively with the G20 and the Financial Stability Board on the global regulatory reform agenda.

IOSCO undertook a fact-finding study in 2004 (“A Report of the ICM Task Force of the IOSCO”, July 2004) to assess the development of ICM from a regulatory perspective and to identify potential regulatory issues. According to the Report, a capital market with a sound regulatory framework and supporting infrastructure must first be present in order to nurture and support an Islamic component; thus, ICM products and services may be introduced and developed within an existing well-structured securities market. The Report also noted that the conventional securities regulation framework and principles equally apply to ICM, with the addition of some form of *Shari’ah* approval or certification processes. The Report further noted that there is no need to formulate separate regulatory principles for ICM.

In this regard, the Securities Commission Malaysia (SC), for instance, regulates the ICM in Malaysia by developing a two-tier approach as part of its regulatory framework. Under the first tier, the universal/general regulatory requirements apply to all capital market products and services. Under the second tier, relevant *Sharī'ah* requirements are applied to specific ICM products and services.

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)

AAOIFI is an Islamic international autonomous not-for-profit corporate body that prepares accounting, auditing, governance, ethics and *Sharī'ah* standards for Islamic financial institutions and the industry. AAOIFI standards are part of the regulatory requirement or IFIs' internal guidelines in jurisdictions that offer Islamic finance across the Middle East, Asia Pacific, South Asia, Central Asia, Africa, Europe and North America, as well as the Islamic Development Bank Group. Notwithstanding, the AAOIFI standards have contributed to a greater harmonisation of Islamic finance practices around the world.

Collaboration

In widening the acceptability and appeal of *Sukūk* and other ICM products globally, an effective disclosure regime has to be put into place. This is an important tool for investor protection and will help strengthen the overall regulatory environment. It would also promote greater cross-border activities by facilitating transparency and greater understanding of the nature of the instruments and related risks and rewards.

Consistent with this, the IFSB has conducted research on the disclosure requirements by capital market regulators in various jurisdictions. Having reviewed several *Sukūk* prospectuses and offering circulars from 2006 to 2010, it concluded that, generally, the contents of the *Sukūk* prospectuses and offering circulars were dependent upon the jurisdiction in which the *Sukūk* were offered as well as the target investors. The *Sukūk* issuers tend to comply only with the local regulations where the target investors are domestic investors. However, where global investors are involved, the *Sukūk* prospectuses and offering circulars may contain more disclosures (to meet the disclosure requirements of the relevant authorities). This reflects that there is currently no international standard for specific disclosure requirements on *Sukūk* issuance.

Following on from the findings, the IFSB had collaborated with IOSCO and the SC to organise a high-level "Roundtable on Disclosure Requirements for ICM Products" in 2012 in Malaysia. The roundtable brought together leading practitioners, senior regulators and academics to present their thoughts and perspectives on issues and challenges in this area. Arising from the roundtable discussions, a joint publication was released in September 2013.

C. LIQUIDITY MANAGEMENT THROUGH ISLAMIC CAPITAL MARKET

Apart from the interbank money market, the ICM plays a significant role in facilitating liquidity management for the overall Islamic finance industry. Mechanisms within the ICM include *Sukūk* issuance and commodity *Murābahah* trading. Some examples from selected jurisdictions are as follows:

i. Bahrain

The Central Bank of Bahrain (CBB) has introduced market instruments based on the principles of *Sukūk al-Ijārah* and *Sukūk al-Salam*. CBB acts as an agent for the government of Bahrain in issuing and managing the periodic *Sukūk* issuances. The *Sukūk* are backed by the government's properties as underlying assets. The issuance of *Sukūk al-Ijārah* is dependent on the debt profile and cash requirements of the government. *Sukūk al-Salam* are instruments issued in the money market by CBB with the intention of directly impacting the levels of current account balances of Bahraini dinar held by CBB for commercial banks in influencing monetary conditions.

In 2011, the Bahrain Financial Exchange launched the first electronic online platform in the Gulf region to conduct *Murābahah* transactions – the e-Tayseer. The platform is used by some of the biggest players in the region for liquidity management purposes. e-Tayseer is a fully automated platform for transactions in the supply, purchase and sale of assets for facilitating *Murābahah* transactions. e-Tayseer allows suppliers to place their assets onto the platform ready to be purchased by financial institutions. Financial institutions can then purchase these assets and conduct *Murābahah* transactions with counterparties to fulfil their liquidity management requirements in a secure online environment. e-Tayseer offers various *Shari'ah*-compliant assets located in the Middle East and North African (MENA) region as well as globally, where all processes are automated end to end.

ii. Gulf Cooperation Council (GCC)

In the GCC, the Liquidity Management Centre (LMC) was established for the purpose of facilitating the investment of the surplus funds of Islamic banks and financial institutions into quality short- and medium-term financial instruments structured in accordance with *Shari'ah* principles. The LMC attracts assets from governments, financial institutions and corporates in both private and public sectors in many countries. The sourced assets will be securitised into readily transferable securities or structured into other innovative investment instruments.

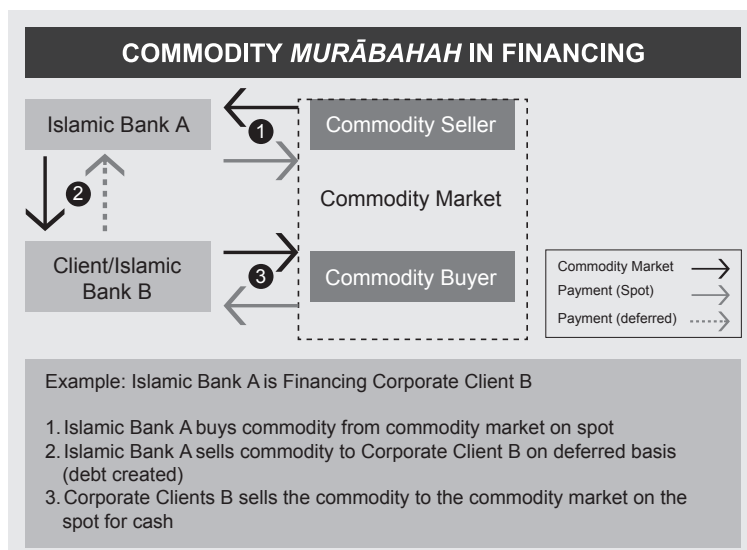
The LMC provides liquidity management facilities to Islamic finance/banking institutions by providing a platform for easy and active secondary trading. This is done through the introduction of several *Sukūk*-based instruments. Aside from enabling secondary *Sukūk* market activities, the LMC also provides standardised facilities for primary *Sukūk* issuance. In addition to providing coordination among parties to enable bilateral funding structures, the LMC also provides services for Islamic fund issuance. For Islamic banks in the region, the LMC's open-ended short-term *Sukūk* programme is probably the most important facility. This program enables collateralised borrowing and lending facilities among institutions, thereby minimising counterparty risk.

iii. Malaysia

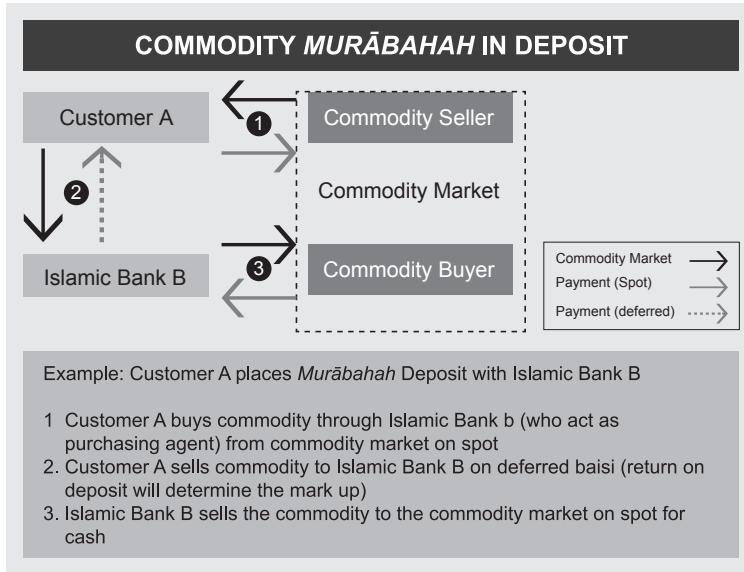
Bursa *Suq Al-Sila'* (BSAS) is a commodity trading platform specifically dedicated to facilitating Islamic liquidity management for and financing by Islamic financial institutions. The fully electronic web-based platform provides industry players with an avenue to undertake multi-commodity and multi-currency trades from around the world. In effect, BSAS integrates the global Islamic financial and capital markets together with the commodity market. BSAS has three main roles in facilitating liquidity management, risk management in the Islamic financial market and Islamic financial product offerings:

Diagram 4.1: Roles of Bursa *Suq al-Sila'*

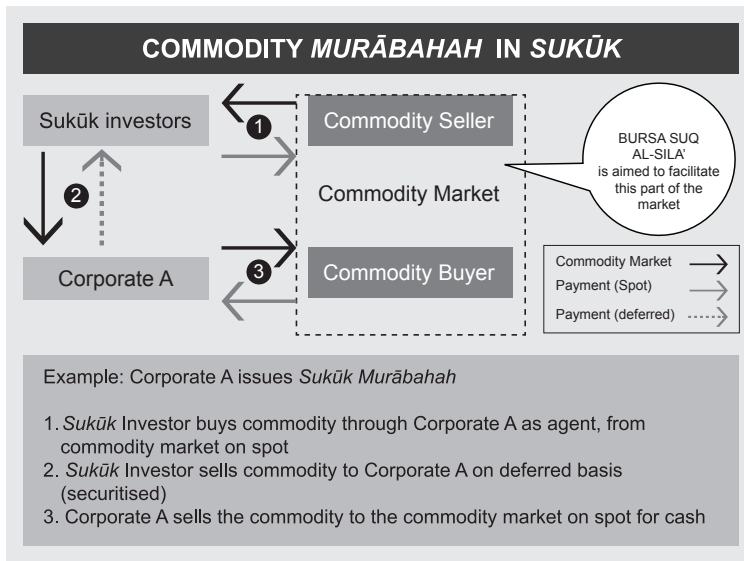
1. To facilitate financing:



2. To facilitate deposit:



3. To facilitate sukūk issuance:



Source: Bursa Malaysia

iv. Turkey

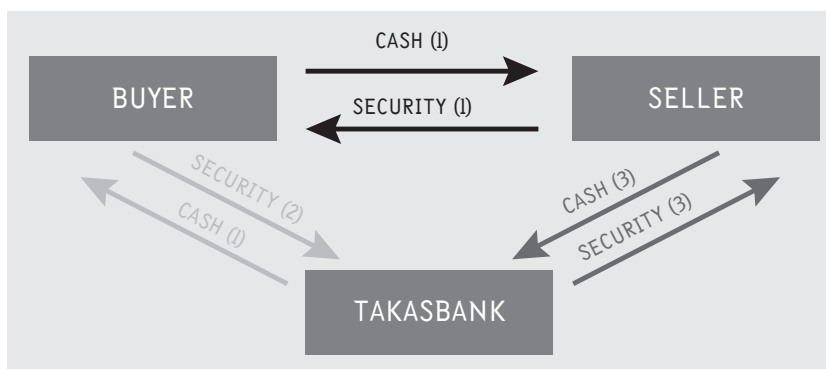
Turkey undertook regulatory changes in 2010 that have created a positive environment for the issuance of *Sukūk* with the introduction of the First *Sukūk* Regulation as well as Asset Lease Company (ALC) as a special-purpose vehicle (SPV). A year later, the government passed vital legislation to facilitate the issuance of leasing certificates (*Sukūk Al-Ijārah*), including tax neutrality measures consistent with equivalent conventional products that paved the way for a series of corporate *Sukūk* issuances in Turkey.

This development was a response to a series of major crises that affected the country – namely the sub-prime crisis, the unexpected global financial crisis and the aftermath of the Eurozone sovereign debt crisis. *Sukūk* were seen as an effective and viable alternative source of raising funds to finance the country's ongoing infrastructure, housing and energy projects.

In September 2012 the Turkish government issued its first sovereign *Sukūk*, a five-year USD1.5 billion issuance which changed the landscape of the industry in Turkey. Three Turkish lira-denominated issuances have since followed, with the government announcing its intention to issue domestic-currency *Sukūk* at least twice a year in order to create a benchmark *Sukūk* yield curve for the domestic debt capital market.

