DECLARATION

In the name of person making the declaration, I make this declaration on my own free will, and upon my honour. My purpose is to serve the greater good of society. I will comply with the laws, regulations and codes of ethics applicable generally and recognise that I also have moral obligations to ensure that my behaviour and actions do not adversely affect the well-being of society, the natural environment and future generations. I recognise that I will face challenges and difficulties in upholding the highest moral values and ethical principles in my financial services.
Features

17 10th International Takaful Summit 2016 (ITS 2016)

We have marked the 10th anniversary of this conference with very full coverage of the event. It is organised into seven themed features running from page 17 to page 50.

18 ITS 2016: The London Market – Contributing to the Takaful Industry

This feature includes presentations from Inga Beale, CEO of Lloyds and David Matcham, Chief Executive, London Underwriting Association and a panel session chaired by Susan Dingwall, Norton Rose Fulbright LLP. These sessions highlight the importance Lloyds and the London market in general place on the takaful and retakaful industries.

27 ITS 2016: Takaful Market Characteristics

Susan Dingwall and Martin Schneider present the results of a survey carried out by Norton Rose Fulbright LLP on some of the reasons why Islamic assets are insured with conventional insurers. David Anthony of Standard & Poor’s examines the impact of low oil prices on takaful and retakaful in the GCC.

31 ITS 2016: Regulation, Standards and Ratings in a Demanding Global Environment

Ajmal Bhatti, Tokyo Marine Middle East analyses takaful standards, particularly in Saudi Arabia and the UAE, highlighting the lack of regulatory uniformity across markets. James Smith, Ernst & Young LLP explains how the IFSB works and its role in the push to standardisation.

37 ITS 2016: Mutually – Options and Issues

Kainal Kassim, Actuarial Partners Consulting Sdn Bhd makes the case for discretionary mutuels, while John Gilbert, M&G Advisory Services Ltd and Azman Ismail, IIFN Consulting Sdn Bhd examine the problems of raising capital for mutuels.

41 ITS 2016: The Role of Effective Retakaful in Increasing Takaful’s Market Share

Chakib Abouzaid, Reinsurance Group Med outlines the state of retakaful today. Mahomed Akoob, Hannover ReTakful reviews the issues of capacity, capital and profitability in retakaful. Mohamed El Dishish, EmiratesRE examines the market issues facing retakaful and Sheikh Zubair Miah, in-house scholar with Cobalt Underwriting presents the Shari’ah perspective on retakaful.

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47 ITS 2016: Developed and Emerging Takaful Markets

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Cover Image: The Lloyds of London Building by Night
Executive Editor’s Note

In late 2012 London hosted the IIBI-ISRA Thematic Workshop entitled Legal Compliance versus Moral Responsibility in Islamic Banking and Finance that called on Islamic finance practitioners, including Shari’ah scholars, to take a voluntary ‘Moral Oath’. This was not dissimilar to the Hippocratic Oath taken by doctors and calls for a moral oath for bankers following the recent financial crisis. This requires individuals to take personal responsibility for serving the greater good of society; complying with the laws, regulations and codes of ethics applicable generally and notably recognising they additionally have an obligation to ensure that the intentions behind conduct and dealings do not inflict harm on society, the natural environment or future generations.

Bernie Sanders, Hilary Clinton’s rival to win the US Democratic nomination for President spoke out in April this year at a Vatican conference. He said, ‘At a time when so few have so much, and so many have so little, we must reject the foundations of this contemporary economy as immoral and unsustainable.’ He quoted at some length from Centesimus Annus, an encyclical letter addressed by Pope John Paul II, not just to the Roman Catholic Church but to ‘all men and women of good will’. This letter talks about the Church’s teaching recognising the positive value of the market and enterprise, but only as long as it is oriented to the common good. It goes on to say that illicit exploitation, speculation or the breaking of solidarity among working people is an abuse in the sight of God and man.

Sanders went to say that ‘with unregulated globalisation, a world market economy built on speculative finance burst through the legal, political and moral constraints that had once served to protect the common good.’ The sentiments expressed in the encyclical and by Bernie Sanders have a strong resonance with the teachings of Islam and particularly with the intrinsic values of Islamic finance.

Bernie Sanders did not win the nomination, but there was enough support for his message to suggest that people are ready to embrace an alternative to the great Moloch that is the conventional finance industry. It has never been more important for Islamic finance to be true to its founding values; to show the world that there is a viable alternative to the ‘extreme individualism’ that promotes self-serving greed, spiralling debt, rampant financial fraud and other questionable business practices. The Shari’ah amplifies Islam’s view of economic justice and values that respect competition and prioritises human needs over the creation of massive individual wealth for the few.
Islamic Financial Services Industry Sees Slower Growth in 2015

The Islamic Financial Services Board (IFSB) in its 2016 Islamic Financial Services Industry Stability Report suggests that the industry in 2015 saw a lower rate of growth than at any time since the 2008 global financial crisis. It believes this is due to a combination of factors including falling oil prices, which has particularly affected many of the countries where Islamic finance has a significant presence. It notes that there is a positive relationship between Islamic banking assets and oil revenues, raising the fear that the revenues, liquidity and profitability of Islamic banks could be affected by lower oil revenues. The report also highlights an alternative scenario where Islamic financial institutions could benefit from increased business, if governments turn to external sources to finance infrastructure projects and deficits.

Islamic banking continues to be the dominant sector in the industry, although liquidity remains an issue particularly where no Shari’ah-compliant interbank market has developed. Its market share has, however, increased in more than half of the 31 countries tracked by the IFSB and the number of countries where Islamic banking is systemically important (accounting for 15% or more of total banking assets) has increased to 11. The report notes the growth of Islamic banking in both North and Sub-Saharan Africa, where a number of new Islamic banks have been established.

The report notes that the sukuk market fell by 50% in 2015 after the Malaysian central bank stopped its regular issuance of short-term sukuk. The market continues to be dominated by sovereign and multilateral issuers (70% of all issuance). While corporate sukuk in Asia, most notably Malaysia, come from a range of industries, in the GCC they are mainly from Islamic financial institutions (IFIs). It also notes that, although there have been no sukuk defaults since 2010, stronger regulation and legal frameworks could help to facilitate more international sukuk issuance.

Three countries account for 84% of all takaful business – Saudi Arabia, Iran and Malaysia with 37%, 34% and 14% respectively. While family takaful is the dominant business line in Malaysia, it is almost non-existent in Saudi Arabia and Iran where non-life business such as motor and health is most common.

Islamic Banker Appointed Governor of Turkey’s Central Bank

Murat Cetinkaya has been appointed as the new Governor of Turkey Central Bank. His banking career has been spent in Islamic banks, but he has no formal economics or finance training. He studied international relations and sociology at Istanbul’s Bosphorus University. He is however in the process of completing a Ph.D. in politics currently and interestingly his dissertation topic is financial regulation. Cetinkaya has been Deputy Governor at the Central Bank since 2012.

The new Governor is unlikely to have an easy ride. He takes office during a period of global economic slowdown and faces economic problems at home including a volatile currency and high inflation. It will also be interesting to see how he responds to President Erdogan’s frequently expressed desire to see lower interest rates, which had been resolutely resisted by the previous Governor.
New Standards for Islamic Forward Foreign Exchange Products

In June 2016 the International Islamic Financial Market (IIFM) and the International Swaps and Derivatives Association, Inc. (ISDA) published two new standards for Islamic forward foreign exchange products for use in Islamic hedging transactions. The ISDA/IIFM Islamic Foreign Exchange Forward is part of an ongoing initiative by the two associations to provide the Islamic finance industry with documentation and product standards to mitigate risk arising from currency and rate-of-return mismatches.

The ISDA/IIFM Islamic Foreign Exchange Forward (IFX Forward) is intended to help minimise the exposure of Islamic financial institutions to foreign exchange volatility. The standards can be used to mitigate currency risk associated with capital markets instruments, as well as trade finance and corporate banking activities.

The IFX Forward falls under the ISDA/IIFM Hedging Master Agreement, a framework document that contains general terms and conditions, and early termination and close-out netting provisions between transacting parties.

‘In recent years, Islamic finance has increased its presence in a number of new jurisdictions and territories, which has resulted in pressing demands for Shari’ah-compliant hedging products to reduce currency risk for foreign and local investors. IIFM has been playing a leading role in the Islamic hedging segment and has produced a number of required documentation and product standards for Islamic risk mitigation purposes. I am confident the IFX Forward standards will benefit all stakeholders of the industry,’ said Khalid Hamad, Chairman of IIFM.

‘The Islamic banking industry has long been desirous of an industry standard that does not require usage of the balance sheet for both counterparties in foreign exchange forward hedging transactions. These standards using the wa’ad structure will overcome this constraint and lead the way to handling other off-balance-sheet hedging structures,’ said Naveed Khan, Vice Chairman of IIFM.

‘One of the unique aspects of the IFX Forward standards is the use of two, independent, unilateral wa’ad, which provides credit risk security to both the transacting parties. IIFM/ISDA efforts have resulted in an innovative risk mitigation product in line with the strict Shari’ah compliance enforced by the IIFM Shari’ah Board. A confirmation template based on single wa’ad has also been standardised to assist users who require this structure,’ said Ijlal Alvi, Chief Executive of IIFM.

Two versions of the IFX Forward standard confirmations have been published as follows:

Single Wa’ad Structure: where only one party is the buyer who grants the wa’ad in favour of the other party.

Two Wa’ad Structure: where each of the parties grants a unilateral wa’ad in favour of the other party and a party’s right to exercise the other party’s wa’ad is subject to an exercise condition being satisfied on the exercise date. Each wa’ad carries a different trigger condition and therefore does not constitute a contract.

UAE Cabinet Approve Unified Shari’ah Board

In early May the UAE gave the green light for the establishment of a new national Shari’ah authority. The authority will oversee the Islamic financial sector, approve financial products even when these have been approved by individual Shari’ah boards and set rules and principles for banking transactions. The members of the new authority will be appointed by the central bank, which will also oversee its operations. The authority will be financed by fees payable by Islamic financial institutions.

The UAE joins Malaysia who established a national Shari’ah board in 1997 and Oman who did the same in 2012. The UAE will apparently base the new authority on the Malaysian model.

Emirates Islamic Claim UAE First for Social Banking

Emirates Islamic has launched Social Banking, offering banking services via Twitter, making it the first Islamic bank in the UAE to offer banking services on a social media platform. Customers will be able to perform select transactions such as balance enquiry, view their last few transactions, and make enquiries about their accounts or credit cards with a simple tweet. To maintain privacy and confidentiality, the bank will only respond to customer queries via a direct message.

The Twitter banking platform complements the bank’s existing digital channels, which include ATMs, 24 hour telephone banking, online and mobile banking. Emirates Islamic’s Twitter banking service will be available to all its saving and current account holders as well as credit card holders through an easy registration process.
IFSBIssue Working Paper on Deposit Insurance

At the beginning of March the Islamic Financial Services Board (IFSB) issued a Working Paper on ‘Strengthening the Financial Safety Net: The Role and Mechanisms of Shari’ah Compliant Deposit Insurance Schemes (SCDIS)’ (WP-06). It sheds light on the principles and existing institutions, through which deposit insurance schemes (DIS) are provided on a Shari’ah-compliant basis. DIS is considered an indispensable component of the new global financial stability framework post-financial crisis, in which the role of financial safety nets in the banking sector have gained widespread acceptance. DIS has been instituted explicitly in at least 113 jurisdictions worldwide. The paper notes that there has been a major shift in DIS design features, post-financial crisis, as a number of elements advocated in the past literature were found to be detrimental to financial stability and were among the factors judged to have undermined depositors’ confidence.

WP-06 states that extending conventional DIS protection to Islamic banks presents several key challenges which include issues in the underlying principles of conventional deposit insurance (excessive gharar and riba, amongst others); the treatment and insurability of deposits accepted under profit-sharing contracts; the priority of claims of different types of deposits collected by Islamic banks and the role of the deposit insurance fund in resolution.

Drawing upon survey results conducted across 27 IFSB member regulatory and supervisory authorities (RSAs), WP-06 identifies four jurisdictions where SCDIS are already implemented and in effect. Additionally, a fifth jurisdiction has drafted its modality and corresponding law for an SCDIS and this is expected to be in operation in the very near future. The IFSB survey and follow-up communications with these five jurisdictions have also indicated variations in the operational practices of these respective SCDIS including, among others, the governance structures, investment strategies, risk assessment frameworks and coverage limits of the deposits protected.

WP-06 goes on to identify the differences in the treatments of SCDIS coverage for profit-sharing investment accounts (PSIA). Subject to various terms and conditions, one out of the five jurisdictions with SCDIS does not provide any coverage to PSIAs; two out of five jurisdictions cover only unrestricted PSIAs and not restricted PSIAs and the last two jurisdictions cover both unrestricted and restricted PSIAs. There are also important differences in terms of rules related to the parties (i.e. IFIs, central banks, depositors, etc.) that will pay the contributions for coverage to the SCDIS.

Overall, WP-06 highlights the current Shari’ah-compliant models of deposit insurance schemes that are being implemented in different jurisdictions and the operational and Shari’ah challenges that need to be considered in the implementation of these schemes. The paper also considers the Shari’ah perspectives that support the provision of funds protection to the IFSI in general and to depositors in particular, in the interest of achieving financial stability and resilience in the system. The paper raises awareness on the importance of having SCDIS; highlights the existing modalities and practices of SCDIS in different jurisdictions; and identifies key design challenges from both Shari’ah and operational perspectives for developing SCDIS.

The paper concludes that the role of a DIS is relevant in the global IFSI, which has achieved rapid growth, transforming into a multi-trillion dollar industry. Aside from the Shari’ah considerations above, due care needs to be given to ensure that SCDIS comply with international principles for effective deposit insurance systems, taking into consideration the modifications necessary to cater to the specificities of Islamic finance.

WP-06 is the second part of the series of IFSB working papers on financial safety nets. They released ‘The Role of Shari’ah-compliant Lender-of Last-Resort (SLOLR) Facilities as an Emergency Financing Mechanism’ in April 2014. The IFSB is now embarking on a third paper in this series related to the resolution and recovery of insolvent Islamic banks.

Bahrain Islamic Bank Seeks to Boost Liquidity

During the announcement of its mid-year results, CEO of Bahrain Islamic Bank, said that the Bank had passed through difficult conditions over the past few years, and that its restructuring would take a considerable period of time. Within days of the results announcement it was announced that the Bank was intending to sell approximately $218 million of unproductive assets including land and shares in associate companies. The driver for the sale is the cost of bank borrowing in Bahrain. (It is understood that the cost of borrowing in local currency is about twice the rate of borrowings in US dollars.) The move is part of a five-year plan to boost growth.
The Knightsbridge Effect

Just fifteen months after it opened its exclusive private banking branch in Knightsbridge, Al Rayan Bank (UK) has revealed that its private client business has experienced unprecedented growth. The flagship branch has opened more than 600 new accounts and helped to grow the value of the Bank’s private client real estate business by 173%, whilst the value of its private client liabilities has increased by more than 140%.

Ahmed Rawaf, Head of Private Banking, Al Rayan Bank (UK) said, ‘As expected, our Knightsbridge branch has become an important hub from where our clients, who are mainly from the GCC region, are choosing to carry out their banking requirements. In just fifteen months since it opened the branch has welcomed many hundreds of new high net worth customers and has been an engine behind the rapid growth in the Bank’s private client business. The branch will continue to quickly respond to the changing needs of our private banking customers and we anticipate that the next year will be equally successful.’

Malaysia’s Islamic Banking Assets Reach 27% of Total Banking Assets

In a speech to launch the Educator’s Manual on Shari’ah Standard Murabaha, the new Governor of Bank Negara Malaysia, Datuk Muhammad bin Ibrahim, revealed that Islamic banking assets in Malaysia have grown beyond the targeted 20% in Bank Negara Malaysia’s Financial Sector Master Plan. They now stand at more than a quarter (27%) of the total banking system. He also noted the greater acceptance of takaful with its penetration rate of 14.8% of the population and the success of the sukuk market, which constitutes more than 50% of global sukuk outstanding for the past 16 years.

Bank Negara Appoints New Governor

Datuk Muhammad Ibrahim has been appointed the Governor of Bank Negara Malaysia with effect from May 1 2016 for a period of five years. He has been a Deputy Governor of the bank since 2010 and it believed that he would have been former Governor Zeti Aziz’s first choice as her replacement. He holds a Masters degree from Harvard University and has worked at Bank Negara since 1984. He was seen by commentators in Malaysia as the most experienced of Zeti’s potential successors and also as the continuity candidate.

United Bank of Egypt on the Market

The United Bank of Egypt was formed in 2006 by Egypt’s Central Bank, which is the majority shareholder (99.9%). It merged the former Nile Bank, Egyptian United Bank and the Islamic Bank for Development and Investment. Now the Central Bank has decided to put the bank up for sale. The timetable is unclear but late 2016 or early 2017 have been mentioned.

According to a report in Egypt’s Daily News expressions of interest have been received from a number of international institutions. Once the Bank has been prepared for sale, the Central Bank say they will draw up a short list of the strongest contenders. Although floating the bank is one option, it is believed the Central Bank’s preference is for a foreign buyer to help improve the foreign exchange crisis.

Union Bank inherited 6 billion Egyptian pounds (EGP) in debt on its formation. It has managed to clear down EGP 3 billion and part of the preparations for sale will involve clearing the remaining debt. The bank has 47 branches, 21 of which are Islamic banking branches. Its main business is with small and medium-sized enterprises, real estate financing and retail banking.
In Brief

**Dubai Islamic Bank** (DIB) has said it has received a letter of intent from a consortium led by Jordan's Bank Al Etihad for the acquisition of MESC Investment, DIB's Jordanian holding company. MESC currently hold 52% of the shares in DIB subsidiary, Jordan Dubai Islamic Bank.

The Bank of England has levied a fine of £1.4 million on **Qatar Islamic Bank (UK)** Plc for ‘significant financial failings’. These failings left the bank undercapitalised and exposed to risk. The situation, for which the fine was levied, dates back to 2011/2012. Since that date Qatar Islamic Bank (UK) Plc has been restructured.

**Indonesia’s Financial Services Authority** has issued a statement of intent to allow Shari’ah-compliant pension funds, either by setting up new funds or converting existing ones. Indonesia’s population of people aged 60 or more is expected to triple by 2050. So far there is no firm date for implementation of this initiative.

**Ghana’s Central Bank** has withdrawn the provisional license granted to Saudi Arabia-based Makkah to establish an Islamic financial institution. It is reported that Makkah had failed to meet the key requirements for a full operating licence.

**Pakistan’s Summit Bank** will become a wholly Islamic bank over the next three years according to an interview with the Summit’s CEO, Zahir Esmail, in an interview in Pakistan Today. So far 14 branches have been converted to Islamic branches and a further five will follow in the next six months.

**Suriname’s Trust Bank** is on track to become a fully-fledged Islamic bank by the end of 2016. The bank first announced its intention to convert to full Islamic status in June 2015.

The **UK Government** has issued a White Paper aimed at making Shari’ah-compliant student loans available. The Muslim Council of Britain has welcomed this move. Dr Shuja Shafi said, ‘The government is to be commended for making this positive step. It would allow Muslims to fulfil their religious obligation to study and to avoid interest. This will undoubtedly pave the way for more students to participate in higher education and there is no reason why non-Muslims too should not be able to benefit from this as well.’

According to a report in the **Middle East Insurance Review Indonesia** is considering introducing a legal framework for Islamic Real Estate Investment Trusts (REITs) in an attempt to attract more property investors, particularly from the Middle East. Islamic REITs would be granted the same sort of tax incentives as conventional REITs.

**Morocco’s central bank** is on track to start issuing approvals for Islamic banks by the end of 2016. It is anticipated that the first Islamic banks will open for business in early 2017. The central bank has received seven applications for full Islamic bank status and three for window operations. In most cases the applications involve local banks partnering with established Islamic banks including Qatar International Islamic Bank, Masraf Al Rayan and Al Baraka.

**Dubai Islamic Bank’s** rights issue to raise Dh3.2 billion in new capital was three times oversubscribed. The bank has not indicated how the money will be used, but it is believed that it is in part at least designed to enable the bank to comply with new Basel III regulations on enhanced liquidity.

A recent report from Standard and Poor’s suggests that Islamic banks in **Turkey** could command 10% of the banking sector by 2025. The sector has grown from 2.5% in 2005 to 5% in 2015. This might have been slightly higher without the problems surrounding Bank Asya, but the decline here should be offset by the new banks entering the sector such as Ziraat and Vakıfbank.

**India’s Gujarat province** should see the first Islamic bank in India. The bank is to be set up by the private arm of the Islamic Development Bank and will be led by Zafar Sareshwala, a prominent Muslim businessman. There is, however, strong opposition developing among Hindu groups, notably Vishva Hindu Parishad, who claim it will encourage conversions to Islam.

Abdullatif Essaje, a don at Kenya’s Nairobi University and a co-founder of First Community Bank, Kenya’s first fully-fledged Islamic bank has called for Kenya to have a separate regulatory framework for Islamic banking. (Currently there is a moratorium on new Islamic banks in Kenya in the wake of the failure of Chase Bank in April 2016.)

A recent survey report from the **State Bank of Pakistan** has revealed that 74% of respondent with bank accounts are willing to transfer to Islamic banking. Interestingly 62% said they were willing to transfer even if Islamic banking products were more expensive. The main obstacle to switching was identified as the lack of an Islamic bank in the account holder’s locality.
Islamic Finance in the UK and Brexit

The Developing Situation
Suspended animation is probably the best way of describing the UK in the weeks following the vote to leave the EU (European Union). The uncertainty has been compounded by not just a new Prime Minister, but a whole new Cabinet, in particular a new Chancellor of the Exchequer. Nobody knows what will happen or, for that matter, when it will happen; indeed some in the City of London probably rather optimistically hope that it may never happen. Brexit will certainly affect the City and it is hard to believe that, in the short term at least, those effects will be positive.

There are some effects that we can be relatively certain about. A big earner for London has been the trade in euros. The European Central Bank (ECB) has not been particularly happy about this situation, given that the UK is outside the Eurozone, but with Brexit it is reasonable to assume the ECB will move to stop such large trades in their currency taking place abroad. It is also reasonable to assume that the withdrawal of passporting, which means that banks and insurers can establish branches and/or trade their UK-approved products freely across the EU without requiring additional authorisation, will have a negative impact. This not only means an additional hurdle for anyone trading out of the UK, and that could be a significant hurdle depending on just how vindictive various EU countries want to be, but it also brings into question the future location of non-British financial organisations that have chosen to site their European operations in London. (The withdrawal of passporting is, however, by no means a given; it will depend on the deal the UK strikes with the EU.)

There are, however, wider issues for the economy and whether the UK continues to be an attractive place for investors. Predicting what is likely to happen on this front is much more difficult. It will depend on just what sort of deals the UK manages to do with its former EU partners and with the rest of the world. The biggest problem is that solutions in this space will not be negotiated quickly and there will inevitably be a fairly lengthy period of uncertainty. In the long term, Martin Weale, a member of the Bank of England’s Monetary Policy Committee said in a recent speech, 'The final outcome will depend on how far trading arrangements suffer and how far the country becomes less appealing as a destination for foreign investment. The effect of leaving the EU will probably be harmful to our trading arrangements but there is a great deal of uncertainty as to how powerful this effect is likely to be.'

