Islamic Finance in the Global Economy: An Exploration of Risk Management and Governance within Shariah Finance

Thesis submitted in accordance with the requirements of the University of Liverpool for the degree of Doctor in Philosophy

By

Seng Kiong, Kok

School of Management, University of Liverpool

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For the ones I love.

Preface

This thesis is submitted to the University of Liverpool in support of my fulfilment of the requirements of the degree of Doctor of Philosophy. This thesis has been the result of one's own work. No quantity of this thesis is currently being presented, either wholly or in part for any other degrees or other qualifications. The sources from which material is drawn are highlighted and identified within.

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5) Kok, S. K., Giorgioni, G., and Laws, J. (2010) The development of derivatives structures in Islamic finance, Durham Islamic Finance Conference, University of Durham, 10th May

6) Kok, S. K., Giorgioni, G., and Laws, J. (2009) Performance of Shariah-compliant indices in New York and London, Salford Postgraduate Research Conference, University of Salford,

7) Kok, S. K., (2009) What is Islamic Finance?, LJMU Research Conference, 13th June

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Abstract

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Seng Kiong, Kok

Islamic finance has grown in prominence and is now widely regarded as a viable alternative to conventional, mainstream finance. However, this rapid growth has been accompanied by a number of pertinent issues relating to the alleged unfavourable performance of Shariah-compliant indexes, the limited availability of risk management tools and the framework of governance and regulatory standards with the Islamic banking and financial system.

This thesis seeks to assess the state of both performance and development of risk management within the Islamic financial system. It investigates these issues through a variety of methods such as quantitative portfolio creation and econometric modelling of diversification benefits, theoretical development of a financial risk management tool and qualitative analysis of semi-structured interviews on the perceptions of how governance and regulatory standards affect both the performance and financial innovation within Islamic finance.

The results presented in this study provide robust arguments for the inclusion of Islamic indices within conventional portfolios both from a performance and diversification standpoint thus vindicating the viability of Islamic finance not only as an investment option but also a risk management option. Moreover, the research puts forward a new structure for an Islamic call-option, based upon risk-sharing rather than risk-transfer, which highlights the benefits of constructing financial risk management products through Shariah-compliant rules. Finally, the research also underlines the consensus of market participants behind central regulatory standards to enhance stable and continual growth and development of the Islamic financial system.

Table of Contents

List of Figures

List of Tables

List of Acronyms

AAOIFI	Accounting and Auditing Organisation for Islamic Financial Institutions
ADF	Augmented Dickey-Fuller
APARCH	Asymmetric Power Autoregressive Conditional Heteroskedasticity
ARCH	Autoregressive Conditional Heteroskedasticity
CAPM	Capital Asset Pricing Model
CIP	Covered Interest Parity
CIPA	Certified Professional Accountant
CSAA	Certified Shariah Adviser and Auditor
DCF	Discounted Cash Flow
DEA	Data Envelopment Analysis
DJIM	Dow Jones Islamic Markets
EGARCH	Exponential Generalised Autoregressive Conditional Heteroskedasticity
FTSE	FTSE Shariah Global Equity Index
GARCH	Generalised Autoregressive Conditional Heteroskedasticity
GCC	Gulf Cooperation Council
HSBC	Hong Kong and Shanghai Banking Corporation
IFI	Islamic Financial Institutions
IFSB	Islamic Financial Services Board
IFSC	Irish Financial Services Centre
IFSI	Islamic Finance Information Service
KLIBOR	Kuala Lumpur Interbank Offered Rate
LIBOR	London Interbank Offered Rate
LSE	London Stock Exchange
MFT	Modern Financial Theory
MII	Mudharabah Interbank Investments
MPT	Modern Portfolio Theory
MSCI	MSCI Global Islamic Index
NASDAQ	National Association of Securities Dealers Automated Quotations
NPV	Net Present Value
NYSE	New York Stock Exchange
OECD	Organisation for Economic Co-operation and Development
OTC	Over-the-Counter
PLS	Profit and Loss Sharing
REIT	Real Estate Investment Trust
S & P	S & P GCC Investables Shariah Index
SC	Schwarz Information Criterion
SCI	Shariah Compliant Index
SPV	Special Purpose Vehicle
SRI	Socially Responsible Investments
SRMC	Secondary Reverse Murabaha Contract
SSB	Shariah Supervisory Board
SWARCH	Switching Regime Autoregressive Conditional Heteroskedasticity
VAR	Vector Autoregressive

Glossary of Islamic Terms[1]

arboun	earnest money contract
bai al-arboun	sale with deferred payment (deposit is placed as advance part payment)
bai al-muajjal	sale with deferred payment
bai al-salam	purchase with deferred delivery
bai bithaman ajil	sale of goods on deferred payment
dhikr	act of religious devotion
einah	sale-repurchase agreement
falah	success
gharar	uncertainty
halal	permissible
haram	forbidden
hawala	debt payment through transfer of claim
hisba	religious verification
hiyal	artifices
ijara	Islamic lease contract
istisna	contract of exchange
jahl	lack of knowledge
maysir	gambling
mudarabah	trustee financing contract/ partnership
mudarib	contributor of labour mudarabah contract
murabaha	cost plus financing
musharakah	equity participation contract/ equity partnership
mutawarriq	borrower in a tawarruq contract
rab al-mal	contributor of capital in mudarabah contract
riba	usury/ excessive interest
ruq'as	credit papers
sadqa	voluntary charity
sharikat al-mafalis	partnership of the penniless
suftaja	bill of exchange
sukuk al-badai	commodity coupons
sukuks	Islamic bonds
takaful	Islamic insurance
tawarruq	cash sale
tawliya	trade at cost
wa'ad	promise to deliver
wakala	contract of agency

[1] Translations in the above table have been verified either by peer reviewed sources or an Islamic dictionary

1. Introduction

1.1. Background of study

The growth of Islamic banking and finance has been very remarkable within the spectra of modern finance. In just over seventy years, modern Islamic finance has grown from initial experiments in Islamic nations to a fully fledge, viable financial system with a net worth of over $950 billion (Ernst and Young, 2011a; Iqbal and Mirakhor, 2007).

Moreover, the growth of Islamic finance has not been limited to traditional Muslim hubs such as Indonesia and Malaysia in the Far East and Dubai and Saudi Arabia in the Gulf Cooperation Council (GCC) region but has also spread into more conventional financial centres (Shubber, 2008). Large financial hubs ranging from Hong Kong, Singapore, the United Kingdom and America have all seen substantial growth in the infrastructure and initiatives to support and adopt Islamic finance as a viable complementary and alternative financial system (Iqbal, 1997; Warde, 2000; Sundararajan and Errico, 2002). This rapid growth has seen the proliferation of the services and products offered by modern Islamic finance and this includes deposit taking facilities, the issue and sale of shares and bonds, Islamic insurance, Islamic mortgages and an increasing number of complex Islamic financial contracts (Jobst, 2007).

With this significant growth of Islamic finance into more mainstream financial systems, there is an increased need to understand the performance, structure and interaction of Shariah financial products and services with that of their conventional counterparts. Existing research such as El-Gamal (2006), El-Sheikh (2000), Karbhari *et al.* (2004) and Dar and Azami (2010) have indicated that whilst Islamic finance is quickly being adopted as an alternative financial system much is still being learnt about products and financial services being provided under the Shariah finance umbrella. Much of this existing research focuses upon issues pertaining to both risk management and governance under a Shariah financial framework.

As highlighted by Iqbal and Mirakhor (2002) and Sundararajan and Errico (2002) the growth of Islamic finance and its increasing prominence within the global economy could lead to increased risk within the Shariah financial system leading to a greater need for the development of risk management tools and structures to meet the needs of market participants (Dar and Presley, 1999). However, the development of risk management tools and financial innovation within Islamic finance is a contentious issue as there is the requirement, unlike conventional finance, to draw a balance between financial and religious principles (Derigs and Marzban, 2008). Moreover, the growth and development of Islamic products and services across the Islamic financial system has meant that there is increased criticisms pertaining to product structures and the scope with which these products and services adhere to fundamental Islamic beliefs (El-Gamal, 2006, El-Hawary *et al.*, 2004).

Proponents of Islamic finance believe that many of the issues relating to the development of risk management and Shariah finance as a whole relate to concerns about corporate governance and regulatory standards within the Islamic financial system (El-Hawary *et al.*, 2004, 2007). These concerns are based mainly upon the fragmentation of the Islamic financial system (major Islamic financial hubs in Malaysia, GCC and UK) and divergences in regulatory standards. This regulatory divergence is not a new matter within the Shariah finance and the creation of central regulatory bodies has shown that concerted effort is being made by the Islamic financial system to address this concern (El-Sheikh, 2000). Whilst effort is being made to address the divergences in regulatory and governance standards there still exists some apprehension that the lack of uniformity within the Islamic finance could hamper overall growth and be of increasing detriment to the development of the Islamic financial system in the future (Derigs and Marzban, 2008).

1.2. Outline of the Key Areas of Research Significance

A key focus of this research project is to examine aspects of Islamic finance from a conventional financial perspective. With the growth of Islamic finance into more conventional financial markets there would be significant value into examining aspects of Islamic finance from a conventional standpoint. It was thought that this research would provide a firmer understanding and new insight into Islamic financial concepts and issues pertaining to risk management and governance.

Part of this examination includes an evaluation of the performance of Shariah-compliant indexes within a conventional portfolio of equity indices. Empirical literature is inconclusive with regards to the benefits of Shariah-compliant equity indexes for both Islamic and conventional investors. Empirical literature such as Hassan (2001), Hussein (2007) and Elfakhani *et al.* (2007) have attempted to compare the performance of Islamic and conventional equity indexes and have also found that there were not consistent arguments for outperformance by Islamic indexes and in some cases there was even an underperformance of Islamic indexes. The growth of Islamic finance has meant that in order to enhance its attractiveness as an alternative financial system there has to be some investment benefits for not only Islamic but also conventional investors. The existing literature has tried to illustrate this aspect but much of the empirical work focuses only on comparing Islamic against conventional equity indexes without consideration for basic investment strategies such as diversification and portfolio optimisation. This clear gap in the literature forms the first key area of research. This study aims to examine the diversification and performance benefits of including an Islamic equity index through a cointegration and Markowitz portfolio optimisation analysis. Many investors understand the benefits of multi-asset portfolios and as such this study incorporates this understanding to the world of Islamic banking and finance.

This leads on to the next key area of research as the growth of Islamic finance into more conventional, non-Muslim financial systems has meant that there is a need to develop financial instruments to deal with the proliferation of risks associated with growth. These include the lack of a risk management framework, increased liquidity risk and the lack of understanding new entrants into the Islamic financial market space. It should be noted that the increase of risks is not limited to Islamic financial hubs in conventional financial systems but also to Shariah finance in Islamic financial systems. There is an increasing amount of literature such as Dar and Presley (2000) and Jobst *et al.* (2008) highlighting the problems of risks associated to Islamic financing principles. Moreover, the opportunity cost of not developing a strong base for financial innovation is also a cause for concern with Islamic finance lacking a salient risk management culture (Noman, 2002). The development of risk management is an important process within any financial system, however, the swift advancement and acceptance of Islamic finance into mainstream financial systems has highlighted the apparent fallibilities of financial innovation with Shariah finance. Fundamentally, the growth of Islamic finance has resulted in the proliferation of risks such as market and default risk where traditional Islamic financial products did not provide adequate tools to address these risk types.

The process of establishing financial innovation and a risk management framework is also made more difficult within Islamic law because of the prohibition of risk management structures such as derivatives. Kamali (1995, 1997 and 1999) has articulated strong views on the permissibility of derivative like structures in Islamic finance and has strongly suggested that derivatives provide a strong based for risk management, which should not be ignored by Islamic finance. Furthermore, an examination of the literature has yielded numerous new Shariah-compliant risk management tools, which recreate the risk management flexibility of conventional derivatives. However, many of these tools still abide by a risk-transfer modus of risk management despite the fact that a pivotal principle in Islamic finance is risk-sharing. The aim is to create a risk management tool that provides the flexibility of a derivative but incorporates the Islamic financial principle of risk-sharing. An examination of the existing literature reveals that there have been no attempts at creating such a structure thus indicating that this is an original contribution to knowledge. An investigation of the current state of financial innovation reveal several regulatory and governance issues. Throughout the empirical process of creating the new hybrid product structure, the researchers had to confront these regulatory and governance issues first hand. These issues were highlighted in the literature as the development of new instruments (Dar and Presley, 2000; Jobst *et al.*, 2008), the composition of Shariah supervisory boards (El-Gamal, 2000), lack of transparency (Honohan, 2001), lack of uniformity (Chapra and Khan, 2000; Chapra and Ahmed, 2002), unclear definition of Shariah-compliance (Grais and Pellegrini, 2006), no clear definition of risk management framework (Dar and Presley, 2000), the lack of a lender of last resort (Hersh, 2011) and the future of Islamic finance.

While the literature identifies these aspects as key concepts and issues of Islamic financial regulation and governance, the academic discussions are very much abstract and theoretical with little empirical evidence to validate these notions. This illustrates another gap in the existing knowledge within Islamic finance and formed the base of another key area of research. Using the issues of regulation and governance highlighted in the literature, the research will try to determine if these issues are being faced by market participants through the use of semi-structured interviews. The interviews would be conducted with a mix of academic and practitioners and because of the niche and relatively new nature of Islamic finance, it was felt that the views of both academic and practitioners could be balanced by an interim group which comprised of both academic and practical knowledge. A significant contribution to knowledge through this facet of the research study is to provide a synthesis of the views of market participants and existing literature on issues of Shariah regulation and governance. The research significance from this aspect of the study will be derived from the amalgamation of views from both market participants and existing literature to highlight the problems and the steps taken to curb the criticisms of Islamic financial regulation and governance.

Summarily, there are three key areas within this research study. Firstly, the analysis of diversification and performance of Islamic equity indexes using conventional investment strategies. Secondly, the examination of financial innovation in Islamic finance and the creation of an entirely new risk management instrument. Finally, the research investigates the issues of Shariah regulation and governance and a validation of these views through the synthesis of actual market participant precepts and existing literature. What can be seen from all three key areas of research would be that the overall research study looks to provide further arguments in support for Islamic finance as a financial system which exists not only for Muslims but as a financial system that can be used and is viable for both Islamic and conventional market participants.

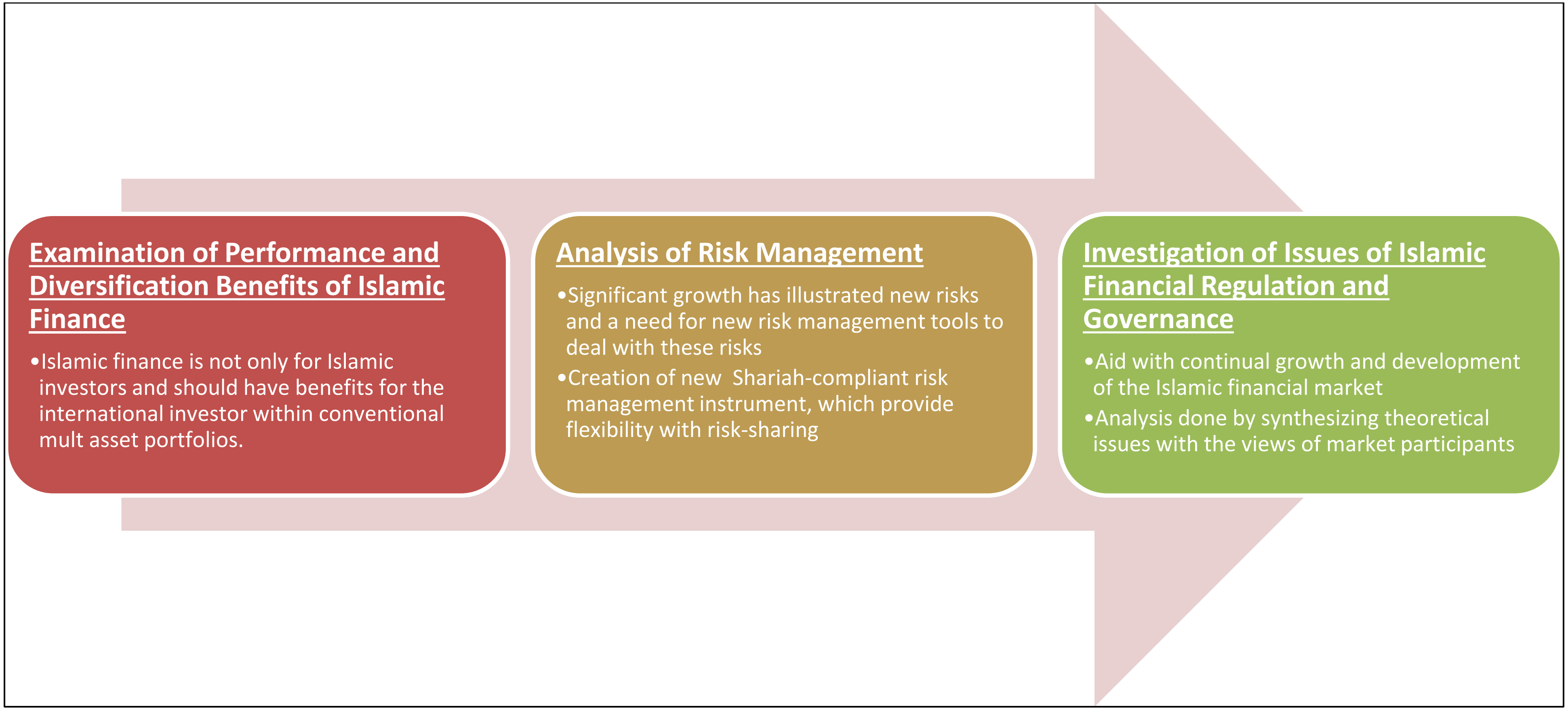

Figure 1: The thought progression of this research study with reference to the Key Areas of Research Significance

1.3. Research aims/ objectives

This research has 4 major aims namely, the examination of the development and growth of Islamic finance, the assessment and analysis of the performance of Shariah-compliant indexes within a conventional portfolio, the evaluation of the risk management and financial engineering capacity of Islamic finance and the investigation of regulation and governance under a Shariah regulatory framework.

(i) **An examination of modern Islamic finance**

This will involve a thorough examination of the basic principles of modern Islamic finance and will provide an overview of the Islamic finance system in relation to the products and services on offer, major activities and market valuation. Additionally, the study will attempt to draw parallels between Islamic finance and conventional finance with an extensive review of the historical development of Islamic finance. A review of the existing literature on Islamic finance and empirical research into the performance, risk management and regulatory and governance issues of modern Islamic finance will be undertaken to achieve this objective.

(ii) **The assessment and analysis of the performance of Shariah-compliant indexes within a conventional portfolio.**

This includes an analysis into the justification for the inclusion of a Shariah-compliant index within a conventional portfolio. This would involve the use of hypothetical portfolios optimised under a Markowitz methodology to determine if there are any performance benefits. The performance will be assessed from a risk management and portfolio optimization perspective. Portfolios will be created using a combination of Islamic, ethical and mainstream indices. These portfolios will then undergo a cointegration analysis to determine there are any underlying stochastic trends. Additionally, portfolios which exhibit no cointegrating vectors will then be optimised to test their risk-adjusted performance.

(iii) Evaluation of Risk Management and financial engineering within Islamic finance

This study will include a thorough investigation of risk management under a Shariah finance framework. It will evaluate existing risk management products and strategies and highlight problems associated to financial engineering within Shariah finance. Financial engineering or financial innovation under a Shariah framework faces a major obstacle of Shariah-compliance. This study will investigate the processes involved with financial innovation within Islamic finance. This facet of the research will essentially be a pen to paper exercise. The researcher will fundamentally dissect existing conventional and Islamic financial risk management tools and reconstruct a new Islamic risk management structure along the interpretation of existing Shariah-compliant rules.

(iv) An exploration of the issues of Governance within the Islamic financial system

Essentially, this objective seeks to establish the issues surrounding governance in Islamic finance. Additionally, the study wishes to determine the precepts of market participants on these issues of governance and possible remedial proposals. The scope of this objective will take to form of semi-structured interviews with that of market participants within Islamic finance. The information garnered from these interviews will be synthesized form the precepts of the literature to provide a review of the current state of governance and regulatory standards with the Islamic financial system.

1.4. Research questions

(i) **How does Islamic finance operate in the modern financial spectrum?**

The research attempts to present a conventional view of Islamic banking and finance in the modern economy. Essentially, it looks at trying to understand the central tenets of Islamic banking and finance. Moreover, the study also looks at the practical and academic development of Islamic finance and delves into the growth of Islamic finance from the medieval to the modern times.

(ii) What are the diversification opportunities presented by Shariah-compliant equity indices?

This questions forms part of the objective in assessing the performance of Shariah-compliant indices. Fundamentally, are there any diversification benefits from holding a Shariah-compliant index within a conventional portfolio? This is an evolution of existing literature pertaining to diversification. Much of the existing literature examines the performance benefits of ethical indices rather than Shariah-compliant indices. The portfolio in this part of the study will include a mainstream, an ethical and a Shariah-compliant index. Moreover, the study also geographically distinguishes between indices and portfolios were formed using American and British equity indexes. Portfolios were assessed using econometric cointegration to discover if there exists any underlying stochastic relationship between indexes.

(iii) What is the concept of risk management within Islamic finance and what are the various risk management vehicles available?

The study intends to explore the risk management operation within Islamic finance. Are there similar risk management strategies and instruments in Islamic and conventional finance? An examination of existing risk management instruments will be undertaken and will look at the adequacy of these instruments. Moreover, the research will also include an evaluation of the current debate surrounding the exclusion of derivative-like instruments within Shariah finance.

(iv) What is the scope for financial innovation within risk management under a Shariah financial framework?

This aspect of the research project seeks to highlight the scope of financial innovation of risk management instruments under a Shariah framework. It highlights the in-roads being made in financial innovation in Islamic finance and presents the arguments advocating the need for continual development of financial instruments within Shariah finance. Additionally, in answering this question, the research also hopes to highlight discussions on the obstacles faced by financial innovators in Islamic finance. The research project will include proposals for a hybrid risk management instrument that promotes risk-sharing as opposed to risk transfer.

(v) What are the current problems and future developments of the regulatory standards within the global Islamic financial system?

This facet of the research aims to explore the issues surrounding the regulatory standards in Islamic finance. The literature has indicated that there is a lack of uniformity of regulatory standards across the global Islamic financial hubs. It is further argued that this could lead to an uneven playing field between Islamic financial systems and is detrimental to the development of Islamic finance as a whole. Moreover, the use of Shariah-screens to promote the development of Islamic finance in non-Muslim financial systems has also come under scrutiny. Interviews will be used for this aspect of the research to gather the views of market participants on these regulatory issues and possible solutions. The interviews will include both academic and professionals within the field of Islamic finance in order to garner a well-rounded perspective.

1.5. Structure of the thesis

The study is laid out as follows. Chapter 2 provides readers with an insight into the history of Islamic finance. It charts the practices of medieval Islamic finance and documents the operation of Islamic finance during the medieval period. It highlights the differences between medieval Islamic and Western finance and provides arguments relating to the lack of adoption of Islamic finance during medieval times. The chapter then moves on to detail the beginnings of modern Islamic finance. Parallels and differences between medieval and modern Islamic finance will also be detailed within this chapter. Chapter 3 provides readers with an overview of the current Islamic financial system. This chapter illustrates the main financial activities of Islamic finance and examine the scope of these activities within reference to conventional finance. It explores the central principles of the Islamic financial system. It highlights the growth of Islamic finance within the modern economy and lists the significant financial activities of Islamic financial institutions. Additionally, this chapter also examines the fundamental financial concepts in Islamic finance and how these concepts could possibly be applied within Islamic financial contracts

Chapter 4 provides the literature review of the key areas of research of Islamic finance for this study. The literature review explores the existing arguments pertaining to risk management under a Shariah framework. The chapter begins by examining the existing thematic discourse on the performance of Islamic equity funds and the arguments pertaining to Islamic finance as a viable outlet for both conventional and Islamic investors. The section then goes on to review the existing debates on risk management and financial innovation within Islamic finance with a particular emphasis on Islamic derivatives. These discussions then lead on to issues of regulation and governance which dominate the global spectra of Shariah finance and the continual development of the Islamic financial system as a whole.

Chapter 5 specifies the research methodology adopted for this research study. It records the research philosophy, approach and design of this project. Essentially, the first sections of this chapter provides the reader with the theoretical and academic grounding of the selected research methodology thus contextualizing the underlying research thought to a greater extent. This section will also examine the specific quantitative and qualitative analysis methods that were used during the course of the empirical work undertaken and provide justifications for the use of these selected methods.

Chapter 6 chronicles the findings from the literature review and empirical work carried out. It offers a summative view of what was discovered over the course of this research project. This section also draws links to the literature to provide a rounded and validated perspective of the findings.

Chapter 7 presents the discussions where the researcher provides and draws links across the central themes of this research project. The aim is to illustrate how the developments of financial products and services of Islamic finance are influenced by regulatory standards and additionally how the innovation of these products and services also drive the regulatory process. Additionally, this chapter documents the original contribution to knowledge of this study. This section of the chapter will further highlight how the results have addressed gaps in the literature and the new findings that add to the existing pool of knowledge on Islamic banking and finance. This chapter will also underline the limitations of this research project as well as the scope for further research. Lastly, the chapter indicates the researcher's own personal reflection from what has been learnt throughout this research process.

2. Islamic Financial History – Theory and Practice

2.1. Introduction to Chapter

This chapter initially aims to provide the reader with a description of the historical development of Islamic finance. Section 2.2. highlights the academic development of Islamic financial theory and examines the changing paradigm of academic thought in Islamic finance in its modern incarnation. Section 2.3. aims to provide a perspective of the growth of practical application of Islamic finance. The section is further separated into two subsections with the first (Section 2.3.1.) examining the working application of Islamic finance in medieval times and the second (Section 2.3.2.) indicating the practical aspects of modern Islamic finance. Section 2.4. provides summative remarks about this chapter.

2.2. Islamic Academic Development – A Timeline

The earliest forms of Islamic financial theory were deeply rooted in trying to replace interest based lending with profit sharing initiatives (Siddiqi, 2006). The main element of this theory was grounded in achieving fairness within each financial transaction where the divergence of risk-bearing between borrower and lender was seen as unjust. This argument is based on the principle of interest lending, where the borrower (customer) would bear the entirety of the risk of business while the lender (bank) would still receive fixed interest payments for the loan. It was argued that there was no justification for these ‘guaranteed’ interest payments if there was no guarantee of returns for the customer (Ghanameh, 1973). Much of the theory on Islamic finance during the 1970s sought to highlight the problems with interest based transactions on the financial system and suggested that economic ailments such as unemployment and inflation were attributed to interest (Hameedullah, 1936; Ahmed, 1972, Iqbal and Mirakhor, 1999; Siddiqi 2006). The arguments presented by El Diwany (2010) in his book 'The Problem with Interest' can best illustrate the short comings of interest based transaction. El Diwany (2010) suggests that the use of interest based project evaluation techniques such as net present value (NPV) and its mirror image of discounted cash flow (DCF) distort the financial world and are "unlike the world that we live in". He further argues that positive/negative NPVs are not the only factors that should influence the investment decision and that in the modern world humans place ameliorated value on aspects such as pollution and stress (El Diwany, 2010). It is difficult, but not impossible to place a monetary value on subjective features such as pollution and stress and whilst these arguments against interest based financing are not new, it indicates the drawbacks of interest financing methodologies. Fundamentally, the views expressed by El-Diwany (2010) are not entirely new but are rather an extension of the precepts found in seminal works such as that of Khan (1986).

The 1980s brought with it the resurgence of fundamental Islamic values, which extend this ideology into the economic spectrum (Homoud and Rhummeud, 1985; Khan, 1986; Ashour, 1999). There was a significant increase in awareness of Islamic Finance in the academic world of Islamic Banking and Finance and even saw the creation of a journal entirely dedicate to Islamic finance – the Journal of Research in Islamic Economics. Much of the literature during this period focuses entirely on explaining this "new" financial system to the world. Works such as Ahmed (1980) and Ahmed *et al.* (1983) highlight the major tenets of Islamic finance and its workings as a financial system. These discussions focused on highlighting the beliefs of Islamic economics and serve to elaborate on recommended patterns of economic transactions (Khan, 1986). Additionally, these works also described the central Islamic financial concept of *riba* and basically addressed to initial concerns of whether Islamic finance was viable and if it could exist within the modern economic spectrum alongside conventional financial systems.

Studies by Naqvi (1982) and Khan (1984), which examined the rationale of profit and loss sharing (PLS) under a standard mainstream financial framework, have shown that it is possible to exist in a financial system without interest. This involved arguments around agency theory and the circumvention of the principal-agent problem through an adequate remuneration package for the agent. In order to combat non-disclosure of profits on the part of the agent, it was stated that agents had to be rewarded for their honesty. The most notable development of the 1980s was the increased use of *murabaha* (cost plus financing) contracts in Islamic finance (Siddiqui, 2008). This proliferation of *murabaha* contracts was to dominate the spectrum of Islamic finance for the years to come with profit sharing agreements taking a back seat and only accounting for 10% of total operations. What *murabaha* contracts brought was capital certainty to the Islamic financial system, which essentially boosted their popularity amongst Islamic financial participants. Whilst the profit sharing modus of operation exhibited the Islamic financial desire for fairness and equality, *murabaha* contracts provided capital security.

A simple *murabaha* structure would involve the lender (bank) purchasing a certain commodity for the borrower who would then proceed to buy this commodity from the lender at cost plus a certain mark-up. This mark-up is essentially seen as the fee with regards to establishing the contract and bearing the risk (Iqbal and Mirakhor, 2007). The capital security is born out of the debt element of this structure. The lender/bank is guaranteed the payment of the cost plus some extra whilst the borrower is guaranteed the required commodity. Moreover, it provided additional security for the lender as the commodity was seen as collateral and *murabaha* contracts were seen as 'safer' than traditional profit sharing agreements (Siddiqui, 2008). The growth of the *murabaha* contracts had significant implications on the development of Islamic finance and whilst some argue (Vogel and Hayes, 1998 and Warde, 2000) its legitimacy and efficiency, its use spread significantly throughout the Islamic financial world. An analysis of these arguments about the legitimacy of *murabaha* contracts indicates that there exist two significant concerns involving risk-sharing and the rebranding of interest elements (Warde, 2000). A more quantitative study into the viability of incorporating PLS as the major form of financing as opposed to standard *murabaha* contracts in a financial system can be found in Presley and Sessions (1994). This study essentially took a model developed by Holmstrom and Weiss (1985) and incorporated the PLS element through an analysis of performance factors of the relationship between manager and bank within a *murabaha* contract. What was discovered from this study was that the informational asymmetry between manager and bank was more efficiently diminished under a PLS modus than standard debt financing procedures (Presley and Sessions, 1994).

Nevertheless, the 1980s and 1990s saw *murabaha* contracts earned full recognition from the Islamic financial society. Although efforts were made to revive academic interest in the area of profit sharing, there was not enough of a response from the Islamic financial economy. This was based on the lack of certainty behind these contracts when it came to financial reporting. The fear of false reporting and/or outright deception was too great. This was posited that financial practitioners valued security over the prospect of returns (Siddiqi, 2006).

Moreover, there were also concerns as to the viability of the use of profit sharing initiatives in certain areas of financing. For example the viability of profit sharing contracts was questioned when it came to financing public sector infrastructure projects. The argument was that while the cost of the projects was borne initially, it would take years for any profits to arise out of these projects (Siddiqi, 2006).

The 1990s up until present day saw the continuous development of Islamic financial macroeconomic policy and the want for increased profit sharing initiatives within Islamic finance instruments. With the advent of the 21st century there was also an increased focus on the development of several areas of Islamic finance, most notably risk management and governance. Within the realm of risk management, the concerns were for the lack of risk management instruments available to fund managers. In light of the financial crisis the use of *murabaha* and *bai al-salam* (purchase with deferred delivery) contracts to manage risk was insufficient. There have been some recent innovations (see Chapter 4, Section 4.2.1. for detailed description of product structures) that involve the use of multiple *murabaha* contracts, synthetic *murabaha* contracts as well as the structuring of an Islamic call option (*wa'ad*) (Dar and Azami, 2010).

Additionally, concerns regarding governance have been highlighted and these issues relate to uniformity of the Islamic financial system as a whole. The development of regulatory standards has to keep pace with the rapid growth of Islamic finance since its first 'experiment' in the 1940s. The propagation of new global Islamic hubs has meant that there are increased calls for further development of a standard code of conduct and guidance. The creation of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) in 1991 and the Islamic Financial Services Board (IFSB) just after the turn of the millennium has indicated that steps are being taken to address the growth and development of the Islamic financial system.

2.3. Islamic Finance in Practice - A Timeline

Khan (2010a) has suggested that the pursuit of Shariah-compliance and the drive towards the prohibition of *riba* (usury) in Islamic finance is a relatively modern (post 1945) idea but let us consider what *riba* is again. *Riba* or usury is the backbone of Islamic finance and is the source of much of the criticisms levied against the Islamic financial system (Iqbal and Mirakhor, 2007). Remember that *riba* is not the prohibition of interest but rather the charging of excessive interest. The foundations of the modern financial system are built on interest financing and the implementation of a financial system which views interest as unimportant seem plausible in theory but not always successful in practice (see Shepherd, 1996).

2.3.1. Islamic Finance in the Medieval Era

Udovitch (1970) suggests several pertinent questions with regards to the charging of interest within the context of historical and modern Islamic finance. These include:

1) To what extent was the prohibition of *riba* actually observed in actual practice?
2) Did this prohibition of *riba* inhibit the conduct of economic life?
3) Did it affect credit operations, money exchange and other operations associated with banking?

It should be noted that medieval timeline dates from the 8th till the 18th century. Udovitch (1970) highlights that while Muslims existing in a medieval Islamic financial framework were prohibited from engaging in usurious activities, there existed Christian and Jewish minorities within the same financial system who were not limited by Shariah laws. While all three, Muslims, Christians and Jews, have specific religious laws prohibiting usurious activities there did not exist constraints preventing them from inter-religious dealings. As such there really was no barrier to creating interest-bearing loans between them (Udovitch, 1970).

Whilst deposit taking generates two-thirds of modern Islamic financial revenue, this was a relatively foreign concept under a medieval Islamic financial framework. Deposit taking activities in this circumstance refer to interest-bearing deposits, where individuals deposit a sum of money with a bank that in turns safe guards it with some percentage capital growth annually. The prospect of interest bearing deposits was and is still seen as usurious within an Islamic financial framework. The circumvention of having these interest payments by modern Islamic finance is very much through a *murdarabah* structure whereby banks invest the money deposited and share the profits and losses. In essence these profits/losses would be seen as the interest on a standard savings account. However, this structure would suggest that should investments make a loss, depositors would lose some of their “capital” injection, which nullified the prospect of a conventional savings account. In its current incarnation, deposit facilities offered by Islamic and Shariah-compliant banks essentially make a “good faith” payment annually as a proxy for conventional interest-bearing deposit account (Siddiqi, 2006).

Within the context of medieval Islamic finance, Fischel (1937) highlighted that a deposit taking institution was essentially seen as an entity that safeguards money and in essence neither institution nor customer should derive more of a benefit (interest payments) from this arrangement. In contrast, Western banks of that time not only granted monetary safe guarding services but were also allowed to invest these deposits. The returns from these deposits were used, partially, as interest payments to depositors but were mainly retained as earnings to the bank. The benefits of these interest-bearing agreements was not lost on medieval Islamic financial institutions who in turn adopted a structure of tax-farming where a deposit loan was given in the promise that a lending institution would be able to collect the taxes from a designated area for a specified period of time (Fischel, 1937).

In essence the concept of understanding deposit taking under a medieval Islamic financial framework should be extended to precepts of credit within the Muslim world. Postan (1928) demonstrates that credit played a major role in trade within the medieval economy and this was extended into the Islamic economy of that period (see Udovitch, 1970; Giotein, 1961; Giotein and Shemesh, 1967), where buying and selling on credit was accepted and widely accepted in commercial practices. Medieval Islamic finance not only outlines the methodology of dealing in credit but also makes provision for through credit instruments such as *hawala* (debt payment through a transfer of a claim) and *suftaja* (bill of exchange). It should be noted that although *suftajas* were designated as bills of exchange, they in fact did not involve any form of exchange of currency. It basically consisted of a payment of a certain amount of currency to a certain merchant bank and is therefore more similar to a modern day cheque. Aside from both *hawala* and *suftaja* there also existed a broad range of credit papers known as *ruq'as*, which also appropriated the functions of a modern day cheque, although in contrast to *suftajas* these were mainly used for short distance and petty payments.

Additional acceptance of credit partnership (*sharikat al-mafalis*) also known as a partnership of the penniless, illustrates this wide acceptance of credit trades during this period (Udovitch, 1970). Principally, this credit partnership involves two parties forming a single entity to buy on credit and then sell in hopes of generating enough revenue to cover the credit purchase with some left over as profits. The role of credit transactions was seen as pivotal towards economic activities and Udovitch (1970) suggested that the main purpose of any credit partnership was the increase and creation of capital. The use of credit notices and services in medieval Islamic finance was in fact common practice on both a wholesale and retail basis where it was not exceptional for deferred payments. Granted that these credit services warranted a slight premium – two prices were usually quoted, one for cash transactions and one for credit transactions.

This acceptance of credit agreements in modern Islamic finance however is slightly more difficult to perceive. While products such as *Bai al-salam* contracts are accepted, their use is not widely documented outside of agricultural transactions (Helliar and Alsahlawi, 2011; Kaleem and Wajid, 2009; Obaidullah, 2002). There is also evidence of a *bai al-arboun* (sale with deferred payment) where the buyer was granted a fixed period in which to decide to exercise the contract – a maximum of three days – however three days does not provide much benefit in terms of credit services. Moreover, the use of the *bai al-arboun* is widely disallowed in the Gulf States in the modern Islamic financial spectrum as it was stipulated to bring about *gharar* (uncertainty) (Dali and Ahmad, 2005; Obaidullah, 2002; Salehabadi and Aram, 2002; Obaidullah, 1998). The use of modern credit facilities such as derivatives instruments is explicitly disallowed within modern Islamic finance.

This proliferation and acceptance of credit services in medieval Islamic finance encouraged the growth of international trade and as such lead to a requirement for currency exchanges and merchant banking services. Financial participants of that era, who were engaged in international trade, required a medium by which to exchange currencies or make payments in distant lands once goods were delivered. Udovitch (1970) highlights that money exchange services of that era were not undertaken by merchant bankers and money changers alone but rather any merchant with the ability to provide these services. This meant that the foreign exchange market of that era held very little regulation and prices were governed by that of intrinsic value and the laws of supply and demand.

Another pertinent question posed by Udovitch (1970), which goes a long way towards explaining the development of Islamic finance through the ages is, with the increased development and acceptance of both commercial and merchant banking services in medieval Islamic finance, why is it that there were no banks? There existed individuals who provided the services of a bank, albeit this was more a form of specialization. For example, one individual provides credit notes and another provides depository services but yet there existed no single financial entity that provided all these services under one roof unlike that of medieval Western finance. This, Udovitvch (1970) postulates, could be attributed to the strict meaning of deposit taking institutions and the loose structure of the money market of medieval Islamic finance. Additionally, it has been suggested that this lack of development of central banking entities was a question of social context. There was an increased importance place upon social relationships within these commercial activities. With all the development of credit notes and services these activities very rarely extended beyond social-personal relationship. This could have been a cause for the retardation of the growth and development of medieval Islamic finance. Moreover, Udovitch (1970) also indicates that while there were Arabic words for specific financial activities such as money exchange and loans, there was nothing describing the general framework of banking and finance. The focus on small intimate financial circles and networks basically meant that while this facilitated a smooth functioning of financial services within the medieval Islamic financial system, it in fact also limited its growth on the broader financial spectrum as these relationships could not be extended further to distant lands.

From the comprehensive historical study of medieval Islamic finance provided by Udovitch (1970) it can be seen that the sluggish progress of Islamic finance was down to the fact that the financial system was based around close knit relationships and that these relationships failed to extend beyond a certain circle. The ability of Western financial systems of that period to engage in commercial activities that were not borne out of developing close ties meant that there was more scope for significant growth in international trade. Moreover, fundamental Western trading methods such as the development of international bankers meant that the closed relationships and trust between contracting parties were not required to safeguard and guarantee the success of a transaction. This allowed for more freedom of movement for the growth of Western financial systems whilst Islamic financial systems struggled to break out of the familial circle.

Effectively, Islamic finance was not practiced on wide scale basis and was overshadowed by Western finance or what is accepted today as modern mainstream finance. The next major milestone for Islamic finance began during the post-World War II colonial period when many parts of the Islamic nation were, for the first time, able to govern themselves (Schaik, 2001). This led to widespread aversion for foreign social-political concepts and in turn created a strong inclination for a return towards traditional Islamic values (Schaik, 2001). The Marxist and capitalist concepts of Western finance were seen as very much foreign to the spectrum of Islam and this saw the adoption of the development of a financial system that was based on the theories and teachings of Shariah. This was the beginning of the modern Islamic financial system as we know it today (Khan, 2010a)

2.3.2. The emergence of Modern Islamic Finance

The first instances of modern Islamic Banking and Finance took place during the 1940s and 1950s in Malaysia and Pakistan which involved small experiments with Islamic banks but it was not until 1960s that saw the creation of the Mit Ghamir Bank in Egypt and Tabung Haji in Malaysia that the global economy possessed modern Islamic financial institutions. With the capital growth of the Gulf States during the 1970s, due in part to the wealth of oil in the region, this period saw the creation of commercial Islamic banks such as that of Dubai Islamic Bank, Kuwait Finance House and Bahrain Islamic Bank. The growth of Islamic finance during this period also created an increased impetus within the realm of Islamic financial academia which in turn aided growth and development of Islamic finance on a global scale (Schaik, 2001). For the first time, modern financial systems were able to understand the concepts of Islamic finance and the operations of a financial system that existed without interest.

The first half of the eighties saw the complete 'Islamisation' of the banking systems of both Iran and Pakistan while the second half of the nineteen eighties were not as favourable to this new financial system in the wake of unrest in the Middle East (Siddiqi, 2006). Over the next three decades from the early nineties up until present day saw the expansion and acceptance of Islamic finance into modern financial systems of the East and the West. Islamic financial hubs were created in large economics such as Japan and Hong Kong in the East to the United Kingdom and America in the West. A further development of the Islamic financial ethos was the adoption and provision of Islamic financial products within standard conventional banking, which in essence saw Islamic finance running in parallel to mainstream finance (Malik *et al.*, 2011). However, the growth of Islamic finance through the current financial crises should not be overstated and while Islamic finance has experienced significant growth since the turn of the millennia, expectations of development for the future should be grounded and modest. Figure 2 below provides a diagrammatic illustration of the temporal progression of Islamic finance from medieval to modern times. The red arrows denote major event of the Islamic financial timeline whilst the blue arrows highlight the use of major Islamic financial products and concepts of the respective periods.

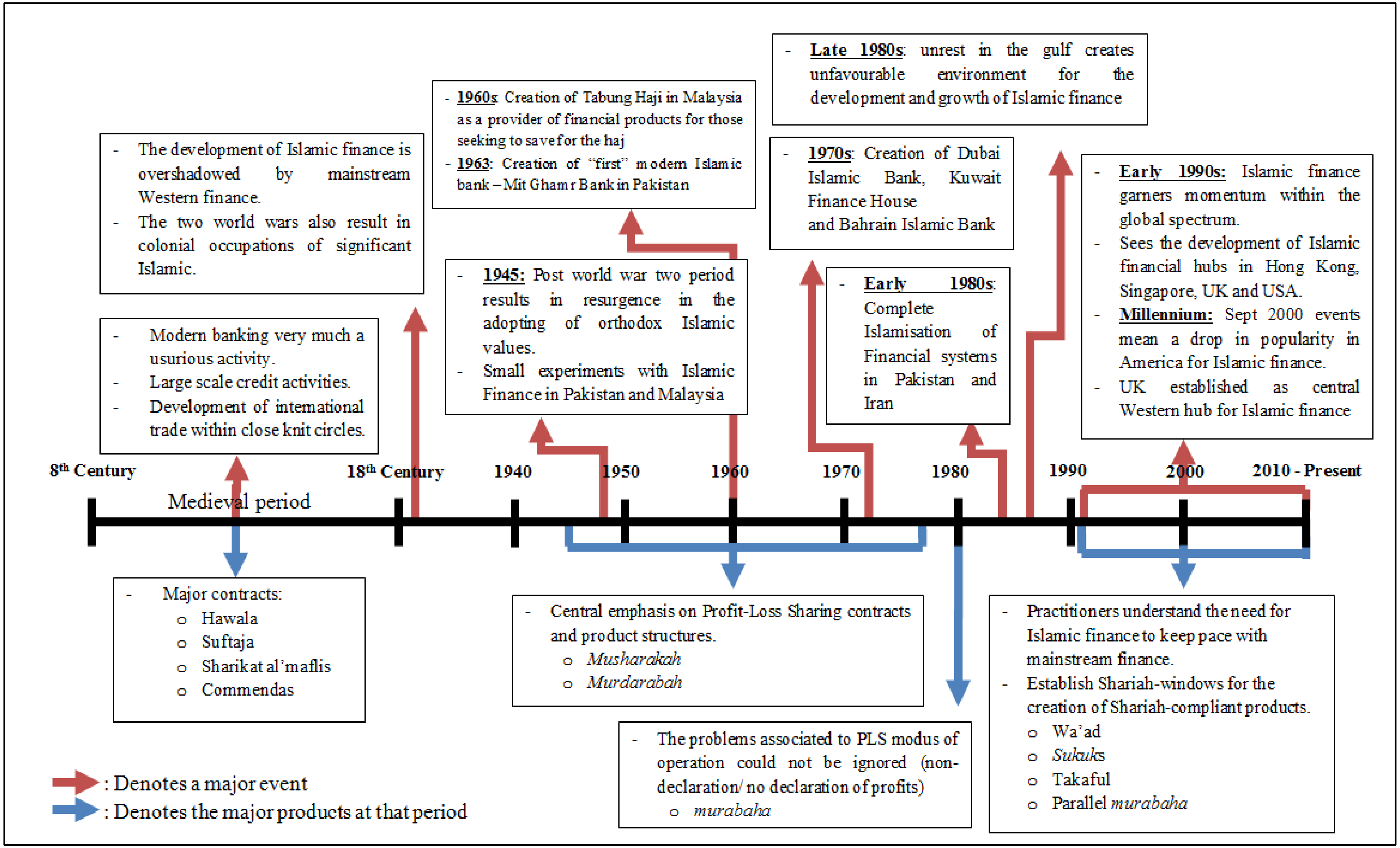

Figure 2: Islamic finance: - A Timeline

2.4. Summative Remarks

Chapter 2 aimed to provide the reader with a historical perspective of Islamic finance in practice. It highlights the operations of the medieval Islamic financial system and underlines, briefly, its day-to-day workings. What can be seen is that medieval Islamic finance has widespread acceptance of credit facilities and was built on close-knit trading relationships. In essence this was a significant reason for its decline through medieval times. These close-knit trading facilities were unable to compete with the informal trading relationships of medieval Western finance whose structure was more conducive towards developing international trade, banking and finance. The chapter has also examined the scope and beginnings of modern Islamic finance. Significantly, what was discovered was that modern Islamic finance did not truly begin until after the Second World War. Moreover, the chapter also highlights the introduction of prominent Islamic financial contracts and the shift of Islamic finance from PLS to debt-financing. Chapter 2 sets the scene for the following chapter, which provides an accompaniment of actual practices to Islamic financial theory.

This chapter provides the reader with an overview of the practical and academic development of Islamic finance. It highlights the change in paradigm of Islamic financial thought with an initial focus on profit and loss sharing being substituted for debt financing and the growth in prominence of *murabaha* contracts throughout the Islamic financial world. In term of the development of the practical application of Islamic finance, what can be seen is that Islamic finance in the medieval world was significantly different from what is now accepted as modern Islamic finance. Nevertheless, the lack of growth in the prominence of medieval Islamic finance when compared the Western finance of that period was down to operation differences. Medieval Islamic financial systems existed in a spectrum of close knit business relationships based on trust which made expansion into international trade difficult which in turn slowed its progress as a financial system. Modern Islamic finance came to fore after the Second World War and its growth has been steady ever since.

3. Overview of the Islamic Financial System

3.1. Introduction to Chapter

The following chapter aims to provide the reader with an overview of the literature behind Islamic finance and introduces the major themes of this research. Section 3.2. and 3.3. provides an introduction to the workings of Islamic finance, placing specific focus on *riba*, *gharar* and *maysir* (gambling). This research considers these three elements as central tenets of Islamic finance and the section considers current and key discourse around them. However, it should be noted that there are further doctrines of Islamic finance that will be documented in latter paragraphs of Section 3.2. Section 3.4. highlights the sudden growth of Islamic finance in the 20th century providing a detailed analysis of the factors that contributed to this growth. It also provides an illustrative look at the proliferation of Islamic finance globally.

Section 3.5. introduces the concept of Shariah-compliance and its continual development in Shariah financial systems. The section describes the types of Shariah windows and the criticisms levied against the use of these screens in the creation of Shariah-compliant products and services. The major activities and financing principles of Islamic Financial Institutions (IFIs) are explained in Section 3.6. with particular importance placed on the composition of PLS to Non-PLS modes of financing. Section 3.7. and 3.8., provide an introduction Islamic capital markets looking at Islamic bonds, equity and insurance respectively. Section 3.8. provides a summary of Chapter 3.

3.2. The Modern Islamic Financial System

The growth of Islamic finance over the last 40 years has been rapid. More recently, during the 1990s Islamic indices were created in both New York and London (Hussain, 2004; Hussein, 2007). These indices consisted of companies who adhered to Islamic law and as such were not engaged in any services that were seen as *haram* (forbidden). Aside from this, the creation of a regulatory body, Islamic Financial Services Board and the issue of *sukuks* (Islamic bonds) further illustrate the development of this financial system to a point where it can no longer be ignored as a plausible outlet for potential diversification opportunities (Iqbal and Mirakhor, 2007; El-Hawary *et al.*, 2004).

During the latter periods of the 20th century there existed sufficient demand for Islamic banking which resulted in the creation of what is widely believed to be the world's first modern Islamic bank, Mit Ghamir Local Savings Bank located in Egypt (Mayer, 1985; Kahf, 2004). Since then the world of the Islamic financial system has evolved rapidly as traditional Western financial institutions realised the significant opportunities that such a system provided. The use of 'Islamic windows', where traditional Western financial institutions set-up specialised entities to provide Shariah-compliant products to consumers, illustrated the importance placed upon the development of this infant financial system (Derigs and Marzban, 2008; Grene, 2009). Examples of the use of these 'Islamic windows' can be seen from the creation of Citi Islamic Investment Bank in Bahrain by Citi Group (CitiIslamic, 2012). Additionally, the aggressive development into the Islamic financial market by institutions such as Hong Kong and Shanghai Banking Corporation (HSBC) would illustrate that this market can no longer be ignored as a viable investment outlet.

Over the past 6 years, the tumultuous economic environment of traditional Western markets has led many firms to seek diversification opportunities. As such, it could be considered that the ability for financial firms, in these stringent times, to be able to diversify into various other markets is one of significant importance in order to provide for an element of liquid security. Liquid security in this context refers to the ability to convert assets into cash. The growth of Islamic financial markets, as such, has not gone unnoticed over the years and has now matured into an industry that is currently worth $951 million (IFSL, 2010). However, the Shariah (Islamic Law) that governs these financial markets has to be carefully adhered with before any transactions for risk management purposes can take place. With elements such as *riba*, *maysir* and *gharar* not allowed under Shariah law there leaves a certain degree of greyness when it comes to risk management (Obaidullah, 1999).

Islamic banking and finance operates on a profit and loss sharing (PLS) basis through concepts such as *musharakah* (equity partnership) and *murdarabah* (partnership) (Dar and Presley, 2000). Under these concepts financial institutions provide an element of finance to firms or private individuals, who will in turn make use of this capital injection. From this use of capital, either profits or losses are shared amongst the financier (financial institution) and financed (borrower). PLS contracting is considered a staple for Islamic institutions and it adheres to every aspect of Shariah. However, research done by Dar and Presley (2000) has suggested that only 20% of Islamic banking activities include aspects of PLS contracting. This research has also highlighted that much of the effort made by Islamic banks mainly concentrates around other Islamic products such as mark-up sales, leasing activities and financial partnerships (Khan, 2010b).

Let us consider one of the most widely use contracts in Islamic finance, a *murdarabah* (financial partnership), whereby two parties come together to engage in an investment. One party in the arrangement provides the capital, while the other party provides the expertise. In essence the former party acts as the sleeping partner. The profits and losses from the investment will be shared out in a predetermined ratio, which is agreed prior to contracting. A significant problem with this arrangement would be principal-agent issues. The party with the capital may not entirely share the same business sentiments as the party with the expertise in the running of the business. If the parties were substituted for a bank and a small business respectively, the bank would like to ensure that the small business is maximising its profit potential while the business maybe more focused on its customer experience. Now this is an extreme example but these concerns could possibly be alleviated through stringent credit checks. The fact that PLS essentially brings to fore principal-agent issues has meant that many Islamic banks are now engaging in practices that imitate that of their traditional Western counterparts. These actions have had a mixed response within the Islamic and Western financial world (Presley and Sessions, 1994; Sarker, 1999; Jobst, 2009). Whilst some feel that Islamic financial systems are failing their Shariah obligations, others believe that the continual development of Islamic banking is a natural direction (Dar and Presley, 2000). There is a need for a general evolution of Islamic finance to meet the requirements of today's financial system. This is not to encourage a diluting of Islamic financial principles but an adaptation of their interpretation in trying to cope with an ever-changing financial world with new risks.

A major area of Islamic financial activities would be in the area of sales. Unlike traditional Western financial systems, sales agreements under the canons of Islamic finance take on a different financial framework. Concepts such as *murabaha* and *tawliya* (trade at cost) may seem similar to Western contracts but a strict Islamic stipulation would be that the seller of these products must also be the owner (El-Gamal, 2006). Therefore, 'short' selling of assets or commodities would be disallowed under the Islamic financial framework. Finally, another major activity of an Islamic financial system would be the development and maintenance of Islamic equities. In essence, these equities would be traded on a stock index and would encompass shares from firms that engage in *halal* (permissible) activities. So what essentially constitutes being halal? Now it would be easier to provide a list of what trading activities are prohibited and these include the sale of pork, investment banking services, assurance products, arms and munitions, tobacco, alcohol and drugs. However, there has been some criticism about companies belonging to these indexes. El-Gamal (2006) has stated that the use of Islamic screens in trying to determine if shares are Shariah-compliant is substantially subjective in nature. A more detailed explanation of these Shariah Screens/Windows is provided in Section 3.5. This in-turn has led to compromises being made about certain stocks and the subversion of critical Islamic laws.

A recent ethical trend would be the concept of 'green' investments. 'Green' investments essentially involve the investment of funds into environmentally sound practices. Islamic finance is not so different from its Western counterparts in this sense. Maybe not in the same ethical context of 'green' investing but nonetheless the selection of investments to meet a certain criteria is of significant importance (Wilson, 1999).

Islam suggests that there is a nexus between the Creator, man and the society on the basis of Divine Law that governs most aspects of life. It is based on this law that the rules surrounding Islamic finance are built (Iqbal and Mirakhor, 2007). It could be said that Islamic finance would quintessentially be a financial system that prohibits interest. However, efforts to try and explain this system of 'no interest' or the prohibition of *riba* are only a few decades old and in that time a considerable amount of literature has been published as highlighted in the review of the academic development of Islamic Banking and Finance in the previous chapter.

As such, the concept of Islamic finance is built around the ideology of the Islamic religion and this has been its focal point

> "… the strength of ideology determines the strength of rule-compliance, and therefore the strength of institutions, which, together with technology, determine the performance and efficiency of an economic system." (Iqbal and Mirakhor, 2007, pg. 6)

Non-interest banking or Islamic finance has been in existence for centuries. However, within the context of the modern economic world, its presence is widely regarded as developing, albeit at a rapid rate. As stated before, the laws that govern Islamic finance are derived from Shariah law, which are in fact Divine law based on the verses of the Koran.

Although Shariah financial law, to a certain extent, is open to interpretation as to its severity, its intention is "for fair play and justice to all parties involved in the transaction" (Bacha, 1999). Having established these stipulations under the Islamic financial framework, the use of traditional Western risk management tools such as derivatives securities is still highly debatable. Many scholars such as Obaidullah (1999) and Bacha (1999) have suggested the need for an evolution of Islamic finance to take into consideration the use of these risk management tools as the economic environment surrounding Islamic finance is ever changing Adequate development of the system should, in the same instance as traditional Western financial systems, be a proactive requirement rather than a reactive condition. A more detailed discussion of risk management under the Islamic financial framework is provided later in this study (See Chapter 5).

3.3. *Riba, Gharar* and *Maysir*

Islamic finance, as its name suggests, adheres to the rules of Islam and as such seek to prohibit *riba* and prevent the onset of *maysir* and *gharar*. *Riba* or the charging of interest is a significant discussion point when it comes to Islamic financial activities, not only from the precepts of Islamic financial institutions but also from the perspective of Western mainstream financial systems. Islamic finance is widely known as non-interest banking within the mainstream financial world and much of the scepticism of mainstream financial participants about Islamic finance stems from this prohibition of *riba*.

3.3.1. *Riba*

Almost every financing method in today's modern economic society includes some form of interest element. Place a deposit in a bank and interest is expected. Take a loan out from a bank and interest is paid. Lend to the government and once again interest is expected to be paid out. On a more macro-economic scale the foundations of sovereign lending and borrowing is built of the foundations of interest.

Interest financing has been the system in place for the better part of two centuries and it plays a vital role towards an understanding of how the modern financial system works. The concept of interest creates a safeguard and remuneration package for both individuals and countries to lend to each other (Presley and Sessions, 1994). It also forms a standard measure of risk and return. So how is it that a financial system could possibly believe that it could make do without interest? Under the Islamic financial model a structure was found that accommodates the lack of interest, albeit, not in the best of ways. It is not the interest percentage that is explicitly disallowed under Islamic finance. On the contrary, it is common to see elements such as the London Interbank Lending Rate (LIBOR) or even Eurobond lending rates existing is Islamic financial contracts (Khan, 2010a; Chapra, 2006).

Even IFIs understand that these are the prevailing rates with which to structure financial products. The purpose of this new financial system is not to create arbitrage opportunities for global traders now is it? It is not the interest rates that cause a moral concern in Islamic finance but rather the fact that when financial institutions charge interest it is basically charging money for money (Khan, 1986; Ahmed *et al.*, 1996; Choudhury, 1997; Chapra, 2006; 2007). The concern for Islamic finance here lies in the tangibility of the product that individuals are being charged for and this is where the argument begins. Islamic finance views the charging and the paying of interest as essentially free money or money for money (Chapra, 2006). Customers for a bank place deposits in the bank and expect interest on their deposits for, what Islamic financial principals argue as no work in return for payment. Under Islamic finance, the real economy is the principal economy. Payment should only be made for a product or service in which both parties play an active part in achieving. This can once again be related back to bank deposits. In its staunchest of interpretations, depositors should receive no interest on any cash deposited as no work has been done to warrant this additional payment. Conversely, banks who lend to customers can only command the amount lent and not an additional interest payment.

It is possible to see the merits of the argument presented at hand as no individual would want to pay extra for an apple just because it was plucked personally, but that is how the modern economy works. It is not exploitation for a local grocer to charge extra for an apple that has to be transported, kept fresh and displayed in a store front to entice customers. These are all real and tangible costs in selling a product. With relation to banks and other deposit taking institution, interest rates are paid for risk being borne by the lenders so it is only fair to compensate for this risk taking. So theoretically speaking, is the Islamic financial model an overtly extreme stance on financial prudence? Yes and no. Yes in the sense that the Islamic financial system believes principally in the real market, where invariably real market activities will lead to stauncher controls on financial activities. The requirement of Islamic finance for proof of ownership before the sale of an item means that risk-seeking activities such as speculation are disallowed (El-Gamal, 2006; Iqbal, 2007). No short selling either in this case. It basically involves a more rigid stance on financing, risk management and investment banking. The emphasis of Islamic finance on having "real" transactions has meant that there is an increased importance placed upon profit-loss sharing (PLS) modes of financing and in fact most Islamic financial instruments can be broken up into participatory (PLS sharing) and non-participatory (Non-PLS sharing) subsets (Khan, 2010b).

On the other hand however, *riba* is not only about the interest rate. More specifically, it is about the charging of excessive interest and in reality this argument is really about exploitation and how interest payments could result in detrimental outcomes in both the micro and macro economies (Chapra, 2007). The argument lies with the fact that the charging of interest will invariably lead to one party in the transaction absolving themselves of responsibility from the deal. A good example to illustrate the Islamic argument for *riba* is a standard repayment mortgage. After a 'rigorous' credit check, a bank provides a mortgage to an individual. Should the customer default on payments the home is repossessed. This structure is considered as *riba* under Islamic finance as it is seen as money for money. The answer to this argument can be seen in the Islamic alternative to mortgages – hire purchase. Now hire purchase is not new to mainstream finance and is still widely used in the global manufacturing industry for the purchase of industrial machinery and its financing structure remains the same under Islamic finance. Bank buys house and lets it out to customer who then buys house off from the bank over a fixed period. The fact that both parties have to actively engage in achieving their end goal – the bank having to ensure that the house is being taken care of and the tenant/owner having to ensure that payments are being made to guarantee a roof over his/her head – means that this agreement exists in the real sense (El-Gamal, 2006). Both parties have a role to play in the fulfilment of this contract.

Having this agreement exist in the spectrum of "real economic activity" essentially nullifies the concerns of the principle-agent theorem of debt financing. Both parties play an active part in the initial formation and the continual maintenance of the agreement and thereby should be rewarded accordingly. For the customer, the end result is a family/investment property and for the bank, the repayments plus "a little extra" every month are a justifiable profit for undertaking the risk of the hire purchase.

It is possible to argue continuously and contentiously (see Dar and Presley, 1999; Chong and Liu, 2009; Khan, 2010b) about the fact that the Islamic financial methodology of structuring a financial product is just a rebranding and renaming of different elements of mainstream financial products and likewise that calling an apple by any other name does not change the fact that it is an apple.

As such the prohibition of *riba* in Islamic finance is not a prohibition of interest as a whole but rather interest financing. Prohibiting *riba* is mainly an exercise in trying to re-establish the real value of financial products by forcing these structures to actively exist in the real economic sense (Chapra, 2006; 2007). In essence Islamic finance is not trying to change the global financial market place but rather create a parallel financial system which focuses more on the real economy.

3.3.2. *Gharar* and *Maysir*

Aside from forbidding *riba*, Islamic finance also seeks to reduce *gharar* and *maysir*. It is possible to draw parallels between Islamic and mainstream finance at this juncture. The want to reduce the effects of uncertainty and gambling in any finance system are not limited to only Islamic finance but are also prevalent in the mainstream financial world. With the advent of the 21st century and the development in information technology, there are now tools available to manage the levels of uncertainty and mitigate the detrimental effects of dubious speculative trades with the conventional banking and financial systems. The Islamic financial argument for the creation of uncertainty stems from the concept of *jahl* (lack of knowledge) and that this lack of knowledge is exacerbated by the proliferation of gambling (Bacha, 1999; Honohan, 2001; Smolarski *et al.*, 2006; Mohammed and Tabatabaei, 2008). Gambling should not be confused with speculation but one can be excused for drawing similar underlying tendencies between the both.

These arguments for speculation and gambling extend to that of the Islamic financial system. The fact that Islamic finance abides by the rules of Islam does not mean that market participants will not try to exploit the loop-holes and the fledgling governing foundations that exist in Shariah finance (Al-Dhareer, 1997). A core purpose of any financial system is the creation of wealth and where there is money there will be people who will try anything to make it.

Now the Islamic argument for uncertainty and gambling is that it arises out of *jahl* and aside from controlling gambling, this lack of knowledge can also be combated through the provision of information about products and services (Bacha, 1999). Due to the fact that Islamic finance is relatively new in the financial spectrum, many individuals, both practitioners and customers alike, have little knowledge of how Islamic financial products and services are structured (Maurer, 2002). This is not helped by the combination of a lack of information and the convoluted websites of these IFIs (Sundararajan and Errico, 2002). In order to combat this lack of knowledge more effort has to be made to "educate" the market about the position of Islamic finance. This should also work in the opposite direction and more effort has to be made to abate the inherent scepticism of mainstream market participants of Islamic finance (Iqbal, 2007; Wilson, 2007; Shaikh and Jalbani, 2009).

3.4. The Sudden Growth of Islamic Finance

With the inherent differences between Islamic and mainstream finance, one has to wonder about the sudden global interest in this fledgling financial system. Research has indicated that throughout the periods of 2000 up to 2008, Islamic finance grew by an average of 20% per year, with year on year growth improving up until the financial crisis (Ernst & Young, 2011a). Islamic financial services and products were valued at upwards of $950 billion and Islamic financial hubs were being established in both Western (American, British and European) and Far Eastern (Japan and Hong Kong) economies (IFSL, 2010). The branching out of these hubs from their more traditional homes in Islamic countries such as Malaysia, Indonesia, Pakistan and the Gulf States highlighted the sudden embrace of the mainstream economies for Shariah finance. This rapid growth can be attributed to a two-stage argument.

The prominence of Islamic finance really took off during the boom years (1980s – 1990s) and more recently at the start of the new millennia. The global economy was experiencing an unusually strong bull phase. With this level of growth, there was an excess of capital in the market, which could be one of the causes of the quick development of Islamic finance. Institutions were always looking for new investment prospects and the size of the global Islamic population provided a market that was virtually untapped on a global scale. Additionally, the results of a well performing financial sector largely generate an increased level of consumption, which in turn results in an increase in manufacturing. The rise of China's manufacturing sector and consequently China's oil consumption meant that oil rich countries in the Middle East were a hive of activity. This left Middle Eastern businessmen looking for investments that could, effectively, generate a return whilst observing their ethical, moral and religious beliefs (Shepherd, 1996). With an increasingly wealthy Gulf region looking for an alternative financial and banking system that adhered to their religious beliefs, it wasn't long before other traditional mainstream financial systems saw the benefits and potential profits of setting up Islamic financial hubs.

The strong ties of the Middle East with countries such as Malaysia and Indonesia have resulted in the rapid growth of Islamic finance in those regions. Moreover in the case of Malaysia, growth and development could also be attributed to government's initiative of promoting Islamic finance to a population that comprised largely of a Muslim majority (Aziz, 2006). Malaysia has been largely leading the way for the development of Islamic banking and finance in the Far East and over the past 30 years has developed a strong regulatory foundation for Shariah finance. Initiatives such as the Islamic Banking Act 1983 and the *Takaful* Act 1984 highlight the strength of the development of the Malaysian framework for promoting Islamic Banking and Finance in the country as well as the region (Dar and Azami, 2010). This stable regulatory standard has resulted in innovative developments within the Shariah financial industry with the creation of several Shariah exchange traded funds, unit trusts and *sukuk* issues (Dar and Azami, 2010). In 2004 measures, which taken to eliminate tax anomalies between Islamic and conventional finance, were included into the Federal Budget to bring Islamic finance to a more level playing field with conventional finance in the country (Dar and Azami, 2010). Figure 3 below illustrates key milestones in Malaysia's development of Islamic Banking and Finance in the country.

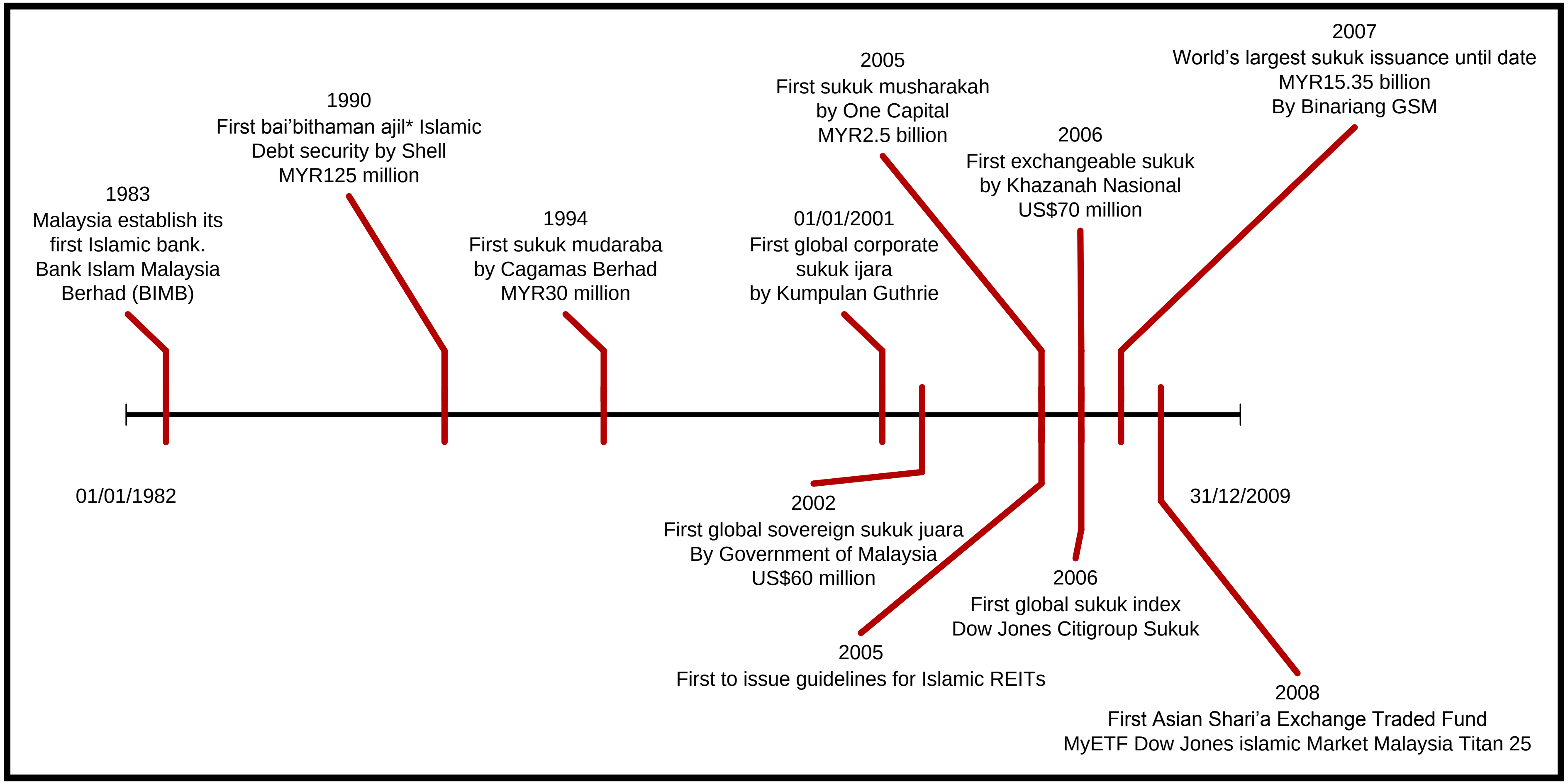

Figure 3: Key Milestones in the development of Malaysia’s Islamic Capital Markets (Source: Dar and Azami, 2010)
*bai’ bithaman ajil: deferred payment sale

The development and adoption of Islamic finance in the West, however, was a varied bag of experiences with the growth of Islamic finance mainly concentrated in the United Kingdom and European region. In the USA, until 2000, the growth and development of Islamic financial products and services grew at a steady rate however, in the wake of the September 11th attacks and the resulting War on Terror, Islamic finance quickly dwindled in the American economy (Khan, 2010a). This was the outcome of Muslims not wanting to invest in America for the war and Americans shying away from Islamic financial products and services due to its perceived associations to terrorism (Kahf, 2002 and 1999; Ali and Syed, 2010). However, in either sense, every attempt was made to revive Islamic finance in the US with the launch of the Dow Jones Bursa Islamic Index, which was a joint effort between America and Malaysia and while early signs were positive, its success ultimately was undermined by a lack of global interest (Khan, 2010a). As can be seen from Table 1 below a major success story of Islamic finance in the West would be the UK with the birth of Islamic banks such as the Islamic Bank of Britain (Ainley *et al.*, 2007; Wilson, 2007). Additionally, the launch of Shariah-compliant banking and financing services by more mainstream banks such as HSBC and Citi-group in the UK has also cemented its spot as the only Western economy in the top ten of market capitalisation of Islamic financial products and services illustrated in Table 2.

Number Located in Each Country	
UK	22
USA	9
Australia	4
France	3
S. Africa	3
Switzerland	3
Canada	1
Cayman Islands	1
Germany	1
Ireland	1
Luxembourg	1
Russia	1

Table 1: Islamic Banks in Western Countries & Offshore Centres (Source:IFSL, 2010)

	Total 2007	Total 2008	Banks	*Takaful*	Other	Number of Firms
Iran	235.3	293.2	290.6	2.6	---	23
S. Arabia	92	127.9	127.1	0.8	---	20
Malaysia	67.1	86.5	84.4	2.1	---	37
UAE	49.1	84	83	2.1	---	18
Kuwait	63.1	67.6	57.4	0.2	10	30
Bahrain	37.4	46.2	44.2	0.4	1.6	34
Qatar	21	27.5	25.3	0.4	1.8	16
UK	18.1	19.4	19.4	---	---	6
Turkey	15.8	17.8	17.8	---	---	4
Bangladesh	5.7	7.5	7.5	---	---	15
Sudan	5.3	7.2	7	0.2	---	22
Egypt	5.7	6.3	6.3	---	---	3
Pakistan	6.3	5.1	5.1	---	---	18
Jordan	3.3	4.6	4.5	---	0.1	6
Syria	0.6	3.8	3.8	---	---	2
Iraq	---	3.8	3.8	---	---	1
Indonesia	3.4	3.4	3.2	0.2	---	20
Brunei	2.7	3.2	3.2	---	---	1
Others	7.2	7.1	6.5	0.4	0.2	26
Total	639.1	822.1	800.1	8.3	13.7	302

Table 2: Islamic Finance by Country (Source: IFSL, 2010)

3.5. An Examination of Shariah-windows/screens

The research has spoken about the proliferation of Islamic financial hubs globally in the West and the Far East but has not indicated how Islamic finance exists within these hubs. Broadly speaking Islamic finance can exist in three different banking and finance models within any financial system (Khan, 2010a). The first model is basically the adoption of a completely

Islamic model where the entire financial system is purely Shariah-based, such as in Pakistan and Indonesia. The second model is a parallel banking system whereby Islamic and standard finance are offered in the market place. This is the model adopted by Malaysia who now possesses highly developed Islamic and mainstream financial markets offering Shariah-based, Shariah-complaint and traditional mainstream financial products. The third and final model of Islamic financial adoption would be a standard financial system incorporating and accommodating Islamic finance through the use of Shariah windows/screens.

In recent years there has been significant development of Shariah-compliant funds that are now traded globally on developed exchanges such as the London Stock Exchange (LSE), the New York Stock Exchange (NYSE) and National Association of Securities Dealers Automated Quotations (NASDAQ). The creation of indexes such as the FTSE Bursa Malaysia EMAS and Hijara Shariah Index (quoted on the LSE) and a host of Dow Jones Islamic Indexes has meant that Shariah Compliant Indexes (SCIs) are now more readily available for the traditional Western, mainstream investor. These indexes essentially include companies that adhere to a number of criteria known as Shariah screens, which impose a halal standard on the activities of companies.

Before going on to discuss what Shariah windows are, it will be best to make the distinction between Shariah-based and Shariah-compliant. Throughout this thesis, the author will make reference to Shariah-based products and Shariah-compliant products. Shariah-based products are based rigidly around the laws of Islam. In theory these are the “true” Islamic financial products as they fully abide to the rules of Islam. On the other hand, Shariah-compliant products are based on the Shariah standards of the Shariah/Islamic windows (Sundararajan and Errico, 2002). This is basically a relaxed interpretation of the rules of Islam to create and foster the development of new Islamic financial products, which are able to deal with the rigours of modern global finance. It should be noted that Islamic financial systems are not forced to exist and operate at either standard's spectrum of Shariah-based or Shariah-compliance but rather these standards run in tandem. It is possible and very common for Islamic financial systems to have both Shariah-based and Shariah-compliant products on offer.

As stated earlier Islamic banks exist in three different spectrums namely as Islamic banks that belong to a wholly Islamic financial system, Islamic banks that operate in a conventional financial system and conventional banks that offer Shariah-compliant products and services. The main issue for banks in all three categories would be Shariah governance. For the former two categories, Shariah governance would present itself in trying to ensure the Shariah integrity of the Islamic financial products and services that are being provided and to guarantee that business transactions of banks do not transcend into haram activities. For the latter category Shariah governance has more to do with the assessment of Shariah-compliance. As Islamic finance has grown there has been a tendency to replicate conventional financial products using Shariah concepts that blur the line of Shariah-compliance (see El-Gamal, 2006; Errico and Farahbaksh, 1998; Khatkhatay and Nisar, 2007a; 2007b). Table 3 below highlights the Shariah-screens used by a Western financial system in assessing the Shariah-compliance of new Islamic financial products and services.

	DETAIL
Main line-of-business screen	Income from non-permissible activities has to be less than 5% of total revenue generated by a company
	Financial ratios screens:
Liquidity screen	The sum of accounts receivables, cash and short-term investments should not exceed 50% of the total assets (or market capitalisation) of a company
Interest screen	Interest income may not represent more than 5% of total revenue of a company
Gearing screen	The portion of total debt may not exceed a certain threshold (either 30% or 33%) of total assets (or market capitalisation) of a company

Table 3: Description of main screens (Source: Obaidullah, 2009)

Note: non-permissible activities (haram activities) include engaging in the sale of alcohol, tobacco, gaming, arms manufacturing, life insurance, pork and banking.

These Shariah windows/screens can be broken up into two categories, namely line-of-business and financial ration screens. Line-of-business screens make reference to the principal business activities of any institution. Should any more than 5% of total income arise from these principal business activities, the company is no longer Shariah-compliant under this screen. What can be see is that line of business screens are qualitative in nature and although some objective (i.e. numerical) thresholds do exist such as the proportion of turnover generated by the forbidden activity (for instance alcohol is sold by airports but that is not the main line of business and therefore they account for a small proportion of their turnover), this type of screen may require a potentially subjective interpretation of Shariah law. This concern is shared by El-Gamal (2006) and Wilson (2004) who state that being subjective in nature, these line-of-business screens may be difficult to govern and may require continual monitoring. This monitoring and compliance with the screen, however, can only be reviewed in line with the frequency of official reports by companies as observed by Derigs and Marzban (2008).