For the management of liquidity, Borsa Istanbul has designed a model as an alternative trading method for *Sukūk* – namely, the Purchase and Resale Agreements on *Sukūk* Certificates.

Diagram 4.2: Structure of Purchase and Resale Agreement for *Sukūk* Certificates



Source: Borsa Istanbul

The first transaction is a purchase and sale transaction carried out at the spot market between the buyer and the seller. Settlement & Custody Bank Inc. (Takasbank) acts only as an intermediary for clearance and settlement for the first transaction.

The second transaction is between the buyer of the first transaction and Takasbank, where the buyer will resell the security to Takasbank at the stated future date and price determined at the first transaction and receives the transaction value from Takasbank. Takasbank is the counterparty to this transaction.

The third transaction is between the seller of the first transaction and Takasbank, where the seller will repurchase the security from Takasbank at the stated future date and price determined at the first transaction and pays the transaction value to Takasbank. Takasbank is counterparty to this transaction. Takasbank has the right of withdrawal from the second and third transactions.

D. DEVELOPING THE ISLAMIC CAPITAL MARKET

A vibrant and efficient ICM can contribute significantly to a country's economic and social development. Apart from the typical role of a capital market in energising domestic economic activities, the ICM has an added advantage of bridging Islamic economies and encouraging greater cross-border financing and investment activities. Furthermore, the ICM promotes greater inclusiveness, particularly among the Muslim segment of the population.

i. ICM in Bangladesh

1. Current Position of ICM in Bangladesh

Islamic Money Market

The Bangladesh Bank introduced an Islamic money market – that is, the Islamic Interbank Fund Market – in 2012 to help address the temporary and short-term liquidity problems and facilitate the liquidity management of Islamic banks. The central bank acts as custodian in the market. Interbank transactions, limited to overnight tenors, are based on a pre-determined profit-share ratio decided by a central bank committee using Islamic banks' deposit rates as a starting reference.¹⁰

Islamic Funds

A recent development in the equity market was the introduction of the Alliance S&P *Shari'ah* Index Fund in September 2013. This open-end mutual fund is the first Islamic index fund in Bangladesh.¹¹

Sukūk

The Bangladesh government introduced a *Muḍārabah* bond named “Bangladesh Government Islamic Investment Bond (Islamic Bond)” in October 2004 to create a new avenue for investment by Islamic banks and financial institutions in the country which could also be used as an approved instrument for the purpose of maintaining the statutory liquidity requirement. Investment in the bond is also open to individuals and non-resident Bangladeshis.¹²

¹⁰ www.reuters.com/article/2012/06/05/islamic-finance-liquidity-idUSL5E8H45DN20120605

¹¹ http://acaml.com.bd/?page_id=270

¹² www.bb.org.bd/pub/annual/anreport/ar0607/chap6.pdf

2. Opportunities for ICM Development in Bangladesh

The Government of Bangladesh has prioritised public–private partnership programs as a key initiative for increasing investments in infrastructure and supporting the realisation of “Vision 2021”, which envisages Bangladesh progressing to a middle-income country by the year 2021. In order to achieve this goal, Bangladesh is targeting raising the GDP growth rate to 8% by 2016 and to 10% by 2021. This would require the share of investments to GDP to be raised to 35–40% from the present average investments-to-GDP ratio of 24–25%. To foster an environment that is conducive to growth, Bangladesh is seeking to increase its investment in infrastructure from 2% to 6% of GDP.

Under the country’s Sixth Five Year Plan, total investments are expected to reach BDT13.5 trillion, of which BDT10.4 trillion will be raised by the private sector. Domestic financing is projected to account for 90.7% of total investments.

Bangladesh’s demographic profile also presents significant opportunities for the development and growth of ICM. With a total population of about 160 million of whom about 90% are Muslims, demand for *Shari’ah*-compliant personal investment and financing products and services may grow substantially in the medium to long term, particularly as the economic growth in the country contributes to an expansion of the middle-income segment.

a. Building Blocks for ICM Development

In establishing the ICM ecosystem, it is critical to ensure that the institutional arrangements for the development and implementation of sound supporting infrastructure and frameworks are in place. In addition, an environment conducive to innovation and development of ICM products and the offering of core and ancillary services needs to be created. Critical factors required for the development of an effective ICM include the following:

Regulatory framework

A facilitative and clear regulatory framework is essential in promoting orderly growth of the ICM as it provides a conducive and sound foundation for product development and service intermediation, while ensuring a robust market supervision regime and adequate disclosure requirements in order to sustain investor confidence and encourage broader market participation. The framework should also ensure that investors in ICM products enjoy the same degree of certainty, clarity and regulatory protection as those investing in conventional products.

Legal framework

A supportive framework that minimises legal impediments to ICM transactions while safeguarding investor rights is important. In addition, the legal framework should contribute towards achieving greater certainty and enforceability in respect of contracts and documentation.

Sharī'ah governance framework

A key differentiator between Islamic and conventional capital markets is the *Sharī'ah* aspect, where *Sharī'ah* governance is a critical inherent component of the ICM. *Sharī'ah* governance plays an exclusive role in ensuring that ICM products and transactions, as well as the operations of institutions offering Islamic financial services, comply with the prescribed rules and principles of the *Sharī'ah*, thereby providing a high degree of assurance to market participants. In practice, the *Sharī'ah* governance framework varies from one jurisdiction to another – in certain jurisdictions, the ultimate responsibility for determining *Sharī'ah* compliance sits at national-level *Sharī'ah* councils or boards, while in others the role is undertaken by *Sharī'ah* committees within individual companies.

Tax

Tax neutrality provisions are imperative to ensure that ICM instruments and structures do not attract higher tax liabilities relative to their conventional counterparts. Such provisions are instrumental in spurring the growth of the ICM (the *Sukūk* market, in particular) as it supports the cost viability of ICM/*Sukūk* transactions.

Products and services

Another pre-requisite for a vibrant ICM is the availability of an extensive range of products and services, supported by the presence of a diverse group of intermediaries that can attract both institutional and retail investors. Having breadth and depth of products in the marketplace provides choices and builds liquidity, while diversity of market participants encourages a more competitive environment that promotes greater efficiency and innovation.

Capacity building

Capacity building is essential in order to develop and sustain a pipeline of qualified professionals to drive the growth of the ICM and ensure that it remains viable and competitive. In doing so, it is important for academic and training institutions to work together with market participants in coming up with suitable programmes which focus on enhancing the required skills and capabilities.

Incentives

Another enabler for the ICM is a set of specific incentives targeted at selected ICM products and services to accelerate their development. However, these incentives should be temporary, as the selected products and services should be commercially viable on their own merit in the longer term.

Government

Firm commitment of the government in promoting the growth of the ICM is instrumental in facilitating the development of the relevant infrastructure for the ICM and in incentivising ICM transactions and activities.

b. Potential Benefits of ICM Development on Market Segments

Sharī'ah-compliant Equities

Development of the Islamic equity market typically involves having in place a *Sharī'ah* stock-screening process which facilitates the identification of *Sharī'ah*-compliant stocks and therefore attracts wider participation from investors that seek *Sharī'ah*-compliant products. At the same time, it can facilitate the construction of Islamic equity indices.

Sharī'ah-compliant equities may also appeal to the global socially responsible investing (SRI) community, as well as environmental, social and corporate governance (ESG) investors, in view of similarities in their underlying values and principles; therefore, the market demand for these stocks is potentially much larger. Furthermore, the screening of stocks creates an additional positive effect for the Islamic financial institutions, as the prohibition of *Riba* (interest) would lead companies to migrate their deposits and financing from conventional banks to Islamic financial institutions.

Islamic Funds

Development of the Islamic equity and *Sukūk* markets facilitates the creation of Islamic investment schemes, such as mutual or unit trust funds and ETFs, with different mandates and objectives to meet the different needs and preferences of investors. In addition, the establishment of publicly available Islamic mutual funds that are accessible to the mass population of the retail market can facilitate greater financial inclusion. To encourage broader participation, investments in such funds can be done through mass distribution points such as post offices. Furthermore, an active and relatively stable real estate market in a particular jurisdiction can contribute towards the structuring and offering of REITs to cater to yield-based investors.

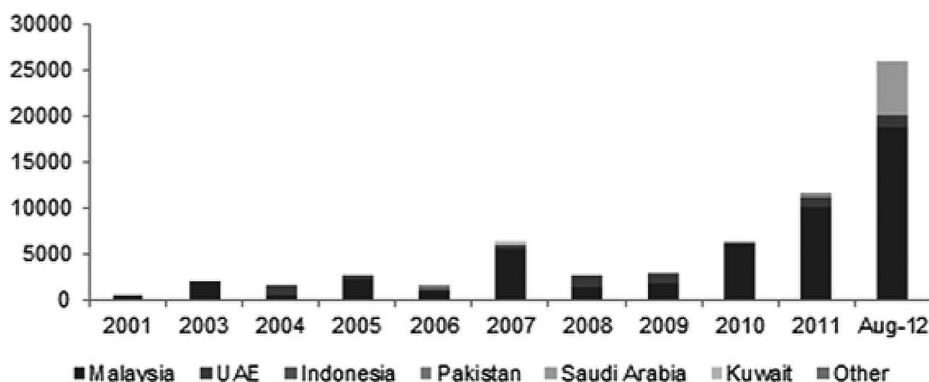
Sukūk

A well-developed *Sukūk* market can help support the stability and efficiency of the financial market. For one, it helps to reduce the dependency on equities as a fund-raising avenue. At the same time, wider availability of *Sukūk*, especially in terms of tenor, would provide income-generating instruments that facilitate liquidity management and asset–liability matching for Islamic financial institutions.

Development of the *Sukūk* market should include both the sovereign and corporate segments, to the extent possible and practicable, in order to enable both the public and private sectors to have the widest possible options for fund-raising. Based on the experience of some jurisdictions, government participation and support would be a major factor in developing a sound *Sukūk* market. Regular issuances by the government would create a yield benchmark for the issuance of corporate *Sukūk* and also encourage *Sukūk* issuance by the private sector. The feasibility of this approach nevertheless would differ between one jurisdiction and another, based primarily on the financial and economic specificities of each jurisdiction.

In jurisdictions with large infrastructure investments, there are significant opportunities for the growth of *Sukūk* as a fund-raising means for both the public and private sectors. The following graph shows the rising trend in the issuance of *Sukūk* for infrastructure projects by selected jurisdictions across the globe.

Chart 4.1: *Sukūk* Issued for Infrastructure Projects



Source: IFIS, Zawya, Bloomberg, KFHR

At the other end of the scale, raising financing through *Sukūk* of relatively smaller sizes will be of particular significance for the SME sector. A facilitative ecosystem to provide SMEs greater access to funding via the ICM would help fuel the growth of these companies and drive the expansion of the SME sector. There are, however, factors for consideration in assessing the viability of SMEs to issue *Sukūk*, including their financial positions, investors' risk appetite and the nature of the business.

There have also been initiatives in several jurisdictions recently to democratise *Sukūk* from being a "wholesale" instrument where investors are usually financial institutions, institutional investors and fund managers. While retail investors may invest in *Sukūk* through mutual funds, *Sukūk* which are offered in smaller denominations ("retail *Sukūk*") will provide access for direct retail participation.

E. CONCLUSION

The ICM is still going through the development stage globally. While some jurisdictions have just embarked on the initial steps, others have achieved a significant level of progress in developing ICM in their respective countries. For any jurisdiction seeking

to develop its ICM, there is no need to reinvent the wheel. Adopting practices and initiatives that have proven effective in other jurisdictions (subject to country-specific peculiarities), as well as observing lessons learned from the experiences of others, can facilitate and accelerate the development of a jurisdiction's own ICM. From a broad, strategic perspective, the formulation of a master plan for the purpose of charting the roadmap for ICM development can be a very useful process. Nevertheless, with or without a master plan, strategies for establishing or enhancing the relevant frameworks and market infrastructure; for attracting issuers, intermediaries and investors; and for developing a broad range of products and services, are critical for a sustainable and orderly development of the ICM in a particular country.

Chapter 5

FINANCIAL INCLUSION THROUGH ISLAMIC FINANCE

Dr. Muhammad Amjad Saqib*

A. FINANCIAL INCLUSION

Social and economic development can be impeded when a large section of society is marginalised and lacks access to financial products that can cater to their needs given their income levels. Greater financial inclusion is a means to realising the aims of development initiatives and goals of poverty eradication. In recent times, financial inclusion has been noted as offering a “comprehensive and complementary” solution to alleviate poverty, to promote inclusive development and to address the Millennium Development Goals (Chibba, 2009).