What Might This Mean for Islamic Finance in the UK?
There is particular concern about the impact of Brexit on Islamic finance in the UK and on the UK's ambitions to be the leading centre for Islamic finance in the West, providing a conduit for funds from the GCC and the Islamic nations of the Far East into Europe. At the end of June the Gulf Times carried a report suggesting that a variety of concerns could result in Luxembourg snatching London's crown. (Luxembourg is better placed than any of the other financial centres in Europe to challenge for Islamic financial business. They have already put in place an Islamic finance friendly regulatory framework; they have become members of the IILM (International Islamic Liquidity Management Corporation) and the IFSB (Islamic Financial Services Board) and have attracted a substantial amount of investment business.) They cited the fear among investors that Brexit would mean tighter regulations and higher taxes; the loss of easy access to the EU and at least two years of uncertainty about the UK's relationship with other markets.

Tighter Regulations
A period of uncertainty is a given and the loss of easy access to the EU is a strong possibility, but what about tighter regulation and higher taxes? Tighter regulation in the UK seems unlikely. Indeed, Brexit would give the UK the opportunity to ditch certain regulations that have proved burdensome and are not in line with UK policy. On the other hand, if the UK finally negotiates a Norway-like model, the financial services industry would still be subject to EU policies, but without having any influence over those policies. (It is widely believed that the UK has used its influence to moderate some of the more draconian financial regulations that have been proposed by the EU. If this is indeed the case then the UK could be subject to tighter regulation through the very act of leaving the EU).

If the UK is free to act in its own interests tighter regulation seems unlikely. UK government is likely to be keen to do everything it can to protect the financial services industry and tighter regulation would do nothing to help. If the UK ends up with the Norway model resulting in tighter regulation, other EU countries would enjoy no advantage, because they too would be subject to the same regulation, so there would be no incentive for Islamic financial institutions (IFIs) to move to other European financial centres.

Higher Taxes
Higher taxes are a less easy issue to address. The logic suggests that, as with tighter regulation, UK government might be keen to provide incentives to the financial services industry in the form of tax cuts and incentives. It is, however, necessary to be mindful of the statement made by Prime Minister May as she...
entered Downing Street in which she committed to prioritising the interests of ordinary working people, saying, ‘When it comes to taxes, we’ll prioritise not the wealthy, but you.’ It is difficult to know exactly what this means or what the implications might be – is it just the usual rhetoric of a new leader or does it mean a taxation policy that will seek to redistribute wealth and if the latter, does it involve taxation on individual wealth such as higher rates of income tax for big earners or a broader approach involving business-related taxes. The answer is no-one yet knows and in that answer lies the problem – uncertainty.

**Easy Access to the EU**

Easy access to the EU or passporting seems to be a lesser concern for Islamic financial institutions in the UK than it would be for the conventional sector. In general Islamic financial institutions in the UK are more concerned with providing investment opportunities for clients from the Middle East, rather than using the UK as a springboard into other EU countries.

The easy access argument does, however, have a potential impact on Islamic finance in the UK. As we have noted above Islamic financial institutions in the UK are concerned with providing investment opportunities and one of the favourite forms of investment for these organisations is property. If Brexit causes an economic slowdown in the UK, and recent IMF (International Monetary Fund) statements suggest that this is likely, and if easy access to the EU causes non-British financial institutions to relocate to other European financial centres such as Frankfurt or Paris, property investment in the UK could start to look a lot less attractive.

**And Back to Uncertainty**

This takes us back to where we started – no-one knows at the moment what is going to happen or when. Theresa May’s government shows no signs of wanting to make any hasty decisions and that is probably a good thing. Knee-jerk reactions seldom work out well. On the other hand any unnecessary delay and the uncertainty that it will create is bad for any business, but it is particularly bad for investment businesses. Of course there are the gamblers who will be willing to take a chance while the pound is relatively weak and property prices have stalled or even fallen slightly, but the majority of responsible investors will opt for certainty. There have been suggestions that Islamic investment funds will see the current situation as an opportunity – better exchange rates for their oil dollars, lower property prices and the prospect of the government needing to raise funds for big infrastructure projects. Whether they grasp that opportunity will depend on how they view the mid to long-term prospects for the UK economy outside the EU, so once again we are back to uncertainty.

**A Rush for the Exit?**

Will Islamic financial institutions in the UK rush for the exit? This is unlikely. Legislative changes over recent years have made the UK a fairly friendly environment for Islamic finance and it will take other European financial hubs some time to catch up, if indeed they decide that is what they want to do. The willingness of European governments to facilitate Islamic finance in their territories cannot be wholly divorced from the wider geopolitical situation. As Brexit has shown in the UK, the average man or woman in the street can and will be swayed by the zeitgeist rather than by an examination of the hard facts and European governments feeling threatened by an upsurge in far-right movements may be unwilling to rock the boat.

To date easy access to EU markets or passporting has been of only peripheral importance to Islamic financial institutions based in the UK. It is, therefore, unlikely to be a major factor in any decisions IFIs make about the location of their operations.

Regulation in the UK is not likely to be any more onerous in the UK than in other European centres and may very well be ‘lighter touch’ as UK government strives to protect the City’s position as a leading financial centre. On the issue of higher taxes, George Osborne had planned to cut corporation tax, currently standing at 20%. It is uncertain what the new Chancellor, Phillip Hammond will do, but even if he opts to do nothing, the UK is still 5% below the average for other European countries and it would be an act of madness to raise it, given the need to make the UK an attractive proposition for foreign investors. Having said that the recent issues surrounding companies such as Amazon and Starbucks demonstrate that multinational have numerous ways of minimising their tax liabilities in the UK and therefore this is unlikely to be a major consideration.

The elephant in the room is economic uncertainty. In recent days there have been reports of off-plan London properties being sold for less than the prices originally listed and those that had already been sold being put back on the market for less than the price paid. Various statistics in July also suggest that the manufacturing and service sectors saw a fall in output and orders. These indicators may, however, be a function of the current state of paralysis rather than a true reflection of mid to long-term prospects.

We suspect that nothing very much will happen in the short term, so no change there. In the mid to longer-term, an analysis of the advantages that IFIs enjoy in the UK suggests that they are rather less likely to relocate than some other foreign financial institutions, although that assumes the UK does not fall into a deep and prolonged recession and then all bets are off.
Sukuk Update

IIFM Launch 5th Global Sukuk Report

In a special session at April’s Islamic Banking & Investment Asia/Middle East Congress in Singapore, the International Islamic Financial Market (IIFM) officially launched its latest Sukuk Report (5th Edition), which analyses the growth and development of international and domestic sukuk issuances in recent years and highlights the different sukuk structures widely used in various jurisdictions.

The findings show that global sukuk issuance of $61 billion (US) in 2015 reflects a decline in issuance volume from 2014 due to the strategic move by Malaysia to stop issuing short-term investment sukuk.

The report found that currently 84% of the $321 billion in outstanding sukuk belongs to just three key markets - Malaysia, Saudi Arabia and the UAE. The IIFM research analysts note that this is likely to change gradually as markets such as Indonesia, Turkey, Pakistan and others become more active.

A positive trend which has emerged from the research is the steady growth in sovereign, quasi-sovereign and corporate sukuk issuances and given the continued interest in Islamic finance from new jurisdictions; the outlook for sukuk in the medium to long term is positive.

The report also covers case studies on landmark sukuk issuances, sukuk markets in IIFM member countries and article contributions from key stakeholders on topics ranging from sukuk rating, listing, primary market and secondary market as well as potentials in new jurisdictions.

‘Despite the increasing interest in sukuk issuances globally there is a lack of authentic data availability for various markets. Not only does this report provide useful data, it also presents insightful analysis on key trends in the sukuk market,’ said Mr. Khalid Hamad, Chairman of IIFM. He noted also, ‘The commercial success of sukuk should not lead us to ignore the underlying principles which are the differentiating factor with respect to conventional bonds. Sukuk are an innovative way to raise financing in a Shari’ah-compliant manner with strong links to the real economy.’

First Quarter 2016 Shows Positive Results

The slightly cautious tone of IIFM’s Sukuk Report has been counterbalanced by two reports focusing on quarterly results for the sukuk market. Ram Ratings noted a 50.5% increase in sukuk issuance in Malaysia in the first two months of 2016.

Fitch reported that Q1 2016 sukuk issuance in Malaysia, Indonesia, Turkey the GCC and Pakistan was up 22% on Q4 2015 and 21% up on Q1 2015. They also report that sukuk issuance in five out of the last six quarters has been above the post 2009 average. They suggest that issuance for the full year 2016 will be at least the same as 2015.

Malaysia Opt for Wakala Sukuk

In April Malaysia’s latest global sovereign sukuk issuance, its fifth, was 4.2 times oversubscribed. The 10 and 30-year issuance went 54% to Asia, 24% to the US, 12% to Europe and 10% to the Middle East. Subscribers came from a broad range of organisations including pension funds, insurance companies, banks including central banks and other sovereigns. The proceeds will be used to redeem trust certificated due in July 2016 and to finance development expenditure.

This is the first global sovereign sukuk to use a wakala structure, which relies on non-physical underlying assets. It is believed that this may encourage other sovereigns, which have problems identifying and transferring ownership of physical assets such as buildings, to consider a wakala structure for future sukuk issuance.

The Malaysian government will no doubt be very relieved that the troubles surrounding 1MDB (1Malaysia Development Berhard) appear to have had relatively little affect on the issuance. They ended up paying a bigger premium to bondholders on the 10-year sukuk, 3.179%, a spread of 135 basis points compared to 115 a year ago.

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The 30-year sukuk was sold at 4.08%, a spread of 145 points, better than the previous 70 points.

1MDB, a state-owned organisation, has been mired in accusations of corruption and money laundering since late 2015. The tentacles of the scandal have reached as far as Malaysia’s Prime Minister, who was instrumental in setting up 1MDB in 2009 with the intention of making Kuala Lampur a financial hub.

In late April 2016 things just got worse when 1MDB defaulted on a payment due in April. The latest problems centre on 1MDB’s relationship with Abu Dhabi’s sovereign wealth fund, International Petroleum Investment Company (IPIC) and its subsidiary Aabar Investments PJSC. IPIC failed to make an interest payment of $50 million in mid April and have subsequently claimed that this is because 1MDB had failed to pay $1.1 billion in principal and interest. 1MDB refute this and claim they have paid $1.4 billion to Aabar Investments. The payment was apparently funnelled through a British Virgin Islands entity called Aabar Investments PJSC, which IPIC say they do not own and which was in any case wound up in mid 2015.

The question is where has the money gone? Two senior executives of Aabar have had their personal assets frozen and been slapped with travel bans by the UAE authorities. In the meantime the Swiss Attorney General’s office has said that it believes up to $4 billion of 1MDB funds may have been misappropriated and investigations are currently under way.

In recent years Malaysia has made important strides in establishing banking discipline and economic stability. It must, therefore, be very disappointing to those who have worked so hard to boost Malaysia’s financial reputation in recent years that this scandal has the potential to set back the country’s aspirations.

US-Based University Bank Issue Sukuk

University Bank, a subsidiary of University Bancorp Inc, is a community bank based in Ann Arbor, Michigan, which provides Islamic banking and mortgage services for the credit union sector. Linklaters have been retained to advise on the issue of a perpetual sukuk, which is for an undisclosed amount, has no maturity date and is limited to an annual profit of 5.75%. More importantly Linklaters believe it is the first sukuk to be governed by US law, in this case the laws of New York State. It is also recognised as Basel III-compliant, Additional Tier 1 capital by US regulators, which is believed to be another first in the US.

Oman Issues New Sukuk Regulations

In mid April the Omani Capital Market Authority issued new sukuk regulations to complement the existing bond regulatory framework. This new Sukuk Regulation aims to provide clarity and transparency to the market players, while providing protection to investors in a sukuk transaction. In addition, it has been drafted to provide flexibility and spur innovation for the market players. Its new measures include:

1. The introduction of a trust structure.
2. Incorporation of an LLC as the SPV.
3. Allowing the issuance of a sukuk programme.
4. No restriction on the structure of the sukuk subject to the approval of the respective Shari’ah Supervisory Board of the issuer.
5. The choice of the SSB is left to he issuer.
6. Optional rating requirement.
7. No restriction on the sukuk amount to be raised based on the company’s capital.

His Excellency Abdullah Salim Al Salmi, the Executive President of the CMA said, ‘The issuance of this new Sukuk Regulation forms an integral part of the overall strategy of the CMA to enable the capital market to play its vital role as a fundraising platform for companies in the economic development of Oman, particularly in the fixed-income market, where sukuk forms an important element to further develop Oman’s Islamic capital market.

‘In addition, this new Sukuk Regulation will form a key milestone in the evolution of the sukuk market in Oman and hopefully spur further sukuk issuances particularly from the private sector players in order to meet their development and funding needs, while diversifying the financing base and risk away from the traditional banking sector. Further sukuk issuances will also provide an essential liquidity management instrument and investment avenue for both Islamic and conventional financial institutions, investment funds and takaful/insurance operators in Oman. Hence, not only providing a wider investor base of both conventional and Shari’ah-compliant investors, but also attracting the required foreign investments into the country. We are confident that this new regulation will have a positive impact on Oman’s capital market and the economy.’

Turkey Returns to Sukuk Market

The Turkish government has raised $1 billion with a five-year sukuk that was approximately four times oversubscribed. Investors came from the Middle East (54%), Turkey (16%), Europe (11%), UK (10%), Asia (5%) and US (4%). This was Turkey’s first sovereign sukuk since November 2014. The sukuk was offered at mid-swaps plus 300 bps plus or minus five bps.

JP Morgan Recognise Sukuk

From the autumn of 2016 JP Morgan will include eight sukuk in their family of indices. Among the instruments to be included are dollar-denominated sukuk from Turkey, Indonesia and
Malaysia, which will be included in the EMBI Global Diversified index; Pakistan will be included in the Asia Credit Index and two corporate bonds, one each from Dubai and Saudi Arabia, will be included in the Corporate Emerging Markets Bond Index.

It is hoped that this will help to kick start a secondary sukuk market. Typically buyers of sukuk buy and hold.

Pakistan Tests the Water for Benchmark Sukuk
It is understood that Pakistan's Ministry of Finance is canvassing expressions of interest in being lead arranger for a proposed dollar-denominated sukuk valued at between $500 million and $1 billion. This would be Pakistan's third dollar-denominated sukuk and the first since late 2014.

Indonesia Launch Savings Sukuk
The Indonesian government has launched what they call a savings sukuk. It is aimed at the general public rather than institutional investors; it is non-tradable and offers a higher rate of return (6.9%) than bank savings accounts or deposits. The minimum purchase is 2 million rupiah and the maximum is 5 million rupiah per identity card. Early soundings suggest that the Indonesian government should have no trouble reaching their 2 trillion rupiah target and may extend the total to 3 trillion rupiah. The proceeds will be used to fund the country's budget deficit.

Nakheel Debt Free
Government owned Dubai developer Nakheel became debt-free following full payment of its AED4.4 billion trade creditor sukuk when it matured on 25 August 2016. (Nakheel were one of the property developers worst hit by the Dubai debt crisis of 2009. The possibility of default rocked confidence in the corporate sukuk market at the time.) The scheduled payment marks the end of the company's financial restructuring, which began in August 2011, with all creditor obligations now fulfilled. Two years ago, on 21 August 2014, Nakheel had prepaid all AED7.9 billion of its bank debt – four years before the scheduled repayment date.

Ali Rashid Lootah, Chairman of Nakheel, said, ‘This is undoubtedly one of the biggest milestones in our history. We are also ever thankful to the trade creditors, lenders, investors, business partners and regulatory authorities who trusted and supported us throughout, and played a significant role in the successful implementation of the business plan adopted in August 2011.

‘In six years since, since March 2010, Nakheel has achieved what some considered impossible: completion – ahead of time – of one of the largest, most complex financial restructuring exercises, followed by the successful execution of a new business plan that placed us on a new path to growth. As we close the curtain on our restructuring programme, we look forward to starting a fresh chapter in which we are stronger and more resilient than ever.’

The sukuk repayment follows a string of other Nakheel achievements and milestones over the last six years, including:

- meeting the restructuring plan targets two years ahead of the scheduled five year implementation programme, with savings of AED25 billion;
- repaying all AED7.9 billion of its bank debt four years ahead of the scheduled repayment date (final payment made on 21 August 2014);
- year-on-year profit growth (2010: AED0.96 billion; 2011: AED1.28 billion; 2012: AED2.02 billion; 2013: AED2.57 billion; 2014: AED3.68 billion; 2015: AED4.38 billion);
- boosting the local economy by making payments of AED38 billion to various creditors and contractors, and awarding contracts worth AED22 billion for project construction and operational matters
- launching more than 70 new projects – ranging from neighbourhood retail centres to entire new communities – some of which are completed and operational while others are in various stages of development handover over 9,132 villas and apartments, and a further 1,923 land units to customers; and diversifying Nakheel's business to increase cash-generating assets.

‘Our success is concrete evidence of stakeholder trust in Nakheel. The last six years have been an amazing journey during which we dramatically outperformed the restructuring plan despite having to work to strict financial discipline under its terms,’ said Ali Rashid Lootah. ‘We will continue to build on that success by further strengthening our business and delivering our diverse range of pipeline projects, including our growing portfolio of retail and hospitality assets that will play a key role in Dubai's tourism vision.’

Nigeria Postpones Initial Sovereign Sukuk
It had been expected that Nigeria, which urgently needs to find alternative sources of revenue to finance infrastructure development due to the dramatic fall in oil revenues, would issue its first sovereign sukuk in the third quarter of 2016. It is understood this has now been postponed with a likely issue date of first quarter 2017 mentioned as a possibility. The reason given for the postponement was ‘unforeseen circumstances’.
The Malaysian and Middle Eastern Takaful Markets Compared

In its new report, ‘The Dynamics of Takaful Markets of the Middle East and Malaysia: Similar Models, Different Approaches, Contrasting Fortunes,’ A.M. Best examine the perception that the takaful market in Malaysia has been relatively successful in forming a vibrant takaful industry, while, despite the Middle East having large Muslim populations, the takaful operators have struggled to establish a foothold in a market that has the potential to reach $20 billion US by 2017.

The report identifies one of the key drivers of the success of takaful in Malaysia is a balance of earnings between the shareholders’ and policyholders’ funds, demonstrated by the stronger returns experienced in their family and general takaful portfolios. Salman Siddiqui, senior financial analyst and co-author of the report, said, ‘Over the last three years, Malaysian operators have generated superior margins on their family takaful portfolio compared with Middle Eastern operators. On the other hand, Middle East companies have spent considerable time and money to develop family takaful products that have not translated into significant revenue to absorb these costs.’

In addition to enjoying higher family takaful margins, Malaysian companies also outperform the Middle East operators in their general takaful portfolios. Mahesh Mistry, director, analytics, and co-author, added, ‘Overall, Middle East takaful companies produce combined ratios above 100%, whilst lower loss ratios in Malaysia help operators produce marginal yet profitable sub-100% combined ratios. This emphasises the value-added proposition that many Malaysian operators can provide clients, with the focus toward bottom-line profitability over top-line growth, allowing technical surpluses to be distributed to policyholders.’

A.M. Best’s report further notes that the lack of differentiation and the associated pricing pressure, along with poor distribution networks, will be the key challenges for Middle East takaful companies going forward. For the industry to tackle these challenges, the operators will need to adopt suitable strategies and appropriate structures to ensure that the takaful model employed is balanced and that it serves the needs of the enormous potential for Shari’ah-compliant insurance, to the benefit of all stakeholders.

**Zurich Insurance Set to Take Control of MAA Takaful**

At the end of April 2016 Malaysian regulators paved the way for Zurich Insurance to take full control of MAA Takaful (MAAT) Malaysia. MAAT was established as a joint venture company in 2006 owned 75% by MAA Group Berhard and 25% by the Bahrain-based Solidarity. An application was made to Bank Negara to allow Zurich Insurance to acquire the full equity of the company in late 2015 and this was approved in April 2016. MAA Takaful Bhd will become known as Zurich Takaful Malaysia Bhd following its acquisition by the Zurich Insurance Group. The transition to the Zurich brand began in July 2016 and is expected to be completed at some point in 2017.

The acquisition gives Zurich access to takaful markets in Malaysia and provides the former MAA Takaful with the backing, brand and resources of an international insurance group. This is unlikely to be the last such acquisition. Our main feature on the International Takaful Conference underlines the fact that single country takaful operators are finding it difficult to generate sufficient organic growth to succeed on their own.

**Egypt Revises Banassurance Rules**

Egypt’s Financial Services Authority and the central bank have revised bancassurance rules, a move which may work to the benefit of takaful in Egypt. Under previous regulations a bank could have one agreement with a life insurer and one with a general insurer. There was no differentiation between conventional and takaful operators. Under the new rules a bank will be allowed to have one agreement with a conventional life insurer, one with a convention general insurer, one with a takaful family operator and one with a general takaful operator.

Currently Egypt has nine takaful operators and during the period January to August 2015 takaful accounted for a 12% share of the Egyptian insurance market compared to 8.75% for the whole of 2014.

**Indonesia’s Takaful Sector Outperforms Conventional Insurance in 2015**

According to a report from Fitch Ratings, although the 4.1% growth of takaful contributions in Indonesia was lower in 2015 than in 2014, the takaful sector grew 2.5 times faster than conventional insurance. Overall takaful now accounts for 6.2% of the total insurance business in Indonesia, up from 2.6% in 2010.
UAE Expected to Complete Separation of Life and Non-Life Business by August 2016

The 13 composite insurers in the UAE are expected to complete the separation of their life and non-life businesses by August 2016 in order to comply with new laws. The deadline for compliance was extended in 2015 due to concerns that the new life insurance businesses created would lack adequate scale.

Zitouna Takaful Turn Corner

Tunisia’s first takaful operator turned a corner with a profit of just over half a million dollars for the year ended 31 December 2015 on a turnover of $28 million, which represents a 42% growth. This compares to a loss of $2.76 million in 2014.

Abu Dhabi National Takaful Get an A Grade

AM Best have upgraded Abu Dhabi National Takaful Company’s (ADNTC) financial strength rating from BBB+ to A-. The upgrade recognises ADNTC’s position as a leading takaful provider in the UAE with strong risk-adjusted capitalisation and technical performance. Through 2014/15 the company reported profits across all business segments, although there is still work to do in reducing the deficit in the policyholders’ fund. The deficit has been reduced from $7 million in 2013 to $4 million in mid 2016, a trend which AM Best expects to continue. The company, which focuses on family takaful and medical, has also managed to handle new regulations imposed by the UAE’s insurance authority without suffering any financial impact.

Arab Insurance Group Set to acquire full Ownership of Takaful Re

Bahrain’s Arab Insurance Group, which already owns 54% of Takaful Re’s equity, has made an offer to buy the remaining 46% of the company’s shares. The proposed purchase is subject to the approval of Takaful Re’s shareholders and the Dubai Financial Services Authority.

The overcrowded Gulf takaful and retakaful market is likely to see more merger and acquisition (M&A) activity. Standard & Poor’s report that there are around 70 takaful operators in the region competing for around $10 billion of business, 80% of which is in Saudi Arabia. In this environment smaller, less diversified organisations find it difficult to operate profitably. In addition regulatory changes in the region around capital adequacy and solvency requirements are proving to be a further spur to rationalisation in the sector.