Derigs and Marzban (2008) provide a useful review of the screens as defined by the Shariah boards of different organizations involved in offering Sharia-compliant indexes[2]. They find a high degree of similarity in terms of which industries are included and whether to totally exclude companies partially involved in haram activities.

The financial ratios screen can be further broken up into 3 subsets including, liquidity, interest and gearing screens. As their names suggest these focus on the liquidity, interest and the gearing of the institution in question. With regards to liquidity, a company is required to maintain less than 50% of market capitalisation in cash and short term investments. Interest screen requires that no more than 5% of total income can come from interest revenue and the gearing screen demands that the portion of debt held cannot exceed a stipulated threshold. This limit is commonly set at either 30% or 33% but would depend on the various exchanges with their own interpretation of Shariah law (Khatkhatay and Nisar, 2007a).

Although the financial (ratios) screens are relatively easier to implement, they still present a number of challenges. Similar in spirit to the capital adequacy requirements set out in the pillars of the Basel Accord, these financial ratio screens provide a (tentative) quantitative framework by which companies will be assessed. Some commonly used ratios in this context are a 33% threshold for company gearing or that total cash and interest bearing securities over total assets ratio should not exceed 33.33% (MSCI Barra, 2007).

[2] The Dow Jones Islamic Index Group, the Financial Times Islamic Index Series, the Standard & Poor's Islamic Index Group, the Morgan Stanley Capital International Islamic Index Series, Dubai Islamic Bank, the HSBC Amanah Fund, the Meezan Islamic Fund , the Amiri Capital Islamic Fund and the Azzad Islamic Fund. Another well-known and cited Shariah screening process is of the Malaysian Security and Exchange Commission, which is, however, not included in the review since the guidelines defined are unique to Malaysia.

However, recent developments linking gearing to market capitalisation rather than assets, has attracted its fair share of criticisms (see El-Gamal 2006), for being too pro-cyclical, with companies (even banks) dropping in and out of SCIs, following the state of the stock markets.

At this point it should be noted that these screens are not enforced separately or on an achievement basis where the fulfilment of one screen means a progression onto the next set of rules on the chain. Rather, both line-of-business and financial ratio screens are assessed in parallel. An institution will not be granted Shariah-compliant status if it passes the line-of-business screens but fails on one of the financial ratio screens. However, from the slight relaxation of Islamic rules is can be seen that these windows construct a structure for easy translation of Shariah-based products into mainstream finance. Moreover, these windows also possess a set of rules that enable traditional financial instruments to be incorporated into Islamic finance (El-Gamal, 2006). It should also be noted that Shariah-compliant stocks are screened at a central level by institutions such as the Shariah Advisory Council and not by individual companies (Nisar, 2007)[3].

This manipulation of traditional financial products to create new Shariah-compliant instruments has greatly aided in the development of Islamic financial in keeping up to date with financing risk management and capital generation activities that are needed in any financial system. These Shariah-windows are set out by most major exchanges, as well as Islamic financial hubs, and each have a set of rules that are unique to themselves although there has been more centralization in the wake of criticisms of a lack of uniformity within the system. These rules are set out by a Shariah council, and consist of a less rigid interpretation of the laws of Islam (Khatkhatay and Nisar, 2007b).

[3] For an exhaustive analysis of the role of Shariah supervisory Boards please see DeLorenzo (2000)

For example, the Dow Jones Islamic index is a Shariah-compliant index formed based on these Islamic windows and contains companies that are deemed halal – so sale of pork, munitions, alcohol, insurance and financial products and tobacco. A demonstration of this less rigid interpretation of Shariah laws is seen in the inclusion of McDonalds in this Dow Jones Islamic index. If one were to consider the global activities of McDonalds, they operate in almost every corner of the world. In countries such as Thailand, Switzerland and Japan, McDonalds sells pork burgers, which is a haram activity under Islamic law. Were this a Shariah-based index, McDonalds would not be allowed but the availability of Shariah windows has meant that all companies that do not conduct more that 5% of haram activities annually are eligible for inclusion into the index. This is just one example of how Shariah windows create opportunities for Islamic finance to develop within the modern financial world. The slightly less rigid interpretation of Islamic laws has enabled product designers to create financial instruments that enable Islamic finance to not only keep pace with the developments of the global economy but also address existing financial issues such as risk management and liquidity transfer (El-Gamal, 2006).

What these Shariah windows allow for would be the flexibility afforded to product and service development by way of Shariah-compliance. Shariah-compliance is an important underlying regulatory issue in modern Islamic finance. As stated before, consumer confidence builds stability, which is pivotal towards the growth of a financial system. A feature of Islamic finance is that consumer confidence is built upon the fact that financial business conforms to their religious beliefs. Should this fail, the pillars upon which Islamic finance was built would crumble (Grais and Pellegrini, 2006). As such the governance and regulation of Shariah-compliant standards are an essential part of modern Islamic finance. The job of assessing the validity of Shariah-compliance takes place at institutional level with each institution that offers Islamic financial services having in-house religious advisors, collectively known as the Shariah Supervisory Board (SSB) (Grais and Pellegrini, 2006).

Shariah windows have come under immense scrutiny in recent years due in part to the decision making process as to what is and what is not Shariah-compliant. These decisions are undertaken by a SSB and individual institutions wishing to create Shariah-compliant products must seek approval from an in-house SSB as to its validity. It has to be made clear that the criticisms are not wholly against the Shariah windows but rather the composition of the SSBs that arrive at a decision as to the "Shariah-ness" of any new financial instrument (El-Gamal, 2006).

For a start, there is lack of disclosure as to the composition of board members. Each institution will have access to its own SSB. This SSB will oversee the Shariah-compliance decisions of all the company's Islamic financial activities be it product development to service provision. There is a lack of transparency when it comes to disclosing who actually sits on these boards (Chapra and Ahmed, 2002). Shariah scholars who are adequately proficient in the interpretation of both Islamic and financial law are few and far between and thus there are only a limited number. Moreover, Shariah-compliance is very much dependent on a Shariah scholar's interpretation of Shariah law and thus "more lenient" scholars maybe increasingly sought after. This has created an inflated demand for "certain" Shariah scholars in what is being termed "Shariah-headhunting" or "Shariah-ala-carte" where companies explicitly seek out specific Shariah scholars based on how lenient their interpretations of Shariah law are. Another source of concern about the SSBs would be that due to the lack of Shariah scholars in the financial system, what occurs is an overlap of scholars on different boards of different institutions (Akhtar, 2006; Khan, 2007; Assem, 2009). This creates a conflict of interest when rival institutions seek Shariah-compliance for financial instruments. This could come down to remuneration packages on offer and as a consequence start a bidding war between IFIs seeking the most moderate Shariah scholars in a want for quick Shariah approval of new products. These are the two main issues with the use of SSBs within the context of Shariah windows.

It is argued however (Chapra and Ahmed, 2002), that these issues would sort themselves out on the basis of moral grounds. Shariah scholars that seek to profit from their position would quickly garner a reputation within the industry and this would eventually lead to a lack of faith in respect to interpretations. It has to be understood that, although it is a financial system, Islamic finance and its participants place a significant amount of emphasis on morality. Thus a Shariah scholar who decides to abuse the position would only be shooting himself in the foot. Moreover, this argument of morality and honesty forms a strong basis within the fundamental principles of Islam.

The argument is that it would be highly unlikely for a scholar of Islam to disregard these principles for personal gain and is in fact a crude postulation that Shariah scholar would provide their services to the best pay package. Additionally, it also boils down to a concern of paying for a service. Let us consider university fees paid by students as an example of how this concern works. University fees do not guarantee a pass and a certificate at the end of a degree but rather provides the student with the privilege of studying at the respective institution. If this argument were to be related to Shariah-headhunting what is derived is a picture whereby an IFI has paid for a Shariah-compliance judgement and it should in fact be known that this payment does not guarantee Shariah approval.

However, the Shariah scholars only form part of the composition of any SSB, with other members consisting of financial engineers and managers. Do these arguments favouring the fact that morality and honesty will sort out the problems of a conflict of interest apply to them? If Islamic finance was likened to ethical investing - ethical investors seek investments on socially responsible grounds. Yes, the main aim could still be to make a profit but the importance of that aim is shared with the want for an ethical investment. It is thus not solely about profit maximisation. Should that investment be no longer socially responsible the investor would more likely that not cease trading in that asset. This would apply to Islamic finance as well. Should there be any doubt with regards to the "Shariah-ness" of any investment or product, market participants would just not invest in it.

It has been discussed how SSBs are a cause for concern with regards to Shariah windows, but doesn't the fact that Shariah windows exist dilute the Islamic integrity of the financial system as a whole? Do note that Shariah-compliance is not a complete nullification of Islamic law but rather a slightly less rigid interpretation. In essence it provides an environment that fosters the growth and development of new financial products and instruments. It allows for innovative approaches to structuring Islamic financial products to meet the needs of the Shariah financial market place. However care has to be taken with the Shariah-compliant process. Whilst initial steps in mimicking conventional products could prove successful in terms of market adoption, this should not be taken for granted. Some of the risks faced by Islamic finance are different from that of conventional finance and innovation should also be directed at mitigating these risks. These Shariah screens should be seen as an opportunity for innovators to engineer financial products and services that would fit a conventional and an Islamic portfolio.

3.6. Islamic financial Concepts – What are the major financial activities of IFIs?

Section 3.5. discusses the differences between Shariah-based and Shariah-compliant and it is only natural for the Islamic financial system to possess a mix of products that exist in both these arrays. This section will introduce the major Islamic financial activities as instruments available to market participants.

Islamic financial activities mainly centre around three major sectors – deposit taking/ lending institutions for personal finance, equity investments and *sukuk*s (Islamic bonds). With reference to Figure 4 below it can be observed that the majority of the $951 billion market capitalisation of Islamic finance services and products is in commercial banking (74%), with investment banking and *sukuk* issues taking up 10% each and the remainder in Islamic funds and *takaful* (insurance) services (IFSL, 2010).

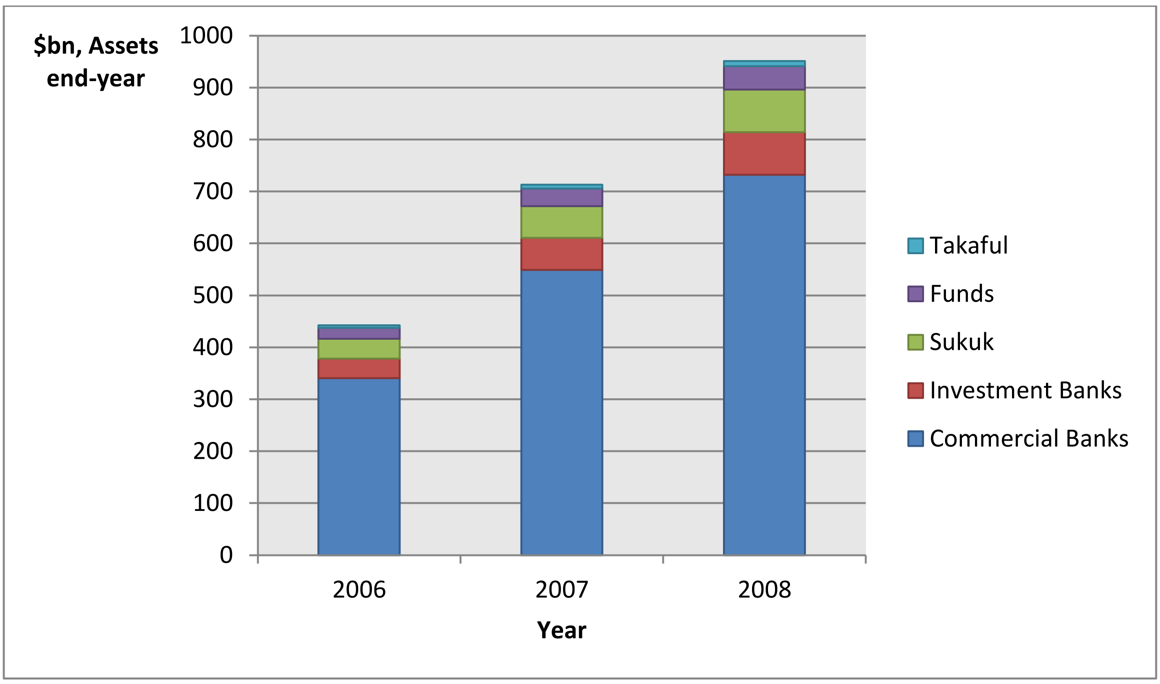

Figure 4: Growth of Islamic Finance (Source: IFSL, 2010)

Within these sectors there are a whole host of products that cater to the needs of market participants and these financial instruments can be further broken up into participatory (profit-loss sharing) and non-participatory (non-profit-loss sharing). Essentially, PLS financing methods are more in line with Islamic principles in trying to prevent *riba (*El-Qorchi, 2005). However, it has been argued that this pursuit of *riba* has been a relatively modern Islamic financial development. This is to say that whilst the prohibition of *riba* is a central tenet of Islamic finance, the chase to eliminate it entirely from the financial system is very much a recent desire. What can be seen from the products above would be that although PLS financing is, to a certain extent, more *riba*-complaint, these contracts fail to provide a viable alternative when it comes to short-term financing and liquidity transfer. These attributes can be achieved far more efficiently through non-PLS modes of financing and in fact the bulk of financing and investment break down for the largest Islamic banks indicate that non-PLS forms of finance dominate the balance sheets as can be seen from Table 4 below.

	2006			2005		
	% PLS	**% Non-PLS**	**% Other**	**% PLS**	**% Non-PLS**	**% Other**
Large Islamic Banks						
Al Rajhi Bank	0.00	99.50	0.50	0.00	99.70	0.30
Kuwait Finance House	20.10	78.40	1.50	22.70	75.10	2.20
Dubai Islamic Bank	14.40	85.60	0.00	25.30	74.70	0.00
Bank Islam Malaysia	0.70	99.00	0.30	0.79	98.80	0.40

Table 4: Spread of PLS and Non-PLS forms of financing in the largest Islamic banks (Source: Khan, 2010a)

There are several financial concepts that are central to the Islamic financial world. The most popular method of organising these concepts is by distinguishing between PLS sharing contracts and non-PLS sharing contracts (Khan, 1992). Moreover, it should be noted that each of these concepts could be a standalone financial instrument or they could be coupled with different Islamic financial instruments to form new products. The structures for Islamic instruments could become increasingly complicated as fund managers modify structures to suit prevailing needs.

3.6.1. PLS financing concepts

3.6.1.1. *Musharakah* (Equity participation contract)

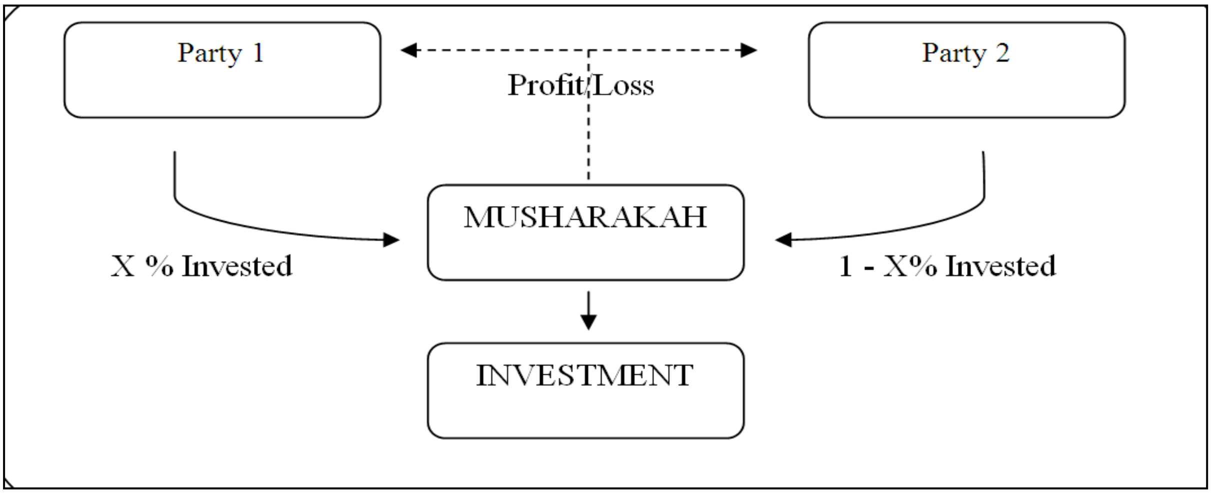

Figure 5: *Musharakah* Structure (Source: Iqbal and Mirakhor, 2007)

Figure 5 above illustrates a standard *musharakah* contract. In this structure the bank is not the sole provider of the capital investment but in fact both parties (bank and investor) contribute a percentage of capital towards the investment opportunity. Profits/losses are shared out at a predetermined ratio, usually set out before contracting takes place and based on the capital invested initially. The main uses of *musharakah* contracts are mainly for long term investment projects. As both parties contribute a capital sum to the investment both are in a position to exercise voting rights and participate in the management of the investment opportunity.

3.6.1.2. *Murdarabah* (Trustee financing contract)

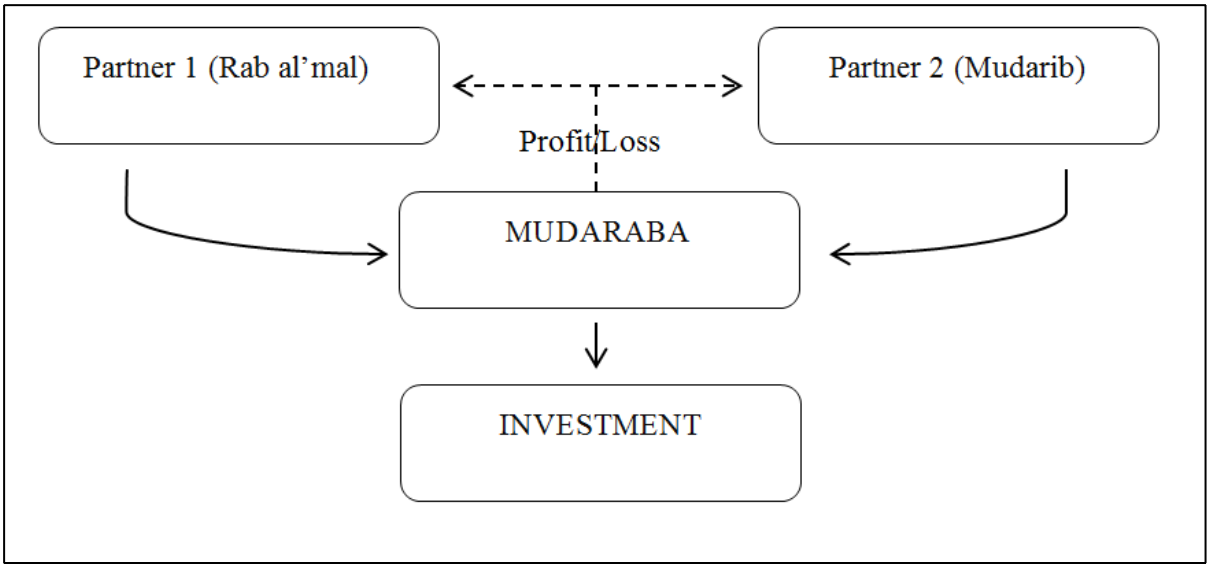

Figure 6: *Murdarabah* Structure (Source: Iqbal and Mirakhor, 2007)

This structure sees the partner 1/ bank (*rab al-mal*) providing the entire sum of capital to partner 2/ borrower (*mudarib*) who possesses the expertise and will undertake the day-to-day management of the investment. Once again profits and losses are shared out at a predetermined ratio set out before contracting. Many of the concerns about PLS sharing stem from this structure whereby the bank bears all of the financial risk of the capital injection. Moreover, this structure requires complete transparency between the parties and is concerned about the presence of non-disclosure/non reporting of profits. This risk can be reduced through a vetting process and a request for collateral before contracting. However, it should be noted that the lender (bank) is only entitled to a principle repayment should there be profits. Should the investment yield a loss the lender bears a percentage of this and it does not constitute a default on the part of the borrower unless it can be proven that this loss was through mismanagement and negligence.

3.6.2. Non-PLS modes of financing

3.6.2.1. *Murabaha* (Cost-plus financing)

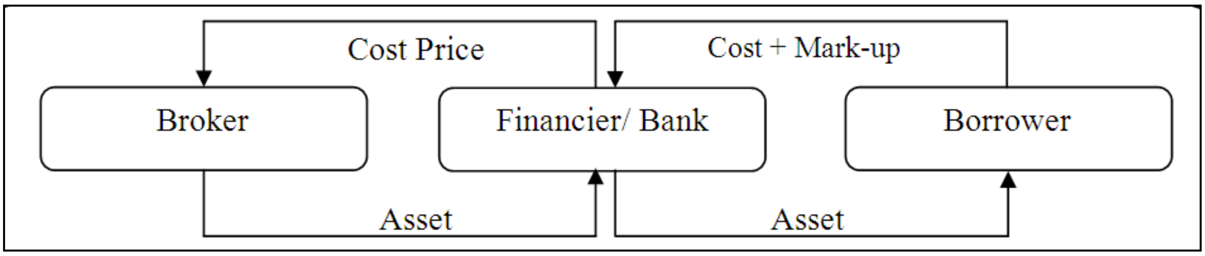

Figure 7: *Murabaha* Structure (Source: Iqbal and Mirakhor, 2007)

This is the most popular financial contract within the Islamic financial world. It essentially, creates a mode of debt financing which provides a clearer cut form of financing. In this structure the lender will purchase the desired commodity/asset from a broker and then sell it on to the borrower at cost plus some mark-up. This contract is used for both long and short term financing projects. The mark-up on this sale on to the borrower will be tied into an interest rate such as LIBOR or US T-Bills and can also be determined based on the borrower's credit rating. Two issues are persistent with this structure namely the value of the mark-up and the non-conformity of goods. With relation to mark up value, lenders must ensure that the prevailing interest rate used and any additional percentage attachment based on borrower credit rating does not tantamount to being excessive. Regarding non-conformity of goods, the borrower would be able to reject the goods, leaving the lender with ownership. However to combat this legal predicament, the lender is entitled to have the borrower act as an agent to verify the assets prior to acceptance.

3.6.2.2. *Ijara* (Islamic lease contract)

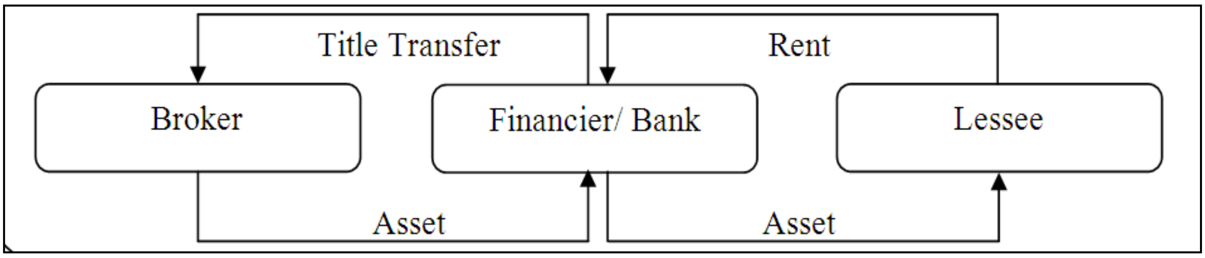

Figure 8: *Ijara* Structure (Source: Iqbal and Mirakhor, 2007)

These lease contracts are similar to their mainstream counterparts. In this contract, the lender (bank) leases out the asset to the borrower for agreed lease payments. The borrower is also under no obligation to purchase the asset at the end of the specified lease period and the maintenance of the assets is the responsibility of the lender. The profit element for the lenders in this case arises from adding a certain percentage on to the overall value of the leased asset and collateral could also be required up front. An issue to consider with *ijara* structures would be the percentage added on although it has been accepted to match Islamic financial law as the return is unique to each individual asset.

3.6.2.3. *Istisna* (Contract of exchange)

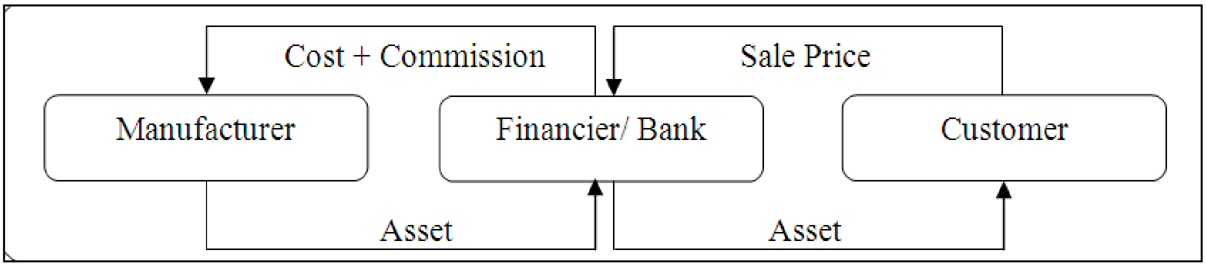

Figure 9: *Istisna* Structure (Source: Iqbal and Mirakhor, 2007)

The *istisna* structure pertains to an exchange of goods at a specified date for a specified price. These items being exchanged should be produced/ constructed to a certain specification, for example a building being built. This contract is mainly used for large industrial or infrastructure projects and can be seen as a structure used for government borrowing.

3.6.2.4. *Salam* (Differed delivery)

The *bai al-salam* was established fundamentally to facilitate agriculture transactions. Under this framework a price for a commodity would be agreed up front and delivery of that commodity would take place at a pre-specified later period. This agreed price could either be paid up front or the value fixed for payment upon delivery. In either case the *bai al-salam* is the closest thing that Islamic finance has to a standard forward contract. *Bai al-salam* is general regarded as a permissible credit facility under a Shariah framework as elements such as commodity being sold, price and delivery date are all decided before contracting eliminating uncertainty. Although permissible *bai al-salam* structures are not very popular in Islamic finance due to two things. Firstly, these contracts require full payment for the commodity either up front or upon delivery. Secondly, markets price bay al-*salam* contracts in a similar vein to standard forward contracts with an interest element and as such some may regard this as *riba* (Obaidullah, 2002; Iqbal, 1999; Iqbal and Mirakhor, 1999; Obaidullah, 1998).

3.6.2.5. *Tawarruq* (Cash Sale)

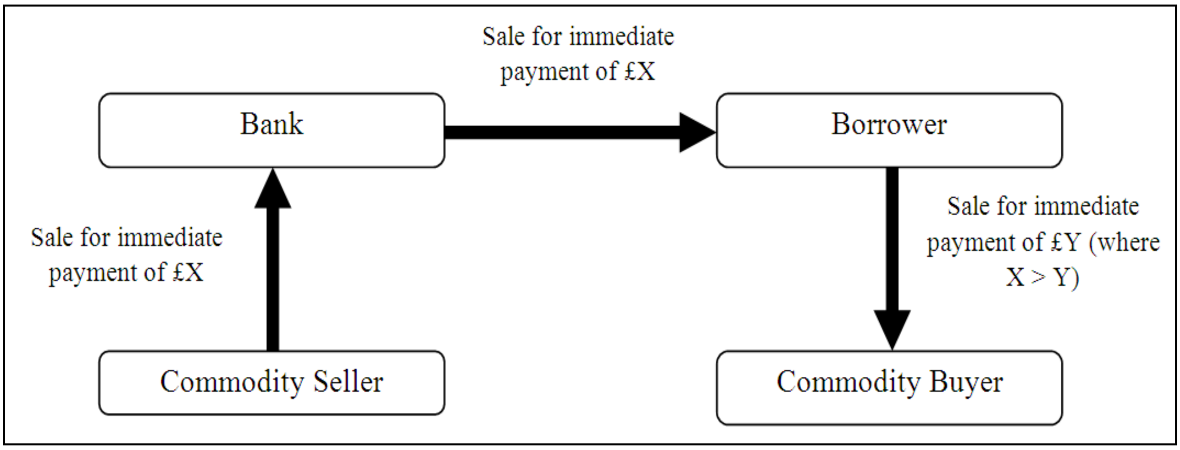

Figure 10: *Tawarruq* Structure (Source: Siddiqui, 2008)

In its most basic form a *tawarruq* is where a borrower, also known as a *mutawarriq* in this contract, agrees to purchase a certain commodity/asset from the lender at an agreed price on a deferred payment basis. This commodity/asset is then sold on immediately at a price that is less than the agreed price between borrower and lender, essentially creating a debt.

3.6.2.6. *Einah* (Sale – Repurchase Agreement)

Like *bai al-salam*, *einah* contracts have been causing slight controversy with regards to permissibility under Islamic financial jurisprudence. Islamic banks are able to transform a standard *murabaha* contract into an *einah* contract by keeping the identity of the broker and borrower the same as demonstrated in Figure 10 below.

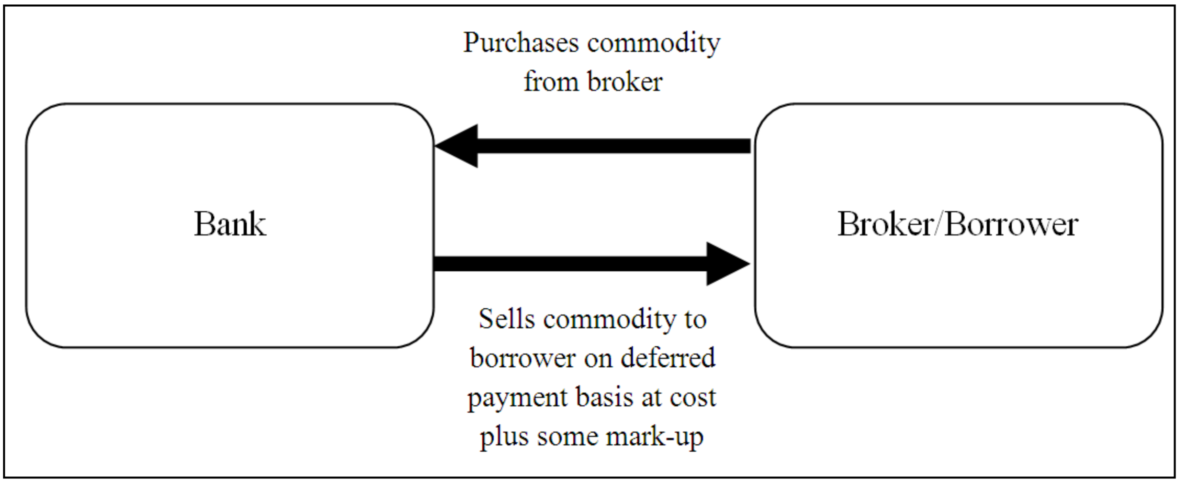

Figure 11: *Einah* Structure (Source: Siddiqui and Athemy, 2008)

Einah contracts are largely regarded as amounting to *riba* on the basis that is a combination of two or more contracts into a single transaction however the advent of modern Islamic banking has seen the adoption of *Bai al-einah* contracts by a few Islamic banks (Siddiqui and Athemy, 2008).

3.6.2.7. *Wa'ad* (Promise to deliver)

Within a financial context a *wa'ad* could also be described as a unilateral promise or the assurance of one party (the producer) to deliver the goods in the future. In its currency incarnation in modern Islamic finance, the *wa'ad* based on a *murabaha* contract is enforceable in a conventional court of law. Since the *wa'ad* is a unilateral promise, the Shariah requirements of ownership and knowledge or price and time before trading do not apply (Razali, 2008). The standard *wa'ad* structure is described in the diagram below.

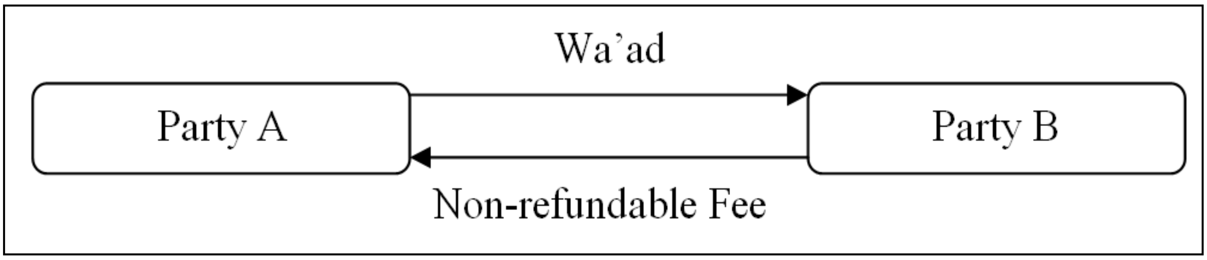

Figure 12: *Wa'ad* structure (Source: Dar and Azami, 2010)

Under this structure Party A promises to deliver a certain amount of goods at a certain price to Party B in the future. In return Party B pays a non-refundable fee (similar to an option premium) for this service. Upon maturity Party B could elect to hold Party A to the promise or waive the contractual obligation of the structure. In essence this is similar to a holder of an option exercising or not exercising the option contract (Dar and Azami, 2010).

The *wa'ad* is a relatively new contract within the Islamic financial spectrum but is becoming increasingly accepted as Shariah-compliant (Razali, 2008; Qazi, 2012). A *wa'ad* allows institutions to synthetically proxy the payoff of a standard call option. This basically, enables the holder of this *wa'ad* to decide if the contract in question is going to be exercised. The availability of this choice, some argue (Noor and Aripin, 2010), violate the *gharar* requirement of Islamic finance. In trying to prevent *gharar* the specifications of all contracts in Islamic finance must be agreed upon prior to trading. The fact that the holder of this contract is given a choice has created an element of uncertainty to the transaction. The research will discuss the stance of Islamic finance on the acceptance of derivative securities in Chapter 5, but in essence derivatives are explicitly disallowed under a Shariah framework due precisely to this creation of uncertainty. However, some argue that the inherent benefits of derivatives within any financial system should outweigh their detriments and in fact promote growth and liquidity transfer within the Islamic financial system (Mohammed and Tabatabaei, 2008).

3.6.2.8. *Arboun* (Earnest money contract)

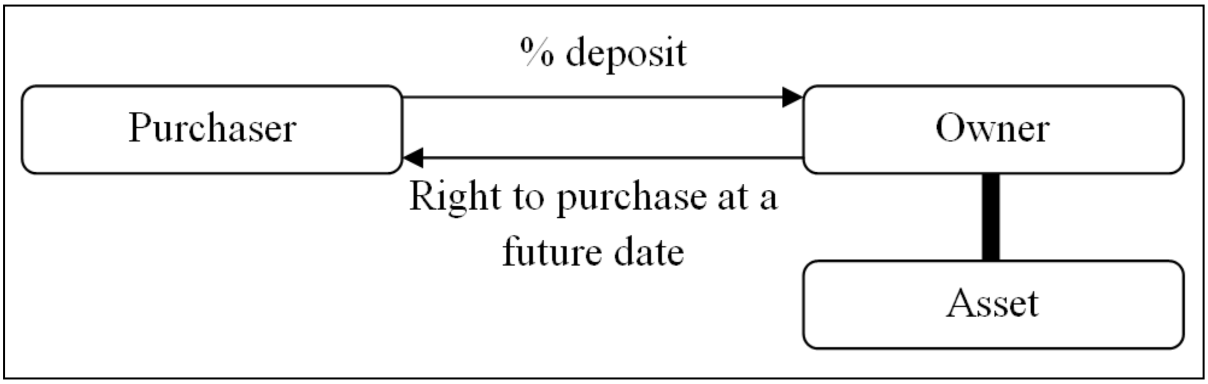

Figure 13: *Arboun* Structure (Source: Hassan and Lewis, 2007a and 2007b)

The diagram above depicts an *arboun* structure. The purchaser pays a percentage deposit to the owner for the right to purchase an asset at a future date. Should the purchaser elect to go through with the contract, the deposit is taken away from the sale price of the asset at the future date. Should the purchaser decide not to proceed with the contract, the deposit is foregone. The percentage deposit could be seen as similar to an option premium. However consideration must be given to the fact that an option's premium is not deductible from the eventual price.

The *arboun* contract is not very popular within the Islamic financial spectrum due to views (Hassan and Lewis, 2007a and 2007b) on its permissibility. This concern is due to the fact that the percentage deposit (or what would be the premium) is conditional on the transaction. However, this basic concept does form a strong basis from which to build Islamic risk management instruments.

3.7. Islamic capital Markets

The foundations of the modern Islamic capital market can be traced back to the 1970s with the creation of the "first" commercial Islamic bank – Dubai Islamic Bank. Since then, there have been large steps made in the development of concepts such as asset management and Islamic funds during the 1990s, which were bolstered by the establishment of AAOIFI. The new millennium saw the issuance of the first Islamic bond (*sukuk*) and the creation of Islamic investment banks. The propagation of aspects such as Islamic investments has highlighted the need for increased development of liquidity management products in Islamic finance (Ismal, 2010; Dar and Azami, 2010).

These developments are not only being encouraged from the GCC regions and large Islamic banking centres such as Malaysia but also from more mainstream sources. With the current financial crisis there has been increased emphasis from mainstream financial participants for safe investment opportunities. With the prohibition of speculation, the impact of the financial crisis was seen to have had a "dulled" effect on the variability of performance of Islamic financial funds (Farooq, 2009). The performance of emerging markets over these financial crises – a product of lower leverage positions – is also an argument for the development of Islamic capital markets and the growth of these products into mainstream financial systems. Figure 14 highlights the major capital market sectors available within the Islamic financial spectrum.

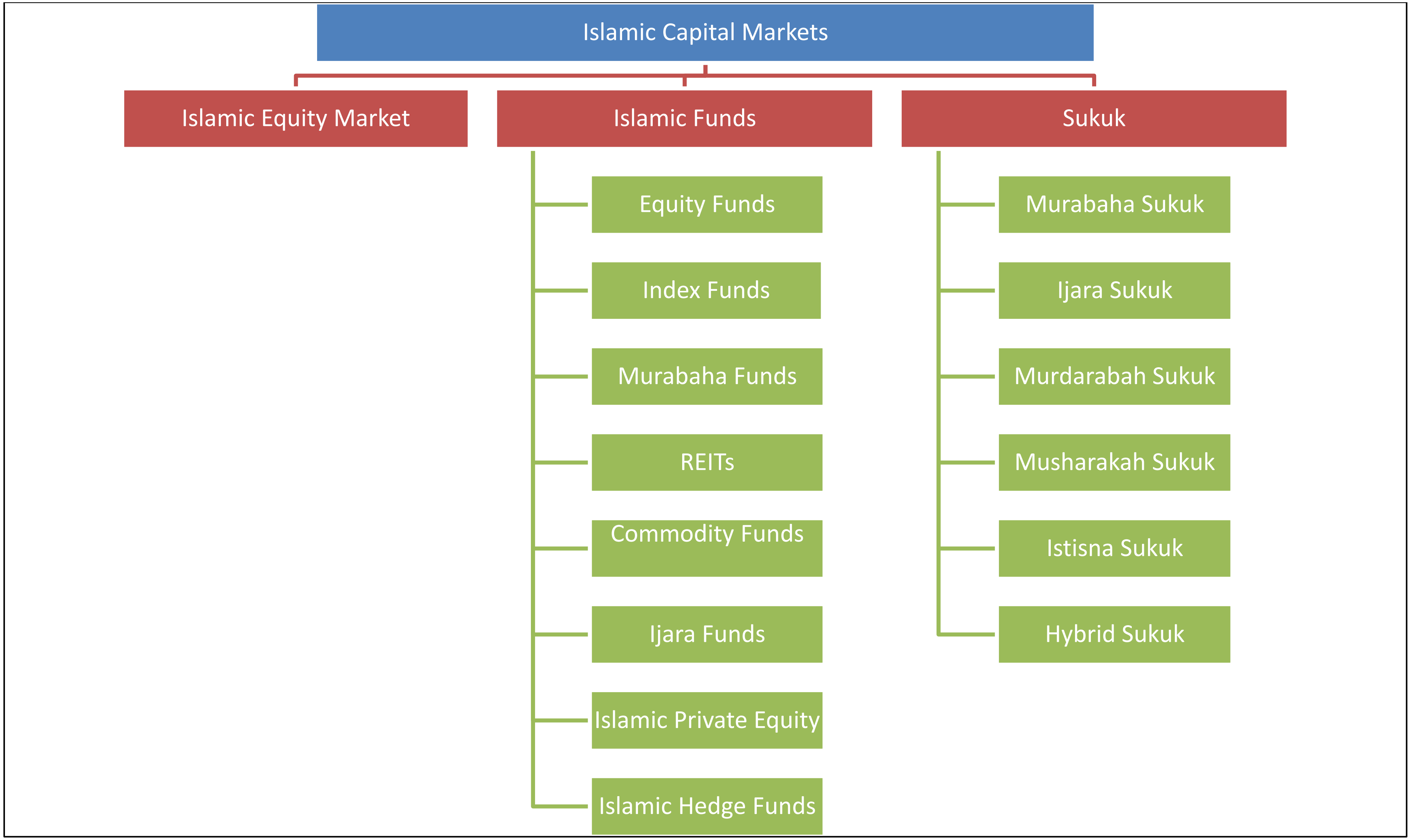

Figure 14: Islamic Capital Market Products (Source: Dar and Azami, 2010)

3.7.1. Islamic equity markets

Islamic equities are essentially stocks and shares in companies that are deemed halal under Shariah-compliant screening process. Companies which engage in business activities that include gambling, sale of pork, alcohol, tobacco, pornography, arms and munitions are all seen as haram (prohibited). Additionally, companies who derive a large proportion of income from interest based activities are also excluded and these include financial entities such as banks and insurance companies. The growth of Islamic finance outside of traditional Muslim economies has meant that the use of Shariah screens has become increasingly important to the global Islamic financial system. These screens are used to create Shariah-compliant indices, which include identified Shariah-compliant stocks and shares.

This first Islamic equity index was launched in Malaysia in 1996 and this was succeeded by the Dow Jones Islamic Index in 1999 (Dar and Azami, 2010). The growth of these Islamic indexes has been steady with a market capitalisation of $709 million as of July 2009. It should be noted that Shariah-compliant companies need not necessarily be Islamic companies and could be prominent, global, non-Islamic institutions. The popularity of Islamic equities can be seen from the proliferation of Islamic indexes on the Dow Jones where Shariah screening processes are applied to the stocks and equities of countries such as China and Malaysia resulting in the creation of the Dow Jones Islamic Market China/ Hong Kong Titans 30 and the Dow Jones Islamic Market Malaysia Titans 25 (Dow Jones, 2012). Exchanges such as the FTSE have also established similar Shariah-compliant indexes such as the FTSE SGX Shariah index, FTSE DIFX Shariah Index and the FTSE Bursa Malaysia Index (FTSE, 2012). While in the East the Hang Seng Exchange has the Hang Seng Islamic Investment Series (Hang Seng, 2012).

3.7.2. Islamic Funds

As can be seen in Figure 13 there are large variety of Islamic funds however their general characteristics remain the same. All Islamic funds are managed according to the rules of Shariah and the investments made by each fund should be halal. All funds are subject to two basic conditions:

1) The return on the investments of any funds are calculated on a pro-rata basis
2) The fund can only invest in Shariah-compliant investments.

The first Islamic fund, Dana Al-Aiman, and the first Islamic equity fund, Arab-Malaysian Unit Trust, were launched in Malaysia in 1963 and 1993 respectively (Dar and Azami, 2010).

The growth of mutual funds in the mainstream financial system has been steady since 2002, growing at an average rate of 17.5% per annum until the end of 2007. 2008 brought with it the height of the financial crisis causing a drop in the overall value of global funds from £26.1 trillion to $19 trillion. The continuing struggles of the global economy has meant that these funds have grown at a more modest rate when compared to the pre-crisis period and as of Q1 2011, the global market capitalisation of global mutual funds stands at $25.6 trillion (Ernst & Young, 2011a). This is indicated in Figure 15 below.

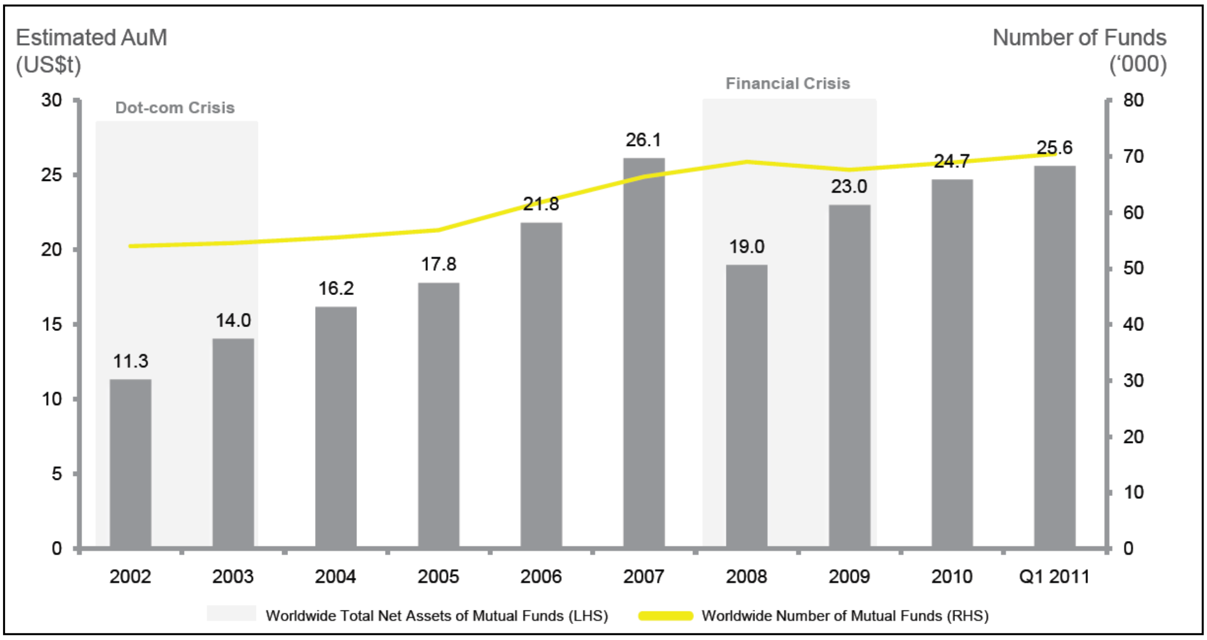

Figure 15: Global Mutual Fund Market Outlook (Ernst and Young, 2011a)

The Islamic fund market accounts for a small percentage of the global marketplace but has seen consistent growth even through the financial crisis. From the period of 2005 until 2010 Islamic funds grew, on average, at a rate of 11.36%. However, the data does indicate that average growth over the financial crisis (2008 – 2010) did slow to around 6% and the bulk of the growth preceded the global crisis (Ernst & Young, 2011a and 2011b). The current market capitalisation of Global Islamic Funds stands at $58 billion with over 700 funds operating globally. This is demonstrated in Figure 16 below.

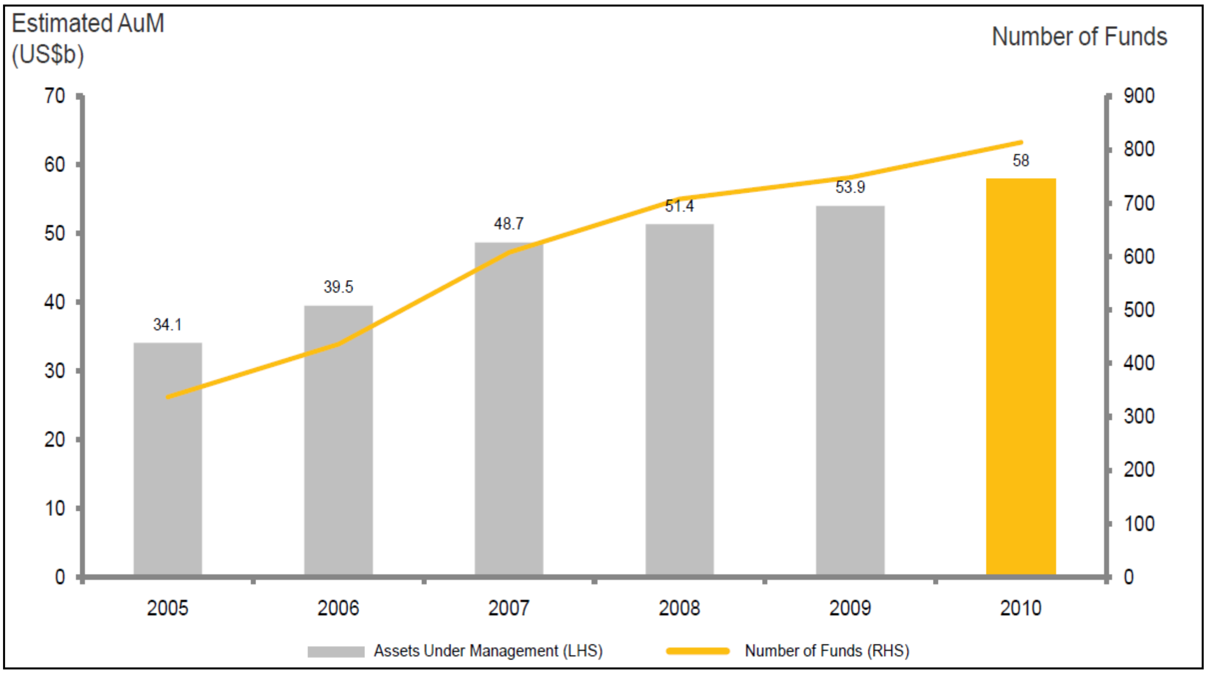

Figure 16: Islamic Fund Performance (Ernst & Young, 2011a)

The performance of these Islamic funds has been attributed mainly to global market performance and as financial systems begin the reversion from the volatility caused by the financial crisis, there is indication of a continuing steady, modest performance of Islamic funds nonetheless. The growth of new funds has slowed, with only 23 new funds launching at the end of 2010 (Ernst & Young, 2011a). The research by Ernst & Young (2011a) also indicates a strong sentiment by market participants of Islamic finance to deposit money with banks as opposed to investing in Islamic funds. With the estimated value of Islamic financial assets at just over $1 trillion, Islamic funds only account for 5.6% of this ($56 billion).

There has been a strong push in the promotion of Islamic funds by banks, financial institutions and government bodies with notable centres of excellence such as Bahrain, Malaysia, Saudi Arabia and Ireland. Whilst the former three have a strong grounding of Islamic values, the surprise here is Ireland. Although its status as a centre of excellence in Islamic finance is not built around the provision of Islamic services and products, its status as a financial tax haven have meant that there is significant development of Islamic investments in the Irish Financial Services Centre (IFSC) (Dar and Azami, 2010). All three, Bahrain, Malaysia and Saudi Arabia have a well-developed Islamic fund market with 87,145 and 131 established Islamic funds respectively.

There are several types of Islamic funds and they can be segregated into specific investment spectrums. Figure 14 highlights the types of Islamic funds ranging from conventional equity, index and commodity funds to *murabaha* and *ijara* funds. Islamic Equity, Index and Commodity funds are only allowed to invest in shares, indices and commodities that are deemed Shariah-compliant. Shariah Private Equity funds and Shariah Real Estate Investment Trusts (REIT) provide pooled investment vehicles allowing investors the right to become partners of the fund. Private Equity fund invest in stock and shares with REIT engage in property development. Shariah-compliant Hedge Funds are relatively new (Dar and Azami, 2010). Whilst conventional hedge funds are high risk, high return with offset of risk against hedging strategies using derivatives, this is highly incompatible with basic Islamic financial principles. However, the use of *salam* contracts as forwards has meant that Islamic finance has been able to engineer a Shariah-compliant alternative to conventional hedge funds. Shariah-compliant Exchange Traded Funds provide market participants with a cheap option for low risk, low cost, high liquidity and diversification. These funds essentially track the Shariah-compliant index that they are based upon. Finally, *Murabaha* and *Ijara* funds are in fact funds that invest in both *murabaha* and *ijara* contracts. These funds deal with the potential profits arising from establishing cost-plus financing and leasing contracts.

3.7.3. *Sukuks*

*Sukuk*s or Islamic bonds are not modern Islamic finance phenomenon and in fact their lineage can be traced back to medieval Islamic finance where governments remunerated soldiers in cash and in kind. This 'in kind' was known as a *sukuk al-badai* (commodity coupons) (Kamali, 1997). These *sukuk* holders would be able to claim, upon maturity, a certain amount of commodity. Moreover, *sukuk* holders were also able to sell on their claims for commodities, highlighting that these *sukuk*s were tradable instruments.

*Sukuk*s function in similar fashion to their mainstream counterparts whereby they act as long-term loans to the issuing company. The differences here lie with how these *sukuk*s are sold and their capital growth opportunities. With standard bonds, issuance is based upon a par value (in the UK usually £100 or in America $1000) on which coupon payments are made yearly. These coupon payments are a percentage based upon the lending rate at that point in time, e.g. LIBOR. Bonds are mainly sold at either discounts or premiums. Discount bonds are sold at a price that is lower than their face value as these bonds provide no annual cash flows (coupon payments) and because there are no annual returns, bondholders will receive the face value upon maturity. On the other hand, bonds sold at a premium provide an annual coupon payment thus creating some income generation over the life of the bond. Institutions wishing to generate capital through a bond issue do not have to issue them through a separate entity. With *Sukuk*s as well, institutions themselves are unable to issue the bonds outright as this would amount to *riba*. The most commonly used *sukuk* issuance structure would be where the issuing institution sets up an ad hoc financial entity known as a Special Purpose Vehicle (SPV).

The structure of the modern financial *sukuk* is slightly more complicated and the model is demonstrated in Figure 17 below.

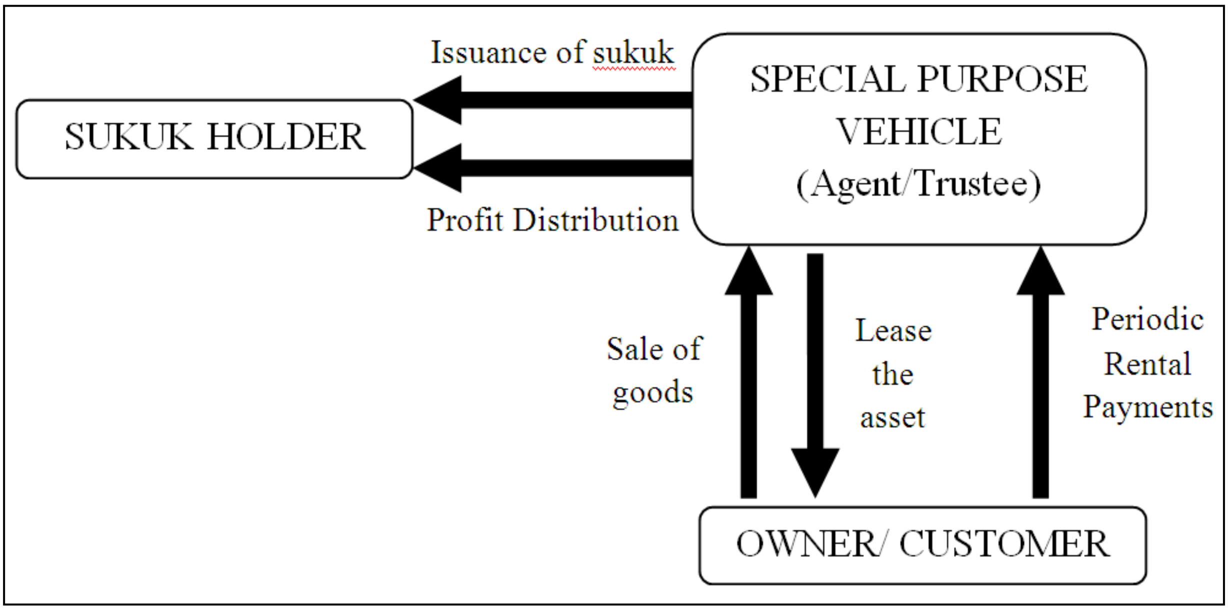

Figure 17: *Sukuk* Structure (Dar and Azami, 2010)

Under this structure, the owner/customer enters into an agreement with a third party (Special Purpose Vehicle) to sell some goods. The SPV acts as an agent/trustee on behalf of the investors who will eventually be the holders of the *sukuk*. It is essentially the SPV that issues the *sukuk* on behalf of the customer. Investors will place their money with this SPV who then purchases an asset, which it will then lease to the borrowing institution whilst at the same time providing the finance as well. The lease payments made by the borrowing company to the SPV and from SPV back to investors will be set up so that they approximate a certain accepted lending rate such as LIBOR + X%. This rental income is distributed to the *sukuk* holders. Upon maturity, the customer will buy back the asset from the SPV who will then distribute the principal amongst the *sukuk* holders. Now before screaming *riba* in this scenario, it has already been discussed that trying to approximate a certain interest rate return does not amount to *riba*. Essentially, to want to make as much money as an investment banker does not make you an investment banker.

This structure is also known as an *Ijara sukuk* and as shown in Figure 7 there are various combinations of basic Islamic financial concepts such as *murabaha*, *musharakah* and *murdarabah sukuk*s on offer. These *sukuk*s can be divided further into two subsets: variable and fixed income *sukuk*s. Both *ijara* and *murabaha sukuk*s are based on a debt security and are therefore classed as fixed return as can be seen from the periodic rental payments made by the customer. On the other hand, both *musharakah* and *murdarabah sukuk*s depend on the performance of their specific contracts and as such coupon payments for these *sukuk*s are not guaranteed. However, it is possible for the customer to maintain coupons should there be a shortfall over a particular period.

There has been a recent development in the global *sukuk* industry, which involves the creation of hybrid *sukuk*s which combines incomes stream for both variable and fixed return *sukuk* structures. Essentially, these hybrid *sukuk*s will have infinite combinations of *ijara*, *murabaha*, *musharakah* and *murdarabah* contracts (See Dar and Azami (2010), Chapter 9 for a more detailed examination of the various *sukuk* structures)

The first sovereign *sukuk* issuance was undertaken by Malaysia in 2002 for a value of $600 million and in the wake of this successful issue other notable Islamic financial centres started issuing their own – Qatar, for a value of $700 million in 2003 and Pakistan for a value of $600 million in 2005. Initially, these *sukuk*s were based on the concept of *bai bithaman ajil*, which is similar to *einah*. The price of a certain asset as well as the profit margin is agreed now with delivery taking place at a later date. However, with calls for standardization, the use of *ijara* is now the most common structure (Dar and Azami, 2010).

Global *sukuk* issuance grew steadily from 2002 until the end of 2007, reaching a value of $33 billion. With the onset of the financial crisis in 2008 *sukuk* issuance retracted significantly to just under $20 billion. However, the market for *sukuk*s picked up again through 2009 and reached a high of $53 billion in 2010. With the growing concerns in the global debt market and the difficulties faced by sovereign debt issues the *sukuk* market withdrew in the first quarter of 2011 and currently stands at around $20 billion (Ernst & Young, 2011a). There has been large scale acceptance of *sukuk*s not only from global Islamic financial institutions but also from mainstream financial participants. This is highlighted by the creation of a rating system by Moody's, which is similar to that of its mainstream bond rating system. Table 5 below highlights the rating of the largest *sukuk* issues at the moment. This system works on an asset backing system, which is similar to the variable and fixed income distinction given to the various *sukuk*s. Asset backed *sukuk*s essentially possess a fixed income guarantee payment mechanism. On the other hand a non-asset backed *sukuk* has to guarantee coupon payment and is, more importantly, based on the credit quality of the asset class.

	Issuer	Issuance Amount (Mil. US$)	Moody's Rating
1	ADIB *Sukuk* Co. Ltd.	5,000	A2
2	DIB *Sukuk* Co. Ltd.	750	A1
3	DP World *Sukuk* Ltd. (Obligor: DP World)	1,500	A1
4	Dubai *Sukuk* Centre Ltd. (Obligor: DIFC Investments LLC)	1,250	A1
5	EIB *Sukuk* Co. Ltd. Programme	1,000	A1
6	Golden Belt 1 B.S.C. (Obligor: Saad Trading Cont. & Fin. Serv. Co.)	650	Baa1
7	JAFZ *Sukuk* Ltd. (Obligor: Jebel Ali Free Zone FZE)	2,043	A1
8	Malaysia Global *Sukuk* Inc.	600	A3
9	MBB *Sukuk* Inc. (Subordinated)	300	A3
10	NIG *Sukuk* Ltd. (Obligor: National Industries Group)	475	Baa2
11	Qatar Alaqaria *Sukuk* Co. (Obligor: Qatar Real Estate Inv. Co.)	300	A2
12	Sarawak Corporate *Sukuk* Inc.	350	Baa1
13	Sun Finance Ltd.	1,368	Aa3/A3/Baa3/NR
14	DB *Sukuk* Ltd	5,000	A3
15	Tamweel *Sukuk* Ltd	272	A3
16	Tamweel Residential ABS CI (1) Ltd., of which:	210	Aa2/Baa1/Ba3/NR
	Total amount of *Sukuk* issuances rated by Moody's:	**21,068**	

Table 5: Moody's *Sukuk* Rating List as of 2009 (Dar and Azami, 2010)

Current trends in the *sukuk* market have been extensively affected by the weakening of the Dollar and the Euro. This could result in the issuance of *Sukuk*s in local currencies within the GCC region. The *sukuk* industry has also seen a slowdown in corporate issuances whilst the forecast is the opposite for sovereign *sukuk*s with issuances predicted to rise. However, the market does highlight the difficulties with *sukuk* offers and the effects of the financial crisis in the West can be seen in the restructuring of debt obligations of Dubai World in 2009 (Cochrane and Pimentel, 2009)

3.7.4. *Takaful* (Islamic insurance)

It will be difficult to discuss Islamic equity funds and risk management structures without at least mentioning *takaful* or Islamic insurance. *Takaful* is one of the fastest growing sectors in the Islamic financial world with numbers coming in at 26% annual growth, which is 11% higher than the conventional insurance market. However, these estimates are mainly for "Islamic" economies concentrated in the Gulf Region and the Middle East. Growth of Islamic insurance in more mainstream economies is relatively more modest with expected annual growth in the region of 4% (Dar and Azami, 2010). The proliferation of institutions offering an Islamic alternative to conventional finance has also risen and as of January 2009 stands at 162 institutions. *Takaful*, like its mainstream counterpart, comprises of general insurance, medical and health, accident and education.

So why is there the need to develop a separate form of insurance? In its conventional incarnation, insurance is prohibited under Shariah financial rules on a number of grounds. Firstly, the use of interest rates in determining the insurance premiums that are required by policy holders (Wahab *et al.*, 2007). This is seen as *riba* as there is no sufficient justification for percentage premium chargeable, although there have been counter arguments suggesting that risk calculators provide some justification towards respective premiums. Secondly, would be the inherent uncertainty of the conventional concept of insurance where premiums are used to pay out on claims as and when they are made. This is seen as excessive *gharar* under an Islamic financial framework. Finally, would be the problems of *maysir* in conventional insurance. Shariah finance essentially sees the pay-out on claims and the investment of premiums to generate access returns, within conventional insurance, as gambling (Wahab *et al.*, 2007).

Takaful companies offer essentially three types of Islamic insurance – *murabaha*, *wakala* and a combination of both *murabaha* and *wakala* – however regardless of the model the underlying structure remains the same (Dar and Azami, 2010). Unlike conventional insurance where premiums are pooled and invested and should a claim arise, it will be paid out of this pool. Under the Shariah financial framework, policy holders essentially pay a premium and the *takaful* companies will invest these premiums in a Shariah-compliant manner (i.e. tangible Shariah complaint assets/contracts). The returns of these investments will be repatriated into a group *takaful* fund, which is similar to a conventional insurance pool. Claims made by policy holders are taken out of this fund but it should be noted that this group *takaful* fund belongs to the policy holders (Siddiqui and Athemy, 2008). As such, should there be any excess from the investments made by the *takaful* company, this excess return will be shared out amongst the policy holders. Moreover, should there be insufficient funds in the pool to cover claims; the *takaful* company will have to make up the losses (Dar and Azami, 2010).

3.8. Summative Remarks

Chapter 3 has also provided a description of the major Islamic finance concepts and essentially split these concepts into PLS and Non-PLS modes of financing. The chapter also provides an overview of the products and services available in today’s modern Islamic financial system with emphasis being placed upon Islamic capital products such as Islamic funds and Islamic bonds (*sukuk*s), Islamic risk management products and a brief description of Islamic insurance (*takaful*).

4. Review of Existing Literature

4.1. Introduction to Chapter

The following chapter documents the existing academic arguments surrounding the key areas of research of this study. The progression of the chapter is as follows. Section 4.2. provides an overview of risk management in Islamic finance. It highlights the growth of Islamic finance and the arguments relating to its performance for both Islamic and conventional investors. It presents the evolution of academic research into the performance of Islamic equity indexes and the academic conclusions. These arguments about performance set the scene which leads on to the analysis of the literature behind risk management. The section provides arguments for the need for further development of new risk management tools and the underlying debates about financial innovation and the inclusion of derivative structures within Islamic finance. Section 4.2.1. illustrates the current state of financial innovation within Islamic finance by documenting existing derivative-like structures within Islamic finance suggesting that there is definitely scope for financial innovation within Islamic finance. Section 4.3. leads on from Section 4.2. Where it was highlighted in Section 4.2.one of the main issues relating to risk management and financial innovation is regulation and governance in Islamic finance, Section 4.3. expands on the disputes of governance and regulation surrounding Islamic finance. Section 4.4. tie the issues presented in the literature review and provides the reader with an overview of the progression of this research study.

4.2. Risk Management in Islamic Finance

The advent of Islamic finance into the 21st century has been widely accepted into the modern economic spectrum as a viable source of diversification and investment prospects. The growth of this financial system over the past decade has illustrated its ‘pulling’ power amongst mainstream Western financial institutions so much so that major Islamic financial hubs are being established throughout the global economic centres from New York and London in the West to Singapore and Hong Kong in the East.

The development and growth of the banking and finance sector over the past two decades has meant that the risks faced by financial institutions have changed. These risks are not limited to mainstream Western finance but extend into the realms of Islamic banking and finance (Makiyan, 2008). Traditionally, the risks encountered in Shariah finance consisted primarily of credit and market risks but today’s financial markets possess a whole array of possible risks (Iqbal and Mirakhor, 2007). As can be seen from Figure 18 the types of risk associated to Islamic finance are similar to that of mainstream finance with the exception of Shariah risk, which arises in trying to adhere to Islamic financial standards.

The prospect of Shariah risk is also significantly associated to reputational risk under a Shariah financial framework and the problems associated to SSBs and that the stability of the Islamic financial system is based on participant confidence. In fact, the creation of Shariah risk would directly stem from the criticisms of SSBs with regards to their composition and transparency (Ahmad and Karim, 2008). Moreover, any doubts as to the integrity of SSBs would eventually filter down to the products and services that the Islamic financial system provides. The Shariah integrity of these products and services are based upon the judgements of the SSB. How this ties into reputational risk is on the basis of moral participation in the financial system. Participants of the Islamic financial system desire products and services that meet their social and moral requirements when it comes to investing whilst at the same time generating some capital growth. Any concerns with regards to religious integrity could and would be highly detrimental towards the reputation of Islamic financial institutions.

Should we also consider the work conducted by Cihak and Hesse (2010) who examined the financial stability of Islamic and conventional banks it can also be understood why risk management is Islamic finance is such a pertinent issue. Fundamentally Cihak and Hesse (2010) looked at the individual banking data for 77 Islamic and 397 commercial banks and further broke the banks down by size – small and large bank comparison. The conclusion of this work provided an interesting perspective on as it indicated that 'small' Islamic banks were financially stronger than 'small' conventional banks and 'large' Islamic banks were less financially stable than 'large' conventional banks. Moreover, this study also asserted that 'small' Islamic banks were financial stronger than 'large' Islamic banks. The notion of size-related financial soundness between large and small Islamic banks was attributed the increased credit, liquidity and prudential risk that were easier to maintain within a smaller Islamic financial institution (Cihak and Hesse, 2010). Additionally work by Ariffin *et al.* (2009) who surveyed 28 Islamic banks in 14 different countries discovered that whilst there was increased prudential risk in terms of Shariah-compliancy and supervision much of the risk associated to Islamic financial institutions were similar to their conventional financial counterparts. This questionnaire study fundamentally examined the view of market experts and their experiences within financial risk management with the Islamic financial world.

Moreover, Makiyan (2008) provides a good summary overview of the major financial risk issues faced by Islamic institutions in today’s modern economy. From a conventional financial perspective issues such as continual development of financial instruments and markets, the creation of a lender of last resort and an adoption of a uniform regulatory standard are common financial risk themes to any developing economy and financial system let alone the Islamic financial system. However, Shariah-adherence and compliance also exacerbate certain well known financial risk but also create specialised risk to the Islamic financial system most notably PLS risk based on Islamic financial precepts and liquidity risk (Makiyan, 2008). The concept of risk and risk management under a Shariah financial framework will be examined in the following paragraphs.

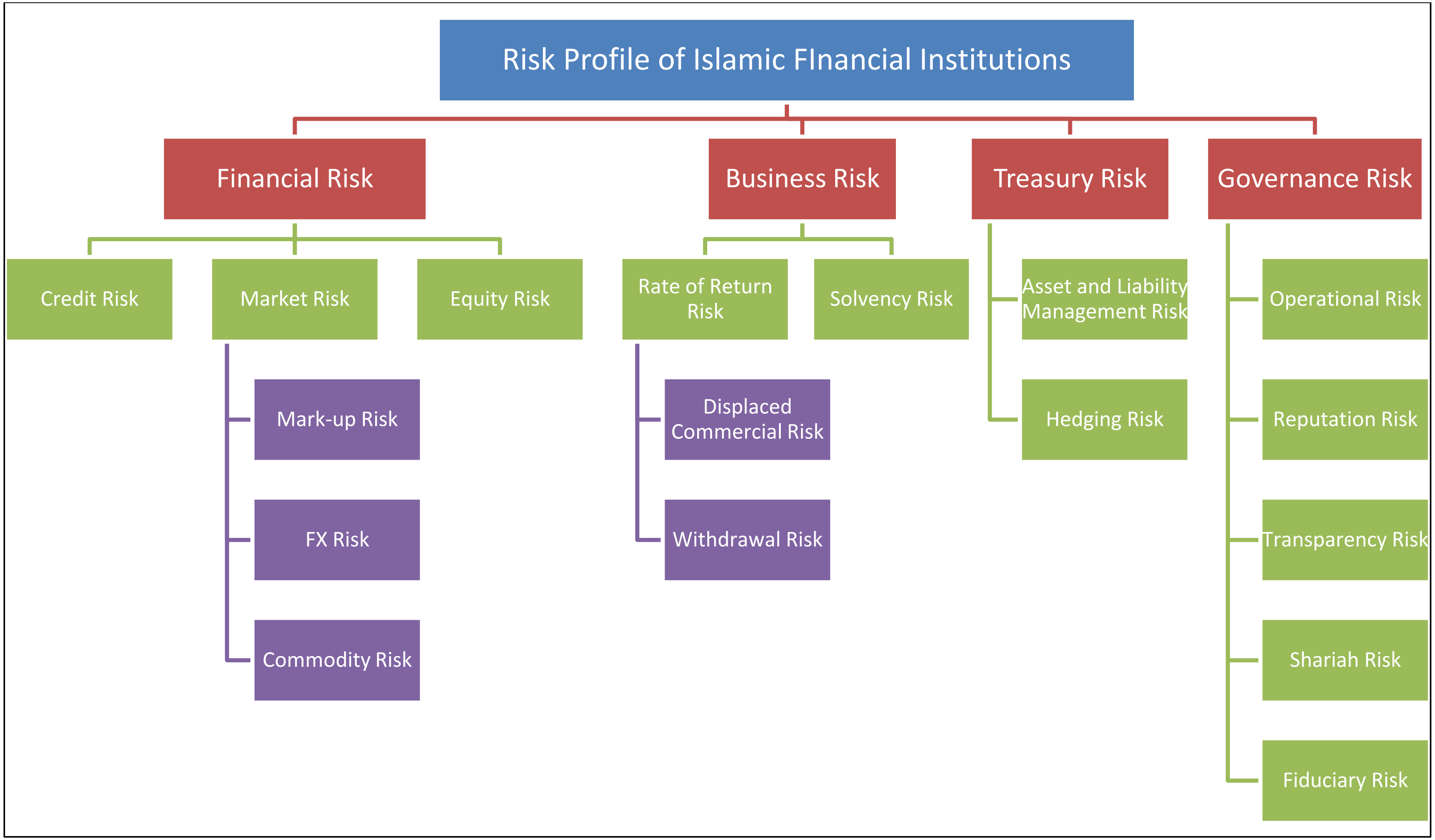

Figure 18: Risk Profile of an Islamic Financial Institution (Source: Dar and Azami, 2010)

An IFI seen as selling or marketing products and services which are not entirely Shariah-compliant or have been instigated to be approved by a Shariah scholar, whose religious integrity is being questioned, would quickly lose its principal customer base.

Risk management in Islamic finance can be surmised into a single word: change. With the advent of the 21st century, Islamic finance and more importantly Islamic risk management has to change to contend with the modern financial world. The rules pertaining to risk management under an Islamic framework differ to those of traditional Western finance and the use of derivatives as risk management tools. For example the basic premise of short selling or selling what is not possess is a strong tool in establishing hedging positions. The ability to short sell would allow a risk manager the opportunity to hedge against a price fall by locking in a price now. Moreover, the availability of derivative instruments such as futures and options have meant that this hedging ability has been compounded through the easy availability of standardized financial risk management tools. Whilst conventional finance offers short selling or cash settled risk management structure Islamic finance has a succinct requirement for proof of ownership within any financial structure and transaction. Whilst this principal requirement means that all risk is kept in the “real financial” sense and one can see the benefits of this, is also proves to be a cost towards the overall financial risk management structure (Bacha, 1999; Jobst *et al.*, 2008).

Additionally, the time span allowed in exercising derivative such as futures and options is another ‘luxury’ not afforded in Islamic finance. Both conventional financial futures and options have standardised maturity dates and in the case of American options; the flexibility to exercise any time prior to expiry is an added benefit. The cash-settlement nature of derivatives also allows for a more dynamic approach to risk management with risk managers being allowed to adjust positions based upon changing market conditions (to close out open positions in either futures or options, the risk manager trades the same number of contracts in the opposite direction). However, even with these discrepancies in the availability and use of risk management tools between conventional and Islamic finance, the principles of risk management still remain intact (Dali and Ahmed, 2005).

It is not a question of nullifying the risk element of participants within the financial system as systematic risk will always exist, but mitigating and justifying the amount of risk exposure that has been the central focus of risk management (Bessis, 2002). Risk management has always been about establishing a level of certainty and this principle extends to risk management in Islamic finance. Therefore, change here does not relate to the fundamentals of risk management but rather the use of new products and concepts to fulfil its need.

From a conventional financial perspective the advent of a new, alternative financial system fundamentally illustrates portfolio diversification opportunities. Moreover with the proliferation of risks associated to particular industries, regions or other demographical classifications, the financial sciences have never been one to shun a new risk management opportunity.

Early incarnations of academic literature into assessing the diversification and performance benefit of Islamic finance essentially pigeon holed Islamic equity products with that of ethical financing equity products. It is not difficult to see why as both require a screening process based on a certain criteria of beliefs. These early works seemed to suggest that the screening processes involved with that of ethical financing were likely to alter the characteristics of the assets in terms of performance return and diversification benefits (Rudd, 1981; Grossman and Sharpe, 1986). More specifically, Rudd (1981) argues that the inclusion of a screening process invariables adds a constraint to the overall investments spectrum thus introducing size and selection biases. This, he further elaborated, would result with the deterioration in long-run performance (Rudd, 1981). These findings were supported by that of Grossman and Sharpe (1986) who examine the impact of a screening process on South African stocks. What was found was that the exclusion of South Africa-related stock, on average, was detrimental towards portfolio performance.

However, the findings were not entirely conclusive as the inclusion of a bias towards South Africa-free portfolio greatly increased portfolio returns (Grossman and Sharpe, 1986). More recent work such as that of Sauer (1997); Diltz (1995); Statman (2000, 2008) and Bauer *et al.* (2005) seem to advocate that a screening process should have no overall effect on the performance and diversification benefit of a portfolio. Diltz (1995) implemented an ethical screening criterion to 28 common stock portfolios and found no significant deviation in performance. Bauer *et al.* (2005), who tested a database containing 103 mutual funds from Germany, UK and the US, found that screened investment underwent a catching up phase but exhibited no difference in performance in terms of risk and return.

However, as the Islamic financial industry grew, both in size and in prominence within the global financial world, the knowledge and understanding of Islamic financial screening processes became more apparent to market participants. What was realised was that whilst there was a distinct similarity in terms of the screening process, the screening criteria differed greatly between that of ethical and Islamic equity indices (Khatkhatay and Nisar, 2007b). This new knowledge allowed for a significant development in the research conducted into the performance and diversification benefits of Islamic equity indices. It should be noted that much of the empirical literature focuses predominately on Shariah-compliant equity indices which were essentially stock and shares of conventional multinational companies trading on conventional indices such as the London Stock Exchange or the Hang Seng. What makes these conventional shares Islamic is the Islamic screening processes documented in Chapter 3, Section 3.5.

The literature on SCIs can be divided into two main areas: one compares the performance of SCIs to other ethical funds, while the other to more mainstream indexes, from which some SCIs were derived.

Elfakhani *et al.*, (2005) for instance argue that much of the past literature has compared and contrasted the returns of Islamic funds to ethical funds as a means to assess their relative performance. Indeed, before information was widely and readily available on Shariah and Shariah-compliant indexes, many researchers used ethical funds as a proxy for the performance of Shariah indexes (see for instance Luther *et al.*, 1992 and Kreander *et al.*, 2005). Seminal work by Luther and Matatko (1994) and Hamilton *et al.* (1993) examined the performance of British and American ethical funds and the results were not significantly varied. Luther and Matatko (1994) discovered that the there was marginal out performance of British ethical funds over the market index of the Financial Times All Share Index. Moreover, this benchmark outperformance was seen to improve when compared to more obscure, smaller capped benchmarks rather than large market indexes. The results from the Hamilton *et al.* (1993) study seemed to provide more robust arguments towards improved average returns using an ethical screening process. The study compares 32 ethical and 170 conventional funds over a 9-year period from 1981 – 1990 and illustrates that average returns ethical funds out perform conventional funds.