Financial inclusion is inherent in the nature of Islamic finance. In the context of a global commitment to achieve financial inclusion, exploring the potential of Islamic finance has been given an increased priority as a plausible solution to the present challenge.

One of the major challenges for Islamic finance, especially for those providers focusing primarily on poverty alleviation, has been bringing its programs to scale without compromising on the *Sharī'ah* or the well-being of the firm and its clients. This paper documents the cases of three prominent Islamic finance providers – Islami Bank Bangladesh Limited, which offers commercial banking services as well as microfinance; Akhuwat, which is offering *Qarḍ al-Hasan* in Pakistan; and *Amāna Takāful*, which extends *Takāful* services in Sri Lanka – which, through different Islamic financial instruments, are promoting financial inclusion in a sustainable manner. Their work not only reinforces the link between Islamic finance and financial inclusion, but also demonstrates the viability of Islamic financial instruments. Lessons are drawn from their models to propose pathways for the development of Islamic finance in Bangladesh.

i. Financial Inclusion

“Financial inclusion” refers to a process that ensures the ease of access, availability and usage of the formal financial services, including savings, loans, insurance and leasing for all members of society. It has been recognised as an enabler for poverty reduction and shared prosperity by the UN Secretary General’s High-Level Panel on the Post-2015 Development Agenda. Today, at least 90% of the estimated 2.5 to 2.7 billion people without any access to formal financial services reside in developing countries (Pearce & Tata, 2013). Although there is relatively little solid data on the economic impacts of financial inclusion, studies have shown that financial inclusion reduces poverty and

* The author is thankful for the research contribution of Fatima Rasheed, Shehribano Rava Rizri and Fazareen Amjad towards this paper.

income inequality (Alliance for Financial Inclusion, 2012). In recent years, the global movement to highlight the need and pave the way for greater financial inclusion has gained momentum. The Maya Declaration in 2011, the first global and measurable set of commitments by developing and emerging country governments, testifies to this. More than 80 countries representing more than 75 per cent of the world's financially excluded population support the Declaration's aim to unlock the economic and social potential of unbanked peoples through increased financial inclusion.

In the last few decades, through the advent of the microfinance movement, financial services have been extended to those low-income members of the population who were previously excluded from the formal financial sector. Today, the rapid growth of microfinance institutions has ensured a direct engagement with millions of poor in the world. By offering access to capital, microfinance has been instrumental in improving their well-being and thereby stimulating socio-economic development. Many bold and innovative moves to modernise financial infrastructures and expand financial access have also been undertaken in the past few years. Mobile money products have seen impressive growth, financial institutions are expanding access to underserved populations, and governments are increasingly disbursing payments via formal bank accounts (Klapper, 2012). The Maya Declaration has catalysed efforts to explore pathways to confront the global challenge of financial inclusion. Islamic finance presents one such pathway.

B. ISLAMIC FINANCE

Islamic financial services encompass a broad range of instruments that reflect the varied needs and capacities of different sections of society and thus offer a comprehensive and holistic mechanism for financial inclusion. Islam's essence lies in the principle of "justice to all", termed as 'adl, which means to divide two things equally or to keep the balance. This encompasses social justice, which is one of the fundamental principles of Islam. Social justice in Islam, also referred to as economic justice or distributive justice, embraces three concepts: (1) fair and equitable distribution of wealth, (2) provision of basic necessities of life to the poor and the needy, and (3) protection of the vulnerable against economic exploitation by the strong. These concepts are manifested in the model of Islamic finance, which, by its nature, is inextricably tied to inclusive growth. In other words, no model of Islamic finance could qualify as being "Islamic" or in line with the *Shari'ah*¹³ were it to compromise on any of the three concepts. The focus on growth promotion, distributive justice and mass welfare makes Islamic finance inclusivity driven (Mannan, 2013).

Islamic finance addresses the issue of financial inclusion in two ways: (1) through a range of specific risk-bearing financial products that provide viable alternatives to interest-based financing; and (2) through specific instruments that encourage redistribution of wealth in a society, thereby creating equilibrium in that society.

¹³ The moral code and religious law of Islam.

i. Risk-bearing Financial Products

This paper does not debate the issue of interest in Islam, but it is of significance to note that Islamic jurists hold a broad consensus about the prohibition of interest in any form or magnitude. Moreover, financial contracts in Islamic finance, which are backed by real sector assets and risk-sharing among partners, including financing institutions, make Islamic financial instruments relatively more stable than their conventional counterparts and more flexible against unanticipated shocks. This critical link brings “prudence to the system, promotes equity relative to debt, broadens financial participation, and minimises overall vulnerability” (Alawode, 2013). Risk-sharing products and asset-backed financing instruments suitable in particular for SMEs and microenterprises are:

1. Mudārabah (profit- and loss-sharing)
a profit-sharing contract, with one party providing 100% of the capital and the other party providing its specialised knowledge to invest the capital and manage the investment project. Profits generated are shared between the parties according to a pre-agreed ratio, and the loss is sustained by the party providing the capital.
2. Mushārah (partnership)
a relationship between two parties or more that contribute capital to a business and divide the net profit and loss pro rata.
3. Murābahah (cost-plus financing)
sale of goods at a price which includes a profit margin agreed to by both parties. The purchase and selling price, other costs and the profit margin must be clearly stated at the time of the sale agreement. The bank is compensated for the time value of its money in the form of the profit margin.
4. Ijārah (leasing)
lease, rent or wage under which the bank makes available to the customer the use of services of assets or equipment such as plant, office automation, motor vehicle for a fixed period and price.
5. Bay` al-Salam (pre-paid purchase)
a contract whereby the buyer pays an advance amount to the seller for the goods to be delivered at a future date. This type of financing can be considered as sales by order.
6. Bay` al-Istisnā` (construction/manufacturing financing)
a contract of sale of specified objects to be manufactured or constructed, also suitable for project financing. The buyer usually pays the amount in instalments related to the progress of the manufacturing/construction progress over an agreed period of time.

7. Takāful (Islamic insurance)

a system of risk-sharing through which insurance schemes in compliance with the *Sharī'ah* are created. Legitimate profit and service charges may be charged with the use of these services, as long as they are in line with principles of the *Sharī'ah*. These revenues are the basis for the institution's financial sustainability and ensure the continued provision of insurance services.

ii. Redistributive Instruments

1. *Qarḍ al-Hasan* is a loan extended on a goodwill basis whereby the debtor returns the principal amount without any additional charges or interest. *Qarḍ al-Hasan* was practised and approved by Prophet Muhammad [PBUH]. It is important to note that no income (profit) is generated for the provider of *Qarḍ al-Hasan*, and that the profits earned by the poor will solely be left in their hands.
2. *Zakat* refers to obligatory charity, which is binding on all Muslims. In most Muslim countries, *Zakat* is distributed on an individual level and through the state.
3. *Sadaqāt* refers to voluntary contributions, which are highly encouraged in Islam. The tradition of giving *Sadaqāt* is prevalent all over the Muslim world.
4. *Waqf* is a religious endowment fund in Islamic law, where assets are donated for charitable purposes and held under a charitable trust.

C. MODELS OF ISLAMIC FINANCE

i. Islami Bank Bangladesh Limited

Islami Bank Bangladesh Limited (IBBL) is one of the pioneers in Islamic banking. Established in 1982, IBBL was the first bank in South-East Asia to provide *Sharī'ah*-based banking services. With over 250 branches country-wide, IBBL is among the largest private-sector banks in Bangladesh. It is the country's largest private commercial bank, with profits double that of the second-largest bank (Kroessin, 2011). Its foundation is laid on Islamic values and principles, and it is working to achieve economic development and growth through investment operations focusing specifically on the less developed areas of the country.

All measures and interventions introduced by IBBL cater to the objectives of Islamic finance (Mannan, 2013). IBBL mobilises deposits through different types of accounts: *Al-Wadī'ah* and *Muḍārabah* accounts. It caters to the unbanked segments of society, by encouraging students and farmers to open savings accounts, and has introduced a "Mudaraba Muhor Savings Account" intended to empower Bangladeshi women. It also offers welfare deposit schemes for *Waqf* and *Hajj*. To realise its vision of development vested within an Islamic framework, the IBBL has two arms – the Islami

Bank Foundation¹⁴ and the Rural Development Scheme (RDS) – that carry out its welfare and social development work.

The investment policy of IBBL is based on the profit–loss-sharing system, centred on Islamic *Sharīʿah* principles. Special emphasis is laid on investing in those ventures which create employment opportunities for the economically vulnerable. Projects addressing the critical needs of those in the rural areas are especially encouraged, and no investment is made in socially harmful ventures. IBBL’s recent interventions involve welfare-oriented investment schemes, which include the Women Entrepreneurs Investment Scheme, Agricultural Investment of IBBL, Small Business Investment Scheme and Micro Industries Investment Scheme. These recent interventions have been carried out under IBBL’s Rural Development Scheme, which aims to alleviate rural poverty through an integrated rural development approach. Thirteen Islamic microfinance institutions (MFIs) operate in Bangladesh, and IBBL is the first bank to introduce the Islamic Microfinance Model. It covers 50% of the global Islamic microfinance and is fast gaining momentum (Mannan, 2013). Although IBBL’s interventions through microfinance remains essentially economic in nature, it echoes a strong social development approach with a focus on the promotion of “moral values” and creates awareness about social rights and responsibilities. IBBL’s goal is to reduce the rural–urban economic disparity and create an equitable distribution of income. This can be achieved through the model of “integrated development approach”, encompassing social as well as economic development consistent with *Sharīʿah* principles.

ii. Akhuwat – Mainstreaming *Qard al-Hasan* in Pakistan

In Pakistan, Akhuwat has been providing interest-free microfinance services in line with the *Sharīʿah* since 2001. It has served over 380,000 families by disbursing PKR5.7 billion in interest-free loans with a 99.8% recovery rate. Akhuwat’s envisioned model of inclusive finance, termed the “Muwakhat Paradigm”,¹⁵ incorporates moral principles and financial logic; it draws on principles of social justice and benevolence as manifested in the *Sharīʿah* to create a model that is both equitable and sustainable.

The underlying aim of the Muwakhat Paradigm is to alleviate poverty through an equitable distribution of resources. In doing so, the model addresses both the needs and reciprocal responsibilities of each member of society. To achieve this, the model has been closely aligned with the spirit of volunteerism, moral principles and the *Sharīʿah*.

The first step in implementing the model involves categorising¹⁶ all members of society based on the resources at their disposal. The nature, mode and delivery of each

¹⁴ The Islami Bank foundation runs a number of projects throughout Bangladesh which reflect the values of social justice within an Islamic society: income-generation schemes through interest-free loans (*Qard al-Hasan*); education, including *Madrasahs*; free or highly subsidised healthcare; relief work; and Islamic propagation, which is further linked to the primarily Islamic microcredit credit operation through the RDS (Kroessin, 2011).

¹⁵ Akhuwat derives its name from ‘mwakhaat’ or brotherhood, the earliest example of which was seen in the fraternity formed by the *Ansars* (citizens of Medina) and the *Muhajireen* (or Meccans) who had migrated to Medina to escape religious persecution. Inspired by the spirit which induced the Medinites to share half of their wealth with the migrants, Akhuwat seeks to invoke this very concept of brotherhood through its operations.” www.akhuwat.org.pk/History.asp

¹⁶ The aim of categorisation is to identify the kind and nature of financial services that may be suitable for the different strata of the population.

financial instrument will differ depending on the needs and capacities of the clientele it is intended to serve. Consequently, it becomes essential to draw broad categories within society and to identify corresponding financial instruments they may require. The categories and corresponding financial instruments are summarised in Table 1.