Kenya Approves Takaful Windows

In mid 2016 new rules came into force in Kenya permitting conventional insurance companies to operate takaful windows. The new rules require companies choosing to open windows to have separate financial reporting arrangements for conventional and takaful insurance. In addition in takaful operations life and non-life funds must be kept separate. Takaful window operations’ operating models must also be approved by Shari’ah boards.

Takaful Training Initiative in Pakistan

IBA’s Centre for Excellence in Islamic Finance (CEIF) has signed a Memorandum of Understanding (MoU) with Pak-Qatar Family and General Takaful Limited. The two organisations agreed to mutually cooperate to enhance the objectives of research, development and training in the field of Islamic Finance and Takaful. The Pak-Qatar Takaful Group also announced a scholarship for students who enrol in MS Programmes in Islamic Finance (to be launched by IBA soon).
Pathways for Matching Islamic Finance Assets to Takaful

To mark 10 years of the International Takaful Conference, this issue of NewHorizon has devoted a major part of its coverage to the proceedings of the 2016 event. Tribute was paid to Professor Iqbal Asaria who has been behind the International Takaful Summit for the last 10 years and who has worked tirelessly to raise the profile of takaful around the world.

We have selected some of the most interesting presentations and grouped them thematically to bring readers a flavour of the proceedings. Unsurprisingly, given that the conference took place in London, there was a heavy emphasis on Lloyds and the London market and what it could contribute to the takaful and retakaful sectors. There were, however interesting glimpses of what is happening elsewhere, particularly in Malaysia and the Middle East, as well as some reflections on the size and composition of the market, standards and the issues such as assets, capital adequacy and profitability.

Opening Remarks
In his opening remarks Dr Alberto Brugnoni described takaful as the younger brother of Islamic finance, which shares the latter's two major challenges – time and values. He noted that takaful needs time to develop; it is a bottom up approach, which inevitably means it grows slowly. It has taken 300-400 years for conventional insurance in European countries to get to the position they are in today. The modern world, however, has no time to allow this organic growth, so it is a major issue for takaful.

Islamic finance boasts about the $3 trillion mark that has been reached by the industry, but recently a respected UK-based consultancy issued a report that gave a slightly different perspective. They quite conservatively put readily measurable Islamic assets at about $11 trillion and they further noted these have been available for the last 20 years. Yet it has taken the Islamic finance industry 15 years just to get to $3 trillion.

The key issue today, however, is values. The basic modus operandi of Islamic finance and takaful is values. There is a risk of losing legitimacy. For instance, more and more critical voices are raised questioning the ethics of the takaful system implemented in Saudi Arabia.

The same applies to Islamic finance. It is a business, not a charity, but it is essential to keep an eye on its purpose and goals. In Mecca, for example, buildings which were critically important to the heritage of Islam have been completely demolished by modern Islamic finance. This should make us question the purpose of Islamic finance.

Secondly, there is a need to focus on goals. Based on Credit Suisse data, we are told that the richest 1% have as much wealth as the rest of the world combined. The 62 richest individuals in the world have as much wealth as the poorest 50% of the world's population. Where does Islamic finance stand in this?

What is in store for the future? That depends on the practitioners of Islamic finance and takaful and how they decide to operate. There are three very important drivers originating from the Muslim world that paint a very rosy picture. Firstly, the halal sector is booming. About 20% of the transactions in the world today are halal – food and drink, clothing, cosmetics and travel, but Islamic finance and takaful are not yet playing a role in these markets. Second is zakat. An increasing number of Shari’ah scholars are allowing the use of zakat within the takaful framework. Finally there is trust, which is impossible to measure. There are three other drivers, which are less powerful – intermediation, equity funding and impact investing.

Mr Brugnoni finally said he believed very strongly that the Western World would experience one of the highest growth rates for Islamic finance and takaful. He suggested that one of the main reasons is that, while the richest Muslims are in the Gulf and the poorest are in the Pacific Rim area, the middle class with hard purchasing power is in Europe, around 25 million people.

The basic modus operandi of Islamic finance and takaful is values.
The Specific Contribution of Lloyds of London to Take Takaful to the Next Stage in International Markets

Inga Beale, Chief Executive Officer, Lloyds

The History

In her keynote speech Ms Beale said that she believed that the London market is still the undisputed global centre for specialist insurance and reinsurance. She added that Lloyds is a very unique and thriving place that is as busy as it ever has been.

Lloyds started 328 years ago. As London’s importance as a trade centre grew, the demand for ship and cargo insurance increased. Edward Lloyd’s coffee house became recognised as the place to go to for marine insurance and it is the genesis of the Lloyds as it is known today. The merchants, sailors and ship owners gathered to get intelligence and find out what was going on at sea and then to start sharing the financial risks among themselves. They were effectively guaranteeing each other. Since 1688 Lloyds has continued to be a pioneer in insurance.

Lloyds Today

Lloyds has grown to become the only physical market in the world that specialises in insurance and reinsurance. Lloyds has often been the very first to write new risks. They were the first to insure the motor car, the plane and satellites. Lloyds pioneered earthquake insurance and business interruption insurance and are still leading the way doing pioneering insurance for cyber risk and supply chain interruption.

The interesting fact is that Lloyds is made up of some of the world’s largest insurance companies. They have syndicates at Lloyds to complement what they do elsewhere in the world and to access Lloyds’ underwriting expertise. Sometimes these syndicates do compete, but sometimes they are collaborating. That idea of sharing the financial risks that was born in that coffee house still exists today, where risks are syndicated across some or many of the syndicates.

Lloyds has this capital mutuality and cooperative risk sharing that is really unique. That is why it can form a very nice partnership with what the takaful industry might want to do.

Lloyds has a truly global reach doing business in more than 200 countries and territories around the world. However big or small each individual syndicate is they have access to the same trading rights. One of the duties of the corporate centre of Lloyds is to provide those trading rights.

Despite some very challenging economic conditions, Lloyds remains financially very strong. It has a Standards & Poor’s rating of A+, Fitch at AA- and AM Best affirms Lloyds at A status with a positive outlook. Every single syndicate benefits from that financial strength rating.

Lloyds is very popular at the moment. There are queues of people that want to come in, but there is not enough space. Lloyds is doing so well because of the strength and depth of the underwriting. It is also why it has been renowned for such innovation.

Lloyds and Takaful

Ms Beale said she believed the Lloyds’ model is well suited to takaful and retakaful syndicates. Structurally the similarities between the two models are quite striking. Lloyds’ unique market structure makes Shari’ah compliance possible. For instance, it can accommodate fund segregation. (Anyone who has a syndicate in Lloyds has to separate funds from the rest of their business so that they cannot be used for policyholders outside Lloyds, but fund segregation can even be enabled within the premium trust funds that have to be deposited. Lloyds is very used to having segregated funds.)

It is not only the structure of the Lloyds market that is conducive to London becoming a global centre for Shari’ah-compliant insurance. There are some inherent advantages to the Lloyds’ unique market structure makes Shari’ah compliance possible.
centre being here in the UK. The UK has a time zone that sits very much at the centre of global capital markets; English is the international business language and there is a deep well of existing expertise in Islamic finance in the professional service industries including 25 law firms. It also has world-class educational institutions offering training courses and qualifications that are second to none, including 10 new Chevening scholarships for Islamic finance. This cluster effect that London has, bringing together so much expertise, makes it a very attractive centre.

The Challenges
There are some obstacles to overcome. The Lloyds market is not fully Shari'ah compliant as its stands today and there are some variations in the interpretation of Shari'ah principles in different countries, but it wants to be mindful of that. Lloyds is always looking to innovate and to be at the forefront of things. It is in its DNA.

A Changing World
The rapidly changing global scene means that everyone has to be aware of what is going on in the wider world. There are many challenges out there at the moment and the global insurance industry is facing a lot of those, because, of course, insurance underpins and de-risks a lot of what goes on in the world. Lloyds is there to de-risk investment in all sorts of infrastructure and to build and support resilience in societies, communities, countries and economies.

No-one is immune to at least some of these challenges. Ms Beale said she was fortunate enough to go to the World Economic Forum in Davos in January 2016. Discussions centred on the issues and challenges facing the entire globe, but there were a few special sessions focussed on financial services. During the Forum, global markets suffered hefty losses on the back of oil prices falling to a 12-year low and the economic slowdown in China. It was an interesting time and it felt as though there was a lot of turmoil in the world.

Aside from what was happening in the financial markets, the big topics of conversation were about climate change, what is happening with the fintech revolution, virtual currencies, robots, artificial intelligence and how some jobs may be done by robots in the future. The underwriter's job appears in the top 10 jobs most likely to be done by a robot in the near future.

All of this illustrates that the world is changing as never before and it is affecting everyone, wherever they are. It cannot be avoided. It is not just how much is changing, but the pace of change. It is happening faster than ever before. McKinsey say it is happening 10 times faster than in any other industrial revolution. Climate change also continues to threaten the future of the entire world unless bold and enduring measures are taken to mitigate it.

All of these things are changing the risk landscape. Technology in particular is connecting people across the world as never before. That is why the cyber issue is such a hot topic, because no-one really knows how to assess the impact one cyber incident somewhere in the world could have.

These things have to be considered as Lloyds thinks about its business models; how it is set up and how it has traditionally done things. When Lloyds looks out at the future, it knows it has very challenging insurance market conditions, but also the whole global growth outlook remains somewhat subdued. In 2015 growth stood at 3.1%; in 2016 it is projected to rise a little bit to 3.4% and to 3.6% in 2017. Undoubtedly, however, there has been a widespread slowdown for some of the emerging economies, where it was thought there might be great business opportunities in the future, but they are still growing. It is not all doom and gloom. Ms Beale said she was very aware that we do not want to talk ourselves down into a self-fulfilling downward spiral, but it was essential to be mindful of that. It is important, nevertheless, to face facts and think about what is happening in the world and of how little growth there might be in some of the developed economies.

The Outlook for Insurance
Lloyds anticipate seeing a continuation of low interest rates and that has an impact not only on returns, but it is also forcing investors to look elsewhere for higher returns and therefore a lot of that capital has come to the insurance market. That in itself is putting further pressure on the market. In addition increasing competition has resulted in further downward pressure on pricing.

As well as pressure on top line growth there is a very active mergers and acquisitions (M&A) market with insurers buying rivals to achieve non-organic growth, a more diversified book of business and often they are acquiring assets in Lloyds. There has even been some significant M&A activity within Lloyds itself including Japanese firms coming into Lloyds through M&As. Lloyds have to think about how to change its market to adapt to what is happening.

A second very important trend is urbanisation. Cities are now the engines of national economic growth. It is a fact that 50% of global GDP comes from 300 cities. This concentration is only likely to increase. By 2025 it is anticipated that 70% of global GDP will be coming from those 300 cities,
so there are ever more concentrated, high-value assets with greater interconnection. While urbanisation may make economies more efficient, they are also very vulnerable to catastrophic and systemic shocks.

The third big thing is the digital revolution. Technology is truly disrupting traditional business models – think Uber, the largest taxi firm that does not own a taxi or Air B&B, the largest hotel chain that does not own a hotel room. It is interesting to try to get your head around these different business models. They have huge implications for all businesses, but also potentially huge implications for Lloyds. It is essential to make sure Lloyds keep on top of these risks and come up with solutions, because its role is very much to de-risk businesses and enable them to invest for the future.

Risks today are much more manmade than they ever were before. Lloyds used to worry about natural catastrophes, but the biggest threat to GDP today is a market crash. There are oil prices, cyber attacks, etc. All of these come up way before a flood or a hurricane. Physical assets are rather less important to protect than digital assets. These risks are difficult to measure and for insurers to get an answer.

The Vision for Lloyds
Vision 2025 was launched a few years ago. Key strands of that strategy include looking at innovation and the expansion of Lloyds’ presence in emerging and growth markets around the world. Lloyds is also looking at adapting its model. If Lloyds want to be around for another 300 years, it is very important to make it accessible and make it easy to do business with Lloyds.

Expansion into the takaful and retakaful markets is seen as an important part of Lloyds’ growth. Ms Beale noted that everyone had come together at the conference in a spirit of collaboration, which is one of the key secrets of Lloyds’ success.

The Takaful Market
The takaful industry is growing. In 2014 the global takaful market was projected to grow by 14% and there are not many markets that can claim that sort of growth. If it keeps growing at that sort of pace, it will be worth $20 billion by 2017. Malaysia along with the UAE and Indonesia will continue to set the pace with the development of takaful products.

A key theme across takaful markets, however, is the significant level of under insurance. Insurance penetration rates in key takaful markets averaged just 2% against a global average of more than 6%, so there are real differences. Under insurance is a worrying trend that we have seen not just in some of these emerging, growing markets, but also in some traditional markets. This has been a big focus for Lloyds, which is keen to help build resilience in places where people are not buying insurance.

There is enormous potential for Lloyds to support development across takaful markets. Lloyds’ model is very much based on working with local insurance industries and it has a huge delegated authority model, which means people can work close to their customers and really understand the risks.

When insurance penetration remains low, the burden falls on governments and businesses to fill the gap. This becomes very unsustainable as the scale of losses increases. The impact of climate change is that the cost of natural catastrophes is five times higher now than it was in the 1980s. There are all sorts of worrying trends that show more work needs to be done on developing insurance and providing the ability for businesses and people to protect themselves. Lloyds is doing its best to actively encourage innovation in all its forms.

Takaful and the London Market
David Matcham, Chief Executive, International Underwriting Association
Background
David Matcham addressed the topic of regulation and standards from the London market perspective. The London insurance market is a £60 billion market made up of 91 Lloyds’ syndicates, 65 insurance companies, more than 150 insurance brokers, about 12 P&I (Protection and Indemnity) clubs and a host of service providers. If that was a country it would come about 63 in terms of GDP (Gross Domestic Product), so it
is a huge economic cluster. The London market is dominant in US, EU and UK business; about 80% of the gross premium is from those territories. A small minority of its business, about 8%, is from Asia. It is also dominant in certain classes of business, particularly marine, aviation and energy. It is a very powerful economic and business base that is looking for new opportunities to enable it to grow.

Commercial lines in takaful is the missing piece in the London market jigsaw at the moment, although it is beginning to be filled with classes such as political risks, casualty, property and aviation. This is one of the main reasons for the formation of a new association, the Islamic Insurance Association of London (IIAL).

The Islamic Insurance Association of London and the London Market
The Islamic Insurance Association of London’s (IIAL) main aims are to raise and promote standards for Shari’ah-compliant products; to educate clients, sellers and the market in a wider sense about what London can do in this space and to promote the London market for these products.

The IIAL has an unusual membership make-up. Most associations represent a sector such as insurers, banking or broking, but this one represents all of them, the whole industry operating out of London. It is also in dialogue now with an association that represents the wider London market, the London Market Group (LMG), which is overseeing many common aspects of the London market such as processing, technology, representational voice to government and other stakeholders and education. Much of their work is as a result of the London Matters report published in 2014. It produced a comparison of the London market with other comparable markets around the world and contained interviews with 200 clients such as risk managers, brokers and retail brokers across the globe, giving a very stark analysis of why they used or did not use London. One of the clear conclusions from that report was that more business is now staying local. For example, 8% of the London market’s business is from Asia, but those markets are high-growth economies and London is not tapping into that as much as it should be. The report drew out underlying challenges and vulnerabilities.

Norton Rose also conducted a survey and there were many parallels with London Matters. Some of the classes that are more prominent in takaful are D&O (Directors and Officers), property and business interruption, which are very much London market classes, but aviation, marine and hull were very low penetration areas for takaful, which is a huge opportunity for London. It mentioned that reasons for not using takaful were missing products, inadequate products and the need for education. This all speaks so clearly to the roles and aims of the new Islamic Insurance Association of London, particularly promoting where London can offer high-quality, high-performing security in a Shari’ah-compliant manner.

The LMG has published a growth agenda. The object is to build on the strengths of London, to not be complacent and recognise the necessity for a continued evolution. It would include building a more talented and diverse population within the market. It is also looking to build on the representational voice of the London market with the government in the UK, but, more importantly, with overseas markets, overseas risk management communities and chambers of commerce. The London market story needs to be spelled out much better and undoubtedly the Shari’ah-compliant market will be part of that. Similarly, when business comes to London, it needs to be processed better and made much more efficient. Efficiency in paying claims and other administration needs to be one of the major reasons for business to come to London and not an excuse not to come to London. Finally, London has been known for its innovation. London must not lose sight of that, because some of the feedback from the survey was that London was losing its touch.

Regulations and Standards
Regulations and standards are critical to the growth agenda of the LMG and the IIAL. Innovation is also very important. A strong regulator is essential and Mr Matcham said that the UK had one. It is a transparent, proportionate and judgement-based regulator. The essence of Solvency II has been introduced across the EU and many of the principles contained in it stem from the UK. The London market is a highly rated community. Shari’ah-compliant products are on the increase. All of this needs to be exploited in telling the London story.

In Summary
The characteristics of the London insurance market and its wider geographical and legal setting, which make it attractive for takaful products include:

- The independent regulatory environment is fair, transparent, proportionate and consistent and the regulator is well respected.
- The business climate facilitates new products and ideas.
- There is no product or rating regulation; it is very much a free market.
- Fiscal policy is certain, clear and competitive.
- There is easy access to international markets for both
trade and investment.

- London is a broker market, which gives global distribution.
- There is a tradition of welcoming foreign firms. There are more than 1,400 financial services firms in the UK. The majority of them are foreign owned.
- There are high-quality, professional support services.
- There is a highly-regarded and impartial legal system based on common law, which tends to be more flexible in responding to financial developments.
- Most recently there is the Insurance Act 2015, which is giving even better client experiences in terms of disclosures and warranties.
- There is a skilled and diverse labour force.
- London has a central geographical location, allowing it to straddle both US and Asian time zones.

There is no doubt that the LMG’s growth agenda exploits these advantages and also meets the challenges that emerged from the London Matters report. London needs to meet the unmet demand for new products and solutions; to reinforce its strength in expertise-based underwriting and to market itself and tell its story better. Regulations and standards are at the heart of the growth agenda.

**Pathways to Leveraging the London Market**

This panel session moderated by Susan Dingwall (SD), Partner, Norton Rose Fulbright LLP included contributions from Cameron Murray (CM), Head of UK, Ireland, Middle East & Africa, Lloyds; Richard Bishop (RB), CEO, Cobalt Underwriting and Dr Terry Masters (TM), CEO, ReSolutions, Aon Benfield.

**SD** Cameron, how does Lloyds as a significant part of the London market see the opportunities in this area and what value add does it bring to bear?

**CM** For Lloyds this is as much about necessity as it is about opportunity. We at Lloyds feel we have to be able to demonstrate our value to businesses and communities around the world seeking a Shari’ah-compliant opportunity. At Lloyds we have long recognised that we cannot continue to rely on conventional sources of business if we are to sustain our position as the centre of specialist insurance and reinsurance in the world. I use the word 'conventional’ in its broadest sense. It is no secret that Lloyds have been reliant on the developed markets of the world for its business. Over 70% of Lloyds’ business has come from the North American and European markets. In the high-growth markets of the world – Africa, Asia and Latin America, Lloyds is underweight. Lloyds are looking to redress that balance and to ensure that our portfolio going forward more truly reflects the way the world economy is moving in terms of where our capital and intellectual capital come from.

Lloyds also has to think in terms of the products provided and the way in which they are provided. Obviously Lloyds has a long history of developing and creating innovative products to meet the specific needs of its customers around the world and that will continue to be the case as those customers are exposed to an increasingly complex and diverse sets of risks, particularly in the high-growth markets.

The provision of takaful and retakaful products is right at the heart of that strategy. If Lloyds is serious about expanding into these markets, it cannot limit itself to traditional insurance and reinsurance. Lloyds has to make sure that its products reflect the demographic in those markets for it to remain relevant to businesses and communities in those markets. That is why Lloyds have developed the capability to provide Shari’ah-compliant products. Lloyds is at the start of a journey and it has a long way to go. There is a lot of thinking to do about how Lloyds can develop its offering, but it has made a good start.

Obviously the major Islamic economies are in South East Asia, the Middle East and Africa and they are at the heart of Lloyds’ 20/25 strategy. Lloyds’ biggest operation outside London is Singapore, where there are more than 20 Lloyds’ businesses operating and in excess of 400 staff. Lloyds are also looking to move into Malaysia. It is important that those businesses are able to offer Shari’ah-compliant products. Lloyds also launched an underwriting platform in Dubai in 2015 and the same applies there. In 2015 Lloyds also launched a strategy for
Africa. The focus initially is in East Africa, in Tanzania and Kenya, where there are Islamic populations looking for Shari’ah-compliant products.

Lloyds is a broker-driven market with a good general agent model, but emerging markets will need to develop deep and rich distribution channels themselves to integrate more effectively with London. The newly-formed IIAS can be a great help in this context. It has already done a lot to spread the word among Islamic communities around the world, particularly about what Lloyds and the London market can bring in terms of developing Shari’ah-compliant products. It also has a lot to do to bring the message back to London about how the offering needs to be adapted to meet the needs of Islamic communities around the world.

SD Richard, as the first Lloyds Shari’ah-compliant cover holder, can you tell us how easy that journey has been over the last 12 months; what have been your successes and how things are looking now?

RB Since we started three years ago there has been an evolution in this market. London has a very deep and diverse base of expertise, but it is stuck in London, so the question is how to get it out into the wider world. When we were approached by the scholarly community to find a way to allow the wider world to get access to greater capacity, the first question we had to ask was how to deliver that. Over the last three years we have developed a model that is unique to the London market and particularly to the Lloyds’ market. This gives us access to underwriting expertise and service that are perhaps unique on the planet. This enables us to address some of the issues others have struggled with and come up with a potential solution. I am not suggesting that everyone is going to want to access London for every aspect of what is needed. We are principally a commercial marketplace, so the risks that we are most interested in trying to develop solutions for are those in the commercial sector.

There is enormous diversity between the life, savings and personal lines aspects of takaful and commercial lines. In addition, how is takaful relevant to the large commercial exposures that the Islamic finance community is very comfortable in financing. The mutual model may not be the most appropriate for dealing with those kinds of exposures.

One of the successes Cobalt has had in the last year is that we have become a Lloyds’ cover holder. This means that we have been able to access the diversity of underwriters within Lloyds. It means we can provide a much greater and broader response to the more specialist risks, the more niche exposures that Lloyds handles so uniquely. A lot of that is down to the fact that Lloyds’ structure lends itself very well to takaful principles. Lloyds’ foundation 350 years ago was in the mutualised model that takaful is founded in as well, so there are a lot of similarities.

There is a requirement within our market to constantly evolve and come up with new products. As takaful has evolved over the last 30-40 years it brings with it new challenges and needs and Lloyds is very well placed to serve those. We are very pleased that we now have the capability to deliver that from London. Cobalt is the only cover holder at the moment; I am sure Lloyds would like to see many more able to deliver their products out into the world, but there has to be a requirement from the other side to buy from London, so we need to make sure our products are relevant, priced appropriately and that they have a meaningfulness to the markets they are going into. One of the successes of the last year has been that we have now opened up that market. We are able to provide diversity. The challenge for all of us is how we take the
knowledge and expertise we have here and deliver it on the ground and how does that get through to the buyer. That is where the broking community has a role to play, because our model in London is broker based, but we also have to build relationships with local markets, particularly those that have set out to become hubs of the Islamic economy. We are seeing a lot of interest coming from the UAE and Malaysia, for example, trying to take a lead in promoting what London has to offer and working closely with London to develop new solutions.

SD Terry, from the survey we heard about this morning, it seems that brokers are not necessarily selling Islamic insurance. Does this ring true with you?