However, findings for consistent significant outperformance of ethically screened financial assets are not present and evidence can be seen from the works of Gregory *et al.* (1997) and M'Zali and Turcotte (1998). Gregory *et al.* (1997) fundamentally expanded the scope of Luther and Matako (1994) and used matched paired analysis on British ethical and conventional funds. What was discovered from this study was that it was the age of the fund that had an impact on its overall performance rather than the screening processes involved. This provided an interesting aspect of the research as it conclusions collude and confirm that of early studies into the impact of equity screening processes on overall performance (Grossman and Sharpe, 1986). M'Zali and Turcotte (1998) adopted the tired and tested method of comparing risk adjusted returns using standard performance indicators such as Jensen (1968), Treynor (1965) and Sharpe (1966). This work compared 10 ethical funds against 17 conventional funds and found that out of the 10 only 4 ethical funds showed risk adjusted outperformance. More recent studies into the equity screening process have also been divergent in the conclusion pertaining to outperformance of the screening processes. Beer *et al*. (2011) demonstrated that both ethical faith-based screened equity indexes possessed higher volatility that the market indexes - a view that is also advocated by the seminal works of Sauer (1977) and Statman (2000). On the other hand Lyn and Zychowicz (2010) examined the monthly returns of 36 faith-based and ethically screened mutual funds from May 2001 to Feb 2008 and found that faith based screening processes outperformed ethical screening processes and both enjoyed marginally better performance than the market index.

Sadeghi (2008) evolves the standard template for performance evaluation slightly and adopts an event-study methodology towards assessing the effects of the screening process. The daily price bid – ask spread and volume for 88 ethically screened, publicly traded companied were taken the mean cumulative abnormal returns were estimated. What was found was that screening results in better performance but the study also goes on to indicate that screened companies experienced a larger bid – ask spread when compared to their conventional counterparts. It was postulated that could be correlated to the amount and quality of information pertaining to conventional, unscreened companies.

As mentioned before the other main area of research involves a comparison of Sharia-compliant indexes with more mainstream, conventional indexes. For instance Hussain (2004) compared the FTSE Global Islamic Index to the FTSE All-World Index over a sample period of 1996-2003. His results show that the Shariah-compliant index consistently outperformed its counterpart in bull markets whilst it underperformed the FTSE All-World Index in bear markets. Moreover, Hussain (2004) study also indicated that by and large the use of Islamic screens, described above, failed to adversely affect the performance of Shariah-compliant funds.

A follow-up and more comprehensive study conducted by Hussein and Omran (2005) examined the performance of various Shariah funds. This study confirmed the findings of the Hussein (2007) study and suggested that the performance of Shariah-compliant funds was due to investment selection when it came to deciding which companies would be included in the fund.

More recent work by Hashim (2008) also validates the findings of Hussein and Omran (2005) and Hussein (2007). Hashim (2008) essentially looked at the monthly returns for the FTSE Global Islamic, FTSE All-World and FTSE 4 Good indexes from January 1999 to May 2007. Additionally, it proxies the Morgan Stanley All Country Index as the benchmark and used LIBOR as the risk free rate of return. Hashim (2008) estimated the capital asset pricing model (CAPM) for each of these indexes and compared both alpha and beta coefficients. The findings from the study indicate does outperformance by the Islamic over the ethical index and matched performance between the Islamic and Market Index, however, the beta or risk measures of these indexes cannot be ignored. What was found was that the screening processes used by both the Islamic and ethical indexes created more risk – a finding that is similar to that of Rudd (1981) and Schröder (2007). Schröder (2007) found that there was no statistical difference in the performance of 29 SRIs (socially responsible investments) for stock indexes over the period covering 1991 until December 2003. In particular he found that the indexes did not show any superior performance (Jensen alpha tended to be zero) and that the joint hypotheses that alpha = 0 and beta = 1 was not rejected but beta tended to be higher than one, showing a relatively higher degree of risk. Hashim (2008) does provide some explanation towards the increased risk and suggests that the advent of the dot.com bubble could have resulted in returns that were not stationary thus have and underlying effect of ameliorated beta/ risk coefficients.

Merdad *et al.* (2010) takes the risk-adjusted analysis a notch further by looking at differences in performance during market up-swings (bull markets) and market down-swings (bear markets). The study examined 28 mutual funds managed by HSBC Saudi Arabia of which 12 were Islamic and 16 were conventional. The data encompasses the period of January 2003 to January 2010 and assess the risk adjusted returns via standard portfolio performance measures. The findings of this study echo that of Abdullah *et al.* (2007) and Alam and Rajjaque (2010) and seem to indicate that the use of Islamic screening processes resulted in rather interesting patterns in terms of temporal performance. What was found form these studies was a distinct underperformance by Islamic equity indices during a market bull and full phase/ cycles and an over performance during a market bear phase/ cycle.

The arguments put forward in terms of explaining these time-based differences in performance came down to the screening processes with Islamic equity indices excluding financial institutions, such as banks, whose performances are highly correlated to that of the overall financial system. Moreover, the increase dependence of Islamic financial institutions on real assets has meant that market swings have a lagged effect on the performance. Additional work was conducted on these temporal performance effects of Islamic equity indices by Hayat and Kraeussi (2011). The paper measures the risk and return for a sample of 145 Islamic equity funds over 2000 to 2009. The findings concluded that this facet of over performance during market bear phases by Islamic equity indexes was not consistent and in fact there was increased under performance during the financial crisis when compared to a conventional equity benchmark. Furthermore, it was suggested that investors looking at the investment prospects of Shariah-complaint equity products could benefit from more diversified spectrum of Islamic equity offerings such as ETFs or tracking funds rather than individual equity holdings (Hayat and Kraeussi, 2011).

A slightly different approach was taken in the research conducted by Albaity and Ahmad (2008) who used a vector autoregressive approach to assessing the performance of an Islamic and conventional index. The indexes in this context were the Kuala Lumpur Syariah and Kuala Lumpur Composite indexes respectively. Daily returns from 1999 – 2005 were used for this study and KLIBOR (Kuala Lumpur London Interbank Offered Rate) was used as the risk free proxy. Whilst this was a study comparing Islamic against conventional equity index, the results were the exact opposite to that of the Hashim (2008) study and indicated that the Shariah index underperformed when compared to the conventional index. It was suggested that this underperformance could be attributed to the relative age of the equity constituents found with the Shariah index. The relatively young age of the constituents meant that they were more susceptible to market moves.

Girard and Hassan (2008 and 2011) have provided evidence that there was no difference in performance between Shariah-compliant indexes and non-Islamic indexes. This study made use of a paired matching analysis, where the performance of the Dow Jones Islamic Indices was matched against seven similar non-Islamic counterparts over the period of January 1996 to November 2005. This study also included a test for cointegration to determine the existence of a relationship between the Islamic Indices and their non-Islamic counterparts. What was found was the Islamic and non-Islamic funds were co-integrated therefore potentially limiting the scope for portfolio diversification.

In terms of risk and diversification benefits of Islamic indexes, the concerns surrounding the relatively volatility of Islamic and Shariah-compliant financial products essentially spawned another branch of research looking into both the efficiency and thus the riskiness of these Islamic funds. This can be seen in the works of Al-Zoubi and Maghyereh (2007), Bader *et al.* (2008) and Saad *et al.*, (2010). Al-Zoubi and Maghyereh (2007) stands out for adopting an advance value-at-risk methodology which fundamentally involved the use of a risk metric calculation and the estimation of both a Student's T-APARCH and a skewed Student's T-APARCH on the Dow Jones Islamic Index. This study looked at the monthly returns from 1996 to 2005. What was found from this study was the Dow Jones Islamic index possesses less risk than the benchmark market index. Al-Zoubi and Maghyereh (2007) essentially highlighted that this increased performance in terms of lower risk was down to the principles of PLS adopted in Islamic finance. The notion of risk-sharing was shown or suggested to have contributed to lower risk levels as this risk was spread amongst market participants albeit not evenly, but allowed for better risk performance than direct risk-transfer of conventional finance. These findings seem to support the traditional Islamic financial view on PLS and its benefits (Ahmed, 2009; Kayed and Hassan, 2011; Chapra, 2008).

The results from both the Bader *et al.* (2008) and Saad *et al.* (2010) studies, however, have shown the exact opposite of Al-Zoubi and Maghyereh (2007). Both these studies adopted a DEA analysis to assess this level of risk and efficiency between Islamic and conventional financial institutions. Bader *et al.* (2008) examined the performance of 43 conventional and 37 Islamic banks over the period of 1990 – 2005 in 21 countries and found no difference in the overall efficiency of these banks. Saad *et al.* (2007) focused on comparing Islamic and conventional unit trusts and analysed performance efficiency ratios such as portfolio turnover and management expense ratios and concluded that Islamic mutual funds were just as efficient as their conventional counterparts.

What can be seen from the evolution of the research on the performance of Islamic against conventional would be that there seems to be no conclusive output that suggests a consistent outperformance of Islamic over conventional finance. Moreover, in what could be seen as research that throws another question into this existing mix of research would be work conducted by Hoepner *et al.* (2011). This study looked at 265 Islamic equity indexes over 20 countries and found not only performance differences between Islamic and conventional finance but also correlation between performance and development of the Islamic financial market place. The conclusions from this study suggest that Islamic funds in developed Islamic markets outperform international benchmarks and conversely Islamic funds in less-developed Islamic markets underperformed when compared to international benchmarks. Hoepner *et al*. (2011) eludes to developed Islamic markets to those of Malaysia and the Middle-East which have a more developed based of Islamic assets and tools and less-developed to Western Islamic hubs such as the United Kingdom and developed centres of financial excellence that offer Islamic services such as Hong Kong and Singapore.

Principally, the Hoepner *et al.* (2011) study further expands the characteristics of Islamic financial performance. Additionally, what can be seen from the literature would be the growth in prominence of Islamic finance as not only an investment outlet for Islamic investors but through the use of a screening process, has become a viable investment for mainstream conventional investors. This rapid growth as not only an insular financial system but also one that research has shown is a viable alternative to conventional finance has meant that there has been an increased call for the further development of Shariah-compliant risk management strategies and instruments within Islamic finance.

The nature and structure of risk management tools within Western finance have been developed, studied and engineered for the better part of a century whilst literature pertaining to explaining Islamic risk management concepts is only two decades old (Elfakhani *et al.*, 2005). Moreover, this relatively young age of Islamic banking and finance has meant that there is also little development of a formal risk management culture (Chapra and Khan, 2000) and unlike mainstream finance, Shariah finance lacks the wide variety of risk management instruments to contend with the risks highlighted in Figure 18. All risks are time dependant and the lack of risk management instruments such as derivatives in Shariah finance has meant that it is difficult to manage this temporal aspect of risk. It should also be noted that much of the existing literature does suggest that Islamic banking and finance faces similar risks to that of its conventional counterpart (Noman, 2002). Hassan (2009) suggests rather than Shariah risk being the prevalent risk type in the Islamic financial system, it is in fact, foreign exchange, credit and operating risk that dominate the Islamic financial spectrum.

Khan and Bhatti (2008a) suggest that the conceptual paradigm of Islamic banking and finance has to change to meet its modern financial needs. Predominately, it is advocated that Islamic banking and finance can learn a lot form the conventional finance in terms of product development and risk management. There is also a basic need and market requirement for further development of both risk management tools and strategies and leading central regulatory bodies such as the Islamic Financial Services Board have been working towards establishing a stronger, more robust and standardized framework for Islamic financial innovation (Hesse *et al.*, 2008). This view for market need is also shared by Iqbal (2007) who highlights that Islamic finance, in its current incarnation, possesses all the necessary preconditions that would foster the continual and rapid development of new financial instruments. These factors have included aspects such as the push towards liberalization, deregulation and privatization of the global Islamic financial system (Bacha, 2004). Khan and Bhatti (2008b) highlights a perfect example of the changing conditions of the global financial scene to accept and incorporate Islamic financial as a parallel banking system. This example comes in the form of the changing of tax laws in the UK to make it possible for Islamic retail banking to operate. Fundamentally, these tax laws were amended to accept the financing implications of PLS within many Islamic financial structures. Moreover, the recent trend of Shariah-compliant innovation has meant that there is increased opportunity for Islamic financial innovation. These, coupled with the growth of Islamic finance in more conventional financial hubs have meant that there is a convergence of need and requirement of new financial instruments and market environment nurturing the development of these instruments (Bassens *et al.*, 2010).

Not everyone is in acceptance of these market conditions however. Chui and Newberger (2006) surveyed the spectra of Islamic financial markets and found that it was increasingly difficult to offer new products to customers. Fundamentally, this raised questions about the apparent need for new Islamic financial instruments but rather posited that there was an unyielding want for financial development rather than actual need. Al-Salem (2009) also suggests that whilst the conditions are right for financial development, innovation in the form of new tools and instruments is still limited. This was put down to the fact that the conceptual framework for financial innovation was still very new and the divergent interpretations of Islamic law made it difficult.

Pushing on from arguments pertaining to a need for new Islamic financial tools arising from its rapid development and inception into conventional finance, Dar and Presley (2000) have suggested a more introspective argument for financial innovation within Islamic finance. Aside from having to manage the need for new risk management tools to contend with the proliferation of additional risk from integrating into a conventional financial system, there is also a need to establish these tools to contend with the vulnerabilities of Islamic finance in the modern economy. The emphasis and dependence on both PLS and debt financing modes have created an inability to deal with these new risk types and the illiquidity of Islamic tools and assets could essentially lead to a similar situation that is currently being faced by countries such as India (Malik *et al.*, 2011).

With reference to the Islamic financial principles described in Chapter 3, participatory principles that engage in a PLS modus are too rigid to provide the flexibility to deal dynamically with certain types risk. From a risk management point of view both *musharakah* and *murdarabah* contracts require two parties that share similar risks to come together to form an agreement to share out this risk or share out an asset that would hedge against this risk. It would be, to a certain extent, time-consuming and difficult to find a counterparty that shares the same type and amount of risk. However, many Shariah financial contracts are over-the-counter (OTC) and could be tailored to suit the needs and requirements of both parties.

Thus this only really leaves the non-participatory instruments. What can be seen from their structures would be that both *bai al-salam* and *bai al-muajjal* resemble very much mainstream forward contracts.

The use of forward contracts in Islamic finance is allowed, albeit with strict preconditions that physical ownership of goods be proven and payment be made up front (Al-Suwailem, 2006). This is financial hedging in its most basic form, which illustrates the need for the development of more dynamic risk management tool tools within the Islamic financial system. Whilst forward contracts allow firms to lock in a price, these contracts are mainly formed privately between two contracting parties (Bacha, 1999). Without a third party to monitor and ensure delivery, counterparty and default risks become an issue. As both options and futures are traded on managed exchanges, the problem of counterparty risk is overcome (Bacha, 1999). The exchanges act as the intermediary and now bear the risk, which it minimizes through the margining and marked to market processes. If the argument against the use of derivative in Islamic finance is the fact that it breeds gharar (see Saleem, 2006; Seif, 2009) then the conventional exchange traded derivative paradigm should effectively remove this element (Bacha 1999). Exchanges act as the intermediary within the derivative markets and in the case of options, the use of daily marking to market and maintenance margins would nullify much of the counterparty risk, which in essence would be removing gharar from the market spectrum. Moreover, the standardization of option contracts in terms of maturity dates and face values would also serve to lessen the overall level of gharar in the transaction. The precepts of looking at the positives of derivatives from and Islamic perspective are very much lacking in today's modern Shariah-compliant world (Mokhtar and Laldin, 2009). In this work, Mokhtar and Laldin (2009) suggest that Shariah-compliant screening processes can approached from two directions – positive and negative Shariah screening. A negative approach is what defines Islamic finance in the global financial spectrum and involves the orthodox prohibition of riba and prevention of gharar and maysir whilst the positive approach looks at financial decisions that promote social egalitarianism, justice and ethics. Mokhtar and Laldin (2009) have shown that much of the Shariah-compliant decisions are based predominately on negative screening processes rather than positive processes. Additional work by Ebrahima and Rahman (2005) has also illustrated that use of standardized futures contracts also demonstrate pareto-optimality over more traditional Islamic financial *salam* contracts. In this regard it could be further argued that the standardized approach adopted by modern derivative exchanges brings about a more succinct notion of equality over traditional Islamic financial products. While this could lead to tentative arguments for inclusion of Islamic derivatives under the guise that they are excellent management tools, in that they allow for the management of contingent liabilities, which relates back to the temporal argument of risks, it cannot be denied that derivatives do advocate a certain level of moral hazard.

Derivatives such as options and futures have been the topic of much scepticism ever since their inception into the Western financial world (see Kreitner, 2000 and Swan, 2000). This early scepticism stemmed from the fact that many derivatives were cash settled and thus lacked the ‘real’ economic characteristics of a proper tool for hedging.

Additional scepticism arose from an economic perspective with concerns directed at the speculative nature by which derivatives could be traded. The ability to separate an asset from its risk allows the commoditisation of the risk element and fundamentally breaches the

Islamic tenet of preventing gharar. By commoditising this risk element, it creates a separate market between underlying financial contract and the risk and it is seen to result in the proliferation of risk and uncertainty. This essentially allows investors to leverage positions and fundamentally trade risk (Buffet, 2002). The ability to separate asset and risk makes derivatives significantly susceptible to small changes in the market and amplifies a company's exposure to an abnormal amount of risks, which could have severe consequences for any economy from a macro perspective (Buffet, 2002 and Steinherr, 2000). The issue here lies with the commoditisation of risk and if this risk is borne by individuals who desire it or by individuals who cannot adequately manage it (Steinherr, 2000).

Moreover, derivatives allow for the creation of artificial risks-rewards structures and this encourages the proliferation of possible arbitrage and speculation (Tumpel- Gugerell, 2003). This ability to create artificial payoffs is a major concern for Islamic finance and Shariah-compliant financial innovation. Known in the Islamic financial system as hiyal or artifices, the impact of these synthetic payoffs via the combination of the payoffs of combining different option classes cannot be discounted and should be a case for consideration during the financial engineering process (Kayed and Hassan, 2011). These speculative trades through derivative are felt to affect the price of the underlying which in turn would distort the economy making it more volatile (Summers and Summers, 1989). This is once again a violation of the Islamic financial principles of preventing uncertainty and the gambling within the financial system. However, the literature pertaining to this issue is inconclusive. Whilst some studies (Jochum and Kodres, 1998 & Pilar and Rafael, 2002) indicate that there is no influence or even positive influence of derivatives on the spot markets, others (Hodgson and Nicholls, 1991) suggest otherwise. Jochum and Kodres (1998) applied a SWARCH (Markov

Switching Autoregressive Conditional Heteroskedasticity) to measure the volatility of the dollar spot exchange rates of the Mexican peso, Brazilian real and Hungarian forint and their respective futures contracts. The unit of measure in this study was daily spot rates from the 1st of January 1995 to the 28th of February 1997. Whilst the VAR analysis does indicate some volatility spill over from the futures to the spot market, the SWARCH results suggest that there is a null effect (neither positive nor negative) from futures markets on spot positions. Pilar and Rafael (2002) approach the issue using a GARCH and EGARCH methodology and analyse the introduction of derivative trading on the Spanish IBEX-35. The period of analysis was October 1990 to December 1994. Fundamentally, a dummy variable was used to proxy the introduction of derivative trading in 1992 on the IBEX-35. What was discovered from this study was that the underlying volatility of the equity markets essentially improved with the introduction of the derivative market, essentially a vindication of seminal work by Stoll and Whaley, 1987 and Kyle, 1985. The table below further highlights the empirical studies behind the impact of derivatives and their impact on the underlying markets.

Author(s)	Date	Underlying	Derivative	Method Employed	Effect on Underlying
Conrad	1989	Equity	Options	Event study	Price increase, decrease in volatility
Stephan & Whaley	1990	Equity	Options	Multiple time-series analysis	Cash market leads the option market
Detemple & Jorion	1990	Equity	Options	Event study	Confirms Conrad; finds cross effects
Stucki & Wasserfallen	1994	Equity	Options	Event study	Confirms Conrad
Shastri, Sultan & Tandon	1996	Currency	Options	Bivariate GARCH	Spot volatility decreases
Clifton	1985	Currency	Futures	Correlation	Increase in spot volatility
Edwards	1988	Stock index	Futures	Event study	Decrease in spot volatility
Ely	1991	Interest rate	Futures	Varying parameter model	Spot market not affected
Schwarz & Laatsch	1991	Stock index	Futures	Bivariate random walk	Futures reduce mispricing
Bassembinder & Seguin	1992	Stock index	Futures	2-equation system	Decrease in conditional spot volatility
Kawaller, Koch & Koch	1993	Stock index	Futures	Granger causality	Increase in volatility strengthens market relation
Chatrath, Ramchander and Song	1996	Currency	Futures	GARCH, VAR	Increase in spot volatility
Jabbour	1994	Currency	Futures	CIP, regression and specification tests	Futures provide good spot rate predictors
Crain & Lee	1995	Currency	Futures	Granger causality	Transfer of volatility

Darrat, Rahman and Zhong	2002	Equity	Futures	EGARCH	Transfer of volatility but spot is inherently volatile regardless
Yang, Yang and Zhou	2012	Equity	Futures	GARCH	Bidirectional dependence on volatility
Kim and Ryu	2014	Equity	Futures	VAR(1)-asymmetric BEKK-MGARCH	Bidirectional causal relationship
Pilar and Rafael	2002	Equity	Futures and Options	GARCH, EGARCH and GJR	Decrease in underlying volatility

Table 6: Empirical Literature on the Effects of Derivatives on the Underlying Spot Markets

The interdependent relationship of risk as well as the interdependent nature of economies would mean that speculation could compound the problems over an entire panel of financial systems. As Kenneth Arrow (1971) suggested "… the situation may actually be worse than without speculation…" (p. 24). Additionally, the association of derivatives as one of the significant causes of the recent financial crisis has not aided the arguments for the inclusion of derivative like structures in Islamic finance. Arguments for securitization of Islamic financial contracts have taken knock ever since the use of mortgage-backed securities was seen as one of the major 'evils' of the financial crisis.

The Islamic view on the permissibility of derivative instruments such as futures and options is a divided one. Whilst certain schools of thought have outspokenly illustrated their disregard for the use of derivative instruments, the reasons for prohibition are mixed at best (see Table 6) (Bacha, 1999). Opponents of derivatives within Islamic finance seem to argue the perspective that the Islamic financial paradigm, and with it the prohibition of derivatives, could have prevented the current financial crisis (Ahmed, 2009). These fundamental arguments stem from the encouragement of PLS modes of financing that is seen to suggest social egalitarianism. Moreover, the use of complex financial contract such as derivatives would invariably lead to increased exploitation and corruption within the Islamic financial system (Chapra, 2008; Siddiqi, 2006). Both Desai (2008) and Brewster (2008) further put forward that the exclusion of derivatives in Islamic finance has meant that the destabilising effects of the current financial crisis were significantly muted on the Islamic financial system. However, it should be noted that whilst the effects of the financial crisis were muted, the Islamic financial system was not immune to these effects. Whilst the asset composition of Islamic equity markets means the exclusion of financial institutions resulted in the smoothing the underlying effects of the financial crisis (Girard and Hassan, 2008), the increased dependence of Islamic finance on real assets meant that any smoothing was gradually eroded as the effects of the financial crisis permeated past the financial assets into the real markets.

Another argument stems from the fact that a derivative is detached from the underlying asset and as such a value cannot be justified for the premium or the view that an option benefits the buyer more than the seller (Kamali, 1997). This disregards for the premia of option contracts relates back to the argument against riba and option premiums are seen as free money but if the issue is indeed considered, the nature of option premiums are dependent upon the volatility and risks in the marketplace. In this regard the option premium could in fact be considered justifiable remuneration for taking on a certain amount of risk (Jobst, 2007).

Moreover, the literature (Obaidullah, 1999 & Smolarski *et al.*, 2006) seems to suggest that a major stumbling block for derivative structures in Shariah approval would be the association of futures and options to *maysir* (gambling). The apparent fallibilities in using derivatives as part of a risk management strategy lie with the fact that it is an excellent speculative tool. This is a central theme in understanding the use of derivatives in Shariah finance. One of the major problems with the inception of derivatives within the Islamic financial framework would be that it is extremely difficult to differentiate between risk management and speculation (Bacha, 1999). The speculative abilities of derivatives arise from the way they are structured and the nature by which they are traded – value derived from an underlying asset and cash settled. Additionally, within the realm of risk management short selling is common game. However, under an Islamic framework, it has to be shown that there is a line of ownership and that aspects such as price, time and quantity must be finalised before the trade

(El-Gamal, 2006). Speculation under Shariah is seen as gambling (*gharar*) and thus explicitly disallowed.

If one of the major concerns of Islamic finance is the lack of certainty (*gharar*) and that this arises out of a lack of knowledge (*jahl*) (Askari *et al.*, 2009) and therefore it is the belief that *gharar* is brought on by a lack of information. However, does this not then become a matter of learning? If this is the case, the problems pertaining to a lack of information regarding the trading of derivative instruments could be circumvented by the creation of organised exchanges as documented above (Smorlaski et al, 2006).

In what was the most extensive study of its kind, Kamali (1995; 1997; 1999) examined the permissibility of modern option contracts in light of Islamic Commercial Law. His conclusions suggested

> "…there was nothing inherently objectionable in granting an option, exercising it over a period of time or charging a fee for it, and that options trading like other varieties of trade is permissible *mubah* and as such, it is simply an extension of the basic liberty that the Quran has granted…" (pg.36)

Moreover, an additional benefit of derivatives would be that it allows for the management of contingent liabilities, which relates back to the temporal argument of risks. Kamali (1995) suggests that the underlying benefit of derivatives should also be considered within the debates of its inclusion with the Islamic financial system. Fundamentally, these debates should not only centre on speculation but rather also see the risk management merits of potential Islamic derivative structures. The notion of *maslahan* argued by Kamali (1995, 1997 and 1999) would relate back to the positive screens suggested in the work of Mokhtar and Laldin (2009).

In an extension to his 1995 and 1997 work, Kamali (1999) further expands his debate for derivatives in Islamic finance. In what was research design to suggest a framework for the Malaysia Islamic financial system, Kamali (1999) highlighted, from an Islamic perspective, that the notion that derivatives 'devour the properties of others' is untrue. Moreover, fact that derivatives promote *gharar* is also untrue on the basis that there is mutual consent of both parties in the contract to its specifications (Kamali, 1999). Further to these point Kamali (1999) does assert that the success of Islamic derivatives would depend on trading volume and it is in this volume that the efficiencies demonstrated from organised exchanges will be derived. Additionally, the pressing issue of the underlying benefits from using derivatives as risk management tools is also vehemently pushed.

In relation to this debate about the positives behind Islamic derivatives, there is also scope in trying to develop a product where risk mutuality is present through a combination of two or more other Islamic risk management instruments. The Western concept of delta hedging to gamma hedging can be applied to risk management within the Islamic spectrum so that mutual benefit is derived from both parties. However, as far as the research is concerned, there seems to be a lack of literature surrounding the combination of Islamic products to produce a specified return (See Obaidullah, 1998; El-Gamal, 2005 and Choudhury, 2009). One suspects that it could be down to the creation of *hiyal* (artifices) (Obaidullah, 2005;

Chapra, 2008). A combination of products may not necessarily yield a product that abides by Shariah.

Derivatives are significant risk managing tools that allow an individual to hedge against the temporal risk associated to an underlying asset. If the Islamic argument against derivatives is that they attempt to detach time from property then there is a question as to whether risk management is viable within this financial system. These arguments however, are divergent at large. Whilst many advocates (See Kamali, 1995, 1997, 1999; Salehabadi and Aram, 2002; Smorlaski *et al.* 2006) of derivative-like structures in Islamic finance tend to avoid the temporality argument, it cannot be avoided that derivatives are excellent risk management tools. The suggestions that derivatives encourage speculation and gambling (Obaidullah, 1999), the researcher feel are harsh. The research has illustrated the difficult beginnings of derivatives even within the Western financial world where speculation, to a certain extent, is rife and allowed. However, if one were to consider it in its entirety there is nothing inherently non-speculative about Islamic finance. Yes, Islamic finance does not encourage speculation but as a financial system, there will always be an element of risk in an uncertain future. Risk is a generalised condition whether or not derivatives are present. It should be known that the development of derivative-like risk management tools is for the purposes of risk management and none other (Kamali, 1999).

Moreover, in an age where information is available at large, can arguments for *jahl* really be that prevalent? *Jahl* or ignorance may, to a slight degree, bear more significance for the private individual dealing with banks as such but between multinationals, can blame for ignorance really be subverted when resources are provided to learn? (Obaidullah, 1999)

There is also another side to this argument on derivatives, which arises from the various schools of Islamic financial thought. Siddiqui (2008) illustrated that the lack of consensus between Islamic scholars about the permissibility of derivatives has meant that there are differing financial engineering frameworks for different Islamic financial systems.

What can be seen from these arguments is that the prohibition of derivative instruments under a Shariah financial framework is based upon differing interpretations of Shariah and the understanding of these instruments but there has been little objection to the way with which options and futures are structured and traded (Bacha, 1999). The research recognises that whilst this is a significant argument for the scope of Islamic derivatives, it is also a regulatory argument, which would have significant implications on not only derivatives but also Islamic financial innovation and the global Islamic financial system as a whole. As such this issue of regulatory uniformity and Shariah-compliance will be discussed later in this chapter in the section that evaluates the issues surrounding Shariah governance and regulatory challenges.

The Islamic financial system cannot be seen through the eyes of Western finance. Islamic finance is a twenty-first century phenomenon. It is not a twenty-first century Western phenomenon. As this research has progressed we have realised that the spectrum by which Islamic finance evolves cannot tantamount to Western standards. However, the need for Islamic finance to develop itself to suit, not a Western world, but a globalised financial world is there. Change like risk and uncertainty is the only certain aspect of finance. To have traditional values deal with modern day calamities would be calamitous in itself. True innovation takes place in the presence of boundaries but there must be a want for change.

The following section provides an illustration to the current state of Islamic financial innovation. It highlights many of the arguments put forward above for the need for continual development and also the growth of market driven financial engineering. The financial structures below emphasize the innovative possibilities through the use of Islamic financing principles to fundamentally recreate the flexibility of conventional derivative like structures.

4.2.1. Derivative-like Instruments in Shariah Finance

Whilst the arguments against the use of derivative products continue, there have been innovative developments in risk management tools in Islamic finance. There has been a recent trend for the development of Shariah-compliant products (Wilson, 2007).

The ever growing nature of Shariah finance has resulted in a new ‘’breed’’ of Shariah-compliant products. There is a quickly developing chasm between Shariah-compliance and conformity to Shariah. What can be seen from the structures and application of these tools would be that they bear a striking resemblance to traditional Western options and futures. However, while these products are supposedly Shariah-compliant products, some, such as the *bai al-arboun*, are widely disallowed by Shariah scholars (Maurer, 2001). The following section of this research is going to be split into two parts, with the first part looking at Islamic tools that resemble options structures and the second part looking at Islamic tools that resemble futures.

This section will highlight several key Islamic contracts when it comes to risk management. It describes several innovative developments with Islamic risk management tools using fundamental Islamic financial concepts. The research has identified key Islamic financial concepts in Section 3.6. and from those *murabaha*, *wa'ad*, *salam* and *arboun* are seen as the most used within the Islamic risk management spectrum. From these concepts there have been significant innovations when it comes to Shariah-compliant risk management tools. However, before examining these new developments in Islamic risk management tools, two key issues must be considered – liquidity and credibility.

Liquidity is an important element within the financial world and mainstream financial institutions are able to generate liquidity through

i) The interbank lending network
ii) Government securities
iii) Lending to corporate customers
iv) Keeping cash at hand.

The issue of liquidity is more pertinent to Islamic financial institutions as the first three methods described above are seen as *riba* and the last does not yield any benefit (Chapra, 2006; 2007; Dar and Azami, 2010). Therefore, this only leaves keeping cash in hand as a possible option out of the four stated above. However, keeping too much cash in hand may not be a viable option and could indicate and inefficient use of resources. The inability to generate liquidity quickly within Shariah finance has meant that there is increased liquidity risk for Islamic financial institution (Akhtar *et al.*, 2011). As such it is important for the development of these Shariah-compliant risk management instruments to first protect against liquidity risk and secondly aid in the creation and generation of liquidity mobility (Ali, 2004).

The development of Islamic financial instruments and services must be to a standard as to be seen as a credible alternative to conventional finance. This is not a question of competition but more of keeping pace (Noman, 2002). The issues of credibility relate towards the governance of the Islamic financial system as a whole looking at the uniformity and transparency of the regulatory standards in the global Islamic financial system. Financial innovators within Islamic finance have to contend with two major requirements. Firstly, ensuring that the product or service produces a beneficial financial output and secondly certifying that the product and service abides by Shariah-compliant rules and regulations. This relates back to El-Gamal's (2005) arguments about substance and form of Islamic financial services and products discussed in Section 3.5. Islamic financial instruments should serve to provide a viable financial service but without nullification of Islamic values (Bacha, 1999). However, at the same time the chase to be Shariah-complaint should not devalue the financial integrity of the product or service. These arguments about form and substance are to a certain extent paradoxical, but the underlying principle is that there should be a balance between the two and the optimal situation would be where innovation produces a product that is both competitive in the financial sense and abides by Shariah regulatory standards (Bacha, 1999; El-Gamal, 2003).

Many of these Shariah-compliant derivatives are based upon combinations of multiple *murabahas* to create swap contracts, use of *wa'ads* as options and *salam*s to create forward contracts. With regards to *salam*, it is structured as a standard forward where a price is agreed now and delivery takes place at a later date. The use of *arboun* in Shariah-compliant derivatives is virtually non-existent as concerns over its Shariah permissibility mean that it is not widely accepted as a viable Shariah-compliant concept and instrument (Bacha, 1999;

2005; Shanmugam and Zahari, 2009). The following sections highlight some innovative use of *murabaha* and *wa'ad* contracts to recreate the payoff and financial characteristics of mainstream derivative contracts.

4.2.1.1. Cross-currency swap

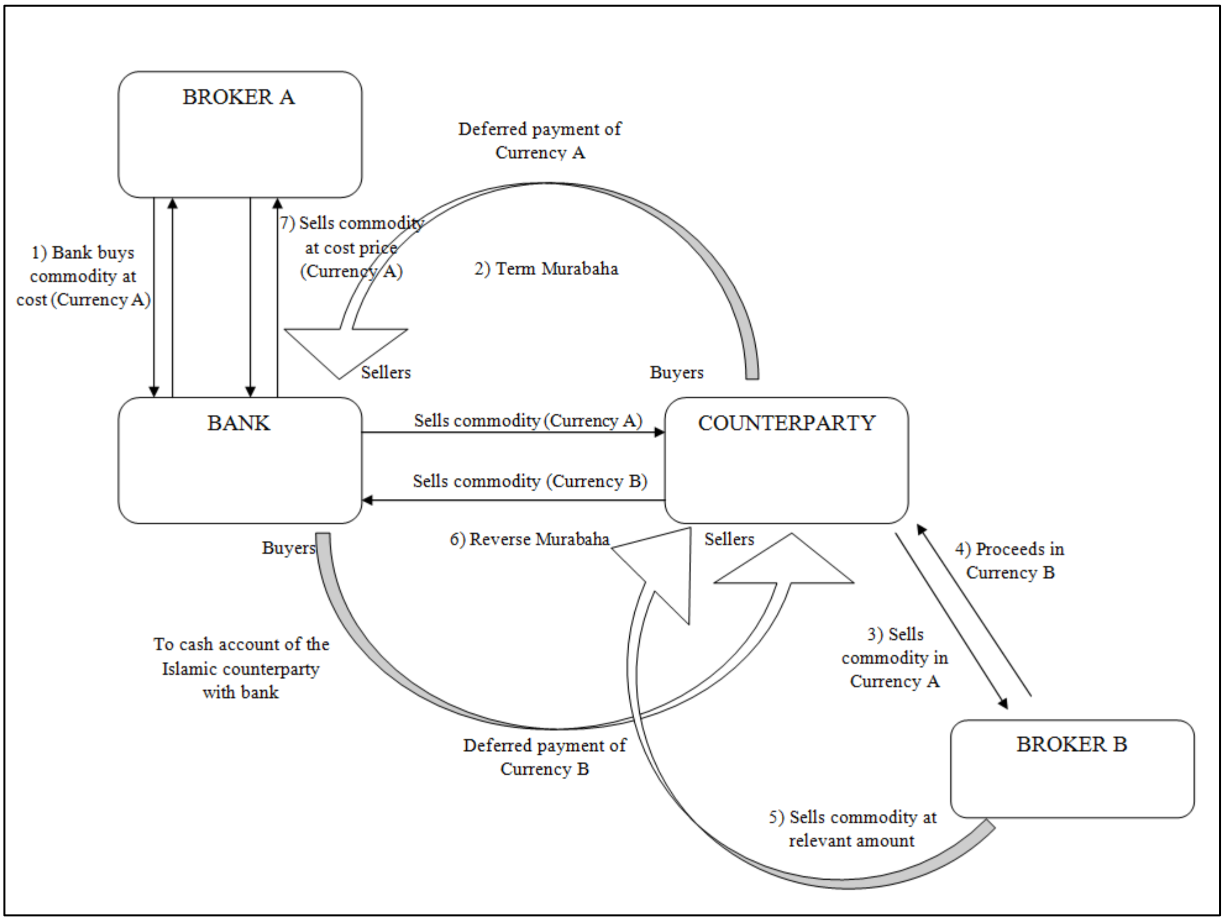

Figure 19: Shariah-compliant Cross Currency Swap (Source: Dusuki, 2009; Dar and Azami, 2010)

A conventional cross-currency swap combines the exchange of the principal loan along with an interest rate swap. It essentially involves three stages whereby stage one comprises of the initial loan principal is exchanged at a certain currency, stage two is the continual exchange of interest rates for the specified currencies and stage three is the final exchange of the principal loans once again. The effects of interest swapping are not permitted under Islamic finance and therefore the structure of the Shariah-compliant cross-currency swap involves the use of multiple *murabaha* contracts. Moreover, there is also the requirement that there is ownership of the specified currencies before contracting takes place. As such the structure is made slightly more complicated with the inclusion of brokers to fulfil the link of ownership of the specific currencies. The structure of the Shariah-compliant swap is illustrated in the diagram above. The numbers in the diagram indicate the steps and direction of trades involved within the structure.

The first *murabaha* contract known as a term *murabaha* involves the bank purchasing a commodity at Currency A (1) and immediately selling this on to the counterparty (2). Both steps (1) and (2) are denominated in Currency A. The counterparty will pay for the commodity from the bank through the primary term *murabaha* on deferred payment scheme, where the payment dates and amounts are agreed upon beforehand. Each of these payments is a portion of the pre-agreed profit element with the final payment being the actual cost of the commodity. Upon receipt of the commodity the counterparty sells this on for Currency B – steps (3) and (4).

The second *murabaha* contract is known as a reverse *murabaha*. Within this part of the agreement, the counterparty purchases a commodity from a broker at Currency B and immediately sells this onto the bank – steps (5) and (6). Both these steps are denominated in Currency B. The bank then agrees to pay for this commodity through the reverse *murabaha* on a deferred payment basis. Once again these deferred payments have pre-agreed sums and dates and each of these payments is a portion of the profit of the second *murabaha* with the final payment being the actual cost of the commodity. The bank then sells this commodity on to a broker to generate an amount of Currency A – step (7).

It should be noted that the commodities sold under both *murabahas* – term and reverse – should have the same value. Moreover, the sale of these commodities by both bank and counterparty should be to two different brokers. The use of this structure first took place in 2006 when Citigroup designed a currency swap to aid Dubai Investment Group in hedging its investment in Bank Islam Malaysia (Bendeich, 2006)

4.2.1.2. Profit rate swap

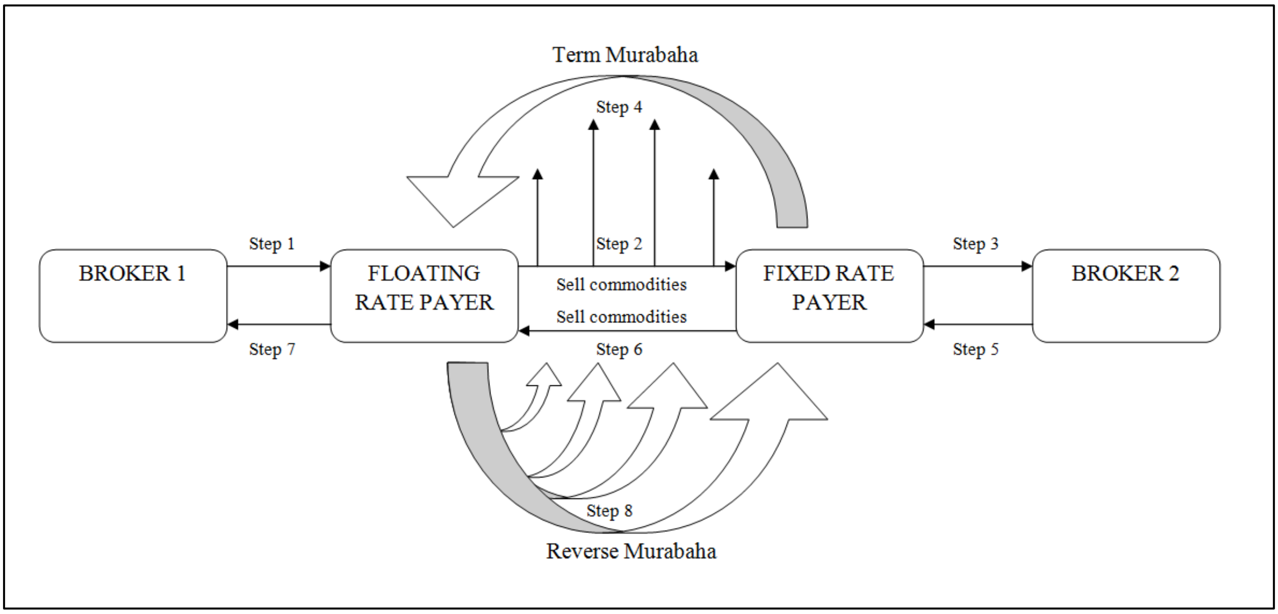

Figure 20: Shariah-compliant Profit Rate Swap (Source: Dar and Azami, 2010; Yankson, 2011)

The structure in the diagram above is a basic Islamic profit rate swap and like its traditional counterpart allows the transformation of fixed rate into floating rate and vice versa. This structure involves the use of two *murabaha* contracts – a straight term *murabaha* and a parallel reverse *murabaha*. Steps 1 to 4 involve the straight *murabaha* where the floating rate payer purchases commodities from Broker 1 (Step 1) and sells these on, at a mark-up, to the fixed rate payer (Step 2) who then sells them on to Broker 2 (Step 3). The money from the sale of the commodities is used repay the initial *murabaha* at fixed intervals and with fixed amounts (Step 4). Under the term *murabaha* structure, the payment for the commodity from floating to fixed rate payer will take place under a deferred payment basis. This completes the transformation from floating rate to fixed rate.

Steps 5 to 8 illustrate the parallel reverse *murabahas*. Each of the arrows in the diagram above for step 8 is in fact a secondary reverse *murabaha* contract (SRMC). The first SRMC is entered into when then initial primary term *murabaha* is initiated. For these SRMCs to work, the fixed rate payer purchases commodities from broker 2 and sells these immediately to the floating rate payer who then sells these commodities on immediately to broker 1 – Steps 5, 6 and 7. Payment by the floating rate payer for the commodity is a single payment for each of the SRMCs and includes the value of the commodity for the relevant SRMC and a profit element linked into an appropriate interest rate – e.g. LIBOR. These SRMCs will be entered into to match the deferred payments in the initial term *murabaha* – Step 8. As each of these SRMCs could be considered separate and with the profit element tied into an interest rate this fulfils the floating element of the swap. This structure was first introduced by Standard Chartered Saadiq, when in 2006 it entered into a three year profit rate swap with Aref Investment Group A.E.K in Kuwait worth $150 million (AMEInfo, 2006).

4.2.1.3. Total return swap

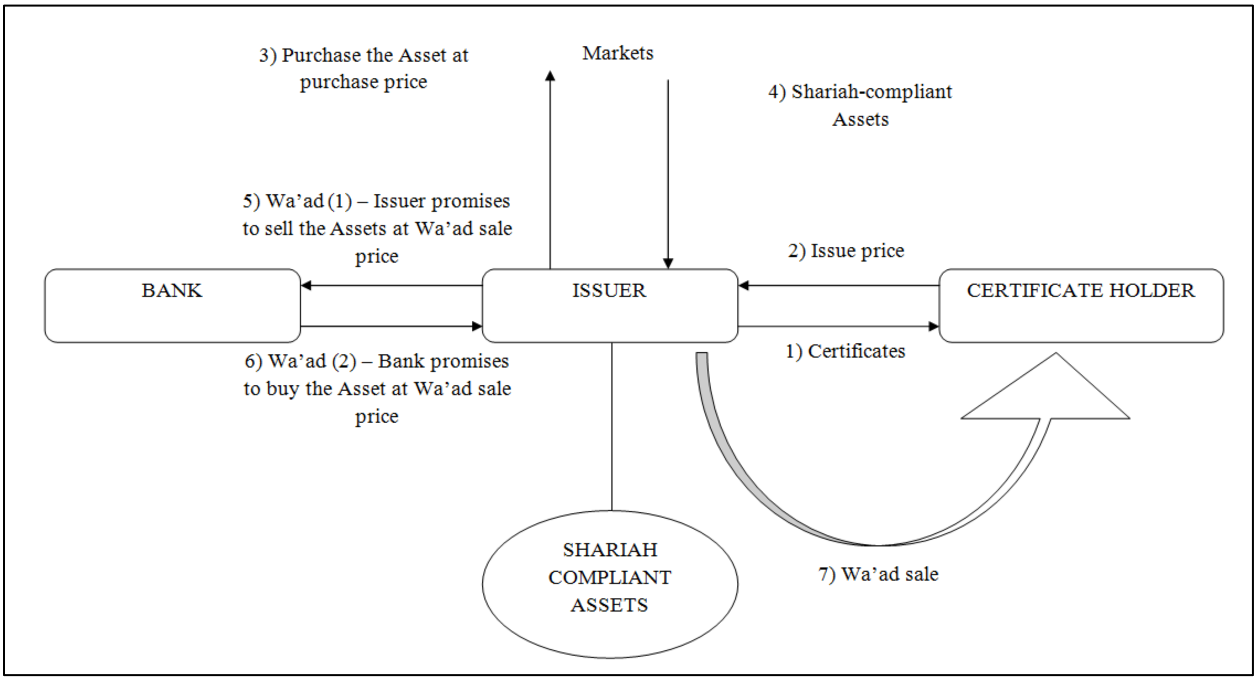

Figure 21: Shariah-compliant Total Return Swap (Source: Dar and Azami, 2010)

In conventional finance a total return swap involves a contract where one party pays a set rate, which could be based on fixed or variable interest rates, and the counterparty makes payments based on an underlying asset. The benefit of such a structure is that it allows the prospect of gaining exposure to an asset class without having to own it. The diagram above illustrates how two *wa'ads* can be used to create a structure that is similar to a conventional total return swap.

Under this structure, a Special Purpose Vehicle, the Issuer in the diagram above, issues certificates to investors at a certain price – steps (1) and (2). The cash generated from this is used to acquire a pool of Shariah-compliant assets, which is the underlying asset in the swap. The certificate holders gain exposure to this underlying through two mutually exclusive *wa'ads* between SPV and bank. In *wa'ad* 1 the Issuer promises to sell the underlying onto the bank at a certain price. In *wa'ad* 2 the bank promises to purchase the pool of assets at a certain price. It should be noted that only ever one of these *wa'ads* will be exercised.

Upon maturity, there are two possible scenarios.

- Scenario 1: Should the *wa'ad* sale price be higher than the value of the pool of assets – then the Issuer will exercise *wa'ad* 2 – Step (6).
- Scenario 2: Should the *wa'ad* sale price be lower than the value of the pool of assets – then the Bank will exercise *wa'ad* – Step (5).

This *wa'ad* sale price will then be used to remunerate the certificate holders. In essence, similar to a conventional total return swap, the certificate holders in the structure above are technically swapping the payoffs of the pool of Shariah-compliant assets with that of the *wa'ad* sale price.

The details of industry usage are vague, however what is known is that the double *wa'ad* structure has been used by Deutsche Bank in the structuring of a total return swap but details such as amount and dates are not available (Risk, 2008).

4.2.1.4. FX option

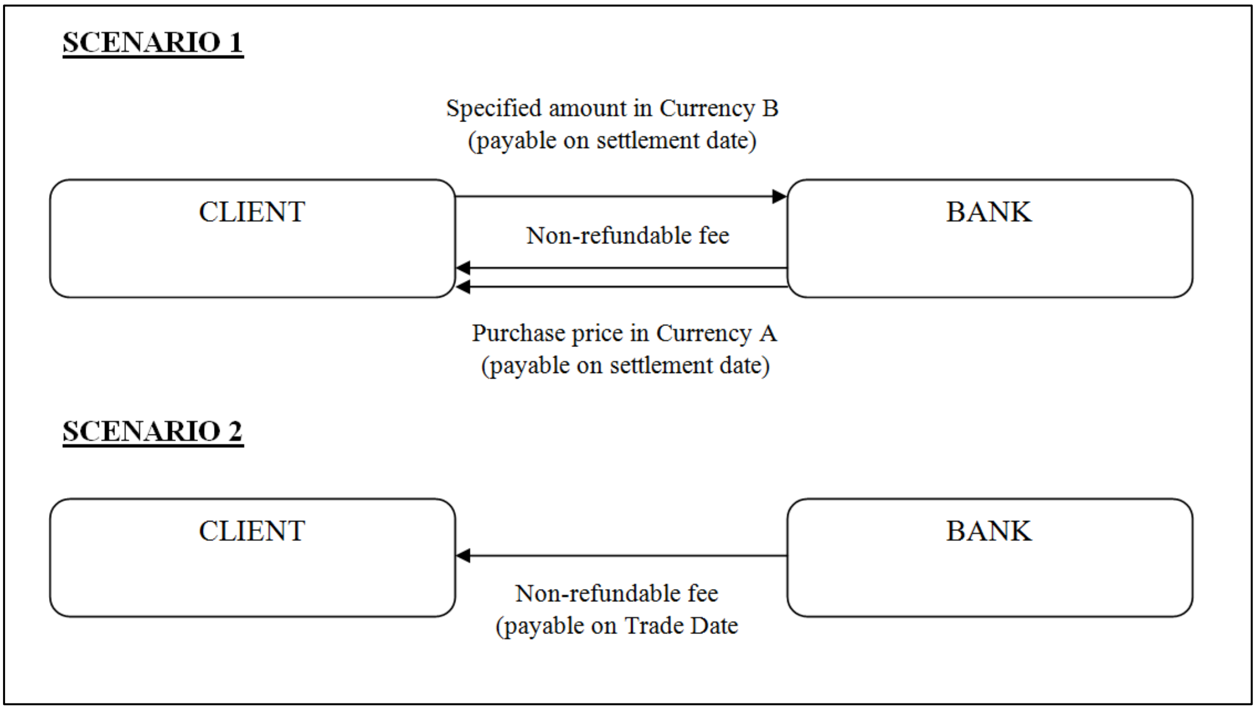

Figure 22: Shariah-compliant FX Option (Source: Dar and Azami, 2010)

Conventional options give the holder the right but not the obligation to buy/sell a particular currency at a designated date in the future. Within the Islamic financial context, the *wa'ad* can be used in the same context as a conventional call option (Qazi, 2012). However, it should be noted that these Islamic options cannot be traded, as they are in mainstream finance, as this would amount to *maysir*. Islamic options are still a debatable Islamic financial instrument due mainly to the fact that they can be used as a speculative tool. Examiners of the legal premises of the wa'ad contract such as Al-Masri (2002), Wisham *et al.* (2011) and Bello and Hassan (2013) have indicated that the acceptance of the wa'ad is still controversial. This inherent controversy with regards to the wa'ad structure stems from the differing interpretations of Islam from the various schools of Muslim thought (see Ayub, 2011 and Ghoul, 2011). As highlighted by Firoozye (2009) in his seminal work on describing the various schools of Islamic thought,

> "While classical jurist has a wide range of opinions on this matter – from deliberate failure to uphold a *wa'd* being morally reprehensible (Hanafi, Hanbali, Shafi'I majority opinions), to being legally actionable subject to the promise suffering loss due to reliance upon the promise (similar to promissory estopple, the opinion held by majority Malikis), whereas modern jurists have for the most part said it is cause for legal action if it is a *wa'd* given with specific conditions." (pg. 6)

Moreover, there is a fine line between risk management and speculation, which fuels the discussions about the permissibility and validity of Islamic options (Bacha, 1999; 2005; Y-Sing, 2009). However, it should it noted that whilst there is increasing literature examining the legal implications of using the wa'ad as an Islamic financial tool or in the context of this research, as a risk management instrument, the views on the permissibility of wa'ad contracts in the global Islamic financial scene are divergent at large.

The diagram above highlights the use of a *wa'ad* as a currency option in Islamic finance. With any option, there are always two possible outcomes, which are determined by the value of the spot market and the option strike price. Considering that this is a call option, should the spot price be more than the exercise price, the *wa'ad* is said to be in the money and as such will be exercised by the bank. Scenario 1 in the diagram above demonstrates this. In this case, the client agrees to sell a particular amount of currency. The bank pays a non-refundable fee (option premium) for the right but not the obligation to purchase this currency against another at a future date (settlement date). Since the option is in the money at maturity, the bank accepts the promise to sell on the part of the client and purchases the currency.

In Scenario 2, the spot price is lower that the exercise price of the *wa'ad* at maturity and therefore, the *wa'ad* is classed at out of the money. In this situation, the bank will not take the client up on the promise to sell the currency and will send a cancellation notice. The non-refundable fee is still paid which is similar to a conventional mainstream currency option. Should the spot price match the exercise price of the *wa'ad* at maturity, the *wa'ad* is said to be in the money and it would not make a difference to the bank if they exercised the *wa'ad*. The use of Shariah-compliant FX option was first seen in 2009 when the Gulf Finance House announced a hedging deal with Deutsche Bank worth over €30 million. This hedge involved an in-house Shariah-compliant option developed by Deutsche Bank (AMEInfo, 2005).

4.2.1.5. Short selling

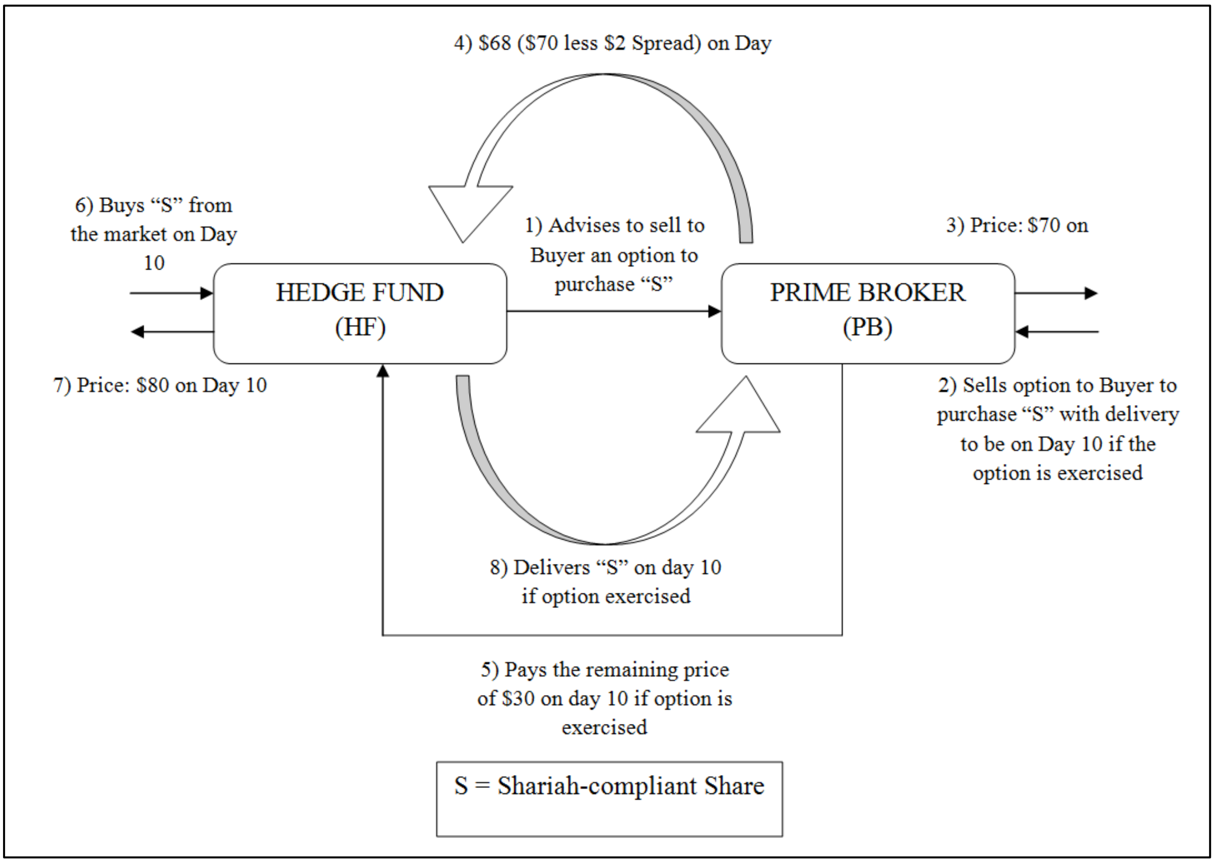

Figure 23: Short Selling using *Arboun* (Source: Dar and Azami, 2010)

Short selling in the conventional financial sense is basically selling an asset that is not owned by the seller. Therefore, there is no proof of ownership and large elements of uncertainty with regards to price and delivery. As such, in its conventional state, short selling is not permissible under a Shariah financial framework. However, it is possible to emulate the characteristics of a short sale through the use of the *arboun* and *salam* concepts in Islamic finance.

The diagram above illustrates how a short sale can be achieved using an *arboun* contract. In the structure a hedge fund will advise the prime broker to sell an option to purchase “S” in 10 days to a client (in this case the value of “S” is $100). The client pays $70 for this option to purchase “S” – Steps (1), (2) and (3). The client is therefore long asset “S” and the prime broker is short “S”. Simultaneously, the prime broker enters into an *arboun* contract with the hedge fund to where the hedge fund will deliver “S” in 10 days. The cost of the *arboun* is $68 with $2 being the spread. This $68 can be seen as the initial deposit in the *arboun* contract – Step (4). Moreover, this *arboun* is conditional on whether the option is exercised by the client. If on day 10 the client wishes to exercise the option, the client will pay the remaining $30 (the overall value of “S”) to the prime broker. This triggers the *arboun* and the hedge fund will have to purchase “S” from the market and deliver it to the prime broker who will pass it on to the client – Steps (6), (7) and (8). The prime broker will pay the hedge fund the remaining $30. The short selling aspect arises from the relationship between broker and hedge fund where in essence the through a broker and use of option, the hedge fund has essentially sold “S” for $100 but will only deliver in 10 days’ time.

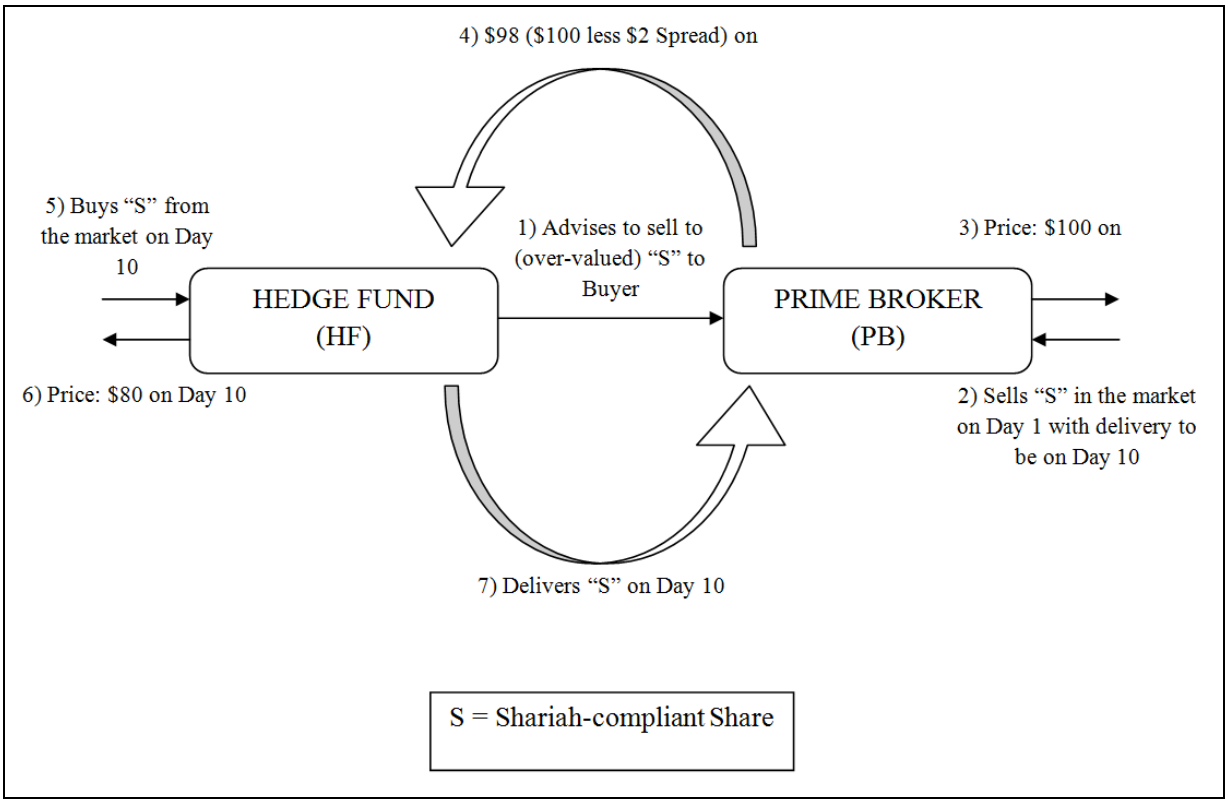

Figure 24: Short Selling using *Salam* (Source: Dar and Azami, 2010)

The diagram above demonstrates how short selling can also be replicated using a *salam* contract. Under this structure, the hedge fund will advise the prime broker to sell "S" to a client for $100. The client will take delivery of "S" in 10 days' time – Steps (1), (2) and (3). Simultaneously, the prime broker will enter into a *salam* contract with the hedge fund to deliver "S" in 10 days. The prime broker will pay $98 for this *salam* contract with $2 being the spread.

On day 10, the hedge fund purchases "S" from the market and delivers it to the prime broker who in turn delivers it to the client.

The use of both *arboun* and *salam* structures to emulate the financial characteristics of short sales very much resemble standard forward contracts but this is down to the way in which both *arboun* and *salam* operate as Islamic financial concepts. Both these concepts are in essence more like for like with forward contracts.

Bai al-salam contracts are subjected to several conditions listed below (Bacha, 1999):

1. Full payment by the buyer at the time of effecting sale
2. The underlying asset must be standardizable, easily quantifiable and of determined quality
3. *Salam* contracts cannot be based on a uniquely identified underlying. The item must be standardizable.
4. Quantity, quality, maturity and place of delivery must be clearly enumerated in the *Salam* agreement
5. The underlying asset or commodity must be available and traded in the markets throughout the period of the contract

These stipulations lead to several criticisms of the *salam* structure. The need for full payment beforehand by the buyer increases the element of one sided counterparty risk associated with non-delivery (Bacha, 1999). Moreover, there is also the problem of double-coincidence which in itself would impose what many would call an unnecessary transaction cost (Bacha, 1999). Double coincidence arises out of the fact that one party must desire what the other party is selling before an agreement can be made to contract. The effort required to find a buyer would relate to the unnecessary transaction costs. This problem is not normally associated with futures and options as the exchange acts as the third party intermediary – a buyer to a seller and a seller to a buyer.

The description of derivative-like instruments above is by no means exhaustive. However, they do provide tentative arguments for the further development of risk management structures. One of the main problems with all the products above would be that, in trying to adhere to their specific requirements they are unable to fulfil the role of a true derivative when it comes to risk management. It is felt that there is further scope to expand the ideas and development of risk management instruments in Islamic finance. Moreover, whilst the structures above illustrate the significant steps in Islamic financial innovation, the use of the instruments listed above is still not widely accepted across the Islamic financial hubs. The lack of uniformity with regards to standards, regulation and governance has meant that financial innovation under a Shariah framework has to contend with not only Shariah rule but also a lack of clarity of these rules. The following section presents the academic debates about issues of regulation and governance which have an impact on the entire Islamic financial system.

4.3. The perspective of governance in Shariah finance

Recent financial events have brought back arguments relating to financial regulation and supervision. The need for regulators to establish adequate rules for financial players has once again been pushed into the spotlight. With the apparent failures of regulatory and supervisory roles being blamed for the recent financial crisis (see Crotty, 2009), the need for sound financial supervision in order to establish market confidence amongst the financial marketplace is of significant importance. This need stretches from conventional finance into the spectrum of Islamic finance as well. These regulatory challenges will invariably have an impact on the overall spectrum of Islamic financial corporate governance, which would have a substantial underlying effect on the confidence of Islamic financial participants. As we shall discuss in the following paragraphs issues of institutional and systemic regulation, transparency, uniformity and stakeholder rights these facets are very much similar to conventional corporate governance concerns. Abu-Tapanjeh (2009) provides an insight into the Islamic financial issues pertaining to corporate governance and compares OECD and Islamic Corporate Governance Principles (see Table 7).

Principle Number	OECD Principles and Annotation	Islamic Principles
1	**Insuring the basis for an effective corporate governance framework**	
	• Promotion of transparent and efficient markets with rule of law and division of responsibilities.	• Promotion of business within ethical framework of Shariah • Believes in profit and loss • Primacy of Justice and social welfare with social and spiritual obligations • Prohibition of interest
2	**The Rights of Shareholders and Key Ownership Functions**	
	• Basic shareholder rights • Participation in Decision-making at the general meetings • Structures and arrangements markets for corporate control • Ownership rights by all shareholders including institutional shareholders • Consultative process between shareholders and institutional shareholders	• Property as trust from God • Sole Authority is God • Society as stakeholders • Accountability not only to stakeholders but also to God, the ultimate owner
3	**The equitable treatment of shareholders**	
	• Protection to minority and foreign shareholders	• Just and fairness of value • Equitable distribution of wealth to all stakeholders and disadvantaged members in the form of *Zakat* and *Sadqa* • Social and individual welfare with both spiritual and moral obligation • Sensation and equality

4	**The role of stakeholders in corporate governance**	
	• In creating wealth, jobs and sustainability of financially sound enterprises	• Islamic accountability to *Falah* and social welfare orientation • Haram/ Halal dichotomy in transaction • Social & individual welfare from both spiritual and material • Consideration to whole community
5	**Disclosure and Transparency**	
	• Matters regarding corporation • Financial situation • Performance, ownership and governance	• Accountability with Shariah compliance • Socio-economic objectives related to firms' control and accountability to all its stakeholders • Justice, equality, truthfulness transparency • wider accountability with written as well as oral disclosure
6	**The responsibilities of the board**	
	• Strategic guidance • Monitoring of management • Accountability to company and stakeholders	• Accountability not only to company or board or stakeholders but also to Allah the ultimate authority who leads to welfare and success • Holistic and integrative guidance • Negotiation and co-operation • Consultation and consensus seeking for each decision with related stakeholders

Table 7: Comparison of OECD and Islamic Corporate Governance Principles (Source: Abu-Tapanjeh, 2009)

The growth of Islamic finance, not only as a financial system for Muslims, but as a financial system for all mainstream customers has meant that there is a greater demand for the development of more a transparent and uniform set of rules and regulation.

The need for adequate financial regulation and supervision stems from the want of a stable financial system. The consolidation of stability within any financial system has a powerful influence on the determinants of economic growth and development (Llewellyn, 2006; Taylor and Fleming, 1999). Economic aspects such as market confidence, capital generation and efficient resource allocation are seen as vital towards the development of any economy however their existence depends extensively on the initial systemic stability of the financial system which is back by a concise and consistent regulatory standard (Llewellyn, 2006). The recent global financial crisis along with the Asian financial crisis of 1997 illustrates how poor regulation could lead to market instability and could impact upon annual economic growth and development in the short to medium term. Additionally, market instability introduces elements of uncertainty that could be detrimental to the economy as a whole over the long term period (Eisenberg and Noe, 2001).

Financial regulation and supervision has always been a topic, which has echoed throughout many an academic and professional arena. The fine art of striking a balance between over-regulation of financial systems against an over-relaxed financial system has always been a subject of debate (Llewellyn, 1999). What justifies good regulation and governance? What should be regulated and how? Moreover, there is also the issue of who should bear this regulatory undertaking. Should this responsibility belong to a centralized body or should it be enforced at an institutional level?

Regulatory and supervisory development within conventional, Western finance has had decades to grow, evolve and form to sufficiently appease the needs of the modern economy. Numerous problems have been encountered, financial crises have been experienced and financial scandals have been exposed. Lessons have been learnt about the damage poor financial regulation can inflict upon any financial system (see Boyd *et al.*, 2000; Caprio and Klingebiel, 2002). So how does this translate to the Islamic financial spectra?

The unique characteristics of Islamic finance do not absolve it from the usual problems that plague the regulatory and supervisory facet of a financial system (El-Hawary *et al.*, 2007). On the contrary more emphasis is placed upon the development of an adequate regulatory standard within the context of Islamic finance. Islamic banks and financial service providers, like their Western, conventional counterparts, experience the same issues relating to regulation and governance. Barth *et al.* (2002) highlights these as:

i) regulating banking activities and commerce links
ii) regulating domestic and foreign bank entry
iii) regulations on capital adequacy
iv) deposit insurance design
v) supervision
vi) private-sector monitoring of banks and
vii) government ownership of banks.

The experiences of Western finance have helped many a developing financial system to learn and identify weaknesses within any economic system and the framework by which to succinctly deal with these problems has been established. Additionally, there exist instances where the emphasis of conventional regulatory standards may differ from that of Shariah finance. In cases such as these, whilst the emphasis maybe different, the regulatory standard remains the same. For example Islamic banking is also known as non-interest banking with the financial system's disregard for usury. *Gharar* and *maysir* also place additional stipulations upon all financial dealings within Islamic finance. These impositions mean that there is less emphasis on the regulation of credit/ interest rate risk as transactions that bear these risks are specifically disallowed under the rules of Islamic finance (Akhtar *et al.*, 2011). With more prominence placed upon 'real' transactions, the emphasis on regulation shifts towards default risk (Sundararajan, 2007). The problem of regulation and governance within Islamic finance lies firmly with adapting existing regulations to protect clients to a similar level to that of their Western counterparts, whilst at the same time maintaining a balanced playing field so that neither Islamic finance nor conventional finance are disadvantaged (Wilson, 2000).

The issues of governance in Islamic finance can be argued on two fronts – Shariah-compliance and the uniformity of Shariah-compliant standards. As stated before (Hersh, 2011) there exist three categories of Islamic Banks

i) Banks who belong to a wholly Islamic financial system
ii) Islamic banks who belong to a conventional financial system and exist alongside conventional banks
iii) Conventional banks who offer Shariah-compliant products and services through Islamic windows

Whilst banks belonging to categories i & ii have to apply, staunchly, the strict Islamic code towards their financial activities, there exist problems of regulating Shariah-compliance in the third category of banks. The offer of Shariah-compliant products and services through Islamic windows was a significant development towards the growth of the Islamic financial system in mainstream finance. It allowed trusted mainstream banking and financial brands the opportunity to offer products to not only Muslims but also conventional consumers. By using established names in the economy, it was a significantly easier task building consumer confidence in these new products (Alserhan, 2010). However, as the Islamic financial system has seen substantial growth over the past decade, the products on offer blurred the line between Shariah-complaint and conventional interest bearing instruments but this was only to be expected (El-Gamal, 2005; Derigs and Marzban 2008). Initial Shariah-compliant products on offer comprised mainly of Islamic mortgages (*murdarabah*) and deposit taking activities.

However, with the growth of the Islamic financial system, there came a demand for more evolved products that would meet the needs of Islamic risk management and investment. This development has led to the inception of Islamic instruments such as multiple *wa'ad* and layered *murabaha*. Whilst the underlying edict behind these products claims to be Shariah-compliant they are not in essence inherently Islamic. This has resulted in arguments between Shariah-based and Shariah-backed banking where the instruments described above belong to a Shariah-based category (see El-Gamal, 2006; Errico and Farahbaksh, 1998; Khatkhatay and Nisar, 2007a and 2007b). Moreover, whilst these products are Shariah-compliant, they are not entirely accepted amongst the different Islamic financial systems.

Shariah-compliance is an important underlying regulatory issue in modern Islamic finance. As stated before, consumer confidence builds stability, which is pivotal towards the growth of a financial system. A feature of Islamic finance is that consumer confidence is built upon the fact that financial aspects of the system conforms to their religious beliefs. Should this fail the pillars upon which Islamic finance was built would crumble (Grais and Pellegrini, 2006). As such the governance and regulation of Shariah-compliance standards are an essential part of modern Islamic finance. The job of assessing the validity of Shariah-compliance takes place at institutional level with each institution who offers Islamic financial services having in-house religious advisors, collectively known as the Shariah Supervisory Board (Grais and Pellegrini, 2006). Whilst the name might suggest that the composition of these SSBs be entirely of religious, pious individuals, they are in-fact made up of a mix of religious scholars and financial practitioners whose job is to debate both the religious and financial underpinnings of each new service and/or product (Errico and Farahbaksh, 1998). The composition and running of these SSBs raises five main issues of a regulatory nature, namely independence, confidentiality, competence, consistency and disclosure. Each of these aspects will be examined in relation to regulatory issues that were raised in the empirical literature.

With regards to independence, members of the SSB are appointed by Board of Directors and are supposed to hold an unbiased opinion of every potential product or service, which requires their judgement (Grais and Pellegrini, 2006). However, the employment relationship between SSB and institution, along with respective remuneration packages, paint a faint and slightly negative picture of their independence. Situations may arise whereby stakeholders attempt to exert a certain influence on members of the SSB also known as ‘Fatwa shopping’ (Grais and Pellegrini, 2006). While this arrangement maybe frowned upon in a conventional financial environment the argument that the ethical standards of SSBs should and would prevent such events from occurring is widely accepted. Should any underhand activities occur, this would severely damage the reputation and lead to due recourse. The argument that the benefits of influencing your SSB are outstripped by the detriments should deter or mitigate the regulatory problems of independence.

This leads on to the issue of confidentiality. Another aspect of SSBs is the fact that members are allowed to sit on the SSBs of different companies. It is argued that this might lead to a possible transfer of information but once again the morality of SSB members should prevent this (Grais and Pellegrini, 2006). However, it does bring about the next problem of competence. The lack of Shariah scholars has meant that there is a distinct lack of man power and new talent in the profession. Regulators have been busy promoting and establishing new incentives and schemes for training and recruitment to such a field.

The consistency of judgements of SSBs has also been scrutinised, considering that assessing the viability if Shariah-compliant products and services is such a subjective science. However, empirical research conducted by the Council for Islamic Banks and Financial Institutions (CIBAFI) has shown that the diversity of judgements on Shariah-compliance is less that first anticipated. Out of 6000 fatwas sampled, it was found that 90% were consistent across banks (CIBAFI, 2009). However, consistency not only entails consistency of judgements but also adoption of rules and regulation. By and large Islamic financial systems are left to govern themselves. Whilst there exists a set of generalised religious beliefs that are implemented to each financial system, much is down to the precepts of individual religious scholars belonging to that particular region. The interpretation of Shariah, differs from the

Gulf Co-operation Council (GCC) countries and the Middle East to that of South East Asia and even that of Western economies (Chapra and Ahmed, 2002; Chapra and Khan, 2000). This has meant that while some products are allowed in one Islamic financial system, it might be disallowed under another. The lack of uniformity results in confusion and a potential problem of double standards, which could and would hurt the development of new implements in Islamic finance. While this issue might be difficult to tackle at institutional level, there have been calls for a central governing body to be established (Chapra and Ahmed, 2002; Chapra and Khan, 2000; El Sheikkh, 2000).

Finally, we consider the issue of transparency. Every financial system prides itself on being open and disclosing the nature of most deals. While it may seem like a naive and overreaching ideal to have complete transparency, an adequate level would suffice to satisfy most market participants (Merton, 1990 and 1995). Regulatory standards in conventional finance require that all institutions publish annual reports pertaining to company performance over the year. Moreover, additional effort is placed into exposing all information pertaining to large trades and mergers and acquisitions. Board members are made known to stakeholders and the entire Western financial system attempts to portray itself as an open, 'nothing-to-hide' economy.

On the other hand however, transparency in Islamic finance is becoming an increasingly important issue (Honohan, 2001; Grais and Pellegrini, 2006). Many large transactions within the Islamic financial system are largely kept confidential. The recent near default by Dubai World on its *sukuk* (Islamic bond) placed great emphasis on transparency and regulation of Islamic financial products (IFSL, 2010). With the prohibition of interest based investments the value of a *sukuk* is very much dependent upon the tangible underlying asset. This default was due to unfavourable market conditions impacting the value of the underlying asset. The issue of regulation that presented itself in the wake of this default was the lack of protection for *sukuk* holders as these bond holders have no explicit claim to the worth of the underlying asset and are unable to force a company to liquidate its position as a mode of recourse (Permatasari and Manurung, 2010).

A major concern emphasized on the issue of transparency of Shariah finance would be that so far scandals and regulatory demises of any kind have yet to be tested within the courts (IFSL, 2010). There is no fixed legislation and precedence to deal with these incidents. Moreover, it is surprising that most legal documentation pertaining to Islamic transactions are governed by English law, which may or may not be accepted in the country the agreement originated within (IFSL, 2010). Consumers have little or no access to information about how certain products are structured, how they are financed or the level of involvement of participants. Moreover, there is no fixed regulation that requires banks, even those providing Shariah-compliant services, to publish reports about SSBs and the fatwas that have been granted. This only serves to dampen consumer confidence and should be an area that is tackled at a centralized level rather than an institutional level.

The analysis on regulatory issues in this research study has so far focused on regulation and supervision at an institutional level. However, there persist issues on a broader scale that involve the entire Islamic financial system as a whole. As stated earlier, the adoption of certain Islamic products into specific Islamic financial systems is diverse. While markets such as that of Malaysia and the United Kingdom have a more liberal stance towards the inception of new and more “Western” products, Islamic markets in the GCC adopt a stricter view on financial innovation (Smorlaski *et al.*, 2006). This divergent view illustrates the differences in regulatory standards across the various Islamic financial systems.

With each of the centralised Islamic financial hubs there exists a different interpretation of Shariah laws. This is put down to the fact that there exist 5 different schools of thought within Islam and each has its own understanding of Islamic law (see Table 8 and 9). This therefore creates different interpretations, which lead to different Islamic regulatory standards depending, on which Islamic financial market participants exist in.