Table 5.1: Overview of Financial Services Accorded to Each Group

Group	Financial Services	Reasons
Group I: Poorest and Destitute	<i>Zakat</i> and <i>Sadaqāt</i>	These individuals are unable to support themselves or their families due to circumstances or ailments which prevent them from being economically active; thus, they can only be supported through <i>Zakat</i> and <i>Sadaqāt</i> . (Purpose: Sustenance)
Group II: Poor	<i>Qard al-Hasan</i> (Interest free loan)	Individuals of this group must be empowered through <i>Qard al-Hasan</i> , as they have the potential and ability to become self-reliant and to contribute to the local economy as opposed to burdening it. (Purpose of loan: Business)
Group III: Vulnerable Poor	<i>Shari'ah</i> -compliant Microfinance	To diffuse the effects of shocks which may push these individuals further down the economic ladder and to enable them to enhance their potential and livelihood, a host of <i>Shari'ah</i> -compliant microfinance services will be offered. (Purpose of loan: Business)
Group IV: Average, Well-to-do, Rich	Islamic Banking	As the members are already economically secure, they will be catered through Islamic banks. Revenue may be generated from the provision of financial services to the members of this group. (Purpose of loan: Business and other)

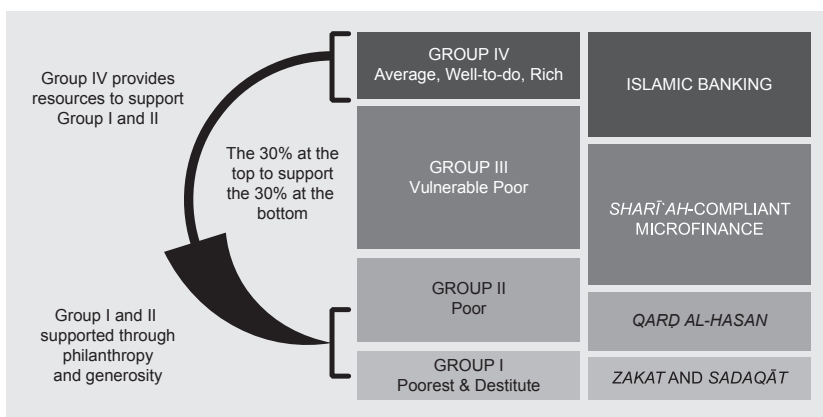
In mainstreaming *Qard al-Hasan* in Pakistan, Akhuwat has mobilised all sectors of society by fostering and harnessing a spirit of volunteerism and relying on indigenous philanthropy to spearhead its programmes. The “Revolving Fund” has been created through donations and is utilised to give loans to the poor and needy without any interest and service charges. Operational expenses are also met through this fund. Because of continuous donations the fund is increasing in size. Its sustainability is based on the assumption that the well-to-do and rich are desirous of sharing their riches with the less privileged and will continue to donate. The success of the model is demonstrated by the fact that the organisation has given around 400,000 loans since its

establishment. If resources from the state are added, the Revolving Fund will increase further. Akhuwat's success relies primarily on developing and reinforcing bonds of brotherhood in a society where all members become cognisant of their rights and responsibilities. This is manifested in many of Akhuwat's borrowers eventually making voluntary donations to the programme, a trend that not only reflects the economic development that Akhuwat seeks to achieve but also, more powerfully, highlights the change Akhuwat aims to inspire in society. These voluntary donations cover at least 70% of Akhuwat's operational costs, with many branches becoming entirely self-reliant.

At the same time, Akhuwat has created a development space for public–private partnerships to promote poverty alleviation in Pakistan. The Government of Punjab, recognising the success of Akhuwat in the past, has partnered with the organisation to lead its flagship socio-economic development programme, called the Chief Minister's Self-Employment Scheme (CMSES). Injection of Rs2 billion in the “Chief Minister's Self-Employment Scheme – Revolving Fund” has helped Akhuwat reach 400,000 families. Not only is there a need for public and private programmes to collaborate over their shared objectives, but also the government must support private programmes to ensure that their benefits can be realised by a greater proportion of the population. In a similar vein, Akhuwat has also provided a platform for private–private partnerships, encouraging and supporting other non-government organisations to replicate its model and embed the Muwakhat Paradigm within their work.

The Muwakhat Paradigm, as envisioned by Akhuwat and in line with the objectives of Islamic finance, is summarised below.

Diagram 5.1: Overview of the Implementation of the Muwakhat Paradigm



Referring to the progress made in Pakistan and as seen by the example of Akhuwat, strong partnerships between the public and private sector are essential for widespread impact. By carrying out its self-employment programs through Akhuwat, the Punjab

government is investing in an established model and yielding extensive results at a faster pace. Instead of creating a new model that would occupy time and resources, this mode proves to be a more efficient and productive. It is recommended that Bangladesh explores similar avenues for growth and prospects for similar collaborations across sectors, which would maximise its potential.

iii. *Amāna Takāful* in Sri Lanka

Takāful is a system of risk-sharing which has similarities to conventional mutual insurance. It involves pooling individual risk exposures on an indemnity basis. The risk is not “sold” to an insurance company but remains with the participants in a *Takāful* scheme. However, the risk pool is not managed by the participants themselves, but by a *Takāful* operator (TO), usually a joint stock company. The TO receives a fee from the participants for the services provided and may also participate in profits generated from the investment of participants’ funds, especially the accumulated capital in family *Takāful* which is the Islamic alternative to life insurance. While the technical aspects of *Takāful* are quite similar to conventional insurance, the design of *Takāful* products is in line with *Sharī’ah* (Swiss Re, 2008). Managers are prohibited under the *Sharī’ah* from taking speculative investment decisions and must invest surplus funds in *Sharī’ah*-compliant (*Halal*) assets. The model creates a financial community in an effort to safeguard the interests of each individual through a collective fund and mutual support. In the case of an ill-fated event, the affected party may benefit from the contributions of the fellow participants who are joint owners of the funds in the risk pool and members of the solidarity group. The emergence of *Takāful* can be traced to the perennial need for a scheme of insurance, void of interest and uncertainty. *Takāful* fills this void with transparency, equity and mutual benefit (*Amāna Takāful* website: www.Takāful.lk/about/concept.php).

The basic models applied in *Takāful* are:

1. The *Muḍārabah* model, which allows the TO to share investment profits with the participants according to a pre-determined ratio. The participants, who are the capital providers, bear the full risk of investment losses.
2. The *Wakālah* model, where the TO charges the participants a fee for technical and investment services.¹⁷

Takāful has also spread to non-Islamic countries. Sri Lanka, one of the few non-Islamic countries to have legislated for Islamic banking, is home to *Amāna Takāful*, one of the leading agencies specialising in *Takāful*. Amana has been in operation for 15 years and enjoys over 2% of the total market share in insurance, with revenue of LKR1.5 billion in 2012 (Reyaz, 2013). It is not just extending its services to Muslims, but providing protection and coverage to all sections of society irrespective of religion. It facilitates financial inclusion by integrating communities for risk-sharing and preventing the

¹⁷ The fee may include recompense for the advisory and support services, claims settlement, operational investment expenses, and so on (Kassim, 2007).

lower economic strata of a society from being deprived of insurance services. Unlike conventional insurance schemes, *Takāful* contracts allow the insured party to terminate the contract at any point that they are unwilling or unable to pay the premium, and the existing premium is returned. In this way, those without much disposable income can confidently invest their money in insurance through a *Takāful* scheme. Second, unlike conventional insurance, *Takāful* schemes rely on a profit-loss-sharing mechanism.

Since 1998, *Amāna Takaful* has been providing *Takāful* products for life and general insurance. It provides insurance across Sri Lanka in the East, South, Western, North Western, North Eastern and Central hills. It is a member of the International Co-operative and Mutual Insurance Federation (ICMF) (*Amāna Takaful* Insurance: ICMIF *Takāful*).

The company also provides *Takāful* coverage to the cottage industry and to self-employed individuals in Sri Lanka, with a focus on people running small businesses. In doing so, it provides security to those entrepreneurs who are highly vulnerable in cases of ill-fated events leading to financial loss.

D. THE WAY FORWARD FOR ISLAMIC FINANCE IN BANGLADESH

With around 53 million people still below the poverty line, Bangladesh faces considerable development challenges. Nevertheless, the country has sustained an impressive track record for growth and development. In the past decade, its economy has grown at nearly 6% per annum, and poverty has been reduced by nearly one-third. The Government of Bangladesh has played a considerable role in enhancing financial growth among the poor masses by introducing policies and regulations for the promotion and growth of financial inclusion. According to statistics of the Institute of Microfinance, around 66% of households in Bangladesh now have access to financial services, including credit, savings and insurance from banks or microfinance institutions and cooperatives. Bangladesh boasts a large number of well-known MFIs, including Grameen Bank, BRAC and the Association of Social Advancement (ASA). Simultaneously, many smaller MFIs have started operations throughout Bangladesh. Being the birthplace of conventional microfinance, Bangladesh has led the journey for microfinance to pave the way for greater financial inclusion.

At the same time, Islamic finance in the country is rapidly gaining momentum. At present, there are eight entirely Islamic banks, while 17 conventional banks have in total (Islamic and conventional banking combined) 770 Islamic banking branches or windows. With more banks in the pipeline, 13 microfinance institutions are operating in compliance with the *Sharī'ah* as well as six *Takāful* operators and three non-banking financial institutions. The Islamic banking industry nearly doubled in size in the past four years, outpacing the industry growth; it accounts for 21% of the banking sector, and in 2012 it crossed the BDT1.0 trillion threshold in assets and deposits. Today, IBBL, the largest private banking network in the country, accounts for 50% of global Islamic microfinance.

The commitment at the highest public levels to financial inclusion, the extensive network of microfinance institutions expanding access to financial services, and the rapid growth of Islamic finance in the country make Bangladesh ideally suited to leading efforts to promote financial inclusion through Islamic finance.

The experience of Islamic finance worldwide, and of the Islamic finance industry in Malaysia, Akhuwat and *Amāna Takaful*, highlight the following lessons for the successful evolution of Islamic finance in Bangladesh:

1. Contrary to popular perception, Islamic finance is not limited to Muslims alone. In fact, the examples of IBBL, Akhuwat and *Amāna Takaful* testify that these services are for all members of society irrespective of religion, cast, colour or creed. This is in line with the spirit of Islamic finance, which echoes social justice. Limiting provision to only a segment of the population would compromise the very aim of Islamic finance.
2. Policy-makers must recognise that financial inclusion is inherent within Islamic finance and may serve as a valuable mechanism to confront the challenge of financial inclusion, as is seen through the example of IBBL.
3. The solution to financial inclusion will be collaborative; thus the development of Islamic finance in Bangladesh will hinge on the efforts of both public and private partners. As the example of Akhuwat illustrates, private–public partnership can be instrumental in creating the momentum to incorporate and spread Islamic finance, while private–private partnerships as demonstrated by *Amāna Takāful* and IBBL will be instrumental in spreading Islamic finance throughout Muslim countries.
4. Islamic banks in general, and specifically in Bangladesh, will need to explore more standardised financial instruments and innovations in line with *Sharī'ah* which will allow them to operate on a par with, if not better than, their conventional counterparts. It would be beneficial for Islamic banks to develop their own interbank money markets and create financial market for their Islamic financial products, both regionally and internationally. Leading global Islamic banks, including the Islamic Development Bank, have an instrumental role in facilitating these efforts. In Bangladesh, IIBL can be proactive in creating a regional market, especially given the potential of Islamic finance in Pakistan and India.
5. To realise the potential of Islamic finance will require capacity building in terms of regulators, market professionals, policy-makers and NGOs. Islamic finance cannot be deemed an “add-on” to the conventional system of finance, but must be recognised as a distinguishable finance system in its own right.
6. The extensive network of microfinance providers will be an ideal starting point in adopting Islamic finance principles. Akhuwat's *Qard al-Hasan* programme testifies to the ability of microfinance organisations to reach the desired breadth and depth of outreach without compromising on financial sustainability. *Qard al-Hasan* could

pave the way for the penetration of other financial instruments into the system in Bangladesh. As demonstrated by Akhuwat, *Qard al-Hasan* must not depend on the religious commitments of its clients; rather, it should be established as a viable poverty alleviation model that does not discriminate on the basis of religion. Instead of promoting doles and charity, *Qard al-Hasan* nurtures dignity and self-respect; the most crucial ingredients of a self-reliant society.

As the world struggles to innovate and implement different solutions for financial inclusion, Bangladesh, through its own example, can demonstrate the vitality of Islamic finance as a means of greater financial inclusion. The seminar titled “Prospects and Challenges in the Development of Islamic Finance for Bangladesh”, held 23–24 September 2013 in Dhaka, testifies to the desire of experts and policy-makers to construct Islamic finance in Bangladesh as a means of achieving inclusive growth and prosperity. The country that gave the world microfinance may very well serve as the initiator of a global movement, nested in *Shari’ah*, that promotes a holistic model of inclusive finance.

This chapter draws upon the major recommendations of the previous chapters for the further development of Islamic finance in Bangladesh, puts them in a context and, finally, provides contours of a roadmap towards a comprehensive Islamic finance infrastructure. The previous chapters focused on three main topics: the development of an Islamic capital market; the contribution of Islamic finance towards financial inclusion; and the design of an appropriate regulatory and *Shari’ah* governance framework.