TM We placed $78 billion of retail premium last year, around the world. In 2016 we are budgeting for that being a significantly lower number as a result of rate reductions and the competition. I think the world is concentrating on price and client value currently and the competition is enormous between brokers and insurers, so the value of slightly more expensive Shari’ah-compliant products has been lost in the global market currently while there is such a fierce premium price war going on. Brokers are under tremendous pressure to get the best, cheapest transactions for their clients. Everybody has been concentrating hard on that and probably not on what the options are. It is no defence, but it is what is happening across the globe currently.

SD Do you think there is a need for more education on Islamic finance for brokers and underwriters in the London market, perhaps in a CII (Chartered Insurance Institute) syllabus?

TM Definitely, but I do not think that is just a London position. If I followed your survey correctly, you are saying that 25% of clients in the Middle East, Malaysia and Indonesia are saying they are not being told by the brokers that there might be a takaful option. They are not London brokers; they are global brokers.

CM I think there may be misunderstanding in the Lloyds market and more widely about what appears to be an overly complicated process to become Shari’ah compliant. Working with Richard and Cobalt, I think the changes that need to be made are not necessarily as all encompassing as it might first appear. Solutions can be found in fairly neat ways to turn a conventional product into something that meets Shari’ah needs. If that message can be conveyed, there may be a greater appetite to play in this area.

RB It is worth adding that there is a lot of debate about the model that should be used. The various sectors of the market need a different model response. There is no one size fits all proposition and if you look at the conventional marketplace, it is not a one size fits all scenario. We do not hide the fact that what we provide from London is based around a windowed response, because that is the only way to provide the depth of capital and the security that is necessary to meet the criteria for large commercial risks.

Until the takaful market has been trading for many more years and builds up the level of capital reserves that will support that kind of requirement from the international finance community, there has to be an adaption of the takaful model into the conventional model. It would be ideal if we could provide a pure takaful model from the start, but we cannot. There is a recognition that London has at least made the effort to develop new solutions to this. They may not be the ideal solutions, but a little bit of pragmatism has to come into play.

The pricing issue is one that is a challenge for everybody. In London we try to work on the basis that, if we try to fight the pricing battles going on at the moment, there is no chance that this kind of product would gain any traction, so we have to convince underwriters to work with a slightly different pricing structure, but the market is adaptable. The principal message we would like to give is that we have flexible capacity, but there also has to be some recognition that, unless there is a demand, the capacity will not evolve.

SD Cameron mentioned that it is not such a leap to make a product Shari’ah compliant. Can you tell the audience something about the variety of products
you have been offering recently?

RB The nice thing about being based in London is that we have a regulatory regime that does not differentiate between whether a product is Shari’ah compliant or not. We also have a legal system that is fairly Shari’ah compliant, which makes it very easy for English law contracts to meet the requirements of Shari’ah, with changes to just some elements. We can, therefore, look at any indemnity class. It is more difficult with accident or health, for example.

The delivery is critical, rather than the policy, making sure the processes are Shari’ah compliant. We have worked with Lloyds to define how it should be done and then that process is available to everyone; it is a scalable solution.

We have products as diverse as equine and political violence. We are working on aviation. We started in property; we have done casualty. For a large inward investment from the Middle East into the UK, we have managed to do environmental impairment. There is a lot that can be done; we do not limit ourselves to fire and peril.

SD Terry, it is striking that there are numbers of projects backed by Islamic finance that are not takaful insured. Do you see any way to close that gap?

RB It is worth mentioning that in the last year we have seen a very strong interest from a number of territories around the world. A notable example would be Pakistan, which has introduced legislation to allow the operation of takaful windows. The problem for them is that they have an expectation on pricing that our market is finding it very difficult to deal with. I suppose it is no surprise, if you have a market geared to providing capacity with a very high degree of security rating. That comes at a premium price and, therefore, for risks that do not necessarily require that kind of security in reinsurance, pricing is going to be even more of a challenge than it is in a highly-competitive premium market. It is very difficult for us to match desire for a solution with a practical one at a price that is acceptable.

CM Your question is one that was asked of us many times when we set up in Dubai. First, we are invariably asked that question when we establish local operations. We recognise the issues on pricing and we have to balance the need to be mindful of local conditions with strict underwriting standards. It is a challenge. Whichever high-growth markets you are looking at, it is pretty much a tough, rates-driven market – whether it is Dubai, Turkey, India or wherever.

Second, some Lloyds’ businesses have been in Dubai, in the DIFC, for some time. Those that have set up have made their own decisions. Lloyds has not suggested anyone has to set up in Dubai. The businesses that have gone to Dubai have gone because they have seen a commercial opportunity, perhaps a niche where they think they can add value. They are not necessarily going to be competing on price with a host of local players. They have gone in very small, focussed on a particular class of business. They may still find pricing difficult, but so far they seem to be doing okay. Only time will tell how successful the model is.

When we went into Singapore 20 years ago, our businesses went in and tried to sell everything to everyone. We have learned the lesson from that.
Of the $78 billion premium that I mentioned earlier, the percentage that comes to London is relatively small and has been getting smaller over the years. London is an expensive place to come to and it is an expensive place to do business. For the business to reach Lloyds or anywhere else in London, it passes through X pairs of hands and that costs more money. The world’s insurers and reinsurers have increased their distribution and the business now may not always come to London. If you look at the cost of doing business in any region, it is often much cheaper than sitting in London hoping that the business reaches you. It is a strategy that Aon absolutely understands.

Richard, how do you reconcile your pricing model with the pure takaful concept?

In the different pricing models that operate across the market, each syndicate and insurer makes its own assessment of risk. First, I would always ask the correct price for a risk. It is always what is commercially acceptable and the margins you build in, whether for the cost of management, provision of capital or the structure of an insurance vehicle, all of those things ultimately affect the profitability you end up creating from the transaction. Every actuary would argue that takaful should carry a premium over conventional, but I am not sure that necessarily translates in practice to the end-user price. It is very easy to debate it in theory, but the practical answer is I do not know.

Do takaful or conventional insurance products carry the higher business risk?

If the insurer has handled the business in the appropriate way, then that should not be a question. The product you receive is either a secure product or a non-secure product. If it is not secure you should not buy it. It comes down to making sure, whether you are takaful or conventional, that your product is the best. You should not rely on it being Shari’ah compliant to sell it. It must always be a quality product.
ITS 2016: Takaful Market Characteristics

Takaful Survey – Why are Islamic Assets Insured with Conventional Insurers?

Susan Dingwall and Martin Schneider of Norton Rose Fulbright LLP

This presentation looked at the results of a survey examining the reasons why Islamic assets are insured with conventional insurers rather than takaful operators. The survey focussed on how buyers of commercial insurance perceive takaful and whether those perceptions match the reality of the situation. The key finding of the survey was that there is a mismatch between the use of Islamic finance and the use of takaful. It is evident that the twin needs are to educate the market and to develop a wider range of takaful products. (This message is echoed in several of the presentations.)

The Sample
Survey respondents included heads of risk and financial officers in organisations in the Middle East, North Africa and South East Asia. The highest concentrations of respondents were in Saudi Arabia, the United Arab Emirates and Bahrain with some participation in Morocco, Egypt, Malaysia and Indonesia. To some extent the geographical distribution of responses reflects the contact base used and any future surveys will endeavour to boost responses particularly in Malaysia and Indonesia.

The majority of respondents (46%) came from organisations with a turnover of more than $750 million. In terms of industry type almost 50% came from financial services organisations, again reflecting the contact base.

Results
The key question in the survey was whether the organisation purchased takaful insurance for business-related risks.

The vast majority of respondents did buy commercial classes of insurance.

In response to the question about whether they purchased takaful insurance for business-related risks, only 30% did. Among those who did buy takaful products group health was taken out by 57% and property and business interruption by 50%. At the other end of the scale was cyber, which no-one had taken out. This was perhaps unsurprising since this is very

![Graph showing types of Takaful policy](image-url)
much an emerging class of insurance that is not well understood currently. More surprising were the low figures for group life and group motor. The majority of businesses surveyed used conventional insurance either exclusively or where takaful could not offer a suitable product.

Asked whether they would prefer to use takaful products, the majority (almost 66%) of respondents said no. The reasons why they gave this answer were grouped into product-related issues, education, competition from conventional insurers and Shari’ah-compliance issues. While there was no one reason which seemed to dominate, the absence of appropriate takaful products was definitely an issue, cited by 23% of respondents. A further 18% of respondents thought that there were capacity issues. Product marketing and education also seem to be challenges with 23% of respondents saying that their broker had never raised the possibility of purchasing takaful. A further 14% were unsure what benefits they would get from purchasing takaful.

A further problem that prevented respondents from seeing takaful as a viable solution was pricing with 23% saying that takaful products were uncompetitive in relation to conventional insurance and Shari’ah-compliance issues. While there was no one reason which seemed to dominate, the absence of appropriate takaful products was definitely an issue, cited by 23% of respondents. A further 18% of respondents thought that there were capacity issues. Product marketing and education also seem to be challenges with 23% of respondents saying that their broker had never raised the possibility of purchasing takaful. A further 14% were unsure what benefits they would get from purchasing takaful.

Shari’ah-Compliant Insurance and Re-Insurance in the GCC in 2016 as Oil Prices Remain Low
David Anthony, Lead Analyst, FI Insurance, Standards and Poor’s Rating Service

David Anthony addressed the issue of why oil prices have fallen and remain low and what that means for insurers generally and Shari’ah-compliant insurers in particular.

Oil Prices
Brent crude was at a high of $115.7 in June 2014, but by the end of 2015 it was down to $36.6 and in February 2016 it was $33. This is a fall 71.5%. Basically what has happened is the US has become self-sufficient in oil. That means that countries such as Saudi Arabia, Algeria and Nigeria that used to export most of their oil production to the US have had to find new customers elsewhere and mainly they have looked to Asia. At the same time Asia has had reduced demand, as has Europe. There are also new sources coming back on stream – Iraq, Iran, Libya and Russia, for example. The strength of the dollar has also had an impact, as have the record levels of production in OPEC countries and Russia.

Standard & Poor’s has been trying to keep up with this. Last year, for example, Citibank predicted that oil prices could go as low as $25 a barrel. There was a lot of scepticism at the time, but they were not wrong. Standard & Poor’s are currently working on the assumption that during 2016 oil will be on average $45 a barrel then rising and flattening out at around $50 a barrel.

In the good old days most GCC governments were working on the assumption they would get at least $80 a barrel and their budgets were all based around this. They are now having to tighten their belts and having to learn to live with oil prices at half their expected rates.

The winners are obviously the energy importers – China, Japan, Europe, the UK, Egypt, Jordan and the Far East. Consumers are not necessarily seeing the benefit, however, because governments are taking the opportunity to increase the tax on petrol. Among the losers are around 250,000 oil workers who have found themselves out of a job over the last 18 months. It is, however, mainly the oil-producing countries that have lost out, particularly those with high-cost oil production such as Oman, Bahrain, Dubai, Iran, Iraq, Libya, Algeria and Russia. There are also some win/lose situations. For example Egypt is a winner as an oil importer, but has lost out on the subsidies they used to
receive from oil producing countries in the GCC.

Saudi Arabia is a loser. They have enjoyed huge oil revenues, but they have been big spenders and are now in a deficit position. As a result Standard & Poor's reduced Saudi Arabia's credit rating to A- in February 2016. It used to be in the AA range alongside countries such as Kuwait and Qatar. Mr Anthony commented that was quite shocking to see Saudi Arabia at the bottom end of the A range.

Other countries have also suffered. Oman has a lot of fixed costs such as government salaries and subsidies, so they are down at BBB-. Bahrain is at a non-investment grade of BB.

There is a pattern in all of this. The outlook for all of these countries is stable, which means that Standard & Poor's do not think the situation will get worse, but they are borrowing and they are making the assumption that this is as bad as it gets. It will, however, take time for them to recover.

What will make the oil price recover? Basically it will be an increase in demand, which depends on the economic situation in China and Europe improving.

How Does This Affect Shari'ah-Compliant Insurers and Reinsurers?
Governments in the GCC are cutting back on prestige expenditure; they are liquidating some of their foreign assets and they are borrowing. Debt does create instruments such as sukuk, in which insurance companies can safely invest. It is better to invest in government bonds than in equities and properties.

This does not affect takaful companies that much. Most of the companies are relatively small and most are by and large oriented towards the retail sector such as group health and motor. They are not really involved in the big ticket commercial and industrial lines. In the short term in the retail sector the demographic is creating demand. A lot of young people are buying homes and cars that need to be insured.

Clearly, if oil prices stay low in the long term there will be fewer expats in the region so fewer cars on the road and less compulsory medical insurance for foreigners. In the long term this could mean a downturn for insurance, but in the short term they are not being affected very much.

If the dollar is strong, and a lot of the GCC countries are linked to the dollar, then that should mean car repairs are cheaper, because many of the cars in the Middle East are Japanese or European. Mr Anthony said, however, that he had not yet found an insurer that has said they are in fact cheaper. Garages are apparently getting increasingly expensive. There appears to be a level of inflation that has no relation to the economic situation.

Looking specifically at the insurance sector, the performance of stocks is reasonably in line with the market downturn. Saudi Arabia has been particularly badly hit. The only mitigating factor is that the Saudi stock market had risen massively on the back of the Saudi stock market being opened up to foreign investment in mid 2015. In fact the flood of new foreign capital never arrived. This downturn is, therefore, something of a correction. The Kuwaiti insurers are the only ones in the region that have bucked the trend.

Probably the biggest impact of the oil price on the Shari’ah-compliant insurance sector is going to be on the asset side of the balance sheet. Rightly or wrongly many takaful companies in the search for Shari’ah-compliant assets have tended to look to equities and property. Traditionally these have been good investments and many people thought the markets would only ever go up, but the reason Standard & Poor's call equities and property high-risk assets is because they do not always go up. They come down and that is what is happening at the moment.

The Stock Market
The state of the stock markets is quite dire. For example, the Saudi stock market has gone down 37.5% over the last year. Qatar is down 28% in the last six months. Apart from Abu Dhabi, which has only fallen by just less than 10%, other stock markets in the region are down by about 20% over the last 12 months. Many of the investors in equities are, of course, insurance companies.

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Probably the biggest impact of the oil price on the Shari’ah-compliant insurance sector is going to be on the asset side of the balance sheet.
Saudi Arabia and the UAE

The two most important markets in the region are Saudi Arabia and the UAE. Saudi Arabia represents 50% of gross written premiums in the global Shari'ah-compliant insurance sector according to Hannover Re. Gross written premiums in Saudi Arabia in 2015 were up just less than 20%, which is excellent growth. This follows a similar increase in 2014. At the net level, premiums were up 24%. The only potential problem is that the gross written premium is very concentrated. The top three companies of the 34 companies in Saudi Arabia, BUPA, Tawuniya and MedGulf, are writing 52% of all the premiums in the marketplace. There are, therefore a lot of smaller companies that are finding it difficult to cope with the leftovers from the larger players. The top 10 companies control 75% of the total premiums.

Saudi Arabia is not getting the same level of oil revenues anymore, but it is still spending. There is a 10% return on equity, which is not bad given the low level of interest rates and insurance capital rose by 25%, so capital is keeping pace with risk exposure. The only bad news is that a lot of that capital growth has not come from retained earnings, which would be preferable; it has come from rights issues, which tend to be unpopular with shareholders. There were 11 rights issues in Saudi Arabia in 2016 and quite a few more to come in 2016.

Most of the bigger companies are doing reasonably well, apart from MedGulf, which is losing money due to internal, operational reasons. Last year most companies increased their tariffs between 15-30%, so prices went up significantly, some companies still cannot make a profit.

The UAE is difficult for analysts because the only published information is for listed companies. There are 29 listed companies in the UAE out of a total of 61. Gross premiums for the listed companies grew by 8% in 2015. The good news for the takaful sector is that gross premiums appear to have grown by about 29%. The market share for takaful is slowly creeping up and the takaful companies seem to be gaining a good foothold in health.

The only problem is that many of the takaful companies are small and many are troubled by the minimum insolvency requirements.

In Conclusion

The market needs more, bigger and better-established Shari’ah-compliant companies, not more small players.

There is also a lot to be said for listing, because it tends to bring transparency. In a number of countries such as Saudi Arabia and Oman, insurance companies have to be listed. That means these companies are subject to not just insurance regulations, but also regulation by the capital markets authority. It also means accounts have to be published quarterly and independent board members are required. It seems to be healthier and to work and if it works it should be seriously considered.

Takaful regulation seems to be improving steadily across the region. Standard & Poor’s used to be a little worried by regulation in the UAE and Qatar, which seemed to be lagging behind the best standards in the region, but they are catching up.

Takaful accounting can be opaque. This does need to be reviewed.

Commercial lines tend to have better margins, so this is an area that takaful needs to get into and away from the commodity retail business. To do that, however, it takes a long time to build up the scale, a strong balance sheet, the lines of business and distribution.

Cheap capital and expanding markets have made it too easy to set up too many takaful companies. Whether or not the market will see consolidation or more companies closing the door remains to be seen. Above all, it takes time.
ITS 2016: Takaful Regulation, Standards and Rating in a Demanding Global Environment

The State of Takaful Markets in the Islamic World

Ajmal Bhatty, Director, Tokyo Marine Middle East

Saudi Arabia

Saudi Arabia and the United Arab Emirates (UAE) are the biggest takaful markets in the GCC. Saudi Arabia has a big population and is fundamentally economically strong. (The same is true of the UAE.) The cooperative insurance laws were introduced in Saudi Arabia in 2003. Under these laws takaful companies are free to have Shari’ah advisors/councils or not, because the laws themselves are Shari’ah compliant. Their choice will be dictated by how they want to approach the market.

In 2013 the laws in Saudi Arabia were strengthened requiring a heavier actuarial input to ensure pricing and reserves were adequate. This has had a beneficial effect on the health of the takaful industry in Saudi Arabia – companies have moved out of loss into profit. The regulator, SAMA (Saudi Arabian Monetary Authority) is very proactive in monitoring the industry to ensure its regulations are being observed.

Saudi Arabia takaful is dominated by general takaful. There are still some inefficiencies, however, particularly in the life side. For example, agents are a relatively new development and there is room for improvement in this area.

Saudi Arabia has a committee made up of representatives from all the companies involved in the industry, which has been very effective in establishing a good dialogue with SAMA. SAMA has been very receptive to the issues raised by this committee. SAMA is very proactive in education ensuring that insurance generally is understood in the country. Their aim is to have a sustainable and profitable insurance industry.

United Arab Emirates

In the UAE new insurance and takaful regulations were introduced in 2015. The takaful regulations have been based on AOIFFE recommendations. For example, window operations are not allowed. The regulator has also ruled that composite companies are not allowed, so these companies must separate into life and non-life entities. The companies have been slow to comply with this regulation and the deadline for compliance has had to be extended.

The new regulations also include a minimum guarantee fund, solvency regulations, penalties for breaches of regulations, a push for better risk management and investment rules being more actively enforced. In addition actuarial reviews have been put in place; financial conditions reports (FCRs) are required on a regular basis, with the regulator being empowered to ask for ad hoc FCRs and the regulator is asking for an improvement in internal controls and governance. The implementation of the new regulations is slow and there is still some way to go before the regulator comes up to the same standards as SAMA.

Pakistan

Pakistan introduced specific takaful regulations in 2005. No window operations were allowed at first, but the takaful companies struggled with the exception of one or two. The result is that window operations are now allowed. It is believed this may well kick start the takaful market.

Other GCC States

Bahrain, which also follows the AOIFFI lead, has put a new framework in place to improve solvency and operational efficiency. Qatar does not have specific takaful regulations, although the Qatar Financial Centre (QFC) does have some. The QFC does allow window operations. Oman is the new entrant into the takaful space in the GCC and it issued a draft law in 2015. Window operations are not permitted in Oman. Kuwait also has a draft law with a separate code for takaful companies.
The regulations are all about risk management, rating procedures and separate solvency requirements for takaful funds. There is some talk about setting up a central Shari’ah board, although this is only talk so far.

**Malaysia**
The Malaysian regulator has been very supportive of takaful. A takaful operating framework was published in 2012 and revised in 2013. The objectives of that were to enhance the business efficiency and sustainability of the takaful industry to safeguard the funds of the participants.

In 2013 new regulations required a separation of family and general takaful. In 2014 there was also a framework for life and family takaful covering operational flexibility, product disclosures, delivery channels and market practices. Risk-based capital regulations were also introduced with capital adequacy requirements.

**Indonesia**
In Indonesia initially window operations were allowed and many conventional insurers took advantage of this opportunity, although for many this was not a successful venture. A new law requires companies with takaful windows to convert these to separately capitalised businesses. Initially they had five years to do this, but this has apparently been extended to 10 years.

**Other Markets**
In 1992 Sudan declared that all insurance companies had to be run according to Shari’ah-compliant principles. In 2014 Nigeria introduced operational guidelines for takaful. Kenya has also drafted takaful regulations. In Turkey takaful windows are allowed. The regulations in Turkey are currently under review.

**Key Gaps**
There are two types of gap. One is the lack of regulatory uniformity. The Ernst & Young Takaful Report says, 'Takaful regulations across markets remain fragmented. The profitability of takaful companies is threatened not just by the strategies they are following, but also by the lack of uniform regulations to ease operating across different models.'

Mr Bhatti said that, in his opinion, better promotion is required. Customers do not know what the difference is between conventional insurance and takaful. He also suggested that promotion and education needed to go beyond the obvious and to stress the ethical values that impact on society in a broader sense.

Above all, however, takaful companies need to be sustainable and profitable. Both customers and shareholders need to be able to benefit.

‘Takaful regulations across markets remain fragmented. The profitability of takaful companies is threatened not just by the strategies they are following, but also by the lack of uniform regulations to ease operating across different models.’
a completely segregated area of the financial universe, but something which is part of it. It works to try to ensure there is no disadvantage to Islamic finance in the regulations proposed by the bodies with which it works.

It is also important to note that the IFSB does not seek to rule on Shari‘ah. Its focus is on supervision and governance.

**IFSB Standards**
The first step in any standard is for the IFSB secretariat to discuss any identified issue and decide whether a standard is needed. If it is decided that a standard is needed the next step is to form a working group. Working group members are nominated by IFSB member organisations. In the field of takaful, in particular, the IFSB is very keen to have industry representatives in the working group, not just representatives of regulators and academics. Mr Smith said that in his experience, the industry input is absolutely essential.

The standard is drafted; the issues are analysed; there is invariably a survey facilitated by the regulatory/supervisory authorities; the standard is then rigorously reviewed by both the technical committee and the Shari‘ah advisory committee and an exposure draft is published for public comment with at least one public meeting. The standard is revised, re-reviewed by the technical committee and Shari‘ah advisory committee and finalised for submission to the council, which has the ultimate say as to whether it will be accepted.

**Key Points of the Approach**
In relation to takaful, the brief given by the secretariat is to concentrate on the specifics of takaful and to look at whether standards for conventional insurance work for takaful; are there aspects of these standards that do not work for takaful and are there aspects of takaful that are not dealt with by conventional standards. Mr Smith said that he thought this was a sensible approach that made it easier for takaful standards to be adopted in jurisdictions where there are mixed economies. That is important as takaful tries to come into the mainstream in more countries, appealing to both Muslims and non Muslims as an ethical alternative to conventional insurance.