Branch	Numbers	Belief
Sunnis (can be further broken up into 4 subsets of teaching beliefs in Table 7 below)	1 billion plus	Follow the sayings, deeds and practices (S*unnah*) of Muhammad. Emphasis on texts and legal interpretation.
Shias	100million plus	Believe Muhammad's kin were his rightful successors, and that the last of a line of 12 imams may reappear soon. Embittered by repression and terrorist attacks.
Sufis	Unknown (many Sufis practice in secret)	Adhere to Islam's mystical tradition; cultivate remembrance (*dhikr*) of God through asceticism and recitation of prayers. May be either Sunni or Shia
Salafist/ Wahhabis	17million	Imitate the earliest generations of Muslims and distrust later interpretations. Strict, austere Sunnis, maybe peaceful or violent, pietistic or political. Often followers of al-Wahhab, 18^{th} century Salafist teacher. Prevalent in Saudi Arabia.
Ismailis	15million	Disagree with other Shias about the line of spiritual succession after 8^{th} century, notable do-gooders, relaxed about religious rules.
Alevis	10million	Downplay formal Muslim rituals, stress sexual equality, overlap with the Bektashi mystical movement, leftist, fear Sunni majority. Based in Turkey.
Ahmaddiyas	4million	Revere a 19^{th} century Indian Muslim revivalist. Vigorous but oppressed in Pakistan and South Asian diaspora, keen builders of schools and hospitals.
Alawaites	3million	Emphasise the Shia imams, esoteric offshoot of Ismaili Shiism. Some rights overlap with Christianity. Rulers of Syria.

Table 8: Muslim Traditions and Sects (Source: The Economist, 2012)

School	Geographical Distribution
Hanafi	Iraq, Turkey, Iran, Afghanistan, Jordan, China and Egypt
Maliki	North Africa, Kuwait, United Arab Emirates and Bahrain
Shafi'i	Yemen, Somalia, South East Asia, Jordan, Egypt and southern parts of India
Hanbali	Saudi Arabia and Qatar

Table 9: Schools of Muslim Sunni Thought (Source: The Economist, 2012)

The diversity of Islamic interpretation with regards to financial requirements is a serious consideration for the Islamic financial system as whole. As Islamic finance grows into the 21st century, its development to maintain pace with conventional finance would mean that there is an increased requirement for a centralised and uniform regulatory standard so as to avoid confusion and more so to build consumer confidence. There have been numerous calls for a more standardise approach to Shariah-compliant decision making with more focus placed upon regulatory consolidation and market harmonization between the various Islamic financial hubs (Hesse *et al.*, 2008). Work conducted by Akhtar (2006, 2007), Khan (2007) and Ilias (2009) have suggested that the lack of a fundamental framework for Shariah-compliance is hurting the development of financial innovation within the spectrum of the Islamic financial system.

Essentially, products that are allowed in a particular Islamic financial market will not be allowed in a different Islamic financial market based upon the Shariah-interpretation of the scholars for that region. Khan (2007) suggests that the standardization of not only Shariah-compliant but Shariah rules would aid the financial system and that there should be greater existence of the regulated use of diversity and flexibility. The diversity if the regulatory standards of Shariah-compliant Islamic finance can be seen in Table 10 and 11**.** What can be seen from the Shariah-compliant screening processes is that there are numerous differences when applying both the qualitative and quantitative screens depending on which Shariah-compliant market you belong to (Rehman and Masood, 2013). Thus, it is not only a difference in the fundamental schools of Islamic thought that affect the Islamic financial markets but also divergences in the way Shariah-compliant markets interpret these Islamic rules. Rahman *et al.* (2010) examined if there was a difference between the screening processes of the Dow Jones and Kuala Lumpur Islamic Indexes. The financials for 642 companies which were deemed Shariah-compliant by the Shariah Advisory Council of the KLSE were examined and it was found that there were differences between the debt criterion and the underlying qualitative screening processes. Jobst *et al.* (2008) iterated that these inconsistencies do not only pertain to Islamic equity indices but also in sukuk issuance. Fundamentally, the divergences in the qualitative and quantitative screens in Table 10 and 11 below have shown to hamper the structuring process of *sukuks* when it came to selecting the underlying asset. However, Jobst *et al.* (2008) does make the distinction that this lack of a regulatory framework and uniformity in Islamic finance is improving with the creation of institutional bodies such as the Islamic Finance Information Service (IFSI).

Activities	SCM	DJIM	FTSE	MSCI	S&P
Riba and Gharar	• Financial services based on riba Stock-broking of share trading in Shariah non-compliant securities. • Conventional insurance	• Banks • Real Estate Holding and Development • Consumer Finance • Speciality Finance • Mortgage Finance • Full line insurance • Investment Services • Insurance brokers • Property & Casualty Insurance • Reinsurance • Life Insurance	• Banking or any other interest related activity (excluding Islamic financial institutions) • Brokers • Life Insurance	• Conventional financial services	• Financials
Non Halal products	• Manufacture or sale of non-halal products and related products	• Brewers • Distillers & Vintners • Food products • Food retailers & wholesalers • Restaurants and Bars	• Alcohol, Pork and other non halal related products	• Pork related products • Alcohol	• Pork related products • Alcohol

Gambling	• Gambling	• Gambling	• Gambling	• Gambling	• Gambling
Immoral	• Entertainment activities that are non-permissible according to Shariah	• Broadcasting and Entertainment • Media Agencies • Hotels • Recreational Products and Services	• Night Club Activities • Pornography and adult entertainment • Prostitution	• Music • Hotels • Cinema • Adult Entertainment	• Pornography • Advertising and Media (newspapers are allowed, sub-industries area analysed individually) • Stem-cell research
Other impermissible	• Manufacture or sale of tobacco-based products or related products • Other activities deemed permissible	• Tobacco • Defence and Weapons	• Tobacco • Arms manufacturing	• Tobacco, Defence/ Weapons	• Tobacco • Trading of gold and silver as cash on deferred basis.
Use Qualitative Criteria only	• No	• Yes	• No	• No	• No

Table 10: Qualitative Shariah-compliant screens (Adapted from Rehman and Masood, 2013)

Denominator	SCM	DJIM	FTSE	MSCI	S&P
		Debt Screen			
Debt		• < 33% of Avg Market Cap	• < 33% of Total Assets	• < 33% of Total Assets	• < 33% of Avg Market Cap
		Liquidity Screen			
Account Receivables		• < 33% of Avg Market Cap		• < 70% of Total Assets	• < 49% of Avg Market Cap
Receivables + Cash			• < 50% of Total Assets		
		Interest Screen			
Cash + Interest Bearing Securities		• < 33% of Avg Market Cap	• < 33% of Total Assets	• < 33% of Total Assets	• < 33% of Avg Market Cap
Interest income	• < 5% of total revenue or profit before tax		• <5% of Total Revenue		
		Non Permissible Income Screen			
Non Permissible Income	• Clearly prohibited income < 5% of total revenue or profit before tax • Unavoidable prohibited income < 10% of total revenue or profit before tax • Mixed rental income < 20% of total revenue or profit before tax • Prohibited income from social good income < 55% of total revenue or profit before tax		• <5% of Total Revenue	• <5% of Total Revenue	• <5% of Total Revenue

Table 11: Quantitative Shariah-compliant Screens (Adapted from Rehman and Masood, 2013)

The tables above provide and insight into the divergences of the Shariah-compliance process and there exists similar regulatory divergences in more traditional Islamic financial markets such as that of Malaysia and Iran shown in Table 12 below (Archer and Ahmed, 2003).

Country	Banking System	AAOIFI Standards	Islamic Banking Law	Existence of Shariah Supervisory Boards	Supervision
Iran	Islamic	No	Yes	No	No
Jordan	Dual	IAS	Yes	Yes	Consolidated
Kuwait	Dual	IAS	Considered	Yes	Consolidated
Sudan	Islamic	Yes	Yes	Yes	-
Yemen	Dual	No	Yes	Yes	No
Malaysia	Dual	IAS	Yes	Yes	Consolidated

Table 12: Diversity in the legal, regulatory and supervisory arrangements (El-Hawary *et al.*, 2007)

El-Hawary *et al.* (2007) examined the diversity of regulatory standards within Islamic financial institutions and discovered that the Islamic financial system required more organisation rather uniformity. Fundamentally, this study suggested that through the organisation of Islamic regulatory standards the Islamic financial system would be able to develop in line with its religious principles as well as establish an adequate framework for risk management.

Initiatives have been put in place to develop a centralised regulatory standard. Institutions such as the Bahrain-based Accounting and Auditing Organisation for Islamic Financial Institution and the Islamic Financial Services Board have been established to create a standardised regulatory and supervisory framework. The role of AAOIFI in terms of Shariah financial standardization is in terms of accounting standards although the institutions has taken on more a central regulatory aspect by presiding over issues of Shariah-compliance rules and regulations by setting up two in-house SSBs – 15 member boards tasked with standards and interpretations and overseeing consistency respectively (Monger and Rawashdeh, 2008). Moreover, AAOIFI have also taken on the role of developing conceptual framework for regulatory uniformity based around stakeholder theory. This stems from an inherent need to further develop Islamic accounting standards and streamlining Islamic accounting to fit the accounting practices observed by the US, UK and International Accounting Standards (IAS) (Sarea and Hanefah, 2013). Whilst these AAOIFI based SSBs have come under the same scrutiny and criticisms as the SSBs on other Islamic and conventional financial institutions – AAOIFI's because board members are part-time – this is essentially an important steps at it indicates the market proactive stance towards continual development of regulatory and governance standards. Additionally, the IFSB have been tasked with,

> "…the provision of prudential standards and guidelines for international application by banking and supervisors in the supervision of Islamic banks." (Hersh, 2011 pg. 56)

These responsibilities stretch to include the creation of a framework by which to identify and quantify risk and minimum capital requirements.

We have already dealt with SSBs at an institutional level and discovered that many of the criticisms stem from their inherent composition, transparency and uniformity of their decisions. The notion of SSBs has also been debated in a systemic context with many calling for the development of an environment that bolsters the development of the Shariah scholar base. A recent study by Farook and Farooq (2013) greatly advocates the development of a central accreditation process for new Shariah scholars thus guaranteeing a much wider base on knowledge and alleviates the arguments of market stresses on the small pool of existing Shariah scholars and the conflict of interest from having similar SSB members on the different boards of varying Islamic financial institutions.

Farook and Farooq (2013) have also put forward a framework for establishing a foundation for Shariah scholar qualifications. This framework centres around i) establishing educational and training institutions ii) industry wide design of curriculum iii) the formation of professional body and iv) address issues of a lack of talent in Shariah-compliance which would involve training individuals with a fundamental knowledge of conventional financial theory. This call for the accreditation of Shariah scholars is by no means a new proposal and Islamic finance analyst such as Wilson (2000) and Karbhari *et al.* (2004) have elucidated the need for the development of an accreditation process. Both Wilson (2000) and Karbhari *et al.* (2004) have also indicated that this accreditation and growth in the talent base within Islamic banking and finance would also aid in the standardization process of the Islamic financial system. Using the framework set out in Farook and Farooq (2013) a universal accreditation process, it is hoped, would result in scholars who would share a similar interpretation of Shariah financial law. In roads are being made into establishing accredited qualifications for Islamic scholars and as it stands AAOIFI currently offers two courses of study – Certified Islamic Professional Accountant (CIPA) and Certified Shariah Adviser and Auditor (CSAA) (Monger and Rawashdeh, 2008).

There have been further pushes towards developing a framework for the standardization of Islamic financial regulation. Once such suggestion for control would involve an evolution of the Basel Committee’s CAMELS rating standard to include Islamic financial institutions (Sarker, 2006). The proposal put forward would see on and off-site supervisions of the activities of Shariah financial institutions to ensure that they abide by the modified CAMELS standard (Sundararajan and Errico, 2002; Sarker, 2006). Invariably, the arguments for attaching Shariah regulation to a tried and tested conventional regulatory standard are to encourage market harmonization and allow for a uniform framework for operation.

The creation of a central regulatory standard across the Islamic financial spectrum would also alleviate and address other pertinent issues on a system-wide basis. One of which would be capital adequacy levels of Islamic banks (see Noibi, 2004). A major business activity of Islamic banks would be as deposit taking institution. Whilst conventional banks are able to invest money from demand deposits to guarantee a fixed return to customers, Islamic banks are not afforded this benefit but rather work on a collective investment scheme where deposits are pooled (Errico and Farrahbaksh, 1998). As interest is disallowed these deposits work on a profit-loss sharing or *wakala* basis (Iqbal and Mirakhor, 2007).

However, these are considered investment deposits and capital value is not guaranteed. Capital values are only guaranteed on demand deposits but these yield no return except for inflation. Considering that Islamic banks are not allowed to engage with interest bearing loans of any kind, their investment environment is hindered slightly. This raises issues of income generation and safeguarding consumer deposits. This prohibition of excessive interest also means that Islamic banks are more illiquid than most conventional banks. This raises the worry of capital adequacy in Islamic banks (Errico and Farrahbaksh, 1998). Whilst the concept established in Basel I, II and III remains the same there exist technical difficulties in assessing and measuring the types of risk faced by Islamic banks. For instance with the concentration of Islamic banks' investments in commodities and 'real' assets, they faced an increased market risk as opposed to their conventional counterparts (Hersh, 2011).

Fundamentally, what can be garnered from these criticisms of this aspect of the Islamic financial regulation would be a call for improvements to the legal framework. This legal framework should support stakeholders in both Islamic banking and finance in traditional 'Islamic' markets as well as the new breed of Shariah-compliant markets. This legal framework should include systemic consideration such as payment systems within Islamic banking and finance, the protection of depositors, Shariah compliance and the integration of Islamic finance within the global financial markets (Chapra and Khan, 2000). It is important to have a framework to support its customers and the existing confusion behind the ligation process for Islamic banking and finance is a substantial worry (Wilson, 2000). As seen from the near default of Dubai world there is a need to define where the legal remittance of Islamic finance belongs. Do customer rights exist within the realm of conventional or Shariah law? This issue is addressed during the empirical interviews with market participants.

As such aside from uniformity there is also a distinct need for definition of Islamic financial legal recourse such as the financial tribunals and arbitration processes found in conventional finance (Wilson, 2000). Furthermore, legal processed have to be define so that they adequately regulate both banks and the products that are on offer. Hesse *et al.* (2008) offers possible solution to streamlining the legal framework for Islamic banking and finance calls upon a two-tiered perspective aimed primarily at integrating both the legal and regulatory processes with that of conventional finance. Moreover, is if further argued that both the legal and regulatory systems in conventional financial systems are flexible enough to accommodate the inception of a parallel Islamic banking system (DeLorenzo and McMillen, 2007). However, this cannot be achieved without the support of the government (Ahmed and Hassan, 2007) and examples such as the Malaysian Banking Act 1993, which altered conventional financial law to allow Malaysian Islamic financial institutions the ability to provide lending facilities using a murabaha system, illustrate the malleable nature of a conventional legal system to adapt to the needs of Islamic finance without disadvantaging conventional or Islamic participants. There are however interesting facets to this arguments about legal recourse in Islamic finance. Fadil (1994), in her presentation at the Info Centre Conference for Islamic Banking and Finance question if Islamic banks should be subjected to the same regulations off conventional banks. El-Sheikh (2000) takes this a step further and argues that Islamic banks should not be regulated by any authority but rather self-regulated institutionally. Whilst Fadil's (1994) arguments arise out of the lack of knowledge and the difficulties of managing Islamic law within conventional courts could be accepted it is difficult to see the sentiment of El-Sheikh's (2000) postulation that Islamic banks should not be regulated by any authority. In both instances the arguments pertaining addressing the legal issues within conventional courts is taking shape with central regulatory bodies such as AAOIFI and the IFSB consulting of legal aspects (Sarea and Hanefah, 2013). With regards to the El-Sheikh (2000) perspective, one has to accept that both institutional and industry wide regulation is required. The arguments for universal, industry wide regulatory standards put forward by both El-Hawary *et al.* (2006) and Wilson (2003) are too compelling to ignore. Furthermore, empirical qualitative research by both Ghayad (2008) and Karbhari *et al.* (2004) have indicated that Islamic banks face increased competition from conventional banks; a systemic issue that must be addressed at industry level.

The need for an adequate framework to quantify risk and capital requirements and legal recourse is made of further importance by the lack of a lender of last resort (see Chapra and Khan, 2000; El Sheikkh, 2000). Conventional financial institutions enjoy the security of a highly established inter-bank lending network. Moreover, should that fail, there are always sovereign central banks who act as lenders of last resort. In a financial system such as that of Islamic finance, where inter-bank lending is underdeveloped due to a lack of available liquidity in the secondary markets a lender of last resort is of utmost importance.

As shown in Dar and Presley (2000) and Noman (2002) the vulnerabilities of the dependence of Islamic finance on PLS and debt finance has meant that there is an increased exposure to credit and liquidity risk. The lack of formal framework and developed culture for risk management has meant that there is increased importance placed upon establishing a lender of last resort. In this day and age where conventional banks are failing even with the support of a lender of last resort, it should serve to provide an element of security to consumers. Ahmed and Hassan (2007) reinforce this need for a lender of last resort and highlight several pertinent issues with the current state of Islamic finance – both Shariah-compliant and Shariah-based. Their analysis of Islamic banks in Bangladesh found that there is an underdeveloped network for interbank lending thus escalating the credit and liquidity risk already present. Additionally, there is a lack of support from governments and a discriminatory or underdeveloped legal framework that creates a significantly restrictive financial environment (Ahmed and Hassan, 2007). There has been considerable effort placed in addressing the level of credit and liquidity risk in Islamic finance. The development of new Islamic financial markets such as that of Mudharabah Interbank Investments (MII) in Malaysia indicate the industry's want to foster an environment of lending and borrowing between Islamic banks (Wilson, 2008). The 'Sukuk Salam Market' in Bahrain is another example of such a scheme set in place and encourages not only interbank lending/borrowing but also creates a market place for Islamic financial institutions to raise capital (Wilson, 2008).

Although the literature does indicate the need for a lender of last resort there is a lack of articulation for who should undertake this role. Solé (2007) suggests that this role can be filled by that of conventional central banks but this would then mean that legal discrepancies should be settled in conventional courts who would not understand the Islamic legal implications of Shariah financial transactions. Siddiqui (2008) highlights that this role should be taken on by a large central regulatory body but would also lead to questions about a conflict of interests in terms of Shariah-compliant decision-making.

Financial regulation, more so, financial regulation in a developing, alternative financial system, has always been a topic of debate. What can be seen from the literature is that the crucial challenge for the Islamic financial system would be to balance Shariah principles whilst adapting to the modern economic spectrum (Wilson, 2000). There is increasing support for Kane's (1988) exploration of the regulatory dialectic within Islamic finance, which encourages the dynamic interaction between regulators and the regulated. Essentially, the regulatory process should be both reactive and proactive to foster its continual development. Regulators should strive to eliminate the polarisation of Islamic financial regulation on a global scale and at the same time engage in active dialogue with market participants. Additionally, market participants should also embrace the efforts being made by large Islamic financial regulatory bodies. This, it is argued by Kane (1988) and Wilson (2000), will invariably lead to increased development and growth of the Islamic financial system.

This aspect of the research has presented a perspective of the regulatory challenges faced by the Islamic financial system. Fundamentally, what can be seen is that Islamic finance faces an immense task in addressing both its institutional and systemic regulatory issues. Moreover, there is a distinct pattern surrounding these regulatory challenges and is the idiosyncratic relationship between the religious principles of Islam and the financial requirements of a financial system. This simple friction between the two facets is best reflected by Asutay (2007b) who describes the Islamic financial system as one that faces tension between establishing rules for social good advocated by religious values and the economic growth that is core to any financial system. Pollard and Samers (2007) further add to these arguments by suggesting that economic geographies dictate the development of the regulatory edicts suggested by the different Islamic financial hubs globally. Moreover, the issue is that religious norms are insufficient to change people's economic behaviour in light of economic welfare and utility (Kuran, 1983 & 1995).

This resistance between objective (financial needs) and subjective (social principles) would invariably create problems for Islamic financial corporate governance as highlighted by Abu-Tapanjeh (2009). Balancing the needs of Islamic corporate governance in light of social and economic needs of any financial system would be a challenge and steps are consequently being taken to adapt the conventional legal framework accommodate Islamic financial needs (Wilson, 2000). Moreover, theses changing needs should not favour either conventional or Islamic financial system but rather attempt to establish a level playing field for both (Wilson, 2000). Iqbal and Mirakhor (2007) have advocated a stakeholder model of corporate governance, which is widely supported by the literature (Wilson, 2000; Safieddine, 2009, Hassan 2009). Bhatti and Bhatti (2010) have also rightly identified the Islamic notion of *hisba* (social good) as a possible model for Islamic corporate governance.

It centres on the very conventional governance principles of proper book keeping, disclosure of information and underlying transparency of the Islamic financial system.

The creation of a uniform standard can only serve to aid the development of the Islamic financial system as a whole. Clearer guidelines would make it easier for new entrants into market as well as enticing more mainstream consumers. The issues of regulation and corporate governance highlight the need to bridge the gap between Islamic and conventional regulation and to create a standard to further encourage the development of confidence amongst market participants. What is clear from the literature however is that the development of this regulatory framework cannot diminish the fundamental socio-religious principles of the Islamic financial system.

4.4. Tying the issues together

With the volatility of mainstream financial markets, market participants will essentially seek new investment opportunities, firstly for diversification benefit and secondly stability (Wilson, 1999; Kok *et al.*, 2009). There have been arguments that the financial systems are inter related and that the effects of a shock in one will be eventually felt by another further down the line (see Merton, 1990 and 1995; Eisenberg and Noe, 2001). So theoretically this should be no different for the Islamic financial system and truth it is not. However, the saving grace for market participants is the observed muted and numbed effects of the global financial crisis on Islamic finance (Farooq, 2009; Hassan and Dridi, 2010). Investment banking services and assurance products are explicitly disallowed activities in Shariah finance and as such, Shariah-compliant indexes do not include banks and insurance provident institutions. With any financial crisis, the first institutions to feel the brunt are banks (Hassan and Dridi, 2010). They are the source of capital for any economy and their main business is money and wealth. Moreover, with the volatility in the financial markets, the investment banking arm of many banks were just not performing and in fact bleeding money more that generating it. Since insurance companies are explicitly disallowed from Shariah-compliant indices this lessens the effects of an economic shock. Insurance companies sit on a pool of cash and have a large exposure to various investment vehicles within any financial system and therefore, any financial shock is bound to have an effect on their performance (Hassan and Dridi, 2010).

The exclusion of both investment banking and insurance from the investment spectrum for Shariah finance means that Shariah indexes provide a more stable investment platform. This is not to say that it was completely absolved of the effects of the global financial crisis, as evident from the stunted growth and lingering development over the past two years, but rather the effects are more manageable and volatility is reduced. So in essence forming a portfolio of Shariah-compliant indexes was not going to increase profit but rather reduce volatility. Empirical research has shown that whilst Islamic banks do not outperform conventional banks, they do provide diversification benefits. Research conducted by Kok *et al.* (2009) indicates that the inclusion of a Shariah-compliant index of shares in a risk-adjusted portfolio yields a better Sharpe ratio than a portfolio with only conventional shares (see Kok *et al.*, 2009).

The fact that Islamic finance provides a less risky investment option during volatile economic times also serves to explain its growth over the past few years. Portfolio managers having to rebalance risk and return within funds have turned their attention to Islamic finance in the hopes of generating some stability. Whilst investing or forming a portfolio consisting of a Shariah-compliant equity index may not exactly generate profits, the smoothing effects that it has on the overall volatility is beneficial (Kok *et al.*, 2009). If one were to think about the benefits of contribution in the accounting sense, contribution does not lead to profits but rather a reduction in the cost and an improvement in short-term sustainability.

Stating that Islamic indexes do not make money would be wrong but empirical evidence has shown that with the removal of financial and insurance institutions, Shariah-compliant indexes outperform standard indexes during bear periods/ market down turn and underperform standard indexes during bull periods/market up turn (Hassan and Dridi, 2010).

The debates of risk management and derivatives and regulatory standards in Islamic finance are multifaceted – we can start from the interpretation of Shariah-compliant rules (see Noor and Aripin, 2010; Razali, 2008; El-Gamal, 2006), from the need for further development of Islamic risk management (see Wilson, 2007; Smorlaski *et al.*, 2006; Maurer, 2001), for the want for a more socially orientated approach to financing (see Obaidullah, 2008; Obaidullah and Salem, 2008) or from the garnering of interest from the global financial community (see Kahf, 1999, 2002 and 2004 ; Zubair, 2005).

These rules and arguments about form and structure have meant that is has been difficult for policy makers to address financial issues from an Islamic perspective. Moreover, the lack of a central regulatory board has also impacted the development of risk management in Islamic finance (El-Hawary *et al.*, 2004). The Islamic Financial Services Board and Accounting and Auditing Organisation for Islamic Financial Institutions are the two main policy makers and so-called regulatory bodies for Islamic finance but even then these standards are only prescribed as opposed to enforced (Dar and Azami, 2010). The only country with a set of central rules for Islamic financial enterprise is Malaysia who is seen as the most lenient and liberally open to Islamic financial policy making. The rules of Islamic finance in the Middle East and Islamic states such as Pakistan vary from region to region and depend largely on individual religious scholars and their interpretation of the Quran.

This dichotomous regulatory standard has made policy making extremely difficult. The lack of unified rules and regulation has meant that whilst certain products may be deemed compliant in Malaysia, for instance, they may be prohibited in other countries. Additionally, there also exists a culture whereby should any doubt be cast upon a particular new financial instrument as to its “Shariah-ness” it would be, more often than not, deemed impermissible.

Financial innovation in Shariah finance branches out into two subsets. One involves Shariah-based innovation, which involves the creation of an instrument that is completely Shariah – e.g. *murabaha* or *musharakah*. The other more along the lines of Western financial innovation is Shariah-compliant development (Khan, 2010b). Shariah-compliant innovation allows for some leeway in Shariah interpretation of financial laws, which in turn provide some flexibility to financial innovators – e.g. a reverse *murabaha* (Dar and Azami, 2010).

Shariah-compliance has been a recent trend and one can observe its benefits. Trying to, for the lack of a better term, amalgamate elements of mainstream finance with little diminishment of Shariah principles has provided a strong foundation for innovation and development of new products and services within the Islamic financial system. This allows Shariah finance to compete on a more level playing field with that of mainstream finance in aspects such as risk management and liquidity transfer.

Many will argue that many Shariah-compliant services and products are prohibited and are not truly Shariah (see Derigs and Marzban, 2008; DeLorenzo, 2000). Moreover, a more pressing issue would lie with the approval processes for Shariah-compliance. While one would not openly criticise the processes involved, there is concern regarding the individuals who administer them. Shariah-boards are appointed by large financial institutions such as HSBC to validate and approve new products and services for the Shariah finance market[5]. The problem lies with the use of similar Shariah board members for different companies. This brings up the issue of a conflict of interest as well as the fear that more lenient board members maybe "headhunted" for an easier approval process. Once again this would be grounds for a study into policy making within Shariah finance but it is a cause for concern considering the processes involved with the creation of a new product.

Despite the issues outlined so far, however, over recent years, the development of Islamic risk management has progressed steadily with the creation of new Islamic risk management tools such as the *wa'ad* (promise) and parallel *murabaha* (cost plus sale) (Ebrahima and Rahman, 2005). The development of the *wa'ad* and its support within the Islamic financial community provides for an interesting picture on the progress of Islamic financial innovation (Razali, 2008). From an Islamic financial standpoint the *wa'ad* is a contractually binding promise to sell at a certain date for a specified price, a structure that is not unlike mainstream call options. The difference being, as opposed to mainstream call options, a *wa'ad* is legally and contractually binding meaning that should the agreement be reneged upon, legal action can be brought against the counterparty (Noor and Aripin, 2010). This new instrument clearly pushes the boundaries of Shariah-compliance and does show the willingness of Shariah finance to innovate and develop. Whatever the level of development, the objective of these tools would be to provide a strong basis for risk managers to manage risk within the Islamic economy.

The development of risk management strategies within Islamic finance has been relatively difficult. This can be attributed to two things. Firstly would be the constraints placed upon innovators by the laws of Shariah and secondly would be an alleged lack of need (Mohamad and Tabatabaei, 2008; Bacha, 1999). Shariah laws dictate every aspect of Islamic finance, which leads on to the following discussion on the constraints of Shariah law on financial innovation (Iqbal and Mirakhor, 2007). This issue of innovation is best described by the form-substance argument suggested by El-Gamal, (2006). Imagine the form being the means and the substances being the end. If both are combined, a means to an end will be arrived at. However, under Shariah finance, neither may necessarily justify the other. Whilst the structure of a risk management tool is Shariah-compliant, its end result may not be. On the other hand the product of this structure may be Shariah-compliant, but the structure itself not. Many Shariah scholars would argue this point but most will also suggest that the substance is more important than the form.

These rules and arguments about form and structure have meant that is has been difficult for policy makers to address financial issues from an Islamic perspective. Moreover, the lack of a central regulatory board has also impacted the development of risk management in Islamic finance (El-Hawary *et al.*, 2004).Empirical research has shown that Islamic finance faces several pertinent regulatory challenges. The rapid growth of Islamic finance has meant that there have been calls for a streamlining of regulatory standards across the global Islamic financial front. The lacks of uniformity of current Islamic financial directives have created uncertainty amongst market participants, which could damage the growth and development of Islamic finance.

This chapter is meant to provide the reader with an overview of the current state of modern Islamic finance. It sets the foundations for this research project through an examination of existing empirical research and literature.

5. Research Methodology

5.1. Introduction to Chapter

This chapter of the research project sets out the methodological foundations of this study by exploring the theoretical foundations of different philosophies that can be applied to a new area of research such as Islamic banking and finance. The chapter further elaborates on the research approach design and strategy documenting the process of research underpinning the research methodology adopted by this study. This is presented as follows.

Section 5.2. highlights the philosophical underpinnings of this study. It provides an introduction to the various research philosophies as highlighted by the literature and includes a justification for the selection of the appropriate philosophy. Section 5.3. details the research approach as prescribed by this research study. This section discusses the direction of the research and its use of theory. Sections 5.4. underlines the research design and strategy respectively. These sections will explain and introduce these concepts and justification for the selection of theory relating to these concepts. Sections 5.5. discusses the actual methods applied. will focus centrally on the three major themes of this research study. Section 5.5.1. will examine the methods for the analysis of the performance of Shariah-compliant funds while Section 5.5.2. will illustrate the development and design of the Shariah-compliant risk management instrument and Section 5.5.3. will look at the methods used in the analysis of governance in Islamic finance and. Section 5.6. provides a few summative remarks about the methodology.

5.2. Research Philosophy

Methodological arguments in the field of finance have been largely dictated by modern financial theory (MFT) and much of mainstream financial academia abides and appropriates towards a functionalist view of financial research (Ardalan, 2003). In essence this functionalist view suggests and encourages the use of a positivist research philosophy which advocates quantitative research methods and that the global financial environment be treated as,

> "…a place of concrete reality, characterized by uniformities and regularities, which can be understood and explained in terms of cause and effect…" (Ardalan, 2003, pg. 202)

From this perspective of financial academic research, major financial theories such as efficient market theory, portfolio theory and option asset pricing theory were born (see Ardalan, 2003). However, to what extent does the research philosophy play in the formulation of these theories? Economist such as Hahn (1992) recognise the methodological philosophies and the arguments that are presented by these methodologies but dismiss it as practically irrelevant in the financial sense. The question posed here was 'is there any practical benefit to financial practices in understanding the methodological philosophies of finance?" (Backhouse, 1992).

The concepts of methodological philosophies that are appropriated in the social sciences, some argue (see Johnson and Onwuegbuzie, 2004; Hoover, 1995; Hahn, 1992; Fisher, 1932) are difficult to implement within the field of finance and economics. The argument put forward is that these methodological underpinnings fail to advance the actual value of finance and economics (Hoover, 1995) and in fact in an excerpt from his letter to the editor of the Royal Economic Society, Mervyn King (1992) quoted the opening paragraph of Irving Fisher's presidential address to the American Statistical Association:

> "…it has long seemed to me that students of the social sciences, especially sociology and economics, have spent too much time in discussing what they call methodology. I have usually felt that the man who essays to tell the rest of us how to solve the knotty problems would be more convincing if he first proved out his alleged method by solving a few himself. Apparently those would-be authorities who are forever tell other how to get results do not get any important results themselves…"

However, this is not to say that there is no value to the philosophical methodologies in financial studies. Having a profound understanding of the philosophies would allow for a slight mitigation of the practical mistakes that could arise as a result of practical application. These philosophies are not, so much, the main aspects of financial studies. This position is held by the application and practical study of financial concepts and the performance of these concepts in the real financial world. However, the research philosophies that dominate the academic world do aid in the understanding of these practical studies. They provide direction in the analysis of real world effects and aid in the reduction of biasness and mistakes (see Lawson, 1992 and 1994), an ethos covered in Blaug's (1992) definition of methodology:

> "…a study of the relationship between theoretical concepts and warranted conclusions about the real world; in particular, methodology is that branch of economics where we examine the ways in which economists justify their theories and the reasons they offer for preferring one theory over another; methodology is both a descriptive discipline – "this is what economist do" – and a prescriptive one – "this is what economists should do to advance economics" – Blaug, 1992, pg. xii

Within the realm of academic research philosophy there exist two camps of purists – one advocating the use of purely quantitative research and the other expressing support for wholly qualitative research. The commonality between both camps would be an expressed scorn for a mixing of the methods and the endorsement of the incompatibility theory (Howe, 1992). This incompatibility theory posits that both quantitative and qualitative research paradigms and methods cannot be mixed on the basis that the principal and foundational beliefs of both forms of research are founded on different sets of logic in the administration of academic research (Guba, 1990)

Quantitative advocates (see Maxwell and Delaney, 2004; Schrag, 1992; Ayer, 1959) who subscribe to a positivist philosophy maintain that research in the social sciences should remain objective and as highlighted in Nagel (1986) that in the absence of time and context-free generalizations the real causes of social scientific outcomes can be determined reliably and validly.

Based on this positivist philosophy, academic researchers are required to eliminate their biasness and remain emotionally detached from the objects of their study (Tashakkori and

Teddlie, 1998). On the other hand there is the qualitative purist, who believes and applies either a constructivist or interpretivist philosophy to academic research. The view in this circumstance is that research and knowledge flow inductively from data (Guba, 1990) where all explanations are derived from observations and that both the researcher and the research subjects cannot be differentiated and will therefore be affected by the overall environment (Johnson and Onwuegbuzie, 2004).

For the purposes of this research study a pragmatist research philosophy has been adopted. The pragmatist approach is seen as the third research paradigm and was borne out of the quantitative and qualitative debates and aims to combine the strengths and minimise the weaknesses of both qualitative and quantitative research approaches (see Appendix 1 for a detailed overview of the strengths and weakness of quantitative and qualitative research).

Pragmatism advocates the use of mixed method approaches combining the best of both quantitative and qualitative methods into single paradigm. However, the selection of any research philosophy would depend heavily on the research questions and objectives that have to be accomplished. It is these variables that should invariably decide the selection of the research methodology.

The major aims of this research were to examine Islamic finance from a conventional perspective. The study focused on several pertinent issues in Islamic finance namely the performance and diversification benefits of Islamic funds, risk management under a Shariah financial framework and issue of governance and regulation within Islamic finance. With regards to analysing the performance and diversification benefits of Shariah-compliant funds (Research Objective No. 2), this facet of the study would have been best served through a quantitative study. The notion of portfolio performance and diversification plays into all the strengths of a positivist, quantitative approach by testing a validated Markowitz approach on established quantitative data. In similar respite, the analysis of modern Islamic finance (Research Objective No. 1) and the analysis of the issue of governance in Islamic finance (Research Objective No. 4), these research objectives would have been best achieved using qualitative approach in terms of analysing the view of market participants. Examining risk management under a Shariah financial framework (Research Objective No. 3) required a more pluralistic approach and involved the use of both qualitative analysis, in terms of designing the product and understanding Shariah-compliant rules and regulations, and quantitative analysis, in assessing the payoff streams of the product.

How does pragmatism fit into the overall equation of trying to achieve the objects and answer the research question? The classical pragmatist argument put forward by James (1907) essentially describes pragmatist problem solving using a hotel corridor as a metaphor. Consider an individual with an ailment searching for a cure and the various rooms contain a cure for that ailment. The individual will be the one that knows when the illness is cured and the ultimate test of the cure would be when the individual is no longer ill – the true value of the treatment. In essence, if the ailment were to be related to a research problem/objective and the treatments in the various rooms as the methodological paradigms then the pragmatist approach would advocate that every room is tried until a suitable answer is found. Moreover, pragmatism suggests a pluralistic view in that solutions can be drawn from various sources whether quantitative or qualitative (Bartle and Shields, 2008).

Drawing inference and relating this argument back to this study, with relation to the assessment of the performance of Shariah-compliant funds, the research has theoretical foundations based on modern portfolio theory (MPT) and from that theory an empirical analysis will be conducted. With regards to governance, it is a subject matter that is difficult to quantify but can be analysed qualitatively through the collection of detail-rich participant precepts. The need to adopt different styles of analysis highlights the pragmatist ethos within this research. However, the pragmatist approach is extremely beneficial and suited to the development of the new risk management tool. By using this research philosophy, inspiration, information and inferences can be drawn from various sources to further the understanding and therefore produce products that are more in line with Shariah-compliant rules than if a single pronged approach of either purely quantitative or purely qualitative been adopted.

One of the major criticisms of the pragmatist philosophy when it comes to research would be the fact that it does not provide the best solution to conducting research but rather just a work around for existing problems (Hoover, 2004). This view is best reflected in the table below, which documents the inherent weaknesses of the pragmatist research philosophy and more specifically point 6 in the table. Fundamentally, the principal weakness of a pluralistic or a pragmatist approach would be that by allowing the basic premises of both qualitative and quantitative philosophy, it does not then form a robust underlying research philosophy. What the research approach is then left with is a somewhat 'Jack-of-all' trade's answer that cannot be attached ontologically to either quantitative or qualitative approaches, weakness which can be seen in Table 13 below (Onwuegbuzie, 2002).

- Basic research may receive less attention than applied research because applied research may appear to produce more immediate and practical results.
- Pragmatism may produce incremental change rather than more fundamental, structural or revolutionary change in society.
- Researchers from a transformative-emancipatory framework have suggested that pragmatic researchers sometimes fail to provide a satisfactory answer to the question.
- What is meant by usefulness or workability can be vague unless explicitly addressed by a researcher.
- Pragmatic theories of truth have difficulty dealing with the cases of useful but non-true beliefs or propositions and non-useful but true beliefs or propositions.
- Many come to pragmatism looking for a way to get around many traditional philosophical and ethical disputes (this includes the developers of pragmatism). Although pragmatism has worked moderately well, when put under the microscope, many current philosophers have rejected pragmatism because of its logical (as contrasted with practical) failings as a solution to many philosophical disputes.
- Some neo-pragmatists such as Rorty (and postmodernists) completely reject correspondence truth in any form, which troubles many philosophers.

Table 13: Weakness of Pragmatism (Source: Hoover, 2004)

It has to be noted that research into finance, as is this research study, are predominately grounded within a positivist camp, advocating the use of multiple statistical and mathematical methods for validation as a singular insistence (Nagel, 1986). However, there is increasing research that is beginning to suggest that this need for quantitative validation through statistical and mathematical analysis is misguided (Downward and Mearman, 2006). Heterodox economists such as Lawson (1988) have indicated that the notion of incorporating qualitative research into the spectrum of economics and financial research will result in a more rounded understanding of economic phenomena, thus illustrating the benefits of incorporating qualitative methods within the positivist dominated world of financial research. Whilst there still exists purists who will argue for the incompatibility theory of a mixed methods pragmatist approach, what can be seen, within the field of economics, accounting and finance, would be an acceptance of the benefits of mixed methods research.

Work such as that by Bartle and Shields (2008) who using a mixed method approach on public budgeting and financial management have suggested that while theory should guide practice, it should also be practice, which informs theory. Further justification for the use of mixed-methods research can be seen from the works of Modell (2005) and Lukka and Kasanen (1995) who examine the inclusion of qualitative methods within accounting research. Modell (2005) concluded that the combination of both qualitative and quantitative methods in a balanced fashion "enabled a broader range of validity threats to be addressed." Lukka and Kasanen (1995) argue that the use of qualitative methods in accounting research fundamentally created results that were more generalizable in nature.

Pragmatism is not a new approach within the field of economics, accounting and finance and is in fact over 130 years old (Bartle and Shields, 2008). The arguments about incompatibility of research methodologies will always exist but there also exists support for mixed methodologies and its practical explanation in the field of financial studies. As Walker (1930) put it,

> "If a budget clerk were to carefully search through the archives of public finance, economic theory and municipal government, he would find pitifully little to assist him in the all-important question of dividing up the city's revenues. His adoption of rule-of- thumb devices to tide him past the crucial points is the most that could be reasonably expected... To understand municipal budget making it is necessary to visualize this

> tremendous pressure that is being exerted from all sides – the pressure of organized interests, of ambitious department heads, of civic groups, of official prejudices, of the political potency of a low tax rate, even of public opinion where not represented by any of the above. The final budget will be the resultant of these forces and not the outcome of a dispassionate evaluation of the various functions.” (Walker, 1930, pg. 29)

For the purposes of this research, the adoption of a pragmatist philosophy and being able to draw inferences from both quantitative and qualitative analyses have ameliorated the investigative process. In approaching the analytical process by not standing on either side of the quantitative/qualitative fence but rather through embracing the qualities and limitations of both has enabled, of this study, a more robust and rounded analysis in the achievement of the research questions and objectives. Principally, the use of a pragmatist approach to understand the major research objectives of the performance and diversification benefit of Shariah-compliant funds, risk management under a Shariah financial framework and understanding issues of governance and regulation within Islamic finance, it is believed, would not only provide a more rounded perspective of the issues but also a more practical perspective and benefit to the research surrounding Islamic banking and finance.

5.3. Research Approach

The research approach for any research study would depend on the explicit nature of theory with relation to the project (Saunders *et al.*, 2009). Namely the direction of the analyses will be dictated by relative understanding of the theory at the beginning or at the end of the research project. There are essentially two central research approaches – deductive and inductive (for graphical illustrations see Figures 25 for deductive and Figure 26 for inductive).

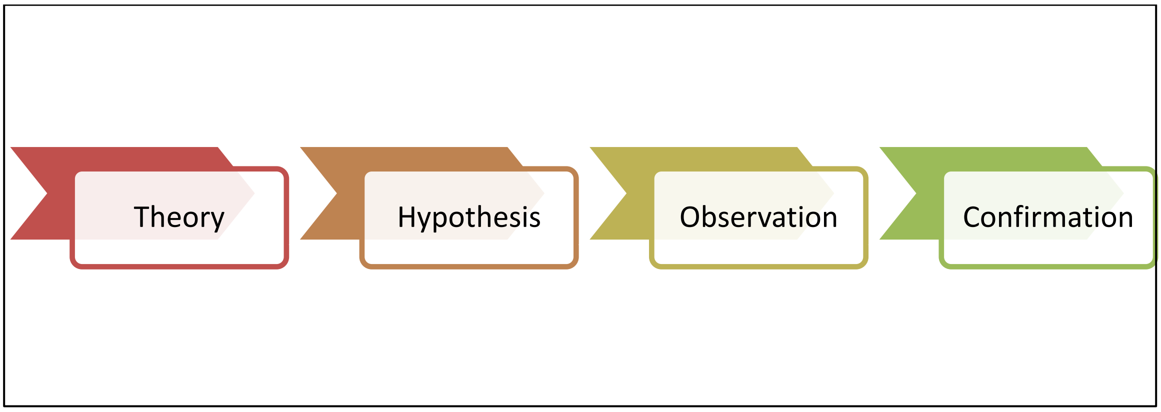

Figure 25: Deductive Research Approach (Source: Trochim, 2006)

The deductive approach encompasses the testing of theory. Fundamentally, a strong theoretical foundation is established through a review of literature and the testing of these theoretical foundations on practical variables that exist in the real world. This research approach is widely used in the more quantitative research projects and requires a structured methodology to achieve the replication of the theoretical study using real variables (Saunders *et al.*, 2009).

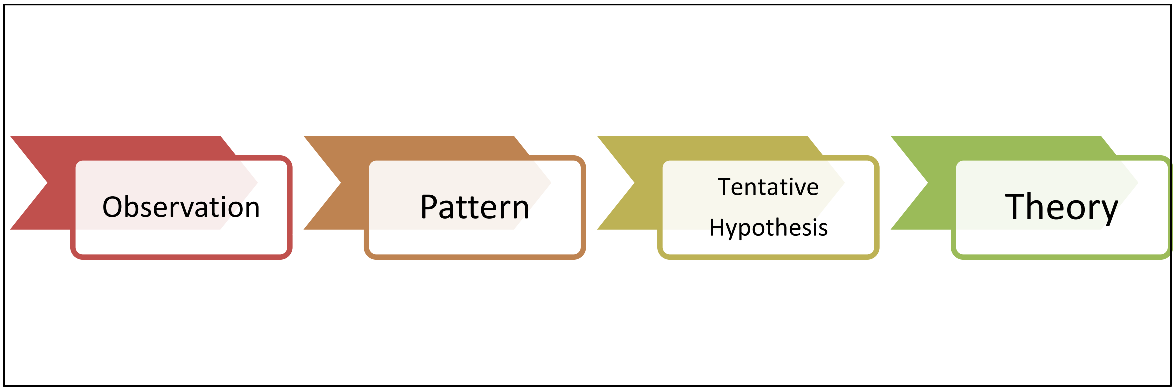

Figure 26: Inductive Research Approach (Source: Trochim, 2006)

On the other hand an inductive approach is all about building the theoretical foundation. The research study starts off with an outline of the variables that are to be analysed and from that analysis the theory generated. In essence it allows for flexibility in understanding how certain real variables react in the real environment without the constraints of theoretical implications. Table 14 below was adapted from Saunders *et al.* (2009) and provides a brief distinction of the differences between deductive and inductive approaches.

Deduction Emphasises	**Induction Emphasises**
• Scientific principles • Moving from theory to data • The need to explain causal relationships between variables • The collection of quantitative data • The application of controls to ensure validity of data • The operationalization of concepts to ensure clarity of definition • A highly structured approach • Researcher independence of what is being researched • The necessity to select samples of sufficient size in order to generalise conclusions	• Gaining and understanding of the meanings humans attach to events • A close understanding of the research context • The collection of qualitative data • A more flexible structure to permit changes of research emphasis as the research progresses • A realisation that the researcher is part of the research process • Less concern with the need to generalise

Table 14: The major differences between deductive and inductive research approaches (Source: Saunders *et al.*, 2009)

It should be noted however that whilst the initial impression is that there is a rigid divide between both deductive and inductive approaches, this is not true. It is not only possible to combine both approaches but a coalescence of this divide can provide benefits towards the research study (Saunders *et al.*, 2009). As such this research adopts a Hypothetico-Deductive (Hypo-deductive) research approach, essentially combining both deductive and inductive approaches. An illustration of the processes involved with this research approach is shown in Figure 27 below which is adapted from Sekaran (2003).

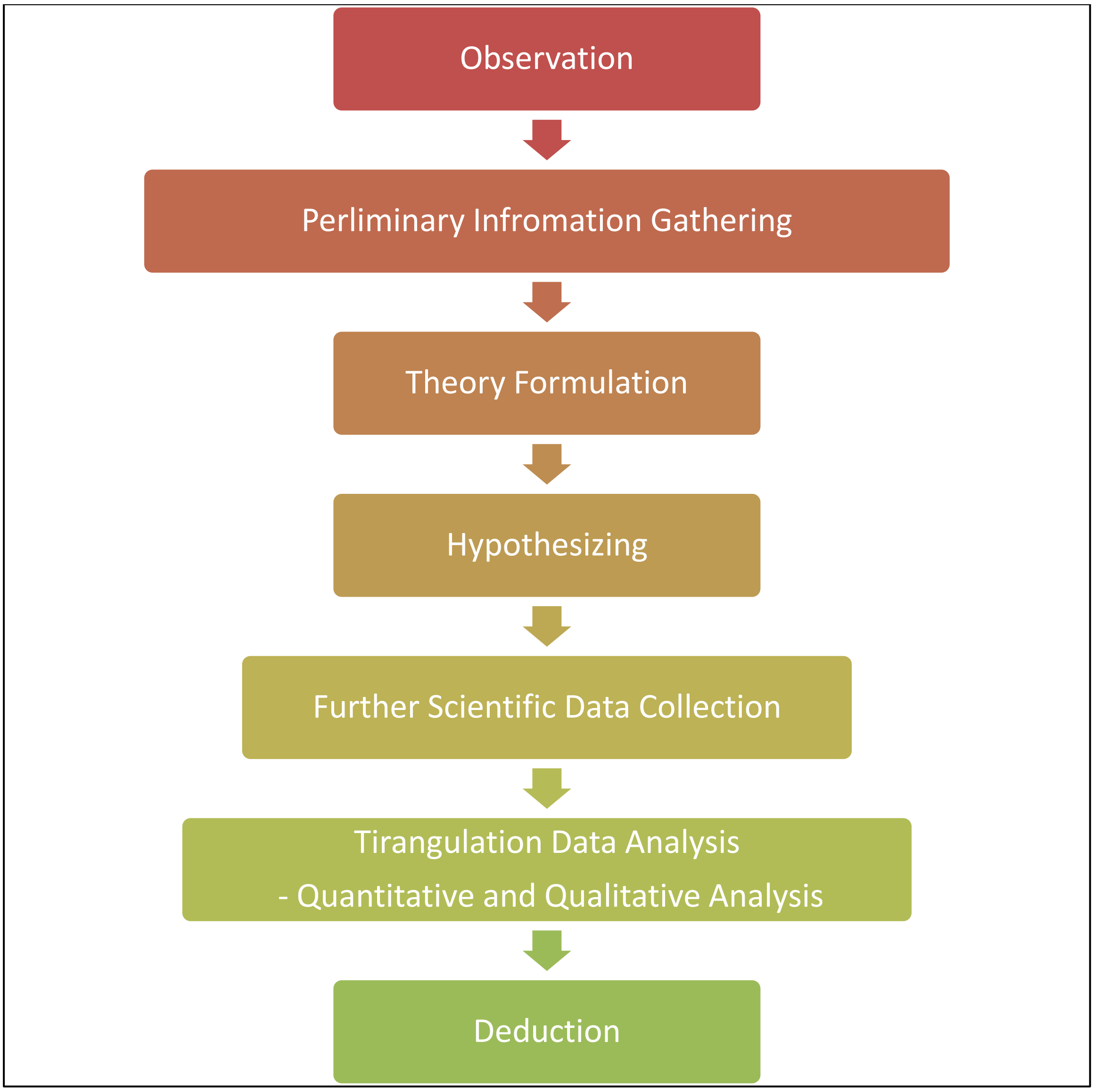

Figure 27: Hypothetico-Deductive Research Approach (Source: Sekaran, 2003)

In essence, the hypo-deductive approach to research commences with an inductive perspective and involves observations of the academic environment surrounding the subject matter. With regards to this study the initial inductive perspective arises from the preliminary information gathering through a review of relevant literature. This review will survey the academic foundations of the development of Modern Islamic finance and will centre on the major themes of this research – performance and diversification benefit of Shariah-compliant equity indexes, risk management under a Shariah financial framework and issues of governance and regulation within Islamic finance. Fundamentally, this preliminary survey of the literature will achieve objective one – a review of modern Islamic finance. This contextual foundation will allow us to formulate theories and hypothesis behind the major research themes. In trying to achieve research objective two, the study tests the performance and diversification benefits of Shariah-compliant indexes in America and the UK. The research wishes to establish if there are any performance and diversification paybacks from holding a Shariah-compliant equity index within portfolio of conventional equities – Research Objective 2.

Additionally, the research seeks to understand the spectrum of risk management under a Shariah-compliant financial framework. Using the developed understanding from this facet of the study the research would then establish and develop a new risk management instrument under these Shariah-compliant rules – Research Objective 3. During the hypothesizing and theory formulation stage of the research approach the study discovered that the problems of regulation and governance highlighted in the literature were being experienced in trying to create the risk management instruments, upon which it was decided that further data collection pertaining to the precepts of market participants on issue of regulation and governance would be required to establish more robust arguments and analysis pertaining to the overall study – Research Objective 4. Fundamentally, triangulation analysis was conducted on the literature review, the empirical quantitative analysis and the qualitative investigation. Essentially, the underlying conclusions of this study aim to be confirmatory in nature. What can be seen from the hypo-deductive approach would be a move from initial inductive thinking to deductive thinking upon completion.

5.4. Research Design and Strategy

The aim of this research project is to explore the development of Islamic finance in the modern economy paying particular emphasis to the areas of risk management and governance. One of the aims of this research is to assess the performance of Islamic funds by creating an artificial portfolio of equities, which included a Shariah-compliant fund. Additionally, the research also seeks new insight into the issues of governance in Islamic finance from differing perspectives and finally to determine if it would be possible to establish a new modus of risk-sharing risk management under a Shariah financial framework. These research aims have a common theme across them in that they strive to pursue new insight into risk management and governance in Islamic finance. Fundamentally, the research design for this study is mainly exploratory.

The research strategy adopted for this study will be both experiment and survey. The survey element will relate to the assessment of the performance of Shariah-compliant-fund and issues of governance. The experiment strategy is connected to the creation of a new Shariah-compliant risk management tool.

5.5. Methods

As stated before, a pragmatist philosophy was adopted for the purposes of this research. Pragmatism advocates the use of pluralism or the implementation of varied views and approaches in trying to answer one's research questions. This involves the use of both quantitative and qualitative methods in the research. This research project essentially embraces a mixed-methods approach and will provide further details in the following paragraphs.

This section is segmented into three subsections for each of the major objectives of this research study. Section 5.5.1 sets out the methods used for the assessment of diversification and performance of Shariah-compliant funds. Section 5.5.2. provides notes on the development process of the Shariah-compliant risk management tool. Section 5.5.3. details the methods used in discussing or examining the issues of governance in Islamic finance.

5.5.1. Examining the Diversification and Performance of Shariah-compliant Funds

The first major objective of this research study was the assessment of the performance and diversification benefit of Shariah-compliant indices (Research Objective No. 2). The performance measure in this circumstance was not profit maximization but rather risk minimization through the creation of an efficient minimum-variance portfolio.

The composition of the portfolio would include a mainstream index, an ethical fund index and a Shariah-compliant index. The weights attached to each of the indexes would be determined using a Markowitz (1959) portfolio optimization process. This essentially involved discovering the optimal weights for each index in the portfolio that would yield the smallest standard deviation or lowest risk. The optimisations were conducted using Microsoft Excel using a matrix multiplier method. The selection of a Markowitz (1959) optimization methodology was based upon similar reasoning presented in Derigs and Marzban (2009). In their seminal and revolutionary work looking at Shariah-compliant investment strategies, it was suggested that active portfolio management afforded by the Markowitz (1959) methodology allowed for the flexibility of portfolio composition selection based upon the investors risk profile. This methodology further allows for a more practical view of portfolio selection. Initially, dependent upon the individual risk profile, there could be a substantial number of efficient portfolios. Allowing individual investors the opportunity to select the appropriate asset mix would prove valuable towards this study. Moreover, additional practical benefits would arise from the researcher controlling the optimization specifications in terms of reduction of complexity by reducing the optimized portfolio spectrum to a representative subset (Derigs and Marzban, 2009). The optimisation periods were set out to 2 years, 1 year, 6 months and 3 months optimisations. The evaluation between the various optimisations was through the use of the Sharpe ratio against a bench mark of a naïve buy and hold strategy of the mainstream for the optimisation periods.

An additional layer of control was added to the optimization process by setting minimum threshold holdings for the mainstream index in the portfolio. Inspiration for this was drawn from the work of Laws and Thompson (2007). The notion that the research observes Islamic finance from a conventional perspective, it was thought reasonable to test an additional optimisation constraint which held that at least 50% of the portfolio would be held in a mainstream financial index. So in essence, the portfolios were optimised in two ways – 1) with free weights 2) with at least 50% in the mainstream index. Moreover, further general constraints were imposed which included no short selling or borrowing and that all wealth was absorbed into the portfolio composition. These general constraints were imposed upon both the optimization specifications.

The sampling frame for the time series was the 1st of January until the 29th of June 2007. This study will employ the use of the returns for the mainstream indexes as a benchmark. The data for this research was obtained from DataStream and will include two Shariah-compliant indexes, two non-Shariah indexes and two sustainability indexes.

These indexes are as follows,

List of Indexes (1st January 2001 up until 29th June 2007):

<u>Shariah-Compliant</u>

1) FTSE Global Islamic Index (FTSEIS)
2) Dow Jones Islamic Index (DJIMI)

<u>Mainstream Index</u>

3) FTSE 100 (FTSE)
4) Dow Jones Industrial (DJ)

<u>Sustainability Indexes</u>

5) FTSE 4 Good Sustainability Index (FTSE4G)
6) Dow Jones Sustainability Index (DJSI)

The choice of this sample period is justified to avoid the effects of the financial crisis which could distort the results. As Islamic equity funds contain no banks the effects of the financial crisis could have been substantially muted and thus dramatically affect the results. The choice of the indexes is on the basis that each mainstream index (FTSE and DJ) is matched by a Sharia-compliant (FTSEIS and DJIMI respectively) and by a sustainability index (FTSE4G and DJSI). All indexes were transformed into logarithms discounting the impact of stationarity and creating elasticity measures. The interest rates for a 3-month British T-Bill will be used as a proxy for risk-free interest rate. The unit of decision in this instance was the daily returns of the financial equity indexes. The use of American and British equity indexes was on the understanding that both countries constituted the largest markets for Shariah-compliant financial activity.

It should be noted that portfolio optimization methodologies operate best when the portfolio composition comprises of low (or better, negatively) correlated assets. For a two asset portfolio an adequate measure of this relationship would have been a standard correlation matrix. However, for the purposes of this research, the use of a multi-asset (more than two) means that a different methodology has to be used to determine the initial relationship between assets in portfolio. Due to its superior performance as a statistical measure, the Johansen cointegration procedure was selected. In terms of overall generalizability, the Johansen procedure allows for multiple cointegrating vectors which make it more applicable in the general sense over the Engle-Granger methodology. Essentially, cointegration analysis determines if there exists any underlying stochastic relationship between the equity indexes. The lack of cointegration would indicate the lack of a relationship thus indicating the possibility for the creation of an efficient portfolio under the Markowitz (1959) framework.

All indexes were tested initially for stationarity using the Augmented Dickey-Fuller (ADF) test. In order to carry out the cointegration regression, the indexes have to be integrated to the order of 1 or I (1). ADF test hypothesis are as follows:

$\mathbf{H_0}$: $\delta = 0$ (time series in non-stationary)

$\mathbf{H_1}$: $\delta < 0$ (time series is stationary)

Upon completion of stationarity testing, indexes were separated into the following groups:

Group 1 :- LDJ, LDJSI, LDJIMI, LFTSEIS, LFTSE, LFTSE4G
Group 2 :- LDJ, LDJSI, LDJIMI
Group 3 :- LFTSEIS, LFTSE, LFTSE4G
Group 4 :- LDJSI, LDJIMI, LFTSEIS, LFTSE4G

Table 15: Index Groupings

The grouping characteristics are defined as:

i) Group 1: All selected indexes

ii) Group 2: All selected Dow Jones Indexes

iii) Group 3: All selected FTSE Indexes

iv) Group 4: All selected ethical and Shariah-compliant Indexes

The first step of the Johansen procedure requires that Vector Autoregressions (VARs) be generated for each of the groupings. These VARs will be used to establish the lag length structure of each of the groups. The Schwarz information criterion will be used for the determination of lag lengths (Koehler and Murphree, 1988). Under the Johansen framework there are two tests for multivariate cointegration – Trace and Max-Eigenvalue tests. Based on the literature (see Cheung and Lai, 1993), the Trace test is preferred over the Max-Eigenvalue as it provides for more robustness when it came to the normality of data. The Trace test has joint hypothesis which are given below

1st Test Hypotheses Set: Number of cointegrating vectors is equal to 0

$$\mathbf{H_0}: r = 0$$

$$\mathbf{H_1}: r \geq 1$$

2nd Test Hypotheses Set: Number of cointegrating vectors is more than 1

$$\mathbf{H_0}: r \leq 1$$

$$\mathbf{H_1}: r = 2$$

Only index groups which exhibited no cointegration vectors were taken forward to the portfolio optimization process. The use of the Johansen cointegration procedure in this instance is twofold. Firstly, the lack of cointegrating vectors will be seen in the same slight as negative correlation for which portfolio optimization works best with. Secondly, the Johansen framework also allows for an analysis into the diversification benefits of selected index groupings.

The next step was the creation of an optimised portfolio under a Markowitz (1959) portfolio optimization methodology. These optimisations were done for four different rolling windows, essentially, 2-Years, 1-Year, 6-Months and 3-Months. This would enable a dynamic calculation of the ratios above rather than having a static picture over the data period. The returns of the FTSE100 were taken as a benchmark. The standard Markowitz (1959) methodology suggests that the risk associated to any particular portfolio is the sum of the risk attached to each individual asset and the combined risk of each asset in the portfolio. This is denoted by the formula below:

$$\sigma_p^2 = \sum_{i=1}^{N} \left(X_i^2 \sigma_i^2 \right) + \sum_{i=1}^{N} \sum_{\substack{k=1 \\ k \neq i}}^{N} \left(X_i X_k \sigma_{ik} \right)$$

For a three asset horizon, the following formula can be expanded to yield:

$$\sigma_p^2 = X_A^2 \sigma_A^2 + X_B^2 \sigma_B^2 + X_C^2 \sigma_C^2 + 2X_A X_B \sigma_{AB} + 2X_A X_C \sigma_{AC} + 2X_B X_C \sigma_{BC}$$

For the amount of optimization required, it was decided that the use of matrix algebra via Microsoft Excel would be the most adequate in terms of ease and time. This process is demonstrated below for a similar three asset portfolio where $X = \begin{pmatrix} X_A \\ X_B \\ X_C \end{pmatrix}$ are the weights invested in each of the three assets. Given as well that a covariance matrix can be generated, let this covariance matrix be Σ where, $\sum = \begin{pmatrix} \sigma_A^2 & \sigma_{AB} & \sigma_{AC} \\ \sigma_{AB} & \sigma_B^2 & \sigma_{BC} \\ \sigma_{AC} & \sigma_{BC} & \sigma_C^2 \end{pmatrix}$. We should also take a transpose of the weights invested in each of the assets, $X' = (X_A \quad X_B \quad X_C)$. Using the formula given below,

$$X'\Sigma X = (X_A \quad X_B \quad X_C) \cdot \begin{pmatrix} \sigma_A^2 & \sigma_{AB} & \sigma_{AC} \\ \sigma_{AB} & \sigma_B^2 & \sigma_{BC} \\ \sigma_{AC} & \sigma_{BC} & \sigma_C^2 \end{pmatrix} \begin{pmatrix} X_A \\ X_B \\ X_C \end{pmatrix}$$

we end up with$\sigma_p^2 = X_A^2 \sigma_A^2 + X_B^2 \sigma_B^2 + X_C^2 \sigma_C^2 + 2X_A X_B \sigma_{AB} + 2X_A X_C \sigma_{AC} + 2X_B X_C \sigma_{BC}$. Once this was establish the solver function was used in Microsoft Excel to derive the minimum variance portfolio under the constraints and optimization criteria set out above. As stated before the portfolios would be optimized with a) no constraints on the investment horizon and b) a mandatory 50% investment in the mainstream equity index.

The use of traditional Jensen (1968), Treynor (1965) and Sharpe (1966) ratios to assess risk-adjusted performance of the portfolios is widely practice. Justification for the use of these risk-adjusted measures of performance can be seen from the works of Elfakhani *et al.* (2005), Abdullah *et al.* (2007) and Girard and Hassan (2008 and 2011) in terms of Islamic equity indexes. Moreover, initial studies into the performance of ethical and mutual funds also abide by this methodology to measure performance (see Luther and Matako, 1994 and Hamilton *et al.*, 1993).

Performance Measure	Formula
Jensen's Alpha	$[E(R_p) - R_f = \alpha + \beta[R_m - R_f]$
Treynor Index	$\frac{(R_p - R_f)}{\beta}$
Sharpe Information Ratio	$\frac{(R_p - R_f)}{\sigma}$
Notes:	$E(\,) = expectation\ operator$ $R_p = return\ on\ portfolio$ $R_f = risk\ free\ rate\ of\ return$ $R_m = market\ rate\ of\ return$ $\beta = equity\ volitality\ measure$ $\alpha = expected\ rate\ of\ return$ $\sigma = standard\ deviation\ of\ market\ returns$

Table 16: Risk Adjusted Performance Measures

Jensen's alpha essentially measures the performance between the actual and expected returns for a given portfolio. Fundamentally, Jensen's alpha is an extension of the traditional single index (CAPM) model. Positive Jensen values indicate an outperformance of the actual against expected returns and negative Jansen values illustrate and underperformance between actual and expected returns along the securities market line (SML).

The use of the Treynor index is to capture excess returns for each unit of systematic risk borne by the equity portfolio. High Treynor values indicate better returns for a given level of systematic risk and vice versa.

The Sharpe index, like the Treynor, assesses excess returns over a given level of risk. The difference here lies with the measure of risk. Whilst Treynor only accounts for systematic, market risk, The Sharpe Information index accounts for both non-diversifiable and diversifiable risk through the use of the standard deviation (σ) as a measure of portfolio risk. Once again a higher Sharpe ratio would indicate better risk adjusted performance.

These performance measures will be compared against a naïve buy and hold of the mainstream indexes. The selection of which mainstream index will be dependent upon portfolio groupings. Should a portfolio comprise of both American and British equity indexes then both mainstream indexes from the two countries will be used. However, should the portfolio grouping consist only of equity indexes from American or the UK, then only the mainstream index from the respective country will be benchmarked against. This mainstream index will correspond to the country represented in the index grouping.

5.5.2. Product Design and Development

Running in tandem to the analysis on the diversification benefits and performance of Shariah-compliant indexes, a significant objective of this research would be to critically evaluate the state of risk management under Shariah financial framework. In additional to surveying the literature behind product design and development and risk management instruments within Shariah finance, this research intends to propose a new Shariah-compliant risk management structure (Research Objective 3).

The methodology for the design and development of the new product was very much pen to paper. The initial understanding of Shariah-compliance was established through a review of the existing literature behind the subject matter (see Chapter 4, Section 4.2.). What was seen from this review was that different Islamic financial hubs across the global economic spectrum possess varying regulatory standards. Predominately, much of the literature attributes these differences to the varying interpretations of Islam from the numerous Islamic schools of thought. Thus for the purposes of this research and for consistency, the Shariah financial standards adopted for this study consisted mainly of an understanding of a broad set of central Islamic financial values. Moreover, it should be noted that this broad set of Islamic financial values will derived from accepted Shariah-compliant financial rules and regulations. The specifications of the Shariah-compliant financial standards are set out in the paragraphs below.

A key aspect of Shariah finance is the prohibition of *riba*. This was the principle starting point for the design of the product. In designing the product, every effort was made to ensure that there were no elements of *riba* and this was achieved by maintaining that the product existed in the real sense. Essentially, this involved paying strict attention to the flow of capital throughout the product structure to ensure that there was no additional creation of wealth by merely trading the product. Moreover, because of this respect for the real and tangible financial markets, the design process involved mapping out the payoff streams for every party involved in the transactions highlighting ownership throughout the two possible payoff states and processes have been taken to highlight, where possible, the movement of tangible goods within the product structure.

Attempts have also been made to streamline the product structure to a significant degree to ensure that only the required number of counterparties exists within the transactions. The mapping of the payoffs and streamlining of the processes essentially aided the design process when it came to dealing with arguments against *gharar*. Through this mapping process, the aim was ultimately to avoid, to an utmost degree, any uncertainties in the product structure. Unfortunately, it is slightly difficult to avoid questions of maysir or speculation due to the option like characteristics of the structure of the *wa'ad*. For the purposes of this research, it will be maintained that this product will only be used for the purposes of hedging and risk management. An additional consideration throughout the product design stage would be that all real commodities used in the product structure must be halal.

In addition to the Shariah-compliant standards that have to be met during the design stage, it has to be understood that this is still a financial instrument and thus conventional financial consideration has to be accounted for. There was an increased worry about product inefficiencies leading to arbitrage opportunities which invariably is unfavourable from a conventional standpoint but it also invalidates the prohibition of riba. Much attention was paid to the product structure to ensure that it maintained the whole notion of a zero-sum game. Once again care was given to the payoffs of transaction parties and the movements of funds throughout the product structure.

The product structure drew inspiration from two existing Shariah financial contracts – the *musharakah* and the *wa'ad*. In essence the *wa'ad* is a comparatively new contract in modern Islamic finance - new in the sense that the acceptance of the *wa'ad* concept in modern Islamic finance is a fairly modernistic innovation. Principally, the wa'ad is the Islamic equivalent of a conventional call option and there are concerns over its validity from both a speculative standpoint as well as structurally as it allows contract holders the option to choose which creates a significant element of uncertainty. Nevertheless, proponents of the wa'ad structure have indicated that sellers of wa'ad are adequately remunerated for the bearing of the uncertainty or risk.

It should be noted however, that the *wa'ad* structure as a risk management tool is very much still about risk transfer. It is a want for this study set out and try to create a risk management tool that adhered towards a risk-sharing mode of risk management which is more in line with the PLS characteristics that are so strongly advocated by the Islamic financial system. The closest existing Islamic financial contract that advocates risk-sharing is the *musharakah and mudarabah* and steps were taken to amalgamate elements of both the *wa'ad* and risk sharing properties of the *musharakah* and *mudarabah* to create a risk management tool that essentially combines the risk managing flexibility of a call option with elements risk-sharing as opposed to complete risk transfer.

However a significant consideration in the creation of the product structure and the methodology itself is the validity when it came to Shariah-compliance. It has to be understood that the Shariah-compliant approval process is through a Shariah Supervisory Board (SSB) of which access is limited. This is not unexpected due to the relative age of the industry and issues of conflicts of interest and commercial security. There was also a distinct worry about the creation of *hiyal* or artifices through the derivation of the product structure. The concern here would stem from the fact that by evolving the existing wa'ad structure to incorporate the risk-sharing element of a musharakah, this could invariably yield a non Shariah-compliant payoff. Moreover as stated before, throughout the design process steps were taken to ensure that both product structure and payoffs met Shariah-compliant standards to the best of the researcher's knowledge.

5.5.3. Issues of Governance

The 4th research objective of the study was to analyse the issues of governance in Islamic finance. In trying to explore the issues of governance in Islamic finance, an exploratory qualitative methodology was employed and this entailed the use of semi-structure interviews with individuals who possessed deep, extensive practical knowledge in the subject matter and ideally a mix of professionals and academics. The interviews consisted of questions that enquired about several pertinent themes on governance in Islamic finance as highlighted from the literature review. These themes consisted of the perception of Islamic finance from the perspective of conventional finance, the view of transparency, the examination of Shariah-supervisory boards, the role of lenders of last resort in Islamic finance and the further prospects and challenges of the Islamic financial system. Unlike structured interviews, semi-structured interviews allow the researcher the option to vary the sequence of the themes based on the direction of the particular interview (Saunders *et al.*, 2009).

Interview questions were established across these central themes and interviewees were allowed to speak freely about these issues. To determine the validity and reliability of questions several pilots were executed to refine interviewing technique, questioning sequence and if questions were achieving their desired effect.

5.5.3.1. Interview Sampling and Administration Methodology

The sampling strategy adopted for this element of the research thesis was judgement/purposeful sampling. Using this strategy the research actively selects the interviewees that could provide the most comprehensive/ productive answers to the interview questions (Marshall, 1996). Critical case or purposeful sampling was adopted for this aspect of the research study. The decision to use a form of non-probability sampling for this component of the research was based on the specialised nature of the subject matter. Whilst Islamic finance is growing rapidly on a global scale and to a certain extent in academia, it is still very much regarded as a specialised, niche market. As such the researcher felt that the most beneficial views on issues of governance in Islamic finance would stem from the opinions of a selected and representative group of academics and professionals in the field. Initial research design for this aspect of the research project only called for the interview of academics and practitioners but it was realised that this could cause a perceptual bias towards either category.

As such it was decided that an additional category of interviewee was required – one that understood both academic and practitioner perspectives. In essence this allowed for systematic triangulation of nodes in the sense that the research gathers views from three different sources – the Academic evaluation, the Practitioner outlook and the Academic-Practitioner assessment. The inclusion of the Academic-Practitioner, the researcher felt, was valuable in balancing the views across the three interviewee groups.

The aim of the sampling methodology was to achieve theoretical saturation of views. The notion of theoretical saturation of views is established in Glaser and Strauss's (1967) seminal work on grounded theory. Fundamentally saturation is described as a process whereby an interviewer continues to sample relevant cases until no new information arises. In terms sampling frame, there is no definite answer as to how many interviews are required to arrive at saturation point. Mason (2010) who examined five hundred and sixty post-doctoral studies discovered that many PhD theses averaged around thirty-one interviews. However, what was further highlighted from the Mason (2010) study was that whilst thirty-one was the average number of interviewees conducted for PhD studies, it did not necessarily result in saturation. Mason (2010) suggested that larger samples did not guarantee saturation and that saturation could have been achieved with samples as small as three interview candidates. Ritchie *et al.* (2003) and Guest *et al.* (2006) further support this view and suggest that sample size is not the only variable that has to be considered in terms of saturation. A study by Guest *et al.* (2006), which looked at women at high risk of HIV, found that saturation was attained after twelve interviews. This was put down to homogeneous nature of the interview candidates. The results of Guest's (2006) twelve interview saturation point is also advocated by Francis *et al.* (2010) who discovered that no new precepts were generated after the first ten cases in theory-based research. However, we have to understand the inherent ambiguity with which saturation can be achieved as one of the limitations of this study. The specialised nature of Islamic finance could be further justification for the selection for the fourteen interviews.

These interviews would be conducted with three types of individuals within the field of Islamic banking and finance – 1) Academic 2) Academic Practitioner 3) Practitioner.

An 'Academic' would be an individual with expertise and significant publications in the field of Islamic finance. The 'Academic-Practitioner' would be an individual with some involvement in the academic field of Islamic finance. The 'Practitioner' distinction would be given to an individual who has expertise in the practical field of Islamic Banking and Finance.

The designation of these three groups is as follows:

i) **Academic**: significant involvement in the academic field of Islamic banking and finance

ii) **Academic-Practitioner**: significant involvement in the academic and practical field of Islamic banking and finance

iii) **Practitioner**: professional involvement in the field of Islamic banking and finance

Based on these three designations potential interview candidates were identified through numerous mediums. These included authors of journal publications, lists of professional selected as conference experts, detailed searchers of academic expertise through university profiles and detailed searches of quality knowledge capacity within Islamic financial institutions. Of this group of potential interview candidates the research will aim for a sample of thirteen interviews based upon the justifications found in Guest *et al.* (2006) for saturation points. These interviews lasted a maximum of 60 minutes were carried out either via phone or in person. Transcriptions of each interview are available in Appendix 1(Carr and Worth, 2001).

The administration of each interview is as follows. Potential interviewees were contacted via email with information on the research scope. Assurances were made to ensure that participants understood that all information provided would be held in the strictest of confidence and were for the sole purpose of this research only. Moreover, participants were afforded the option to opt out of the research at any point and all information provided would be destroyed (interview access documents can be found in Appendix 2). Once interviewees had agreed to a date and time, interviews were conducted over the telephone and recorded for analysis. At the beginning of each interview, the researcher introduced himself and the interviewees were once again briefed on the themes being covered as well as the safe guards on anonymity and information provided. The research also once again explained the reasons for the study and the reasons why the respondents had been selected. Once recorded, the interviews were transcribed and the transcriptions would be analysed using NVivo. The interview transcripts will be coded into nodes, which were then analysed for triangulation across all three groups of interviewees.

In order to combat potential errors during the interview process, several measures were taken prior and during the interview process. Prior to actual interviews, several pilot interviews were carried out to ensure that questions did not lead interviewees and to ascertain that interview questions covered the stated themes on governance in Islamic finance. Moreover, all interviews were carried out only by the one researcher to reduce the amount interviewer variability (Saunders *et al.*, 2009). Interviews were based around the themes identified by previous discourse as pertinent, further adding to the validity, consistency and generalizability of the research study.

5.5.3.2. Interview Analysis Methodology

As stated before the interviews will be analysed using NVivo and step were taken to ensure that the results generated from the analysis is valid. These steps involved running and initial pilot interview to assess the viability of the questions being asked. Based on the results of these pilot interviews the question were refined and reworded to confirm that they did not lead the interview groups on their views of governance in Islamic finance. Moreover, all interviews were transcribed professionally and reviewed by both members of the supervisory team. Completed transcriptions were sent out to the relevant parties and crosschecked to ensure that accurate transcripts were produced. Any discrepancies or difference of views highlighted by interview candidates were incorporated into the transcripts.

Aside from diagnostic processes to ensure the validity and reliability of the data collected, the actual analysis subscribes to the procedures seen in seminal works such as that of Miles and Huberman (1994) and Lillis (1999). Fundamentally, empirical qualitative research highlights the benefits of adopting a 'quote-research' method to analysing the interviews. Under this method of analysis, quotes from the interview transcription are taken as illustrative or confirming examples (Folkestad, 2008). Moreover, whilst a 'quote-research' method might provide a technique of analysis, it does bear several arguments as to its overall robustness as a singular approach to analysing interviews. In order to bolster the use of this 'quote-research' method, this study will implement, as well, a process based method of analysis that incorporates transcribed quotes. Following Lillis (1999) these process can be defined as:

i) Data Reduction – development of underlying qualitative themes pertaining to governance and regulatory standards in Islamic finance. This fundamentally involved establishing the central themes of the underlying interviews as well as classifying these themes into nodes. The systemic classification of interview themes into nodes allows for a more robust and certain qualitative analysis (Miles and Huberman, 1994; Erlandson *et al.*, 1993)

ii) Data display – seeking meaning amongst collected interviews. Once interviews were transcribed, themes across each interview were classed into their respective nodes that were set out in the 'Data Reduction' process above.

iii) Conclusion – comparing, contrasting and triangulation of collected interviews and initial underlying themes and linking this to overall aims of the study. The coding of interview themes into nodes will allow the researcher to provide an informed perspective of interview candidates. Moreover, these nodes will be used to synthesize the views of interviewees with that of the empirical literature using a 'quote-research' analysis method. The conclusions will also indicate where saturation has occurred over the interview candidates.

In order to aid the robustness of the study, this research has also evolved the tests for saturation developed in Francis *et al.* (2010) Francis *et al.* (2010) suggested a starting sample of ten interview candidates with a stopping criterion of three as a test for data saturation. Fundamentally, this test called for a review of data saturation of qualitative research at intervals of three interview candidates. For this study the research has essentially adopted the stopping criteria of three but has implemented this without a starting sample size. Essentially, the analysis will highlight commonalities in themes after three, six, nine and all interviews. The implementation of the Francis *et al.* (2010) test will provide a better picture of the saturated themes across the interview candidates and groups.