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Chapter 6

THE WAY FORWARD FOR THE DEVELOPMENT OF ISLAMIC FINANCE IN BANGLADESH

Professor Dr. Volker Nienhaus

A. ISLAMIC CAPITAL MARKET DEVELOPMENT

Several recommendations in different contributions underscored the importance of a further development of the Islamic capital market – in particular, the Islamic securities (*Sukūk*) market. The recommendations were both for the short- and long-term *Sukūk* markets.

i Short-term Islamic Capital Market and Liquidity Risk Management of Islamic Banks

For the short-term side of the market, Bangladesh Bank's launching of the Islamic Interbank Fund Market as a *Sharī'ah*-compliant money market was recognised as a notable development. It was suggested that the liquidity of this market would be enhanced through additional issuances – for example, by issuing the *Sharī'ah*-compliant equivalent of Treasury bills. This would facilitate a better liquidity management of Islamic banks. However, the particular structure of the Islamic banking sector in Bangladesh should not be overlooked – namely, the high concentration and dominant market share of one bank (IBBL). Its relative size may impact on the effectiveness of the interbank market, and the central bank should take a further look at this issue. Another issue of concern is the asymmetry in the effectiveness of an interbank market, which is more effective in providing profitable outlets for excess liquidity than in providing liquidity to banks in stress situations, such as in the case of unexpected large-scale deposit withdrawals. Therefore, the interbank markets should be supplemented by *Sharī'ah*-compliant lender of last resort (SLOLR) facilities of the central bank.

The IFSB has dealt with the liquidity risk management of Islamic financial institutions in “Guiding Principles on Liquidity Risk Management for IIFS” (IFSB-12),¹⁸ and has summarised its findings regarding SLOLR facilities in its Islamic Financial Services Industry Stability Report 2013 (IFSISR, 2013).

Elements of an Islamic Liquidity Infrastructure

An effective Islamic interbank market is only one component of a more comprehensive liquidity infrastructure as summarised in the following diagram. Liquidity infrastructure “refers to a set of key institutional and operational arrangements which can provide a facilitating environment to financial institutions in that jurisdiction for managing their liquidity in normal and stressed times, as well as supporting market liquidity in the

¹⁸ IIFS = institutions offering Islamic financial services. Previous to IFSB-12, in 2008, the IFSB had published a “Technical Note on Issues in Strengthening Liquidity Management of Institutions offering Islamic Financial Services: The Development of Islamic Money Markets”.

system” (IFSISR 2013, p. 80). An effective liquidity infrastructure for IIFS requires a system of business laws and a regulatory framework as the basis for the structuring and management of liquidity instruments by IIFS and the central bank. To support market players and policy-makers, IIFS have to disclose timely and relevant information that can also be used by the central bank for its macroprudential surveillance and systemic stability assessment. If deemed necessary, the central bank can apply *Sharī'ah*-compliant monetary policy instruments (e.g. open market operations or *Muḍārabah*-based financing facilities) to intervene in the Islamic money market. The effectiveness of the liquidity infrastructure depends on the existence of a vibrant Islamic securities market, supported by an efficient clearing, payment and settlement system.

An appropriate liquidity infrastructure may be even more important for Islamic banks than for conventional banks because their different business models “mean that the effects of volatility in the financial markets, and more so the real economy, could force Islamic banks to seek financial support earlier than conventional banks. At issue is that an appropriate safety net needs to be developed to ensure that in a time of difficulty, IIFS would be able to access provisions with regulatory authorities and ensure that the IFSI is not susceptible to systemic risks.”¹⁹

The IFSISR 2013 provides some observations which underline the relevance of these considerations for Bangladesh.

- As long as the Islamic capital market is of a very small size, Islamic banks have to rely nearly exclusively on deposits for their financing business. A high credit growth in the banking sector can lead to a shortage of cash money. Islamic banks in Bangladesh faced liquidity constraints in 2010 when their advances/deposit ratio had exceeded the ceiling set by the central bank. As a consequence, Bangladesh Bank required the monthly submission of “Structural Liquidity Profiles” so that the banks and the central bank can easily detect any maturity mismatch (see IFSISR 2013, p. 92).
- The IMF used in its Financial System Stability Assessment 2010 a scenario analysis to assess Bangladesh’s banking sector. “Since the country relies heavily on the export sector – and garment exports account for 75% of all exports – a slowdown in economic activity would have a direct effect on banks’ asset quality. Based upon a regression model, it was found that the proposed decline of GDP would have an effect on NPLs (20%), exchange rate (25% depreciation of the taka against the dollar) and interest rates (200bp decrease), due to the implementation of monetary policies consistent with a lower foreign exchange (FX) rate” (IFSISR 2013, p. 97). Liquidity shortages would be a consequence of such a scenario.

¹⁹ IFSISR 2013, p. 17; IFSI = Islamic financial services industry.

Sharī'ah-compliant Lender of Last Resort Facilities

Against this background, SLOLR should get attention with priority. IFSISR 2013 (Chapter 3.2) provides some preliminary findings of a survey of IFSB on SLOLR.

- The importance of lender of last resort facilities is generally acknowledged, but only a minority of jurisdictions has introduced SLOLR. In a larger number of jurisdictions, conventional and Islamic banks are treated equally, and no special arrangements have been made for Islamic banks. This means that Islamic banks do have access to LOLR facilities, but the instruments used by the central banks are not *Sharī'ah* compliant. This can create a reputational risk for the Islamic banks.
- The mechanisms of SLOLR and conventional LOLR are basically the same, but the instruments have to meet *Sharī'ah* requirements. The IFSB survey listed a number of facilities which are deemed *Sharī'ah* compliant in different jurisdictions – in particular, sale and buy-back transactions (based on *Bay' al-'Inah*), collateralised *Murābahah* (based on *Rahn* and *Murābahah*) and interest-free loans (based on *Qard*). Suitable arrangements for standing refinancing facilities could be repos for collateralised borrowing (based on *Qard* with *Rahn*), repo sale and buy-backs (based on *Bay'* and *Wa'd*), *Tawarruq* deals and short-term *Muḍārabah* financing. It should be noted that not all of these techniques are accepted by regulatory or *Sharī'ah* authorities in all jurisdictions.

The implementation of SLOLR may require more than marginal tax, regulatory and legal reforms. Several of the mentioned SLOLR facilities presuppose the existence of high-quality, *Sharī'ah*-compliant assets as good collateral, but they are in short supply as long as an Islamic capital market is widely lacking. Nevertheless, conceptual work on SLOLR should not be put aside until the Islamic capital market has reached a critical mass.

In recognition of the limited sources of *Sharī'ah*-compliant funds for banks besides deposits from the general public, Bangladesh Bank has set the statutory liquidity requirements (SLR) for Islamic banks to 50% of the SLR for conventional banks (10%, compared to 20%). This allows Islamic banks a higher utilisation of deposits, and it can be seen as a compensation for the lack of capital market (re)financing possibilities of Islamic banks. However, this privilege has the critical flipside that the instruments of Islamic banks for their liquidity risk management are very limited. In cases of sizeable and unexpected deposit withdrawals, Islamic banks may face a liquidity crunch. Without a well-developed Islamic capital market and without access to SLOLR facilities, Islamic banks can resolve such a situation only by recourse to their own liquidity reserves. It has already been mentioned that volatility in the real economy may have more pronounced adverse effects in Islamic banking than in conventional banking, and the liquidity pressure can be enhanced if the Islamic banks utilise deposits at a higher rate than conventional banks. Once Islamic depositors become worried about the future of their funds, unexpected large-scale withdrawals cannot be ruled out. So while the probability of a stressed liquidity situation is higher in Islamic banking, the

disposable liquidity buffers are lower. This is a rather awkward constellation, and it should be rectified in perspective. The enhancement of the refinancing options through an Islamic capital market would reduce the systemic risk in the Islamic sector. If the capital market instruments of the Islamic institutions were at par with the instruments of the conventional institutions, the SLR privilege should be reconsidered.

Sharī'ah-compliant Deposit Insurance

The vulnerability of Islamic banks in cases of large-scale withdrawal of deposits underscores also the importance of customer confidence for systemic stability. Without trust in the system, difficulties of an individual bank could grow into a general run on Islamic banks. Therefore, confidence-building measures should be taken by the central bank, and a measure of prime importance would be a *Sharī'ah*-compliant deposit insurance scheme. Bangladesh has introduced a deposit insurance scheme that covers all scheduled banks, including the Islamic banks. But this scheme seemingly does not take note of the specificities of Islamic finance. For example, the funds of the deposit insurance are invested in interest-bearing government securities, conventional and Islamic banks have to pay the same contributions per deposit, there is no difference between current accounts ("true" deposits based on *Wadī'ah* contracts) and risk-sharing investment or savings accounts (based on *Mudārabah* contracts), and it is not explained whether investment account holders of an Islamic bank going bankrupt would receive the nominal value of their paid-in funds or only a reduced amount if losses had occurred but were not yet allocated to the account holders before the bankruptcy of the bank. To avoid confusion or misunderstandings, the central bank should explain in sufficient detail and plain language the approach applied in Bangladesh. This is not only in the interest of transparency and consumer education; it is also in the interest of consumer protection and systemic stability: If the mechanisms of deposit insurance are not transparent, it could happen that someone declares deposits with Islamic banks to be not *Sharī'ah* compliant because of the particular form of deposit insurance. If this form was unknown before, it could create anxiety among depositors and other fund providers and maybe unexpected deposit withdrawals, with destabilising effects.

ii. Long-term Islamic Capital Market and Resource Mobilisation

Following the conventional distinction, the long-term capital market comprises the market for equity titles (the stock market) and the market for medium- to long-term debt titles (the bond market).

Conventional and Sharī'ah-compliant Stocks

It has been illustrated in Chapter 2 that the stock market in Bangladesh is relatively small with a rather volatile total market capitalisation. For the time being, there is no explicit "Islamic" stock market in Bangladesh – that is, a market for stocks that have been classified as *Sharī'ah* compliant by some recognised institution. Such an Islamic stock market does not require a separate trading platform; a publicly available list of *Sharī'ah*-compliant stocks traded on the national stock exchanges would be sufficient.

Such a list could be produced by a commercial index provider (e.g. S&P, Dow Jones) or a *Shari'ah* board of the capital market regulator (as it is in Malaysia) after the definition of *Shari'ah* compliance criteria (i.e. negative lists of prohibited activities and thresholds for a tolerable level of the “*Riba* pollution” of the business of a shareholding company) and a screening of all listed stocks according to these criteria. At present, a systematic screening of the stocks listed on the stock exchanges of Bangladesh is done neither by a commercial index provider nor by a *Shari'ah* board of the Securities and Exchange Commission since such a *Shari'ah* board does not exist.

Conventional and *Shari'ah*-compliant Debt Securities

The Islamic equivalent to a bond market would be a *Sukūk* market with medium- to long-term issuances. A *Sukūk* market in Bangladesh is non-existent, and the market for conventional bonds is in a very nascent stage. The Annual Report 2011–2012 of the Securities and Exchange Commission records a meagre BDT555.7 billion (USD7.0 billion) as the market capitalisation of 221 government Treasury bonds, three corporate bonds and eight debentures listed on the Dhaka Stock Exchange (DSE) by mid-2012. The total number of listings on the DSE was 511 with a market capitalisation of BDT2491.6 billion (USD31.5 billion). These figures show that the capital market in Bangladesh is dominated by far by equity-based securities, and companies are virtually absent as issuers of debt securities. Their investments are financed by internal sources and externally by the issuance of equity titles and by bank loans. The outstanding industrial term loans of banks and financial institutions stood at BDT802.4 billion (USD10.1 billion).

Against this background, the establishment of an Islamic capital market is a challenging task. There can be many reasons for low utilisation of the debt segment of the capital market. Before anything else, it has to be clarified what are the reasons for the underdevelopment of the long-term capital market in general and the Islamic capital market in particular.

- It could be a lack of companies of sufficient size and standing as issuers of debt securities. This problem would be the same for a conventional and an Islamic capital market. A reflection of this lack of “quality issuers” would be the reluctance of financial institutions or individuals to buy debt securities. Legal and regulatory reforms that strengthen corporate governance and investors’ protection could reduce some of the hurdles in this case.
- It could be a tax issue; that is, the tax system may favour bank financing over capital market financing. Such an issue could be solved in a relatively short time, provided there is a political will to do so.
- It could be a crowding-out problem: government Treasury bonds may have been priced such that corporate issues would be too expensive compared to equity or bank financing. Similar to a tax issue, this problem could be solved quickly if there is a political will.