The same is true of accounting standards. There is no point in having a completely separate standard for takaful companies if they are operating in countries where they will be obliged to conform to IFRS (International Financial Reporting Standards). Mr Smith commented that he thought the Malaysian accounting and takaful industries took a very appropriate approach when they did an analysis of IFRS IV to see how they could apply it.

The IFSB recognises that it cannot impose standardisation and that regulation will always be the responsibility of the regulatory/supervisory authority in any given jurisdiction. IFSB standards, therefore, tend to remain at the level of principles and recommendations rather than detailed prescriptions. That is, in fact, what has happened in the conventional industry as well, although there is a direction of travel in the conventional industry towards more standardisation, driven particularly by the G20 and the FSB (Financial Stability Board). Mr Smith said he believed that this is likely to facilitate standardisation in the takaful industry.

The IIS (International Insurance Society) began very much as a discussion group, but its standards have become increasingly refined and it is now developing a common...
framework for the supervision of the internationally active insurance groups. This direction of travel will inevitably rub off on takaful; it is going to become easier for takaful to become standardised, because the drive from the conventional sector will mean less variation.

The IFSB tries to encompass the takaful universe. It is inclusive rather than exclusive in its standards, although it is sometimes difficult to find appropriate words to reflect the spirit of Shari’ah.

**Takaful Specific Standards**
The first takaful specific standard to be issued was IFSB 8 on governance.

IFSB 10 on Shari’ah governance is not specific to takaful, but it has to be included because it is so fundamental to Islamic finance. It has been referred to by every subsequent working group when they look at what subject matter they need to include in standards.

IFSB 11 sets high-level standards for solvency requirements. Mr Smith expressed the view that this is an area where the industry will see more standardisation in the future. The IIS is currently field testing an international capital standard for insurance. The IFSB is the obvious body to drive an examination of that and decide whether it could be applied to takaful; what modification would be needed and would it be good for takaful.

IFSB 14 covers risk management.

There is a standard on retakaful currently under preparation. It has reached the post exposure stage, where final revisions take place.

In 2001 there was also a guidance note on the recognition of ratings.

**Standardisation**
Standardisation may be desirable, but it relies on sufficient practitioners agreeing on the advice of scholars about what is acceptable and currently there is no agreement. For example, some people take the view that murabaha contracts for underwriting are acceptable and others say it must be wakala and some authorities say window operations are acceptable and indeed the only way to go to make progress and other say they are not. Even if it is accepted that none of these views are haram that does not necessarily mean standardisation, because any industry needs to innovate and that sometimes means departing from the current standard. It is going to take time to resolve these issues.

The IFSB's contribution is to promote and facilitate high-quality supervisory practice in their standards and to do so in a way that does not run counter to current developments in conventional insurance regulation being driven by the G20. For mixed economies in particular IFSB standards can guide regulatory and supervisory authorities in working out how they can adapt and apply rules originally designed for conventional insurance to takaful. Mr Smith said that in his opinion this is a really important aspect of the approach taken by the IFSB.

In this context the engagement of the IFSB with conventional regulators, both locally and globally, helps to keep Islamic finance in the spotlight. Mr Smith believes that the core principles being developed by the IFSB will in due course be treated as the benchmark for the IMF's (International Monetary Fund) FSAP (Financial Sector Assessment Programme), in much the same way that Basel and IIS core principles are treated.

The IFSB is performing a really useful function. It is helping standardisation at a high level, but at the more granular level it will take time, because it needs agreement between people from different traditions, jurisdictions and geographies. The direction of travel, however, is clear; it is towards standardisation. The push from the FSB, the G20 and the conventional sector can only lead, in time, to standardisation in takaful as well.
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*Richard Thomas, OBE, Chief Executive*  
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*Ruth Martin, Managing Director, Chartered Institute for Securities & Investment (CISI) UK, 2013*

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*Mohamed Iqbal Asaria, CBE Visiting Faculty, CASS Business School, Teaching Fellow*  
*Aston Business School, Visiting Faculty, Bangor Business School, UK, 2013*

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ITS 2016: Mutuals - Options and Issues

Discretionary Mutuals
Kainal Kassim, Senior Partner, Actuarial Partners Consulting Sdn Bhd

Mr Kassim said that his presentation was not necessarily representative of takaful in Malaysia, which is where he is based. It rather reflected his thoughts about the next step for takaful in terms of how it should be developed or whether there should be a more radical approach, taking a step back and considering an alternative to the current model.

The Challenges
First, what are the challenges for takaful companies globally? Obviously, as in any industry, there is a need for talent – people who understand the business; people who can contribute to it and make it a success. For eight years Malaysia only had one takaful company, Takaful Malaysia, and the industry today can track its success back to that company. They are benefiting from the experience of Takaful Malaysia.

System is very important in the insurance industry, which is all about service. The problem for takaful is that a company cannot simply select a system and know that it will work. Malaysian takaful companies that have been around for many years still have problems with their system and that is not good.

Distribution is another issue. A company can have the best products in the world, but if it does not have distribution, it is not going to be successful.

Regulatory challenges are another problem. Regulations in many parts of the world are geared towards supporting a market where insurance companies compete against each other on service and price. The regulators’ perspective is to ensure that customers are treated fairly, but also to ensure that insurance companies can pay out on claims, i.e. they are solvent. The problem for takaful is that the companies do not really have capital; there is zero risk capital. What they have is people contributing to a pool, which pays out on claims. How can a takaful company compete with a conventional insurance company based on price?

The ability to compete goes back to the pricing issue. Price will always be important to customers when selecting an insurance product. This means that in takaful companies the risk pool will more than likely be in deficit.

Balancing Expectations
The next point is shareholders’ expectations. Shareholders are there to make money. As far as the participants are concerned, however, they are there to help each other in times of need. The problem is how to manage these very different sets of expectations simultaneously; this is very difficult.

What do the customers want? They want to be Shari’ah compliant, but they also want low prices and a surplus refund as well, but that assumes surplus refunds have been costed into prices. If a surplus refund has been costed in, logically the premium will be higher than for products that have not had to do this. Customers also want the benefit to be guaranteed, but if there is no capital, how can benefits be guaranteed? A guarantee implies reserve funds, which have been accumulated during the good times, so it is very difficult to guarantee benefits in a pure takaful operation. Tabarru is another issue. The takaful industry has been around for more than 40 years, but Shari’ah

Price will always be important to customers when selecting an insurance product. This means that in takaful companies the risk pool will more than likely be in deficit.
scholars still argue about whether there should be surplus refunds. If a customer is providing a donation, why should they get something back? It is interesting to note that in 2013 a Fiqh Academy ruling did away with the concept of tabarru; they looked instead at the concept of mutuality, where there is no problem about paying a surplus, because the rules and regulations set out how the pool should be managed.

The Model Issue

Are the other stakeholders – the shareholders and management to blame for how takaful is developing? This is basically a model issue. The model they are using makes it impossible for takaful to be sustainable. This is a mindset issue. In the Middle East, for example, there is a high turnover of CEOs (Chief Executive Officers). Takaful CEOs normally come from a conventional insurance background, where the mantra is ‘get market share’, whether that is through pricing or service. Market share is seen as the basis for building a profitable business. The problem is that takaful cannot really compete on price, because there is no capital.

Takaful is about risk sharing, not risk transfer. Some of the current problems takaful companies are facing can be resolved by moving closer to the mutual model. The mutual model is more about affinity groups and helping each other. Pricing is not really the main issue. Would the mutual model result in a takaful industry that is more sustainable? That is something that needs to be considered.

In a discretionary mutual, there is no need for capital and that translates into cheaper products.

Looking at the way takaful is implemented in several countries, there are some differences. This is confusing for customers. If there are different ways of doing things, there needs to be different systems and different skill sets, all of which increases costs. Cost is something that needs to be minimised in order to compete on price.

Investors expect a return on their capital. If they are told they are going to get only 50% of the return on capital that they would get by investing in conventional insurance, would they be motivated to invest in takaful? Mr Kassim said that he found it quite frustrating that people expected takaful to be a gold mine. That is far from the truth. These businesses are starting from scratch; there are additional costs when compared with competitors and systems have to be modified to cope with takaful, so people are not going to make money any time soon. Down the road, when shareholders realise they are not going to make money, will they exit?

Discretionary mutuals have been around for a long time in the UK and Australia (the only two markets where they exist). In discretionary mutuals the claims are paid at the discretion of their boards. Basically they are not obliged to pay claims. It does not mean they will not pay claims; in fact, sometimes they will pay claims they are not obliged to pay. There are no terms and conditions as there are in a normal insurance policy that enable companies to avoid paying claims.

They are not subject to insurance supervision, because they are not insurance companies. That is why the problem is for takaful as well, because in most markets now regulations are there to ensure solvency. The problem there is that the more capital required for a company to ensure solvency, the more expensive the product will be, because that capital needs to be serviced. In a discretionary mutual, there is no need for capital and that translates into cheaper products.

It has already been noted that the boards of discretionary mutuals are not obliged to pay claims, so why are premiums being paid? The only way to think about this is to say that the premiums are basically donations.

There are specialist companies that manage discretionary mutuals. They handle all the technical aspects such as claims underwriting, policy documentation, sell and make sure risk management is in place. They have experienced staff and can supply the same service to a group
The key to any successful takaful or insurance operation is reaching critical mass, enabling the organisation to justify its expenses and become profitable fairly quickly.

of discretionary mutuals at the best price.

The boards of discretionary mutuals have contracts with these service companies and they pay a predetermined fee. If that service entity does not provide an adequate service, they can be replaced very easily and that is one of the major differences between mutuals and takaful companies.

Mr Kassim suggested that a two-tier takaful system might be the answer, where takaful operators with a system and a pool of skilled employees could offer to service affinity groups. The good thing about such an approach is that the surplus in any discretionary mutual remains with that entity. The way that a company can ensure that it can pay claims is by using retakaful. If claims ever exceed a certain level due to a catastrophic event, the retakaful company provides the protection.

The main problem for mutuals is capital adequacy.

The Future
The question is whether takaful can continue on its current path. Mr Kassim said that Malaysia is a developed takaful market and the leading companies such as Takaful Malaysia are in a good position, because when they started there was very little competition. The new takaful companies, however, are struggling to achieve critical mass and build up a surplus.

Mr Kassim proposed that governments should allow the establishment of discretionary mutuals. Service companies are able to ensure these mutuals are run professionally. There are some countries that have self insurance, group schemes, but the problem with these is they are most probably not professionally run and may well fail. If you have a professionally run mutual it is possible to have the best of both worlds, a successful takaful operation run by a professional service operation.

The key to any successful takaful or insurance operation is reaching critical mass, enabling the organisation to justify its expenses and become profitable fairly quickly.

Capital for Mutuals
John Gilbert, Partner, M&G Advisory Services Ltd

The Academic Case for Mutuality
Mr Gilbert said he was introduced to Mahmoud El-Gamal, an Egyptian based in the USA and Professor of Islamic Studies at Rice University. In his paper ‘Mutuality as an antidote to rent-seeking, Shari’ah arbitrage in Islamic finance,’ he argued that many of the traditional Islamic finance structures replicate conventional finance and therefore lead in terms of values to a less efficient and solid result than might otherwise be the case.

The Practical Argument
The practical argument is that a pure mutual solution is a simpler one than many of the structures that are used. It is also transparent, which is a good thing, particularly in the eyes of the regulators. In the UK and elsewhere in the world there is increasing scepticism following the financial crisis of 2008 about complex financial products.

Mutuals have been around in Europe for 300 years. They are a ready-made vehicle for Islamic finance, at least in Europe.

The Case Against Mutuality
There is, however, a case against mutuality. There are capital constraints. Leaving aside the discretionary mutual model, in a contractual mutual the only source of capital is the profits accumulated over the years, the inherited estate. The problem has been compounded in the UK with mutuals that have looked at setting up Shari’ah-compliant products having had some difficulty finding suitable retakaful. In addition if you are
Alternative Ways of Accessing Capital
Azman Ismail, President, IIFN Consulting Sdn Bhd

Over the last 20 or so years there has been a process of demutualisation, which has been encouraged or enforced by regulators. In Malaysia, for example, a law was passed in 1996 that prohibited the existence of mutuals and this is happening all over the world. Demutualisation is a licence to steal.

Accessing Capital
The main problem for mutuals is capital adequacy. Legislation such as the UK Mutuals’ Deferred Shares Act 2015 goes most of the way to solving this problem and it is to be hoped that other jurisdictions follow the UK lead. There may have been a time when demutualisation was the right thing, but now there is a prevailing opinion that mutuals are to be encouraged and the law needs to change to accommodate that changing view.

Access to capital is not impossible, but maybe it is time to look at alternative methods of raising finance such as crowd funding, which can be debt based or donation based. In the West there is a problem, because when an organisation gets money through crowd funding, it cannot give equity in return. The return is arranged in a different way. For example, an author may get crowd funding to publish a book. The donor may get 10 free books in return. Malaysia, however, has developed a system of Islamic crowd funding.

Crowd funding as a way of raising capital for mutuals may sound like a mad idea, but many ideas in the past have been dismissed. For example, Thomas Watson, the chairman of IBM said that he thought there was a market for about five computers in the world; Ken Olsen the founder of DEC (Digital Equipment Corporation) said that there was no reason for any individual to have a computer in his home and Robert McDuff, founder of 3Com predicted that the internet would go spectacularly supernova and collapse in 1996. They all got it wrong.

The problem may be with the regulators. Regulators dare not take risks. If things go well they do not get any credit, but when they go wrong they will be blamed.
ITS 2016: The Role of Effective Retakaful in Increasing Takaful’s Market Share

The Retakaful Landscape
Chakib Abouzaid, Group Marketing Officer, Reinsurance GroupMed

There have been two generations of retakaful. The first was the companies that started before 2005. In the 1980s and 1990s there were four companies, which have either disappeared or are now in run-off. The second generation started in 2005 with Takaful Re, which was the first fully fledged retakaful company, although it too is now in run-off, along with some of the other post 2005 start ups. There have, however, been successes among the post 2005 companies, some of which are fully-fledged retakaful companies and some are window operations.

Retakaful Company Weaknesses
The first weakness, and one which is still prevalent, is the short-term strategy of shareholders, who expect dividends from the first or second year of operations. Secondly there is the limited size of the retakaful market. Market analysis suggests the takaful market is worth $20 billion, but $10 billion of that is the Iranian market and the Saudi Arabian market is mainly medical and motor, which is not something that requires retakaful. That does not leave very much. The market is also geographically limited – the Middle East and South East Asia.

Third there is the leakage of retakaful business from takaful to conventional. This is not compliant. Fourth, the underlying business, to some extent due to the portfolio structure, is not profitable, particularly in the Middle East. Retakaful was also penalised from day one by the high wakala. When Takaful Re started, wakala was 20%.

Retakaful was also unlucky. The second generation had barely got started when it was hit by the 2008 global financial crisis; all the investments were making losses. It was a catastrophe for the whole industry. Another external factor was the sanctions on Iran, Sudan and Syria. The industry lost all these markets. The lack of regulation in a very competitive market also did not help.

The conclusion is that a regional retakaful model cannot work. Retakaful companies have to be international players.

Retakaful Company Strengths
International retakaful players such as Swiss Re and Hannover Re are strong, because they have a brand, the experience, group diversification and the contacts. They also have economies of scale and as a result low operating costs. They can also write sophisticated lines of business and their shareholders have a long-term strategy.

Regional reinsurers who accept conventional as well as takaful business have an advantage. They are also close to their markets.

Fit or Purpose?
The model is not working for regional fully-fledged retakaful companies, because there is insufficient business to make them profitable. Companies writing conventional halal business can be successful, but there is a need for diversification and particularly regional diversification. It is a little too early to judge whether they will succeed or not.

Subsidiaries of international groups have a very positive experience on the life side, family takaful. On general
takaful things are improving after a difficult period up to 2012. The windows of the regional players are something of an unknown, so it is difficult to say whether they are being successful or not.

**Improving Retakaful Provision**

Retakaful should be part of international reinsurance and/or have a large, diversified portfolio. Regional reinsurers do not have a large, diversified portfolio. Being an international player helps a lot.

Companies need to act as leaders, but to act as a leader you need an A rating. Retakaful companies also need to accept conventional business. If they do not, they will not have the diversified portfolio they need. Finally they need a long-term strategy. Shareholders who are asking for a dividend after two or three years should not be investing in retakaful.

**Conclusions**

Retakaful was and still is the missing link in the takaful chain. It needs to be developed; the industry needs retakaful. On the positive side, there is a young population in the Muslim world and a growing middle class. The industry is showing growth in the Middle East and in South East Asia.

To succeed the retakaful companies should adopt a takaful mind set. Companies cannot do takaful or retakaful with a conventional mind set. They also need to comply with Shari’ah; otherwise they cannot sell takaful products.

Geographical and line of business diversification is also essential. Above all they need to avoid accumulated deficits. Accumulated deficits after three years of operation are not sustainable.

**Capacity, Capital and Profitability**

Mahomed Akoob, Managing Director, Hannover ReTakaful

**Introduction**

Retakaful is a young industry. It has seen double digit growth at a time when the global economy is experiencing growth of less than 1%. It does lack economies of scale and lack of customer awareness is another issue, but there are many positives.

How does retakaful support the takaful industry? It is, in fact, the backbone of the industry. It started as an alternative to conventional reinsurance and it now has to take its place in the mainstream. It provides underwriting, enterprise risk management and pricing.

For many retakaful companies profitability is just not there; they cannot even earn their wakala fees, which are not high.

**Is Retakaful Supply Adequate?**

In terms of pure commercial industry business, the capacity is adequate. In terms of aviation and space, for example, it is not adequate. In general, however, there is sufficient capacity. If takaful business is being placed, by definition there is enough capacity. Perhaps it is time to stop moaning that there is insufficient capacity.

The question should be – is the takaful industry willing to use retakaful or is it still going to conventional reinsurers. The issue is not lack of retakaful capacity; it is whether takaful companies are prepared to use it.

**Profitability**

As part of an international group Hannover ReTakaful does have economies of scale, but the regions have to sustain themselves, to pay claims, otherwise international reinsurers would be out of business. For many retakaful companies profitability is just not there; they cannot even earn their wakala fees, which are not high.

The issue is about profitability, not capacity. For example, there have been huge fires in the GCC, but the reality is that the industry pool cannot even pay for one claim. Is the industry correctly assessing risk or is it gambling? And the industry is supposed to be in Shari’ah compliant!
There is no future unless there is rationality in the business and pricing is done on a more pragmatic basis. Only then will the industry move. That is true for the conventional side as well. It should be a responsibility never to have a deficit in the pool. Whether it is done on a mutual basis or some other basis, capital has to be found. The regulators are certainly not interested in deferred capital; they want to know whether there is enough capital to pay the claims. Go to Solvency II and it gets even worse.

The question that needs to be asked is - is the business profitable or is there insufficient retakaful capacity?

**Final Words**

Is capacity not available or is the industry reluctant to see it? The industry needs a mindset change. It needs to understand whether it would like retakaful companies to be part of the environment or whether it is simply going to concede the business to conventional reinsurers.

The main reason why the industry has lost a number of companies is profitability. Mr Akoob acknowledged that Hannover ReTakaful had suffered losses and had had to take hard measures to turn the situation around, but he added the company had not paid a single dividend in 10 years and had only survived because of the commitment of the shareholders. There has to be enough capital; reinsurance and retakaful require huge capital. Mr Akoob said he did not see it in the industry. Unless and until the industry is able to have capital, the business will have to go to conventional companies.

A takaful company can sustain itself by subscribing to the local regulator's rules. A retakaful company cannot do this, because it works across borders and has to contend with different models and regulations. For example, Bahrain insists on AOIIFE; Malaysia has its own accounting system with a different surplus distribution model; Saudi Arabia has yet another distribution model and so on. All of those have to be absorbed into one. It is not an easy task.

There has to be recognition of retakaful. There have been huge debates. For example, the IFSB has a set of regulations drawn up without any consultation with retakaful practitioners. This is a serious flaw. It is all very well to talk about the good things, but it is necessary to talk about the realities as well.

**Market Issues**

Mohamed El Dishish, Chief Executive Officer, EmiratesRE

The first issue is whether takaful and retakaful are only fit for family takaful and personal lines or fit for all other classes? Local companies do not have the capacity to handle business such as aviation. If they accept such business, they will merely be a front and they will be handing it on to international groups that do have the capacity. Takaful and retakaful companies should only go for the big ticket business if they have the capacity, the rating and the diversification.

The second issue is diversification beyond the Muslim world. Companies have to have the scale. Takaful and retakaful companies are not charities; they are there to make a profit and therefore the business model has to be sustainable. Other speakers have talked about the 20% wakala fee and the conflict of interest between policyholders and shareholders. It is a challenge, not a conflict. In EmiratesRE the wakala fee is 6.75%. This has been achieved through controlling costs and only a marginal profit has been added. If companies do that they will have a sustainable model. A balance must be struck between shareholders and policyholders.

Third, there has to be added value. The issue is not just about capacity. The industry is very specialised and there is a great deal of talk about lack of talent. There has to be investment in training and research. If added value cannot be demonstrated, customers will take their business elsewhere.

Fourth is standardisation. Mr El Dishish expressed the view that standardisation is impossible. There are various models and the variety provides flexibility, innovation and the freedom to select the most suitable model. Difference should be looked at as a plus.
Finally, there is the issue of size. In 2014 and 2015 the industry has seen about 16 mergers and these have not been mergers between small companies but between giants with $500 million or more in capital. They have joined together to form $1 billion companies, because they have to have the scale and capacity in order to dictate the terms and get the mega projects. This is where profit comes.

A Shari’ah Perspective
Sheikh Zubair Miah, In House Scholar, Cobalt Underwriting

Introduction
Sheikh Miah said that he had heard a delegate say that scholars did not really consider the social benefits of product innovation. He said that he would have to disagree, because social benefit is one of the sources of Shari’ah law, so they have to consider it. Shari’ah scholars are restricted by Islamic principles, rules and regulations, so there is a limit on how far they can go, but Shari’ah scholars have gone a long way to accommodate the takaful industry. Permitting retakaful is an example of that.

In takaful or insurance the participant is the most important aspect. For an insurance or takaful company participants are supposed to be at the heart of the entire project. Of course Shari’ah scholars do consider the shareholders.

Takaful relies on retakaful for sustainability and growth

The takaful industry has grown, but it faces challenges. There is, however, one issue that requires no argument – the importance of and need for retakaful. Takaful relies on retakaful for sustainability and growth.

Permissibility
There are scholars who disagree with reinsurance, because effectively it means passing on the risk to someone else, but the Fiqh Academy in 2013 ruled that retakaful is permissible and, in the absence of retakaful, conventional reinsurance is allowed in cases of necessity.

Why is reinsurance necessary? Reinsurance allows the insurance company to accept more risk and it also protects the insurance company. The ultimate goal of an insurance company is to redistribute risk across multiple balance sheets and this spreading of the risk in turn assists solvency.

Establishing a Retakaful Company
The issue is how to create Shari’ah-compliant reinsurance. A retakaful company is established in the same way that a takaful company is. Retakaful, however, has additional requirements. First, there is the ceding commission, which is where the reinsurance company pays a commission to the insurance company for ceding the business. Some argue that this commission is for the overheads of the insurance company. The Shari’ah view is that the insurance company should not accept this commission. It should instead ask the reinsurance company to charge net premiums.

Second, there is profit commission. If the reinsurance company makes an underwriting profit, they may distribute this profit. If the profit is a surplus and therefore Shari’ah compliant then it is acceptable, but it must be put into the participants’ risk fund; it cannot go to the shareholders.