Furthermore, the overall aim of this aspect of the research would be to fuse the perspectives of financial participants of Islamic Banking and Finance with that of the literature with regards to governance and regulation. Essentially the research looks towards a saturation of views of the underlying themes for confirmation. This involves decomposing interviews and empirical literature and using an understanding of both to represent a view of the actualities of governance and regulatory standards in Islamic finance.

5.5.4. Methodology Map

Figure 21 below highlights the overall methodology map of the research project. Whilst the underlying research philosophy for this study lies with pragmatism, the methodology map illustrates the actual use of both quantitative and qualitative research methods within each of the empirical research chapters. The diagram aims to provide the reader with a better perspective at how the pragmatist philosophy ties into the overall research.

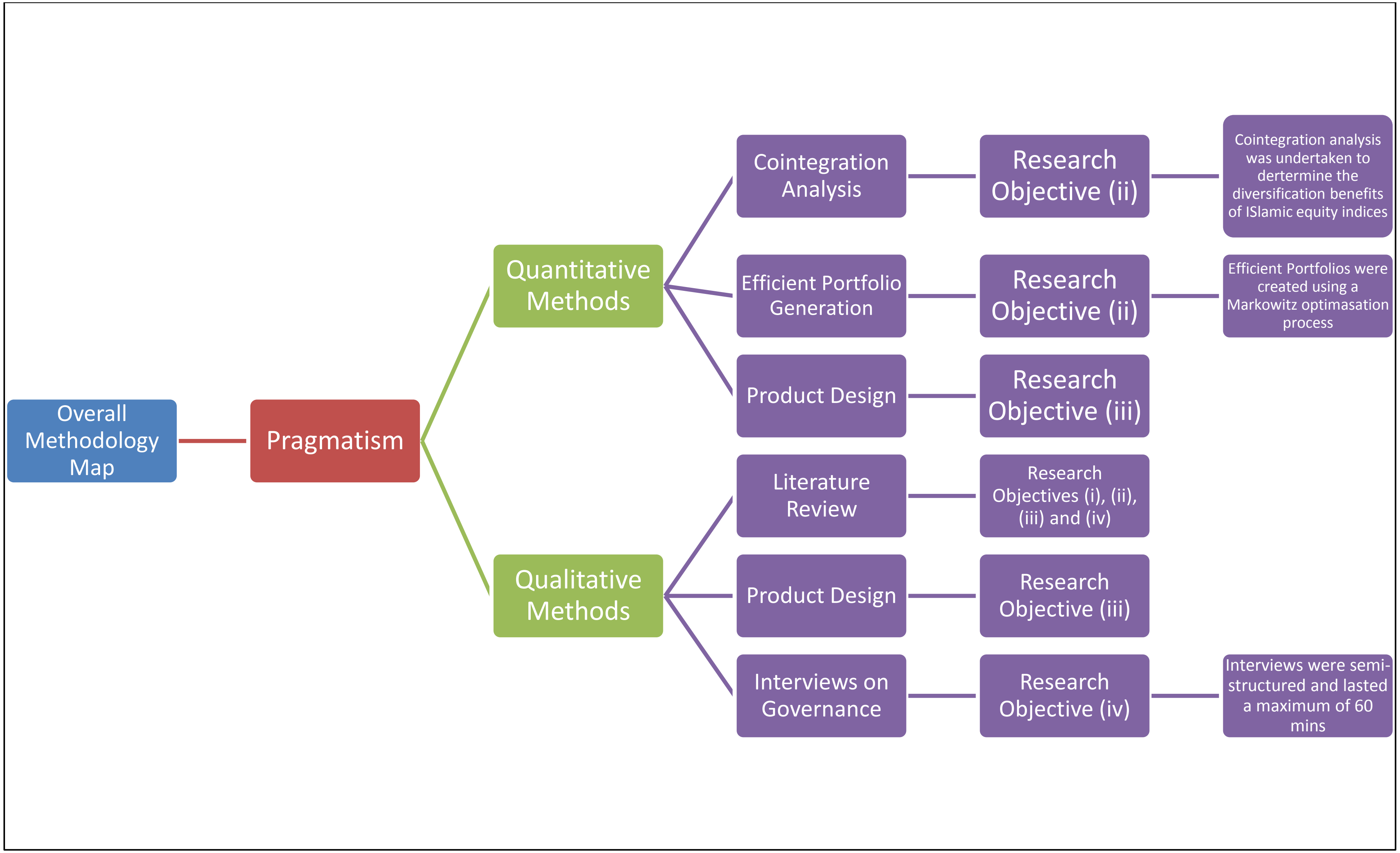

Figure 28: Thesis Methodology Map

5.6. Summative Remarks

This chapter of the research project has set out the methodological foundations of this study. It initially indicates the philosophical direct of this study where, for the purposes of this research and with regards to the research questions and objectives, a pragmatist philosophy has been adapted. With Islamic finance being a comparatively new area in both academic and practical finance, the ability to draw inference from not only quantitative modes of analysis but also qualitative methodologies would provide greater and more robust insight into the questions that are being asked in this research. The chapter has further elaborated on the research approach, design and strategy.

Following on from the pragmatist philosophy, which advocates pluralism and mixed methods, the hypo-deductive approach best suits this philosophy with the use of both inductive and deductive modes of thinking to arrive at a conclusion for the study. Additionally, the research design is fundamentally exploratory as this study aims to explore several pertinent issues in Islamic finance – namely performance, risk management and governance – and the development of the overall Islamic finance system in today's modern economy. This study also adopts experiment and survey research strategies. The experiment strategy is illustrated in the creation of the new Shariah-compliant risk management tool and the testing of the performance of Shariah-complaint indexes. The interview strategy is implemented in the analysis of governance in Shariah finance with the use of interviews with both academics and professionals in the field of Islamic finance. The chapter further documents the actual methods of analysis for each of the research objectives. In assessing the performance and diversification benefit of Shariah-compliant equity indexes – Research Objective 2 – the study abides by a quantitative method of analysis. Equity indexes from

American and UK are initially split into predetermined groupings/portfolios and tested for cointegrating vectors to establish if there are any diversification opportunities. Portfolios that exhibited no cointegrating vectors were then optimized under a Markowitz (1959) framework to determine if the inclusion of a Shariah-compliant equity index within a conventional portfolio resulted in the outperformance of a conventional equity benchmark.

In creating a new Shariah-compliant risk management instrument – Research Objective 3 – this facet of the research was very much pen to paper. The study established a broad understanding of fundamental Shariah-compliant rules. The divergent nature of Shariah-compliant standards meant that in order to avoid confusion, the study abided by a general, common set of Islamic principles across the Shariah-compliant hubs. This circumvented prescribing to a single set of Shariah-compliant rules but rather provided for a structure that would be more generalizable in terms of Shariah-compliance.

The study wanted to discover the views of market participants on the issues of regulation and governance within Islamic finance. It was decided that this would be best achieve through semi-structured interviews with the aim of attaining a saturation of participant precepts. With the specialized nature of Islamic finance, it was believed that the best method of sampling would be judgment sampling with a sampling frame of thirteen interviewees providing the saturation point. All interviews were analysed using NVivo and views were classed into predetermined nodes. These nodes were recognized as pertinent issues discussed in the existing literature on Islamic banking and finance. The following chapter will document the findings from the empirical research.

6. Findings

6.1. Introduction to Chapter

This chapter provides an overview of the findings from this research study. It is sectioned as follows. Section 6.2. highlights the findings from the literature review. Section 6.3. features the results of the examination of the performance of Shariah-compliant funds and Section 6.4. provides some interesting insights in the creation of the new risk management structure. This section is further broken down into subsections which highlight the payoffs of the hybrid structure to each of the parties involved. Section 6.5. emphasises the major findings on the analysis of the issues of governance in Islamic finance and breaks down the pertinent nodes. Section 6.6. and 6.7. will provide a summary of all the findings and concluding remarks which sets the scene for the discussions that will be found in Chapter 7.

6.2. Thematic Findings from Previous Discourse

The review of literature presented in this research study will provide the reader with an overview of the development of Islamic finance in the modern economy. The literature begins with an introduction to the development of the Islamic financial system throughout medieval periods and its evolution into what is now known as modern Islamic finance. The thematic findings from the prevailing literature essentially achieve Objective one of this study.

What can be seen in the literature review is that functional aspects of current thinking in Islamic finance were, in fact, during medieval periods, widely accepted as the core values of modern finance – for instance the building of financial relationships based on trust and respect (Udovitch, 1970). There was wide spread acceptance of financial practices such as credit based notices in medieval Islamic finance, which is not presented in modern Islamic finance (Giotein, 1961; Giotein and Shemesh, 1967). These credit based notices were very similar to modern day's bills of exchange or bills of landing.

However, the literature (see Udovitch, 1970) does indicate that the bifurcation in the evolution of medieval Islamic finance with that of Western finance was down to the reality that medieval Islamic finance possessed an ingrained desire for close, personal trading relationships. The importance of these close trading relationships meant that the development of international trade for medieval Islamic finance was severely hampered when compared to the development of international trade of Western–styled finance, which was supported by a network of financial providence institutions or medieval banks established during that period. These banks enabled the growth of formal, impersonal credit lines, which did not require the formation of close knit trading societies but rather resulted in the proliferation of detached but trusted credit facilities. Whilst Islamic finance was steeped deeply in trade based on personal relationships, Western finance was developing a network of trade based upon financial relationships, which forms the foundation of today's modern economic system.

The resurgence for Islamic finance took place after the Second World War when for the first time large regions of the Islamic nation (re-) gained political independence and were able to govern themselves (Schaik, 2001). There were obstacles and reluctance of acceptance of Western financial concepts in those newly independent Islamic regions and there was a desire to return to more traditional Islamic values. Effectively, this want to return to something familiar is seen as the birth of modern Islamic finance or the Islamic finance that is accepted in today's economy (Khan, 2010b).

Modern Islamic finance has grown substantially since the 1940s and this growth is not limited to Islamic nations such as Pakistan, Malaysia and the Gulf countries. There is strong infrastructure for growth in Western and Far Eastern economies such as the United Kingdom and Hong Kong (Schaik, 2001; Siddiqui, 2008). Steps have been taken to try and integrate Islamic financial precepts into the underlying regulatory and legal conventions of mainstream finance (Bassens *et al.*, 2010). Moreover, there is indicative evidence suggesting that many legal systems are flexible enough to accommodate Islamic financial precepts (DeLorenzo and McMillen, 2007). A good example of this flexibility in accommodating Islamic financial principles can be seen from the evolution of UK tax laws in 2003, 2005 and 2006 to make it possible to provide Islamic mortgages (Khan and Bhatti, 2008a). This development and acceptance of Islamic finance in what is widely seen as more traditional mainstream economies has greatly aided in the overall image of modern Islamic finance.

Modern Islamic finance is based around three central tenets – the prohibition of *riba* and the prevention of *maysir* and *gharar*. Moreover, all financial transactions have to be halal – this excluded dealings that included pork, tobacco, alcohol, munitions, insurance products and banking services (Iqbal and Mirakhor, 2006). Financial contracts during the formative years of modern Islamic finance mainly suggest a PLS modus of wealth distribution however, the development and acceptance of the *murabaha* contract over the 1980s changed the landscape of Islamic financing (Ashour, 1999). The problems associated to PLS distribution – principal-agent issues – led to the widespread acceptance of debt financing provided by *murabaha* contracts (Naqvi, 1982; Khan 1984). Additionally, the benefit, ease and familiarity of debt financing exacerbated the acceptance and popularity of *murabaha* contracts, which till today remain one of the major forms of Islamic financing (Vogel and Hayes, 1998; Presley and Sessions, 1994).

Whilst, the growth and development of the murabaha as one of the most widely used Islamic financing concepts has been beneficial to the Islamic financial system, it brought with it several issues. Firstly, the use of debt financing, while accepted, has always been seen as inferior to PLS which, many in the Islamic financial world see as more in line with Shariah principles (Kayed and Hassan, 2011). Supporters of a PLS modes of financing (Kayed and Hassan, 2011; Chapra, 2008) have indicated that this would result in a more efficient and equitable distribution of wealth and income and the building of more robust financial relationships. In light of the recent financial crisis and the impact of excessive debt financing on many financial institutions and sovereigns, there has been a throwback to the initial studies of modern Islamic finance and the arguments for PLS integration within Islamic financial contracts such as those presented in Naqvi (1982) and Khan (1984) have seen a resurgence.

The providence of commercial and investment banking services make up the bulk of the major financial activities of modern Islamic financial instruments. This is due in part to another recent development of modern Islamic finance, the use of Shariah-windows where mainstream financial contracts and assets are assessed using several levels of Shariah-screens (Obaidullah, 2009). Assets and contracts that pass these screens are deemed Shariah-compliant and can be actively traded by Islamic financial institutions. These Shariah-windows have been used to create Shariah-compliant indexes out of mainstream companies and some prominent examples include the Dow Jones Islamic Index and the FTSE Bursa 100 Index (Khatkhatay and Nisar, 2007). These Shariah-windows have also resulted in the growth of financial innovation within Islamic finance and there has been great impetus in the development of Islamic financial instruments in the field of liquidity transfer and risk management (Jobst, 2007). Alongside, traditional Islamic financial contracts such as *musharakah*, *murdarabah* and *murabaha*, innovative steps have been taken to enable risk managers to actively manage modern financial risk. This has led to the creation of financial instruments such as parallel *murabaha*, Islamic swaps and call options (Dar and Azami, 2010; Yankson, 2011). The notion of financial innovation being further pursued in light of the current financial crisis and as highlighted by Chapra and Khan (2002) Islamic finance possess no formal framework for risk management. In light of these risks, there have been increasing debates about risk management structures and the use of Islamic derivatives and whilst the arguments are still divided (Kamali, 1999; Seif, 2009) there is robust indication that there is a need for further financial innovation within Islamic finance (Hesse et al, 2008).

This is no surprise as product development and risk management have been indicated in the literature as a significant issue in modern Islamic finance (Bacha, 1999; Dar and Presley, 2000). The substantial growth of Islamic finance has meant that risk managers operating under a Shariah framework have had to contend with an ever changing and evolving gamut of financial risks. There have been calls for additional development of financial risk management instruments that would enable Islamic finance to keep pace with mainstream finance (Noman, 2002). However, one of the difficulties with financial innovation under a Shariah framework as suggested in the literature was down to the interpretation of Shariah-financial rules, the perceived need for the development of these instruments and the use of Shariah-windows.

These use of these Shariah-windows have resulted in several criticisms mainly stemming from the subjective nature of ‘what is?’ and ‘what isn’t?’ Shariah-compliant (Bacha, 1999). Another issue raised with relation to Shariah-compliance was the nature and composition of the individuals that passed these judgements on Shariah-compliance (El-Gamal, 2006). The issue of Shariah-compliance was highlighted as one of the major issues in the governance of the Islamic financial system exacerbated only by the lack of uniformity across the global Islamic financial spectrum (Chapra and Ahmed, 2002; Chapra and Khan, 2000). The analysis of Shariah-compliant standards has indicated differing standards of governance and regulation in different Islamic financial hubs such as those in the West, the Gulf and the Far East (Rehman and Masood, 2013; El-Hawary *et al.*, 2007). Predominately, this lack of uniformity results from the varying interpretation of Islam from the various schools of Islamic thought and there have been calls from both an academic and practical perspective for a clarification of Islamic financial edict (Wilson, 2000; Solé, 2007; Cihak and Hesse, 2008) and the creation of fundamental standardization of Shariah-compliant standards. It was indicated that this lack of uniformity could have an effect on the stability and as such impact the overall confidence of the Islamic financial system (Jobst *et al.*, 2008; DeLorenzo and McMillen, 2007)

The findings from the literature essentially serve well to inform the empirical analyses conducted in this study. In the following sections, the empirical findings from the analysis of performance and diversification of Islamic financial equity indexes, Islamic financial innovation and governance and regulatory challenges will be presented. At every juncture, attempts will be made to link both the empirical results to that of existing literature.

6.3. Performance and Diversification of Islamic Equity Indexes

Objective two of this research study looks to examine the performance and diversification benefits of incorporating a Shariah-compliant equity index within an optimised portfolio. Indexes were selected from both the Dow Jones and FTSE over the period of 1st January 2001 until the 29th of June 2007. The unit of analysis is daily data and the results will be benchmarked against a naïve buy and hold strategy of the FTSE100 over the same period.

The list of indexes selected is given below:

List of Indexes (1st January 2001 up until 29th June 2007):

Shariah-Compliant

1) FTSE Global Islamic Index (FTSEIS)
2) Dow Jones Islamic Index (DJIMI)

Mainstream Index

3) FTSE 100 (FTSE)
4) Dow Jones Industrial (DJ)

Sustainability Indexes

5) FTSE 4 Good Sustainability Index (FTSE4G)
6) Dow Jones Sustainability Index (DJSI)

The logged returns were calculated for each of these indexes and the results of initial summary tests are presented in the table below:

	LDJ	LDJSI	LDJIMI	LFTSEIS	LFTSE100	LFTSE4G
Mean	0.0001280	-0.0000276	0.0001080	-0.0000385	-0.0000108	0.0000271
Maximum	0.0615470	0.0755930	0.0446420	0.047959	0.0690270	0.0543960
Minimum	-0.0739620	-0.0681770	-0.0399640	-0.044224	-0.0631350	-0.0562520
Std. Dev.	0.0101530	0.0145700	0.0090530	0.009930	0.0118860	0.0105930
Skewness	-0.0026200	-0.0293440	-0.0395240	0.030314	-0.1111860	-0.2393400
Kurtosis	7.9995250	6.6035510	5.4105920	5.154067	6.7257820	7.2573490
Jarque-Bera	1765.291	917.350	410.840	327.7665	983.870	1296.262
Probability	0.000	0.000	0.000	0.000	0.000	0.000
Observations	1695	1695	1695	1695	1695	1695

Table 17: Summary Statistics

The sample period for all six indexes was from the 1st of January 2000 until 29th June 2007 using daily data as the unit of analysis, which yielded 1695 data points. An examination of the New York indexes (LDJ, LDJSI and LDJIMI) indicates that only the Dow Jones sustainability indexes (LDJSI) exhibited an average net loss over the period. On the other hand the analysis of the London indexes denote both the FTSE Islamic Index (LFTSEIS) and FTSE 100 (LFTSE100) as having negative average returns over the sample period. Whilst kurtosis is high in all indexes this is offset with volatility (standard deviation) being consistent and low across the board with all six indexes.

Indexes were then organised into the following groups given below:

Group 1 :- LDJ, LDJSI, LDJIMI, LFTSEIS, LFTSE, LFTSE4G
Group 2 :- LDJ, LDJSI, LDJIMI
Group 3 :- LFTSEIS, LFTSE, LFTSE4G
Group 4 :- LDJSI, LDJIMI, LFTSEIS, LFTSE4G

The grouping characteristics are defined as:

v) Group 1: All selected indexes

vi) Group 2: All selected Dow Jones Indexes

vii) Group 3: All selected FTSE Indexes

viii) Group 4: All selected ethical and Shariah-compliant Indexes

Diagnostic testing is required on the indexes prior to running the Johansen procedure for cointegration. This involved testing all indexes for stationarity. Note cointegration can only be done on series, which are integrated to the order of 1 or I (1) series. The Augmented Dickey-Fuller (ADF) test was used to ascertain the order of stationarity of the series and is based upon the following hypothesis:

$\mathbf{H_0}$: $\delta = 0$ (time series in non-stationary)

$\mathbf{H_1}$: $\delta < 0$ (time series is stationary)

The results are given in the table below:

Variables	**I(0) (p-values)**		**I(1) (p-values)**	
	No Trend	**Trend**	**No Trend**	**Trend**
LDJ	0.7283	0.3231	0.0000	0.0000
LDJSI	0.5076	0.6265	0.0000	0.0000
LDJIMI	0.8994	0.3584	0.0000	0.0000
LFTSEIS	0.4690	0.6358	0.0000	0.0000
LFTSE	0.6249	0.7312	0.0001	0.0000
LFTSE4G	0.6544	0.5295	0.0001	0.0000

Table 18: Results of Unit Root Tests at 5% Confidence Interval

What can be seen from the results is a rejection of the null hypothesis at I (0) indicating the presence of a unit root in level. The test was run again at I (1) and the results show an acceptance of the null hypothesis signifying that all series were stationary to the order of 1 or I (1) series. Being that all series were stationary at I (1) they were progressed to the next stage of the procedure.

This stage involved the creation of Vector Auto Regressions in order to determine the lag length structure for the cointegration analysis. The indexes were split into 4 different portfolio groupings 1) All indexes 2) New York Indexes only 3) London Indexes only 4) Islamic and Ethical Indexes only. The Schwarz Information Criterion (SC) was used to determine lag lengths for each group and the results were as follows – three lags for Group 1 and two lags for the subsequent groups. For the cointegration analysis the Johansen methodology was adopted and under this methodology the Trace test for cointegration was preferred over the Max-eigenvalue test on the basis that empirical literature indicates that the Trace yields superior results based on normality (Cheung and Lai, 1993). The hypotheses for the Trace Test are as follows:

1st Test Hypotheses Set: Number of cointegrating vectors is equal to 0

$$\mathbf{H_0}: r = 0$$

$$\mathbf{H_1}: r \geq 1$$

2nd Test Hypotheses Set: Number of cointegrating vectors is more than 1

$$\mathbf{H_0}: r \leq 1$$

$$\mathbf{H_1}: r = 2$$

The results of the Trace Tests are shown in Table 19.

Vectors	Group 1 All indexes			Group 2 Dow Jones indexes only			Group 3 FTSE indexes only			Group 4 Ethical and Shariah-compliant indexes only		
	Trace Test (r)	**Critical Value 5%**	**P-value**	**Trace Test (r)**	**Critical Value 5%**	**P-value**	**Trace Test (r)**	**Critical Value 5%**	**P-value**	**Trace Test (r)**	**Critical Value 5%**	**P-value**
0	119.7579	95.7537	0.0004	43.7997	42.9153	0.0407	28.8736	29.7971	0.0636	53.0457	47.8561	0.0150
1	79.8772	69.8189	0.0063	23.9240	25.8721	0.0857	12.7785	15.4947	0.1232	23.4401	29.7971	0.2251
2	47.8379	47.8561	0.0502	9.1961	12.5180	0.1686	2.7646	3.8415	0.0964	8.0885	15.4947	0.4560
3	26.1426	29.7971	0.1245	-	-	-	-	-	-	0.8286	3.8415	0.3627
4	11.7864	15.4947	0.1675	-	-	-	-	-	-	-	-	-
5	3.3227	3.8415	0.0683	-	-	-	-	-	-	-	-	-

Table 19: Trace Test Statistics

Looking at the P-values Groups 1, 2 and 4 exhibited significance at a 95% confidence interval and a rejection of both null hypotheses for the Trace test thus indicating the existence of cointegrating vectors. With regards to the scope of this thesis the existence of cointegrating vectors indicates a long-term stochastic relationship thus nullifying the diversification benefits derived from forming an efficient portfolio of the indexes included in these groups.

Group 3 was the only group, which did not indicate any significance at a 95% confidence interval suggesting an acceptance of the Trace null hypotheses, concluding that there were no cointegrating vectors and the possibility for diversification from forming a portfolio of these three indexes. Group 3 essentially comprised of the three London Indexes – FTSE 100, FTSE 4 Good and FTSE Global Islamic Index.

Using these three series, the study further tests this diversification benefit by creating an optimised portfolio in order to analyse the risk-adjusted returns against a naïve buy and hold of the FTSE100. Considering that the study is looking at Islamic finance from a conventional financial perspective, it was deemed reasonable to expect a 50% investment in the conventional equity index. For a more robust analysis the study incorporates this into the optimisation procedure and two separate portfolios were created – one with free weighting for each of the indexes and the other constrained with 50% invested in the conventional equity index, which in this case is the FTSE100. Additional constraints included no short selling which is more in line with Shariah financial principles. The specification of the naïve buy and hold of the FTSE100 included a purchase at the start of the sample period (1st Jan 2001) and sell at the end of the sample period (29th Jan 2007).

The optimisation process used the Markowitz (1959) framework and optimisation periods included 2 year, 1 year, 6 months and 3 months. Optimisations were conducted using Excel's solver function for minimum variance. The results presented below are the calculated annualised risk- adjusted returns for each of the optimisation periods.

The results of the optimisation are presented below in Table 20:

Period	Statistics	Jensen	Treynor	Sharpe
2 Year Optimisation				
Constrained portfolio	**Average**	-0.0106	-0.0285	0.0443
Unconstrained portfolio		-0.0016	-0.0194	0.0601
1 Year Optimisation	**Average**			
Constrained portfolio		-0.0080	-0.0460	-0.0423
Unconstrained portfolio		-0.0014	-0.0408	0.0169
6 Mth Optimisation	**Average**			
Constrained portfolio		-0.0260	-0.0906	-0.0051
Unconstrained portfolio		-0.0138	-0.1060	-0.0122
3 Mth Optimisation	**Average**			
Constrained portfolio		-0.0167	-0.0952	0.0349
Unconstrained portfolio		-0.0547	-0.1344	-0.0536
BENCHMARK	**Average**			
Naive buy and hold		0	-0.027	-0.145

Table 20: Optimisation Results (Annualised Returns)

The analysis will take on two forms. Firstly the study will look at comparing the optimisations over the various periods. It can be seen from Table 20 that risk adjusted performance appears to improve as the optimisation period becomes longer, although the deliberate omission of transaction costs should put these results in the right perspective. Whilst it is difficult to ascertain the true value of the transaction cost, as this would be tied into the volume and value of trade we can draw inference for this conclusion from the amount of rebalancing required across the optimisation periods. For the two-year optimisation window, the portfolio would have to be rebalanced 3 times whilst for a three-month optimisation window the portfolio would have to be rebalanced which could invariably lead to higher transaction costs. Relatively speaking, the constrained portfolio performs better than the unconstrained portfolio over shorter optimisation periods. A possible explanation for this could be extracted from the findings of Hussein (2007) who suggested that Islamic equity indexes underperform their conventional counterparts during market bull phases. The sample period for this study explicitly ignored the financial crisis and observed a period of relatively strong global financial performance. The use of the mandatory conventional index investment constraint could have resulted in the capture of the excess performance over the period. In the former, each portfolio must contain at least 50% of FTSE, in the unconstrained portfolio the weights are freely chosen by the optimisation algorithm. The weights (apart from the FTSE100 in the constrained portfolio) are continuously re-assessed within the optimisation window.

The theoretical arguments towards rebalancing of portfolios over these time horizons stems from the notion that should an investor not rebalance a portfolio it will invariably drift from its efficient frontier (Tokat and Wicas, 2007). Moreover, should transaction costs, taxation and temporal effects be taken into accounted, there are further variables that should be added to the rebalancing argument (Donohue and Yip, 2003). Looking at the risk-adjusted returns for portfolio, there is clear indication of better portfolio performance over a longer-term optimization horizon, however, it is difficult to ascertain if the principal cause of this is the exclusion of short selling or the constraint of 50% investment in the conventional index. One possible explanation for longer rebalancing horizons could be found in Hau and Rey (2008) who have suggested that portfolio manager rebalance in light of combating volatility movements. The sample period was taken specifically to exclude the distortionary effects of the financial crisis and moreover also include a period of relative stable growth in the equity market spectra. This could go towards suggesting a longer term rebalancing horizon, as there is not a need to manage the inherent fluctuations. This facet of the research is not a central objective of the study but would definitely warrant further and future research.

The second element of the analysis looks at comparing the performance of the optimised portfolio against a naïve buy and hold strategy of the mainstream (FTSE100) index. In this regard we consider the performance ratios.

The Jensen, Treynor and Sharpe ratios for the benchmark, naïve buy and hold strategy for the FTSE100 are 0, -0.027 and -0.145 respectively. Considering the results in totality, the picture is mixed at best. Based upon Jensen's alpha we see a consistent underperformance of the portfolios against the conventional, FTSE100 index, the same can be said for the Treynor index. What is interesting, however, are the results for the Sharpe ratio. Being seen as the most robust measure of the three as it accounts for both systematic and unsystematic risk, it is indicative of better performance of the portfolios over the conventional mainstream index. Based upon the empirical results for the Sharpe ratio we can suggest that the inclusion of a Shariah-compliant equity index yields not only diversification benefits but also results in the out performance of a conventional equity index.

These findings of mixed performance echo that of previous studies conducted by M'Zali and Turcotte (1998), Abdullah *et al.* (2007), Elfakhani *et al.* (2007) and Girard and

Hassan (2008 and 2011). However, what can be surmised form the results of this aspect of the empirical research would be that there are arguments for the inclusion of Islamic equity indexes within conventional portfolio. Compared the existing research, which mainly focus upon comparing the performance of Islamic against conventional equity indexes, the results from this study suggest that within a conventional portfolio there are diversification and performance improvements from incorporating a Shariah-compliant equity index.

This empirical objective of the study looked towards discovering if diversification opportunities existed should a Shariah-compliant equity index be included within a portfolio of assets. These opportunities were defined by the lack of existence of cointegration among the indexes in a portfolio. It was found that by grouping a base index such as the FTSE100 along with a sustainability and Islamic index, diversification was possible.

The results are mixed, but based upon the Sharpe ratio there is an illustration of a significant improvement in performance over that of just buying and holding the base index. Moreover, seeing that risk-reduction was the basis of the optimisation models used in this study, great emphasis was placed upon the weights attached to the FTSE Islamic fund, more often than not, when it came to achieving minimum variance.

However, the researcher accepts the limitations of this exercise in determining diversification and performance. Optimisation periods could have been shortened to envelope a greater degree of information and greater emphasis would have been placed on realistic costs and problems involved with investing in Shariah funds. The inclusion of transaction costs would be a variable for inclusion in further studies as well as the problems associated achieving exposure to these funds. For further confirmation a larger scope of equity indexes could be taken into account with more varied groupings. Seeing that the inclusion of an Islamic index within a conventional portfolio can result in not only diversification but also a performance benefit this clearly indicates its status as a viable alternative for both Islamic and conventional market participants. These diversification and performance benefits, it can be argued, form a significant share of the arguments for the growing acceptance of Islamic finance as an alternative to conventional finance. This continual acceptance and growth has resulted in calls for the proliferation of risk management instruments which leads on to the next empirical facet of this study which involves the creation of a Shariah-compliant risk management tool.

6.4. Creation of New Shariah-compliant Risk Management Tool

6.4.1. The Structure of the Hybrid Product

A significant objective of this study is the creation of a Shariah-compliant risk management tool. This facet of the research complements both the findings from the literature review and the initial empirical work looking at the performance and diversification benefit of the inclusion of a Shariah-compliant equity index with a portfolio of conventional indexes.

This section details the findings from the processes involved with the creation of a risk management tool that adheres to Shariah-compliant standards. It is demonstrated as well, via the payoff streams that the structure could perform sufficiently well in the practical world. The main specifications of the instrument would involve not only trying to achieve a sufficient hedge but also trying to incorporate an emphasis on risk sharing as opposed to risk transfer. This focus on risk sharing as opposed to risk transfer stems from the strong arguments presented in the literature for PLS and its support within the Islamic financial world (Kayed and Hassan, 2011). PLS and Islamic finance advocates financial responsibility throughout financial transactions and it is believed that the choice to include an element of risk-sharing would further bolster these arguments for accountability. With the priority placed upon risk-sharing as opposed to risk transfer, the basis of the model will stem from the *musharakah* or partnership agreements.

A basic *musharakah* is essentially a partnership contract where both parties actively engage in the investment and management aspects of the business venture. Profits and losses in this context are shared based on contributions to the business venture in the form of expertise, management and capital injection. These contributions need to be equal from each contracting party and the profits (and losses) will be divided accordingly. Like most Islamic financial contracts, the profit (or loss) sharing ratio will be decided initially within a master agreement to avoid problems of *gharar*. The structure of the *musharakah* is given below.

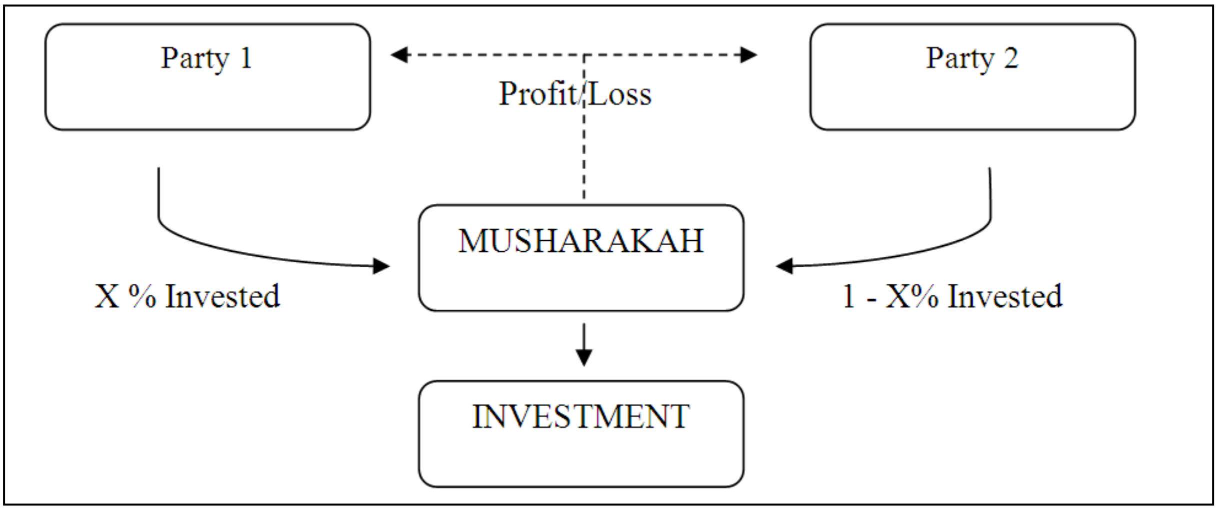

Figure 29: *Musharakah* Structure (Iqbal and Mirakhor, 2007)

Both Party 1 and 2 agree to enter into a *musharakah* contract. The agreement to this *musharakah* will set out the proportion of investment that each party decides to include. The ratio of investment by each party will also determine the profit/loss that is shared amongst the two parties.

Under this agreement, two parties form a partnership, under which profits and losses are shared out in a specified ratio. In its standard form it is not entirely a risk management tool and does not provide institutions with a hedging instrument but rather a way to share risk. Could this principle be applied within the spectrum of a partnership option where the call option writer shares the risk with the call option buyer? One possible model is illustrated below.

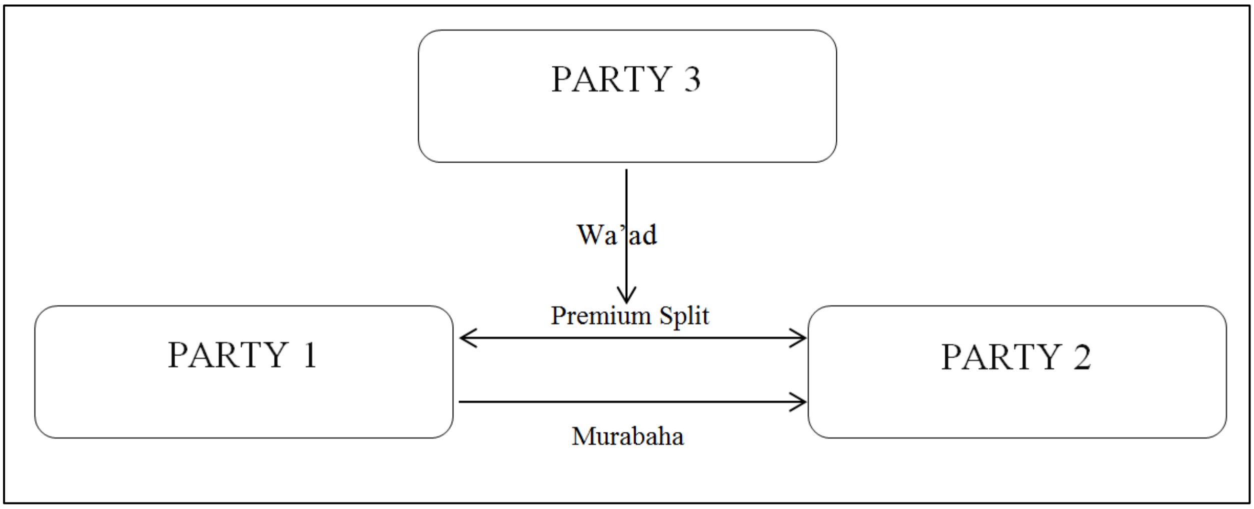

Figure 30: Hybrid structure combining *wa'ad* and *murabaha* contracts

The designation of the parties in the structure above is as follows:

- Party 1: Bank – organizer of the structure
- Party 2: Customer – requires protection and seeks coverage from bank
- Party 3: *Wa'ad* seller – facilitates the option element in the structure

Summary of symbols:

- α^0: Party 1's share of amount of commodity to be purchased
- α^1: Party 2's share of amount of commodity to be purchased
- β^1: Premium for *wa'ad* (in some instances it could also be a down payment)
- X^1: cost plus mark-up price of *murabaha* (lets set it equal to $S_0 + \beta^1$)
- Q^1: exercise price of *wa'ad* (clearly above S_0, but could include/ not include β^1 if this is a down payment)
- S_0: spot price at time T_0
- S_1: spot price at time T_1

Party 2 is afraid of a rise in prices and wishes to protect itself. Within this hybrid contract, Party 2 contacts Party 1 (the bank, that may believe that price is going to fall) to organise a structure for protection against a rise in prices. Under the stipulations of this contract, both Party 1 and Party 2 enter into an agreement to share the costs and benefits of a *wa'ad* that is purchased from Party 3. The cost of the *wa'ad* (β^1) is split between Party 1 and Party 2 based on a predetermined ratio (α^0: α^1) with exercise price (Q^1). This ratio will also determine the spilt for the amount of tangible goods should the *wa'ad* be exercised. The nature of this split ratio will play a pivotal part towards the entire contract as it determines the proportion of each party's payoff streams.

At the same time, a *murabaha* is set up between Party 1 and Party 2 whereby it is agreed that at the expiry of the *wa'ad* option, Party 1 will sell its proportion of the commodity at cost plus some mark-up, which we set, without loss of generalisation as equal to $X^1 = S_0 + \beta^1$, the same as the premium of the *wa'ad*. Apart from simplifying the algebra, both the mark-up and the premium will be known (and set) at the same time T_0 and will enable the direct comparison of the hybrid product, with a straight *murabaha* and a straight *wa'ad*. This will be regardless of whether the *wa'ad* is exercised. Moreover, to adhere to the principles of Islamic finance the bank will purchase its share (α^0) of the commodity at time T_0 at price S_0 and retain ownership of it until T_1.

Should the *wa'ad* not be exercised, Party 1 will then pass its share of the commodity onto Party 2 for the agreed price inclusive of a mark-up (S_0 + β^1), whereas if the *wa'ad* is exercised, then Party 1 (the bank) will purchase its share (α^0) of the commodity from

Party 3, but sell it at S_1 onto the market, while passing the commodity already in its possession onto Party 2.

6.4.2. Payoffs for each of the parties

The following paragraphs will illustrate the model in two different scenarios. It should be noted that this structure is for a call option and as such Party 2 is afraid of a rise in prices.

Scenario 1: There is an increase in the spot prices for a commodity. Party 2 is going to exercise the *wa'ad*.

Payoffs at time T_0:

- Party 1 pays premium to Party 3 = α^0 x β^1
- Party 2 pays premium to Party 3 = α^1 x β^1
- Party 1 (the bank) purchases α^0 of the commodity at S_0

Payoffs at time T_1:

- *wa'ad* is exercised
- Party 1 takes delivery of commodity and pays Party 3 = α^0 x Q^1
- Party 1 sells its portion of the commodity onto Party 2 at cost plus some mark-up = α^0 x X^1 or α^0 x (S_0 + β^1)
- Party 1 sells its portion of the commodity at the spot price S_1
- Party 2 takes delivery of commodity and pays Party 3 = α^1 x Q^1

Scenario 2: There is a decrease in the spot prices for commodity. Party 2 is not going to exercise the *wa'ad*.

Payoffs at time T_0:

- Party 1 pays premium to Party 3 = $\alpha^0 \times \beta^1$
- Party 1 (the bank) purchases α^0 of the commodity at S_0
- Party 2 pays premium to Party 3 = $\alpha^1 \times \beta^1$

Payoffs at time T_1:

- *wa'ad* is not exercised
- Party 1 sells its proportion of commodity to Party 2 at cost plus some mark-up = $\alpha^0 \times X^1$ or $\alpha^0 \times (S_0 + \beta^1)$
- Party 2 purchases commodity from spot market = $\alpha^1 \times S_1$
- Party 3 sells commodity on the spot market at S_1Q^1

Tables 21 and 22 below provide a better illustration of the payoffs for each party in each scenario.

*Note: Negative signs denote expenditure and a positive sign denotes revenue.

Party 1 (Partner Bank)	Party 2 (Customer)	Party 3 (*Wa'ad* seller)
T_0: pay premium to Party 3 $-\alpha^0\beta^1$ Purchase a^0 of commodity $-\alpha^0S_0$	T_0: pay premium to Party 3 $-\alpha^1\beta^1$	T_0: receive premia from Party 1 and Party 2 $+\alpha^0\beta^1 + \alpha^1\beta^1$
T_1: $-\alpha^0Q^1 + \alpha^0(S_0 + \beta^1) + \alpha^0S_1$	T_1: $-\alpha^1Q^1 - \alpha^0(S_0 + \beta^1)$	T_1: $+\alpha^0Q^1 + \alpha^1Q^1$
NET: $+\alpha^0(S_1 - Q^1)$	NET: $-\alpha^1Q^1 - (\alpha^0 + \alpha^1)\beta^1 - \alpha^0S_0$	NET: $(\alpha^0 + \alpha^1)\beta^1 + (\alpha^0 + \alpha^1)Q^1$

Table 21: Scenario 1- Rise in prices and *wa'ad* is exercised

Party 1 (Partner Bank)	Party 2 (Customer)	Party 3 (*Wa'ad* seller)
T_0: pay premium to Part 3 $-\alpha^0\beta^1$ Purchase a0 of commodity $-\alpha^0 S_0$	T_0: pay premium to Part 3 $-\alpha^1\beta^1$	T_0: receive premia from Party 1 and party 2 $+\alpha^0\beta^1 + \alpha^1\beta^1$
T_1: $+\alpha^0(S_0 + \beta^1)$	T_1: $-\alpha^1 S_1 - \alpha^0(S_0 + \beta^1)$	T_1: $+\alpha^0 S_1 + \alpha^1 S_1$
NET: 0	NET: $-\alpha^1 S_1 - (\alpha^0 + \alpha^1)\,\beta^1 - \alpha^0 S^0$	NET: $(\alpha^0 + \alpha^1)\,\beta^1 + (\alpha^0 + \alpha^1)\,S_1$

Table 22: Scenario 2 - Fall in prices and *wa'ad* is NOT exercised

Tables 21 and Table 22 report the outcomes of the strategy in both cases when the *wa'ad* is exercised and when it is not. Table 23 presents the payoffs of the *wa'ad* seller.

	(*wa'ad* exercised)	(*wa'ad* NOT exercised))
T_0	T_0: receive premium from Party 1 and Party 2 $(\alpha^0 + \alpha^1)\,\beta^1$ Purchase $(\alpha^0 + \alpha^1)$ of commodity $-(\alpha^0 + \alpha^1)\,S_0$	T_0: receive premium from Party 1 and Party 2 $(\alpha^0 + \alpha^1)\,\beta^1$ Purchase $(\alpha^0 + \alpha^1)$ of commodity $-(\alpha^0 + \alpha^1)\,S_0$
T_1	T_1: honour promise to sell commodity at Party 1 and Party 2 at agreed price Q^1 $+(\alpha^0 + \alpha^1)\,Q^1$	T_1: sell commodity at spot price S_1 $+(\alpha^0 + \alpha^1)\,S_1$
NET:	NET: $+(\alpha^0 + \alpha^1)\,\beta^1 + (\alpha^0 + \alpha^1)\,Q^1 - (\alpha^0 + \alpha^1)\,S_0$	NET: $+(\alpha^0 + \alpha^1)(S_1 - S_0) + (\alpha 0 + \alpha^1)\,\beta^1$

Table 23: Perspective from seller of a *wa'ad* (Party 3)

Party 3 (the seller of the *wa'ad*) will gain: $+ (\alpha^0 + \alpha^1)\,\beta^1 + (\alpha^0 + \alpha^1)\,Q^1 - (\alpha^0 + \alpha^1)\,S_0$ if the *wa'ad* is exercised as $(Q^1 + \beta^1) > S_0$.

However, if the price falls $+ (\alpha^0 + \alpha^1)\,(S_1 - S_0) + (\alpha^0 + \alpha^1)\,\beta^1$ the outcome depends on the size of the fall or in other words whether $(S_1 – S_0) > \beta_1$.

The benefits of this structure for Party 3 will depend greatly on price at which they are able to purchase the commodity and sell on to Party 1 and Party 2. Moreover, there is no clear indication that ownership is required prior to entering into a *wa'ad* contract.

However, more interesting comments may be drawn by comparing the case when the combined strategy (*wa'ad* plus *murabaha* with sharing) is compared with a straight *wa'ad* and no sharing.

Table 24 illustrates the outcomes of the straight *wa'ad*.

Straight *wa'ad* (*wa'ad* exercised)	**Straight *wa'ad* (*wa'ad* NOT exercised)**	**Combined product (*wa'ad* exercised)**	**Combined product (*wa'ad* NOT exercised)**
T_0: pay premium to Party 3 $-(\alpha^0 + \alpha^1)\ \beta^1$	T_0: pay premium to Party 3 $-(\alpha^0 + \alpha^1)\ \beta^1$	T_0: pay premium to Party 3 $-\alpha^1\beta^1$	T_0: pay premium to Party 3 $-\alpha^1\beta^1$
T_1: EXERCISED $-(\alpha^0 + \alpha^1)Q^1$	T_1: NOT EXERCISED $-(\alpha^0 + \alpha^1)\ S_1$	T_1: $-\alpha^1 Q^1 - \alpha^0(S_0 + b^1)$	T_1: $-\alpha^1 S_1 - \alpha^0(S_0 + \beta^1)$
NET: $-(\alpha^0 + \alpha^1)\ \beta^1 - (\alpha^0 + \alpha^1)\ Q^1$	NET: $-(\alpha^0 + \alpha^1)\ \beta^1 - (\alpha^0 + \alpha^1)\ S_1$	NET: $-\alpha^1 Q^1 - (\alpha^0 + \alpha^1)\ \beta^1 - \alpha^0 S_0$	NET: $-\alpha^1 S_1 - (\alpha^0 + \alpha^1)\ \beta^1 - \alpha^0 S_0$

Table 24: Comparison with straight *wa'ad* (no sharing, no *murabaha*) from the point of view of Party 2 (customer)

It is possible to see from Table 24 above that in the case that the *wa'ad* is exercised Party 2 (customer) is better off in the combined product because the net outcome (expenditure) of the combined product when the *wa'ad* is exercised is:

$-\alpha^1Q^1 - (\alpha^0 + \alpha^1)\ \beta^1 - \alpha^0S_0$, which surely is less than $- (\alpha^0 + \alpha^1)\ \beta^1 - (\alpha^0 + \alpha^1)\ Q^1$ as S_0 is less than Q^1.

However, Party 2 (customer) is NOT better off with the combined product because the net outcome when the *wa'ad* is NOT exercised is:

$-\alpha^1S_1 - (\alpha^0 + \alpha^1)\ \beta^1 - \alpha^0S_0$ that surely is less than $- (\alpha^0 + \alpha^1)\ \beta^1 - (\alpha^0+\alpha^1)\ S_1$ as S_1 is less than S_0.

Although we ignore the inter-temporal analysis, it should be noted that Party 2 is paying less at T_0 in terms of the premium (i.e. $-\alpha^1b^1$ instead of $- (\alpha^0 + \alpha^1)\ \beta^1$ of the straight *wa'ad*)

Straight *murabaha*	**Combined product (*wa'ad* exercised)**	**Combined product (*wa'ad* NOT exercised)**
T_0: Agree purchase for mark-up: $(S_0 + \beta^1)$ at T_1 No Purchase of commodity: at T_0	T_0: Pay premium to Party 3: $-\alpha^1\beta^1$	T_0: Pay premium to Party 3: $-\alpha^1\beta^1$
T_1: $-(\alpha^0 + \alpha^1)(S_0 + \beta^1)$	T_1: $-\alpha^1Q^1 - \alpha^0(S_0 + \beta^1)$	T_1: $-\alpha^1S_1 - \alpha^0(S_0 + \beta^1)$
NET: $-(\alpha^0 + \alpha^1)(S_0 + \beta^1)$	NET: $-\alpha^1Q^1 - (\alpha^0 + \alpha^1)\ \beta^1 -\alpha^0S_0$	NET: $-\alpha^1S_1 - (\alpha^0 + \alpha^1)\ \beta^1 -\alpha_0S_0$

Table 25: Comparison with straight *murabaha* from the point of view of Party 2 (customer)

The comparison with a straight *murabaha*, in Table 25 above, shows that the customer is worse off when the price increases and the *wa'ad* is exercised because Q^1 is larger than S_0:

$-\alpha^1 Q^1 - (\alpha^0 + \alpha^1)\ \beta^1 - \alpha^0 S_0 > -\ (\alpha^0 + \alpha^1)\ (S_0 + \beta^1)$ or after some simplification $-\alpha^1 Q^1 > -a^1 S_0$.

The comparison with a straight *murabaha* shows that the customer is better off when the price decreases and the *wa'ad* is NOT exercised:

$-\ (\alpha^0 + \alpha^1)\ (S_0 + \beta^1) > -\alpha^1 S_1 - (\alpha^0 + \alpha^1)\ \beta^1 - \alpha^0 S_0$ or after some simplification $-\alpha^1 S_0 > -\alpha^1 S_1$

As shown in Table 26, from the point of view of the bank, the comparison with a straight *murabaha* reveals a complex pattern. The bank secures a guaranteed mark-up $(a^0 + a^1)\ \beta^1$ in the case of the *murabaha*. The outcome of the combined product as already explained depends on the size of the movement of the price of the commodity at time T_1 (S_1) and the agreed exercise price for the *wa'ad* which is $+(\alpha^0 + \alpha^1)\ \beta_1 > +\ \alpha^0(S_1 - Q^1)$

The bank, however, has a zero outcome when the price decreases and the *wa'ad* is NOT exercised:

$$+\ (\alpha^0 + \alpha^1)\ \beta^1 > 0$$

The bank therefore incurs a loss only when the price increases and in the case that Q^1 is higher than S_1, but certainly will incur the opportunity cost of not receiving the mark-up even when the price decreases and the *wa'ad* is not exercised.

Straight *murabaha*	Combined product (*wa'ad* exercised)	Combined product (*wa'ad* NOT exercised))
T_0: Agree sale for mark-up $(S_0 + \beta^1)$ Purchase commodity at: $-(\alpha^0 + \alpha^1) S_0$	T_0: Pay premium to Party 3: $-\alpha^0\beta^1$ Purchase a0 of commodity: $-\alpha^0 S_0$	T_0: Pay premium to Party 3: $-\alpha^0\beta^1$ Purchase a0 of commodity: $-\alpha^0 S_0$
T_1: $+(\alpha^0 + \alpha^1)(S_0 + \beta^1)$	T_1: $-\alpha^0 Q^1 + \alpha^0(S_0 + \beta^1) + \alpha^0 S_1$	T_1: $+\alpha^0 (S_0 + \beta^1)$
NET: $+(\alpha^0 + \alpha^1) \beta^1$	NET: $+\alpha^0 (S_1 - Q^1)$	NET: 0

Table 26: Comparison with no sharing (straight *murabaha*) from the point of view of Party 1 (bank)

6.4.3. Summative notes on the structure

1) At every juncture of the innovation process attempts have been made to ensure that the product is Shariah-compliant. Based upon a broad set of Shariah-compliant screening rules the product abides by:

    a. Commodity in question is halal

    b. There are clear lines of ownership

    c. Transaction contains no riba

    d. Wa'ad premia to bank is justified on the basis of organisation of contract and risk bearing.

2) As highlighted above, the problems with compliancy to Shariah and the way in which the product is structured, as well as, the end hedge may lead to arguments about either its form or substance. Whilst is it felt that the use of risk-sharing is more in line with Shariah principles there are grounds on which to argue that the purchase of commodities does not amount to a plausible investment. The use of a *musharakah* and *wa'ad* in this manner may make it non-Shariah-complaint if it is deemed that there is no active management of the investment sum to justify the partnership in the first place.

3) Secondly, admittedly it is a complicated method to structure an option. The want for risk-sharing has meant that one additional party had to be included into the contact in what would otherwise be achieved with a straightforward *wa'ad*.
4) The inclusion of Party 3, which accounts for the *wa'ad* element of the structure, creates additional uncertainty. Islamic finance requires proof of ownership of commodities before any sale can take place. Where possible, the structure has taken into account ownership of commodities before sale but the *wa'ad* element creates subjectivity as to whether ownership is required before the agreement of the *wa'ad* contract.
5) Underlying Shariah-compliance can only be achieved through Shariah-supervisory board. This would be scope for further research to ascertain if the product structure is in fact Shariah-compliant.

This section has provided arguments for a possible Shariah-compliant risk management tool by applying the principle of *musharakah* (shared investment) to a combination of a *wa'ad* and *murabaha* contract.

The combination of a *wa'ad* and a *murabaha* contract to create a hybrid risk-sharing approach to financial risk management has yielded mixed results when compared to straightforward *wa'ad* and *murabaha* contracts.

When compared to the *wa'ad* alone, the hybrid contract was more beneficial to the parties when it was in the money but less when out of the money. Vice versa, when the hybrid was compared to a singular *murabaha*, it was less beneficial on the upside but was cheaper when the contract was out of the money.

For Party 2 (the customer) an initial benefit would be the lower *wa'ad* premium on the basis that is this shared with Party 1 (the bank). Moreover, Party 2 also benefits when the hybrid *wa'ad* is exercised but loses out when the hybrid *wa'ad* is not exercised. This is down to additional cost of the parallel *murabaha* that is set up between Party 1 and Party 2.

The benefit to Party 1 (the bank) is more complicated and will depend on several factors. Should the hybrid *wa'ad* be exercised the return for the bank will depend heavily on the spot price at expiry and the exercise price of the *wa'ad*. Furthermore, when the hybrid *wa'ad* is not exercised the bank receives nothing although the opportunity cost of entering the contract has to be considered.

All in all, considering the hybrid risk management instrument in its entirety, the inclusion of a risk-sharing within the instrument structure has indicated that it is beneficial to the customer when the hybrid *wa'ad* is exercised. However, the inclusion of risk-sharing has meant that the contract is "more expensive" should the hybrid *wa'ad* not be exercised. This exercise in the incorporation of risk-sharing into a risk management tool has shown, tentatively, that there are benefits to be derived from moving away from traditional risk-transference.

This study set out to explore the scope of incorporating risk-sharing within risk management option-like tools under a Shariah financial framework and whilst the results do not provide a definitive argument of the advantages, they do illustrate the benefits of risk-sharing methodologies within financial instruments such as that of premiums and down payments.

As stated before every effort was taken to ensure that the hybrid instrument adhered to Shariah-compliant rules and regulation. However, during the innovation process what was discovered was that whilst there existed underlying religious requirements, there was not clear standardized framework as to what constituted Shariah-compliance for a particular region. As shown Chapter 4, Section 4.3., Tables 10, 11 and 12 there are clear divisions in Shariah-compliance framework within both Islamic and non-Islamic financial centres. The realization of the issues of standardization highlighted in the literature lead on to the next aspect of the research which further examines these issues of Shariah governance and regulation.

6.5. Issues of Governance and Regulation

Interviews were professionally transcribed and to ensure consistency and reliability were reviewed alongside by the supervisory team to ensure accurate contextualisation of issues and concerns. Transcripts were sent back to the respective parties to ensure that their views were captured in the transcription process. Any discrepancies were incorporated into the transcripts for accuracy.

Transcripts were then imported into NVivo Version 12 for analysis. A number of key thematic areas or nodes that emanated from current discourse on the major issues of governance and regulation in Islamic finance were utilised in the analysis of interview data. These are detailed below:

- **Alternative**: Islamic finance as an alternative to conventional finance
- **Development of new instruments**: the importance for the further development of new instruments in Islamic finance
- **Future**: the future prospects and challenges for Islamic finance
- **Lender of last resort**: the need for a lender of last resort in Islamic finance
- **Shariah supervisory board**: issues pertaining to the role and composition of Shariah supervisory boards
- **Transparency**: issues of transparency in Islamic finance
- **Uniformity**: the standardization of Islamic financial governance and regulation
- **Interest-free**: the perception that finance is purely interest-free
- **The perception of Islamic finance**: how Islamic finance is viewed by operators in conventional finance
- **Diversity of instruments**: are there enough financial instruments in the Islamic financial system currently
- **Risk**: the risks faced by Islamic financial institutions
- **Shariah-compliance**: issues pertaining to Shariah-compliance
- **Financial crisis**: how has Islamic finance dealt with the financial crisis

The aim of this aspect of the research was to examine if there was a synthesis of issues of governance and regulation presented in the literature and with that of experiences individuals who have an interest in the Islamic financial system.

Only nodes that were triangulated and highlighted by the three interview groups were utilized and examined in deeper detail. The concept of triangulation revolves around having each of the nodes being confirmed by all three of the interviewee groups.

Fundamentally, once a node has been confirmed the uncertainty behinds its interpretation greatly reduces thus increasing both the reliability and validity of findings (Webb et al, 1966; Tashakkori and Teddlie, 2003). In addition to this, a number of key nodes achieved triangulation and consensus i.e. a unanimous acceptance by all interview groups and interviewees of a particular issue (see Table 27 below). This has not only enhanced robustness by triangulation but also further contributed to generalizability and reliability and in doing so achieved strong levels of saturation. The notion of data saturation within the context of this study is best defined by Glaser and Strauss (1967) as,

> "… the point at which no additional data are being found whereby the (researcher) can develop properties of this category. As he sees similar instances over and over again, the researcher becomes empirically confident that a category is saturated…" (Glaser and Strauss, 1967, pg. 65)

Applying Francis *et al.*'s (2010) framework for saturation the research interviews undertook a range of iterations to achieve robustness in findings. Francis *et al.* (2010) advocated a starting sample of ten interviews with an additional three interview stopping point, this research utilizes the three stopping point with an initial sample of three interviewees.

Issues of Governance	Saturation by Consensus over three candidates	Saturation by Consensus over six candidates	Saturation by Consensus over nine candidates	Saturation by Consensus over all candidates
Islamic Finance as an Alternative				
The Development of New Instruments	•	•	•	•
The Future of Islamic Finance	•	•	•	•
Interest-free Transactions				
The Perception of Islamic Finance	•	•	•	•
The Diversity of Financial Instruments				
Lender of Last Resort	•	•	•	•
Risk	•	•	•	•
Shariah Supervisory Boards	•	•	•	•
Shariah-compliance				
Transparency	•	•	•	•
Uniformity	•	•	•	•
Financial Crises		•		

Table 27: Data Saturation by Consensus (Framework Adapted from Francis *et al.* (2010)

The initial sample of three consisted of a candidate from each of the three interviewee groups – academic, academic-practitioner and practitioner. This was the subsequent pattern for the ensuing addition of candidates into the saturation sample – one interview from each of the three interviewee groups. This was to ensure a consistency of views building on enabling a holistic and reflective group to voice their opinions.

Initial analysis with three interview candidates revealed a consensus across eight of the thirteen nodes. Expanding the interview analysis to three additional candidates revealed the node 'Financial Crises' to be of importance. To build upon this and to verify saturation against the Francis *et al.* (2010) framework, eight further interviews were conducted. This led to data collection from a total of fourteen interviewees. Of note is at nine interviewees, saturation by consensus seemed to move away from results at six. Nonetheless, all fourteen interviewees seem to concur with the results highlighted at three interviewees. Thus, aside from the additional node during the six candidate analysis, what can be seen from the table below is that there is saturation of eight nodal themes. To a certain extent it can be argued that saturation was achieved by the third interview candidate which is in line with the arguments presented in Mason (2010) and Guest *et al.* (2003) that larger samples need not necessarily guarantee saturation and that saturation could very well be similarly achieved through smaller samples. Based upon the results from the saturation test framework, the research will now examine these eight, saturated nodes to a greater detail.

Table 28 below indicates the ranking of nodes based upon the number of references split by the three interview groups. What can been seen from the table is that 'Transparency', 'The Perception of Islamic Finance', 'Risk', Uniformity' and 'The Development of New Instruments' are seen as the major five issues, collectively, for all three interview groups.

Issues of Governance	Academic-Practitioner	Practitioner	Academic	Total
Transparency	23	46	26	95
The Perception of Islamic Finance	30	28	21	79
Risk	19	35	24	78
Uniformity	13	24	35	72
Development of New Instruments	24	16	23	63
Shariah Supervisory Board	18	16	15	49
Future of Islamic Finance	9	15	16	40
Lender of Last Resort	11	15	9	35

Table 28: Node Ranking Based Upon Number of References

An illustration of this is given in the following diagrams below and provides a better view of the individual interviewee group node rankings based upon the number of references given to a particular node.

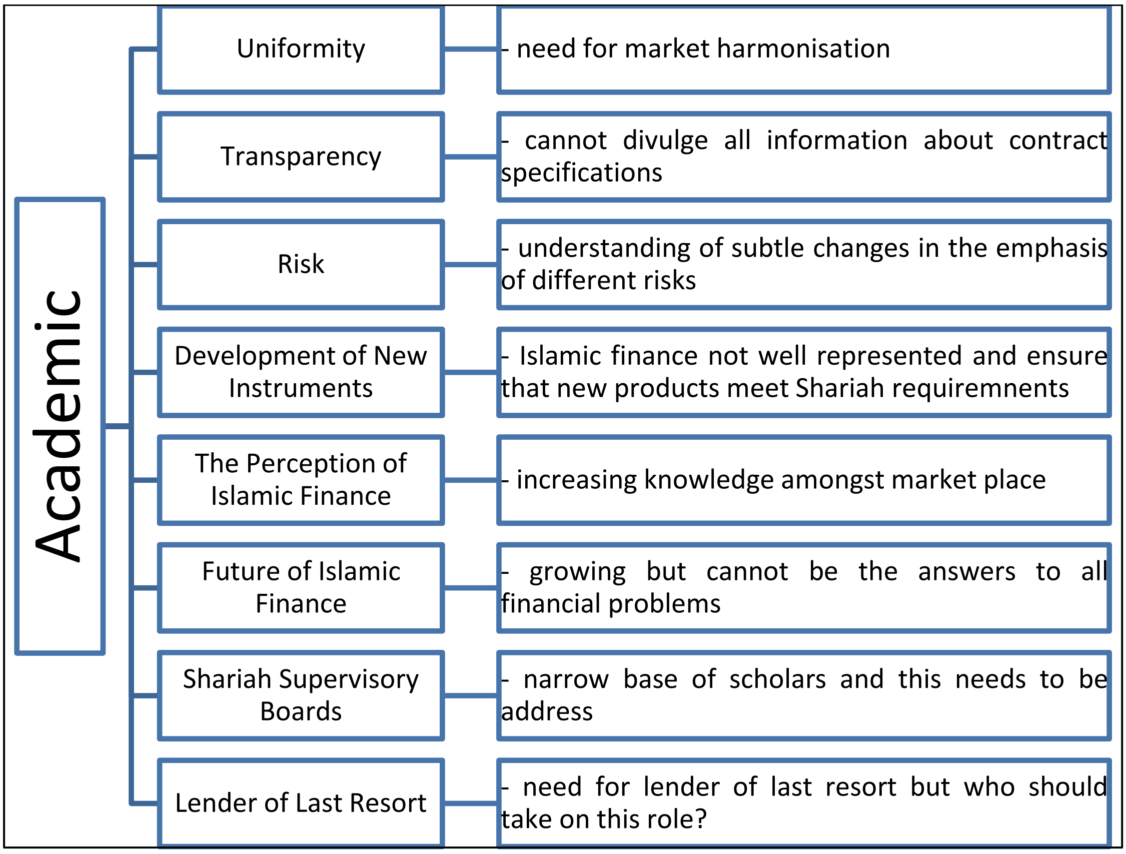

Figure 31: Individual Ranking of Academic Nodes

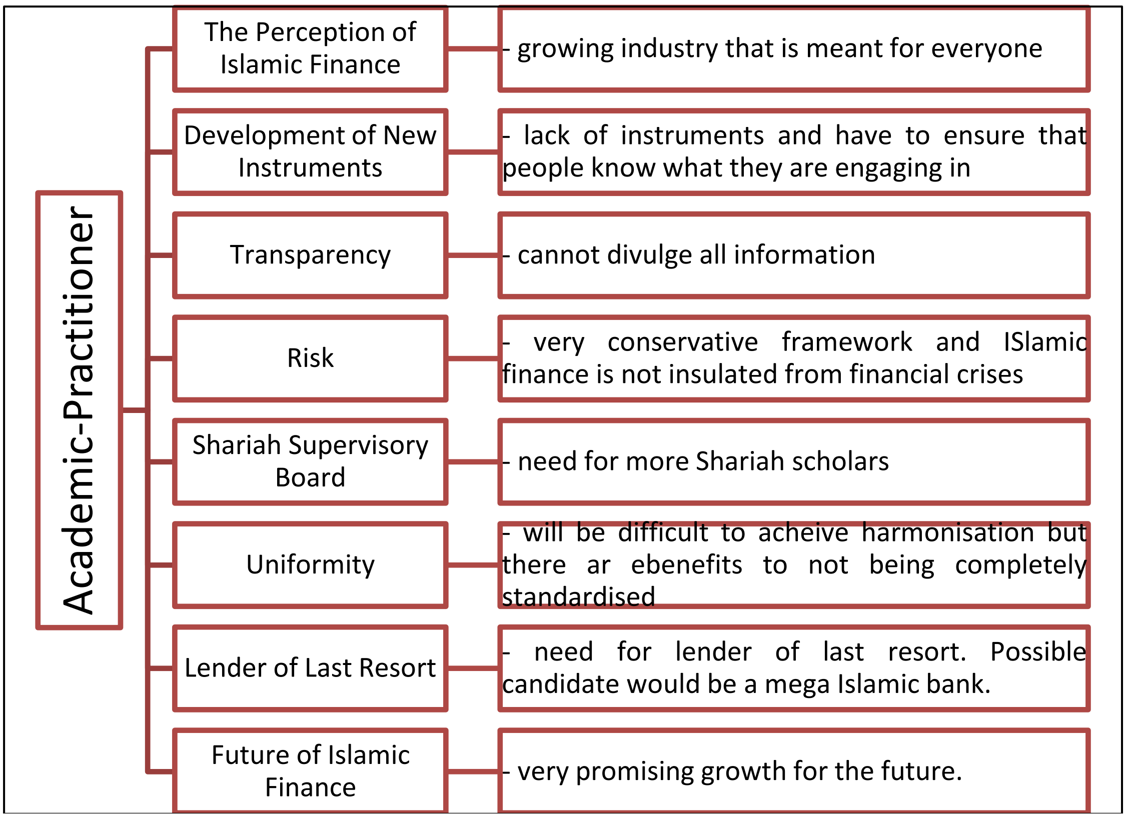

Figure 32: Individual Ranking of Academic-Practitioner Nodes

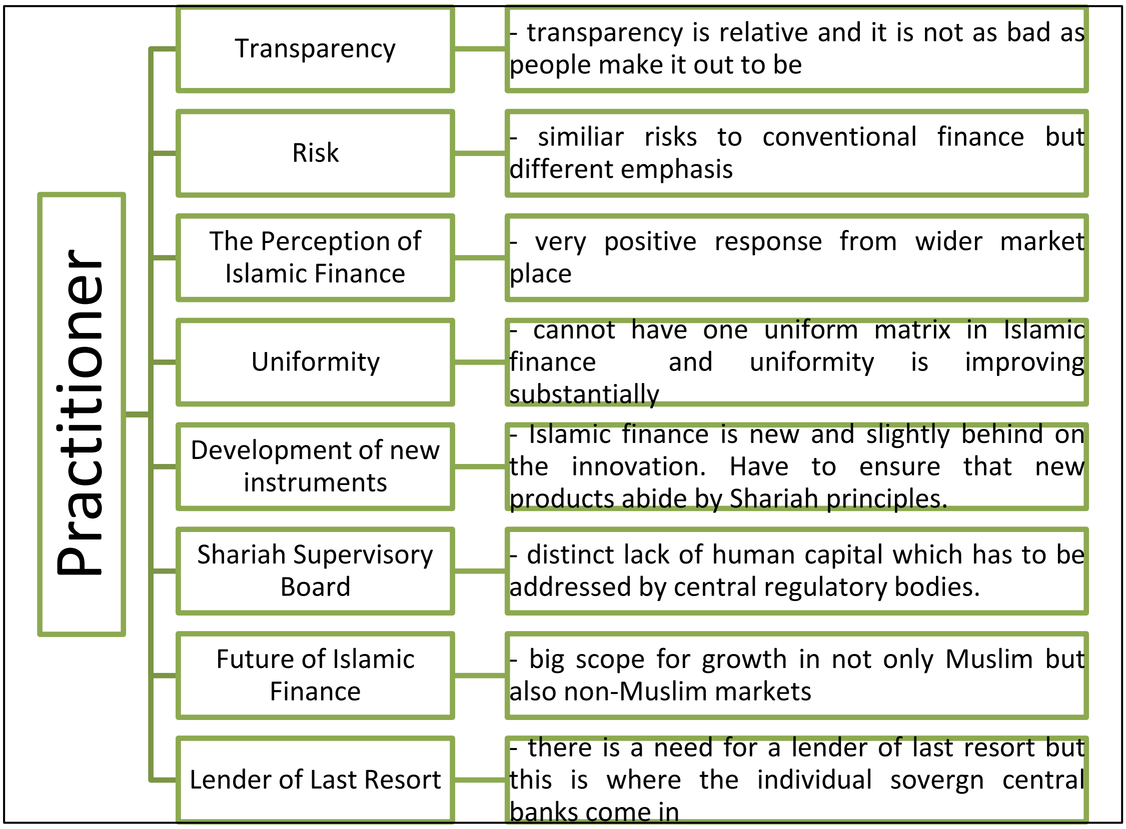

Figure 33: Individual Ranking of Practitioner Nodes

6.5.1. Perception of Islamic Finance

What can be seen from the analysis is that there is increasing acceptance of Islamic finance within the conventional spectrum and this can be seen from the development of new Islamic banking avenues within Western financial hubs such as the United Kingdom. Moreover, the significant growth of academic literature since the 1980s pertaining to all aspects of Islamic finance from *takaful* (Islamic insurance) to *hisba* (Islamic book keeping) and financial innovation further illustrates this growing acceptance of the Islamic financial system.

> "The former Labour government were very interested in the social inclusion of Muslims so the idea that people weren't getting mortgages because it offended their religious faith they saw as a problem. They also saw a very clear economic agenda with it which is about positioning…"
>
> – **Academic**

> "… some people view it as sort of a niche industry, targeting Muslim communities in the world. However, in practice, or even in theory, Islamic finance is targeting all the types of consumers, Muslims and non-Muslims. Some people view the industry as a sort of bringing foreign direct investments to each society or each country or the host countries. Some others view Islamic finance as a way of offering new banking services to certain segment of people, new products maybe generation of new jobs and contribution to the economy, so it has been viewed from many angles and many perspectives and I think it serves all these perspectives but it's not considered as a niche industry for Muslims, it's

an industry for everyone."

– Academic-Practitioner

"In general they [the financial markets] view it positively, in particular I think in 2008 and the financial advisors, people in general they started, you know, looking at Islamic finance as maybe an ethical and different approach to finance. There was a huge interest from the media regarding Islamic finance and how Islamic finance was different from the conventional and how it works and this is evident basically here in the UK."

– Practitioner

While Islamic finance is growing rapidly, there is still a consensus between the groups on the distinct lack of knowledge in the wider financial industry. The overwhelming sentiment that comes across from all three groups of interviewees would be one that suggests that there could be more knowledge across the conventional financial industry about Islamic finance.

"…I think there is increasing knowledge about Islamic finance by people in the financial system. Obviously, it depends on their seniority and the kind of bank that they are in basically but certainly in investment banking circles there is a fair amount of interest and knowledge of Islamic finance, certainly in London as we have a significant Islamic financial sector in London…"

– Academic

> "…there is still a fairly high degree of ignorance about what's involved. The thing that most people fasten on is of course this kind of obvious thing – the lack of *riba*, the lack of an interest rate denominated return…"
>
> **– Academic-Practitioner**

> "…I think that there is a mix of views. Some people see it, especially in the Western world, they see it as a real alternative to conventional financing, the conventional financial system and this view, I think, is becoming stronger with the waves of financial crises that we are receiving over the last 2-3 years. There is another group that has a view that it is something old-fashioned, it may not be adequate for the 21st century and they associate it to some terrorist activities or political agendas more than anything else. They do not consider it as a serious alternative; they see it as more of a threat to the Western culture and society. I must say that the latter of the two groups is much, much smaller in number. The general view is that it is actually something that is considerable as an alternative and it requires more research in how and why it behaves…"
>
> **– Practitioner**

This concern about the lack knowledge is highlighted in numerous studies, most notably, Maurer (2002) and Pollard and Samers (2007), who highlight the anthropological notions of Islamic banking and finance. Principal behind these views is that transparency stems from a lack of knowledge of the Islamic financial system thus creating a false veil of opaqueness.

6.5.2. Risk

Another issue addressed during these interviews was the risks faced by Islamic financial institutions – both present and future risks. The views here are consistent across all groups of interviewees. There were two sub themes to this question: i) the nature of risk borne by Islamic financial institutions ii) the risk faced by the Islamic financial system as a whole.

In terms of the risk faced by Islamic financial institutions there was a large emphasis on Shariah-compliant investment being taken on by these Islamic financial institutions. These arguments for having to manage the types of risk further fuel the need for financial innovation and are in line with works of Dar and Presley (2000) and Chapra and Khan (2000).

> "…because of their different requirements of equity capital, you know, within, I don't know why that is but that seems to be the case, they are less profitable, you know, and they're less efficient which you can explain these because of their different internal religious requirements…"
>
> **– Academic**

> "Well the risk management framework is conservative in Islamic banks. I work with Islamic banks and I work with conventional banks so what I can say that it's more conservative in Islamic banks and I think this is for the sake of protecting investors, not for the sake of being like achieving low revenues, just we try to protect investors and I think the risk management framework does not allow you to go below investment rate in some cases

> and consider the rating factors and fundamental analysis of each and every security or an investment vehicle as a major issue to be dealt with before putting the money somewhere or somehow."
>
> **– Academic-Practitioner**

> "…biggest risk that they are facing is the concentration of their asset class."
>
> – **Practitioner**

With regards to the risk borne by Islamic financial system, the consensus between the three interviewee groups was that market participants have to be careful with the risks being undertaken in Islamic finance. While the fundamental principles of risk management remain the same there could be a different emphasis on the types of risk from conventional financing (Smorlaski *et al.*, 2006).

> "I think in the Islamic finance, as a conventional finance, we should take consideration of the risk but what we call it in Islamic finance is a calculated risk. You have to take consideration of the risk because you still have a risk when you have a partnership (*musharakah*) with your customer, if you open a business and you still have a risk for losing your money… you have to be careful with who you go to give the money…"
>
> **– Academic**

> "…all money is involved with other money which is why, you have in the global economy, the grave danger that risky trades in one sector, for

> example the sub-prime effect, will affect transactions in other quite unrelated or apparently unrelated parts of the economy and many, many, many aspects of Islamic finance are actually exposed to the same market conditions as the global economy generally."
>
> – **Academic-Practitioner**

> "The risks borne by Islamic finance are very similar to conventional finance but obviously there might be a separate importance placed upon different risks. In conventional finance this might be credit risk whilst in Islamic finance the emphasis will be on liquidity or default risk. Moreover, there is also the issue of Shariah-compliance and Islamic financial institutions have to take great care in ensuring that they adhere to Shariah principles."
>
> – **Practitioner**

6.5.3. Development of New Instruments

With consideration for the proliferation of risks, interviewees were asked if they found that there was a need for further development of financial instruments within Islamic finance. This underlying theme was identified as one of the pertinent issues during the product development process whereby much of the literature suggested that the development of Islamic financial risk management instruments was slightly lacking. Both Chapra and Khan (2000) and Dar and Presley (2000) have indicated that the growth of Islamic finance has resulted in a proliferation of risks for Islamic finance thus requiring the need for further development for financial innovation under a Shariah financial framework. All interview groups shared this view for further financial innovation:

> "The scope is still pretty good but the problem is that there are a lot of difficulties in the global economy basically with major restructuring occurring. Islamic finance is not terrible well represented than some of the faster growing markets and that is an issue."
>
> **– Academic**

> "In terms of maybe in a way providing instruments and solutions for money markets shows in certain aspects Islamic banks are disadvantaged because they don't have enough instruments maybe for money markets or short or long term liquidity and strong assets so there are still lots of work to be done."
>
> **– Academic-Practitioner**

> '…there is a lack of innovation maybe because Islamic finance is emerging, still emerging, it's not developed, it's not like the conventional, there is no real system, that is governed by, for example at the global level, not like the conventional…So there is lack of innovation definitely there is. In terms of risk management yes there is also still I think they are way behind on how other banks are managing their risk and liquidity also so yes they are still behind. Because it's newer than the conventional but it will pick up, it will pick up soon. It will have to pick up."
>
> **– Practitioner**

Whilst interviewees across all three groups concurred that there was a need for further development of Islamic financial instruments there was an interesting underlying sub-theme to these responses and that was the notion that Islamic financial innovation cannot just mimic conventional financial instruments.