- It could be explicit or implicit restrictions in the banking law that prevent banks from holding equity positions or debt titles of a particular type at all or beyond a certain threshold. In this case it should be considered whether less restrictive regulations could serve the same purpose.
- It could be an aversion against interest-bearing debt securities on the part of potential corporate issuers. This might explain the very small size of the conventional bond market, but it does not explain the even smaller size (or the virtual non-existence) of a market for *Riba*-free debt securities, *Sukūk*, which were introduced in the 1990s. Since the early 2000s, the concept has become more popular and has been adopted by a growing number of companies in various jurisdictions. This raises the question why it has not been adopted by companies in Bangladesh.
- It could be that the necessary legal and regulatory framework for *Sukūk* does not exist. *Sukūk* have to use *Sharī'ah*-compliant contracts, which may not be recognised by the secular law of the country (outside the banking sector, where these contracts are sanctioned by Bangladesh Bank's "Guidelines for Conducting Islamic Banking"). For example, *Sukūk* are often backed by real estate, and this requires appropriate property laws and a bankruptcy law that defines, inter alia, the priority of creditors and the modalities for a valorisation of the *Sukūk* assets.

The actual situation is most likely the result of a complex bundle of interdependent inhibiting factors. Without an in-depth analysis, recommendations regarding the benefits of a well-developed wide and deep long-term Islamic capital market can only be made in principle. The same holds true for policy recommendations and for an assessment of possible impacts.

Benefits of a Well-developed Bond and *Sukūk* Market

A number of benefits of a well-developed long-term capital market for *Sukūk* have been outlined in the previous chapters.

- *Sukūk* have become an attractive fund-raising tool for corporates and governments throughout the world. They have a particular appeal to investors who are looking for fixed income instruments but shun interest-bearing bonds.
- It is sometimes argued that *Sukūk* as a new asset class could mobilise dormant savings. Strictly speaking this would only be the case if savings were kept outside the financial system as hoarded cash, and it is questionable whether this is true in a sizeable quantity. But in a broader sense it could mean that funds that were employed in, for example, the real estate market could be brought back into the financial system. The benefits could be less bubble-prone property markets on the one hand and more resources available for the financing of productive ventures on the other hand.

- *Sukūk* have become the preferred instruments for infrastructure funding in many countries. *Sukūk* could also support the ambitious investment plans of the government of Bangladesh. If sovereign *Sukūk* could be placed on the global market, additional capital would be attracted from abroad.
- A sufficient volume of long-term *Sukūk* would support the development of family *Takāful* and *Sharī'ah*-compliant pension business.
- If banks can issue *Sukūk*, they could reduce their dependence on deposits. As a function of who subscribes to the *Sukūk* issuances, this may increase the volume of investible funds in the economy.

While *Sukūk* are an instrument for institutional investors in many jurisdictions, Malaysia has shown that it is possible to launch successfully “retail *Sukūk*” for the financing of important infrastructure projects. Retail banking customers can apply for the purchase of certificates through various channels, including the internet and ATMs. Perhaps Bangladesh could develop this approach further and become the pioneer of “micro-*Sukūk*”, meaning certificates of small denominations which could be offered as an attractive savings and investment product to the microfinance clients of Islamic banks and NBFIs. The proceeds of the micro-*Sukūk* issuances could be used for projects Public Private Partnership (PPP) in the realm of the microfinance clients.

A sector that would benefit greatly from a more developed *Sukūk* market in general and from long-term sovereign *Sukūk* or highly rated corporate *Sukūk* is the family *Takāful* industry. This industry is in need of *Sharī'ah*-compliant investment opportunities with predictable and competitive returns of a longer period. There is also a need for short-term *Sukūk* and the development of a liquid secondary market so that *Takāful* operators can meet regulatory requirements in a more efficient way. At present, the only interest-free government securities accepted for deposits with the central bank (Bangladesh Government Islami Investment Bonds) have a rate of return that is 70% less than the rate of return of interest-bearing government securities.²⁰ This affects *Takāful* operators adversely compared to their conventional competitors.

Capital Market and Financial Sector Development

Before the benefits of a well-developed capital market can be enjoyed, a possibly complex bundle of obstacles has to be removed. This should not be done in a spontaneous rush but on the basis of a comprehensive and medium- to long-term financial sector development plan that is appropriately sequenced. Malaysia can serve as the example of a country where such planning (with two consecutive ten-year plans) was successfully implemented. Its respective legal, regulatory and tax reforms have achieved a remarkable transformation of the financial system with a strong Islamic sector.

²⁰ See Kazi Md Mortuza Ali (2003), “*Takāful* in Bangladesh – Seeking a Framework for Growth”, www.meinsurancereview.com, December, pp. 47–49, at 48.

Such a plan should consider the timing and sequencing of the reform steps and reflect on the particular and unique conditions of the country. The following illustrates this point:

- One of the benefits of a developed capital market is that companies have additional financing options and become more independent from banks. At the same time, savers have a wider choice of savings and investment vehicles. This, taken by itself, does not imply a larger savings volume – that is, a larger volume of investable capital. In an extreme case, it will only shift funds from banks (where they were held as deposits) to the capital market (where they buy *Sukūk*). This loss of deposits is compensated by a reduced demand for corporate financing, but only for the banking system as a whole and not for each individual bank. Some banks may suffer reduced deposits while the demand for corporate financings is unchanged, while others may keep the deposits but lose in their financing business. If the shifting of funds takes place on an unexpectedly large scale, liquidity squeezes in some banks and excess liquidity in other banks as well as growing maturity mismatches would be the result. An effective Islamic interbank or money market and the capacity to issue, if the need arises, a sufficient volume of *Sukūk* of different tenures should prevent or moderate destabilising effects.
- A possible friction that requires particular attention is related to Islamic banks that are strongly engaged in microfinance and SME financing. Businesses of this kind are of high relevance for job creation, income generation and poverty alleviation. But SMEs – let alone microentrepreneurs – have no access to the capital market by issuing *Sukūk*. They depend on bank financing. Hence, an erosion of the deposit base of their banks that forces the banks to reduce their credit exposure could create undesirable side effects for which a compensation mechanism might be considered.
- The situation would be very different if *Sukūk* were not just replacing bank financings but increasing the total volume of corporate financings on the one hand and mobilising savings which previously were kept idle and outside of the banking system. But taking into account the “savings gap” in Bangladesh – where domestic savings account for 19.4% of GDP and investments for 25.5% – this may not be the most likely constellation.
- There is another way to enhance corporate financings by *Sukūk* without a crowding-out of bank financings – namely, the placement of *Sukūk* on the international market. An implication of such a strategy is that the legal, regulatory and tax environment must not only focus on the needs of domestic *Sukūk* subscribers but also consider in parallel, and right from the beginning, the requirements of international *Sukūk* subscribers. Foreign exchange regulations and international investment protection and dispute resolution schemes become highly relevant and add complexity to the policy agenda.

The previous points serve not as recommendations but as illustrations of the importance of an in-depth analysis of the reasons for the actual underdevelopment of the debt securities market, possible reactions of interdependent markets to measures in support of *Sukūk*, the importance of clearly set targets, and the usefulness of a strategic document (financial sector development plan) that sets priorities and takes interdependencies into consideration.

B. ISLAMIC FINANCE AS INCLUSIVE FINANCE

Islamic finance is often seen as inherently inclusive finance: its institutions and instruments are particularly well suited for the development of entrepreneurial talents in all social strata, including the poorest segments of society. Islam offers a wide range of informal and formal arrangements that cater for the financial needs of all Muslims – from the richest to the poorest.

Microfinance and Financial Inclusion

IFSISR 2013 has dealt with microfinance and financial inclusion and proposed the following terminology:

- The hardcore poor (or extreme poor, destitute) are people whose capabilities are severely restricted – for example, due to poor health, physical or mental handicaps, or old age. It is impossible to empower them to earn a market income. These people require special attention and are eligible to receive support from *Zakat* funds.
- The moderate poor are the prime target group for microfinance. Their actual income is below the poverty line, but it can be raised by access to finance. The example of Akhuwat shows that it is possible to mobilise funds from philanthropic sources for the disbursement of benevolent loans (*Qard al-Hasan*) for productivity-enhancing purposes. Additional resources can originate from international donors (which often provide funds at concessional rates) and commercial microfinance at market rates.
- The actual income of the vulnerable non-poor is above the poverty line, but it is permanently at risk: a temporary sickness, a poor harvest in agriculture, or a superior competitor may induce a fall-back below the poverty line. Therefore, vulnerable poor may still be served by microfinance institutions. But with a stabilisation of the income above the poverty line, the vulnerable poor qualify as customers of Islamic banks.
- The main target group of Islamic retail banks is the non-poor with a predictable income and some financial buffers for unexpected unfavourable events.

Microfinance caters for the financial needs of poor people who previously did not have access to financial services because they were not accepted as customers by banks due to high risks and low volumes of transactions. By the provision of financial services

to involuntarily unbanked groups, microfinance contributes to financial inclusion. But inclusive finance is a wider concept. It covers also those people who can have access to financial services but voluntarily abstain from their use. A frequently quoted reason for such an abstention is the observance of religious prescriptions, especially the prohibition of *Riba* in Islam.

i. Philanthropy-based Microfinance

Early microcredit experiments were commercially not viable and required continuous support from external financiers (governments or private donors). Further, recipients often spent funds from interest-bearing microloans for consumption. This did not enhance the productive capacities of the clients, which would have been the pre-condition for the redemption of relatively expensive microloans. The result was an increasing indebtedness with no realistic prospects for debt reduction.

An alternative approach that avoids these shortcomings because it combines a better control of the use of funds with close-to-zero costs for the recipients was the Akhuwat model in Pakistan. The basis for this Islamic microfinance institution is voluntary contributions (donations) by philanthropists, but also by former recipients of microloans who have improved their economic situation in a sustained manner and are now in a position to extend the support they have received to others by donating to Akhuwat. All donors feel obliged to contribute to the empowerment of people, which is a fundamental value of Islam. The donated funds are disbursed as benevolent loans (*Qard al-Hasan*) to eligible poor. (See Chapter 5 for more details.)

Governments of Muslim countries should not just allow, but even encourage, this model of Islamic microfinance in their jurisdiction. The Akhuwat approach not only epitomises brilliantly the Islamic ideals of brotherhood and solidarity; it also has a number of attractive economic qualities:

- The approach is extremely successful according to all microfinance criteria.
- It mobilises, bundles and efficiently employs donations.
- The model does not require deposits for its sustainability. Being a non-deposit-taking non-bank microfinance institution could facilitate a faster and wider geographical spread compared to deposit-taking or bank-driven microfinance institutions that are subject to more restrictive regulations.
- A philanthropy-driven microfinance network with exceptional performance, transparent minimal operation costs and no commercial motives may be the ideal partner for international donors or the national government as a distribution channel for funds earmarked for poverty alleviation programs.

One could also envisage a productive cooperation respectively a division of labour between philanthropy-driven and bank-backed microfinance schemes. A successful

philanthropic institution can reach large numbers of people, but it has limitations with respect to the maximum size of its financings as well as the possible technical support it can provide to the recipients of its benevolent loans for productive purposes. Those recipients who have the potential to graduate from cottage industries producing for local markets to small enterprises producing for regional or supra-regional markets need larger funding volumes and more management advice than a philanthropic institution can provide. Hence, they are candidates for microfinance products of bank-driven institutions or microfinance banks. These institutions offer financing on commercially viable terms, and can provide basic management know-how (accounting, law, marketing, etc.) to the new small entrepreneurs.

The “ecosystem” for philanthropic microfinance in Bangladesh differs from that in Pakistan where Akhuwat is flourishing. The Islamic microfinance sector in Bangladesh is shaped by the Rural Development Scheme (RDS), which was set up by the country’s largest Islamic bank (IBBL). With 228 branches, RDS has an outreach of nearly 17,000 villages (out of a total of 87,000). This suggests that a new philanthropic institution could focus on villages not served by RDS and, in particular, on the urban poor. Obviously, there is enough room for additional providers of Islamic microfinance in Bangladesh.

ii. Commercial Microfinance and SME Financing

Bangladesh has a lot of experience in conventional microfinance, including commercial microfinance schemes. Such schemes charge a rate of interest for microfinance loans that allows full cost recovery and a reasonable return on capital. It is possible to structure a *Riba*-free Islamic commercial microfinance scheme which provides productive loans to businesses of the moderate poor and vulnerable non-poor. The Islamic ethos is at odds with profit maximisation in transactions with the poor, but it does not repudiate cost recovery. This is a basic premise for a number of arguments why Islamic financing techniques are particularly suitable for the microfinance context – that is, for the financing of new entrepreneurs and small and medium-sized businesses.