Third, interest may accrue, for example, on money that is retained to settle future claims or from premiums that are invested. Interest is unacceptable to a Shari’ah-compliant operation and therefore must be removed from the contract. If interest is received then it must go through a purification process to remove the interest.

Fourth, when an insurance company recovers money from a reinsurance company following a claim, they may have received money that is not entirely Shari’ah compliant. It has been agreed by the scholars that the recoveries, regardless of whether they are coming from a retakaful company or a conventional reinsurance company, must go into the participants risk fund.

Finally, treaty business, unlike facultative insurance, involves many risks and it is sometimes impossible to review every single risk. Shari’ah scholars advise that, if the overall risk is Shari’ah compliant, e.g. political unrest, then accept it.
ITS 2016: Navigating Asset Management Challenges in Takaful Operations

The Rating Perspective

Mahesh Mistry, Director –Analytics, AM Best

Background

During the financial crisis a lot of companies, including takaful operators, had investments in equities and real estate and they were very badly hit. Some companies lost 30% of their shareholders’ equity in a single year. We still see companies, however, with the same investment strategies, so not much has changed.

The challenges today are rather different. There is a low-interest environment and oil prices have had a depressive effect on the GCC stock markets. In the UAE, for example, there has been a 10% reduction in shareholders’ equity. This all adds volatility to the equity and real estate markets. All of the GCC currencies are pegged to the US dollar and there would be potentially substantial implications if something changed there. This all puts pressure on shareholder returns and this is a key challenge.

Key Risks

Underwriting is a key risk, but the investment side is also important. For life companies 15% of impairments, defaults or companies going out of business are down to investment issues, because they do have a greater allocation to higher-risk investment classes on the life side. On the non-life side impairments are 6%, less but still important. For takaful players it is the concentration in those assets that is important.

The takaful investment issues include aggressive investment strategies, equities, real estate, investment performance dictating earnings, underwriting performance below par and single market players investing in their own markets with limited diversification. There is also the issue of underdeveloped capital markets, so there may be little opportunity to invest in other asset classes.

Concentration risk is a big issue, whether it is in a country, a single counterparty or a single asset. In addition, takaful has the added complication of two funds – shareholders’ funds and policyholders’ funds.

In Malaysia the split of premiums leans towards the life rather than the non-life side and is, therefore, more similar to mature Western markets. In the Middle East, where the business is mainly non life, there is a stark contrast with investment in equities, real estate and fixed income. That probably means there are more potential problems in the Middle East.

The contribution of sukuk in Malaysia is a lot higher. There are currently fewer sukuk investment opportunities in the Middle East. This is a drawback and the alternatives are not obvious.

The Capital Perspective

The main aspect of risk that is driving capitalisation is underwriting risk. There is a stark contrast in the Middle East. Companies are concentrating on underwriting, but when they are considering capital, there is no mention of investments, but investment exposure is essentially driving capital requirements; investment is consuming companies’ capital. There seems to be a material disconnect between the underwriting and investment sides. This area needs to be addressed, more so because there are two funds with all the investment risk in the shareholders’ fund. The policyholders’ fund generally has cash so the risk is low key. There is a more balanced profile in Malaysia, more akin to mature markets.

What attracts the charges in rating agency models? Cash will be low risk and investing in equities or real estate will be high risk.

A lot of takaful companies invest in mutual funds. These could be a mix of private equity funds and money market funds, so there is a need to understand the characteristics of these funds’ liquidity aspects in order to calculate the appropriate charge.

Where in a country investments are made can also have an impact. Rating agencies need to understand the depth of markets, their liquidity, the level of concentration a company has to these investment classes and the level of volatility. It is not simply a case of choosing to invest in equities or real estate. There are implications to that from a capital perspective.

Operating Performance

The combined technical ratios in the market are generally above 100%; Malaysia is doing a lot better than the GCC, although expenses are more on a par. The discrepancy between the wakala fees is really interesting. Wakala fees are normally the administrative expenses plus the cost of capital. Malaysia do a much...
better job in terms of allocation of fees compared to the GCC markets, which are going in the wrong direction. Maybe that could improve over time with regulation.

This highlights the problems many companies have on the takaful side within the GCC, which is causing heavy deficits. The contribution to earnings for the shareholders from technical performance is minimal; they are very dependent on investment income, which is why investments are important for the companies.

**Comparing the Middle East and Malaysia**

With technical performance in the Middle East and marginal technical performance in Malaysia; wakala fees in the Middle East and more balanced wakala fees in Malaysia and a dependence on qard hasan in the Middle East and a much lower dependence in Malaysia, a lot of these companies are operating the same model. The structure and the components of the model, however, seem to be varied. Aligning shareholder and policyholder interests is key.

The Middle East is very dependent on investment income for earnings, which creates volatility, not just in operating performance but also in capitalisation. It is more conservative in Malaysia and they seem to be doing a lot better in terms of their returns. An aggressive strategy does not necessarily deliver benefit; maybe being safe and secure is the better option.

**Risk Management**

Risk management is a very grey area. Companies always want to talk about the underwriting side and never the investment side, but the key risks for a lot of the takaful players are on the investment side. Motor and medical are retained, but a lot of the larger risks are ceded out. There are some counterparty credit risks, risks of mispricing and under reserving in the market, but probably the main risk in a lot of these companies is on the investment side due to their exposure.

**In Summary**

Strategies are aggressive; they do create volatility in earnings and capitalisation. These markets are affected by external factors. A key risk is that investment decisions are made by the board and there is often a disconnect with the management and what is required in terms of liquidity and asset management. There is also limited availability of some of these assets and they are single market players operating in a country, which creates a concentration risk.

The investment side is an important component on the balance sheet. Companies should not just focus on the liabilities side, but should also focus on the asset side as well, particularly emerging market players given their exposures. It does create volatility in operating performance and capitalisation. Rating agencies do not really like that.

In addition consideration should also be given to capitalisation, to their ratings and to the solvency requirements that regulators have in order to manage companies effectively. There are some improvements in capital markets developing for Shari’ah-compliant products and the UAE intends to become an Islamic centre, which may lead to greater diversification and reduce the concentration of risks there.

Finally, investments are important, but they need to be matched to the liabilities of the company; there should not be a disconnect there and management should look at everything holistically and manage the whole business rather than just certain aspects of it.
The Transformational Journey of Takaful Malaysia
Dato’ Sri Mohamed Hassan Kamil, Group Managing Director, Syarikat Takaful Malaysia Berhad

Background
In 1981 the Malaysian government set up a special taskforce to establish the first Islamic insurer in Malaysia. The Takaful Act, which regulates takaful, was enacted in late 1984. Syarikat Takaful Malaysia Berhad began operations soon after that date in mid 1985. Takaful Malaysia became a public listed company in 1996 with a paid up capital of 55 million ringgit (slightly in excess of £9 million). In 2003 the company undertook a restructuring programme, which resulted in paid up share capital almost tripling to 126 million ringgit.

Dato’ Sri Mohamed Hassan Kamil, a qualified actuary, joined Takaful Malaysia in early 2007 following almost 20 years working for conventional insurers and consulting firms. He said that he had been watching Takaful Malaysia from the sidelines for many years, wondering how it could survive, because for the first 20 years it was heavily dependent on government-related businesses and credit-related products from government housing loans. It had very little presence in the non-governmental sector and its market share at that time was very small, while companies such Allianz and Tokyo Marine had grown to be enormous presences in Malaysia.

He realised when he was asked to join Takaful Malaysia that a substantial amount of effort would be needed to transform the company into a player in the broader insurance industry, particularly in the areas of people and processes, which needed to be addressed simultaneously. The company’s tag line today reflects the ambition to be a player in the broader insurance industry. It is ‘Your Preferred Choice for Insurance’.

Early Strategic Decisions
The first step in 2007 was to recruit the right people for the right positions, including non Muslims. It was also necessary to implement a new core operating system, which would be robust, dynamic and able to deliver the level of service customers expect. New products and services were also introduced. It was effectively a complete revamp.

From 2008 to 2010 the focus was on the internal re-organisation to enable the company to compete with the conventional insurance companies. There was no interaction with potential investors at that time; there were no sessions with fund managers and analysts.

One of the first actions taken during the switch to wakala was to revisit agency remuneration. Previously most agents were remunerated solely on a salary basis with very little variable component. This is quite different from the conventional insurance industry, where agents’ remuneration is 100% on a commission basis. It was necessary to revamp the pricing of all products along with all the remuneration, commissions and incentive structures to bring them into line with the conventional insurance industry. This was the only way to attract agents to join Takaful Malaysia; no-one wanted to work with an organisation where the compensation scheme was inferior.

Next Steps
Having addressed the basics and put the house in order, the logo was changed. In Malaysia 60% of the population is Muslim, but purchasing power for insurance is predominantly with non Muslims. To penetrate that segment of the market it was essential to have a logo that would appeal to the mixed races of Malaysia, so, for example, no Arabic writing on the logo. While Takaful Malaysia is an Islamic company, a lot of customers today are not Muslim. The company offers insurance products that happen to be Islamic, but they are a good value proposition and they are competitive with or even better than conventional insurers. That is one of the differentiating factors created through the repositioning of Takaful Malaysia. The message is a simple one – buy from Takaful Malaysia because the product is attractive and meets the needs of the buyers. They are not buying from Takaful Malaysia because the company is Islamic.
The Outcome
The outcome in the last five years has been nothing short of incredible. Group assets today stand at 7.5 billion ringgits; shareholder equity is close to 690 million ringgits; profits have grown at an annual rate of 34% since 2010, even in 2015 in the teeth of an economic crisis; market capitalisation has grown from 297 million ringgits in 2008 to almost 3.2 billion ringgits at the end of 2015; the share price has increased from less than 1.5 ringgits in 2007 to close to 20 ringgits today and the dividends that have been paid over the last five years have enabled shareholders to recoup their investments.

The company has achieved this with just 23 service centres nationwide, down from more than 100 in 2007 and in excess of 1,600 staff; today there are 950 staff. Takaful Malaysia has more than 3 million customers and more than 5,000 corporate customers. Takaful Malaysia is the only company to offer a cash back scheme. For example, if a customer buys a general takaful product and has no claims they get an automatic 15% rebate.

No other Malaysian company has been able to provide such excellent growth for shareholders. Takaful Malaysia has a 25% share of the total takaful market in Malaysia and 19% of the overall insurance market.

Takaful Malaysia has also raised the profile and understanding of takaful in Malaysia. Interestingly, Dato’ Sri Mohamed Hassan Kamil said that today conventional insurers are actually hiring staff from Takaful Malaysia, a previously unheard of phenomenon.

Key Success Factors
Summarising the factors that have brought about this success, Dato’ Sri Mohamed Hassan Kamil cited
• new and enhanced products
• an expansion of distribution capabilities
• solid financial backing

• a robust and dynamic IT infrastructure
• strong links with all the Islamic banks in Malaysia, which feed business through to Takaful Malaysia
• attractiveness to investment managers both inside Malaysia and across the world
• an aggressive brand awareness campaign
• a strong underwriting and investment team
• the cash back scheme, which is particularly driving growth in general takaful

Insurance accounts for around 2% of GDP and it is growing. The market is heavily skewed towards non-life, although life is now growing. The whole financial sector is worth €30 billion in terms of assets of which 87% are in banking.

Why Invest in Bosnia?
The business environment is steadily improving, driven to a large extent by reforms designed to allow the country to become a member of the EU. The country has a stable currency and a well-capitalised banking system. The insurance sector is somewhat less developed. A big investment opportunity in Bosnia comes from the cycle of privatisation, which includes insurance companies.

Islamic Finance in Bosnia
Islamic finance has been present in Bosnia since the 15th century. In the modern era, Islamic banks began to set up in the early 1990s, but the war caused these initiatives to fail. In 2000, however, the Dubai Islamic Bank and the Abu Dhabi Islamic banks opened for business in Bosnia and there are some new initiatives to extend that number, but currently there is no takaful, despite some positive feasibility studies five years ago.

Among the challenges for insurance in Bosnia is the strength of Austrian insurance companies; low income and high unemployment.

There is a fairly active microfinance sector in Bosnia, including one Islamic microfinance institution. It is possible, therefore, that microtakaful could be a good fit for the Bosnian market. The Muslim community is very well organised in Bosnia and could be a useful vehicle in spreading Islamic microfinance and microtakaful.
Iran
Shabbir Razvi, Managing Director, International Finance Solutions

Background
Iran is a new El Dorado for the market – a place of fabulous opportunity, particularly for takaful. Iran is the fourth largest producer of crude oil in the world; has the second largest natural gas reserves and it is the 18th biggest economy with a GDP of $400 billion. It is also predicted that it could be the 10th largest economy by 2030.

Iran is the second largest economy in the Middle East and North Africa (MENA) region after Saudi Arabia. The economy was heavily dependent on oil with 63% of government revenues being derived from it in 2010, but this has dropped to 25% in 2015. The government is making strenuous efforts to reduce this even further. The IMF is forecasting moderate growth for Iran’s economy up to 2019.

It has a population of 78 million with a growth rate of 1.3% per annum. Some 64% of the population is under 35 and life expectancy is 72 for men and 76 for women. Wealth is distributed more evenly than in many other countries including the USA, Russia, Turkey, China and Brazil.

Market Opportunities
The reason why Iran is now a market worth considering is the recent ending of sanctions and the re-engagement of Iran with the international community. It is forecast that life insurance premiums will grow by 2.1% year on year in 2016, although non-life premiums are expected to contract by 0.4%. This is a huge opportunity.

Currently there are three foreign insurance companies active in Iran. The Iranian insurance regulator has announced that foreign companies are welcome and the laws to enable them to operate are in place. In addition the Iranian insurance regulator has announced that foreign companies are welcome and the laws to enable them to operate are in place. In addition foreign insurance companies will be able to take shares in existing insurance operators up to about 25%. Companies intending to operate in the life sector need about $80 million in capital and general insurance companies about $200 million. Reuters recently reported that eight out of 11 of the world’s top insurers see Iran as an attractive opportunity, with a number having plans to enter the market. Currently some countries such as the UK are having slightly more difficulty doing business in Iran than countries such as France and Germany, perhaps for historical reasons.

In 2015 Iran Insurance were reportedly in negotiation with Iraqi state insurance companies with a view to strengthening co-operation. Iran’s government has also participated in a joint commission meeting in India aimed at trade and investment agreements across a number of industries including insurance and banking.

Islamic Finance in Iran
Iran is the only Muslim country beside Sudan, where the entire financial sector is obliged to be Shari’ah compliant and as a result accounts for 40% of the world’s Islamic banking assets (Saudi Arabia has just 18.5%, Malaysia almost 10% and the UAE just over 7%) and 95% of the Iranian population has a bank account.

Although Iran’s insurance market is reasonably developed by regional standards, there are significant opportunities for growth particularly in the life segment and most non-compulsory, non-life lines. Reinsurance is another opportunity. Most reinsurance has been undertaken within Iran in the last five years, but they are now looking for overseas opportunities to reduce the risk being carried by Iranian insurance companies.

Pakistan
Nameer Khan, Head of Marketing and Corporate Communications, Pak-Qatar Takaful Group

In 2007 there were two fully-fledged takaful companies in Pakistan, which have grown substantially in the last eight years. They have enjoyed a compound growth rate of around 39.2% in contributions, significantly higher than around 3.6% for conventional insurers. They are still, however, relatively small compared to conventional insurers.

Takaful has strong regulatory support in Pakistan. This is a key to success. Recently the regulator has begun the process of granting takaful window licenses, for which there are approximately 12 applications and four new window operators already in the market. The expectation is that in future there will be about 20 to 25 takaful window operators.

Takaful window operations are a blessing, because it leads to increased penetration and the opening up of untapped areas. (Currently insurance penetration in Pakistan stands at 0.4% of GDP) Window operators can draw on years of experience, reach and resources, brand image and loyalty. All of these will benefit the takaful industry in Pakistan as a whole.

Other factors encouraging takaful growth include an improving GDP, currently increasing at 4.3% and an increase in both consumer spending and confidence. Main challenges include raising consumer awareness and increasing the number of trained staff.

Moving further on, it is essential to understand customer needs and to be innovative with product development, particularly products for low-income groups, which comprise the majority of the population and also corporate customers, which could provide
immense opportunities. One of the things that is helping with innovative products for low income groups, for example microtakaful, is the rapid spread of mobile technology in Pakistan. There is also a need to have customer-centric products that can be sold by multiple channels with options such as payment by instalment.

Takaful has huge potential in Pakistan. Takaful has been growing and people are responding to the new and innovative offerings of takaful operators. Takaful, however, should not limit itself to targeting Muslim customers; takaful is for everyone.

**The Prospects for Africa**

**Omar Gouda, Managing Director, Africa Retakaful**

Sudan was the first country to have Islamic insurance in 1979. South Africa was next in 1989, followed by Egypt in 2003 and it has gradually spread across the continent since then. The industry, however, faces many challenges in Africa including a shortage of experienced staff able to promote takaful and explain its differences from conventional insurance, which results in customers sticking with what they know, i.e. conventional insurance. Education and training are, therefore, one of the keys to success in Africa. Mr Gouda also said that Africa needed to work hard to develop appropriate legal frameworks for takaful.

Above all, the takaful industry should not rely on business from Muslims, expecting that a certain proportion will not rely on business from Muslims, (In Africa 53% of the population is Muslim.). For many the fact that takaful is Shari’ah compliant is an insufficient reason to choose it over conventional insurance. Takaful needs to be presented to potential customers as an affordable alternative and as part and parcel of that the high management costs inherent in takaful need to be reduced.

**Dr Adel Mounir, Secretary General, Federation of Afro-Asian Insurers and Reinsurers**

Dr Mounir said that the prospects for takaful in Africa were good. There is high population growth in the region, including among the Muslim population and signs of economic development. He pointed out, however, that there are only 41 takaful operators in Africa that produce about 5% of the total takaful contributions worldwide. (South Africa alone produces about 2% out of that 5%). The conclusion is inescapable that takaful in Africa is lagging behind other regions.

Mr Mounir suggested that one initiative that could help takaful is the sort of cooperative venture that, for instance, the car industry has tried successfully. Several companies have collaborated on the production of parts, getting the benefits of scale, while still marketing their end-user products under their own brand names.

**A Sudanese Success Story**

**Tarig Osman, Managing Director, The United Insurance Co (Sudan) Ltd**

Mr Osman said that it was his belief that takaful had better products than conventional insurance in every respect. He said that his company, United Insurance, had been distributing about 40% of its insurance surplus. The decision on how much the company will give away is made at a policyholder meeting. Interestingly policyholders can also elect a member of the company’s board. That member can attend meetings of the investment committee to make sure that investments are made in the interests of the policyholders and also the compensation committee to make sure remuneration for employees is fair. The object is to make sure the customer is represented at every strategic level of the company.

The company’s investment strategy had also worked well and contributed to the record returns for investors in 2014. Focussing the shareholders on making money from investments rather than from the insurance side of the business had been critical to the company’s success. Staff had also benefited from performance bonuses. He added that it had not been an easy ride getting to the present position; it had been trial and error, but it had, in the end, been successful.

The company is currently private, although all its accounts are online, so there is a commitment to transparency and good governance. The next step will be to take the company public and also to look at regional operation taking in countries such as Somalia and Djibouti.

Mr Osman, commenting on the remarks that takaful penetration was low in Africa, said that insurance penetration in general was low in the continent. He said that the unique selling proposition of takaful had a better chance of changing African attitudes to insurance than the conventional model, because policyholders have the chance of getting something back, whether or not they make a claim.

**On the Starting Blocks in Tanzania**

**Mohsin Hussein, Founder/Director, Tanzania Takaful Ltd**

Mr Hussein began by noting that Tanzania was in the process of enacting regulations to allow takaful operations and these were expected to be completed by the end of the first quarter 2016. This will open the door for Tanzania Takaful to start operation.

He noted that there were many challenges in sub-Saharan Africa in part because many people still believe that takaful is only for Muslims. He underlined the message that takaful is for anyone and everyone. He said that Tanzania Takaful’s marketing message would not focus on the word ‘takaful’.
Shari’ah Governance in Islamic Financial Institutions: An Appraisal

By: Abdurrahman Raden Aji Haqqi, Faculty of Shari’ah and Law, Sultan Sharif Ali Islamic University (UNISSA), Brunei Darussalam

Abstract

With the fast and huge growth and development of Islamic financial institutions in only four decades, their operation is in need of continuous improvement and enhancement. The Islamic financial system is a combination of innovation and tradition, of ancient values and a vibrant forward-looking design, which says much about the current state of confidence around the world and about the state of the financial services industry and its potential to contribute not only to the Islamic, but to the non-Islamic world as well.

The base line for any discussion about Islamic financial services is their obvious commercial success. People want them. It is true that Islamic finance is still small compared to the whole global financial system, but the sector is growing fast, as is illustrated by the fact that total assets in Islamic banks in the world increased by an average of 24% a year. Nor is the market restricted to the Islamic world. Freddie Mac, the US mortgage-lending corporation, has been offering mortgage-backed securities as a financing option to the Muslim community in the United States. In London, Europe’s first stand-alone Islamic bank opened its doors for business in September 2005. Before that, one of the UK’s biggest retail banks announced the launch of a Shari’ah-compatible account, claiming that it would make Islamic banking ‘mainstream’.

Harmonised Shari’ah governance rules like their counterparts in corporate governance rules are needed to assure a high-level playing field to improve transparency and enhance trust. Shari’ah governance plays a key role in ensuring the effective functioning of the Islamic financial market and promoting its integrity.

This paper is an attempt to demonstrate that a unification-based approach of the Islamic legal system and the conventional is required. For this purpose it will discuss Shari’ah governance reforms that have been recently implemented or proposed.

Introduction

While participating in the 9th Asian Law Institute (ASLI) Annual Conference 2012 at the Faculty of Law, National University of Singapore (NUS), the writer attended Panel A2 in which a paper titled ‘Corporate Governance Principles: Toward a Universal Concept?’ by Benedicte Francois of the University of Tours, France was presented. The writer was inspired by the topic and then he had the idea of writing about it in relation to Islamic financial institutions (IFIs) in the next 10th ASLI Conference 2013 at the National Law School of India University, Bangalore, India. Here is that idea encapsulated in this article with the title ‘Shari’ah Governance in Islamic Financial Institutions: An Appraisal’.

The most crucial challenge facing IFIs is full compliance with Shari’ah rules and principles in both its products and services. As Islamic finance continues to attract global attention, the area of Shari’ah governance is being increasingly analysed and scrutinised by stakeholders across the industry.1 Corporate governance for IFIs is assuming increasing significance with the steep growth in the Islamic finance system both regionally and now globally. This industry has become a major source of wealth creation and financing for investment projects worldwide and with the cumulative worth of its transactions reaching a trillion dollars. IFIs provide a viable option to savers and investors who are inclined to deal exclusively with the Islamic financial system given their religious and ideological stance. ²

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1See: Abdussalam Ismail Onagun and Abdussalam Mikail, ‘Shari’ah Governance System: A Need for Professional Approach’ in Proceeding of Shari’ah Economics Conference, 29 February 2013, Hannover, p. 71
2See: Dr. Shamshad Akhtar, ‘Shari’ah Compliant Corporate Governance’ a keynote address at Annual Corporate Governance Conference Dubai on November 27, 2006.
The corporate governance model in Islam has its own unique features and presents distinctive characteristics in comparison with the western concept of the Anglo-Saxon and the European models. It combines the element of tawhid (Islamic doctrine), shura (Islamic consultation concept) and Shari’ah rules and maintains the private goal without ignoring the duty of social welfare. The objectives behind Shari’ah governance in IFIs include increasing transparency, disclosure, and professionalism, improving oversight of the IFIs and the functioning of the governing body, which would lead to strengthening investors’ confidence in the industry.