> "It's through being more transparent and greater linkage between the religious principles by which you stand and the products that you offer so everybody understands that linkage and not selling products or offering products which everybody knows are fictional in terms of the general Islamic principles…"
>
> – **Academic**

> "Sometimes you are getting in such a complex way of creating intermediary organisations to in effect handle all the risk and buy the outcome from you that sometimes it is very hard to see the wood for the trees in those things."
>
> – **Academic-Practitioner**

> "If you are only repackaging the form of the product then fundamentally the problems that arise from the substance will still be the same. Changing the name of something does not make the problems go away. What you will be left with if Islamic finance continues in this direction would be the same problems of conventional finance such as the current financial crisis."
>
> – **Practitioner**

The existing literature on financial innovation such as El-Gamal (2008) has highlighted this aspect with regards to the debates on the permissibility of derivatives within Islamic finance (see Chapra, 2008; Ghayad, 2008; Siddiqi, 2006). It is interesting to see the tie-in to fundamental religion principles and having to balance these principles with the financial needs of the Islamic financial system (Choudhury, 2009). There is an extension of this basic balance of 'religious-financial needs' that is suggested in the work of Asutay (2007a and 2007b). This further brings the arguments for additional development of Islamic financial instruments into both the realms of risk management (Bassens *et al.*, 2010) and the governance of Islamic finance (Safieddine, 2009; Iqbal and Mirakhor, 1999). Moreover, the interview themes could be extended to match that of Kayed and Hassan (2011) and Seif (2009) on derivative type innovation within Islamic finance, essentially focusing on the concern over how Islamic financial instruments merely seem to mimic the payoffs of conventional instruments. Regardless of which there are pertinent calls for further development of Islamic risk management instruments as there is a clear market need and an opportunity cost to non-development (Hesse *et al.*, 2008)

6.5.4. Shariah Supervisory Boards

Much of the arguments pertaining to the development of new instruments also extend to the decision of Shariah Supervisory Boards and the Shariah-compliant decisions that they make. Early criticisms of SSBs arose from arguments presented by El-Gamal (2005), who was highly critical of their composition of Shariah-scholars. He noted, with increasing, frequency that Shariah scholars were sitting on the SSBs of numerous Islamic financial institutions. El-Gamal (2005) suggested that this would call in question the validity of these decisions on the basis of a conflict of interest.

The analysis of the interviews indicates that SSBs were regarded as an issue across all three interviewee groups. There is a consensus that the initial concern presented by El-Gamal (2005) is greatly reduced by the increasing familiarity and knowledge base of the Islamic financial system. The criticisms levied by El-Gamal (2005) on the composition of SSBs are quickly diminishing as the number of Shariah scholars continue to grow and there is more expertise in the Shariah financial system. The views of the candidates seems to suggest that there was a need for an overlap of scholars on different boards as the expertise, in terms of number of scholars, struggled to keep pace with the substantial growth of the Islamic financial system during the early year of the new millennium.

> "…Well obviously most banks want to have the most prestigious scholars so they (Shariah scholars) tend to have a scarcity value and they are head hunted but the industry is open so others can come in so it is not impossible and others are coming in. The net is widening but obviously those on top, who have had a head start, are in a better position…"
>
> – **Academic**

> "… it's more having scholars who are qualified and basically understand the legal, regulatory and the operation system of the financial system or the banking industry itself. It's not any Sharia scholar (who) would have these sorts of qualities or skills. There are, for example, the typical or in a way traditional Sharia scholars. Yes they are knowledgeable, they are qualified about Sharia but maybe they don't have the required skills in order to apply this knowledge on the current financial system or products or maybe they don't understand how it works fully so that in a way (it) will be an

> obstruction for them. That's why maybe those scholars who have this sort of expertise and skill or maybe they have in a way the academic qualifications on both sides; economics, finance and at the same time they have the Sharia qualifications and the experience as well, there would be maybe more preferable or well known in a way in the industry and maybe taking on more responsibilities in terms of being on various Sharia supervisory committees."
>
> – **Academic-Practitioner**

> "…It is a double digit annual growth and it is very difficult and very hard for the industry to manage this growth by providing the resources that will be required including human and financial resources etc. etc. [sic] and this is something that you cannot develop overnight…"
>
> – **Practitioner**

A further discussion point to arise out of these interviews and one that is highly pertinent within the academic literature as well was the creation of a Shariah scholar qualification. There has been increasing amount of new research looking into this facet of Shariah governance that has indicated the benefits of having a standard of qualification which is very similar to that of professional bodies. Ghayad (2008) and a more recent study by Farooq and Farook (2013) illustrate these calls within the academic world for calls for accredited qualification for Shariah-scholars. The Farooq and Farook (2013) study also specifies a framework for establishing this qualification standard. The responses were highly critical of this need for further expertise in the Islamic financial system and saw it as an opportunity to expand the knowledge base of Shariah finance.

"…we were looking at the role out of Islamic finance in the US and UK and one thing that becomes clear very quickly is the reliance on this very, very narrow base of Sharia scholars and you would talk to people about where those scholars come from and what qualifications you have to have and it's very much a taboo subject and it's not about educational qualifications or there aren't any transparent criteria about what you have to do to be a Sharia scholar, it's shrouded in mystery and that's part of the whole sort of cache of getting one of these positions, it's about religious authority, it's not about education per se or experience, so it's famously opaque how certainly this tier of Sharia scholars, where they come from and how they're formed and that's been a huge issue because the industry has grown, there's been a huge growing shortage of these scholars…"

– **Academic**

I've been in meetings where, you have two Shariah scholars sort of screaming at each other that the others ones got it totally wrong. There are two types of Shariah scholar that you would get on your board One will say "look this is the way I read it and I have to tell you that I think this is not right" and that's relatively rare. The number two kind of Shariah scholar is the one who will find a way of getting an apparently Shariah-compliant answer to what it is that the board wants to do anyway and that is why, of course everyone will tell you we can't go around investing in pig meat or alcohol, nothing involving gambling and so on, you're going to find money which comes ultimately from impeccable Islamic sources in all of those sectors. The way the thing works is very often you make sure you do approach someone who

> you think is going to give you the answer you need. I think it is hard to put up a firewall against that kind of stuff."
>
> **– Academic-Practitioner**

> "When Islamic finance first started there was very much a lack of expertise in terms of Shariah scholars. With the growth that Islamic finance has experienced over the past few years, there has been a lot of emphasis on developing a larger expertise base which would mean that you will see new faces on different boards. For me it is not a question of similar members on different boards for the sake of a salary but rather there were just not enough people who possessed the knowledge. The central bodies have been making an effort to try and improve the amount of expertise in the area and it would also be good to have individuals who possess not only an understanding of Islamic finance but conventional finance."
>
> **– Practitioner**

The final view by the practitioner provide an interesting point suggesting that central bodies should take on this responsibility of providing a recognised qualification. Monger and Rawashdeh (2008) have highlighted that steps have been taken by AAOIFI in offering these qualifications. As it stands AAOIFI currently offers two different courses of study 1) Certified Islamic Professional Accountant 2) Certified Sharia Adviser and Auditor which are industry recognised. The issues presented about SSBs also encompass the debates about the transparency and uniformity of the Islamic financial system.

6.5.5. Transparency

The issue of transparency within Islamic finance is widely debate within the academic literature. Both Honohan (2001) and Grais and Pellegrini (2006) provide a salient perspective into the overall transparency of the Islamic financial system calling it highly opaque and to certain extent secretive. What was clear from the interviews was that the level of transparency within Islamic finance as quickly improving with the level of growth and the increasing knowledge based. Moreover, an interesting facet of this debate that was presented across all three groups was the notion that complete transparency is unattainable. The views presented suggest that Islamic finance could not be expected to be completely transparent when conventional financial systems had nuances of opaqueness in terms of contract specifications and confidentiality laws.

> "…obviously they don't put all the details; they put broad details of what goes on but they don't put details of the structures they are recommending to individual clients as that would be a breach of confidentiality and obviously they are going through some effort to tailor these things (products structures) to the needs of individual clients who are paying for this service. So, like any banking contract, it is not in the public domain…"
>
> – **Academic**

> "I think maybe in a way some Islamic banks need to be more transparent and when I say more transparent in terms of products and I would say that maybe because of the regulatory requirement… In some parts maybe or maybe in other countries, this sort of requirement is less strict or not

> adhered to fully… Maybe the competition would be a reason for that in a way that the bank doesn't want to reveal everything, you know, because of the competition element."
>
> – **Academic-Practitioner**

> "I am not saying that Islamic finance is fully transparent but the level of non-transparency that people talk about is not that bad and is quickly disappearing."
>
> – **Practitioner**

> "Transparency is relative and to different people transparency could mean different things and everyone has a different requirement of transparency. We cannot just say that we need more transparency for the sake of it. It is not like conventional finance is fully transparent and people still get on fine with the financial products"
>
> – **Practitioner**

However, an interesting undertone to these views was the precept that transparency or the lack of it could be attributed to a lack of knowledge about the Islamic financial system linking back to debates presented by Ahmed (2009), Abu-Tapanjeh (2009) and Maurer (2001). Fundamentally, there was a synthesis of literature and interview themes suggesting that transparency could be alleviated by further informing the market space about Islamic finance and that a certain level of standardization was required to ease the confusion behind Islamic financial regulation. This leads on well to the next saturate node of 'Uniformity'

6.5.6. Uniformity

Uniformity has been a contentious issue within the realm of Islamic finance and many arguments pertaining to criticisms of the Islamic financial governance and regulation stems from these debates about uniformity. The basis of this argument is the varying interpretation of Islam via the various schools of Islamic thought and has led to differing regulatory standards across the global Islamic financial system. Prominent works include Akhtar (2006, 2007) and Khan (2007) who provide strong arguments suggest that the lack of standardization across Islamic finance is substantially hurting development and growth. Further work by El-Hawary *et al.* (2007) has shown that there is a distinct divergence in regulatory standards. Moreover, more recent studies such as that of Farook and Farooq (2013) highlighted calls for the creation of Shariah-scholar qualification from an accredited, central awarding body to promote standardised rulings and improve the level of expertise in the Islamic financial system. The precepts collected from the interview candidates suggest that there is consensus amongst all three groups that there needs to be significant progress towards developing a salient fundamental regulatory framework.

> "… you have differences on what is allowed in some markets and what isn't. You've got the conflict between the various schools of interpretation. If you don't have harmonisation, you don't have products that have been traded between markets, there's a lack of liquidity, so keeping things opaque and having separate rooms, separate schools and separate interpretation is not going to lead to a deep market"
>
> – **Academic**

> "Unfortunately the interpretation of the Sharia law varies among these boards so what is permissible in Malaysia may not be permissible in London. What is permissible in Egypt may not be permissible in Malaysia because everyone has his own interpretation of the Sharia law or the Quran… and I think standardisation won't be achieved easily in this arena…"
>
> – **Academic-Practitioner**

> "This is a major cause for concern but this issue is diminishing over time. If we were talking about the same issue a decade ago then it would have been a major cause for concern because of the regional schools of thought found in the Islamic world where Shariah is interpreted in slightly different ways."
>
> – **Practitioner**

A fascinating aspect from these interviews, however, was that they stopped short of calling for complete harmonisation of the financial system. Essentially, they accepted the benefits of a unified, fundamental regulatory framework but there were no clear advocates to complete uniformity. The following views further captured the principal tones

> "…but you don't want standardization because that will obviously preclude innovation – putting everything in sort of a strait jacket, then there is not much scope for devising new methods of doing things…"
>
> – **Academic**

"…we always like to talk about the need for more harmonisation but you must remember how many lawyers are making an awful lot of money out of the fact that there isn't this harmonisation and that lack of overlap or harmony between different sets of regulations creates a lot of work which is very good for all sorts of people involved in financial services so making Islamic finance work in the UK regulatory context it creates jobs, it creates work for people… so people might complain about the lack of harmonisation but actually it's a good thing for the people who have to work about"

– **Academic**

"…I think the essence of complex systems and the world financial system is a highly complex system, is that there is always diversity and diversity is emergent and you get both adaptive changes but you get 'acceptive' changes and that is one of the reasons why learning after a disaster is often a pretty logical thing because what happens after a big disaster is that the pieces are still there but they are just put together is a different kind of array, different structure so my answer to it is I don't think there ever will be one uniform matrix into which everything will conform…"

– **Academic-Practitioner**

"…most successful global brands have adopted the approach of customising to local scenarios such as HSBC with the slogan "The

> world's local bank", even the menus of McDonalds has a twist of differences in different parts of the world…"
>
> – **Practitioner**

As postulated by DeLorenzo (2000) the idea of a complete 'one structure fits all' regulatory standard is impractical and impossible. Further work by DeLorenzo and McMillien (2007) broach this issue from a conventional regulatory position and their findings have suggested that as opposed to Islamic banking creating a uniform standard there is scope and flexibility for conventional regulatory and legal frameworks in incorporating Islamic financial principles. These arguments and views from both academic literature and interviews seem to relate back to Kane's (1988) view of the regulatory dialectic stressing the importance of the dynamic interaction between the regulators and regulated. This leads on to the next node which examines the role of a lender of last resort as a point of central regulatory reference.

6.5.7. Lender of Last Resort

The classification of this node arose from an examination of literature behind central regulatory bodies within Islamic finance and the calls for standardization. Academic research such as that of El-Hawary *et al.* (2007) and Archer and Ahmed (2003) illustrated the divergences in regulatory standards within Islamic finance and these discrepancies caused an increased concern in terms of customer protection and legal recourse (see Hersh, 2011; Noibi, 2004; Errico and Farrahbaksh, 1998). Essentially, this lender of last resort would act as a buffer for the Islamic financial system in order to improve levels of confidence.

Much of the literature (Noibi, 2004, Hersh, 2011) highlight the need for a central regulatory board and as such the creation of a lender of last resort but there is little discussion of the creation of lenders of last resort across the various Islamic financial hubs. The observations from conventional finance suggest that this is the method adopted and there is no one centralised lender of last resort for the entire conventional financial system.

The common theme across all three interview groups clearly indicated that there was a need for lender of last resort but there was no definite indication as to where and who should undertake this responsibility. This is very much in line with the existing literature surrounding the idea of an Islamic central bank. Solé (2007) proposes sovereign central banks could adapt their role to fit this mould however the concern would then revert to the underlying Shariah-ness of the lender of last resort's financial assistance.

> "…I think it's very difficult to sort of think about Islamic central banks I suppose in the sort of abstract without thinking about which territories and legal contexts they're actually going to be plot down in and how they again, they've always got this issue of adapting to what rules are already in place about how banks function and what they do if they get into difficulties so again it's not like you're sort of designing a system from scratch, you are always going into the context where there are other institutions that deal with…financial institutions have got into difficulty, what happens now? For the Islamic Bank of Britain it's the Bank of England, that is their first port of call and then it's, presumably whatever

funding streams they may have from the Gulf if they need to raise new capital beyond that, so there's always going to be a particular context institutions have to be embedded in which will determine how they, you know what the lender of the last resort is and what it can be…"

– **Academic**

"Well I think we need a mega Islamic bank. It's either through IDB or through any other shareholding structure, we need a mega Islamic bank which is overseeing the whole industry and we need again to try to achieve this sort of regional standardisation. I'm positive about it especially with expansion, with horizontal expansion of Islamic banks and if you look at Europe, for example, you'll find lots of potential on this…"

– **Academic-Practitioner**

"For me it doesn't work because in the conventional industry, every country or every market has its own lender of last resort which is usually the central bank of the country. So either we are saying that the Islamic financial industry as a whole is just one market and its dynamics are completely identical from one and to the other only then I think we can think of having a central lender of last resort. If that is not the case, which it is definitely not in my view, then I think we cannot imagine having one lender of last resort for the whole industry…What I would suggest is we definitely need a lender of last resort but this is where the central banks have to be considered and they have to start moving towards a position where they will be able to act as the lender of last resort for Islamic institutions in an Islamic way."

– **Practitioner**

6.5.8. Future

The future of Islamic finance was clearly a saturate node within the interview analysis. There was clear agreement across all three interview groups that there was scope for further growth of the Islamic financial system on a global scale. These calls for growth have been presented in existing literature and can be seen in works of Iqbal (2007) and Bacha (2004) suggesting that the conditions are ripe for the growth of Islamic finance.

"…I mean the industry is growing, it's always going to be a niche, it's not going to take over the global financial system or something, but it is an alternative way of doing things…"

– **Academic**

"…I think the growth, if it is not exponential, it is very good and very promising and that will continue I think…"

– **Academic-Practitioner**

"…I think the overall perspective of Islamic finance is actually quite positive and very strong…there is big room for growth, I would say, internationally because it is not only the countries or the markets with the Muslim majority but it is also very relevant to the non-Muslim population as well…"

– **Practitioner**

An interesting thought that arose from garnering further perspectives on what this growth could be expected to be, yielded an interesting Academic opinion. Whilst the view was that Islamic finance would grow into the future there is a misconception from market participants and supporters of the Islamic financial system that it essentially a white knight during the financial crisis

> "Well I think some people sort of expect it as the answer to all the problems of the global economy and the conventional system but it's not. Well obviously Islamic finance is trying to do things a different way but we have to be realistic about essentially where it is and where it's heading and it makes a contribution to the debates but obviously it is unlikely that all the principals and all the ideas are going to be adopted internationally. Conventional banks are very strong willed companies and they are going to continue with the kind of activities that they have done."
>
> **– Academic**

To the best of the researcher's knowledge this view is not widely address directly within existing literature. Wilson (2004 and 2007) provides a good overview of the expectations of Islamic finance in the UK and Europe. What can be seen however is the acceptance within the academic literature about establishing competitive ground between Islamic and conventional banks. Moreover, this competitive element can also be inferred from the development numerous studies looking at comparing the performance of Islamic and conventional indices (Girard and Hassan, 2008 and 2011; Elfakhani *et al.*, 2005; Hussein, 2007 just to name a few). Karbhari *et al.* (2004) and Ahmed (2009) highlighted the establishment of this level playing field as a major regulatory hurdle.

6.6. Overview of Empirical Observations

This empirical facet of the study sets out to examine the prevailing issues in the Islamic financial system. It aimed to accomplish this through an analysis of the literature along with the views garnered from interviews with academics and professionals in the field of Islamic Banking and Finance. Several pertinent issues were highlighted in the initial review of the literature surrounding governance in Islamic finance such as the perception of Islamic finance, transparency, risk, lender of last resort, uniformity, Shariah supervisory boards, the future of Islamic finance and the development of new instruments.

Table 29 below provides an overview of the findings for this research study. It essentially breaks down the overall research thesis into its central themes and highlights the findings from the existing literature and the empirical research undertaken over the course of this project. The following table provides a summative view of the overall findings of the empirical analysis undertaken in this study.

Research Theme	Findings
1) <u>The development of Islamic finance - a medieval and modern perspective</u>	
i) The medieval Islamic financial system	• Parallel integration of Islamic centred finance and other financial systems (what we now know as conventional, mainstream finance). • Although medieval Islamic finance adhered to Shariah rules, there was widespread acceptance of more traditional, "interest-bearing" mode of financing. • The exponential difference in the development of Islamic finance was down to the fact that the financial system was built around close-knit and establish trading relationships. This invariably led to obstacles in establishing international trade relationships during the medieval period.
ii) Modern Islamic finance	• The birth of modern Islamic finance took place after the Second World War when Islamic colonies were given the opportunity govern themselves. There was a want to return to more traditional Islamic values as opposed to adopting unfamiliar Western systems. • Concepts such as *riba* were strongly established as core values towards the creation of a modern Islamic financial system.
iii) Risk management in Islamic finance	• Adequate development of risk management strategies and tools pivotal towards the continual evolution of the global Islamic financial spectrum • Concerns regarding the obstacles presented by Islamic financial rules on financial engineering but it has to be understood that true financial innovation takes place in the face of these obstacles.
iv) Governance in Islamic finance	• Concern at the uniformity of regulatory standards of the global Islamic financial community and integrity of Shariah supervisory boards. • Different regulatory standards across different Islamic financial hubs could lead to regulatory uncertainty. • Composition of Shariah supervisory boards could lead to conflicts of interest. This is down to similar board members sitting on numerous Shariah boards for different financial institutions.

2)	**<u>The performance of Shariah-compliant Indexes</u>**	
i)	**Diversification benefit of incorporating Shariah-compliant index in a portfolio.**	• Dependant on the index composition. In this circumstance a portfolio comprising of the FTSE 100, FTSE 4 Good and FTSE Global Islamic presented diversification benefits.
ii)	**Performance of “Islamic” portfolio with that of conventional portfolio.**	• Based on the Sharpe ratio, the portfolio containing a Shariah-compliant index outperformed the market portfolio across every optimisation period.
iii)	**Performance of constrained “Islamic” portfolio with unconstrained “Islamic” portfolio**	• No conclusive outcome as to whether a constrained portfolio with at least 50% investment in the mainstream index yielded better risk adjusted returns across the optimisation periods.
3)	**<u>Creation of Islamic Risk Management Instrument</u>**	
i)	**The structure**	• Hybrid combination of *wa’ad* with profit/ loss sharing characteristics of musharakah. • This was a step away from the more conventional risk transfer approach of traditional risk management instruments.
ii)	**Performance when compared to more conventional Islamic risk management products (*wa’ad* and *murabaha*)**	• Benefits to *wa’ad* seller are dependent on the price of the commodity at expiry and the exercise price. • Customer benefits if hybrid *wa’ad* is exercised but loses out when hybrid *wa’ad* is not exercised. • Bank gains if hybrid *wa’ad* is exercised and the spot price at expiry is more than the exercise price of the hybrid *wa’ad*. However if the hybrid *wa’ad* is not exercised the bank encounters opportunity cost of engaging in contract but receives nothing.
iii)	**Issues with the structure**	• Shariah compliancy cannot be truly determined. Attempts have been made to adhere to Shariah-compliance rules to the best of abilities. • Complicated way to structure what is essentially achieve through the use of straight *wa’ad* contract.

iv) Overall evaluation of structure	• The want for risk-sharing has made the structure more complicated with the involvement of an additional party. This invariably leads to "increased" costs. • However, when compared to a straight *wa'ad* and *murabaha*, the hybrid *wa'ad* outperforms when it is exercised but under performs when it is not exercised.
4) <u>The perspective of market participants on the issues of governance in Islamic finance</u>	
i) Central themes organised by progression of issues	1) Perception of Islamic finance 2) Risk 3) Development of New Instruments 4) Shariah Supervisory Boards 5) Transparency 6) Uniformity 7) Lender of Last Resort 8) Future
ii) Interesting Perspectives on these central themes	• Islamic finance is growing rapidly and is now seen as a viable alternative but there is an agreement between the interview groups that there is still a lack of knowledge and more has to be done to address this issue. • There is distinct concern about the level of risk within the Islamic financial system that has been brought about this significant growth and new market participants should understand that whilst the risks faced by Islamic finance are similar to conventional finance there may be a different emphasis on specific types of risk. • More attention has to be paid to product development on the risk management front to contend with the proliferation of risks due to the significant growth. Interviewees made the distinction that financial innovation cannot be only about mimicking conventional financial payoffs. • This innovative process has to be aided by Shariah Supervisory Boards. Moreover, the issues pertaining to SSB composition are quickly diminishing and there are calls for accredited Shariah qualifications, which would also help with issues of transparency and uniformity of the Islamic financial system. • Issues of transparency are down to a lack of knowledge. Moreover, complete transparency

	cannot be expected. • There is a want for a set of fundamental regulatory standards but once again there is agreement that a 'one size fits all' approach is impossible and could even preclude development and financial innovation in Islamic finance. • There are benefits from having a lender of last resort but there is no clear indication as to who should take on this role. • Islamic finance will continue to grow although the market has to be modest with its expectations.

Table 29: Overview of Findings

6.7. Summative Remarks

This chapter has provided a descriptive perspective of the findings of the research study. It highlights the major issues from the literature along with the results of the empirical work carried out over the course of this research study. This, in essence, sets the scene for the discussions in the next chapter where links will be drawn across the central themes of this research

7. Linking the Debates – Conclusions

7.1. Introduction to Chapter

The following chapter contextualises the findings presented in this research study. The chapter brings together both philosophical and empirical aspects of this study and provides linkages across the three central themes of this research. Chapter 7 is set out as follows. Section 7.2. revisits the main issues that that were looked at in this research project, outlining the major research objectives achieved in each chapter and will cover the analysis of the performance of Shariah-compliant indexes, issues of governance in Islamic finance and the development of risk-management under a Shariah framework. Section 7.2. will draw linkages across these central themes and examine these major aspects of this research study not as individual facets but as interrelated components of Islamic finance. Section 7.3. illustrates the original contribution to knowledge of this research study. It highlights the gaps in the existing literature and the new findings from this study. Section 7.4. will highlight the limitations of this project and the potential for future research to be carried out around the area. Section 7.5. will present the concluding remarks on the findings of this research and the overall thesis.

7.2. Summary and Conclusions

7.2.1. The Growth of Islamic Finance through the Ages

The development of Islamic finance from its medieval beginnings to its current status in the modern financial spectrum provides much food for thought. The descriptions of medieval Islamic finance provided by Udovitch (1970) paints the picture of a financial system that is fundamentally similar to what is known as modern Islamic finance. Both medieval and modern Islamic finance share regulatory standards that are governed by Islamic law and as such both financial systems abide by the three central tenets of prohibiting *riba*, preventing *maysir* and thwarting *gharar* (Udovitch, 1970; Siddiqi, 2006). However, it is difficult to not see the differences caused by the temporal break between the two financial systems as well. As argued by Udovitch (1970 while Islamic finance existed to a significant degree in medieval times it did not possess the strict '*riba*-chasing' characteristics that dominate the modern Islamic financial spectrum (Khan, 2010a). Instead, the medieval Islamic financial system is described as inclusive. It behaved in a way where on the one side Islamic values governed a financial system whilst on the other side it was encompassing of conventional trade and financial practices. A good example of the differences between medieval and modern Islamic finance would be the acceptance of credit finance.

The systemic construct of medieval Islamic finance consisted of close-knit trading relationships and even within the context of international trade and finance, these relationships still played a significant part in overall trading practices (Udovitch, 1970). This invariably led to difficulties with regards to international trade within the medieval Islamic financial system, which was the cause of its eventual decline and the adoption of what is now called mainstream financial practices. The close trading relationships of Islamic finance created a substantial network of lenders and borrowers. Moreover, these trusted networks resulted in a trustworthy trading grid that could have been described as lower risk when compared to medieval Western finance. This network included brokers, lenders and borrowers who would facilitate the international trading requirements of market participants. Unfortunately, this close arrangement also meant that the medieval Islamic financial system was significantly more closed off to the wider trading economy when compared to Western finance of that time. Additional evidence that supports this argument for the steady decline of medieval Islamic finance can be seen from the fact that medieval Arabic possessed words such as money lending or transfer of debts as well as words that were related to specific, personal financial transactions (Udovitch, 1970). However, there were no words that described the abstract and generic functions of any financial system and nomenclature such as banks and banking and finance were virtually non-existent.

Essentially, the medieval Islamic financial system was unable to extract itself from the personal trading network that it was built around and fell victim to the lack of impersonal trading relationships that now pervades commerce, banking and finance. Trust was no longer required for security in light of standardized regulatory controls. Close trading relationships were not required to engage in trade as these were circumvented with the advent of brokers and agents. Therefore, the very foundations that made Islamic finance a success were also the cause of its eventual demise. Medieval Islamic finance's comparatively narrow social structure impeded its ability to move towards a larger interconnected financial structure that was not built around social proclivities but rather a more informal organization of commerce and trade.

What can be seen when comparing and contrasting medieval and modern Islamic finance is a distinct emphasis on *riba* within modern Islamic finance. This firm stance on *riba* would be a product of a few factors. Firstly, as stated before, there was a want for reversion towards a more traditional and familiar mode of financing (Schaik, 2001). This exacerbated socio-economic push towards Islamic finance could have been a deliberate effort to differentiate itself from its more conventional financial equivalent by offering a banking and finance system that excludes a central conventional financial characteristic – interest financing. Much of the early academic literature on Islamic banking and finance centralised around exploring and promoting the effects and benefits of an interest-free financial system (Ahmed, 1972; Khan, 1986; Ashour, 1999; Siddiqi, 2006). Moreover, a lot of this literature is not without merit and their arguments present an extremely convincing case. Removing interest from the equation of many financial transactions requires them to exist in the real economy and indeed tangibility and ownership is a central aspect of many Islamic financial contracts (El-Diwany, 2010). Having a financial contract devoid of interest and existing in the real economy results in lower risk in the sense that both parties are forced to absorb responsibility for the transaction (Homoud and Rhummeud, 1985).

However, whilst the benefits of interest-free banking were there, the elimination of the interest element in finance presented many problems itself – the intensification of counterparty risk and principal-agent problems (Vogel and Hayes, 1998, Warde, 2000). In the early years of modern Islamic banking and finance it was felt that the best solution to interest banking was a profit and loss sharing modus of finance and the use of *musharakah* and *murdarabah* contracts (Siddiqi, 2006). However, these contracts resulted in the increase of principal-agent concerns mainly as a result of mal-practice or the hiding of profits/losses. These problems led to the adoption of the *murabaha* contracts in the 1980s, which essentially transformed the landscape of modern Islamic finance. These *murabaha* contracts allowed market participants the benefits of debt financing, which essentially created a significantly more feasible way of structuring finance. It provided the parties involved with capital protection and trade modes of financing and alleviated all the problems associated with profit and loss sharing.

The advent of modern Islamic finance occurred with the end of the Second World War when with the withdrawal of colonial rule many Islamic regions were once again allowed to govern themselves (Schaik, 2001). This distinct sudden reversion of control meant that the conventional practices of their once colonial rulers were quickly seen as foreign and strange and this included financial practices. This unfamiliarity with Western practices resulted in the want to revert to a system that was more understood and widely accepted amongst the region, which gave way to the adoption of Islamic values to govern everyday life including commercial activities such as banking and finance. These initial experiments into the viability of an Islamic financial system took place in the 1960s with the establishment of an Interest-free bank in Karachi and Tabung Haji in Malaysia (Schaik, 2001).

Since that period Islamic finance has grown significantly with the creation of numerous Islamic financial hubs – in both the West and the East –and the proliferation of new financial instruments and product lines (Malik *et al.*, 2011). What is now known as modern Islamic finance is valued at just over $1 trillion and is expected to grow four fold by 2016. The rise of Islamic financial hubs in both the East and the West has also shown the growing prominence of Islamic finance in the conventional market place (Malik *et al*., 2011).

7.2.2. Performance and Diversification of Shariah-complaint Equity Indexes

Shariah-complaint equity funds have been the source of much talk in recent years. These compliant equity funds use a screening process to filter out haram companies and as such these equity indexes explicitly exclude banking and insurance institutions and other entities that engage in haram activities to a certain standard. With the financial crisis much research has been conducted on the performance of these Islamic indexes with reference to conventional indexes. What was found that Islamic indexes exhibited under-performance during bull market phases and over-performance in bear market phases (Hussein, 2007). This should be of no surprise based on the composition of these Shariah-complaint funds. The exclusion of banking and insurance institutions would unvaryingly mean that the initial shocks of any financial crisis would be muted. The large exposures of both these types of institutions – financial and insurance – within the investment market place would mean that they would be the first to exhibit poor health should there be a detrimental shock to the global marketplace.

In contrast, the benefits from propitious shocks to the marketplace would be experienced by these institutions initially. Referring back to unfavourable market shocks, this is not to say that Islamic finance would be completely insulated from the damages that a financial crisis could wreak on a financial system. It has to be understood that whilst Islamic indexes exclude the activities of banking and insurance from the funds on a principal level, capital outflows and inflows still arise from conventional, mainstream sources. In a sense, investors in Islamic funds need not necessarily borrow from an Islamic bank. Moreover, using the Shariah screening process means that whilst companies on the index are Shariah-complaint, they are not inherently Muslim and will actively invest in non-Shariah-compliant investments themselves. There is also an increased dependence of real assets due to the nature of Shariah financial requirements and it takes time for the effects of the financial crisis to filter down from the financial into the real markets (Hayat and Kraeussi, 2011). Therefore, these muted effects of financial shocks should only be regarded in the short-term.

There has been a substantial amount of research (for a full review of existing literature refer to Chapter 4, Section 4.2.) conducted into the comparing and contrasting the performance of Islamic against conventional funds and what appears would be a divergent view of whether the Sharia-screening processes make a difference to both risk and return. Whilst work by Elfakhani *et al.* (2007) and Hoepner *et al.* (2011) suggests that the Islamic equity indices possessed no outperformance over conventional equity indices, work by Abdullah *et al.* (2007) and Hussein (2007) seem to indicate that the performance of Islamic equity indices were dependent on market phases. What is common across the existing research was the distinct separation between Islamic and conventional indices with analysis looking at comparing Islamic against non-Islamic. The identification of this gap in existing research provided the inspiration for this research to examine the performance of Islamic equity indices not in isolation but rather as a component within a portfolio of assets. The findings from the empirical analysis (see Chapter 6, Section 6.3.) highlighted that there were not only diversification benefits from incorporating Islamic equity indices within a conventional portfolio but the inclusion of Sharia-compliant equity indices also resulted in improved risk adjusted returns when compared to a conventional equity index. Fundamentally, the inclusion of a Shariah-compliant equity index within a portfolio of assets demonstrated no long term stochastic relationship under a Johansen cointegration framework. Furthermore, assessing the risk adjusted performance of this portfolio using a Markowitz optimisation methodology also indicated superior risk-adjusted performance with the inclusion of a Shariah-compliant equity index. These outperformances over a conventional equity index could be seen over both a longer and shorter time span. These provides strong arguments towards the growing perception of Islamic finance as a viable investment and diversification opportunity for international investors and for both Muslim and conventional investors. It should be noted that, to the best of the researcher's knowledge, there have been no attempts in the existing literature to make this comparison of Shariah-compliant and conventional equity indexes using conventional portfolio optimisation methodologies. Much of the existing literature looks at a base comparison of Shariah-compliant against conventional equity indices only with no consideration for modern portfolio theory and the importance of multi asset portfolios.

However, with the current economic conditions, conclusions for the performance of Islamic finance have to be modest. Interdependencies between financial systems have meant that whilst Islamic finance is slightly insulated from the effects of the financial crisis, it still experiences knock-on effects from conventional sources – both in terms of capital investment and volatility of investments (Chapra, 2008). Nonetheless, it should also be regarded as an opportunity for Islamic finance as individuals look for alternatives. Islamic finance may not change the spectrum of conventional finance but it does offer market participants an option when it comes to investments and finance (Ahmed, 2009). This could be another explanation for the growth of Islamic finance over the past decade. The analysis of the interviews conducted as part of this research also supports these views suggesting that market participants view Islamic finance very favourably although Islamic finance cannot be seen as the answer to all financial problems.

7.2.3. The Need for New Risk Management Instruments in Islamic Finance

However, this rapid growth has brought with it a few problems, mainly with the management of volatility and the issues of governance – which are matters that are very much linked with each other. Examining the risk profile of Shariah finance, what can be seen from the risk profile of Islamic financial institutions would be that it experiences similar risks to its conventional financial counterpart with the exception being Shariah-risk (Makiyan, 2008). However, whilst the risk profiles of both Shariah and conventional finance are similar, the nature of the risk is different (Dar and Presley, 2000). The prohibition of *riba* has meant that all Islamic financial contracts have, as an important condition, proof of ownership before a transaction can take place. For a start, this invariably leads to increased commodity risk (Sundararajan and Errico, 2002) and moreover, the proof of ownership prior to contracting involves its own risks. This illustrates that whilst the risk types are the same the nature and occurrences of these risks are slightly different.

The danger arises if there is a lack of understanding for the differences in the risk of conventional and Islamic financial contract. The underlying principal of risk management in both conventional and Islamic finance is a mitigation of risk but the methodology applied is different in both cases. This has resulted in the calls for the provision of Islamic financial qualifications which were strongly pushed by both the literature (Ghayad, 2008; Monger and Rawashdeh, 2008) and from the interview analysis carried out. There was strong consensus amongst the three interviewee groups that Shariah financial qualification would not only help alleviate the lack of knowledge but also aid the uniformity of Islamic finance. With the vast amount of volatility in the economy today, there is no need for an additional layer of uncertainty by trying to manage Islamic financial contracts in the same vein as conventional financial contracts.

There has been additional criticism with the composition and structure of new Islamic financial risk management tools. These criticisms were also highlighted during the interviews and stem from the fact that many new Islamic financial instruments aim to mimic the characteristics of conventional financial tools. The literature does indicate this phenomenon and the rise in popularity of Shariah-compliant financial instruments have meant that there are now more Islamic financial instruments that mirror their conventional counterparts (Kayed and Hassan, 2011; Seif, 2009, El-Gamal, 2008).

Recent years have seen financial innovation in Islamic finance progress greatly and much of this innovation has been centred on the *murabaha* contract. Islamic profit rate and cross currency swaps are two good examples of the Shariah-compliant innovative process that involves the use of two *murabaha* contracts in tandem. As highlighted by Hesse *et al.* (2008) and Iqbal (2007) Islamic financial systems are working at establishing a robust framework for financial innovation and the conditions, such as liberalization and deregulation, are there for further development of new products

The growing Shariah acceptance of the *wa'ad* as an Islamic financial contract has shown that there is greater enthusiasm in embracing financial innovation under a Shariah financial framework. However, using an Islamic call option in the form of the *wa'ad* is still a contentious aspect of Islamic finance as derivative structures are explicitly disallowed under a Shariah framework (Saleem, 2006; Seif, 2009). The lack of ownership and high risk nature of derivatives (see Steinherr, 2000; Summers and Summers, 1989) has meant that they are prohibited within Islamic finance although Mokhtar and Laldin (2009) have argued that there are risk management benefits from the use of derivatives. Moreover, empirical studies (Conrad, 1989; Crain and Lee, 1995) into the effects of derivatives on the overall risk spectrum are inconclusive. It does look like the benefits of derivative-like structures for risk management is not lost on Shariah financial innovation and new product structures such a Shariah-compliant profit rate swaps or Shariah-compliant FX options are making their way into the financial system.

However, a lot of these products still operate on the basis of risk transfer and there seems to be a need for research aimed at creating new hybrid risk management structures that incorporated elements of risk sharing. The arguments for the adoption of risk sharing over risk transfer are there in the form of overall accountability and equality which related back to the roots of modern Islamic finance (Naqvi, 1982; Khan, 1984). Highlighting this gap in the literature the research essentially created a hybrid risk management tool which incorporated the mechanisms of a *wa'ad* and risk sharing. The hybrid structure articulated the flexibility of a call option with the benefits of a risk sharing modus. To the best of the researcher's knowledge the specification of this structure were not highlighted in the existing literature thus signifying another gap in the prevailing knowledge. The payoffs for this hybrid were assessed and the results were indicative that risk-sharing did provide some benefit to contracting parties (the structure is described in Chapter 6, Section 6.4.).

What was revealed from the analysis of the payoff was that when the hybrid product was exercised, the customer benefitted from the overall contract whilst the benefit to the bank would be dependent on the spot price of the commodity upon maturity. For the customer, the benefit arose from the fact that he/she would be paying lower premiums initially and that the overall cost of the contract would be lower should the contract be exercise (see Table 25, pg. 226).

On the downside there is an additional cost to pay for this structure (this can be seen when the hybrid product is not exercised). The rulings are unclear as to whether ownership is required for a *wa'ad* contract and as such the research has account for both ownership and non-ownership. When the hybrid product is not exercised, the requirement to purchase the net asset value from the bank to complete the contract resulted in it being more expensive than a straight *wa'ad* contract (see Table 24, pg. 225). The conclusions from the payoffs demonstrate the effects of the implementation of a risk-sharing modus within a product structure. What occurs is a fundamental reduction in the overall efficiency of risk management but what is returned is accountability and knowledge sharing. As the bank is part of the hybrid structure they would invariably bring better market knowledge which would have underlying benefits to the client who wishes to hedge a position in the first instance.

The exercise in creating the hybrid product highlighted the possibilities of financial innovation in Islamic finance and, in essence, that initial concerns about a lack of risk management tools in Islamic finance were gradually diminishing. The progression and growth of Islamic finance in the eyes of conventional banking and finance has meant that there has been steady advancement on the risk management front. Furthermore, the development of Shariah-compliance rules has substantially improved these innovative opportunities. However, these Shariah–compliance rule and regulations have constantly been cause for worry in the Islamic financial system and much of this concern (El-Gamal, 2006; Errico and Farahbaksh, 1998) relates to consistency and uniformity of these regulations – concerns that spill over into governance and regulation of the Islamic financial system as a whole.

7.2.4. The Development of Governance and Regulation within Shariah Finance

Governance and regulation play a significant role in any financial system in the sense that it creates and promotes stability through the building of consumer confidence (Llewellyn, 2006: Taylor and Fleming, 1999). What was discovered from the literature on governance and regulation was that there was a need for the further development of a regulatory standard that would clearly identify and protect the rights of market participants (IFSL, 2010; Wilson, 2000). However, whilst the literature provides theoretical precepts of issues of governance and regulation there is little in the form of validation of these academic opinions. In lights of this gap in the literature, this study aimed to assess if actual market participants agreed with these hypothetical notions highlighted within the literature.

What can be seen from the research is that many of these concerns about regulation and governance originate from debates involving the uniformity of global Islamic financial regulatory standards (Hesse *et al.*, 2008). Regulators play a significant role within the Islamic finance system with regards to its promotion and development within the global economy. From the empirical analysis of the interviews, it was discovered that the need for uniformity of Islamic finance was a strong view held by both academics and professional. In many respects it was a vindication of the issues highlighted the literature. Having different regulatory standards for different regions is a fundamental result of the different schools of Islamic thought (see Tables 10, 11 and 12). However, this has given rise to different standards for different Islamic financial systems and invariably this leads to confusion within the global Islamic financial markets and the creation, to a certain extent, of an uneven playing field amongst the central Islamic financial systems (Akhtar, 2006; 2007). Market participants, based on simple bounded rationality assumptions, would seek out the Islamic financial market, which best suited their needs at any one time.

This argument pertaining to an uneven playing field is further ameliorated in Shariah financial hubs, which provide Shariah-compliant financial services and products. Shariah-compliance is assessed through Shariah-windows and what has been learned is that whilst certain products and services are allowed in one Islamic financial system, based on these Shariah-windows; it is disallowed in another (Rehman and Masood, 2013). Moreover, an additional criticism of these Shariah-compliance standards would be the composition of Shariah Supervisory Boards (SSBs), whose role is to administer these windows (Grais and Pellegrini, 2006). It has been argued that the structure of various SSBs comprise of similar members sitting on different SSBs. This led to apprehensions about Shariah-scholars being headhunted for their interpretation of Islamic financial law (El-Gamal, 2006). Essentially, scholars who had a more-lenient interpretation of Islamic financial law were the most sought after by financial institutions that required Shariah approval for a new product or service. This was initially a serious issue but what can be extrapolated from the literature (Jobst *et al.*, 2008) and the empirical research would be that this is a diminishing concern and in fact much was attributed to a lack of expertise in the Islamic financial marketplace. During the formative years of modern Islamic finance there was a slight lack of expertise with regards to Shariah-compliance law however, this is begging to change and as Islamic finance grows in popularity, there unvaryingly will be an influx of new expertise into the market place.

Conversely, whilst the interviews demonstrated that market participants were strongly in favour for a fundamental set of regulatory standards, they did question the concept of all-encompassing standardization of the global Islamic financial system. The interviewees affirmed the view that there should be, at a foundational level, elements of regulation have to be standardized, there were no calls for complete harmonization of the financial system and suggesting that there are some benefits from keeping some differences in the interpretation of Islamic financial law. It would be impossible due to the differences between Islamic schools of thought and impractical as it would result in the retardation of financial innovation and development of the Islamic financial system as a whole (DeLorenzo, 2000). It is very much a sense of plummeting into the same pitfalls that have been experienced by conventional finance. The standardized nature of conventional finance has seen product development within the mainstream industry take on an evolutionary aspect as opposed to an innovative outlook.

With that being said, many of the issues highlighted in both the literature and the empirical interviews concerning governance and regulatory standards in Islamic finance are being addressed. The expansion and the influence of the two large regulatory bodies – AAOIFI and IFSB - within the Islamic financial system are indicative of the progress that has been made by the Islamic financial system in trying to tackle these regulatory issues (Hersh, 2011). Essentially, both bodies are charged with the development of fundamental regulatory standards across the global Islamic financial system with AAOIFI focusing on accounting standards and the IFSB concentrating on Shariah financial standards and codes of practice (Sarea and Hanafah, 2013). Moreover, recent developments between two major Shariah financial hubs – Malaysia and Saudi Arabia – have seen efforts being made to stream line the regulatory guideline between the two nations (Y-Sing and Ho, 2012). An interesting precept that arose from this research was the strong calls for a Shariah financial qualification (Farook and Farooq, 2013). These calls were echoed during the interview analysis with academic and practitioners suggesting that the creation of an accredited Islamic financial qualification would help alleviate the problems of uniformity and consistency by providing a foundation of knowledge. While these calls for qualification are not new (See Wilson, 2000; Karbhari *et al.*, 2004) it was interesting to understand that that was where the Islamic financial market was headed.

Further development could take the scope of central regulation through a sovereign central bank, in essence bringing the support of Islamic financial institutions up to par with that of its conventional counterparts (Wilson, 2000). However, this could breed further issues with regards to the institution that would take on this role. There are favourable views that there should be a lender of last resort in Islamic finance within the literature (Solé, 2007; Ahmed and Hassan, 2007) and these views are reflected within the interviews with market participants within all three groups highlighting support for the provision of such a service. However, like the literature there is no consensus as to who should undertake this role with support for Solé's (2007) suggestion for a central bank and Siddiqui's (2008) proposition that this role should be filled by a central regulatory body such as that of AAOIFI or the IFSB.

It can be seen from the research that the impact of governance and regulation affects all facets of Islamic finance. Central regulatory standards would impact the development of risk management tools and strategies under a Shariah framework. There has to be a balance between uniformity of regulatory standards across the global Islamic financial system and scope for financial innovation (Asutay, 2007a; 2007b). However, it is felt that better fundamental central regulation (such as a standard set of Shariah-compliant rules) would aid greatly for the growth of Islamic finance. This would make it easier for mainstream participants to engage in the Shariah financial system without fear of varying and subjective financial standards. The regulators play an important role in any financial system. In the case of Islamic finance, there is the additional challenge of striking the right balance between objective financial practice and subjective religious tenets. There is no denying the growth of Islamic finance on a global scale. Its acceptance in the Far East and in the Middle East as a parallel financial system indicates its ability to function alongside conventional finance. This argument for Islamic finance is further bolstered by its development in Western finance systems such as that of the United Kingdom and recognition within the conventional financial systems as a viable alternative to mainstream finance (Dar and Presley, 1999).

7.2.5. Mapping the Conclusions

One of the main objectives of this research project was to approach both the concept of Islamic risk management and governance from a conventional, mainstream perspective. Through the empirical work, it has been indicated that there are benefits to incorporating Shariah-compliant products within a conventional portfolio. Should this be taken as an indication that Islamic finance is more than a niche market? The simple answer is yes and no. No because Islamic products and services should not be seen as only for Muslims. There is tangible benefit from holding Islamic financial contracts within conventional portfolios as demonstrated by the empirical findings conducted in this study. On the other hand however, Islamic risk management products are still not as efficient as their conventional counterparts just yet and in this regard are still very much niche. With regards to whether, Islamic risk management tools could be used in conventional financial strategies, the practical consensus is that while Islamic risk management tools are able to manage certain types of conventional risk, these instruments are considerably more expensive than mainstream risk management contracts.

The implications of financial innovation for any financial system are huge and more so for a financial system that is trying to make its mark on the global scene. This research addressed the issue of financial innovation in Islamic finance with the aim of creating a new Shariah-compliant risk management. The research has highlighted that there is scope for financial innovation and there are benefits to incorporating risk-sharing within risk management strategies. Whilst Shariah-rules may seem like a significant obstacle towards promoting financial innovation, it is in the face of these obstacles that innovation takes place. This development of innovations in Islamic finance is once again supported by its growth in the conventional market place and this can only serve to drive the innovative process forward. In this respect the Islamic financial system has a robust foundation for its financial innovative processes.

However, there has to be some semblance of regulatory control and standards of best practice in terms of governance. With new market entrants, the Islamic financial system has to ensure that it promotes itself in the right vein. More effort has to be made to educate new entrants to the market. The continual development of Shariah-compliance could aid in this area by providing Western Islamic financial hubs, which lack the vast market knowledge of the Middle East and Malaysia, with a steady foundation from which to build upon. Effort should also be made to ensure that there is some trace of regulatory uniformity across the global Islamic financial market place. Institutions such as AAOIFI and the IFSB should be commended for their efforts in trying to establish regulatory uniformity however there is still much development to be done.

The Islamic financial system has to be modest with its impression of itself. It cannot regard itself as the white knight that is here to rescue conventional finance from the depths of recessions. On the contrary, Islamic finance should see itself as complementary to conventional finance. The growth of modern Islamic finance since the 1940s signifies that it is here to stay, however, at this point in time, it is still seen a very niche market but with the path that it is on currently, that could change very soon.

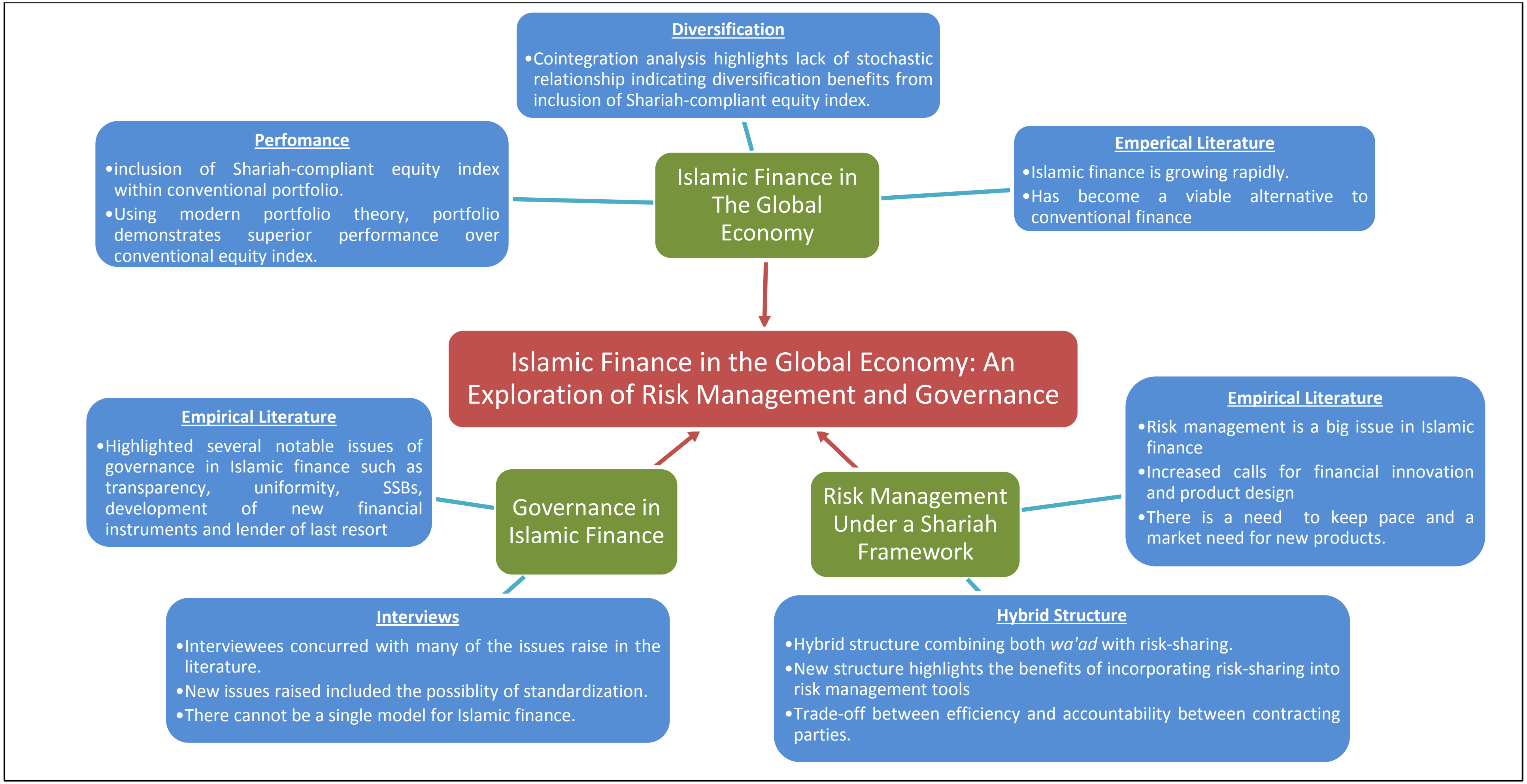

Figure 34: Mapping the Conclusions of the Thesis

7.3. Contribution to knowledge

The contribution to knowledge is an essential facet of any research study. Both terms, contribution and knowledge, carry a weight and meaning of context. Knowledge refers to key elements that have been established within a particular discipline – in this circumstance the empirical literature that presents the views, beliefs and works of finance and Islamic banking and finance. In order for a researcher to contribute to this body of work, it has to be ensured that all empirical findings from the study are verified either by existing literature or concluded from evidence via a process of examination.

The growth of Islamic finance over the past decade has resulted in not only its acceptance by the mainstream financial world but also a proliferation of academic research into its fundamental underpinnings. The evolution of both the practical and academic knowledge of Islamic finance has grown substantially and in tandem. The expansion of Islamic finance into non-Muslim and more conventional markets has meant that there is an increasing amount of research that attempts to look at Islamic finance from a mainstream financial perspective and this is where this research study will be positioned.

The research study initially set out to examine the performance and diversification benefits of Shariah-compliant equity indices. Shariah-compliant financial products have been a recent trend in the Islamic financial world and from an international financial perspective could provide, both the conventional and Islamic investor a viable outlet for not only risk reduction but also significant performance benefits. The scope of knowledge behind assessing the performance of Islamic equity indices has evolved substantially over the past decade. Initial published research into this aspect of Islamic finance involved 'pigeon-holing' the returns of

Islamic equity indexes with that of ethical mutual funds and it was believed that he screening processes behind choosing equity constituents resulted in similar risk-return profiles.

Seminal works such as that of Luther and Matatko (1994), M'Zali and Turcotte (1998) and Hamilton *et al.* (1993) have shown that there was no consistent outperformance of ethical funds to that of conventional equity funds. The growth of Islamic finance resulted in better access to data pertaining to Shariah-compliant equity indexes and increased published research. Works such as Hassan (2001), Hussein (2007), Elfakhani *et al.* (2007) and Hayat and Kraeussi (2011) have attempted to compare the performance of Islamic and conventional equity indexes and have also found that there were not consistent arguments for outperformance by Islamic indexes. An interesting observation from these studies was that the comparisons were made on an insular basis i.e. a base comparison between ethical/ Islamic against conventional indices with no semblance of modern portfolio theory.

This inherent gap in the literature formed the inspiration for the first aspect of this study. Essentially, if Islamic finance is being widely accepted as an alternative financial system, then in this regard, investors, both conventional and Islamic, should have the opportunity to include Shariah-compliant assets within a portfolio of assets. As such, this research looks to examine the performance and diversification benefits of incorporating an Islamic equity index within a portfolio of assets comprising. Fundamentally, modern investment and risk management strategies place great have shown the benefits of multi asset portfolios. Thus, it was felt that an analysis of the performance of an Islamic equity index would be better assessed within the context of a portfolio rather than the base comparison of Islamic versus conventional finance which is widely used in the existing literature.

The study uses Islamic equity indexes from the two largest Islamic financial hubs in the West – the US and the UK. As it was agreed that, the portfolio would be utilized by an international investor, the study abides by a cointegration and Markowitz portfolio optimization methodology. The results from this empirical aspect of the study indicate that the inclusion of Islamic equity indexes not only provide diversification benefits but also demonstrates improved risk-adjusted performance. These conclusions contribute new insight into the performance and diversification benefits of Shariah-compliant equity indexes. Fundamentally, the empirical results extend existing academic knowledge on the performance and diversification characteristics of Shariah-compliant equity indexes. Whilst the existing literature focuses on a simple comparison of Islamic against conventional index performance, this study furthers that precept by incorporating conventional financial strategies and Islamic finance. Additionally, the results of diversification benefits and improved risk adjusted performance further validate the notion of Islamic finance as not only for the Muslim investor but also for the conventional investor.

The results from the analysis Islamic equity indexes led the researcher to further question the risk profile of Islamic finance. With its substantial growth in both Muslim and non-Muslim markets, was there an increase in the risks and were there adequate tools to deal with these risk? An examination of the existing literature indicated that the need for financial innovation in Islamic finance is not a new topic. Works such as that of Dar and Presley (2000) and Jobst *et al.* (2008) have highlighted the need for further development of the Islamic base of risk management instruments. Essentially, these arguments relate to Islamic finance's use of PLS and increased emphasis on real transactions.

Whilst there is a need for further financial innovation in Islamic finance, the process of engineering new financial instruments in Islamic finance has been relatively difficult due to Shariah financial rules and regulations. In what is regarded as the most comprehensive study into derivatives in Islamic finance, Kamali (1995, 1997 and 1999) has suggested that there is nothing inherently wrong with derivative structures in Islamic finance and a further examination of the scope of risk management instruments within Islamic finance yielded interesting results with the unearthing of numerous innovative Islamic risk management structures such as an Islamic profit rate swap and an Islamic call option, both of which perform in the same vein as their conventional derivative counterparts albeit structured in an Islamic way. The empirical results from the performance and diversification analysis of Islamic equity indexes above already provides strong arguments towards support for Islamic finance as a viable alternative to conventional finance and this research aimed to further bolster that support by creating a new risk management tool. The creation of this tool would be to extend the existing knowledge base on Shariah-compliant financial innovation and to theoretically add to the current based of Islamic risk management instruments.

An examination of many of these new Shariah-compliant risk management structures indicated that they were highly innovative in restructuring conventional payoffs in a Shariah-compliant manner. However, the product construction still suggested a risk-transfer modus of risk management and with Islamic finance placing increased emphasis on PLS it was felt that there was scope for incorporating risk sharing in a risk management tool without sacrificing risk-management flexibility, which, to the best of the researcher’s knowledge, is an exercise that is not present in existing literature. The study embarked on creating an entirely new risk management instrument, thus adding to the existing theoretical spectrum of Shariah-compliant risk management instruments.

The product structure consisted of a hybrid combination of a *wa'ad* (Islamic option) and *murabaha* (cost-plus financing) to create, what is principally a risk-sharing, option structure. An examination of existing literature yielded no reference to a similar structure once again illustrating an original contribution to knowledge. Moreover, an examination of the payoffs of this hybrid structure has also indicated that that the notion of risk sharing has benefits to the parties involved within the transaction. While the want for risk sharing has meant that the product is not as efficient as a conventional derivative or *wa'ad*, the risk sharing element makes the overall cost of the hybrid product cheaper. Once again, taking these results into account, this study adds further fuel to the arguments supporting Islamic finance as a financial system that is not only for Muslims, but also a viable alternative for conventional risk managers.

Throughout the process of creating a new risk management tool, every attempt was made to keep the instruments in line with Shariah-compliant standards. However, what was discovered was that there was a lack of consistency in Shariah-compliant regulatory standards. This made the financial engineering process more complex and led onto the final facet of this research study. The existing literature highlighted several pertinent issues of governance and regulation (see Chapter 4, Section 4.3.) in Islamic finance these discussions are very abstract and do not possess any empirical research into determining the validity of these problems. Recent work such as that of Rehman and Masood (2013) might be an exception as they have interviewed individuals to ascertain if there were differences in regulatory standards. However, they have not addressed the implications of those differences.

This research aimed to fill that gap in the literature by garnering the views of market participants on the issues that have been highlighted within the literature to ascertain if the theoretical concerns of the existing literature matches those of individuals 'on the ground' through data saturation and triangulation. Moreover, in order to provide a rounded view of the issues individuals from both an academic and practical background were interviewed to examine their thoughts and opinions on the subject area. With Islamic finance still relatively "new" it was thought that it would be good to balance the views of academic and practitioners with an interim group of individuals who were involved in both the academic and practical side of Islamic finance.

Aside from wanting to discover the empirical views of market participants on issues of regulation and governance in Islamic finance, the aspect of the research also adopts a novel approach to analysing the data in terms of data saturation of precepts. The empirical facet of the research essentially evolves the framework set out by Francis et al. (2010) for testing data saturation and uses a starting sample of three interviewees with a stopping criterion of three interviews. What was discovered from a methodological standpoint was that larger interview samples did not guarantee saturation and that saturation could be achieved by samples as small as three or nine.

Aside from the methodological discovery, the actual analysis of the interviews yielded very interesting results. Existing thematic discourse highlighted thirteen significant issues of regulation and governance in Islamic finance but the empirical analysis of the interviews suggested that there was triangulation amongst the three interviewee groups for only eight or the thirteen issues – ‘The Perception of Islamic Finance’, ‘Risk’, ‘Development of New Instruments’, ‘Shariah Supervisory Boards’, ‘Transparency’, ‘Uniformity’, ‘Lender of Last Resort’, ‘Future of Islamic Finance’. What was even more interesting was the consensus amongst the interview groups about these eight nodal themes highlighting that the views of market participants are very much similar to that of the literature. However, there interviews did yield more detail about each of these eight nodes.

In terms of how conventional operators viewed Islamic finance, there was a general conclusion that Islamic finance is growing in prominence within the modern financial world and is garnering greater acceptance but there is a need to further educate the market participants about Islamic financial practices. This finding adds further weight to the empirical conclusions on the performance of Islamic equity indices conducted in this study. Essentially, Islamic finance can prove to be a viable alternative and is a financial system that is not only for Muslim investors but also conventional investors. However, there is a need to adequately manage the level of risk in Islamic finance and as it currently stands there is insufficient development of financial risk management instruments. As highlighted by the interviewees, there is always scope for growth of product innovation and this would aid greatly in the management of emerging Islamic financial risk. The views of the interviewees essentially support the creation of a hybrid risk management instrument conducted by this research. The development financial innovation, however, has been linked to Shariah-compliance standards and as such the composition of SSBs. The literature was very critical of SSB composition however the views shared by the interviewees were less acute. The consensus amongst the three groups was that there was a lack of expertise in terms of man-power in the Islamic financial industry which resulted in similar board members on different SSBS. What were more pertinent issues were the consistency, transparency and uniformity of these Shariah judgements. While the interviewees quickly concurred with the literature for the need to be more transparent and uniform, not only in terms of Shariah-judgements but as a financial system as a whole, there was an interesting underlying tone that was not addressed in the existing literature thus further indicating contribution to knowledge.

On the transparency front, interviewees highlighted the fact that many Islamic financial contracts were just as transparent as their conventional counterparts and that privacy laws dictate that the level of transparency suggested in the literature could not be achieved in light of privacy laws. In terms of uniformity, the interviewees highlighted that complete standardization could not be achieved by Islamic finance. Moreover, conventional financial systems each had their individual idiosyncrasies which meant that they too were not entirely standardized. The underlying conclusion from this node was that there was a need for further clarification of a fundamental set of regulation but the notion of complete standardization would only serve to hurt the overall Islamic financial system in terms of growth and development. These arguments stretched to cover an Islamic lender of last resort. Interviewees suggested that a lender of last resort would aid the formation of a fundamental set of rules but as per the literature little was said in terms of whom or what central body should undertake this role. Finally, all interviewees were very positive on the future outlook of Islamic finance once again adding further fuel to the arguments for Islamic finance as an alternative to conventional finance.

The aim of this research objective was to ascertain the views of market participants on issues of governance and regulation within Islamic finance. In this regard the research has definitely demonstrated contribution to knowledge through not only the collection of views but also the synthesis of these views to that of the existing literature. In this regard the context of the analysis adds new insight into the actual feelings of market participants on issues of governance and regulation already highlighted by the literature. Fundamentally, the need for continual development would relate to Islamic finance as an alternative to conventional financial system and addressing these issues will invariably aid growth and help new market participants, from both a Muslim and non-Muslim demographic, in utilising Islamic financial services and products on offer.

In summary, there are three main areas of significant contribution to knowledge within this research study. The first significant contribution to knowledge arises from the analysis of the diversification and performance benefits of Islamic equity indexes using the conventional theoretical notion of an efficient portfolio. Secondly, the analysis and creation of a completely new and hybrid Shariah-compliant risk management structure by incorporating a wa’ad with risk-sharing principles. Finally, the study examined the views of actual market participants on the theoretical issues of regulation and governance within the Islamic financial system. All three aspects of this research study aims to fill gaps highlighted in the literature and further the knowledge base on Islamic finance in the international economy. In sum, the three significant contributions to knowledge from this research study provide further robust foundation towards the argument that Islamic finance is a financial system for both conventional and Islamic financial participants.

With the current financial crisis the concerns about Islamic finance imitating conventional financial practices are understandable. However these worries are to a certain extent paradoxical. For Islamic finance to grow there is a need for innovation but innovation is about circumventing the regulatory dialectic established to promote this growth. Islamic finance is not supposed to replace mainstream finance but rather adopt a role as an alternative financial system that runs parallel to conventional finance. Moreover, the Islamic financial system cannot be closed off to mainstream finance by suggesting that Islamic financial instruments and services are only for use within the Islamic financial system. As an alternative, Islamic services and products should be able to provide for both conventional and Islamic financiers and bankers. The analyses on the performance of Shariah-compliant equity indexes, the creation of the hybrid risk management structure and the understanding of the views of market participants attempt to address this notion of inclusivity and it is believed that the arguments presented from these empirical facets of this research provide strong, relevant and new arguments for Islamic finance as an international financial system and not just as a Muslim financial system.

7.4. Research Limitations and Scope for Further Work

This section highlights the limitations of research and areas of possible further research. There are essentially three central themes to this research project – assessing Islamic finance in the global economy, an assessment of risk management under a Shariah framework and an analysis of governance within Islamic finance. Throughout this study much has been learnt about these facets of Islamic finance but there is always scope for further research.

With regards to the performance assessment of Shariah-compliant indices future research could also examine the use of Shariah-compliant indices in a multi-asset portfolios. The scope of this aspect for this research was limited to equity indices and as such the inclusion of other Shariah-compliant assets and conventional financial contracts could further bolster the argument for the inclusion of Islamic financial contracts with conventional investment and risk management strategies. Furthermore, this would also provide important insight into whether there is an additional 'Shariah-cost' for Islamic financial products and services.

Moreover, adjusting the portfolio mix could also yield additional insights. For instance indices were only selected from the USA and the United Kingdom for the simple reason of the availability of long, unbroken time series for the years before the 2007 financial crisis. Future research would benefit greatly from the inclusion of more geographically diverse set of indices as and when they become available. Moreover, additional research could also assess the periods after the 2007 financial crisis. This would enable the research to assess if Shariah-compliant indices have the same diversification and performance benefits beyond the American and British Shariah-compliant hubs.

It has to be understood that the hybrid product has to be assessed by a Shariah Supervisory Board before being actually deemed Shariah-compliant. This is outside of the control and overview of the study, with access of SSBs limited. Whilst it has been indicated from this research that there are benefits to structuring risk-sharing within an 'option-like' product, the only way to assess its validity in the Islamic financial marketplace would be with access to a Shariah Supervisory Board. This could be scope for further development of the product in future research.

A further area of research for financial innovation within Islamic finance would be an extension of the hybrid structure presented in this study. Fundamentally, this would involve the creation of an Islamic put option with risk sharing. This would invariably lead on to an analysis of Islamic risk management strategies using both Islamic put and call options with inference to conventional option risk management strategies incorporating option 'Greeks'.

There is always a worry that the interview analysis would comprise of some element of cognitive bias but every effort has been made to address these issues such as cross-checking transcripts by sending them back to the respective parties for validation, cross-check by the supervisory team and pilot interviews. Scope for further research could involve more node subsets to further break down the individual issues. This could provide further perspective into issues of governance and regulation.

7.5. Concluding Remarks

This research was undertaken with the purpose of contributing to the existing literature on Islamic banking and finance. This research was not undertaken with the view to change the spectrum of Islamic banking and finance but rather more modestly to examine risk management and governance of the Islamic financial system from a conventional perspective. Through the use of innovative methods in terms of portfolio creation, hybrid financial engineering and data saturation of participant precepts this study has provided useful insight into the workings of both risk management and governance of Islamic finance and more so, from a perspective outside that of Shariah finance. What has resulted from the undertaking of this research is that the study has arrived at fresh and original arguments for Islamic finance as a financial system for the international investor. It is further hoped that this research would provide the foundation for further works into product design and development and the advancement of Islamic finance within the global financial markets.

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Appendix 1 – Strengths and Weaknesses of Qualitative and Quantitative Research

Strengths of Quantitative Research	Strengths of Qualitative Research
• Testing and validating already constructed theories about how (and to a lesser degree, why) phenomena occur. • Testing hypothesis that are constructed before the data are collected. Can generalise research findings when the data are based on random samples of sufficient size. • Can generalise a research finding when it has been replicated on many different populations and subpopulations. • Useful for obtaining data that allow quantitative predictions to be made. • The researcher may construct a situation that eliminates the confounding influence on many variables, allowing one to more credibly assess cause-and-effect relationships. • Data collection using some quantitative methods is relatively quick. • Provides precise, quantitative, numerical data. • Data analysis is relatively independent of the researcher. • The research results are relatively independent of the researcher • It may have higher credibility with many people in power. • It is useful for studying large numbers of people	• The data are based on the participants' own categories of meaning. • It is useful for studying a limited number of cases in depth. • It is useful for describing complex phenomena. • Provides individual case information. • Can conduct cross-case comparisons and analysis. • Provides understanding and description of people's personal experiences of phenomena. • Can describe, in rich detail, phenomena as they are situated and embedded in local contexts. • The researcher identifies contextual and setting factors as they relate to the phenomenon of interest. • The research can study dynamic processes. • The research can use the primarily qualitative method of "grounded theory" to generate inductively a tentative but explanatory theory about a phenomenon. • Can determine how participants interpret "constructs". • Data are usually collected in naturalistic settings in qualitative research. • Qualitative approaches are responsive to local situations, conditions and stakeholders' needs. • Qualitative researchers are responsive to changes that occur during the conduct of a study (especially during extended fieldwork) and may shift the focus of their studies as a result. • Qualitative data in the words and categories of participants lend themselves to exploring how and why phenomena occur.

	• One can use an important case to demonstrate vividly a phenomenon to the readers of a report. • Determine idiographic causation.
<u>Weaknesses of Quantitative Research</u> • The researcher's categories that are used may not reflect local constituencies' understandings. • The researcher's theories that are used may not reflect local constituencies' understandings. • The researcher may miss out on phenomena occurring because of the focus on theory or hypothesis testing rather than on theory of hypothesis generation (called the confirmation bias). • Knowledge produced may be too abstract and general for direct application to specific local situations, contexts and individuals.	<u>Weaknesses of Qualitative Research</u> • Knowledge produced may not generalise to other people or other settings. • It is difficult to make quantitative predictions. • It is more difficult to test hypotheses and theories. • It may have lower credibility with some administrators and commissioners of programs. • It generally takes more time to collect the data when compared to quantitative research. • Data analysis is often time consuming. • The results are more easily influenced by the researcher's personal biases and idiosyncrasies.

Strength and Weaknesses of Quantitative and Qualitative Research (Source: Hoover, 2004)

Appendix 2 – Academic Interview Transcripts

Academic 1

Q: How do you think conventional finance views Islamic finance?

I think the Islamic finance and the conventional finance, it's a different structure of the relationship between the customers and the financial institutions. In Islamic finance it's all based on partnership. It's the money which is involved between the two parties, the customers and the financial institution from Islamic finance perspective. It's a partnership but the conventional finance, it is the lender as opposed to the customer, the depositor money and the financial institution and the conventional finance and they pay for them the interest fixed rate. The customer does not have any say where their money will go, where their money will invest and what is the real return of their investment but in Islamic finance it is working as a partnership. The customer provides the money to the financial institutions and they have to confirm for them where they would like to invest their money and this is why we have, what we call it, the restricted account and unrestricted account. The financial institution, they devise a non-protected rate of interest but a return dependent on where they invest the money and what is the real return from their investing and the share, the return between the depositors and the bank in terms of what they will get from their investment.

Q: Sure. Fair enough. How do you think people see Islamic finance? I mean say for example how do you think people in the marketplace see Islamic finance?

I tell you there is a steady finding about using Islamic word because the media now, when you see Islamic, when they see Islamic cultures but you are not seeing Islamic finance as a new model. A new model, it is not like a new today but it is a model which is the people they don't know before because the structure of this model it is different. For there is a stereotyping about Islamic finance model and sometimes as well the stereotyping it is coming from the practice themselves because some of the financial institutions which they call themselves Islamic finance or Islamic banking, they practice exactly like the conventional banking but just only change the name and this is why some of the people they didn't get the right meaning of Islamic finance. From the practice of some of the Islamic banking which they don't have to use the same word. For some of the Islamic banking, just to change the name of interest and they call it rent for example or sometime they call it return but when you look in details with this what should be, look at details how they calculate the rent or calculate the return, they can create it exactly the same way like the conventional finance and they come up with the same amount but they call it something different and this is why some people they start now to not believe there is something called Islamic finance which it is not true. If we practise the Islamic finance with the way it should be which is the finance is tied and embedded to the real transaction and the finance always should serve the real economy and the return on financing is paired with a wealth creation and as well you should have this linked with the financial needs for some of the conventional finance you are not give any particular interest or something important for the community work for any SMEs because they always judge them about the profit they make but in Islamic finance we have a community element. We have what we call it the social responsibility to build this relationship with others for I think if we start talking about the Islamic financials only one product like the conventional finance because the conventional finance it's all, whatever you call the name, call it mortgage, call it overdraft, call it credit card, call it short loan, all based on loan, on debt but in Islamic finance we have at least five or six products which they can use it. We have like a joint venture like Musharaka they have al-Salam, they have the ijarah, they have a mudaraba, they have a lot of features which is different because the main five pillars of Islamic finance is very important which they always base on relationships, based on partnerships and very important it's based on PLS which always we call it the profit and loss sharing and very important as well it's asset packing principle. I think Islamic finance we have a lot of developed and the way to provide the right product to the right customers but unfortunately the Islamic finance they have a lack of financial involvement, a new product or what you call it, R&D, research and development which it is not the way we should actually provide more development on this area, something like a micro finance which would work on this and start to cater the needs for the society by the Islamic finance and the final draft, it's always Islamic finance embedded within the value which always link to the basics or work to the ethical investment and work as well with the community, community banking for example, so we have to build on this value of good governance or the central to Islam as a whole.

Q: You associate Islamic banking to ethical banking.

Yes.

Q: What do you think about this? Are they very similar or are they very different or should Islamic finance be considered the same as ethical banking?

I think it's very important to define what ethical means because when I say ethical I am not considering it a legal site because sometimes you can do a legal but unethical. When you do something it is ethical but maybe it was not legal. For always we have to think about what ethics means and what ethical means because maybe it's different for you from different ethical, for example the ethics or the ethical finance you always link to the social responsible investing. Sometimes it is related to the environment and the community and the governance which if you have a green product it's ethical. Some people they always link to the ethical banking by helping the society through the charity organisation. For if you think the ethical banking and the ethical finance, it is part of the Islamic finance because the Islamic finance has more to offer, not only ethical because sometimes it is not ethical for example to sell the alcohol because if you found now how much the NHS they pay in UK through the diseases related to the alcohol, how much money they pay for the smoking disease and smoking related as well and you can see how much money they reduce from the NHS for example the heart disease and the other disease but they spend more money on the smoking related. How much money and business they lose through the smoking disease as well, how many people are ill and off sick, how many people they are like passive smoking. If you see now the Islamic finance it is all embedded all of this. Islamic finance always liked to invest where we help in the community. Islamic finance we invest where there is equality on sharing the profits and sharing the loss as well. For ethical finance they only work on the environment for example where we invest but the ethical finance it's more than that. It's not only where we invest for something should help in the community and not harm the society but as well Islamic finance has extra miles on that which the relationship between the financial situation and the customer which should be on profit and loss sharing which you can see the ethical finance they have shared area with Islamic finance in terms of where we should invest our money. This is shared together. Islamic finance says we have to invest where we help with the community, not harm the community. Where will be environmental friendly, we are not investing on arms, weapons, on alcohol or tobacco or child labour, we as Islamic finance we cannot invest on that. Exactly the same and this what we shared with the ethical banking, we share the same value, what you call it shared value, we share this value together but Islamic finance will go beyond this where we invest but as well how we invest which what is the relationship between us as a financial institution and our customer as a depositor which the relationship between them will be coming as a profit and loss sharing but the ethical banking, you don't mind if they lend the money by loan and charge interest paid. For the Islamic banking they allow to charge the interest but the Islamic finance no, we can't allow to have the interest as all the money as a commodity itself. The money, it is like a medium of change, it is not the commodity but the Islamic, sorry the ethical banking they don't have a project to make the money as a commodity but the only thing they share with Islamic finance is where we invest which it is an ethical investment for something to help in the community and help the society as well.

Q: Sure. You also mention that there's a lot of stereotyping with Islamic finance, there's a lot of misunderstanding about Islamic finance. A lot of research has said that this is down to the lack of transparency in Islamic finance in terms of, say for example, regulation and Sharia supervisory board decision, so on and so forth. How do you feel about this?

I think we have to discuss this issue with more transparency and to be honest, there will have to be a transparency with you about discussion. One of the reasons behind the stereotyping about Islamic finance is the Sharia board committee themselves because if you found a product devolved by bank A, the financial institution A, as they have approved this product from scholars and the same product from another institution, maybe the same Sharia scholars or different one, it's not good to accept this product and reject the project. For the customer now will get confused. It is the same product, the same structures, the same development. Why one bank will not approve it from the Sharia committee scholars and although the bank is indebted and this leads off to the regulatory organisation which should bring a credibility through the standardisation of the practice and this is one of the issues I always came to talk about it, it's the standardisation. The same product, the same product is accepted by Sharia committee or scholar committee member and approved in one bank should approve as well in the other and this will be like a standardised and the problem is as well, some of the products in a different region of the world in different ways. For example South Asia they can approve one product but the same product never go to approve in the Middle East because of the different madhhab, different scholars accept it so we don't have a standard which we say this is standard should apply for every situation and in the same time as well we have a different regulatory group, we have the AAOIFI which is it the auditing and accounting organisation for the Islamic financial institution which is based in Bahrain. We have as well the IIFM as well, this will be based in Bahrain as well which it is Islamic global, Islamic capital and money market and we have as well, another one is called the GCIBFI which as well this is something related to Bahrain. Even in Bahrain itself there is a full regulatory. AAOIFI, IFM and GCIBFI and LMC as well. For all of these they have a different and don't forget as well we have the IRRA which as well in Bahrain and we have the International

Financial Board as well as regulatory on Malaysia. For if you can see now it's a different regulatory organisation and they issue different products as well. So we have the accounting and audit organisations, AAOIFI, we have international Islamic financial markets, we have a general council for Islamic banks and the financial institution. We have the Islamic financial services board. We have an international Islamic rating agency as well, IRRA, so at least four or five regulatory and I think this is what makes the people confident as well. For what we need now, we need to make the Islamic finance standard and you have a standardisation of a practice. We need to filter all the products which are all over the world and make one organisation umbrella for all of them which is only one organisation. Like we have international financial reporting for the accounting for example, we have the financial accounting standard board in America so we have to have this mandatory, not compulsory, not actually should be compulsory, we need to have not options, we need to have this regulatory and I think as well another issue which come out of this which I think it's very important, it's qualifications as well. You can see how organisations in Malaysia, another one in London, another one in America, another one in Dubai, all of these you don't have a knowledge of the qualification as well. You see CIMA, Chartered Institute of Management Accountants provide as well as qualification with Islamic finance, we see as well a lot of association of business practice as well, providing a qualification. You see the Islamic bank and the insurance organisation in London or Dubai as well. You have in Malaysia as well. I think there's a stereotype coming as well from the practice itself so I have to be honest with you and tell you this is stereotyping, we as Islamic finance practice people whether in academia or its practice, we are the reason behind that and make confusion for the normal people no details about the Islamic finance because they are not need from us details, just only need common practice and will be standard practice.