Collateral or Guarantees for *Sharī‘ah*-compliant Microfinance Lending

Microfinance is sometimes considered a risky business due to the lack of collateral for microcredits. Conventional microfinance institutions have addressed this issue by group lending schemes and peer monitoring techniques. This creates a kind of “social collateral” which reduces the impact of information asymmetries and ensures high recovery rates. Such mechanisms can also be applied by Islamic microfinance institutions. They may be even more effective in an Islamic environment because of the religious obligation of a borrower to honour his or her promises and to meet contractual obligations.

However, group lending is not the method of choice once it comes to the financing of entrepreneurial activities (even if they are on a small scale). It has been argued that Islamic microfinance institutions do not require additional collateral because they only finance transactions which are backed by real assets. These assets – e.g. the traded

objects in a *Murābahah* sale or the leased objects in an *Ijārah* transaction – could serve as collateral, and since Islamic financing is based on sales or rent contracts, it is “self-collateralising”.

However, if the financed business fails, the market value of the financed assets may be far less than the outstanding financial obligations. The usual *ex ante* solution for this problem – namely, asking the entrepreneur for additional collateral – will not work in a microfinance setting where new small entrepreneurs do not own additional assets which could be used as collateral. An alternative could be a third-party guarantee. In principle, *Sharī'ah*-compliant guarantees (*Kafālah*) can be structured and the guarantor can charge a fee for this service. If the government wants to support the expansion of Islamic microfinance for small businesses, it could provide such credit guarantees at a low cost or even free of charge (taking into account, however, that this could create an incentive for too much risk-taking which has to be counteracted). Such guarantees can be of particular relevance when banks provide microfinance loans which are funded by deposits from the public in general and from risk-averse vulnerable groups in particular. In this case, credit guarantees shield the depositors from losses in the microfinance business, and they can be seen as a support for financial inclusion both in the financing and in the savings business.

Partnership Contracts with Profit- and Loss-sharing

Another class of instruments that transpose the Islamic ideals of brotherhood, fairness and solidarity into financial practice are partnership contracts with profit- and loss-sharing (PLS) arrangements (*Muḍārabah*, *Mushārah*). They are recommended, in particular, for the financing of start-ups and small businesses because they do not require existing collateral and release financial pressure from the entrepreneurial partner in cases where the business is performing worse than anticipated.

The sharing of financial burdens may be desirable from a developmental perspective, but it poses serious challenges for the bank. A bank is not a venture capital company funded by risk-taking capital providers, but rather a trustee for mostly risk-averse and often vulnerable depositors. If the entrepreneurial projects are funded by *Muḍārabah*-based investment accounts, project losses will be passed on to the depositors who may be neither willing nor able to absorb them. It is very difficult, if not impossible, to guarantee investment account holders a minimum performance or to shield them from investment losses in a *Sharī'ah*-compliant manner. In principle, it would be better to separate the deposit-based banking business from the more risky PLS financing of start-ups and small enterprises. Banks could set up subsidiaries for PLS financing that are funded by *Sharī'ah*-compliant securities. They could issue, for example, *Mushārah Sukūk* to attract venture capital from the Islamic capital market. Structurally similar to venture capital companies in the Western world, the PLS finance companies (PLSFCs) would provide not only financing but also consultancy services (i.e. technical, marketing and management know-how) for their less experienced entrepreneurial clients. PLSFCs can use accumulated expertise in relevant business fields for guidance and monitoring of their customers. But whatever its merits may be, for the time being such a model

has not been implemented anywhere in the Muslim world. An adoption in Bangladesh would not be easy because of the underdevelopment of the conventional and Islamic capital markets.

Linking Islamic Microfinance with Responsible Investing in the West

External donors have always played an important role in the funding of conventional microfinance, and in recent years additional funds were provided on commercial terms by institutional investors. Islamic microfinance has also received external funding mainly from Muslim countries and from Muslim minorities in the West. But chances are that Islamic microfinance can tap into additional resources from the West. In the aftermath of the global financial crisis, the demand for ethical banking and responsible investment has grown substantially in the West. The inherent ethical dimensions of Islamic finance in general and of Islamic microfinance in particular could be appealing to institutional investors with an explicit interest in socially and ecologically responsible investments.

For example, some teachers' pension funds build portfolios of responsible and sustainable investments that are diversified in terms of geography and asset classes. A "wholesale" funding for an apex organisation of an Islamic microfinance network could well be one element of such a portfolio, provided the Western investor can be convinced of the ethical substance, the social impact and the commercial solidity of the microfinance activities. It may be that an alliance of a group of Akhuwat-type philanthropic institutions with a microfinance network backed by an Islamic bank has the best chances to be accepted as a partner by international institutional investors with an ethical orientation. It should be noted that the total assets in ethical banking and responsible investing in Europe and the US are a multiple of the volume of the global Islamic finance assets, and the growth rates of this sector of Western finance are not less impressive than the growth rates of Islamic finance.

C. THE REGULATORY FRAMEWORK

It has been mentioned several times that a flourishing Islamic finance services industry requires a comprehensive and robust *Shari'ah* framework. It has also become clear that prudent regulations in support of systemic stability and consumer protection as well as financial instruments for monetary policy have to be introduced or refined.

1. *Shari'ah* Governance

The necessary components of an effective *Shari'ah* framework have been spelled out in detail in Chapter 3. There, but also in other contributions, Malaysia is presented as a possible model for Bangladesh. Both countries started Islamic banking in 1983, and the market share of Islamic finance is around 20% in both countries. But while Malaysia has the most complete and elaborate *Shari'ah* framework in the Muslim world, Bangladesh still has to install such a framework.

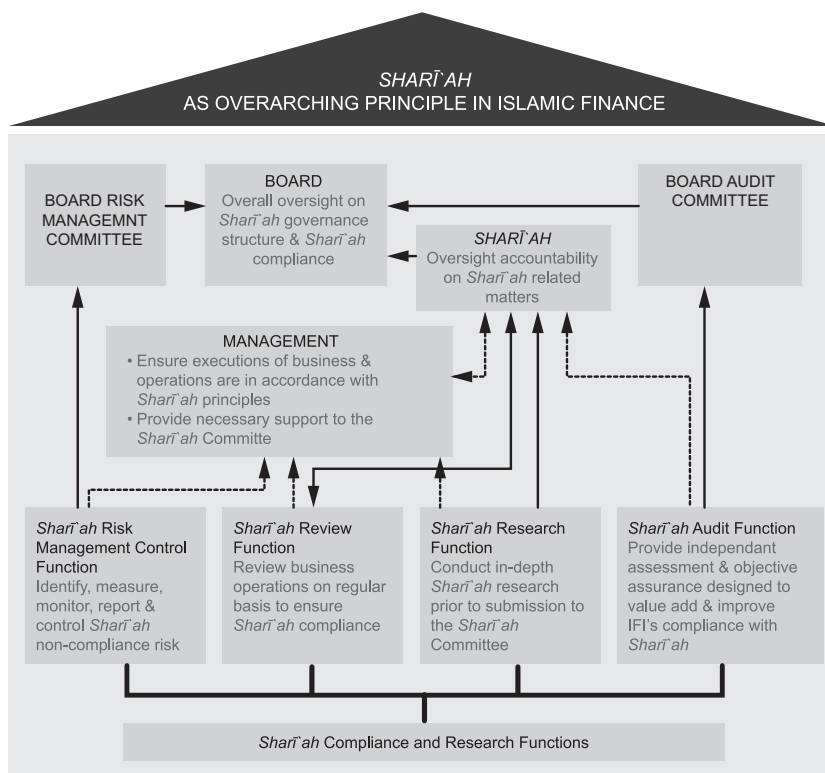
Malaysia as a Model

A look at the Malaysian model is certainly useful, but one must not overlook the differences between Malaysia and Bangladesh.

- To start with, the market shares of Islamic finance (as a percentage of the total financial assets of the country) look roughly the same for both countries. However, only around 60% of the population of Malaysia is Muslim so that the “per Muslim” market penetration in Malaysia is still higher than in Bangladesh where close to 90% of the population is Muslim.
- While the market penetration was demand driven in Bangladesh with no government interference, the Malaysian success was prepared by a finance sector development policy with clear visions of the growth of Islamic finance, strategic targets and sequenced policies over a long period. The committed government provided not only a level playing field for Islamic finance but also financial incentives and directives in support of the industry.
- Islamic finance in Malaysia today has a strong underpinning in a well-developed and sophisticated Islamic capital market, while the capital market in Bangladesh is still in its infancy. Hence, growth drivers of the Islamic finance industry in Malaysia could be very different from growth drivers in Bangladesh.
- Financial inclusion is also on the agenda of the Malaysian central bank, but with its much lower level of income, inclusion and Islamic microfinance could become the top priority in Bangladesh. Non-bank financial institutions play an important role in microfinance, and their regulation is different from banking regulation. The Malaysian model would not provide much insight for a microfinance-focused strategic sector development plan. Other country experiences should also be considered.
- The market share of the oldest and largest Islamic bank in Bangladesh is approximately 50% of the deposits and investments of the Islamic banking sector. In addition, this bank has the largest branch network of all private-sector banks, and it is, through a subsidiary, the largest provider of Islamic microfinance. This is a unique market structure which cannot be ignored in strategic planning.
- The Islamic banking sector in Bangladesh comprises seven stand-alone Islamic banks and 16 conventional banks with Islamic windows. Windows were a “fast track” to create a larger number of market players and to enhance competition in the Islamic financial services industry within a short time span. But there are also a number of critical regulatory, accounting and *Shari’ah* issues, and the attitude of the central bank of Malaysia towards Islamic windows has changed over time – from supportive to restrictive. This is also the case in Bangladesh. The central bank in Malaysia would like to see the windows being transformed into subsidiaries with separate legal personalities. Its aim is not an abrupt prohibition but a phased transformation which should not disarrange the industry. Bangladesh could exploit Malaysia’s experiences in this regard.

The differences indicate that the point of departure for an Islamic finance sector development plan in Bangladesh is quite different from Malaysia. The Malaysian model is not suitable for simple replication, but it can serve as a reference point, and its *Sharī'ah* governance framework for Islamic financial institutions is exemplary. It was summarised by the central bank in the following diagram.

Diagram 6.1: *Sharī'ah* Governance Framework Model for Islamic Financial Institutions



A National *Sharī'ah* Board?

A special feature of the Malaysian model is the attempt to create legal certainty by the installation of national *Sharī'ah* boards (“*Sharī'ah* Advisory Councils”) at the central bank and the securities commission which have the power of binding final decisions over *Sharī'ah* interpretations in Malaysia. In addition, institutions for alternative resolutions of legal disputes over Islamic finance contracts (arbitration, mediation) have been established, and measures to enhance the *Sharī'ah* competence of civil law judges have been taken.

To put this into perspective, the lack of harmonised *Sharī'ah* interpretations is increasingly seen as a major obstacle for more cross-border transactions in Islamic finance. Divergent *Sharī'ah* interpretations imply a *Sharī'ah* non-compliance risk

that most (potential) global investors are not willing to take. Several prominent speakers at the 10th IFSB Summit held in May 2013 called for a harmonisation of *Shari'ah* interpretations in one form or another. It was even proposed to overcome legal uncertainties and risks which originate from the fact that conventional courts with limited or no *Shari'ah* expertise have to decide in cases of disputes over Islamic finance contracts by the establishment of an International Court for Islamic Financial Products.

These far-reaching proposals indicate that legal certainty in general and clarity about *Shari'ah* interpretations are of high importance for the development of Islamic finance – in particular, when international Islamic investors shall be attracted.

ii. Prudent Regulation

The general regulatory framework for Islamic financial institutions has been expounded in various IFSB standards and guidance and technical notes that deal with transparency, corporate and *Shari'ah* governance, risk and liquidity management, and capital adequacy. Microfinance services are often provided by NBFIs and through branchless techniques (in particular, through banking agents and mobile devices) by banks. This is of regulatory relevance insofar as, for example, the verification of the identity of customers can become more difficult (anti-money laundering), customers could get funding beyond their capacities from different sources (consumer protection), and mobile network operators can factually turn into financial service providers without proper supervision (systemic stability). Bangladesh Bank is well aware of these issues and challenges and has implemented regulations for banks in general.