The uniqueness of corporate governance for IFIs stems from two principle elements: (i) a faith-based approach that mandates the conduct of the business in accordance with Shari’ah principles; and (ii) the profit motive that recognises business and investment transactions and maximisation of shareholders’ wealth, etc. At times these elements could be perceived to be in conflict with each other and as such the corporate governance framework for IFIs has to treat these tensions effectively, while providing an enabling framework that allows ample opportunities for the growth and strength of the system.4

Corporate Governance: A Must?
Corporate governance is a crucial for banks and other financial institutions. They play a significant role in the economy and they should adhere to strong corporate governance standards to:
- ensure stakeholders’ satisfaction;
- confidence in the banking and financial system.

The definition of corporate governance5 has evolved and broadened in recent years since numerous financial and corporate scandals have hit the economic world, e.g. Olympus, Madoff, and the S-chips scandals. These failures revealed that many boards of directors were unable to exercise effective control over senior management and to challenge a strong CEO or a controlling shareholder. Corporate governance reform remains a critical issue not only throughout the Asian continent but also in other leading jurisdictions.6

Generally, the definition of corporate governance can be viewed in two ways. Firstly, in the narrower sense corporate governance can be defined as a formal system of accountability of senior management to the shareholders. Secondly corporate governance includes the entire network of formal and informal relations involving the corporate sector and their consequences for society in general.7 According to the Organisation for Economic Cooperation and Development (OECD) corporate governance is ‘the system by which companies are directed and controlled, in the interest of shareholders and other stakeholders, to sustain and enhance value’. On the other hand, the Cadbury Committee defines corporate governance as ‘a system by which companies are directed and controlled’.8

However, we may say that corporate governance refers to ‘the method by which a corporation is directed, administered and controlled’.9 It includes the laws and customs affecting that direction, as well as the goals for which it is governed.

Corporate governance aims at providing institutions with a body of rules and principles, with a view to ensuring that good practices guide the overall management of an institution. It has now come to mean the whole process of managing a company and the incentive structure to address principal/agent issues and ensure that executive management serves the long-term best interests of the shareholders and sustainable value of the company in conformity with the laws and ethics of the country.10

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5Akhtar, ‘Shari’ah Compliance…’

6The discourse on corporate governance as a discipline in its own right is relatively new as it has evolved over centuries (Cadbury, 1999:3). There are various definitions of corporate governance and the absence of any real consensus on its actual meaning leads to various interpretations. Literally, the word ‘corporation’, as defined in the Oxford English Dictionary (1989), is derived from the Latin word *corpus* which means ‘a group of people authorised to act as an individual and recognised in law as a single entity’. A similar definition can be found in the American Heritage Dictionary (2007), where a corporation is referred to as ‘a body that is granted a charter recognising it as a separate entity having its own rights, privileges, and liabilities distinct from those of its members’. In terms of legal definition, Black’s Law Dictionary (2009) defines a corporation as ‘an artificial person or legal entity created by, or under the authority of, the laws of a state’. In short, these three different definitions lead to a similar conclusion that a corporation can be defined as a form of organisation that represents a group of people as a single entity for certain purposes.

7The term ‘governance’ originates from a Latin word, *gubernare*, which means to steer or to govern (Cadbury, 2002:1). Lewis (2005:5) also mentions that the word governance comes from the Greek word *gybernan* which means to steer, to guide or to govern. The Oxford English Dictionary (1989) provides a wide meaning of governance as to include any ‘act or manner of governing’. All of these definitions present a very wide meaning of governance as the term may cover areas of politics, economics, social justice and public administration. In other words, the term governance in a general sense means the style or way an organisation, institution or corporation is guided, steered and controlled. (See: HASAN, ZULKIFLLIN (2011) SHARI’AH GOVERNANCE IN ISLAMIC FINANCIAL INSTITUTIONS IN MALAYSIA, GCC COUNTRIES AND THE UK. Doctoral thesis, Durham University Available at Durham E-Theses Online: http://etheses.dur.ac.uk/810/)

8Beneficite Francois, ‘Corporate Governance Principles: Toward a Universal Concept? 9th ASLI Conference, 31 May – 1 June 2012, Faculty of Law, National University of Singapore, Singapore.

9Hassan, ‘Corporate Governance…’ p. 278.


11Hawkamah, the Institute for Corporate Governance 2011, ‘Policy Brief on Corporate Governance for Islamic Banks and Financial Institutions in the Middle East and North Africa Region’, p. 11-12.

12ibid
Among corporate governance standards that are well recognised by the international community are OECD and Basel Committee standards. OECD Principles of Corporate Governance 2004 include:

i. Ensuring the Basis for an Effective Corporate Governance Framework,

ii. The Rights of Shareholders and Key Ownership Functions,

iii. The Equitable Treatment of Shareholders,

iv. The Role of Stakeholders in Corporate Governance,

v. Disclosure and Transparency, and

vi. The Responsibilities of the Board.

On the other hand, Guidance by the Basel Committee on Banking Supervision on Enhancing Corporate Governance for Banking Organisations 2006 reveals:

Principle 1: Board members should be qualified for their positions, have a clear understanding of their role in corporate governance and be able to exercise sound judgment about the affairs of the bank

Principle 2: The board of directors should approve and oversee the bank’s strategic objectives and corporate values that are communicated throughout the banking organisation

Principle 3: The board of directors should set and enforce clear lines of responsibility and accountability throughout the organisation

Principle 4: The board should ensure that there is appropriate oversight by senior management consistent with board policy

Principle 5: The board and senior management should effectively utilise the work conducted by the internal audit function, external auditors, and internal control functions

Principle 6: The board should ensure that compensation policies and practices are consistent with the bank’s corporate culture, long-term objectives and strategy, and control environment

Principle 7: The bank should be governed in a transparent manner

Principle 8: The board and senior management should understand the bank’s operational structure, including where the bank operates in jurisdictions, or through structures, that impede transparency, i.e. ‘know-your-structure’

**Shari’ah Governance: A Concept**

Shari’ah governance is a very critical area in Islamic financial institutions and is no less important than is corporate governance to any institution. It is the mechanism that determines the compliance of any particular Islamic business or financial institution. The significance of Shari’ah governance transpires via its role in ensuring the confidence of the Islamic finance industry in the eyes of the stakeholders. This is crucial, considering that compliance with Shari’ah rules and principles is the *raison d’être* of the IFIs. In addition, history has shown that improvement in the aspect of Shari’ah governance can assist the speedy and better growth of the Islamic finance industry.¹¹

Shari’ah governance is defined by IFSB-10 as ‘a set of institutional and organisational arrangements through which IFIs ensure that there is effective independent oversight of Shari’ah compliance over the issuance of relevant Shari’ah pronouncements, dissemination of information and an internal Shari’ah compliance review’ (IFSB, 2009a: 2).¹²

The definition above illustrates the extensive duties that need to be performed by the Shari’ah supervisory board (SSB); it is understood from the above definition that the duty of the SSB is to oversee and supervise the Shari’ah compliance of the Islamic financial institutions; as such, their competence is essential to forming a robust Shari’ah board. This definition also implies that the institution of the Shari’ah board is crucial to the Shari’ah governance system as an authoritative body ensuring Shari’ah compliance.

Good governance is crucial to the ability of a business to protect the interests of its stakeholders. These interests may extend beyond the purely financial to the stakeholders’ ethical, religious or other values. In the case of an institution offering Islamic financial services, stakeholders expect its operations to be carried out in compliance with the principles of Shari’ah (Islamic law). A corporate structure that enables such an institution to implement good governance through Shari’ah-compliant operations is, therefore, essential.¹³

¹¹Abdussalam, ‘Shari’ah Governance…’, p. 72
The Shari’ah governance framework for Islamic financial institutions is designed to meet the following objectives:

i. sets out the expectations for an IFI’s Shari’ah governance structures, processes and arrangements to ensure that all its operations and business activities are in accordance with Shari’ah;

ii. provides comprehensive guidance to the board, Shari’ah committee and management of the IFI in discharging its duties in matters relating to Shari’ah; and

iii. outlines the functions relating to Shari’ah review, Shari’ah audit, Shari’ah risk management and Shari’ah research.

We may conclude by saying Shari’ah governance is simply the alignment of corporate governance according to the Islamic principles. Specifically, Shari’ah governance is ‘the set of institutional and organisational arrangements, policies, processes, procedures, rules, regulations and laws which leads the organisation towards Shari’ah compliance’. Shari’ah governance applies to IFIs with compliance being the only reason for an IFI to exist. Shari’ah governance is based on four pillars, discussed in the subsequent parts of this article, and is monitored, either through a Shari’ah board or through a dedicated internal Shari’ah review department, working under the board of directors.14

Why Shari’ah Governance?

The globalisation of Islamic finance has reinforced the mysticism of Islamic Shari’ah and every business activity which demonstrates growth and involves public interest needs to be regulated by a set of rules and regulations. The growth of Islamic finance demands that IFIs are to be regulated through such a set of standards, which are capable of raising early warning signals of Shari’ah non-compliance. The standards, or Shari’ah governance, are also necessary to maintain the trust of clients of Islamic financial institutions in Islamic banking and finance and safeguard the interest of investors and other stakeholders in the Islamic financial system. To achieve a certain level of maturity, regulators of Islamic financial institutions need to address the Shari’ah regulatory issues by a legitimate and sound Shari’ah governance model based on the true principles of Islam. A comprehensive Shari’ah governance model is based on the four basic pillars discussed hereunder.15

There are three cases which may illustrate possible corporate governance weaknesses in IFIs.16 The first relates to the failure to ensure compliance with stakeholders’ religious beliefs. The other two cases show how poor corporate governance structures, both internal and external, can affect investors’ finances, particularly those of the relatively unprotected, unrestricted investment account (UIA) holders, as well as the stability and sustainability of the Islamic financial industry.

The 2001 collapse of Ihlas Finance House (IFH) of Turkey illustrates the consequences of capture by special interests in an environment of weak internal and external checks. The largest of the Turkish IFIs, with over 40% of the sector deposits, IFH was liquidated by the Turkish Banking Regulation and Supervision Agency, because it had illegally appropriated almost $1 billion, virtually the entire value of the deposit base, through connected lending to shareholders, concealed by the rapid growth of deposits. Concentrated ownership and control had permitted an incentive system biased in favour of shareholders. When the bank was liquidated, the misappropriation of funds was so large that the bank was unable to pay back its 200,000 depositors.

IFH, like other Turkish special finance houses, was not covered by deposit insurance. The failure created a panic that threatened to bring down other IFIs in the country. In spite of the reportedly sound fundamentals of the sector, and assurances by Turkish regulators as well as the Association of Special Finance Houses on the good health of the system, runs eroded 63% of total deposits in IFIs within the first quarter of 2001. Compounding the IFH failure was the inability of IFIs to manage liquidity in the absence of Shari’ah-compliant secondary markets. Overall, the failure of IFH revealed the contagion risks to the financial stability and reputation of other IFIs because of poor corporate governance.

The 2003 failure of the Patni Cooperative Credit Society of Surat in India provides an example of how weakness in the external institutional environment can affect the governance

13Minhas, ‘Shari’ah Governance…’
14Ibid.
15See, Wafik, ‘Corporate Governance…’, p.8-10. Other notable examples mentioned by Wafik but not discussed in his paper, include the Kuwait Finance House engulfment in the Souk al Manakh crash (1986-87); the liquidation of the International Islamic Bank of Denmark due to excessive financing exposure to a single client (1986); and the failure of the Islamic Money Management Companies in Egypt (1988-89).
of IFIs. External corporate governance includes the legal, regulatory and conflict resolution frameworks. As an example, the Reserve Bank of India Act, by requiring that deposit-taking institutions maintain interest-bearing accounts with the central bank, effectively prevents the functioning of IFIs as deposit-taking businesses.

Most IFIs have chosen the organisational form of a cooperative and, as such, face two sets of conditions that magnify the challenges of their operations. Firstly, they can operate only in the state in which they are licensed, as prescribed by the Cooperative Societies Act. Secondly, they have to observe conventional prudential standards on capital adequacy, income recognition and asset classification and provisioning, all of which extend to financial cooperatives. The cumulative effect of these conditions complicates the intrinsic challenge of liquidity management for IFIs, given their exclusion from conventional money markets. They also limit the potential scale of the firms’ activities and affect their competitive position. The management of the Patni Cooperative may therefore have been induced to take excessive risks, resulting in an unsustainable level of nonperforming loans.

**Shari’ah Governance: Four Pillars**

It is believed that political support is a driving force to promote Islamic finance in any country. Yet an accommodative regulatory and supervisory framework for effective Shari’ah governance is also imperative for its growth. It would not be wrong to call Shari’ah governance the brain of the Islamic financial industry. It provides a complete system to ensure compliance with the Islamic principles of doing business. By ignoring Shari’ah governance, it is impossible to guarantee that a true and successful Islamic financial system and markets are in place. Minhas believes a comprehensive Shari’ah governance system is based on following four pillars:

1. **Management and Supervision**
   Management is the first pillar of Shari’ah governance and the board of directors (BOD) comes first in the management. The BOD, senior management and the organisational structure outline a complete set of behaviours within the organisation. The success of any entity, specifically an IFI, entirely depends on the management’s willingness to adopt and implement Islamic principles in the organisation. The provision of adequate resources, systems, procedures, infrastructure and code of ethics for the acceptance of business and its legitimacy according to Shari’ah governance entirely depends on the management. Providing proper policies and systems are not enough, if they are not implemented and supervised positively.

2. **Shari’ah Advisory Board**
   An independent Shari’ah advisory board or Shari’ah advisor is the second important pillar of the Shari’ah governance model. Preferably the Shari’ah board is established in two tiers, first at the regulatory level, the central Shari’ah advisory body and the other at the internal level of the IFI, the in-house Shari’ah advisor/board.

3. **Shari’ah Compliance and Review**
   Shari’ah compliance and review is the third important pillar of the Shari’ah governance model. Shari’ah review and assessment of the adequacy of internal controls is a regular feature of Shari’ah compliance. For this purpose, an internal Shari’ah audit department, under the internal audit committee of the board, is to be established with the objectives of ensuring compliance and developing a Shari’ah non-compliance risk awareness culture in the organisation.

4. **Transparency and Disclosure**
   The fourth pillar, transparency and disclosure, is a critical part of the Shari’ah governance model. Transparency and disclosure always have a material impact on the cost of capital, reputation, investors’ decisions and stock prices. Stakeholders, shareholders and the general public are always interested in correct and timely information about a company for their investment decisions. Information is of two types: financial and non-financial. Positive information on the affairs of the organisation makes them a blue chip and it becomes...
easy for the organisation to raise funds from the general public or financial institutions at a lower cost.

Shari’ah Governance in Islamic Financial Institutions: An Implementation
At present Shari’ah governance standards vary across jurisdictions since, in the absence of a well conceptualised framework, countries evolved their own frameworks drawing from their own needs and experiences. At the same time, IFIs encouraged product innovation, which moves away from fixed-interest (riba) loan transactions to promoting a contractual arrangement for profit-sharing in businesses. The inherent risk exposures (legal, credit, market etc) in financial instruments are very different from risks associated with loans. An appropriate corporate governance framework would need to recognise these elements and identify risks and challenges associated with the different Islamic contractual arrangements and instruments. An IFI’s reputation is highly dependent on the perception of customers with respect to Shari’ah compliance and issues surrounding investor’s protection given the traditional reliance on deposits, products, etc.

Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds), December 2006
The Guiding Principles are designed to facilitate Institutions Offering Only Islamic Financial Services (IIFS) in establishing and implementing effective corporate governance practices. While Islamic mutual funds and Islamic insurance (takaful) institutions are excluded from the definition of IIFS, the Guiding Principles will be applicable to commercial banks, investment banks, finance houses and other fund-mobilising institutions that offer only financial services and products complying with Islamic Shari’ah rules and principles, as determined by the respective supervisory authorities. The IFSB recognises that the specific corporate governance practices of each IIFS will vary in scope and content depending on its activities. In certain countries, IIFS are exploring advanced corporate governance practices. The IFSB shares the opinion of the OECD that there is no single model for good governance, which is why the Guiding Principles do not set out detailed prescriptions in addressing all corporate governance issues. All supervisory authorities are encouraged to review their current recommendations, if any, in the light of the principles set out in the Guiding Principles.

Undeniably, different prudential regulations covering the aspects of capital adequacy, risk management, investor protection, transparency and market discipline, accounting practices, etc, would all have a corporate governance dimension with regard to the structure and business practices of IIFS. In this regard, the IIFS are expected to view compliance with these regulations from a holistic perspective.

Guiding Principles on Shari’ah Governance Systems for Institutions Offering Islamic Financial Services, December 2009
In recent years, the Islamic Financial Services Board (IFSB) has developed three Guiding Principles to help strengthen governance structures and processes in various segments of the Islamic financial services industry (IFSI) in line with its mandate to promote the soundness and stability of the Islamic financial system. It was noted that in all three projects, concerns over the roles and functions of the Shari’ah boards, which constitute part of the broader governance system, have been a recurring theme. This is crucial, considering that compliance with Shari’ah rules and principles is the raison d'être of the IFSI. In fact, other IFSB standards – such as those on risk management, capital adequacy and supervisory review process – also contain requirements and recommendations aimed at ensuring that an appropriate Shari’ah governance system is in place.

Consequently, the IFSB Council, during its ninth meeting in Jeddah, approved the preparation of a set of Guiding Principles on the Shari’ah governance system, which is expected to:

(i) complement other prudential standards issued by the IFSB by highlighting in more detail to the supervisory authorities in particular, and the industry’s other stakeholders in general, the components of a sound Shari’ah governance system, especially with regard to the competence, independence, confidentiality and consistency of Shari’ah boards;

(ii) facilitate better understanding of Shari’ah governance issues and how stakeholders should satisfy themselves that an appropriate and effective Shari’ah governance system is in place;

(iii) provide an enhanced degree of transparency in terms of issuance, and the audit/review process for compliance with
Shari’ah rulings; and provide greater harmonisation of the Shari’ah governance structures and procedures across jurisdictions, especially since there are increasing numbers of IIFS with cross-border operations.

In reality, the detailed scope of the Shari’ah governance system may vary from one jurisdiction to another, depending on the types of structures adopted by the IIFS as permitted by the authorities.

**Conclusion**

Shari’ah governance is the nexus for a comprehensive regulatory and supervisory infrastructure. It is the brain of the Islamic financial regulatory and supervisory infrastructure as the overall compliance of Islamic financial business will solely rest on the adequacy and efficiency of Shari’ah governance. Ignore it and you will have a limping infrastructure. The policy makers need to zoom into the components of Shari’ah governance to appreciate the complete link Shari’ah governance provides to the oversight of Islamic financial services in their country.

Shari’ah governance comprises two vital components: (a) a Shari’ah apex body as appointed by regulators or supervisors and (b) a Shari’ah body as set up by a financial institution.

The Shari’ah apex body is intended to assist the Islamic financial industry in the interpretation of the Shari’ah issues. This body will never interfere in the regulation and supervision of the industry, but will deal strictly with Shari’ah compliance issues. Regulators or supervisors may impose rules on how this body will operate and the appointment of the Shari’ah scholars to it.

(iv)  provide greater harmonisation of the Shari’ah governance structures and procedures across jurisdictions, especially since there are increasing numbers of IIFS with cross-border operations.

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Introduction
The city of Baghdad was one of the largest in the world in the 10th and 11th centuries and its rulers were able to indulge in their interests in knowledge. It is said that one of the caliphs, Caliph Al Ma’mum went to sleep one night and in a dream Aristotle appeared to him and said, ‘Knowledge has no borders; wisdom has no race or nationality. To block out ideas is to block out the Kingdom of God.’ This is in line with Islamic teachings about seeking knowledge. When Caliph Al Ma’mum got up in the morning he instructed his men to go to Byzantium and Persia and bring back camels laden with the great books from all corners of the then known world. He set up libraries and created a centre for scholarship and learning in Baghdad called Bayt al Hikma or the House of Wisdom with scholars focusing on astronomy, mathematics, arts, religious studies, philosophy etc. This was a precursor to modern universities. The concept of Bayt al Hikma is the beginning of significant work in thought and thought leadership and specifically for our purposes in commerce and finance.

February’s lecturer, Irfan Harris also referenced a short story by the German writer Heinrich Böll known as The Mexican Fisherman. In the story an American businessman is standing at the pier in a sleepy, coastal Mexican village and he sees a fisherman step out of a small boat with a catch of tuna in his hands. The American compliments him and asks how long it took him to catch the fish. The fisherman replies it only took a short time. The American then asks why he didn’t stay out longer. The fisherman tells him he had enough for his needs, so the American asks what he would do with the rest of his time. The fisherman replies that he would sleep late; fish a little; take a siesta in the afternoon; play with his kids and in the evening stroll into town to sing songs and drink with his friends. The American scoffs; he tells the fisherman he is an MBA from Harvard and a management consultant at McKinsey and he can help the fisherman. The fisherman asks how he can help. The American tells him he needs to spend more time fishing and use the extra catch to buy a bigger boat and then a fleet of boats; get more cash; cut out the middleman with his own cannery and sell directly to the end customers. He tells him that he can eventually move to Mexico City and then Los Angeles and then to New York. The fisherman asks how long this would take. ‘The Americans replies that it would take about 15 to 20 years. The fisherman asks, ‘What do you do after that?’ The American says, ‘You can go public; float your shares on the New York Exchange and you will make millions.’ ‘Millions’, says the fisherman, ‘what would I do then?’ ‘Well,’ says the American, ‘you can retire to a sleepy coastal village; sleep late; play with your children and in the evening go and sing songs and drink wine with your friends.’

This story illustrates the point that in modern life we measure progress through GDP (Gross Domestic Product). Mr Irfan said that in his view GDP is not really a measure of progress, nor is it the Islamic view of progress. It does not measure our impact on the environment, divorce rates, literacy or happiness, for example. What does measure mean and why do we measure human progress by this number?

The History of Debt
David Graeber led the Occupy Wall Street movement. He coined the quote, ‘We are the 99%’. He wrote a book called Debt: The First 5,000 Years in which he contends that money originates as debt. About 5,000 years ago agrarian societies had created elaborate systems that allowed them to trade with each other. For example, the farmer buying clothes from a merchant might have paid with an IOU to be redeemed against the farmer’s crops when they were ready. The merchant in turn had to have some repairs done to his house and he might have offered the IOU from the farmer in payment. This IOU kept circulating until it came back to the farmer, who, by then, had a crop. That is the origin of money.

Imagine when a community becomes large enough and has the power to conquer and enslave neighbouring communities. These early civilisations also had large temples, which were like industrial complexes with stores for grain, commodities, minerals etc. The priests of these temples were clever businessmen, who would lend the items held in store to merchants to trade. There would have been no accounts to establish profit and loss. What they did was charge a fixed rate, interest. They had effectively created a loan contract. The merchants provided some sort of collateral for the loan, but what if that collateral was insufficient to repay a defaulted loan? The merchant would offer himself or a member of his family to compensate, so that slavery is not just an outcome of war; anyone can...
end up as a slave. This is a particularly egregious manifestation of debt.