Q: How do you think the lack of standardisation and lack of a common practice is currently affecting the Islamic financial system?

Yes I think the lack of the transparency of the Sharia board affect a lot on the Islamic finance and even we still have a different way to provide Islamic banking through the window for example or through the microfinance or through the full branch of Islamic finance product. Even if you have all of this in place but still as well the lack of the common practice among in Egypt and even the Soviet country because you found here in London for example one bank in London to provide a product, another bank in Manchester provides another product and plus they are contradiction for each other.

Q: In terms of AAOIFI and the IFSB, I mean they are central regulatory bodies that are meant to basically bring together Islamic finance under a big umbrella, do you think they're doing their job?

I think they do the job but the problem because it is not mandatory. Their standard it is optional. It is not something you have to use it but if you make their standards mandatory and compulsory you have to do every organisation and this will be the solution for that because these institutions are playing a key role in setting up and the standard edition Sharia yes. In financial the account be standard yes but this is not something we really embedded as a 'should-be' but it is like our options, the bank they can take it or not use it.

Q: Sure. How do you feel about a lender of last resort in Islamic finance? So say for

example in the UK we have the Bank of England, do you think the Islamic financial system would benefit from a lender of last resort?

What do you mean?

Q: Would Islamic finance benefit from a lender of last resort, so in essence a central financial bank to aid Islamic financial institutions globally?

I think if you mean about the support you can get it from your government for example. I think they already start and do that, for example in the last global Islamic finance conference which the first time it is in London and I think it's David Cameron the Prime Minster of the UK, he announced about government will issue a sukuk for next year around £350 million for sukuk is Islamic way and this has boost actually, boost as well the Islamic finance and started people thinking about that as well. I think Islamic finance they have to use this facility especially as well we have a lot of companies now, they bankrupt because the level of debts which already the mountain on it, so if these companies they start to utilise the Islamic finance or the Islamic finance people like Islamic finance institution if they start, think about how we can use this climate to provide a real, and this is what I mean, a real Islamic finance product, it is not only a copy of the conventional banking and they change the name because you have to be honest when you go to structure the financial product and maybe there is another issue as well about the profit maximisation because we know now the capitalisations and the profit maximisations and the globalisation, all of this too has a bad impact on the society. When we have the profit maximisations target this will be a problem and this is why the Islamic finance comes here and said okay, we are not targeting the bottom line and to make a profit maximisation. No, we're looking for a reasonable profit which is a profit they can make plus you can make as well a contribution to the society and this is why the Islamic finance has a role to play here in the West and even as well in the East as well because the problem is the problem. We have the social justice problem, we have the lack of resources and the banking sector now has started to dry up and there is not enough resources to help the small business as well and even the government, when they go to bail out the bank, they try to help the bank to stand up and they help the business people and they help the individual as well. If we're helping the individual plus helping as well the companies because if the company it is up and running again, you will create jobs, will create product and we use it but Islamic finance has a role to play here, therefore Islamic finance you can come up and say yes we have a model here which we can prove it is the right model for the financial crisis which we are for the last five years now, from August 2008 until today and will come from bubbles to another bubbles from problem to another problem and is not sorted because we are not looking for the root causes of the problem but to try to solve the symptoms of the problem, looks like if you have a headache, you don't have to give treatment paracetamol, you have to diagnose for it. What is the cause of the headache? Maybe it is from the eye, maybe from the blood pressure, maybe it's another reason and after you diagnose the reason behind the headache, you can start to write a prescription and remember, when you go to the GP he can explain to you one hour to ask you about questions to identify exactly where the root cause is of the symptoms you've got and within five minutes he can write the prescriptions which we sort out so we need to spend more time to think about what is the root causes of the financial problem we've got and the social justice we got problem of all the problems we got, financially or economically we have to spend more time to diagnose the problem, to identify where exactly the problem and within this time we can describe it and Islamic finance have this which if the Islamic finance practice academia, they can play a role on that but to give straightaway the paracetamol without knowing why the root cause is the problem and this what is the problem now when the government and the companies they start to reduce their deficit, they would like to reduce the debts. Why? Creating more debts and more loans and this is the same problem because the main on the principle of the problem is the root cause if the problem it's the relationship to areas the relationship between the finance organisation and the customer which as the customers you are a company. If we can't get this relationship correct, the structure of the product according to this correct structures, we can solve the problem within this time but to go around, around, around by talking about we need to push the economy by putting more debts and debts and debts and this is a problem and you can notice as well for a lot of years, it's not only the individual you corrupted or the individual they bankrupted, no but we have as well the company bankrupted how many companies you already out of the business and it's not only the individual or the company, they are countries as well and you notice as well for the last couple of years how many countries you already and you have the Greece, it is not far from us and the protocol is not far from us as well, it's all here in front of our eyes and you can see how all of this, the Islamic finance has a role to play on the global, the local, international level and the individual for the company and for the country as well.

Q: Sure. In terms of standardisation, do you have any proposals as to what can be done to standardise the Islamic financial system?

Yes I have actually a proposal on that which if we can filter what you already have, whether it is in the practice. If we have 350 financial institutions call themselves Islamic finance or Islamic banking or asset management or fund manager or pension fund or whatever, or insurance company, if we can look on this product, if we have allowance maybe 100 or 200 products, if you can make those products common products and you can see exactly where the product which will suit the people in America, the people in England, the people in Indonesia, the people in Egypt, the people in Syria, the people in Iraq, we have the product but first we have to look what is existing and we try to eliminate the one it is has not common product and they take it out and we can have a filter which is telling us which product will be fit because there is the Islamic principle and rules and this will be the standard and will go to measure this standard. If you know if you have a different method, different method like we have Hanafi, we have Hamberley, you have Malik, you have different ones, I mean we try to make sure those four they agree about as well, about something. Even if we say the Maliki for example he do not agree about bay al'dayn for example when you go to sell the loan another scholar say no we can't do that. If we cannot agree about the difference, all we can work on what we agree upon before we agree about what or we can standards what we agree upon and eliminate what we are not agree upon and this is my proposal. First I don't like to re-invent the wheel and produce a new product which will be a standardised product but I would like to filter what we already got and we can take it forward and we can use as well the four organisations which I mentioned. These four organisations you can sit together and see exactly what's your standard on that, what's your standard on that and you can see the standardised of that like the international financial reporting done with a local accounting standards because we have a local accounting standard for example in the UK and you have a local accounting standard in America as a national standard and now we have international accounting standards therefore we have to make sure we have the international standard which fits all the four or five organisations.

Q: Sure. Just the final few questions. In terms of the problems of standardisation, how do you think that will affect the governance of Islamic financial institutions?

Yes, we affect by reducing more people taking more money and it makes the product really expensive because once you've got a standardisation means you can have an organisation not an individual scholar and you can apply for this in organisation which is international and all the scholars are now all the financial institutions, you can see like one scholar he working as a scholar for the Sharia committee for 50 banks therefore he didn't have time. He was like all his time just to transport from bank in Malaysia to bank in Saudi Arabia to another bank in India to another bank in Australia or the bank in Canada or the bank in Germany because now we start to expand. All of the Sharia scholars should qualify it and it is something we don't have yet. We don't have organisations which graduate or a give a qualification to be Sharia scholars. All what we've got now, it's the people they are educated on Islamic institutions like other university and they study this and they don't have enough knowledge about financial transaction in the reality and this was the problem as well for if we can make a standardised of the qualification with the Sharia scholars should have, it means there is a curriculum and this curriculum it is based on the standardisation as well for all the Sharia for only go to teach accounting for example in the student in England, they teach accounting to the students in America the same principles, assets, liabilities, equity, expense, revenues so we know what is the matching concept means for if you have a concept and principles, all of this will be standardised as well. Therefore if we can go for the standardisation will affect the scholars and this is maybe they are not deal with me because it's a business, it's a business for them because they're working for different banks but if those people they think outside of the box and say we are clear about the future for the Islamic finance and if you come up with how many scholars for the Sharia government, for example Sharia committees for all the 350 institutions for example plus, we're talking about 1,000. Less than 1,000. If you think these 1,000 pupils they can work under the one institutions which you come up and those people are still working as well, they are not going to lose their business but they're still working but to be honest because there is more money involved and this is something like, what they call it? Selfish interest not the interest on Islamic finance as an industry.

Sure.

Sorry, I am very honest.

No it's fine.

Thank is why I am just telling you what I'm feeling and what I can comment on that.

Q: That's what I'm looking for, for someone to be honest as opposed to just beat around the bush. You mentioned basically one Sharia scholar sitting on five Islamic boards, do you think that's a good thing or do you think that's a bad thing? Do you think that's a problem there?

I think it's a problem here. Why? Because maybe it's the same scholars if you work in Malaysia who will approve a product there and the same scholars go back to Middle East which do not approve of the same product will approve as well so looks like a contradiction because the same scholars he works for two banks and the two banks based in different region. In this case it's no good for the industry and makes confusion as well and the more stereotyping for of course we are stereotyping about Islamic finance but if you have all these facts, they got approved from one institution and those people they work it under these institutions which will give them the standardised. This will be the good thing for the industry but it's a bad thing for him, for him or her, as an individual because they go to work only at one institution but you are not working for the different five banking for which you can get more money. To be honest, this is what I see. Maybe it's not all of them the same but this is what I see. I see different scholars, they work at different banks and they charge huge money to approve the product to be honest and as well once they charge as well the huge money of the product this will cost of the product itself and this will cost the customer but if you can have single institutions with a single approval will make the cost for the product less in this case. When they good for the society come back again to the society which is helping the society by providing them the right product with the right price and as well not a confused product.

Q: Sure. Just the final two questions. What do you think are the risks for Islamic finance in the future?

What do I think about what sorry?

Q: What do you think are the risks for Islamic finance going into the future?

Risking as an investment, like a business risk or a risk like risking the Islamic finance system?

Q: The financial risk.

Yes the financial risk, yes. I think we should take in the Islamic finance as a conventional finance we should take consideration of the risk but what we call it in Islamic finance call it a calculated risk. You have to take consideration of the risk because you still have a risk when you have a partnership with your customer, if you open a business and you still have a risk for losing your money. With them you have to be careful with who you go to give the money to and very important as well, you had to do what is called a risk assessment. Risk assessment of their capability to run the business and the risk assessment that they have the ability to pay that or to pay the return when the business is up and running and they make a profit because the Islamic finance it is helping, not helping the failure but you should recognise the successor and give the incentives for them to start up another business but to be honest the conventional banking, they reward the failure and it gives them a lot of money they don't deserve but the Islamic finance we have to as well be careful where we go to get and who will be partner with, whether they got suitability, they got qualification, they got the way to run the business efficiently and the effectiveness and profitable as well but when I say profitable, not a maximum profit but will be the reasonable profit and profit which does not harm the community which always I say nothing wrong if you can do good but at the same time you do well. Doing good while you're doing well.

Q: Final question, where do you see Islamic finance in about five or ten years?

To be honest if we didn't start from now to identify what is the problem with Islamic finance we go to stay as it is in five years but if we start to identify where our problem within the people in the Islamic finance, not the outsider and try to say where the standardisation, where is the development, where is the qualification, where is the education, where all this if you have got the solution for all of this because what I can see, the problem now with the Islamic finance it's standardisation. It's Sharia scholars' qualification and the third one it is development of the product which the scholars research and development. We have a lack of that. We just only copy what is the conventional banking and started to sell it as we change only the name and the fourth element it's human resources which I call it human capital so if we know where we can do in these four areas and this lack of the problem, we will tell in the same way, like exactly five years ago we have the financial crisis and we're still in the financial crisis and we will go to stay in the financial crisis. Why? Because we didn't start where is the problem and what is the plan to solve this problem. If you can say Islamic finance will grow, it will grow only if we can identify this problem and start to put a solution as action plan for the future. If you don't do that I think we will be just only a bubble like the normal financial problem and bubbles and also we said Islamic finance grew by 15%. Yes but it's not real Islamic finance, it's just only a bubble and it might have again a problem and we saw the problem in Dubai and the United Arab Emirates as well when they have the collapse of the properties and you have a problem as well with the debts.

END

Academic 2

Q: How do you think conventional financial systems view Islamic finance?

I think it depends in part what you mean by conventional so I think in the UK context certainly the last Labour government were very interested in Islamic finance because it ticked various boxes about social inclusion. The former Labour government were very interested in the social inclusion of Muslims so the idea that people weren't getting mortgages because it offended their religious faith they saw as a problem. They also saw a very clear economic agenda with it which is about positioning, the city of London as being always at the cutting of what is going on in financial markets, be it Islamic finance or carbon markets or whatever it is so I think they saw, yeah I think it in part depends what sort of flavour of government you have in place. With the new coalition government I would say there's less. Islamic finance is a harder sell or there's still a very clear economic rationale for it in its various constituencies the city of London are interested in but I think the whole sort of social agenda has sort of fallen, well is less significant than it used to be and there's lots of, you know there's lots of popular media about, you know post 9/11, you know about the dangers of Islam and precious civilisations and all this and a lot of sort of cynicism I think about it, so it varies, I think it's very difficult to talk across the piece about how conventional finance views the Islamic finance and again there's so many different variants of Islamic finance. If you look at the differences between the Malaysian version which is much more liberal than the Gulf version, you know it's not one sort of homogeneous entity that you're talking about or trying to sort of generalise about.

Q: Sure. I mean in terms of that social inclusion facet of Islamic finance, I mean it gets very much pigeon holed with ethical financing, do you think they're very similar in nature in that respect?

Well certainly the way that Islamic finance has been trying to position itself, again I mean I talk primarily from looking at a UK context yet they certainly, I mean people like the Islamic Bank of Britain have looked to market themselves as an ethical bank and whether they, and they've said, you know, you can come in here and get an account and people who would normally use like the Co-op Bank, you know, can come here or people who want a more ethical version of finance, so they very much position themselves as an ethical entity and not a religious entity but yeah, I mean you look at some of the principles, things like profit and loss sharing and they sound, you know they sound very nice, they sound very sensible about, you know, keeping the sort of financial economy and the productive economy closely tethered together. It all sounds very good and they are very clear about whey they don't like interest and why they deem it as exploitative and unfair and, you know, fundamentally asymmetrical so I would see, yeah I would see very close links between at least the principles and not necessarily the practice.

Q: Sure. In terms of the social inclusion in terms of ethical financing, do you think like that's the main selling point behind Islamic banking and financing in terms of being a more social solution to finance?

I mean I think there is certainly a political space at the moment for thinking about alternatives to business as usual but that's talking all sorts of forms so that, you know, it could be crowd funding, it could be, there's all sorts of new sub-prime lenders moving in, there's you know credit unions of Islamic finance, there's all sorts of institutions. I think the real test is probably for all of these things is going to be economic so I think the economic interest in Islamic finance and, you know, getting London a space where it can secure lots of fee income by looking after all that excess liquidity in the Gulf States and things is probably going to be more important in what drives it and the government's interest in it than any kind of social inclusion agenda. I mean there's lots of talk about alternatives to mainstream banks, about making our big banks smaller and more socially responsible but you know actually remarkably little has changed in my opinion since the crisis of 2008 and the banks are extremely well organised to prevent any kind of major change. So I think if Islamic finance is going to do well, it will do well because it's a vehicle for getting access to money from parts of the world that have got more money than the UK. I think it will probably be the economic agenda that drives it.

Q: Sure. I mean being socially responsible plays a big part in the whole scheme of like conventional corporate governance. One of the main issues with corporate governance and Islamic finance would be the transparency of the Islamic financial system. What do you think about that?

Well I mean they're famously opaque, I mean in terms of ... one of the interesting things, we had this project with a guy called Michael Samers who is at the University of Kentucky and we were looking at the role out of Islamic finance in the US and UK and one thing that becomes clear very quickly is the reliance on this very, very narrow base of Sharia scholars and you would talk to people about where those scholars come from and what qualifications you have to have and it's very much a taboo subject and it's not about educational qualifications or there aren't any transparent criteria about, you know, what you have to do to be a Sharia scholar, it's shrouded in mystery and that's part of the whole sort of cache of getting one of these positions, it's about religious authority, it's not about, you know, education per se or experience, so it's famously opaque how certainly this tier of Sharia scholars, where they come from and how they're formed and that's been a huge issue because the industry has grown, there's been a huge growing shortage of these scholars. A lot of them are guys in their 50s, 60s or 70s who now sit on 50 or so Sharia boards and there's not enough of them, they're now very expensive. There's delays in getting things approved and sanctioned because they're so over-worked. So the question of where this new generation of scholars are coming from and whether you can increase the supply of them is a huge issue and it's a very difficult issue for people, certainly I think Muslims to talk about. When we talked to people about the FDIC they would just say how they do that, you know it's not our problem it's theirs and they had absolutely no idea how about that sort of layer of government and as long as it didn't sort of interfere with, you know whether those are reasonable people to be running a bank then it was, you know as long as it was outside the boundaries of what they had to deal with, they thought it's not their problem but yeah I think the whole transparency thing is a problem but I would say it's also a problem for the whole, yeah what has corporate social responsibility done for transparency of Barclays or HSBC or Lloyds I mean so I think they have problems with transparency in maybe different ways.

Q: This issue of Sharia supervisory boards and Sharia scholars is quite a pertinent issue within the literature, I mean how do you feel about the notion that Sharia scholars are

headhunted or, you know, basically selected for leniency in terms of the interpretation of Sharia law?

Well I mean people in the industry say it's absolutely crucial. I have a PhD student at the moment who, he's a Nigerian man, you know Muslim and said yeah, you know, people follow different scholars and people from you know a certain demographic, from the Gulf or particularly a part of Islam will follow certain people and not others and it's absolutely crucial they are what, you know, and it is the word of the Sharia scholar and not the property of the mortgage that is crucial and people like Bill Maurer who's done a lot of work on Mortgage market in the US has pretty much found the same thing but recruiting the right scholars is absolutely, if you want to have any credibility in these markets then you have to have your scholars lined up and also you need your local Imams to be saying yes this is halal, it's reasonable, it's okay and if your local Imam is saying no, no, no this is all smoke and mirrors, you know it's invested under another name then people are not going to go for it so the role of the scholar, yeah I mean I know HSBC were very, very careful in recruiting who they did but yes you have to know who your demographic you're targeting is and which scholars they will listen to.

Q: Do you think there's also a lack of transparency when it comes to legal and regulatory standards in Islamic finance?

Well I mean there are, I mean there's things like IFSB and AAOIFI, I mean they now are trying to sort of harmonise things, I mean they're doing the equivalent of Bal and they're doing the equivalent of sort of Islamic accounting standards so, but yeah I mean there's always going to be an extra layer in there of adherence to religious authority which, you know for people who are not of that persuasion or you know we'll always see a strange extra layer of accountability but yeah I mean there's been issues with regulatory harmonisation but again that is AAOIFI and IFSB are trying to do things about that then there's also, you know when we talked to people in London about that they said oh yes, you know, we always like to talk about the need for more harmonisation but you must remember how many lawyers are making an awful lot of money out of the fact that there isn't this harmonisation and that, you know lack of overlap of harmony between different sets of regulations creates a lot of work which is very good for all sorts of people involved in financial services so, you know, making Islamic finance work in the UK regulatory context it creates jobs, I mean it creates work for people which you said, you know, so people might complain about the lack of harmonisation but actually it's a good thing for the people who have to work about, you know, being consultants at IBB and telling them what they have to do to get a licence to bank in the UK, etc.

Q: What do you think can be done to kind of improve the level of transparency, because it's very opaque at the moment, it's very much ... do you think it needs improving or do you think that the level of transparency is kind of like the way it will be in the future?

I think, I mean the signs are that there's more and more, certainly through things like AAOIFI and IFSB, that they are doing things that in many ways mimic, you know, super national regulations that affect non-Islamic banks and indeed one of the critiques of the Islamic banks is that the more mainstreamed they look then the harder it is for them to assert their difference from mainstream finance, so on the one hand they need to sort of harmonise and become more transparent and then if they do that it makes them look more like the kind of institutions that they're supposed to represent and an alternative to so they're sort of damned if they do and damned if they don't so I think, yeah I think AAOIFI and IFSB will oversee more harmonisation but I'm not sure that that lack of transparency per se is going to be, well you know Islamic finance is still growing very rapidly so I'm not sure it's going to be a huge stumbling block in the next little while.

Q: Sure. Onto this notion of harmonisation, I mean you kind of indicate that harmonisation in the UK or the lack of harmonisation in the UK is kind of a good thing because it creates more jobs but if we were to look at it from an international context, say for example throughout the Islamic financial hubs, Malaysia, the Gulf, the UK, do you think that lack of harmonisation is a problem in that respect?

It's difficult to say. I mean I think it depends in part, you know, who wants to use Islamic finance and for what ends so I think if you're doing, you know if you've a sovereign wealth fund or if you were doing international trade deals then yes the lack of harmonisation or if you're a government looking to issue a sukuk or something, that lack of harmonisation might be something that would worry you. If you're a middle class Muslim in the north of England with an Islamic mortgage in the UK then you know I think as long as you've decided it's halal and that it's Islamic then I think it's probably irrelevant to you. So I think it depends on which sorts of markets we're talking about and who is using these products.

Q: Sure. If we were to look at it from let's say a multinational prospective or even a sovereign perspective in terms of trying to develop the Islamic financial system so we're looking at the macros perspective of Islamic finance, I mean would the lack of uniformity be an issue for Islamic finance?

Well I think yes, I mean I suppose at that level it would be but I think also there's a lot of, you know there's a lot of stuff being written in the sort of the IPE literature about the need for a more plural and polycentric international financial system so you know one of the things that happened out of the 2008 crisis is people look to the Canadian banks and the Australian banks and said why weren't they, you know why haven't they suffered as badly because they weren't playing in the same derivatives markets as UK and US banks and they weren't allowed to join the dance and had come out looking, you know, relative so there is, I think we need to be careful about not representing you know interest base finance again as this sort of transparent homogeneous entity that is harmonised because there clearly are a difference between you know the German banks and the UK banks and some economies are much more financialised than others so I think, you know, I think there is plurality in the international financial system and the Canadian banks have been working in different ways to British banks, even though they would get called, you know, HSBC or whatever, so I think the fact that there are these different models of Islamic finance, I think the interesting thing is I think that it's still growing and how it positions itself as an alternative and then there's this, yeah there's this huge internal debate about what kind of alternative and is it, you know, capitalism with an Islamic face or is it some kind of alternative and there is no agreement on that within Islamic financial circles so you know I think it's going to take a long time and a lot of people wouldn't want sort of harmonisations or want model. I think part of its, the lure is it says that we're different to this and that there's difference variants of it and in the same way that, you know, the co-ops now are getting more attention in Germany and that there's more interest again in regional banking and, you know, socially responsible banking, there's all sorts of different variants, whatever kind of flavour of finance we're talking about that people are interested in so it's difficult to sort of say at that macro level really.

Sure. I mean one of the few criticisms in terms of you make a very salient point in a sense that no financial system is actually completely similar to another financial system. I mean in terms of one of the criticisms would be the underlying regulatory framework. Say for example in conventional finance we have the Basel Accord dictating capital adequacy levels. Do you think something like that would be needed in Islamic finance, say for example just a fundamental framework to kind of work around by?

Yeah my understanding is that people like IFSB are basically starting to do that thing, I mean they are basically looking at capital adequacy issues and trying to get people to sign up to say right this is, you know we're all going to have, you know, reserve ratios and X and things like that so I think they are trying to do that and they very clearly looked at Bal as a model that they can use in the Islamic world which again some people see as a good thing and other people say well, you know, if you're going to start doing what Bal is doing then why don't we just call ourselves regular banks yeah so it's very difficult for them if any kind of Islamic institution look to form sets of standards, you know, whose standards, where do the standards come from if they're just going to ape the standards of Bal then some people will say that's a great idea, it makes it much more clearer, it's easier to harmonise and others will say well what are you doing, you know, why do you want to harmonise with them so this is just sort of constant jostling about, you know, how they position themselves as being different to conventional finance but how they also, yeah, position themselves as being, you know, safe and responsible and being transparent and having reasonable capital reserves if they get into difficulty. But I think IFSB have certainly looked at Bal as their model for how they come up with a set of capital adequacy rules for Islamic banks.

Q: Sure. What do you think about AAOIFI and the IFSB, do you think they're doing their job? Do you think they're evolving?

Well I haven't done any sort of work in particular on AAOIFI. I mean they are basically, you know, sorting out the accounting, I mean they sort of have the accounting standards that a lot of the banks are signed up to and they, although a lot of their rules are not binding, they are this beacon that when what's his name made his sukuk ruling, when Ismali made his secret ruling that he thought something like most of the Islamic sukuk in circulation had moved away from the spirit of Islam, you know, and he was the head of the AAOIFI committee that looked at it, I mean they've since changed their mind again but there's been a huge dent in the sukuk market globally so they were very, very powerful organisations. Whether or not, you know, they could be doing a better job or not, I don't really, I don't have a sort of strong sense of that.

Q: Sure. I mean in terms of a central regulatory body there've been calls for, say for example, an Islamic central bank in order to like, you know, basically regulate the market and provide a lender of last resort type role. What are your thoughts on that?

I think, well it would make, I mean a key element of any banking system is yeah the notion of this sort of hierarchy and where the lender of the last resort is so I think, again it depends on which context they're working in so the Islamic bank of Britain to get a licence to bank in the UK has got to meet, you know, it's got to meet, play by the same rules as every other British bank which also then gives it a licence to, if it wants to, go to the Bank of England as lender of last resort if they're short of money yeah so they do the same things if they're short of money as if, you know, Barclays got into trouble so yeah there's always an issue. I mean one of my interests in this is that I'm a geographer so these things, these institutions I've always embedded in particular context which have a whole set of rules and regulations which is different in the US than it is in the UK or in Germany or in Dubai or in Malaysia, yeah so there's always local rules about capital adequacy and who the lender of the last report is and then the question is whether you build these, you know, either national versions of a, you know, whether you'd like go in Malaysia route and have dual track banking and you have, you know, an Islamic lender of the last resort or whether you have some sort of super national agency but I think it's very difficult to sort of think about Islamic central banks I suppose in the sort of abstract without thinking about which territories and legal contexts they're actually going to be plot down in and how they again, they've always got this issue of adapting to what rules are already in place about how banks function and what they do if they get into difficulties so again it's not like you're sort of designing a system from scratch, you are always going into the context where there are other institutions that deal with, okay, you know, financial institutions have got into difficulty, what happens now so for Islamic Bank of Britain it's the Bank of England, that is their first port of call and then it's, you know, presumably whatever funding streams they may have from the Gulf if they need to raise new capital beyond that, so there's always going to be a particular context institutions have to be embedded in which will determine how they, you know what the lender of the last resort is and what it can be, if that makes any sense?

Q: Sure. I mean one of the main idiosyncrasies about Islamic finance would be the fact that it's trying to balance kind of like a social religious corporate governance objective, you know, motion with that of a financial system that's meant to make money, I mean in terms of corporate governance, what do you think are the main issues that could plague Islamic finance?

Well I think it is probably the tension of deciding what they're there for so there's this real tension between, you know, there's loads of liquidity in the Gulf. Is it about big, I mean one of the criticisms of the industry is that it's not done a lot of profit and loss sharing, it's done an awful lot of murabaha deals which look, walk and talk like interest and that it's been the rich clients in the Middle East who want to come and, you know, buy up commercial property in London. He's not done a lot to help, you know, the poorest of the poor, you know he's not done a lot to help, you know, working class and middle class Muslims buy their own homes or to help, you know, small entrepreneurs start businesses in the east end of London yeah so one of the critiques is that it's been about, you know, it's used murabaha deals that most resemble interest based finance and it's helped large property developers and rich people rather than getting involved in retail markets and I think that's a crucial issue for how it rolls forward and people in the industry would say well don't judge us too quickly, the industry is still very young, you know, we're getting more involved in smaller loans and micro finance but things like profit and loss sharing which goes to the heart of the morality of Islamic finance, you know it's very hard to price those contracts so there has been this sort of default to making money the easiest way and the quickest way which is murabaha so I think there is this real struggle for the sort of soul of Islamic finance and whether it is just another niche and another way of making money very quickly or whether it is going to be different and try and do something else.

Q: Do you think this notion of like mimicking or even following conventional finance, you know, do you think that's hurting the Islamic financial system?

Well again I mean it depends who you ask so I think for people who like to think that Islamic finance is something different, they just say well, you know, the industry has sold its soul, yeah if it's now got a Dow Jones Islamic index then you know we might as well pack up and leave yeah, we're just becoming part of the mainstream and we've lost our sense of difference and there's others who say, look we have to be more practical, we need a Dow Jones Islamic index, we need to be in the city of London, we need a division in HSBC because that's part of making Islamic finance accessible for people in the UK or the US or whatever so there is a battle between the sort of more religiously inflected people who are interested in the morality of Islamic finance versus I think more of the sort of banking mentality that says look we need products, we need to be practical and yes we need to make money and one of the attractions of capitalism is that in various parts of the world at various times it has produced lots of economic growth and that's what we need in places like, you know, the Gulf and if we can harness capitalism for Islamic ends through things like Islamic finance then, you know, in places like Malaysia it's been pushed as a way of generating economic growth and it's the economic sense of it that has won through and scholars there have been told to not be constrained by Sharia law but explore the boundaries of Sharia to be innovative and to make things happen in the name of economic growth so I think it depends which constituency you talk to. Some would already say Islamic finance has sold out, you can forget it, others who would say no it's been very pragmatic and practical and if it's going to grow and become an alternative, it has to get embedded in places like London and you know wherever so again I think there's a real tension in the industry about whether it's a good thing or a bad thing, the mimicking and you can find people who will tell you both sides of that argument.

Q: You kind of mention innovation being very important to the Islamic financial system in terms of growth and development, I mean how do you, are these constraints in terms of uniformity and transparency, are they placing increasing constraints on the level of innovation or would that be, you know, just another day at the office really in terms of financial innovation?

I think, I mean there are places like Malaysia, I mean initially when Malaysia came up with sukuk, you know the Gulf states refused to recognise them but now you know that's moved so I think my sense is that if the industry is making money then I think that will drive innovation and there's now talk about, you know, Islamic derivatives which again will make some people want to just turn off the light and go home, other people are saying this is great, you know if we can now start having derivatives in Islamic finance then we can really start making some money so I think you know the fact that Islamic finance is popping up all over the west and it's having to make itself a home in all sorts of legal and regulatory environments means that it's always innovating and sort of compromising and fudging and making itself fit in so many environments, I think it's very good at innovating and making do and doing those sorts of things so I don't sort of see the innovation as a big problem.

Sure. Do you feel there's a need for more innovation in terms of product structures and governance standards?

Well yeah I mean I think, I mean one of the things I've been interested in is the retail markets which are tiny now in the UK and there's a very, very small, there's very little action going on in things like mortgage markets and if you're going to talk about or if they're going to talk about the social inclusion agendas then you know they have to somehow convince three million Muslims in the UK that Islamic finance has got something to do with them and isn't just about big sovereign wealth funds and rich investors from the gulf so I think products that make sense or that, you know I once did a project in, I used to work at the University of Birmingham before I was here and I had a colleague who was working in ethnic minority sort of entrepreneurship and he said that, you know, Somali entrepreneurs who were very devout Muslims in Birmingham and they would have their businesses go to the wall rather than go and get a loan from an interest based bank so for them, you know, had there been some sort of halal funds that supported small businesses then, you know and he was making a series of policy recommendations about these funding gaps of small businesses, I think products, yes a different demographic and a lower income Muslim I think are very much needed if Islamic finance is going to become anything other than for the very rich. I would say the key area where they need to do more to innovate and also to try and persuade people that they are interested in them.

Q: So develop more as a microfinance institution or a microfinancial system providing finance needs to small/medium enterprises?

Yeah and also just things like mortgage funds, so not even microcredit but just loans for businesses, you know loans under £1 million. There'd be people in the clothing industry in Bradford who might think about going and getting halal loans rather than loans from interest based banks but those products would have to be competitively priced and they would have to be, you know, have the endorsement of scholars that were credible in those constituencies but at the moment there just aren't those sort of things. I think the US has a more developed market in terms of like business lending that is halal but it's certainly not happening in the UK at the moment.

Q: One of the recent developments in Islamic finance in terms of the academic literature would be the fact that, if we look at it from a prospective of the users of Islamic finance there is not much legal protection or not much legal standards protecting them from should anything happen. What are your thoughts on this?

I'm probably not the person to ask. My understanding with certainly like the retail end of it is that you know Islamic Bank of Britain are regulated like any other UK bank so one of the sticking points when they first wanted to get their licence was that they had to, to get their licence, they had to like guarantee your deposit, you know 100% if I put my salary cheque every month in the Islamic Bank of Britain and they go bust next month then they can't, you know I have to get that money but yeah I'm guaranteed 100% to get that money back and of course the issue of IBB was well, you know, nominally they would be profit and loss sharing so, you know, if they make a loss they can't guarantee and if they make a profit then you get something that doesn't get called interest but looks like interest and one of the things they had to do was persuade what was then the Financial Services Agency that they had to take an undertaking that if necessary they would borrow money from the Bank of England which the Bank of England couldn't guarantee would be Sharia compliant that they would use to make good any money they lost on current accounts and they had to do that to get a licence but you know there was no category of like deposits in Islamic Finance, it doesn't exist so that was one of the biggest sticking points is that how do you guarantee that customers will not lose money in those kinds of products. Now I don't know how it works in, if you're talking more about large corporate clients who are trading in different products but I know there's like a deposit guarantee now that works as IBB but is the same as Barclays or Lloyds or whatever so in that sense consumers have exactly the same protection as they would have in mainstream retail banking and that had to be done for them to get like, it would not be possible for them to function here without that or to have that. They couldn't have a banking licence without it. But yeah how it works for Islamic whatever, private equity firms or whatever, I couldn't tell you.

Q: Sure. Just a final few questions. In terms of Islamic finance going forward, what do you think are the main risks involved with the whole financial system? Do you think there are any areas that need improving? Do you think there are any areas that are improving drastically or is everything okay at the moment?

I think the key thing is that lots of Muslim consumers don't know what Islamic finance is and they're very cynical about it and they say well how can I get a mortgage, you know how does that not involve interest and they see it as using smoke and mirrors to try and ... I think the whole issue about what is Islamic and people seeing that that is authentic, however they define that, is absolutely crucial to the credibility of the industry and you know so lots of people were very excited here about Islamic Bank of Britain because it was a completely Islamic Bank whereas people have looked at HSBC and the Amana division within it and they'd say well how on earth can they really ring fence the Amana division, how do we know that that's really, you know it's not an Islamic enterprise, you know it's a profit centre within an interest based bank so people were often uneasy about that, even though it gave much more exposure to the market so I think there's a lot of cynicism out there about Islamic finance because lots of Muslims don't believe in it and I think the key danger for it is just being seen as another sort of fashion or fad that's about making some rich Muslims some money. So I think that's the key thing about how they persuade people it is an alternative and that's a huge problem for, you know, whether you're the Co-op Bank or whether you're a Credit Union or whether you're a Pay Day lender or whether you're an Islamic Bank, you've got this huge problem of how do you persuade people that you're alternative because you have to sustain yourself by making money and you've got to make a sufficient amount of money to stay in the business and to grow and to keep investing in your IT systems and to be easy to use and all these sorts of things so that's a very, very difficult tension.

I mean in the current economic climate, what do you think is the scope for growth for Islamic finance?

Well part of me would like, I mean I'm fairly cynical I suppose about the way it's been practised in the UK, I mean I would like to see, I would like to believe in Islamic finance, I would like to think there are institutions out there that are genuinely more interested in supporting economic growth and in, you know not just making, not just getting rich quick but are interested in supporting entrepreneurs and doing things and working in tandem with the product and economy. I think it's a very nice set of ideas so I would like in that sense to see some institutions be able to do that, whether they're called Islamic Banks or whether they're called government industry banks that they're now setting up to fund small businesses and I think there is a huge need, there's a huge hole for institutions that can come in to these sorts of places and provide credit at reasonable cost to people who need it and I think Islamic financiers are one group who could be in there but I think they need to develop their product base to deal more in those markets and yes those markets are very difficult and they're hard on the price and they make less money and in all sorts of ways they're less attractive in terms of their economic potential but they are hugely important in terms of supporting economic growth. Part of me would like to see it do well and I think there is certainly a niche for different kinds of institutions that sell themselves as something different.

Q: Do you think Islamic finance will ever be viewed as a viable alternative to mainstream finance or do you think that it will always be a niche product in terms of what it offers?

I think in the foreseeable future in a UK context it will be a niche product. I mean there's lots of different alternative institutions but they're all small and again if they stop being small and start becoming big then people start saying well, you know people it then becomes this problem for them although they seem to have been mainstreamed or co-opted but yeah I think Islamic finance and again the levels of sort of Islamophobia in the UK, Islamic finance is going to be a niche product I think for the foreseeable future.

Q: Do you think the whole notion of Islamophobia could ever be eradicated in terms of developing the financial system or marketing the financial system?

Well I think, I mean I think there's lots of professional people in the city of London who are very happy with Islamic finance while they're making money for it. I think in terms of sort of the development in more consumer markets, I think the right wing press would just have a field day with it and I remember when I was in Australia looking at Islamic finance, there was all this stuff in the press about it's outrageous, Islamic Banks here offering immigrants loans with no interest and us poor Australians, we have to pay interest, it's not fair, you know it's like immigrants getting free houses and all this and then you point out well actually they're paying all sorts of other things for these loans. It's not called interest but I think if the Daily Mail started getting hold of Islamic, you know if Islamic finance started looking too good you can be sure the Daily Mail or somebody would get hold of it and be talking about how it's a threat to British sovereignty or something crazy like that but at the moment it's too small to worry about on that score but I think certainly since 9/11 and I think with the change of government there is more Islamophobia and less interest certainly in the arguments about social inclusion of Muslims and the debate moved much more to immigration and why don't we deport more folk and all this kind of stuff rather than understanding how things work in the east end of London or what possibilities, what sort of progressive politics could be built around these kinds of alternative financial services.

END

Academic 3 and 4

Q: How do you think conventional financial systems or conventional financial participants view Islamic finance?

Aca 3: I think they are, I just want to say sceptical but I don't think it's so much sceptical as an inability to understand how it differs so it's a lack of understanding of the principles and a perception that it's essentially a religious practice and if it's seen on that basis, they probably feel that it is not accessible to non-Muslim users, so the image is of a banking system based on religion, fairly closed in terms of its target audience and just a general lack of understanding as to what it means. I mean if you say to somebody, what do you think of the basic principles of Islamic finance then I'd say 95% wouldn't have a clue. The other 5% would say something about the prohibition on payment or receipt of interest, but that's about it.

Aca 4: I'm less pessimistic than Simon. Having gone now twice to Islamic conferences, what I see is actually quite the opposite. From the point of view of Western banks, I see this as a market niche to be exploited. The reason being is that when they see how banks in Islamic countries like Pakistan operate, it actually doesn't look that different from what they do. It's just a marketing issue and this was something that came through time and time again at this conference. Is Islamic banking the way it's practised now truly a theological and a religious issue or is it simply a way of branding? You know it's a bit like the Co-op branding themselves as ethical banks that if you say you're an Islamic bank you're branding yourself and you're not really doing anything that's supposedly/Islamic according to Islamic scholars. I'm not an Islamic scholar. And what was interesting about this was that there was some econometric results that looked at the segmentation of the market. In a country like Pakistan it turned out that, I mean something like 80% of deposits are still held in non-Islamic accounts and the elasticity of substitution between them, because the Islamic counts as profit sharing and in the non-Islamic it's interest, that the elasticity of substitution based on exposed yields is very, very high so that means Islamic people are willing to substitute from one account to the other for their small change in interest rate, you know, so what was driving them is the profit motive again and that made me think about this, you know, that if that's true for Islamic people in Islamic countries, that could be equally true for Islamic people in non-Islamic countries, so HSBC will be able to offer accounts or mortgages, will be able to offer accounts that will sit alongside conventional ones and people can choose these. These then become much more of a branding issue, a marketing.

Aca 3: As opposed to the banks themselves because you have Islamic windows, so it's that rather than the niche so, yeah in terms of knowledge amounts, non-Islamic banks, it's very high. You know the conferences I've attended it's been non-Islamic bankers, they know about the basic funding techniques and so on but you know I'm talking about the layman I guess.

Aca 4: The layman, okay.

Q: I mean you bring up a pretty interesting point in a sense that Islamic banking was kind of like, you know, random in the same way as ethical financing was as a mode, not

as a mode of investment, I mean do you think Islamic finance gets that a lot in a sense that it is pigeon holed with ethical banking finance as in it's a form of screening your investment spectrum?

Aca 3: Definitely.

Aca 4: I find that's the same. Ethical banking, Islamic banking, at this conference many of the bankers themselves were offering Islamic banking as a counter to the greed of Western banking following the 2008/2009 crisis. They saw themselves as, this is the new, this is the opportunity. Here we've been branding ourselves as ethical banks, as religious, that's what's attractive to the West. Not that we're Islamic but we're ethical. You know you don't invest in tobacco product stuff or alcohol stuff and you can push the range out, you know, armaments, the lot and that's, I can see that that's very attractive but my reply to them was that, you know, I was a discussant and a key note lecturer, the same ... if you think a banking system that's been going around since the Medicis is not going to reinvent itself and survive, you're wrong, you know, I mean they can suddenly turn round and be we're ethical too, and they can remarket themselves and they will survive so Islamic banking has to offer something more than that and as far as I can see, because of their different requirements of equity capital, you know, within, I don't know why that is but that seems to be the case, they are less profitable, you know, and they're less efficient which you can explain these because of their different internal religious requirements, you know, for them but, you know their customers who are the Islamic population aren't weathered to Islamic banks, they don't do Islamic banks because they're Islamic. You know they do Islamic, a lot of them do Islamic banks because it actually gets them a higher yield or something like that, you know.

Q: Okay, that's a pretty interesting point because a lot of the research gets pushed to the fact that Islamic banking or participants of Islamic banking participate in the financial system because it basically advocates their religious beliefs but I mean that's a ...

Aca 3: I'm a member of Islamic banking network on the internet and there was an email that was circulated a few months ago from the marketing director, the former marketing director of a major Islamic bank here in the UK and he left his post so he was able to say what he really thought and he said we have never made a profit, we are unsuccessful because of our image. We assume that if we say it's an Islamic bank we automatically have entitlement to the business from some students, for example, and he said that's not true. We're not offering comparable services so the religious principles are important but they're clearly not enough to catch Muslim business as opposed to non-Muslim business and he said we continue to make losses and it's funny because shortly afterwards I was going to London through the East End in a taxi and just by chance I passed by the office of this particular bank and there was nothing about it which was appealing. I looked at it and thought yes this is a marketing prop to some extent, compared to other banks they didn't seem to be offering the same sort of services and if your marketing is ethical, I think there is a difference between ethical banking and religious banking, so we have for example the Co-op advertise themselves as ethical and there are other banks that say they are ethical but when you say to the Islamic bank yes of course it's fundamentally an ethical issue but it's the religious dimension as well so I don't think you can look at it as entirely ethical banking necessarily and as you say, Islamic business will look at returns, it's not just the religious principles which is the sole concern.

Aca 4: It always interests me, in an Islamic country where they allow non-Islamic banks to survive you know because in Saudi Arabia it's very difficult to do that but in places like Malaysia or Indonesia or Bangladesh which is more than 50% Islamic banks, they still have non-Islamic banks. I asked myself a question, how do the non-Islamic banks survive? You know it's a Doug North type question of institutions, you know, economic argument which say if their people are staunchly Islamic, how come non-Islamic things survive? It's a bit like saying, you know, in countries where they don't ban alcohol, Islamic, you know how does alcohol survive if we're all meant to be Islamic and the thing is it's a question of choice. People make these choices and that's how they survive and they survive, even allowing for those who are not Islamic with a big I, you know who might want to, you know, do it because they're offering a service, it's a comparative advantage, you know, it's like asking how small merchant banks in London or wholesale banks survive in a market of universal banking where Deutsche Bank offers you everything. Okay? It's because of specialisation and a service, comparative advantage. Standard old fashioned economics.

Q; Sure. I mean this whole notion of image actually leads on to our next point in that respect which is a transparency of Islamic Bank and finance, I mean transparency from the legal perspective, transparency from product perspective, transparency from, for example, a Sharia supervisory board perspective, I mean what are your views on basically transparency of Islamic banks, do they need to, in terms of legal side of things, do they need to be more open with their rules, do they need to be more, you know ...?

Aca 3: Well as far as I'm aware, fatwas are not publicly available so you have banks developing new products. The decision making process is opaque. The religious ruling is opaque. The competence of the Sharia boards themselves is a question mark as to the availability of expertise and using Sharia scholars who give you the answer that you want. So I think the system, it's opaque and lacking in expertise and lacking in terms of provision of information to the public so if you're going to develop a consistent or standardised product, you have to have standardised rulings and standard understanding and that is lacking at the moment. How you'll overcome that is difficult because it doesn't seem that the banks would not want to have the fatwa made public if it was negative. If they were trying to develop products which failed so I don't think you're going to get transparency there either, so I think there is an image problem.

Aca 4: It's complicated isn't it? We were talking about the innovation and the creation of new products because a lot of the stuff that comes out of the West, so the derivatives of bond markets have still got the time value of money somewhere along in this and one of the themes I had from one Islamic banking scholar who was based in Oman or Kuwait or something was that nothing that involves the time value of money is Sharia compliant. Well that just cuts out just about everything, you know, I mean because a lot of the innovative products you're talking about have got some time value of money in the calculations, it sounded to me like, you know, if truly Islamic banks followed this, they'd have a very narrow market and it's obvious that they're not following it. So it probably pays for banks to have this opacity, to have this differences in Sharia interpretation because if there was one that laid out the law, it would probably cut out quite a lot of their market, okay? I mean so in a way it's a bit like, I mean I don't know what you think Simon but it seems to me like you can, you know, you can buy the right Sharia law if you went to the right person.

Aca 3: But then you'll have inconsistent products, you'll have products that trade in some markets but not in others. I had an MSc student a couple of years ago and we were looking at Islamic finance in shipping and I said well we need to look at hybrids and I've been given a hybrid financing model by a law firm in London for financing an oil tanker and I looked at this complex arrangement and I saw the features of it and I asked the partner where is the Islamic part to this and he pointed to one part of the diagram, he said that's the Islamic part. So it was a mix. So when I mentioned to her that we would look at hybrids she said I'm not going to look at hybrids, it's either Islamic or it isn't, we don't recognise hybrids. So you have differences on what is allowed in some markets and what isn't. You've got the conflict between the various schools of interpretation. If you don't have harmonisation, you don't have products that have been traded between markets, there's a lack of liquidity, so keeping things opaque and having separate rooms, separate schools and separate interpretation is not going to lead to a deep market.

Aca 4: But isn't it the case Simon that, although the market for individual Islamic products might not figure in the Islamic markets, it doesn't mean to say that the non-Islamic markets wouldn't use these products as part of a general portfolio and therefore, you know, I mean there are two ways of looking at the selling of an Islamic product. You sell it to your Islamic constituency and that's a reasonably high, or you sell it in the capital market, and that's a bigger constituency, okay, and many portfolios would like to have Islamic products in there, not because they're Islamic but because it's a form of diversification.

Aca 3: But then how are you going to work out the risk? The problem that working out the riskiness and if you have certain religious perspectives on collateralisation and security which is not allowed, it's very difficult for you to look at something and say well what is the security on this instrument and what's the underlying collateral and there are no assurances, you can't take any guarantees.

Aca 4: No you can't, but then you expect a higher return on it and you expect it. Remember the principle for portfolio diversification is not just the risk but the covariance between that and other areas so you could incorporate into a portfolio a high risk, high return instrument provided it's got negative covariance with all the others.

Aca 3: Yeah but how would you understand it? How would you be able to understand the risk?

Q; Do you think it will lead to inefficiencies in the marketplace as well having maybe different standards for two types of products that could essentially lead to the same?

Aca 4: Yeah, yeah, yeah.

Q: Fair enough. Kind of going back to the Sharia supervisory boards, I mean you mention basically head hunting Sharia supervisors and Sharia scholars, the kind of like, do you think that's ... how do you think that could be alleviated in that respect? Do you think it happens, do you think like banks actually go out there and they look for the Sharia scholar that is the most lenient or do you think that, you know, there is some sense of integrity in that respect or if there actually is a problem in that in the first

instance?

Aca 4: Well the answer is I don't know. I'm just talking about incentives. If there's an incentive, at the margin I expect more of one thing to happen than another and if it came back to me and said, you know, banks in Indonesia use this Sharia rules and banks somewhere else use something else, my first question is to ask why? Why aren't they using the same thing, okay? And my suspicion would be, it's not all to do with religion unless there are different Muslim interpretations of it, and that may well be. Protestants and Catholics, you know, but if it's not that then it's got something to do with economic motive.

Aca 3: Buying of scholars is a serious problem. How you get around that, I think you have to have transparency in terms of what they are paid, to whom they're accountable. Greater transparency on their reports and their reasoning but it seems to me particularly in context of Malaysia that the quality of some of the people issuing fatwas is not as good as it could be and there is an allegation that they're in the pockets of the banks and that leads to distrust, not just from other banks but also from your stakeholder.

Aca 4: Is that information that you read something recently?

Aca 3: There was a PhD on this very point that I was the internal examiner last year and that was the conclusion.

Aca 4: Oh right, interesting.

Aca 3: So it is a big problem.

Aca 4: Right.

Q: I mean, do you think that with more transparency that could be, as you put it Simon, that there could be more uniformity just in a sense that if you know what the fatwas are about, if you know what products are allowed and what aren't allowed, that could be more uniformity in Islamic financial system?

Aca 3: Eventually it will come, yes.

Aca 4: Yes I think that's probably true but the speed of convergence will depend really on market conditions, I mean the transparency is two ways, not just from the point of view of the bank but also from the point of view of the customer. If it were shown through transparency that customers prefer one type of Sharia interpretation to another unless, you know, it's dictated, you know if there are ... I think of this as currency competition, okay? If there are two interpretations of the same product there will be a natural market solution. If there was complete transparency and we knew exactly what were the differences and that would be dictated by, you know, what people want to have and I suppose, let's try and give a heuristic equilibrium here. Suppose there are two instruments, both having different interpretations on Islamic banking but there is no opacity. Everyone knows exactly what the differences are, okay? One of these will be preferred to another, okay? Suppose the more trades you get in one of these instruments, the more liquid that market becomes and the more that market grows. If there is suddenly through transparency, a desire for one particular instrument, more people will use it. That means it will become more liquid. As it becomes more liquid it will grow, it will drive people away from the other one. So through a kind of natural selection, there will be a convergence to the one that people want but it can only do that through transparency. Opacity will actually limit that, you know, the more opaque you can be, the less likely the market's going to converge.

Q: Sure. So in essence you're saying that for the market to kind of grow they need to kind of put everything out there in the open, let people choose and from there you grow your market on that basis.

Aca 4: That's right.

Q: That's a pretty interesting point. That kind of leads us on to uniformity in that respect so we've seen these divisions like as standard for Sharia compliance in Malaysia, as a standard for Sharia Islamic banking in the Middle East and as a standard for Sharia compliancy in the West, I mean do you think uniformity is important to the Islamic financial system in terms of the legal precepts in terms of product structures, in terms of underlying regulatory standards, do you think it's an important factor?

Aca 3: I think it's important but not attainable.

Okay.

Aca 4: So it's important but not attainable? Well ...

Aca 3: I think there are too many fundamental differences on interpretation. I remember I supervised a PhD a couple of years ago on arbitration in the Middle East. He was a Palestinian student and he gave me an example of the difference between the approach at schools. He said with one school if you go to a bank and you say I want a loan, they'll say for what purpose? I want to buy grapes. At one school that would be acceptable.

Aca 4: You want to buy grapes?

Aca 3: I want to buy grapes. If you go to another bank under another school and say I want to buy grapes, they would say for what purpose?

Aca 4: Yes okay. I understand where this question's leading.

Aca 3: I want to make wine and that's not allowed so it seems that there are different interpretations. When you can't have agreement on what is riba and what isn't in Middle Eastern markets, you have disagreement on what is permitted and what isn't, you can't have uniformity and I think it is a barrier to liquidity and to tapping bigger, wider markets. I think you will end up with the localised markets trading in local products that are not necessarily tradable in other markets.

Aca 4: Okay, that's interesting. I hadn't realised it was as simple as that, you know, in terms of the purpose of the loan. In some ways the first bank is not asking that question because they don't want to know, alright? The second bank is pushing it further along, you know.

Aca 3: So there are fundamental differences. So you'll end up with differences between Islamic scholars, on interpretation, on what instruments are like. Look at Musharakah, Mudarabah, you look at some of these instruments that have been thrown up and they come very close to the non-Islamic, when you have mark-up finance for example is concealed interest.

Aca 4: That's right, yeah.

Aca 3: And that discredits the system.

Aca 4: Yeah there's quite a lot of talk about that with these conferences, market finance, yeah.

Aca 3: Because it looks as if you are providing non-Islamic instruments under the disguise of an Islamic label and that doesn't do anybody any good but at the same time, it was interesting for you to say well how do non-Islamic banks compete, how do they survive as if they are the weaker entity? I always think the other way. I think how does the Islamic bank survive in Islamic country when there's non-Islamic bank which can do anything?

Aca 4: Yes, yes, so they're not focused on one particular area.

Aca 3: It's just like money lenders in Italy in the 15th and 16th Century, there were some who were allowed to be involved in money lending and paying and receiving interest and there were some particularly Christians at that time would say well no you're not allowed to pay or receive interest so we'll get somebody else to do it and so in a non-Islamic bank that can do anything, that can provide any kind of loan without looking at the religious framework, they have a competitive advantage because they're not constrained and they have another advantage in that they can take security. They can charge up-front fees and be open about it instead of disguising it as a mark-up finance, this sort of thing, so they have greater flexibility and non-Islamic bank in Islamic country has got greater capacity.

Aca 4: I'm always interested to understand how banks offer both Islamic and non-Islamic products within the same house.

Aca 3: Separate subsidiaries.

Aca 4: Well they can do, I mean I did some study with someone who is now at the Reserve Bank in Pakistan who looked at the demand for money using Divisia construction of different types of deposits and some are Islamic and they were very good, they were able to identify the yield, exposed yield on the deposit of Islamic and the interest rate on non-Islamic account and they were able to find a cointegrated relationship so there was an equilibrium, you know it was not as if one was trying to outdo the other, they both had the same I1 properties, you know, and to me that says that the market finds an equilibrium, even within the same, you know, bank.

Q: So this is the lack of uniform, I mean the lack of uniformity could actually, is actually an effect of the marketplace itself in a sense that it cannot be standardised

firstly on the basis of belief and secondly because each market drives its own.

Aca 4: That's right, I mean the market finds a segmentation, you know if you kept differentiated, the market will try to identify these things, simply because that's what markets try to do. They try to garner information, they try to, you know, exploit this information and if they're efficient, ultimately we tend to think that markets will tend to a deficiency in the long run then they're trying to separate out these products. So it seems to me that it's not, well I mean I might have a slightly different view to Simon here, it doesn't seem to me that important that it's useful to have clarity but if you had opacity, the market will try and find a way round it to try to, you know, identify what the differences are. It's just more costly that's all. So it's more efficient to have transparency but so what? I mean central banks, you know central banks will try to obviscate the market by trying to influence expectations. We spend many, many, pay a lot of teenage scribblers in the city to try and interpret what is in the mind of Mark Carney or Ben Bernanke. It's because if there was complete transparency we don't need these people. We don't have to pay them so much. Everyone would just get it off the internet but in fact they're trying to interpret markets and that's about information so the same will happen with Islamic instruments as well.

Q; I mean what do you think about these large regulatory buy-ins that have been set up in Islamic finance in terms of like AAOIFI the accounting standards and then the IFSB, International Islamic Financial Services Board that admit to be there to kind of like oversee the overall, do you think they actually play a significant part within the marketplace or do you think that, you know, it's just an ancillary role in terms of ...?

Aca 4: I think they have to, you know, because people like the FSB have to understand, even in the loosest way, what are the risks, and if it's a product that they know very little about, it's better to know something than to know nothing and these advice, these boards can provide some information about the risks and they have to then construct regulations consistent with where that risk class is, you know, to them, you know is it up here or is it down here? So I think there is something but how good it is I don't know.

Aca 3: It depends what the function of the body is. Is it to promote common standards? Is it to protect stakeholders by making risk more transparent and so the impression I get is that these bodies are a little bit unfocused as to what they're trying to achieve and are they saying that they should promote harmonised standards, common standards and is that necessarily a good thing? The PhD on arbitration, commercial arbitration in the Middle East, the conclusion was that harmonisation was a bad thing because differences represent local cultures and if you have differences you're more likely to have acceptance by local cultures instead of trying to impose from outside the common sense standards so the view in that dissertation was that you should accommodate international standards if possible but at the same time don't try and force everything into a standard template so it might be that those bodies are trying to force everything into a standard template when it can't be done and maybe if by doing so you deter a whole range of stakeholders who are looking for genuinely Islamic products.

Aca 4: Yeah that's an interesting, you know, conception isn't it, to think that actually what you observe, it's very much in Doug North's theory of economic institutions. Things have evolved because they are following an efficiency pattern, you know, things have evolved through a market solution.

Aca 3: There's a need for it.

Aca 4: There's a need for it and that's the differences. Now you try and force them together, well you're creating a new equilibrium. It may be less efficient.

Aca 3: And less acceptable.

Aca 4: Well I mean we know for instance the Euro is the construction of an artificial currency that covers, you know, one size fits all. You can do it, you can actually force it, okay? But it creates inefficiencies elsewhere, you know as by doing it but you know it's a bit like squeezing on a balloon, you can say I can control the air by squeezing on it, it just goes somewhere else and creates these inefficiencies elsewhere so yes you can construct a single body but is it desirable? Well, you know, it's not clear that it is.

Aca 3: I was going to say, to which standards would it bias itself? If you're going to look at international standards or local standards, the view from this Palestinian student was that international standards had been hijacked to some extent by history and Western values and so on and he said if you impose that from either side and then local businesses would find it unacceptable.

Aca 4: Interesting, yeah.

Q: What about the notion of a central bank or a lender of last resort for Islamic finance? Because if you think about most conventional financial systems you have essentially this fall back, I mean do you think that could add to the value or do you think that could be beneficial? I mean obviously it goes back to your argument of need but do you think it would be beneficial to the Islamic financial system?

Aca 4: You see there is a tension here because Islamic banks have constructed the, my understanding of it is a bit like free banking, you know, they can stand alone, you know, after all they're profit sharing okay and so their customers, their clients, their depositors are expected to take this as part of the, alright, why do we need a lender of last resort? A lender of last resort is needed if by chance there is a run on the liquidity of a bank, okay, and that occurs if there's a perception that there are losses in the offing, people try to withdraw their money, the bankrupt, that's why you need a lender of last resort to put this in but in fact this shouldn't happen under Islamic rules so I'm not at all, you know, there's the tension, I believe that there should be a lender of last resort, it will create stability, but there's the tension with Islamic thinking is to how that fits in to it, you know because after all, I mean you're meant to take the risk on yourself, you're meant to share that risk. It's not meant to be shared with the taxpayer which is a lender of last resort will eventually, you know, finance that, so it's a puzzle, I don't know what the answer is, you know. I think in practice there should be one. I also think there's lots of problems with, for instance bond financing. How do governments bond finance and therefore control the money supply in Islamic countries if interest rate is barred? How do they? You tell me.

In terms of bond financing issues, the sukuks, I mean as far as I know about it, I think

sukuk issuance is based upon an underlying Islamic asset so as opposed to having that interest proxy, you essentially have an actual asset that will, in essence if you think about cost plus financing, what happens is that asset is, you have multiple Murabahas selling that asset on at periodic times which generates that extra cost plus mark-up which the market element will then be that interest finance on the one payment so that's how they generate the liquidity.

Aca 4: But the underlying asset in the case of the bond finance for a government is future taxation, it's not to observe now, you know, it's your next generation who's going to pay for that.

I think what Dubai did was use their government, remember Dubai World, that large amusement park, they actually used that as an underlying, as a Sharia compliant asset to basically add that one.

Aca 4: Oh I see, what they built with it.

Yeah what they built with it so that was ...

Aca 4: But how then do you finance your army or an invasion? Oh well the assets you're going to steel. I mean there are lots of issues, I mean a Western government will send bonds to finance not just the NHS or road building which might have some underlying asset but current consumption okay? So ...

Aca 3: I think if you don't have a central bank it seems that in the Middle East there's a problem of holding of cash. If you have a central bank it's more likely that cash will come into the system. Without a central bank the system will be more volatile.

Aca 4: Well the central bank can lend to individual banks, okay, I mean that central banks do but the lender of last resort is lending to a system, it's the banking system as a whole. If there's a generalised systemic run, okay I mean and if there's a run it seems to me that, you know, Islamic banks should fail with their customers.

Aca 3: Yeah but as you say, it's just relocating risk somewhere else.

Aca 4: Yes.

Q: Just the last few more questions in terms of, I mean regulation obviously has a large impact upon governance and corporate governance structures in Islamic finance. How do you think, you know, that that relationship will hold in Islamic finance in terms of like if we take all the issues that we've just discussed in terms of uniformity and transparency, how do you think that would impact the overall corporate governance structure of Islamic institutions or Islamic central financial systems?

Aca 3: In terms of make-up of boards or fatwas or ...?

Q: In terms of fatwas, in terms of basically composition of companies, in terms of Sharia even Sharia compliancy.

Aca 3: I think the problem is that when I look at credit crunch and the lead up to the crunch where you have interbank lending falling away, it seems that one of the reasons was a lack of trust between banks as to which were holding toxic assets and which were not. A criticism of governance might be that if you have two parties in a room and they don't trust each other, there is a problem. If the government comes in and says well here's the money anyway, there is no incentive for either party to open up and say what's the nature of your distrust? So we still don't know where the toxic assets are really because there is no impetus to be more transparent and it seems ...

Aca 4: In fact it would be better to be more opaque in the circumstance, yeah.

Aca 3: Well you're still going to get the money, even if you're opaque, you still get it.

Aca 4: Exactly.

Aca 3: So it seems to me that if Islamic banks want to reach out and to widen their stakeholders and products, and so on, then the drive must be transparency and compliance with standards because if you're not compliant then presumably you won't have access to the same resources. When you start having external structures, it's a kind of, it's almost like moral hazards and assumption that the system is better than it actually is and there's no incentive for banks to be more transparent. For example, why are fatwas not made public? So I think its move towards harmonisation may not address the underlying problems because you might have token compliance, tokenism, rather than a drive towards transparency. If you're on the board of an Islamic bank and you're thinking well how do we expand our base? It's through being more transparent and greater linkage between the religious principles by which you stand and the products that you offer so everybody understands that linkage and not selling products or offering products which everybody knows are either fictional in terms of the general Islamic products so I think there's a danger that these frameworks that have been put in are not going to promote the transparency necessarily.

Aca 4: I'm not going to say anything more than that that sounds right.

Q: Okay, just final two questions. What do you think are the risks for Islamic finance going forward and what do you think are the growth opportunities for Islamic finance going forward?

Aca 3: That's a tricky one. The opportunities are to capture that ethical gap. I still can't really understand. Maybe there's some simple explanation as to why Islamic banks are not offering finance to SMEs that are non-Islamic. Is there are particular reason?

Aca 4: I don't know. I don't think so.

Aca 3: Because if you look at an SME in the UK, typical SME that feels has been let down by its mainstream bank, if you have an Islamic bank that's making a presentation at let's say a Chamber of Commerce, you say well the Islamic principles are really something for us, it's not for you to worry about. The implications of this method of financing are joint venture vehicle, prohibition on interest, share in profits and so on. An SME director would say ah ...

Aca 4: Yeah he wouldn't really care where it's coming from, yeah.

Aca 3: ... I don't care about it. I don't care about the relationship, but you've explained how it works and it seems to me that it is a form of ethical finance.

You're given an option basically.

Aca 4: Yeah.

Aca 3: Yeah.

Aca 4: But at this conference I went, I mean that's exactly what Islamic bankers and Islamic bank scholars from the Middle East were saying, that there's absolutely no reason why Islamic banks shouldn't lend to non-Islamic clients, in fact that's what they should reach. They have to do that if they want to expand and so there's no reason, you know, ideologically.

Aca 3: There's a legal jurisdiction problem.

Aca 4: No, if you're an Islamic bank in Britain.

Aca 3: Yeah well ...

Aca 4: There are plenty.

Aca 3: ... but in terms of enforceability of contracts, is it going to be through the normal court process, is it going to be through a tribunal? We don't have the equivalent of AAA (43.20) courts for example so you would have to have an Islamic commercial arbitration system in the UK to make, unless of course Islamic banks are prepared to strike out that fundamental clause that they must include which says that this agreement is in compliance with Sharia principles. Now whether they be prepared to take that. If I was director of an SME I would look at that and I'd say what's that clause mean? If there's a dispute between us I know that you're not going to take my home and throw me out on the street. I know you're not going to strip my assets but I need to know what is this jurisdictional point. Which court will deal with this if there's a dispute between us because you've got this Sharia compliant clause here so that is an important issue, the legal enforceability of contracts but marketing, it seems to me that Islamic banks in the UK are really missing out on a trick. They should be going out and saying your local bank has let you down.

Aca 4: Let you down, yeah that's right, come to us.

Aca 3: Look at RBS and the allegation was to what they had been doing.

Aca 4: Yeah absolutely, yeah.

Aca 3: So I think they should do that and also they should capture more of the young population, the student population in terms of products.

Q: I mean in terms of that legal jurisdiction, that was quite an interesting point, I mean do you think that Islamic finance lacks that protection for both parties in that respect, like an undeveloped protection mechanism for both ...

Aca 3: Yes.

... the institution that's given you whatever finance and the person that's partaken in that financial contract, I mean is there a big problem?

Aca 3: Well it is because it seems that the Islamic bank it's fundamental, Islamic lender I should say is based on trust. I will not take security from you in the form of a personal guarantee, a charge over your home and so, I trust you and so on. Whereas the non-Islamic model says I don't care what you want the money for but if you don't make the interest payments I'll ultimately throw you out of your house and liquidate your business, so it's a totally different perspective on enforcement and how would you take an Islamic contract which is what this is before a County Court Judge because that Judge would say I don't understand this and there's a clause in it, it's a bit like jurisdiction clauses in London arbitration, where's the centre for international shipping disputes to be resolved? London, because they have an arbitration clause and a jurisdiction clause in the event of a dispute it will be dealt here, so you have that Sharia compliance and jurisdictional issue which would have to be understood because, as I say, it's a matter of trust and if I'm director of an SME I'd feel a little bit pleased because I'd think to myself, the bank, Lloyds TSB or Lloyds as it is now, I wanted a loan from them and they really tied me up in all kinds of guarantees, they took charges over assets, they took floating charges over the contents of the warehouse and goodness knows what else, they're absolutely secure but I've got this Islamic bank saying ultimately we trust you, we're not going to charge you interest. I'd be thinking now there might be an opportunity for me to get away with the cash and leave the Islamic bank with a thumping loss, so that is an issue but legal jurisdiction and enforceability of contracts, and I don't see how an Islamic bank can move away from that fundamental clause which says that both parties understand this is Sharia compliant and then you're back to the problem of marketing and understanding. How do you say to a director of an SME from Yorkshire this is a Sharia compliant agreement and this is the nature of your obligations and ours and also there's the business, if it's based on trust, the Islamic bank is going to be more intrusive in asking for more information and ...

Aca 4: But that might be a trade-off that he's willing to accept.

Aca 3: Yes.

Aca 4: After all that would be what he would have if it was a venture capital type of agreement as well.

Aca 3: Yes.

Okay, thank you very much gentleman.

END

Academic 5

Q: One of the few things about Islamic finance is that it has grown over the past few years but a lot of people still don't know much about it. How do you think others view Islamic finance within the financial world?

A: I think there is increasing knowledge about Islamic finance by people in the financial system. Obviously, it depends on their seniority and the kind of bank that they are in basically but certainly in investment banking circles there is a fair amount of interest and knowledge of Islamic finance, certainly in London as we have a significant Islamic financial sector in London.

Q: What do you think are the inherent risks faced by Islamic financial institutions going into the 21st century? (not in the sense of competing but being on par with mainstream financial institutions?)

A: Islamic finance has got its own particular risk. Obviously, there is potentially more market risk of the Islamic financing facilities basically than there is conventional banking because Islamic banks can invest directly and take on ownership risk for example and regulators are necessarily terribly happy about that but that is something which is inherent in Islamic finance and one cannot get away from that really if the various facilities that they have to offer are to continue to operate but they have to be managed carefully.

Q: One of the main issues of governance in Islamic finance is an issue of transparency – transparency in the sense of transactions. What do you think about this?

A: Well Islamic banks obviously have to abide by the regulation system in the markets in which they are operating basically. So in the UK, are financial reporting requirements, (2.18) by the FSA, so they do have to have properly audited accounts, they have to have interim statements. So there is reporting every six months but obviously they are not reporting every single operation but at the end of the day the financial services authority does have the right to look in to any operations if there is a complaint by clients. So they are pretty transparent; actually I wouldn't say they are less transparent than other banks.

Q: Another criticism is the composition of the Shariah Supervisory Board (SSB). You get conflicting view of having similar members on different boards over the different spectrum of companies. What do you feel about this?

A: Obviously some scholars are basically, it is true that they serve on many different boards but they are not an on their own individual. They basically have back up staff doing research and investigating things for them so in a sense you can think of them as developing rather like accounting firms (3.24) matter of KPMG for example do thousands of audits and so on and that doesn't mean to say that they are not able to do that. So it is a question of how you want to go. You can either go and have single Shariah scholars working all by themselves in which case they can build up their businesses or you can have Shariah scholars, yea they give their name to the businesses if you like, but essentially they have a lot of people working for them. So they can maybe handle serving on 50 Shariah boards. That is a lot but it is possible with enough back up staff.

Q: How do you feel when people talk about 'Shariah ala-carte' or 'Shariah Head-hunting' where certain Shariah scholars are scouted for certain boards?

A: Well obviously most banks want to have the most prestigious scholars so they (Shariah scholars) tend to have a scarcity value and they are head hunted but the industry is open so others can come in so it is not impossible and others are coming in. The net is widening but obviously those on top, who have had a head start, are in a better position.

Q: There is also talk about the transparency on how products are structured such as sukuks and murabahas. A lot of the general public do not really know about who buys or sells these products. What do you feel about that?

A: Well obviously holdings can be confidential and people don't have to disclose everything they are holding to everybody. In terms of the actually structure themselves, most of them are basically devised by law firms like Norton Rose and so on but obviously they don't put all the details; they put broad details of what goes on but they don't put details of the structures they are recommending to individual clients as that would be a breach of confidentiality and obviously they are going through some effort to tailor these things (products structures) to the needs of individual clients who are paying for this service. So, like any banking contract, it is not in the public domain. So we know what murabaha, musharakah or ijara contracts look like but obviously we don't see the names filled in basically because they client wouldn't appreciate that action. I mean the banks wouldn't want it and their clients wouldn't want it.

Q: All this negative talk about transparency in Islamic finance. What do you think could be done to make Islamic finance seem more 'friendly' to the public?

A: Well obviously it is important to maintain proper standards and regulators do try to do that. If there are basically not such good standards in some jurisdictions it doesn't necessarily reflect on the Islamic banks or Islamic financial institutions; it reflects on the regulators and their effectiveness basically but on the whole most of the jurisdictions that they are operating in are pretty well regulated and there haven't been really all that many problems in Islamic finance, some did happen in conventional finance. They (Islamic finance) withstood the financial crisis of 2008 pretty well but obviously some of them get into difficulties when there was a recession and in particular the crash of the property market. In cases like Dubai and so on, it obviously put some strain on Islamic banks as it did on every other type of bank but you know they have survived. Some have been recapitalised but that is not really a big surprise.

Q: You mention regulation and that is another issue in Islamic finance. We have different regulatory standards across different regions in Islamic finance. The regulatory standards in Malaysia are different from the regulatory standards in the Middle East which are in turn different from the regulatory standards in the west. How will the lack of uniformity affect Islamic banking and finance?

A: Well just in the same way as conventional banking; it isn't regulatory uniformity, it does vary from country to country and region to region and quite a lot in regions. Obviously it is the Bank of International Settlements (BIS) where they have Basel I, Basel II and now there is Basel III basically which will be implemented, including by Islamic banks over the next few years up to basically 2019 so there is basically a fairly long transition period but Islamic banks do have to comply with these sort of minimum regulatory requirements plus any additional regulatory requirements that individual regulators have. Any shortcomings in particular jurisdictions you can ultimately blame the regulator over the Islamic banks. Islamic banks will do what they have to but obviously they are not going to do more; like any institution because it is costly. So basically they will abide by the regulation as they could lose their license.

Q: The divergence in the rules regarding the permissibility of Shariah risk management tools for example, a bai al-arbun will be allowed in Malaysia but not in the Middle East. How do you think that will affect risk management and financial innovation in Islamic finance?

A: Well obviously Malaysia has been more kind of adventurous and things have been approved which wouldn't have been approved in the gulf for example but having said that there is a degree of convergence because Islamic banks and institutions from the gulf are now involved in Malaysia and obviously, so they (Malaysian Shariah finance laws) are very aware of the kind of requirements by the market operating there. I think Malaysia's probably gotten more conservative in the last few years. So some of the things that used to happen don't any longer happen basically and obviously there are different schools of Islamic jurisprudence as well. So Malaysia is the Shaffi School, which is regarded as kind of more liberal when it comes to financial affairs than the others so that is obviously reflected through to the practices in Malaysia but I think these differences can be exaggerated and there is precinct degree of convergence. But you don't want standardization because that will obviously preclude innovation – putting everything in sort of a strait jacket, then there is not much scope for devising new methods of doing things.

Q: Why do you think Malaysia is becoming more prudent with its Islamic finance laws?

A: Well I think because they are influenced by the institutions that have come from the gulf to Malaysia, like Al-Rajhi bank, Kuwait Finance House and so on. Al Rajhi bank has quite a significant operation in Malaysia and obviously they tend to manage things, not exactly like they do in Saudi Arabia but at the end of the day the Shariah scholar is sent from Riyadh to sit on the board in Kuala Lumpur and obviously does look at what's going on. (10.58)

Q: There has also been talk about lenders of last resort. How do you feel about that in Islamic finance?

A: Well what happens in practice is that the central banks or banks that are in difficulty, (11.16) usually not necessarily themselves, but they get their confidence from potentially stepping in and recapitalise banks and that effectively has happened with some Islamic banks as well – Amlak in Dubai for example which is basically an Islamic mortgage company, was obviously pretty much bankrupt from when the property market went down. So that (Amlak) has been recapitalised basically, bought by the government and also by merging it with another entity to make it bigger and more viable so the same kind of things have to be done for Islamic banks. So obviously they can't be the lender of last resort on the basis of interest but the recapitalisation can be done in many different ways and that's not a problem. It is needed unfortunately sometimes.

Q: What are your thoughts on the two large central regulatory bodies at the moment, the IFSB and AAOIFI?

A: Well AAOIFI is there basically to provide accounting standards and ensure that basically that there is consistency in how Islamic financing is reported. It is a very specific organisation and its concern should be consistency. for example how murabahas trades are illustrated in the same way across different banks which makes sense. They are not trying to replace the international financial reporting standards rather as a kind of add-on looking at the nature of different Islamic financing facilities. It is things like if you have a murabaha, for example, and payments are coming in not just 2011 but also 2012 when do you 'book' them. do you 'book' them all in 2011 or do you 'book' them a little bit in each year. Basically, AAOIFI comes up with standards for that kind of thing so you can compare banks across jurisdictions and indeed within jurisdictions so that makes sense. The Islamic Financial Services Board is basically concerned with a whole host of issues primarily concerning governance of Islamic banks including Shariah governance and also risk management. Essentially it is concerned with the kind of things that the Bank of International Settlements is concerned with and how it should be interpreted by Islamic banks and they produce guiding principles, all of which are on their website, and people find these quite helpful. It saves reinventing the wheel but of course the various central banks of all the countries where Islamic banks operate in represented on the Islamic Financial Services Board and are very welcome to participate in basically the development of these standards and they do participate and contribute their ideas. But it still doesn't make much sense for countries to be developing all these things in isolation so basically just like we have the Bank of International Settlements for conventional banking; we have the IFSB, which is recognised by the Bank of International Settlements, as the body which deals with Islamic Finance.

Q: What do you think could be done to improve aspects of the IFSB and AAOIFI and regulatory channels in Islamic finance?

A: I think they are doing quite a good job. AAOIFI does a good job on accounting issues and auditing issues and so on. The issue is really whether it over reaches itself with regard to its Shariah standards on whether it should have Shariah standards or not. It is primarily an accounting body and there is obviously overlap and indeed conflict between AAOIFI's own Shariah board and the Shariah standards and also the OIC Fiqh Academy, which is recognised by the Islamic Development Bank and obviously represents 56 Muslim countries, so it is confusing having two different bodies basically but it has evolved this way historically and they are not totally in conflict but obviously there are differences and that is an issue because there is different people, different scholars serving on these bodies basically.

Q: Do you think that these standards will help the growth of Islamic finance in the future with particular emphasis on risk management and product development?

A: Yes I think they have helped already and they will continue to help. I mean the industry is growing, it's always going to be a niche, it's not going to take over the global financial system or something, but it is an alternative way of doing things. It's got a proven track record going back to the 1970s so it's got a long history now, its withstood various crises, both global and regional and in particular countries, so it's here for the long term and we'd expect it to continue to expand and grow. It is obviously easier to grow from a low base but as you get bigger the growth tends to slow down somewhat.

Q: During the Durham Islamic Finance Summer School, you mentioned that practitioners in Islamic finance have to adopt a more modest view of the Islamic financial system. Could you expand on this?

A: Well I think some people sort of expect it as the answer to all the problems of the global economy and the conventional system but it's not. Well obviously Islamic finance is trying to do things a different way but we have to be realistic about essentially where it is and where it's heading and it makes a contribution to the debates but obviously it is unlikely that all the principals and all the ideas are going to be adopted internationally. Conventional banks are very strong willed companies and they are going to continue with the kind of activities that they have done.