Successful Islamic microfinance will bring new clients into the financial system whose economic position is weak and vulnerable and whose financial knowledge is very limited. They deserve special protection. Only a few Muslim countries have incorporated Islamic microfinance into their existing accounting, reporting and regulatory framework. The IFSISR 2013 has touched upon special regulatory requirements in systems with a strong microfinance sector.

The regulatory framework for the microfinance sector should replicate the structures of existing banking regulations, but it has to pay attention to the specificities of microfinance banks. For example, the minimum required capital for microfinance banks could be reduced in absolute amounts, while the minimum capital adequacy ratio could be set at a higher level (as a stronger capital buffer for critical situations where microfinance banks have fewer emergency tools at hand than high street banks). The central bank has to decide how the loss-absorbing potential of *Muḍārabah*-based deposits should be treated in the calculation of the required regulatory minimum capital.

Only in a few countries do microfinance institutions operate in a competitive environment with large numbers of microfinance market players. As a consequence, very little is known about competitive processes in microfinance markets, and even less about Islamic microfinance markets, such as the elasticity of supply and demand,

the existence of feedback loops, possible contagion effects, positive and negative externalities, and so on. Therefore, regulations and procedures for an orderly unwinding or market exit of an Islamic microfinance venture, as well as safety nets for the users of Islamic microfinance services, are required in order to contain the systemic risk.

Consumer protection should be ensured for the Islamic microfinance sector. For example, the low level of financial literacy makes it more important to explain terms and conditions of *Shari'ah*-compliant contracts to the customer in plain language, and it could become mandatory for banks and non-banks involved in Islamic microfinance to participate in financial literacy campaigns and consumer education programs under the leadership of the central bank. *Shari'ah* governance should also be explained in these initiatives.

In the interest of customer protection, restructuring options for unsustainable financings and conflict resolution procedures should be implemented and customised to the specificities of Islamic microfinance. This requires cooperation between the regulator and the recognised *Shari'ah* authorities.

In view of the country's great demand for Islamic financial services and its long experience with conventional microfinance, Bangladesh could become a leader in the development of Islamic microfinance.

D. TOWARDS A ROADMAP FOR THE ISLAMIC FINANCE INDUSTRY IN BANGLADESH

The situation in Bangladesh is unique insofar as a sizeable Islamic banking sector exists, but the country lacks specific Islamic finance regulations and important segments of a comprehensive Islamic finance industry. The resulting vulnerabilities of the Islamic finance sector have been recognised and are to be addressed by the authorities. Furthermore, the huge potential of Islamic finance in support of inclusive growth has also been recognised, and efforts are being made to create an environment that is conducive to realising this potential. It would be in the interests of transparency, credibility and consistency to prepare an assessment of the status quo and to compile all intended actions and chosen strategies in an Islamic finance sector development plan.

Such a document could start with a section on the legal and regulatory framework, in which the authorities spell out their main objectives and general approach. The document can:

- clarify whether the aim of developing the Islamic financial sector is, for example, to create a level playing field for Islamic and conventional financial institutions or, more broadly, to actively promote Islamic finance. In the case of active promotion, measures in support of Islamic finance should be explicated in later sections of the document.

- set the course for the range of permissible business models in the IFI – for example, by spelling out whether Islamic windows can (continue to) operate in the future or have to be phased out over a certain period of time.
- address the main elements of the *Sharī'ah* governance system – namely, whether a national *Sharī'ah* body is to be dispensed with or created to act as an advisory council or as a board with discretionary competences and standard-setting powers.
- describe whether special *Sharī'ah* courts for Islamic finance disputes, arbitration bodies or other particular dispute settlement structures will be established.
- clarify whether a separate law for IIFS will be enacted or existing laws amended to cater for the specificities of Islamic financial transactions.
- address tax issues (e.g. related to sales taxes for sale-based modes of Islamic financing such as *Murābahah*, stamp duties, taxes on profits in *Muḍārabah* and *Mushārahah* transactions).
- specify accounting and auditing requirements (e.g. application of AAOIFI standards or of IFRS with a few adaptations).

The more technical sections of an Islamic finance sector development plan should deal with the role and instruments of the central bank as well as with initiatives for the different sectors of the Islamic finance industry – capital market, banking and *Takāful*.

A special chapter could cover central bank instruments for monetary policy and money market interventions to support the liquidity management of Islamic banks, a strategy for the development of an effective *Ribā*-free interbank market, the setting of benchmark rates for *Sharī'ah*-compliant fixed income instruments (*Sukūk*) and bank financing (as an Islamic alternative to LIBOR or similar conventional rates).

The development of an Islamic capital market could enhance the efficiency of the existing Islamic financial services industry, but it could also support its further development – for example, in the *Takāful* and Islamic pension sector. In addition, new tools for monetary policy could be created. However, specific recommendations require a thorough analysis of the reasons for the presently very small size of the capital market in Bangladesh in general. The specific obstacles to the development of an Islamic market for equity and debt securities have to be identified. For example, it is not obvious why private companies issue stocks but avoid debt securities, preferring bank financing instead. Further, the role of government bonds should be addressed: would they facilitate or crowd out private issuances? Research on the financing strategies of corporations should be a high priority, and public sources should provide or at least contribute substantially to the funding and provision of basic data.

If there is a political will to promote development of the Islamic capital market, the private and public sectors could prepare the ground for the use of Islamic instruments.

For example:

- Stock screening techniques are at the core of the Islamic equity market, and private consultancies could cooperate with *Sharī'ah* scholars and the operating Islamic banks to develop a screening model for Bangladesh.
- *Sukūk* are *Sharī'ah*-compliant structures for debt-like securities that use *Sharī'ah* contracts (such as *Ijārah* or *Mushārakah*) for the generation of income for *Sukūk* holders. The *Sharī'ah* contracts as such are not part of a secular legal system, and therefore it would be advisable to transpose them into documents that clearly express the rights and obligations as well as the intentions of the contracting parties so that these documents can provide the basis for court decisions in a common law country. Private law firms could study the practices in other countries.
- The regulatory authorities and the government – perhaps jointly with private-sector consultancies – should analyse concepts and structures for sovereign *Sukūk* that do not require the temporary transfer of the ownership of public assets to the private sector. Several options could be considered, depending on the existing legal framework: for example, the sale of usufruct instead of assets, the transfer of beneficial ownership, or *Mushārakah* or *Muḍārabah Sukūk* that do not require an initial transfer of ownership. *Mushārakah* and *Muḍārabah Sukūk* could be suitable structures for the financing of infrastructure projects.
- When more *Sharī'ah*-compliant securities become available, the toolbox of monetary policy should be enhanced by more open market instruments. The central bank should also consider the introduction of a *Sharī'ah*-compliant equivalent to repos, but it must be aware of divergent *Sharī'ah* views on this topic.
- If public authorities wish to promote the *Sukūk* market, they should initiate or support awareness or information campaigns on corporate financing by *Sukūk*, possibly teaming up with business associations or chambers of trade and commerce and Islamic banks.

Legal certainty is of prime importance for the further development of the industry, in particular with respect to cross-border transactions. The existing legal, regulatory and tax environment should be amended or adjusted to accommodate specificities of Islamic finance. The final aim should be the creation of a comprehensive and consistent legal and regulatory framework for all sectors of the Islamic financial services industry.

- An integrated comprehensive framework cannot be installed overnight, but it should be the background for a long-term financial sector development plan that could be implemented in a gradual and piecemeal manner. Amendments of existing laws and new regulations should always be checked for consistency with the development plan and the potential for regulatory arbitrage.

- The need for alternative dispute resolution (arbitration, mediation) institutions should be assessed. This may give additional confidence to foreign market players and facilitate their entry into an emerging Islamic capital market.
- National *Sharī'ah* boards can contribute to legal certainty and reduce *Sharī'ah* non-compliance risks. However, Islamic finance can flourish even in those countries that do not have a superior national authority for finance-related *Sharī'ah* interpretations. If governments or regulators take a more neutral position, they may prescribe just the minimum *Sharī'ah* governance structures for Islamic financial institutions but abstain from the establishment of national *Sharī'ah* boards.
- Legal certainty includes that court decisions are made by judges who have sufficient understanding of Islamic finance. This cannot be taken for granted in countries where Islamic finance laws are recent phenomena that did not exist when today's judges were studying law and starting their professional careers. Support provided to the incumbent judges by an Islamic finance consultancy body could create more consistent judicial decisions.

Systemic stability and consumer protection should be prominent on the political agenda. An engagement of banks in shallow and volatile capital markets exposes the banks to additional risks which have to be contained.

- The regulators have to decide on capital adequacy regulations. The Revised Capital Adequacy Standard for IIFS (IFSB-15) provides comprehensive guidance.
- The regulators also have to decide on the treatment of *Muḍārabah*-based investment accounts with respect to capital adequacy. The options outlined in IFSB-2 – that is, the original capital adequacy standard of 2005 – have been carried over to the revised version in IFSB-15.
- A major stabiliser could be a *Sharī'ah*-compliant lender of last resort. A more developed Islamic capital market would enhance the scope of available instruments. However, different views of *Sharī'ah* scholars have to be noted.
- Different *Sharī'ah* opinions can also have an impact on the choice of an appropriate deposit insurance scheme. For *Muḍārabah*-based deposits, third-party guarantees or *Takāful* solutions (with pooled profit equalisation reserves of Islamic banks) have been discussed. An alternative would be to structure savings accounts with a return for the account holders on the basis of a different *Sharī'ah*-compliant contract such as *Wakālah*. Both approaches, however, are not totally free of *Sharī'ah* issues. Nevertheless, the prevention of bank runs and consumer protection should have a very high priority in a country that promotes financial inclusion because this implies that a large number of savers will not be in a position to bear any financial risk originating from a bank failure.

- Bangladesh has a great wealth of experience in conventional microfinance. The promotion of Islamic microfinance should become a priority area for both the private and public sectors. Islamic microfinance initiatives in the private sector – philanthropic as well as commercial – should be encouraged. They require an adapted legal and regulatory framework that is consistent with both general Islamic finance regulations and microfinance stipulations.
- Islamic microfinance is actually largely driven by Islamic banks. If banks with a widespread branch network could utilise their infrastructure fully, this might reduce transaction costs and enhance the access to microfinance services. The benefits of restrictions should be balanced against the gains from cost reduction and improved access.
- The regulations have to take into account the specificities of Islamic non-bank financial institutions and branchless banking (in particular, electronic banking) of microfinance banks. From a regulatory perspective, it is advisable to stick to bank-led branchless banking.
- The *Takāful* sector in Bangladesh is still very small. However, (micro-) *Takāful* can help to make the vulnerable poor more resilient against shocks and fluctuations in their income. This is beneficial not only for the individual and the family, but also for the economy as a whole, because it enhances the overall risk-bearing capacities and encourages self-employment and entrepreneurial initiatives. Islamic micro-*Takāful* operators can learn from the risk calculation methods and distribution techniques of conventional micro-insurance providers in Bangladesh and abroad. Solid growth of this sector requires a sufficient supply of long-term, *Sharī'ah*-compliant securities with predictable returns (such as *Sukūk*). It requires also a legal and regulatory framework that protects the solvency of *Takāful* enterprises and the saved-up capital of family *Takāful* participants.
- Commercially viable Islamic microfinance may become a target sector for global investors who are looking for socially responsible investment opportunities. The private Islamic microfinance sector should attract funds from abroad, and the regulation of the capital markets should allow not only the inflow of funds, but also the transfer of profits and later the repatriation of the invested capital.
- Islamic microfinance could unleash the power of private philanthropy. In the past, Islamic states accepted *Waqf* as a form of institutionalised and sustainable charity. A revival of this form of segregation and protection of private wealth for social purposes could create, support and stabilise donation-driven revolving funds. It may require an amendment of the secular law with regard to the recognition of endowments, foundations or trusts.



The implementation of a comprehensive legal and regulatory framework, the involvement of new market players in the Islamic capital market, intensification of the *Takāful* and microfinance segments, and expansion of the *Sharī'ah* environment all require well-versed qualified human resources that are in short supply. This creates great opportunities for private and public training and education service providers that launch programmes in the field of Islamic law and finance. They will be in high demand and contribute to the further development of the country.

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