The primary enforcement mechanism for slavery is violence. There is, therefore, a link between debt and violence that we see even in the modern day. Mr Irfan suggested that this is one of the reasons why early religions had injunctions against certain forms of debt. For example, usury was forbidden in Christianity.

There were also occasions when rulers decided they needed to wipe the slate clean to prevent slaves rising in revolt against their masters. For example, the Bible tells us that Nehemiah, the governor of Judea in the 5th century BC established the law of Jubilee, whereby every seven years the slate was wiped clean and slaves would be sent back to their families. We again see this in the modern day. For example, Kuwait in 2013 established a law that citizens would have their consumer debts wiped clean, which was in response to the Arab Spring. Kuwait decided it needed to keep its citizens happy.

The Nature of Money

The only recorded instance in the Bible where Jesus is violent is when he drives the money changers from the Temple during Passover, calling them robbers. It is particularly notable because it was a very public act taking place when there would have been huge crowds present to celebrate Passover. It demonstrates clearly early Christianity's view of money lending/changing.

There is a very important distinction between the views of money in a modern Western context and a traditional Islamic context. Money is a medium of exchange in an Islamic context; it is not a commodity to be traded; you cannot trade it for another amount of money; you can only transfer it at par value.

There was a very famous 12th century theologian called al Ghazali, who analysed the nature of money very carefully. He did not do it in isolation; he built on the work of previous philosophers, Aristotle in particular. He said that Allah had created dirhams and dinars so that they might be circulated between hands; act as a fair judge between different commodities and work as a medium to acquire other things. He concluded that whoever affects the transactions of money is committing an injustice, because money is created for other things and not for itself.

If we are prohibited from trading in money, we cannot create money out of money; we cannot lend at interest and we cannot transfer debts other than at par value, because we are then creating money out of money, e.g. bond trading. Perhaps al-Ghazali was predicting the rise of the modern financier.

The Rules of Trade

Al-Ghazali also established rules of trade. He talked about transfer of ownership; that goods should be in one's possession, so you cannot do any short selling, selling something that you do not own, but have borrowed from somewhere else. He talked about the tangibility of assets. His rules of trade are talking about a real economy. The world has talked about this a lot in recent years because of the global financial crisis. Mr Irfan said that he believed Islamic finance was about the real economy; there is a one-to-one correlation between the real economy, real assets and the financial economy. That is not the case in the modern financial system.

Shari‘ah and Economic Development

The Shari‘ah is a very interesting subject, because in the modern world the assumption is it is something very different to its origins. Mr Irfan said he believed Shari‘ah is a very organic and evolving body of law; it is subject to change based on certain fundamental principles found in the Qur'an, which is the word of God and the Hadiths, which are the words, sayings and actions of the Prophet (PBUH). These are very basic, universal principles – justice, social good, equality, etc. Codifying those principles into something that can be used in different circumstances, e.g. trade or our daily interactions with our family and friends was the work of men who came after the death of the Prophet (PBUH).

Mr Irfan said he considered the grandfather of Islamic economics to be Imam Abôu Hanifa. He was a textile merchant in the town of Kufa. A lady came to him to sell him a silk garment for 100 dirhams. He told her it was worth a lot more than that, which was an odd thing to say, when you are the buyer of something that is being sold to you very cheaply. She replied she would sell if for 200 dirhams and he said that it was worth more. She kept raising her selling price, until the lady decided he was mocking her and turned to leave the shop. He stopped her and suggested they get an independent merchant to value the garment. The independent merchant valued the garment at 500 dirhams and Imam Abôu Hanifa and the lady agree a deal, which will give him the chance of a profit and her a fair price for the garment. This story demonstrates that he was a man who lived by the principle of a free market economy, but within certain parameters, which allowed for the protection of the weak and vulnerable in society. It also illustrates for us the basis of Islamic
economics, which is that a free economy is good for the progress of society, but there have to be some boundaries in place.

The followers of Imam Abû Hanifa were liberally inclined and inquisitive. In a way they were the opposite of what we have come to see from Islamic religious scholars today. They are seen as dogmatic, intolerant and cruel and the rest of the world sees them as regressive, but during the first 1,350 years of Shari’ah law development was progressive, tolerant, inclusive and harmonious with the society around it. It actually borrowed what was good from civilisations around and rejected what was bad. You, therefore, have the creation of a free market economy with concepts such as the money economy, where gold and silver became paper notes and there were cheques, letters of credit and money transfer. These mechanisms were essential to facilitate long-distance trade. All of this came about through the work of men such as Imam Abû Hanifa.

In addition to trade there was the transfer of knowledge and entrepreneurism. These were the roots of emerging capitalism. Unfortunately it died a little with the Ottoman Empire, which adopted many of the interest-based banking techniques of Southern Europe at the time. Mr Irfan said he thought that this is very important for us today, because there is this assumption that somehow Shari’ah is a dogmatic and inflexible body of law. Mr Irfan said that he believed this is a fairly recent, post-colonial development by Muslim rulers who wanted to create an identity for themselves. They used religion as an instrument of oppression rather than something progressive.

Has Islamic Finance Succeeded in Delivering the Spirit of the Shari’ah?

Mr Irfan said that his introduction to Islamic finance came about in 1996, when he was invited to a lecture hosted by Iqbal Khan, who was the head of an organisation that was to become HSBC Amanah. He had invited Sheikh Muhammad al Yaqoubi to speak to an audience of City workers and bankers. He is one of the most famous scholars today sitting on around 60 boards. Mr Irfan said that it had inspired him to learn more about Islamic finance and see if he could apply some of the principles such as social good, economic progress, protecting vulnerabilities and a free market to the modern banking system.

Mr Irfan said that he did not think Islamic finance had succeeded in delivering on these aims. He said that the concept of Islamic finance is ethical, but he was unsure that the execution has been particularly successful.

The Mood of Investors

Investors today are becoming increasingly aware of the need to ensure that their money is being used in a way that accords with their sentiments. That is true not just in profit-related enterprises but also in charities. For example, Save the Children Fund and Comic Relief have both had problems with investments. Comic Relief has a mission statement and part of that statement says they want to work to reduce alcohol misuse and minimise alcohol-related harm and yet they were heavy investors in companies that sell alcohol. Save the Children has a fuel poverty campaign every year and it had censored criticism of energy firms that acted as partners to the charity, a clear conflict of interest.

Mr Irfan said that as a donor to charities he was very interested in knowing where his money was going and how it was being invested. He did not want it to be invested in ways that did not accord with his personal sentiments. For example he did not want them to buy stocks in arms’ manufacturers or favouring energy companies just because they are a corporate sponsor of the charity.

There have been examples in wider society. For instance, the Archbishop of Canterbury made an announcement at the time payday lenders such as Wonga were charging 1,000% APR (Annual Percentage Rate) saying that he would compete Wonga out of existence by creating credit unions within churches. The Financial Times discovered that the Church of England had a significant holding in Wonga. Mr Irfan said it was deliciously ironic for someone like himself, working for an Islamic asset management firm. Had he appointed an Islamic asset manager that would not have happened, because they would not have invested in Wonga.

Mr Irfan also said he thought it was ironic that a church that once specifically forbade the charging of interest in any form is now setting up credit unions in the church. Boris Johnson famously said, ‘The Archbishop is not turning over the tables of the money lenders; he is bringing in his own money-lending tables.’

Paying Lip Service to the Rules

Mr Irfan commented that it was interesting that the church’s definition
of usury has been diminished over the years to the extent that by 1970 the Vatican was investing in fixed interest bonds. If you think that is bad, look at what happens in Islamic investment banks. Mr Irfan said he thought Islamic finance has a problem that it has imported from the conventional finance industry. It happens everywhere at every level. Bankers play cat and mouse with regulators; they know they have to tick a few boxes, so they try to do that. They do not really care; they have not really bought into the culture of compliance. The same is true of Islamic finance; they have not really bought into the spirit of Shari’ah compliance. They do not really want to talk about the nature of money; they just want to show their version of a fixed interest bond. They do not want to talk about the real economy. When they create a sukuk, they take an asset and create a structure around it so that it appears on the surface to be asset backed, but they actually have an undertaking by the obligor to repurchase that instrument so that asset is not very important to the deal.

There are, however, some upsides to being an Islamic institution. One is that in a major financial downturn, exposure to toxic assets such as CDOs (Collateralised Debt Obligations), derivatives and financial stocks is very much reduced. Did Islamic finance make use of that during the downturn; the answer is no. Islamic finance has not told anyone; the industry has missed a trick in its marketing.

During the period when the church had outlawed usury, financiers came up with a very clever technique to circumvent those bans. It created three contracts, which, in isolation, were not interest-bearing loan contracts, but when put together they created interest. Islamic finance has modern day equivalents of this – tawaruq and commodity murabaha, which are essentially synthetic contracts allowing Islamic banks to lend at a profit rate. Although the form is very clearly in compliance, because individual contracts have been vetted by scholars, once you put them all together they are participating in the same reserve banking system as everybody else.

Mr Irfan said he could not blame Islamic banks, because they have to abide by central bank regulations that were devised for the conventional banking system and it made it very difficult for Islamic banks to break out of it. One very interesting fatwa in the early 2000s created a very fancy contractual structure that allowed Deutsche Bank to replicate the return from any financial instrument while appearing to be Shari’ah compliant. It was referred to by the Islamic scholar, Yusuf Tala DeLorenzo, as the Doomsday fatwa. He very publicly criticised Deutsche Bank for creating something that he believed would open the floodgates to mayhem in the Islamic financial community. Fortunately, it did not get out of hand, because the financial crisis hit before there were very many of these instruments in the market. Since then Deutsche Bank have not really gone back to that structure and there have been some revisions of it in order to protect the Islamic finance industry.

There is a disconnect between what actually happens and the spirit, which the Islamic finance industry has not managed to overcome.

**Case Study Goldman Sachs**

Goldman Sachs decided to jump on the Islamic finance bandwagon in 2011. Mr Irfan said he had been approached to help them raise $2 billion for a conventional financial institution. He told them it was possible and asked what structure they intended to use. They replied that it was a commodity murabaha, which is one of the synthetic murabaha, which is intended to use. They replied that it was a commodity murabaha, which is one of the synthetic structures, which Mr Irfan was not too keen on. Mr Irfan suggested that the market might not react too positively to that and suggested that they should look at assets and see what could be used in a real economic context and create a structure around that, for example, a lease back. They replied that they had all their approvals and it looked like a loan. Mr Irfan said it was possible to work with it if certain things were done, but he then asked what they intended to do with the money. They said, ‘Don’t ask too many questions.’ At that point Mr Irfan withdrew; he told them they needed to be absolutely transparent, because the Islamic investors would demand that.

Goldman Sachs appointed another firm to help them to create that structure and it failed. It is in fact the only public sukuk that has failed in recent memory. Goldman Sachs returned to the market about two to three years later with the structure Mr Irfan had suggested at the time. Mr Irfan said that he thought this was good proof that attempts to arbitrage Islam, which is something investment banks have been trying to do, are not always successful. Some banks have got away with it for a while, but there are occasions where the investors fight back and refuse to buy, because they are not sure it is ethical.

**The Future of Islamic Finance**

The industry has a habit of preying on people’s religious insecurities by following the letter and not the spirit. One scholar, Mahmoud El Gamal, who is very critical of his fellow scholars, has said that Islamic finance specialists are like gun manufacturers; they do not care to whom they sell; they just want...
to make it as easy as possible to buy a gun. Mr Irfan said he thought that to some extent that is what is happening in Islamic finance. There is the potential to create toxic derivatives with so-called Shari’ah-compliant instruments and there are no checks or balances on them.

The reality is that it is very hard for Islamic banks to operate a true profit and loss sharing structure, which is fundamental to the Islamic economy, because they have to abide by central bank rules. Mr Irfan said that he thought it was in the FinTech sector that the Islamic revolution is going to come. It is more entrepreneurial; it has not imported the conventional banking culture and it has the right group of people.

A lot of today’s students of Islamic finance have high ideals of social progression, economic justice and Islamic finance being an enabler. Mr Irfan said that he thought that importing these ideals was the next step.

Look at the cities of Cordoba or Baghdad in the 11th and 12th centuries; these cities were models of progress in science, arts, mathematics, culture, philosophy, tolerance, harmony and inclusion. Islam stood for those values then and yet a lot of wider society thinks Shari’ah stands for the opposite of that; that it is dogmatic, intolerant, cruel and regressive. Mr Irfan believes that has been the case only in the last 50-60 years.

Mr Irfan said that, although he was pessimistic about the state of the industry today, maybe even about the state of the Islamic world today, he was optimistic about the future, because there is a generation that will elbow the old guard out of the way very soon and hopefully do it right this time, rather than become jaded along the way, losing their idealism.

Irfan Harris is head of investment banking at the European Islamic Investment Bank and founder of Islamic finance advisory firm, Cordoba Capital, now an EIIB group company. He has been an investment banker (both conventional and Shari’ah compliant) for 20 years, including 11 years with Deutsche Bank (corporate and project finance, capital markets, structured products and private equity). He was formerly global head of Islamic finance at the Barclays Group and a founding member of Deutsche Bank’s world leading Islamic finance team and former CEO of Deutsche Bank’s Islamic subsidiary. He is the author of ‘Heaven’s Bankers: Inside the Hidden World of Islamic Finance’.

March 2016: Basel III: The Challenges and Opportunities for Islamic Banking

Introduction
Mr Iqbal Asaria began by saying that he thought it was quite important to get a handle on new developments in banking post the global financial crisis, particularly because there were some things that could cause problems for Islamic finance, but could also present opportunities.

Background to the Basel Accords
The Basel Committee came into being around 1974 and was designed to supervise banking as the industry was being deregulated especially after the repeal of the Glass-Steagall Act in the United States. As universal banking came into being there was a need to understand the structure of banking and the risks it posed when there was no longer a division between investment and retail banking. That allowed banks to take greater risks.

Basel I
The first capital accord was developed in 1988. It looked at aspects of banking such as the amount of capital that banks should hold. Money is created by banks, therefore, it is reasonable for someone to look at how much capital banks should hold, because creating money is via debt and there can be too much debt.

The capital ratio was set at about 8%, but the definition of capital was very loose; it was not just equity capital. Capital was divided into tier one and tier two. Tier one was ordinary, paid-up share capital and disclosed reserves. Tier two was undisclosed reserves, asset revaluation reserves, general...
provisions, hybrid debt equity capital instruments and everything else. Tier two was really a mixed bag of things, which nobody really understood. In the event of a crisis tier two capital became completely useless; it was only tier one that could take losses.

**Basel II**

In May 2004 after the slight dip in market, with the collapse of the information technology companies, there was a perceived need to beef up provisions, because the losses to banks were significant.

**Basel III**

Thinking on Basel III started before the global financial crisis. In Basel III tier two capital has been removed. There is now a beefed-up tier one composed of many components. There is a minimum level, a conservation buffer and counter-cyclical buffer, which are all designed to make sure banks have sufficient capital to withstand any losses. If you imagine a bank that is leveraged 30 times, it does not take much of a loss to wipe out its capital. That needs to be controlled and there needs to be assurance that there is enough capital to withstand the type of losses that can occur.

Basel III is composed of many components. To calculate Basel III ratios there is a need to understand things such as risk-weighted assets. To this day the definition and composition of risk-weighted assets is left to the banks themselves. When the banks calculate their risk-weighted assets each bank is doing it differently and in a way that even the Financial Conduct Authority in the UK, for example, fails to understand. There is now discussion around the idea of having the regulator issue a specific definition of risk-weighted assets and forcing the banks to calculate it accordingly.

The liquidity coverage ratio relates to how much liquidity a bank has over a period of time, which is required in case of stress and in that there are high-quality liquid assets. This is important for Islamic banks, because there is a need for liquid assets that can be readily accessed. Within this there are level one and two assets. Level one is cash, central bank reserves and sovereign bonds. Level two includes other government securities, corporate bonds and corporate debt securities. Level two B may also include mortgage-backed securities and equities. Level two assets should be less than 40% of high-quality liquid assets and Level two B less than 15%.

The liquidity coverage ratio is the stock of high-quality liquid assets divided by the total net outflow over the next 30 days. This is designed to show that over an extended period of 30 days of stress a bank has sufficient liquid capital. This is because what happened in the global financial crisis was that liquidity suddenly dried up. Institutions such as Northern Rock had started to fund most of their activities, not from deposits, but from liquid borrowings from the financial markets and that liquidity suddenly dried up. That resulted in the first potential run on a UK bank for a long time and the government had to guarantee 100% of Northern Rock’s deposits to remedy the situation.

The net stable funding ratio looks at funding over a 12 month period plus stress testing. This is to ensure that banks have sufficient funding to operate over a 12 month period. The implementation of this mechanism is still being negotiated and is likely to take some time as, with the global financial crisis receding, banks have begun to lobby to make some of these requirements less onerous. The implication is that it will require banks to hold more equity and if they hold more equity for the same amount of business, return on equity will fall. Before the financial crisis banks were earning a 25% return on equity and with the new rules that would fall to 10-12%. Obviously shareholders would not be very happy.

The Basel committee have introduced an overall 3% non-risk-based leverage ratio. The leverage ratio is the capital measure over the exposure measure. The capital measure is the tier one capital and the exposure is on balance sheet exposures and derivative exposures. It is proving quite challenging for banks to calculate these measures and equally challenging for regulators to understand them.

In summary Basel III means banks are going to have to hold a lot more capital and develop a new type of relationship with their clients – a more long-term relationship. Banks are probably looking at $1 trillion plus of additional capital. If the level of business is the same and you add $1 trillion plus in additional equity, it is clear there will be a very significant impact on return on equity. If, however the level of business drops, it is evident that the pressure increases. That is why the CEOs (Chief Executive Officers) of many leading banks are leaving, because banking is becoming quite challenging.
**Islamic Banks and Basel III**

The basic Basel III proposals on increasing tier one capital do not pose that much of a challenge to Islamic banks. Islamic banks have always had high levels of liquidity, because they could not have debt capital.

The challenge to Islamic banks is really in the liquidity requirements, because there is no credible source of high-quality liquid assets for the Islamic banking sector, where they could exchange liquidity among themselves. This is where the key challenge will come.

Before Basel III the average cost of capital for a conventional bank was 12.5%. It was 20% for an Islamic bank, because they could not have debt capital. Now it is equalised, because conventional banks are forced to hold more tier one/equity capital. The problem for conventional banks is to seek ways to reduce their debt capital and replace it with equity capital.

In a capital sense Islamic banks are relatively more attractive, because they are much better capitalised with equity capital than conventional banks. They will be able to compete more effectively if they get their act together and get their liquidity constraints in place.

To help this process the Islamic Financial Services Board (IFSB) has issued standards and guidance notes. Standards 15 and 16 are about how to handle capital adequacy and Basel III. Guidance Note six is about particular Islamic financial products and how to handle the issues. For example, if a bank has a proper profit-sharing investment account or a mudarabah account, this is potentially loss-bearing capital, because it is exposed to loss. It is, however, complicated by property collateralisation reserves and all the other problems associated with it.

Asset-based sukuk, which are predominant in the market and are very close to debt instruments, will not qualify as tier one capital. They behave exactly like bonds on liquidation or stress. (Many people object to this type of sukuk, because they do not share risk.) This is leading to the issuance of a new type of bond, which is a tier one perpetual sukuk, which is, in a sense, loss bearing. If these perpetual sukuk are developed properly, they could also be used by conventional banks, because what conventional banks have started to do is to issue contingent convertible (CoCo) bonds. These bonds turn into equity if certain stress conditions develop. For example, in early 2016 Deutsche Bank had a panic and the prices of its CoCo bonds went through the roof, because people thought they were going to convert to equity. It is evident that they are not really suitable for this purpose, because by the time they convert the battle is lost. In light of this conventional banks might look at perpetual sukuk or covered bonds, which are bonds covered by specific assets.

M Iqbal Asaria, a qualified economist and accountant, is an associate of Afkar Consulting Ltd. He is also head of European operations for Yasaar Ltd and non-executive director at Amiri Capital Services. He has worked as an investment analyst in the City of London for several years. More recently he has been involved in consultancy on financial product structuring and niche marketing services to faith and ethnic communities in the UK and was a member of the Governor of the Bank of England's working party set up to facilitate the introduction of Shari’ah-compliant financial products in the UK market. He teaches graduate level courses in Islamic finance, banking and insurance at a variety of UK universities and business schools. He was awarded a CBE in 2005 for services to international development.
Diary of Events

September 2016


Topics to be discussed at this two-day conference include the role of London in the takaful world, the challenges and opportunities involved in moving takaful forward in the non-Muslim world, fostering takaful growth through an effective regulatory environment, microtakaful, retakful pool reforms and the development of takaful in Africa. The conference takes place at the Mandarin Oriental, Kuala Lumpur, Malaysia.

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October 2016

11-13: 11th International Conference on Islamic Economics and Finance, Kuala Lumpur

The title of the conference is ‘Rethinking Islamic Economics and Finance: Paving the Way Forward for Inclusive and Sustainable Development’. Topics will include risk management and stability, the regulatory landscape for Islamic financial markets and institutions and the socio-economic role of zakah, waqf and Islamic microfinance.

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November 2016

2-3: International Islamic Banking Summit Africa, Djibouti

‘Harnessing the Driving Forces for the Successful Development of Islamic Finance in Africa’ is the title of this two-day conference, which takes place at the Djibouti Palace Kempinski hotel. The key note session looks at how African countries can build the regulatory infrastructure to foster the growth of Islamic finance in Africa. Other sessions cover topics such as building the links between Africa and the GCC, other OIC countries and beyond and the role of Islamic finance in increasing the flow of trade and investment in Africa.

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3-4: Islamic Banking and Finance: Regulatory, Risk and Compliance, London

This course is designed to provide delegates with comprehensive training in the latest regulatory, risk and compliance issues affecting Islamic banking and finance. The course will take place at the St Pancras Renaissance Hotel.

Tel: +44 (0)20 7846 0076
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16-17: Bonds, Loans & Sukuk Turkey, Istanbul

This Turkey-centric conference brings together issuers, borrowers, investors and bankers to discuss developments in the local and international syndicated loan, bond and sukuk markets. Topics will include how the government is planning to sustain economic growth and infrastructure development in 2017 and beyond, can project bonds and sukuk play a role in financing Turkey’s infrastructure sector and the development of the Islamic financial markets.

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28-28: 8th Annual World Islamic Retail Banking Conference, Dubai

The conference is subtitled ‘Reigniting Innovation’. Topics include how to achieve higher cross and up selling, redefining the Islamic banking retail model, loyalty and customer retention, fintech and segregation of funds.

Tel: +421 257 272 100
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December 2016

5-7: World Islamic Banking Conference, Bahrain

Entitled ‘Economic Uncertainties: Vigilance and Growth’ topics will include sessions on keeping pace with macro-economic trends, Islamic finance in a digital age, the ethical banking opportunity and the launch of the latest Thomson Reuters sukuk perceptions and outlook for 2017 report. The venue is the Gulf Hotel, Manama, Bahrain.

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Dr Ahmad Mohamed Ali, President, Islamic Development Bank

“The ethical principles on which Islamic finance is based may bring banks closer to their clients and to the true spirit which should mark every financial service”
Osservatore Romano, Vatican official newspaper March 2009
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Our clear understanding of the key issues facing Islamic finance enables us to develop strategies and recommendations that meet your business needs. Our insights are valued by clients globally. Find out how we can help you see clearer, at ey.com.