Q: In the current economic climate, what do you think is the scope of growth for Islamic finance?

A: The scope is still pretty good but the problem is that there is a lot of difficulties in the global economy basically with major restructuring occurring. Islamic finance is not terrible well represented than some of the faster growing markets and that is an issue. Obviously the situation in the gulf is stable and the governments are spending more and that's all helping Islamic finance. Situation in the Mediterranean-Arab countries, since the Arab spring, is extremely uncertain and obviously the countries are in growing economic difficulties. We hope that things will stabilise but who is to say what will happen. We have to wait and see essentially and it's going to take a while. It is an opportunity for Islamic finance in places like Egypt and so on but obviously Islamic finance is very much in the margins there, nobody is going to be investing significant amounts of money in Egypt in the coming months until all the political uncertainty is resolved one way or another, so that's an issue. The middle east, particularly northern countries in the middle east are plugged into the European union and Europe and because the European Union and the Kingdom are basically pretty stagnant that means that there is not much growth (in Islamic finance) which is unfortunate. There is obviously, not much growth in North America either which has its own jobless recovery. So really you are looking at China and India but the problem basically is that India is kind of hostile to Islamic finance and China there is very little and they have their own issues. There is an eye on Islamic banking in western China but the whole issue of Islam in China is a very difficult issue for the Chinese. So there is either outright hostility, as is the case of the BJP in India and India is a very rapidly growing economy, that not helpful or basically suspicion and unwillingness to do too much in China so that's unhelpful given that these are the fastest growing regions or the world.

Q: A lot of people pigeon hole Islamic finance with ethical financing and there is a religious issue at hand such as in India and China. How do you think this will affect Islamic finance in the west?

A: Well Islamic finance has obviously got its own criteria and you can draw parallels with the criteria used in Islamic finance and those used by ethical funds for example. Obviously the criteria are different but there are some similarities and I think one can learn for the other basically. Probably at the moment Islamic finance can learn more from ethical financing than vice versa but essentially ethical people are concerned about how their money is used and ethical funds take those concerns on board. Similar people who want Shariah-compliance you can have Shariah-compliant funds where again they take these concerns on board but the criteria are different. There is a little bit of influence from one to another for example there are issues in Islam about smoking and so on but the issue is that because this has been something that has been taken on by the ethical finance industry, you find that most Islamic funds don't invest in things like tobacco companies for example despite the popularity of Shiska. So there is some crossover basically.

END

Appendix 3 – Academic-Practitioner Interview Transcripts

Academic-practitioner 1

Q: Islamic finance has grown rapidly over the past few decades, how do you think others view Islamic finance? How do you think conventional finance views Islamic finance?

In general they view it positively, in particular I think in 2008 and the financial advisors, people in general they started, you know, looking at Islamic finance as maybe an ethical and different approach to finance. There was a huge interest, you know, from the media regarding Islamic finance and how Islamic finance was different from the conventional and how it works and this is evident basically here in the UK. You see there are five fully Islamic banks, independent Islamic banks for investment and the IPP is the only fully Sharia compliant bank. In addition to some conventional banks they offer one or two Sharia compliant products like Lloyds, Barclays, RBS, HSBC. In total I think there are in the last report they report there are around 22 Sharia compliant providers in the UK only providing Sharia compliant financial products, that includes (Shariah) windows or conventional banks specifically providing one or two Sharia compliant products.

Q: Sure. Well you mentioned something about ethical banking, do you think Islamic finance is very much compared to a lot of ethical financing like let's say green investments, do you think Islamic finances compare to that?

In a way yes, however it in terms of basically its requirements to be Sharia compliant are more than just ethical investment or the ethical approach. Maybe the ethical approach they don't see you know the payment or receipt of interest as an issue, however they are looking at their investment basically into ethical investment vehicle that excludes certain parts of investment. From basically Sharia complaint perspective in terms of offering financial products, the payment and receipt of interest, one of the main elements that should be eliminated or excluded from any financial transaction in addition to basically the selection of investment is based on the Sharia and ethical principles so normally any unethical investment is considered from Sharia perspective that to being Sharia compliant and Islamic banks are not allowed to invest in. However, this extends even beyond that. For example shortening that might be in a way acceptable from ethical perspective, it is not allowed from Sharia compliance perspective basically because that principle of pretty much all transactions in terms of buying and selling from Sharia compliance perspective that the commodity or that there should be an underlying commodity or asset for any transaction and this commodity should exist and as you see maybe the majority of financial transactions now in the financial markets, whether short setting or options and futures, basically if you had raised the transaction itself or track it, there is no underlying assets of commodity so the items sold basically bought and sold over and over without any transfer of legal proprietor of the commodity or of, you know, or of the commodity being there as the subject matter or the financial transaction itself. So this is not permissible for Islamic bank to do so basically it's more like the real economy and that there always should be an underlying asset in terms of any financial transactions, not just money against money which is basically the typical borrowing lending relationship in terms of generating interest which is basically not allowed.

Q: Sure. You mention basically riba and essentially ownership of assets before they can be sold which is kind of like the core principles of Islamic finance.

Sorry say again, I couldn't hear you.

Q: You mention riba and basically ownership as several of the core principles of Islamic finance.

Yes.

Q: Do you think that, how do you think conventional finance has reacted to having, you know, these new constraints on a financial system or these new approaches to finance?

Sorry just the last bit of the question wasn't clear.

Q: Sorry. How do you find, how do you feel conventional finance reacts to let's say the concept of riba, the concept of ownership having actual ownership, so how do you think conventional finance reacts to a financial system that does not operate on an interest basis?

Okay just repeat maybe the last bit to make sure that I got your question correctly. You're asking about how conventional banks perceive this sort of transaction that this will be underlying assets …

Yes.

… from Islamic banking?

Q: Yes so how do you think conventional finance perceive like a non-interesting banking system, a banking system that does not operate on interest?

Okay. I mean it depends. If you look at let's say in terms of, you know, just normal people who are basically they are the target market for financial institutions or they're Islamic or an Islamic, you know some of them basically they are not bothered about it. Some of them who would be looking at an ethical perspective, it would appeal to them. From financial system perspective there is basically a positive view about Islamic finance, however you can say, you know, the mainstream is basically the conventional system which in a way it's dominating the scene. However, you know, Islamic banking is growing and basically this positive view about it is also growing. Some Muslims are basically taking up Sharia compliance products because basically in a way they are fed up with the current conventional financial system as we saw, you know, a while ago when, you know, people start protesting against the current financial practices and the current financial systems. So it's basically more than in a way that the practices by conventional banks which is looks into the individual benefit of that financial institution and it is basically management shareholder but it doesn't look at or maybe it doesn't look fully at the financial benefit of its customers. Basically it's the society in a way and the economy overall and this is what we saw that, you know, these sort of practices were harmful to the economy as a whole and we all were affected by that on different levels. So there is in a way basically a positive look at it but I think for maybe some financial institutions it is not suitable, maybe the approach for them because maybe that will impact in a way some of their financial practices that currently they do and that perceived maybe from Sharia compliance perspective as non-ethical you know because of certain elements in those practices.

Q: Cool. In terms of growth of Islamic finance, what do you think, for the foreseeable future, what do you think would be the main areas of risk when it comes to Islamic banking and finance? What areas need to be addressed at this point in time?

Sorry can I ask please just to repeat the question?

Islamic finance going into the 21st century …

Yeah.

Q: … what do you think are the main areas of risk relating to Islamic finance? Which areas have to be addressed, which areas are weak, which areas are strong in Islamic finance?

Okay I think the main thing is basically the educational aspect of it, the awareness about Islamic finance, how Islamic finance is different from conventional, I think maybe lots of people mainly, you know, non-Muslims they think when you, you know, you mentioned Sharia compliant, you know, financial products or Islamic banking they will say okay it's just, you know, something related to the Islamic law or to Sharia, it's for Muslims so something, nothing to do with them or maybe they don't have this interest maybe to know more about. Some people they do maybe they have this sort of interest to know more about it and then they will basically get educated more about it. The main thing is basically explaining how as in a way the financial system or which basically follow certain rules in Sharia are related to finance and conducting financial transactions how it works, how it basically would offer maybe a different approach to finance that would consider maybe all stakeholders in the society or in the financial system and look into their benefit as a whole rather than the benefit of maybe a few individuals or smaller group of people in the society or in that financial institutions. Also the main element how products are structural, maybe they see that the economical or the economic outcome of this product is in a way the same but that the working back, the back of this operation, basically the structure of the product itself and how it works is completely different, there is always, you know, an underlying asset, there is always sort of trade commodity, etc. selling and buying so there is an economic activity in the background happening to offer this financial product does not apply, for example the convention is just lending and charging interest for that, you know for the mortgage for example or for that personal or business loan, etc. So it's mainly basically there are the education around that.

Q: With regards to education, do you think Sharia finance needs to be more transparent or is there an issue of transparency when it comes to Sharia finance?

I don't think there is an issue around transparency. On the contrary I mean in terms of Islamic banks particularly they have regulatory obligations in terms of monetary reporting so they have, you know, this sort of obligation and the extra obligation from a Sharia compliance perspective that they have to report and this is also included in their financial statement in terms of during a certain period of, you know, Sharia compliance audit or the bank's operation that the bank was operating in line with ethical and Sharia principles so then basically Sharia has provided a committee which is an independent body to supervise the bank with a Sharia reportable statement that about their opinion about the bank's operations during a certain period and there is of course review now Sharia compliance audit to ensure that they review all the documentation, the transactions or some of the transactions show that fact. In addition the Sharia compliance provision it offers an extra layer of governance for Islamic banks. Basically they are not employees of the bank, the committee does not report to the board or to the senior management of the bank, it's an independent committee and there is also a Sharia compliance department in the bank to basically monitor the daily operation of the bank and they report directly to the Sharia supervisory committee to ensure their creditability and independence from the bank's management. It is something that you don't see basically or you don't find in conventional banks so and everything basically should be transparent and clear in terms of the product itself, documentations of the product. Certain things, key risks, key issues in the products should be made prominent and clear to customers and that is basically monitored and signed off to ensure that everything is transparent with our own, you know, products and customers' level or in terms of financial reporting level and basically the length of the required regulations.

Q: So do you feel that basically these arguments for transparency are due to the fact that it's more a marketing issue than it is essentially an issue of transparency so the knowledge has to be disseminated better to the public, do you feel that that is the case?

It is, yes it is in a way, yeah it's basically, this is as we, maybe we know from different practices and conventional banks and maybe some statement like from the former governor of Bank of England, Mervyn King, who said basically we need a cultural change in our financial system in terms of, you know, the practices of bankers, etc. In Islamic banking case this, basically the Sharia compliance aspect or of course Sharia compliance governance in the bank to avoid in a way control for these financial practices and I think an aspect of it ensure that basically the Sharia requirements are adhered to in all aspects of the products when developing the product itself, when launching the product, when selling the product and the processes of after, you know, selling the products so during the whole cycle of the product itself and operation of the banks which ensure this in a way, you know, this change of culture and we, I mean we see them for example when, you know, the bank of course we've got, you know, employees from different backgrounds, Muslims and non-Muslims, so even, you know, with employees who join IPP they are Muslims or non-Muslims, they see basically a different culture here, the way that, you know, a customer is put first in terms of the way, the transparency, the conduct of business and these things so they see a difference between what they used to and sort of a new approach to finance.

Q: There is also a lot of criticism in terms of Sharia supervisor board composition. A lot of the literature and a lot of the criticism stem from the fact that the Sharia supervisory board is not transparent, the Sharia supervisory board has similar members on different boards. How do you feel about this?

Maybe in a way I can understand this criticism. First of all maybe the issue of bias, maybe the same members of the Sharia supervisory committee they sit basically on maybe ten banks or something like that or they are the same on maybe many banks. It is, the reason why basically now there is sort of some initiatives to, in a way, to develop the next generation of scholars, increase the number. As you know Islamic finance as an industry is still a new industry or a new system and basically those scholars, it requires qualified scholars who basically have the Sharia knowledge, the knowledge of our Islam financial transactions and at the same time the understanding of the banking system, the conventional banking system, how basically they can interpret or the application of the Sharia knowledge in terms of the current banking practices, what needs to be done and unfortunately they are the qualified scholars in that domain, they are currently few, that's why you find maybe the same names are repeated on, you know, on the Sharia supervisory committees of different banks so that's one aspect. The other aspect in terms of the transparency, usually they issue for example for each product they're what we call a fatwa or Sharia legal opinion on that product and they say we reviewed this product, this product works on this particular aspect which we believe that it is Sharia compliant as long as the management of the bank applies our guidance or how this should be done because it's the responsibility of the management and the bank to apply this basically so in a way they give transparent and a clear opinion in their fatwas but this maybe sometimes has to be limited because basically if it's a new product, a new innovation, you can't disclose everything, you know, otherwise basically the institution or that particular institution would be giving everything to its competitors because this fatwa has to be published on the website or basically anyone can have access to it. We know that this financial product normally got copied, you know, after a while but at the beginning maybe it's the right of this institution maybe not to reveal everything but it's a requirement that at least this Sharia legal opinion issued by the Sharia supervisory committee, it's adequate.

Q: How do you feel about some of the criticisms levied at basically different Sharia banks headhunting specific scholars to get the desired approval in terms of Sharia compliance, do you think that exists or do you think that is just not true?

I mean they just attract maybe who, scholars who basically in a way they have liberal views …

Yes.

… so to speak. This is again, as I mentioned, it's in a way more, you know, it's more having scholars who are qualified and basically understands the legal regulatory and the operation system of, you know the financial system or the banking industry itself. It's not, it's not any Sharia scholar would have these sort of qualities or skills. I mean there are, for example, the typical or in a way traditional Sharia scholars. Yes they are knowledgeable, they are qualified about Sharia but maybe they don't have the required skills in order to apply this knowledge on the current financial system or products or maybe they don't understand how it works fully so that in a way will be an obstruction for them. That's why maybe those scholars who have this sort of expertise and skill or maybe they have in a way that, you know, academic qualifications on both sides, you know, economics, finance and at the same time they have the Sharia qualifications and the experience as well, there would be maybe more preferable or well known in a way in the industry and maybe taking on more responsibilities in terms of being on various Sharia supervisory committees.

Q: What do you think could be done to make Sharia finance look more transparent, you know, within the global spectrum?

So the middle bit of the question wasn't clear?

Q: In terms, so basically I mean a lot of effort has gone in to make the structures of products available online, you know Sharia rulings online that all the information's available …

Yeah.

Q: … but certain people still feel that Islamic finance is still very confined and we don't know much about it. What do you think can be done to improve this image?

Sorry again, the last bit this time wasn't clear. I'm sorry just the voice is not clear.

Q: Sorry, apologies, no it's my fault. What do you think can be done to make Sharia compliant more transparent?

Okay. I think maybe in a way some maybe a few Islamic banks need to be in a way more transparent and when I say more transparent in terms of maybe products and I would say that maybe because of the regulatory requirement, for example here in the UK as a bank we've got to put everything on the website and from Sharia compliance perspective that we should give all the information and make it available to customers to make an informed decision for any products. In some parts maybe or maybe in other countries, this sort of requirement is less strict or not adhered to fully. It's in a way you can relate to maybe best practice and in a way understanding the importance of, you know, of doing that. Maybe the competition would be a reason for that in a way that the bank doesn't want to reveal everything, you know, because of the competition element. However, I would say in general there is a very good level of transparency in terms of, you know, Islamic banks. Maybe it's good but maybe there is also room for improvement or making these sort of practices better at the same time.

Q: Okay, one of the main elements of my research is looking at financial innovation in Islamic finance, more specifically financial innovation under Sharia compliance.

Yes.

Q: Do you think there is, I mean Islamic finance has got several major hubs, one in Malaysia, you have the GCC countries and you have the UK as some of the few major hubs but there's a lack of uniformity when it comes to regulatory standards or basically uniformity as the financial system as a whole. Do you think there's a lack of uniformity in Islamic finance?

In a way the short answer, yes and no.

Okay.

It's basically you would expect, when I say yes because you would expect that as a new industry or, you know, Islamic banking as a whole it's considered a new innovation basically in a way of providing this approach or the structure of the Sharia compliant products so you would expect this sort of standardisation of the industry will take a time basically or will be done over time gradually which we noticed over the last maybe two to three decades where, you know, certain bodies were separated by the accounting and auditing organisation for Islamic financial institutions, the Islamic financial services board as well. Those bodies basically issue standards regarding Sharia compliance of the products on offer to regulate this product and they start, you know those bodies started basically to gain high level recognition in the industry so it's something in a way work in progress and it's getting there but that will happen over time. In terms of the different approaches in Malaysia, it's perceived as sort of taking little approach to Islamic finance. In a way they do adopt in a way exceptions approach to certain things like other maybe scholars or Islamic finance hubs like Goldsmiths here in the UK, they may disagree with. It's the way they are taking basically this approach, you know, in comparison to the Malaysian approach that the industry is giving you and basically if you start making exceptions from the beginning and then more exceptions, this will divert the industry from its main purpose and basically, as you say, main slogan or approach that is an ethical Sharia compliance alternative and basically that's why many of those raise their concerns about that and those basically exceptions or this sort of in a way was a logical approach should be looked at carefully and unless there is a need or a necessity to make an exception on certain financial transactions this should be avoided if possible in order to maintain, you know, the Sharia compliance element sound intact as possible.

Q: So you mentioned that Malaysia has a different approach, I mean they've got a more liberal approach to Islamic banking, the UK has a different approach to Islamic banking, this is based on interpretation of Sharia. Do you think that this will have an impact on let's say product development in Islamic banking?

In a way yes. When I said they have sort of like more liberal approach in Malaysia, it's not basically for everything, it's not like, you know, they are coming up with completely different approach. It's basically mostly it's in line with the mainstream or let's say the GCC countries' approach and the UK approach, however they differ with them on certain maybe let's say principles adopted or certain elements regarding maybe some products that they use maybe in a way a juristic opinion, opinion that it's not that strong in contrast to maybe to the opinion adopted by, you know, other regions like GCC and the UK so maybe in order to precipitate certain transaction so that's basically the main reason and it's not like completely different approach, you know, it's pretty much the same it's just, you know, there are some differences regarding certain elements in their approach. Mainly the interpretation is governed by, I mean in terms of any different financial institutions always refer or in most cases to the Sharia standards issued by AAOIFI, the accounting and auditing organisation and those scorers on the AAOIFI board basically represents nearly all or most Muslim countries so they represent different regions so and this sort of approach is done on consensus basis, that's why it will be more adoptable approach and acceptable to everyone.

Q: In your experience have you ever seen an Islamic product that is deemed Sharia compliant in one region but deemed not Sharia compliant in a different region? Say for example it's Sharia compliant in the UK but not Sharia compliant in the GCC countries?

Not really no. No I don't think so.

Sure.

Maybe something that I didn't see but I heard about in terms of maybe certain financial transaction that practised in Malaysia that would maybe the majority disagree with but I didn't see, you know, any actual documentation for that.

Sure.

It's basically related to what I was mentioning in terms of maybe, you know, they use different interpretation on the specific issues related to that transaction other than what basically the majority of other scholars that, you know, that shows in terms of interpretation.

Q: Do you think this could have a negative impact on Islamic finance for the future? Say for example from a conventional financial perspective, having different standards say for example in Malaysia and the UK, do you think this would be a bad scenario?

I don't think it's that big to have this negative impact as long as it's kept controlled in terms of its judgement and basically provide the criteria so any individual financial institutions or countries they will not cross any red lines basically because this would be rejected from the industry and from the people themselves taking up this product, you know, so it's important for them, for the financial institutions or, you know, and that reason that they stay within the overall agreed upon framework or Sharia compliance parameters.

Q: Okay. How do you feel about AAOIFI and the IFSB, do you think they are meeting their requirements as central regulatory bodies?

In a way they are doing a really good job in terms of standardising and the industry help and the industry issuing those standards. The IFSB in terms of the regulatory aspect, you know, pass the regulations and how this can be interpreted for Islamic banks because basically the structure of the product is different in a way and on the other side are usually in terms of basically the Sharia standard for financial products and putting different governance for basically Sharia compliance governance and in banks so showing lots of guidance on these issues. This is basically the passage for standardising this industry as it goes, these basically standards and this will grow with it as well.

Q: Sure. Some have indicated that for more standardisation, Islamic finance needs a lender of last resort. How do you feel about this, like a central bank to support Islamic finance, how do you feel about this?

There is in a way lack of resources or skilled people especially in key areas like products of Sharia compliance, certain areas for example like a credit, maybe IT and system in terms of banking system, they are not that bad because basically it's pretty much the same with some adjustment. Operations maybe to some extent as long as basically the procedure and processes are replaced, finance or to some extent so the issue of resources in certain and particular very specialised areas that basically may be there is a huge gap or lack of resources in that area.

Q: In Islamic countries such as Malaysia and the Gulf region, Islamic banking gets a lot of support from the government, do you think there's enough support from let's say the governments in non-Islamic countries?

Yes I think the UK may be the best example for that in terms of, you know, amending the regulation, the tax regime, to accommodate Islamic finance, however it's something sort of ongoing process. In a way it doesn't stop, for example the first step or the second step of this amendment because the industry is developing this requirement especially also developing and adjustment of this regulation is also needed further and in a way maybe it's moving slowly but there is good progress done here in the UK.

Q: What do you think could be done to help improve the overall standardisation of Islamic finance going into the future or do you think there's a need for overall standardisation going into the future for Islamic finance?

I think there should be in a way yes standardisation in order to, in a way to maintain this industry and to basically keep it in the right direction.

Q: Okay we're coming down to our last theme so basically we're now looking at finally corporate governance in Islamic finance, how do you feel, what do you think is the level of corporate governance in Islamic finance at the moment?

I think in a way it's very structured and it's good governance as long as it satisfies the requirement of the financial institution basically in terms of having adequate resources, Sharia compliance department in the institution and that would be subject of the size of the institution as well having Sharia supervisory committee in place for the institution and basically having tried and skilled people to operate those functions.

Q: In your experience, has Sharia compliance been a big issue in terms of governance, having to manage Sharia compliant governance, Sharia governance, do you think that's been a really big issue when it comes to elements such as new products, product design, risk management?

Yes it is because basically for Islamic banks Sharia compliance is the main risk that they have to account for in everything because if the bank is perceived to being not compliant with Sharia basically this is in a way very damaging to the bank and the bank's reputation and there will be a huge loss of business as well so it's one of the main and very important risks that the bank has to control and manage efficiently.

Q: Okay this is basically the final few questions. Where do you see Islamic finance heading in the future? Do you think it will continue to grow at the high rates that we've seen so far or do you think, you know, how do you feel about Islamic finance going into the future?

I think it's basically developing steadily and gradually still developing even in the tip of the financial crisis, you know there was development and new products launched, new players again to the market and the industry kept growing and I think it will stay on that path in the future, I would say maybe it’s getting bigger, more interest generated, maybe more countries is trying to look at it and adapt or amend their financial system or regulations that accommodate for Islamic finance?

Q: And how do you think Islamic finance perform during the current financial crisis, do you think it performs better, do you think it was a better alternative?

Sorry I didn’t hear the first bit. You mean how they came out of the financial crisis or how they ?

Q: Yes, how do you think Islamic finance basically performed during the financial crisis? Do you think they out-performed conventional finance? Did they under-perform conventional finance or were they able to deal with the risk better?

I think in general they were able to deal with the financial crisis better than the conventional system because, you know, the different approach to finance and the way they operate so the impact, although in general as basically part of the economy as a whole there was a general impact and you know they were in a way affected as part of the overall economy but as an institution basically in contrast to a conventional financial institution they survived the financial crisis much better than the conventional banks because of course of their approach.

Q: Do you see any areas of Islamic finance that require improvement?

Of course there is always room for improvement, in a way maybe improvement in Sharia compliance governance or showing that they maintain this aspect because in a way this is their key selling point and from ethical approach basically this is the differentiator between, you know, their approach and a conventional approach. In terms of maybe in a way providing instruments and solutions for money markets shows in certain aspects Islamic banks are disadvantaged because they don’t have enough instruments maybe for money markets or short or long term liquidity and strong assets so there are still lots of work to be done.

Q: You mention new instruments, one of the, in terms of liquidity, one of the major users, one of the big players in commercial finance would be the use of derivatives such as options and futures, I mean these are explicitly disallowed in Islamic finance, how do you feel about that?

For example in certain areas as you mentioned like equities, Islamic banks they can’t use the same instrument that conventional banks use because those instruments are not being Sharia compliant and that in a way basically pushed the Islamic finance industry to create suitable instruments for them in order to address this issue, however this has not been addressed fully and it’s in a way work in progress and more development is, you know, being achieved on that front but more needs to be done with that regard.

Q: Great. Okay final question. Where do you think the main areas of growth will be for Islamic finance in the future?

Sorry, say again.

Q: Where do you think the main areas of growth will be for Islamic finance in the future?

The main areas of …

Of growth.

Sorry, of what?

Of growth, so main areas of development.

Development.

Yeah.

It pretty much, you know, it goes back to addressing certain issues regarding certain financial instruments in terms of inter-banking and financial markets, more structure, maybe Sharia compliance governance and in a way developing more products and innovations.

END

Academic-Practitioner 2

Q: Islamic finance is something that's relatively, well we won't say new but sort of mainstream economy it's semi-new to a certain extent. How do you think people within the mainstream financial system view Islamic finance?

Well, some people view it as sort of a niche industry, targeting Muslim communities in the world. However, in practice, or even in theory, Islamic finance is targeting all the types of consumers, Muslims and non-Muslims. Some people view the industry as a sort of bringing foreign direct investments to each society or each country or the host countries. Some others view Islamic finance as a way of offering new banking services to certain segment of people, new products maybe generation of new jobs and contribution to the economy, so it has been viewed from many angles and many perspectives and I think it serves all these perspectives but it's not considered as a niche industry for Muslims, it's an industry for everyone.

Q: Sure. You say it's viewed from different angles, could you elaborate further on those different types of angles?

Well I mean if we are considering the expansion of Islamic banks or Islamic finance all over Europe for example, you will find that the host countries like England, France, Germany may view this from an economic perspective so they won't have new fold direct investment, they want a creation of job, they want to get some taxes, they want to get also more contribution to the industry, also from maybe a small political perspective, people look at the industry as maybe serving their aims of providing a global hub of financial services and from the other, from the Muslim community, you look at the angle that the view the industry as a way to serve their needs in an Islamic perspective which is a religious wise, religious perspective.

Q: Sure. Well one of your main points would be that people kind of view Islamic finance as a particularly niche industry in a sense that some people say that it's only meant for Muslims, do you feel that that is a very strong view in terms of let's say, within practice do people come up to you and say, you know ?

Well initially most people come with that but when they know that we can provide services to each and every one then they start to look to the fundamental aspects of any banking service which is the price, the risk, the investments, the tenors, and so on. But initially people think that it's for Muslim only. When we do proper marketing and we do proper advertising that this service is for all then people will start to look at the fundamental aspects of the banking services.

Q: Do you think it's been tough in that sense trying to get people to understand that it's not only for Muslims?

It's not difficult but when we come to the point of convincing people which we don't, do not take time then they look at the course, the revenue and the risks of the Islamic bank itself so.

Right so it comes down to …

The fundamentals.

… the fundamentals, that's fair enough.

Yeah, yeah.

Q: Right going into like, with all, you know with the current situation with the financial crisis and so on and so forth, what do you think are the inherent risks faced by Islamic finance, you know, in a current financial system?

Well if we look at the Islamic banks in general compared to the financial crisis, you will find that use of derivatives are very limited so the industry was not that much exposed to derivatives because all of the transactions are being hedged normally. You will find all the problem is in the real estate aspect of the prices. If you consider that Islamic banks had some sort of exposures to real estate things during the crisis then there is a problem and to equity funds definitely, there is a risk in equity funds and there is a risk in real estate because during the financial crisis when they started with the mortgage issue or the real estate issue in the US, equities went down and accordingly some sort of equity funds went down and some went below 50%, that means liquidation in the Islamic banking industry, so the risk I believe is concentrated in the real estate and the equities and investments. However, the other risks, I mean the foreign exchange risk, the money market risk and the other types of credit and market risks are normally hedged by sort of underlying assets.

Q: Sure, I mean from what you're, from what I'm gathering from this, I mean the risk profile of Islamic banks is very similar to that of conventional banks, would you say that?

It's not because if you consider the real estate investments and at the end of the day you will be having an asset. Okay? If you consider the equity investments at the end of the day we'll be having companies which is trading in the market and there is a sort of also of an asset but Islamic banks are not exposed to speculation by any means so dealing with uncertainties is very, very tough in the Islamic banking industry, we don't like uncertainties and we don't like volatilities so I can say that each and every transaction has to have a sort of underlying asset as a hedging or as protection to their investors but the conventional banks you'll find that taking speculative positions, derivative positions, options and so on, options in Islamic banks for example are just useful hedging, they cannot be used for speculation of trading so. I think the risk, the risk you will find is more conservative than conventional banks.

Q: Fair enough, that's cool. Would you think that issues such Sharia risk are important? In essence we've got this whole concept of Sharia compliancy and non-Sharia compliancy, do you think that's a big risk in trying to, if you design a new product or if you start trading these products that there's an increased risk there?

Well I think the risk is very low simply because on board we have a Sharia auditor and this Sharia auditor is responsible for approving each and every new product and even the existing products he do like a frequent, certain annual, review on these products and if he finds that any of these products are not Sharia compliant, he simply will take the product, we will go outside this product and the profit made of this product will go to charity.

Okay, great.

So I think the risk is very low because we have two levels of Sharia compliance, the first one is the on-board or the onsite Sharia auditor and the second thing is the Sharia board, the Sharia supervisory board where this auditor onsite is reporting to the Sharia board directly and this Sharia board has really strong powers to stop anything which is not Sharia complaint.

Q: Sure. So you actually have an onsite Sharia board within the bank.

We have an onsite Sharia auditor.

Right okay.

Then this Sharia auditor's report to Sharia supervisory committee which is hired by the bank but it's independent, so it's not onsite it's off-site.

Q: How do you feel about, let's say the Sharia compliant rules within the UK, say for example the FTSE has its own Sharia compliant rules in terms of what companies are allowed within, you know, what companies are Sharia complaint, how do you feel about that?

Well actually any Sharia compliant committee has its own guidelines and risk guidelines, they consider the companies that they should not trade in wine, for example, alcohol, entertainment, pornographic, weapons and all of these things, so I think the Sharia compliance limitations or guidelines are fine with the FTSE thing but again they consider also the debt, the level of the debt in each and every company so the screening has the activity port and has also the red port because the debt of the company is above or below certain level, this may not be acceptable to go for it.

Q: Okay, that's great. I mean I think it's kind of reducing now at the moment but I think when, let's say about ten months ago Islamic finance was very much compared to ethical investment funds like environmentally friendly investment funds, would you draw that distinction between them? Would you say there's a similarity or would you say there isn't a similarity?

Well I think it's not environmentally friendly, most definitely. It may be considered as a sort of ethical banking. We are trying to do ethical banking but I don't think it's related to the environment. Islamic finance try to put some sort of weight on the corporate social responsibilities but I think there is a slight difference between those.

Q: Okay that's cool. Right okay you mentioned something about, I mean you say that basically derivatives are not allowed. I mean derivatives are, well derivatives are allowed but they are only meant for hedging.

Well there are some sort of derivatives which are allowed for hedging and this is like FX forwards, FX swaps okay and FX options so just the simple plain vanilla type of products of each one of these so what I can say that it is FX for the FX swaps and FX options, this is the only way but for example if we consider the FRS it is not allowed.

Right okay.

So it's just the three types.

Right okay so I mean in terms of the forwards you'd be looking at bai salam or a similar, a salam contract.

No we name it unilateral promise, Wa'd.

Right okay, okay Wa'd.

Yeah.

Q: In that sense, I mean wouldn't the Wa'd structure be similar more to an option or would it be more to a forward?

Well we use the Wa'd for both, for options and for forwards.

Okay.

So there is no more, there's no underlying commodity.

Sure.

The problem is one party is promising the other …

Yeah.

… and it is, sometimes it is a binding contract, sometimes it's not binding but again the similarities, it's similar to the conventional ways in terms of calculation but again it is just a promise, it can be implemented and cannot be implemented so it's …

Q: Sure. I mean how do you feel about, your risk management is quite tough within Islamic banking, I mean why would you say that? What would you attribute that to?

Well the risk management framework is conservative in Islamic banks. I work with Islamic banks and I work with conventional banks so what I can say that it's more conservative in Islamic banks and I think this is to the sake of protecting investors, not to the sake of being like achieving low revenues, just we try to protect investors and I think the risk management framework does not allow you to go below investment rate in some cases and consider the rating factors and fundamental analysis of each and every security or an investment vehicle as a major issue to be dealt with before putting the money somewhere or somehow.

Q: I mean in that case I mean do you think, I'm sure you have loads of people coming up to going we want to manage some risk, do you think you have enough instruments to manage that risk? Do you think you have the adequate tools to manage that risk?

Well again the tools of managing risk is the same as the conventional ways, there is no difference on this, it is almost the same. Again we say the VAR, the market value, the market risk, the PPV value, it's all the more the conventional ways of managing risks.

Q: Sure, I mean in that sense so the way in which we manage, the fundamental way of managing risk in Islamic finance would be similar to that of conventional finance.

Yeah.

It's always about mitigating that, sure.

Yeah. About mitigation it is just conservative way but it is always the same.

Q: How do you feel about product development within Islamic finance? How do you feel about, you know, the new products? Like the Wa'd is a relatively new product, you have profit rate swaps which are relatively new as well. How do you feel about product development within Islamic banks?

Well this is where you find the Sharia risk, the product development is where you find the Sharia risk somewhere. Because again you have many Sharia boards, you have some Sharia boards in Malaysia, you have Sharia board in London, you have Sharia board in the Gulf, you have in Egypt, you have, you have, you have. Unfortunately the interpretation of the Sharia law varies among these boards so what is permissible in Malaysia may not be permissible in London. What is permissible in Egypt may not be permissible in Malaysia because everyone has his own interpretation of the Sharia law or the Quran.

Yeah.

So this is the risk of the product so if somebody comes with a product which may be approved in one place and rejected in another place.

Right okay.

This is the only risk we have. The product development is good but it's slow.

Right okay.

Because it takes too much time to be approved.

Right okay.

So if we are saying on example we are trying to develop a standard format of the ISDA which is similar to the International Swaps Dealers Association agreement.

Okay.

International Swaps Dealer Agreement. This has been taken like maybe four years now to be developed because again the ISDA which is an agreement to trade derivatives is not Sharia compliant so reaching a Sharia compliant version of this ISDA is really something difficult so the product development is going on but it's a slow process.

Q: What do you think could be kind of, how do you think, do you think it can be improved in that respect?

Yeah we were able to develop a sort of product in terms of structured notes like doing the capital protected note with a basket of equities managed by an investment agent according to the Sharia law so the components of the basket is Sharia compliant equities or Sharia compliant fixed income instruments. The Sharia approved it because they said or we said there is a sort of capital protection so if the capital is protected then the Sharia normally is happy because this is protecting investors dealing with uncertainties and avoid losses to the people who put the money in so I think it will keep taking time but this will reduce gradually. It will develop but slowly so we can say that the proper term is slowly but surely.

Slowly but surely, fair enough.

Yeah.

Q: I mean it kind of feels like basically a lot of the development in Sharia finance and Islamic finance comes down to basically establishing a sound regulatory base because I mean that's the vibe I'm kind of getting in a sense that if we have a good regulatory standard, if we have, you know, we can actually progress forward. Would you agree on that?

Well the regulations in the UK are about the full weight of regulations we have to consider this. The problem is the regulatory framework to Islamic banks or for Islamic banks is almost similar to the conventional banks a part of some things like the buffer, for example the liquidity buffer.

Sure.

Conventional banks are able to place on the cabin floor facility with Bank of England. Islamic banks found this facility is not Sharia compliant.

Right okay.

Okay so what was approved to the Islamic banks as a liquidity buffer or liquidity facility is the Sukuk or the Islamic bonds or of Islamic Development Bank which is IDB in Jeddah because it is the only Islamic institution that is treble A rated. The case is all of the Sukuk here or all of the bonds of the Islamic bank or Islamic Development Bank are in US dollars and we are sterling based bank.

Right.

All the Islamic banks are sterling based banks so you will find again a foreign exchange exposure between the dollar and sterling.

Right okay.

Also you will found the liquidity of the product is a hassle so the regulatory framework in this aspect is not the same between Islamic and conventional banks so I think if we dealt with the liquidity management thing or the liquidity buffer issue, the regulatory framework will be the same and it will won't make a difference because again the regulatory framework in the UK is very tough and old so it's trying to protect again the overall investors.

Q: Right, I mean you say the liquidity management side of the Sukuk in that sense, would that be down to the fundamental structuring of the Sukuk requiring a tangible asset?

Yes I think so because we are trying now with Islamic Development Bank to issue a sterling Sukuk and to provide liquidity on the current Sukuk because the liquidity is very tough in terms of buying and selling such type of Sukuk. Triple A rated Sukuk, a lot of people have lots of demands on triple A rated but you find the supply is very limited so when you need to buy something for your own buffer, it's a little bit of a hassle together. So I think this is the only variation in the regulation between the Islamic and conventional banks in the UK because the liquidity management stuff, if we were able to tackle this issue I think the regulatory framework will be the same and it will be tough on all of us.

Q: I mean with the UK side, you've just said that there's different interpretations of the Quran and you know in Malaysia, do you think the lack of uniformity within, let's say the UK, the Middle East, the Gulf countries and Malaysia in the Far East, do you think that's hindering, you know, do you think that's a problem?

Well I think yes, I think yes it's a problem and I think standardisation won't be achieved easily in this arena. However, the Malaysians have applied a very nice version on standardisation, they have made an association in AIBM, or AINB, I don't remember but again this association is responsible for Islamic banking in Malaysia. They developed standard agreements to be used by all the Malaysian banks, Murabaha, Wakala profit rate swaps, what you can imagine, all the agreements have been done there. They have provided standard format of Sukuk, ijarah, leasing, whatever, you know, Wakala management Sukuk so they succeeded, I can confirm that the Malaysian version of standardisation succeeded, however this is not it implemented in the Middle East or in London, I think we need a sort of again association maybe or something like this but in addition to the RIFM or the AAOIFI are already in place but somebody to force the standardisation because again you will find the agreements in the UK, this agreement differs from our agreements differs from the other banks' agreements and in the Middle East it's the same hassle so I think Malaysia was able to achieve a regional standardisation which may be the case if we were able to achieve like four regional standardisation, one in Malaysia, one in Europe, one in Middle East and one maybe in North Africa, it will be something good but overall standardisation I think this would be different because there are four Mazhab, there are four branches of interpretation to Sharia law, if you are unaware of this, there are four, we name it Mazhab, Mazhab is somebody, some scholar who developed a way and some others with them so we have Mazhab, Shafi, Imelki, Hanbali and Hanafi so it's four sectors and four scholars. You'll find the Egyptians for example following the Hanafi, finding Malaysians following somebody else, Iraqi follow, it is different.

Q: Do you think that basically I mean in terms of uniformity I mean you say it's difficult to have, I mean the Malaysians have standardisation, the UK doesn't really have standardisation in the Middle East, it's extremely tough to have standardisation I mean in terms of let's say financial innovation, so you develop the product in the UK that you want to trade that you, you know, think is a good product and you want to have Sharia approval in the UK and you want to advertise that product in the Middle East, would you encounter a lot of problems?

Well in some cases you find the same Sharia scholars on the board.

Right okay.

So if we say one of the famous scholars as in Sheikh Nizam Yakubi for example, he is on our board and he is on other 46 boards.

Right okay.

So if you find the same scholars on other boards, it's very easy to sell your products in the Middle East. If you find different scholars then you have to put these scholars in front of these scholars. Normally they come with a middle ground of agreement. In very few cases they didn't achieve an agreement and that's why the product stopped but this is very few cases.

Right.

Normally they sit with each other, even on the 'phone or conference call or video conference, whatsoever, and they agree a middle ground of doing that.

Sure. I mean …

So we have to keep everybody happy.

I'm afraid that's a really tough job that one.

Yeah.

Q: Coming down to that, so you basically have, so I mean it was one of the criticisms of the Sharia supervisory boards in a sense that you have one scholar sitting on many different boards. Do you think that's a big issue? Do you think that is a problem that, you know, that affects?

No I think this is an indirect way of achieving uniformity.

Right.

Because at the end of the day if you find one, if you are on the Sharia board and you approve this in London, how you would be able to reject it in the Middle East? Yeah it's a little bit of a tough job. You will be contradicting yourself or he will be contradicting himself.

Fair enough.

So I think this is an indirect way of achieving uniformity.

You make a very fair point there.

Yeah.

Q: I mean another thing basically with uniformity there's also the issue of the lender of the last resort, you kind of indicated that in the UK you have, you know, buffer levels better established with the Bank of England. With Islamic finance you've got the Islamic Development Bank as semi lender of last resort, do you think that could actually be, you know, do you think that could be further developed?

Well the lender of the last resort for Islamic banks in the UK are normally the parents, in the Middle East because all of them are Middle Eastern, having a Middle Eastern linkage. However, the Islamic development bank will remain the lender of the last resort but there is no official facility, there is no, the Bank of England overnight facility is not there for Islamic Bank so the bank is there, when you go and negotiate with them, when you go they help you and when you go to them and they help you, however the facility itself is not there.

Right.

For example in other institutions, conventional institutions, if I have a lack of liquidity overnight, I go to the central bank, I have my limits, I go online, I go and get the money overnight and return it next day or the day after, whatsoever, this facility itself is not there so I think there is a need to develop a sort of facility even managed by Islamic Development Bank or any other association that helps the Islamic banks to cover the liquidity.

Q: I mean would you like this to be let's say the bank in the host, the central bank in the host country or would you like this to be a separate entity from the central bank?

Well I think it should be the bank, the central bank in the same host country simply because, you know, there are different time zones and different liquidity requirements and different even rules so the rules in the UK is not the same as the rule in Jeddah and Saudi Arabia where Islamic Development Bank is there and it is not the same in Qatar so I think it has to be done through the central bank or the regulatory entity in the host country.

Q: Fair enough. Another thing that was interesting in the sense that if you, sorry I lost my train of thought there. Okay, in terms of AAOIFI and the IFSB, you know the two large regulatory bodies within Islamic banking finance, how do you feel their role, how do you perceive their role within the financial system?

This will come to one aspect which I read in your paper on the governance. Okay they are very good in doing that and they're establishing like a sort of even Shariah certificates, training, whatsoever and governance, okay what is important here? Okay if you are achieving say that this is standard document developed by AAOIFI, Islamic banks has to, Islamic banks have to apply this. Okay if one Islamic bank didn't do it, if any of the banks didn't do that where would be the problem? There would be nothing because this will, they already laterally or they are overseeing the industry but without enforcement powers. If you have a liquidity requirement from the FSA and you did not meet with this liquidity requirement, somebody who is the treasurer who would be fired and the bank will be paying penalty so the sort of enforcement and governance by government I think these institutions are good as long as the Islamic banks agree themselves that they apply the same standards on 100%.

Q: Do you think that both AAOIFI and the IFSB then should be given enforcement powers to basically imply?

Yeah.

Q: I mean would you think that could ever happen, would you think that's, you know, a way?

Again it's very difficult because you find again the IFSB and the AAOIFI are in Saudi Arabia and you have different regulators and regulations in the UK, I think in terms of agreements and contracts, they can have this but in terms of liquidity and some other regulatory stuff I think it's difficult.

Q: Okay that's a very interesting point there. Right I just realised what I forgot to ask you in a sense that because Islamic banks don't have that ability to depend on let's say the host country central bank because it's not like banks technically are, you know, they operate in different way in terms of, you know, the way they trade, the way the funds invest in, do you think that there is a competitive advantage to either one of them conventional banking or Islamic banks, do you think there's a competitive advantage for conventional banks over Islamic banks at the current situation?

Well at the current situation I think yes in terms of pricing. Standard banks are not able to compete with pricing. If you look at the standard mortgages versus the conventional mortgages in the UK as just a little bit of an example, just all of the Islamic banks are just small in size or medium sized, so just compare the mortgages provided by Islamic banks with some other small UK conventional bank entity, you will find Islamic banks are asking for 20% deposit, some other banks are asking for 10 or 15. You will find the price here is 4.99, the price here is 3.49, so again the customer, from a customer perspective, if you are not that much tough on religion on the Islam you will go for the good pricing. Why you pay 4.99 if you can get it for 3.49? However, the uniqueness of Islamic finance you will find many people going for the 4.99. Why? Because they want to go to an Islamic product. Again this is how the conventional banks have a competitive advantage on this. I think also the market accessibility for conventional banks are wider than the market expected for Islamic banks. Islamic banks have strict rules to be with. If you find how many Islamic banks in the world, are you able to deal with all of them? The answer is no, you have to deal with any risk management standard and country limits and country risks so again we are not able, for example, to deal with Islamic banks in Afghanistan for example there is a country risk just on example okay but you find accessibility of the conventional banks are really good. If you have a small bank in the UK you can just place money in anywhere in the world if he have the approved limits and risk framework but again we find all over the world Islamic banks, 100 banks, 74 banks, so it's very different.

Q: Yeah. What do you think could be done to make it more of a level playing field? I mean like how do you think you can, you know, what proposals could go?

I think the transactions and legally the operation of course itself it's hard for Islamic banks. If you go to any lawyer asking him to develop documentation for Islamic banks, he would charge you almost double, he would charge you high because it says this requires more effort, this requires more consultancy, we have to ask our experts. Like on the transaction of course at the time being it's high, there is of course the commodity involved in each and every day because of the commodity involved aspect so again if you were able to take the operational costs down plus using more technology and innovative product development and innovation of the products, you will be able to do something otherwise it will be again the same way.

Q: Fair enough. Do you kind of find that innovation within Islamic finance, financial products is at par with financial innovation within conventional finance because if you think about conventional finance we have evolution of products, we don't really have new products coming out year on, year out whereas with Islamic finance you have new interpretations and so on, do you think that, you know, they are?

I think the revolution of the products are going better than the innovation of the products. Again I think the cost factor and I think also that we need to access the market and do well marketing for the Islamic banking products so if we were able to do that, there are some products in the Islamic finance arena performed well so performed really well and some funds performed really well, maybe better than the conventional line but who knows?

Fair enough.

It's again the accessibility, the marketing accessibility, how we do market the product.

Q: Right. I think one of my, you know what I would really want to see from Islamic finance would be like its ability to kind of integrate itself but basically having mainstream customers kind of use Islamic products, so on and so forth, and you know across like if you want Islamic products you can use them, if you want conventional products you can use it, how do you feel about that in terms of integrating, let's say, an Islamic Wa'd into a conventional risk management strategy, how do you feel about that?

Well okay the risk management strategy is comparing to bases, to the market movement of the Wa'ad whatever, market risk or whatsoever, so I don't think there is a problem of benchmarking a product to conventional risk management because simply the product in reality, you will find the same calculations as the conventional way. The only difference is in the underlying contract all the operations, accounting, processing so the contract is different but again the calculations are the same so it's fair to benchmark it to our conventional risk management thing. However, is Islamic banks you cannot mix conventional money with Islamic money but you can again you can benchmark your thing. Again look at the reality.

99.9999% of the Islamic banks in the area are benchmarking the profit rate anticipations or expectations to Libor which is a conventional facility. Again when they tried to, when Islamic banks tried to adapt or develop a market tool or a formation tool with BBA, the British Bankers Association, similar Islamic LIBORS, it's in a very premature stage and even it is there by the way, it is already in place but you'll find contributors are very low and you will find also maybe the same people who contribute to the Islamic Libor is benchmarking according to the conventional Libor which is a contradiction but I think this would be fixed over time, it would take too much time to be there because you need more contributors. Again you need many people to put, to contribute to the Islamic Libor facility. It's not like three or four big banks and that's it.

Q: Sure. How do you feel about the uptake of Islamic banking, you know, in that respect because you need more contributions? How do you feel like is the market place readily accepting Islamic?

Well actually the market is accepting finance, Islamic products but the problem is that Islamic banks, specifically in the UK are very small in size so they are not, I believe they are not well capitalised by their parents, I don't mean a criticism but I mean that the parent companies in the Middle East aimed at having small entities not big entities so their competitive edge would be by default smaller in nature to the competitive edge if anything. If you are talking about the average capitals in the UK, a bank of 50 million, a bank of 100 million, which is very again very, very tiny comparing to the industry itself.

Q: That's fair enough. How do you feel about the expertise with an Islamic bank and like do you think there's better, I mean you know you've got loads of little Islamic banks being set up, you've got new Islamic banks being set up and year and year on, how do you find the expertise within the market place, is there enough to basically go round or do you think it's a struggle to find people that know what they're doing?

Well I think Islamic banks needs the blend of the western banking expertise with the good Muslim professionals, or good people in the profession, for example most of our industrial practitioners are from the UK or British people and they have the previous conventional experience in HSBC and Europe, whatsoever, X, Y, Z banks but this expertise is running alone, it won't achieve anything. Without having the people from the Muslim community who know what Islam and how to do this but yeah I mean they're good people, I think there is a problem on the human capital. The level of expertise, our expertise is not as we expect and I think most expertise in the Islamic banking comes in the Middle East.

Q: Sure, okay. Do you also find like a problem, I mean because you have loads of conventional people within the commission market coming into Islamic banking, do you find that there is a bit of, you know, a bit of a shock to their system when they're coming and going, okay it's a different way of doing things?

Well I think most western professionals do not do the proper study before moving to an Islamic bank because most of the people do it for better position, for better money, for better salary, for fundamental financial remuneration and packages but if they looked on how they are going to do the things, I think they will think deeply whether they can do it or not because some of them comes and they are really able to do the job and they are happy to do the job and some others are struggling, they don't understand this and they don't maybe struggle to understand things so again it will depend on the person himself because some people are really good in this and some others are really not so.

Right, fair enough.

I think that maybe we need to have like a sort of qualification which is, again the IFQ which is developed by the CISI is not sufficient.

Right okay.

I see that as a very fundamental qualification and even the language of the book itself is not clear and it's not reflecting the real way of doing things but again I think if we have a sort of proper qualifications by a proper institute but CIMA is trying to do something, maybe CFA is trying to do something, it's something tough and something good and some accredited training providers we can achieve something.

Q: Fair enough. Okay that's cool. Right another issue when it comes to Islamic banking that's been highlighted within, you know, the Islamic role will be the transparency of Islamic banks in terms of, you know, when it comes to the way products are structured, I mean a lot of people complain that oh I go into an Islamic bank and I don't know what the products are about, how do you feel about that?

The transparency of the product is available. The product structure is available but it will come to the person who is conveying the message to the client. Does he understand the product he is marketing or not? Is he aware of what are the risks or not so it will come to the human factor but again to reach the stage of approving the product by the Sharia board is very difficult and it has to be transparent so each and every step is one, two, three, four, very clear. The problem here will come to the human factor who is conveying the message, also to the marketing and advertising strategy which may be a little bit vague in some cases. But not all. I think in some cases it is vague, it needs like a sort of more clarity and more explanation to the difference between this product and that product.

Q: Right. So it's down to the institutional level where basically the problem lies.

Yeah I think it's not about the transparency of a product, it's about the way of marketing and the human capital. The human factor who is conveying the message to the client, I have dealt with people in other banks maybe in my careers who are marketing the products which they don't know anything about it.

Right.

You ask them is capital productive, you know when he start to do that you will definitely, something wrong here.

Sure.

So I think the human factor here has …

Q: What about large transactions, because one of the things like if you think about it, in terms of Sukuk structure and I think Sukuks are large transactions …

Yeah.

… I mean I think one of the main concerns was basically down to how, who was participating within these Sukuks, who was buying a large proportion and, you know, and people wanted to know with disclosure of that information, do you think, you know, is that an issue in your ?

Well I think well who is buying, I don't think this is the problem with Islamic banks, I think the problem is the structure is to be Sharia complaint, the asset to be Sharia compliant in the investment of the Sukuk proceeds itself to go in a Sharia compliant manner. Who is buying? I think this is similar to the bond market. You can buy, I can buy, everybody can buy and I don't think that all the bond holders of each and every conventional bond insurance are disclosed. You will find maybe the liquidity provider, you'll find their ranges. You'll find the big players, maybe the major holder, the core arrangers but you don't find the one who buys two hundred grand and three hundred grand. And you know you have to consider something that most of the Sukuk or some of the Sukuk goes to private banks and funds. If it goes to the funds then investors I think are clear in the prospects rather than the prospectus of each and every fund. The types of investors or the geographical locations. However for private banks how you will be able to tell that this Sukuk was sold to X, Y, Z investor because you have for example KFC private bankers buying three million of Sukuk but this bank is not buying the Sukuk for themselves, they are buying for their ultra-high network individuals who are clients of these banks so you cannot ensure they've got disclosure of this.

That sounds like it's pretty much similar to the conventional banks …

Yeah exactly.

… because you don't get full disclosure within the conventional markets as well.

Exactly so I think again it is about the product, the structure and the investments of the proceed not about who is buying the case.

Q: That's great. I mean in terms of transparency as well there was a bit of a concern about, you know, the processes in light of the financial crisis, I think Dubai had a bit of an issue with Sukuk issuance and there was a bit of concern in terms of the protection for its customers. How did you find the overall protection of customers of Islamic finance?

Well again it depends on the structure of the Sukuk itself. If the structure of this, for example, ijara then you have the asset, you can liquidate the asset and do the pari passu and that's it. But if the structure is Wakala management, Wakala management you are giving the money to a company to invest it in it's something, again how it is going to be done, this is to the company and its investment strategy and whatsoever. If the company defaulted then we have again the pari passu and all the government support but with government backed companies they will find that normally government backed companies, you will find the government will interfere and do something which I think was the case in Dubai World because the Sukuk is trading at premium now so that's …

Q: Do you think there is a need for an overall framework as to, you know, to highlight the protection that customers get when you participate in Islamic banking, you know like litigation, so on and so forth, is there a way forward? How would you recoup the money?

Well I think the things are there in the prospectus of each and every Sukuk but I think nobody reads. Yeah because you find the prospectus is like 300 pages. Nobody reads. I read it once but afterwards I read just certain points, the risks, the pricing, the investments of the proceed, so I think it is there. I think maybe it's not well indicated to the people. So I think it is there but I think it is either not communicated properly to the client or I mean to the retail and individual client because it's communicated by default and institutional investors so when there is a Sukuk in the market I do not put a single penny in the Sukuk unless I have the prospectus and this prospectus I read it as from a treasury prospective and it is being sent to the Sharia and to the risk management and to the compliance and it goes through a long process of approval. So if these things are not there, it will not be approved but I am telling you about the Sukuk specifically, everything in the prospectus but nobody reads simply.

Q: Do you think that it's down to marketing once again that basically you need to market the product?

What I think it's done to marketing, to retail and individual customers for institutional customers I think they have the expertise to deal with such things again. If you have, it's by default if you have a general support, you have asset. If you have a leasing you have an asset. If it's Wakala I don't have the assets so it will depend on the credit risk of the company.

Right. Just a few, last few questions.

Yeah.

Q: You mentioned at the start basically the exposure of Islamic indices or Islamic equity funds is, you know, less to risk compared to conventional funds because we don't have banks, we don't have insurance companies within equity funds and Islamic finance. Do you think that that is actually the case? Are Islamic equity funds really lower risk than conventional funds?

Well for me equities are of high volatility and of risk but again it will depend on a lot of the construction of the fund. If you are looking for example at one of our products which is IFI Fund, Islamic Financial Institutions Fund, you will find that this is only dealing with the shares of Islamic financial institutions so yes there is a concentration risk because of the Islamic banking industry when down the fund will go down. However, the distribution with foreign banks and Dubai banks and London banks and Singapore banks and Malaysia, all Islamic banks, I mean here, here, here, there so again the markets in the whole universe will not be falling down unless there is a disaster and in this case the disaster will come to everyone, not to a certain type of investors, so again it will depend on the construction of each and every fund. The risk weighted average of each security and the geographical distribution of the security. So there is a risk. It may look lower than the conventional but again it will depend on the fund manager's construction of such components.

Q: Okay so equity funds is that, what about the Islamic financial system as whole, do you think that there's a lot of talk that basically if you invest in Islamic finance you essentially get a low risk asset regardless of which facet is …

Yeah I think how people view Islamic finance are like a bit more conservative about conventional banks and yes they consider it low risk.

Q: But I mean in terms of basically let's say if you have an Islamic Sharia compliant index within the UK that includes a, for example, let's think of an Islamic finance, let's say it includes a company that access the conventional finance because it's just based in this, do you think that basically to the sixth degree, to the seventh degree that company still borrows funds from conventional banks, you're still kind of exposed to conventional shocks that a system, do you think that Islamic finance is, you know, is not affected by the financial crisis?

No it is affected, it is affected. Surely it's affected, surely it's affected. Again maybe they were well protected on the derivative side but they were affected on the equities on the real estate. Again, no it is a risk I think.

Right.

Even if it's on FTSE Islamic or in SPU, Dow Jones Islamic it is a risk.

Q: Fair enough. Okay where do you see Islamic finance in the next few years, like how do you see Islamic finance moving forward?

Well I think we need a mega Islamic bank. It's either through IDB or through any other shareholding structure, we need a mega Islamic bank which is overseeing the whole industry and we need again to try to achieve this sort of regional standardisation. I'm positive about it especially with expansion, with horizontal expansion of Islamic banks and if you look at Europe, for example, you'll find lots of potential on this, specifically Turkey, Germany. France is now trying to do something so it is going well, I'm positive about it. I don't expect it will be like matured as a, efficient as conventional banks in the coming few years but definitely within maybe 10 to 15 years it will be a different story.

Q: Fair enough, I mean, you know, with the current economic climate, how do you see growth forecast, you think you know I mean for the past few years Islamic finance has grown exponentially, we're looking at 20% growth, year on year, so on and so forth, do you think …?

I don't think it will be 20%, maybe around 5%.

5%?

Yeah maybe.

Q: Do you see it as a white knight in terms of, you know, when it first came on the scene with the financial crisis people were like oh we have to go to Islamic finance because that's the main, because it's an alternative we won't get, do you see it as …?

That's part of the rumours and the fact so I think we got all the money at the financial crisis so we need another crisis to reach this 20%. I think it will be growing but I don't think it will be by 20% honestly speaking.

Q: Where do you see the main growth areas in terms of?

I think it's fund management, asset management and the treasury standard I don't expect that much because I think maybe on the real estate thing if we were able to develop some sort of real estate funds so I think the fund management and asset management are the main areas.

END

Academic-Practitioner 3

Q: How do you think Islamic finance is viewed by mainstream finance?

A: Well I think I can answer that fairly directly because I was actually on a panel at Bloomberg's just 10 days ago in London and we had a whole bunch of city people, we had a very good turnout, we had a number of people from Islamic financial institutions and a couple of us academics, myself and Khadom Shuber, who you probably know was at Westminster University and he has written a lot on Islamic finance. He is definitely somebody you should interview and he has translated a number of pieces, including a book on Islamic finance and he was the editor for some time of the journal that I set up which was the International Journal of Middle Eastern Management and Finance, so we are covering the whole thing. So how do people in the west see it? Well I think there is a good deal of lack of knowledge really. I remember many year ago when I was at Branford I was interested in this whole area and in correspondence with a number of people and I was a member then of the International Islamic Finance Forum, which you probably know is a conference that meets twice a year, so I was kind of in that network and I was discussing this with one of my professors of accountancy who just said "well its rubbish isn't it?" and I just said "oh ok" and she said "yea it is complete rubbish". She said that they don't have any idea how to price assets, they have no idea how to work out risk and essentially they are just lending to their mates and I said yes but I think that there's a bit more to it. So the first thing is that there is still a fairly high degree of ignorance about what's involved. The thing that most people fasten on is of course this kind of obvious thing – the lack of riba, the lack of an interest rate denominated return and I think if you go into where that comes from in Islamic thinking you understand why to them it is haram to be able to predict an outcome. This is the essence of the issue that under Islamic thinking only God can know what the future can be. No human being can know that. Therefore, you cannot put a quantity value; you cannot put a numeric value onto the future. If you claim to do that you are usurping the role of God. I think that is one thing that we need to get clear about it (Islamic finance). The second thing that I think people in the west find very hard to understand is the idea that the intrinsic thinking in this field in Islam is conservative. The chair at our panel in Bloomberg's last month, we were having coffee together before hand and he was saying "well they are very risk adverse aren't they?" and I said "yes, they are" because they think that that's the role of a financial system to conserve wealth because it is again haram, immoral, it's spiritually wrong to waste wealth. So we talked about it and he said "well this is going to be difficult about investing in leading edge situations" and I said "by leading edge situations, if you're talking about the way in which the western financial systems have got themselves into, the mess we are in, you can see why they are kind of suspicious about that because you start off with wealth and you end up with less wealth and under Islam that's really morally wrong". Wasting other people's wealth that's one thing, but actually wasting God's wealth because this all belongs to God. These are very simplistic notions but I think one of the reasons why we, in the west, just don't get it, is that we think risk, per se, has got to be a good thing. We have these kinds of little one liners like 'high risk, high return' but what if its 'high risk and no return'? Do you jump down on to the underground rail track because you think it is ok to take on a risk and you can put it up on YouTube? No, there are something's you just don't do and why in a financial system would you think it's credible to lend money to people who can't ever pay you back? So by the same token, if we are talking about 'high risk, high return' and it is a western criticism of Islamic approaches to finance that they are quote 'risk adverse' which by definition a lot of our financial people think is a bad thing. Well how would you like it if I say I am going to build a bridge across a canyon and the guy is a really good engineer, he likes taking risk and he's never done this before and its going be very exciting and your approach is probably going to be no, give me a rather conservative engineer who will put up a bridge under which people can travel every day and it's going to be safe. So I think there is some deep, this is the area that interests me very much obviously, not the precise mechanics of how you denominate asset prices or how you value a sukuk and that kind of thing but, where in that psyche is this thing coming from with what we are calling Islamic finance and how does that differ from the way we look at money. So that's where I'm coming from basically.

Q: People tend to pigeon hold Islamic finance with ethical financing. What are your thoughts on that? Do you think we can draw parallels between the two?

A: Well in a way not, you see and I'll tell you why because this distinction of 'what is ethical and what is not?' that is a very western kind of liberal capitalistic thinking that we have brought into it. It is almost as though we are saying "well there's making money, there's business and then there's ethical making money and business" and the Islamic way of thinking, you've got to be the same, you've got to be made out of the same stuff all the way through. So I think the view that I come across is 'why would you trust, in business, someone you wouldn't have to your home' and when we say, and I hear this from colleagues, not just American colleagues, "oh its business! Oh I ripped him off! It's fine. But that's business!" Well we don't think that is business. If you do business in that way then that means you are really not a very 'OK' person. So why would you need to have a special category of what is ethical finance? Does that mean that all the other finance is unethical? How do work that out? See I think that there is this idea that Islam really permeates all aspects of life. It is what you are in every aspect. So you got, in the sense, to be made out of whole cloth. You don't have an area which is ethical and then another area which is unethical.

Q: What do you think is the inherent risks faced by Islamic finance going into the 21st century?

A: Well of course there are inherent risks. Everything that I am saying is conditioned by the fact that we really don't have deep silos in international finance. So all money is involved with other money which is why, you have in the global economy, the grave danger that risky trades in one sector, for example the sub-prime effect, will affect transactions in other quite unrelated or apparently unrelated parts of the economy and many, many, many aspects of Islamic finance are actually exposed to the same market conditions as the global economy generally. So you can't be insulated from it that's for sure, that's absolute. But I think there are two kinds of fairly big ideas which make you wonder whether Islamic finance might not be something we need to look at more deeply. First is this. It has been accepted, for I guess the last 50-60 years implicitly and in business education quite explicitly, that the western, liberal capitalist model is not merely the best way but is the way everybody is going to have to go because it is simply an economic reality. I think the events of the last few years have put a big question mark about that. I don't think , for example the Chinese, feel they've got to follow our rules and this isn't to do with Islamic finance, it has to do with are we running a world economy on the same basis as its been run since, let's say, the 60-s and 70s. And I think the Chinese are saying “no, we can actually create and push through into a different state of economic development by managing capitalism in a different way from the way ‘you guy’ (the west) do. So when, for about 10 years, we are saying “hey hey hey big trade surpluses are building up, the Chinese are going to have to revalue”, I don't think the Chinese ever thought they were going to have to revalue. I think they thought “yea we a building up great trade surpluses and our balance of payments are actually looking very good”. So they had if you like, going back to an old idea, a more mercantilist kind of approach and a liberal open market approach, likewise with Islamic finance. one of the things that I find, I mean I do a lot of work in the middle east particularly, we’ve worked a lot with people from other regions, Malaysia and so on, Indonesia. One of the things that is very important about Islam is that it is a coherent culture, coherent (13.42), what the Germans call Vold Dam Skol, which is internally very strongly bonded and if you look at the history of Islam, it’s been internally well structured, and well supported even at times when it appears to the west to be not doing as well as it should. So my feeling about it is that it has great, the culture has enormous survivability. That's really what I think. I think if you look at inherent risks, I think that the way those societies are structured and organised, not always at all according to western expectations, they do stuff their way and they do seem to be able to deal with hard times as well as they deal with good times.

Q: Do you think the lack of conformity, with the mainstream western model, will cause future problems down the line?

A: Yes I think it does. I don't buy this Samuel Huntington thesis of a clash of civilisations. What I think we have to understand is that our way is not the only way. It kind of suits us, it’s our culture suits our temperament, some of the time, when it’s going well but I think we are seeing trouble on the streets here. I think this is only the start of the troubles that we are getting into. I am not at all positive or sanguine of the political situation either here or in Europe generally or even in the states because I think we are still kind of reeling with the shock of what’s hit us and u don't think we quite comprehend. I can remember hearing Gordon Brown say, I was at a dinner, when was it? 2007 when the credit crunch was biting and he said “No. people are saying it’s like the 1930s. It is not like the 1930s”. I’m think “Buster, this could well be much worse than the 1930s and the 1930s didn't actually work out terribly well until we got World War II to really recharge the economy and a lot of what we are seeing now does, frankly, remind me of the 1930s. So I think the future is going to be, well, very interesting. Yea, of course I’m worries about it. I think that the Islamic model is one of the new big players that we have to take account of.

Q: Moving on to the second theme of this interview which is the transparency of Islamic finance. One of the criticisms of Islamic finance is the lack of transparency with regards to transactions, product structure and the composition of Shariah Supervisory Boards. What are your thoughts on this?

A: Well I think you are absolutely right. I think that there is a lack of transparency and I think that is very, very true. I think that Shariah boards, which we see as quite an important link with CSR kind of concepts, but I’ve been in conferences where, I’ve been in meetings where, you have two Shariah scholars sort of screaming at each other that the others ones got it totally wrong. There are two types of Shariah scholar that you would get on your board. One is, if you (17.58) objective will say “look this is the way I read it and I have to tell you that I think this is not right" and that's relatively rare. Exactly as having a non-executive director on your board who says "I'm sorry it's your company, you control the other directors, but I am here to tell you that I feel that this is not right" and non-exes on the whole tend not to do that. Now likewise the number two kind of Shariah scholar is the one who will find a way of getting an apparently Shariah-compliant answer to what it is that the board wants to do anyway and that is why, of course everyone will tell you we can't go around investing in pig meat or alcohol, nothing involving gambling and so on, you're going to find money which comes ultimately from impeccable Islamic sources in all of those sectors. Some Shariah scholar has found a way of shielding the reality. So I think just saying "we have a Shariah board and we have the notable Shariah scholar, so and so on the board" that doesn't necessarily mean that you are transparent.

Q: You mentioned that companies would like the Shariah scholar that will push through for Shariah-compliancy. That is also known as Shariah head hunting or Shariah ala'carte. How do you think we could alleviate or circumvent that?

A: It's hard to do that. The way the thing works is very often you make sure you do approach someone who you think is going to give you the answer you need. I think it is hard to put up a firewall against that kind of stuff.

Q: Another issue is the transparency of Shariah-compliant instruments. No one really knows the details of these instruments. How do you think that will affect the Islamic Financial system?

A: Well I think. I don't know the answer to that. I share your worries. Sometimes you are getting in such a complex way of creating intermediary organisations to in effect handle all the risk and buy the outcome from you that sometimes it is very hard to see the wood for the trees in those things. I mean I am not a financial structures expert and my son in fact has been for many years in the field of asset management and we've several times talked about this. He does most of his investment in the Far East and in eastern Asia and from time to time I've introduced him to people who might have money to invest. We've looked at the middle east region and sometimes he just comes to me and says "look this is just too complex. I can't see who's doing what and I don't see where the risk is really held from and so I'm not putting my client's money into it".

Q: What do you think could be done to improve the transparency in Islamic finance?

A: I think I am going to pass on that one because I am not close enough to it to really be able to give you an answer to that. I suspect that the way; what do people learn from? You will probably need some big sovereign fund to go belly up before people say "oh crikey, how did we get into this?!". So I suspect that people don't learn until bad things happen really.

Q: Moving on to another theme of this research which is the uniformity of Islamic finance. We have different regulatory standards for Islamic finance in the west, in the Middle East and in Malaysia. How do you think the lack of uniformity of Islamic finance is affecting it?

A: I think it is inevitable. I have got to say that I don't think there is any one thing which is; and this is difficult and I've made this point at the Bloomberg seminar; I've supervised a number of doctorial theses, not particularly in the area of finance but in other aspects of business and management and organisation and we've just had a doctoral student who's graduated from Lancaster who did a thesis on Islamic management and the concept of learning organisation, who looked at a number of organisations and she's a Malaysian and sometimes she would come around my office and says "Islam teaches that!" and I would say "no not quite. I've heard this version" and I suspect you've got at least three different dimensions. You've got what is Islamic. That very so much by the region and the culture, the kind of deep culture of how people have been doing business but I don't expect everything to work out the same. I think the essence of complex systems and the world financial system is a highly complex system, is that there is always diversity and diversity is emergent and you get both adaptative changes but you get acceptative changes and that is one of the reasons why learning after a disaster is often a pretty logical thing because what happens after a big disaster is that the pieces are still there but they are just put together is a different kind of array, different structure so my answer to it is I don't think there ever will be one uniform matrix into which everything will conform.

Q: If there was no one similar matrix. Would this problem affect mainstream finance as well?

A: Yes, I think so.

Q: Within mainstream finance there are lenders of last resort. With Islamic finance, it is hard to see a central regulatory body adopting this position. How do you think this will affect Islamic finance?

A: I think it is a very interesting question and I think it is a very good question. Lenders of last resort. We have institutionalised risk over the past 200 years or so and this is the essence of the liberal capitalist model. The way we have developed the banking system and the way we set up state or para-state or inter-state organisations so the European central bank or the Bank of England and we developed a concept of a Lender of Last Resort out of those kinds of institutions. Now lender of last resort quite often tend to be an individual but in the Islamic model, at the end of the day when you say well who's backing this and what is our guarantee and are we in it for 5-25 years, an institution that we probably don't study as much as we ought to and I've done some work with them – I did one project with them in Jeddah – is the Islamic Development Bank which was set up effectively to fund development projects in parts of the third world. How does it work? Well it basically works through the rich guys helping the poor guys and their model for that is of course Zakat. That under zakat it is offensive to the system if you have someone who is extraordinarily rich and someone who is starving that they could be helping. I suspect that one of the things that is going to be happening over the next few years and I know this is happening for example in southern Africa, sub Saharan Africa, there are people who look at the Islamic finance model for development projects and they are not going to say 'who's backing this?' or 'what institution is backing this in terms of the lender of last resort?'. They are going to say why are these guys interested in us and can we trust them? In a way that's an older model. If you go back to the Hansiatic system, go back to the Foggers, if you go back to what we call the medieval way of bankrolling projects you do find a higher degree of personalisation. A book that I find very illuminating on that is a book by an Irish author Origo, an anthropologist, called The Merchant of Pranto which is based on basically the day books and diaries of someone who was an Italian merchant in the city of Pranto during the renaissance period and you do I think in that see some of these highly personalised transactions backed in a sense by personal credibility. So the lender of last resort idea is a very interesting one and I think it is leading to some quite fundamental differences in the way Islamic finance is justified.

Q: What about a central regulatory body such as the ECB is to the Eurozone? Would that be beneficial to Islamic finance?

A: Well I think it would. It is probably going to happen because it is a trend towards making their map on to our way of looking at things. My point I think is that underneath it all you're going to have a trust based system and what they are really going to be saying is how much do you trust these guys.

Q: What do you think would be good governance in Islamic finance?

A: I think what you're dealing with in this whole world view is a system that is based on a personalisation of trust and the way trust is built into relationships and so you have this idea of (30.00) whasta which is networking and business networking, I've written quite a lot about that. Many, many Muslims hate it when you tell them about whasta and in fact after the Bloomberg seminar a young Saudi academic came up to me and said "please don't talk anymore about whasta. It is a really bad thing and we must have a society in which whasta is not so important" and of course if you're young Saudi professional, well trained intelligencia, you definitely think like that because you think Whasta is the old guy who is highly networked and that's the glue that holds our society together but it's really bad. It is also the glue that creates oppressive regimes and it is stopping us getting anywhere. However if you do then turn the tables and then ask " at what point in the near future do you think you will have abolished whasta?", he is just going to laugh and say "it doesn't work like that". Of course it doesn't work like that because Whasta comes out of much, much deeper cultural tradition which basically says that a Whasid is a middle person, maybe an entrepreneur but someone who both sides trust, so the approach is something that is much deeper than just through the financial sector. Now what does that mean in practice? How would an Islamic finance institution seek to protect its investment? This is what I studies with Ahmed Al-Genahi who became CEO of an Islamic investment bank and what we find of course is how do you deal with a situation of a business failure. The answer is you really find it very hard to handle business failure so you do everything you can in an early a stage as possible so you can make sure that the failure is not transparent. So you network, you support, you find out, you get involved. Why are you doing that? Because you are not in a lender borrower situation. You are in a situation which is essentially a joint equity and therefore you are always just as much as the borrower and do you want that to be known on the streets and that's the kind of thing you do and the answer is definitely not. So you get in as early as you can, you try and handle it in a way that the whole thing doesn't become transparent. So I think again that this idea of corporate social responsibility and transparency are coming out of different places in the western ideology from what they are in the Islamic ideology and I am not saying that either is better, I am just saying that you have to understand that these guys are thinking about it in totally different ways. How does it work? Well it works essentially because you it and you talk and you listen and then afterwards someone may say “oh well, I’m having second thoughts about this so let’s take a little bit longer”, therefore they have doubts so what does that mean and eventually you get into this area where you might say “look I need to know. Are you putting money into this or are you not?” and they say “well I’d love to be doing business with you and so on and so forth” and you have to formulate your own conclusions that they probably aren’t going to be going with it. So I think we tend to think transparency is a good thing, regulation is a good thing, corporate social responsibility is definitely a good thing but they are kind of thinking in a much more, if you like, gut level but the one thing you can’t do is for example you cannot say to the other party in a relationship are you a virgin or have you been sleeping around. Those are the kind of questions that you do not put on the table because you don’t want to know the answer either way actually. Not that he’s going to tell you the truth. Maybe you shouldn’t put that in your report!

Q: What do you think the scope of growth is for governance and risk management in Islamic finance?

A: Well I think it is great of course objectively they face the same problems that we all do. First problems is how do you safe guard what you have already? How do you not lose out of this? There will be growth in sophisticated instruments and I’m sure, I’ve been in meeting where people, because it is not my bag I tend to find it boring, how do you create a fund of funds and still be Shariah compliant and I think there are going to be millions of ways of making money out of creating instruments which show that a particular structure is or is not compliant. At the end of the day, which system is going to survive and I think both systems are going to survive. I think Islamic finance has been seen as marginal on, a bit different, probably not going to last the cause because it is inherently risk adverse and so on. Now my answer to that is that actually Islamic finance is very new although they love to do the kind of tracing it back to the Quran, and the Hadith and finding the intellectual lineage of the idea. Islamic finance as we know it has only been around since world war II and a lot of it doesn’t start in the heart lands of Islam – in Arabia and the middle east. It starts in Pakistan and Malaysia because these are societies that are saying we have chosen to follow a certain path. Pakistan is an interesting case because the growth of Islamic economics, you can I think, see a very clear line from the theorist in Pakistan thinking where we say we are an Islamic society, we say that this is for Muslims and what does that mean? We’ve never had to build a society around that kind of way of thinking before so this is new territory and its quite interest if you look at publications and so on. I started this journal through emerald about 5-6 years ago, I head the idea about 10 years before that and all the time they are saying to me, it’s very marginal and finance people told me there’s nothing in it and so on and so forth. As soon as we started this journal they are now running two other journals in Islamic marketing and Islamic business so I think the growth, if it is not exponential, it is very good and very promising and that will continue I think.

Q: You mentioned not trying to lose out? Do you think Islamic finance is in direct competition with mainstream finance?

A: I think it is for them. Yes I think it is. For that world in that culture yes. There is a lot of restructuring going on I think.
END

Appendix 4 – Practitioner Interview Transcripts

Practitioner 1

Q: How do you think mainstream finance views Islamic finance?

In my opinion based on perception by the local industry, Islamic finance is considered as an alternative to the general public to choose their banking preference. For Muslims, it gives them the opportunity to conduct their way of living –"muamalat" based on Islamic concept. Whilst for non- Muslim, it is another opportunity to benefit from the various concepts which suit their preference. Thus, rather than viewing Islamic finance as a competitor it is considered as a factor to enhance conventional banking instead to attract or maintained their base market. Overall, it is a healthy situation.

Q: What do you think are the inherent risks of Islamic finance going into the 21st Century?

The main risk faced by Islamic finance is the lack of understanding by the industry operators itself and the general public of the various Islamic concepts whereby are the basis of Islamic products creation. Therefore, the Central bank should stress on extensive training and knowledge to industry operators and conduct on-going programs to educate and create awareness to the public of its advantages and concepts.

Secondly, the risk is the indifference in the Syariah rulings. This is obviously seen between rulings made by the Middle East countries and other Islamic nation i.e. Malaysia views on certain Islamic concepts i.e. Bay al-dayn differs from scholars from Middle East countries. The inconsistency could lead to complications in implementation and a disadvantage to the concern Financial Institution in cases of legal dispute.

Q: Islamic finance tends to be compared to ethical banking and finance. What are your views on this?

This is very true. The comparison is made in the light of lack of understanding in Islamic finance. As we know, Islamic finance is new in comparison to ethical banking and finance which has a strong base with track records. Thus, in a way the comparison undermine Islamic finance and slowed down its growth because the general public is sceptical and unsure of its results. Both types of finance should be looked at their respective advantages which are beneficial to the consumers instead of highlighting its weaknesses.

Q: What are your thoughts on the issues of transparency highlighted above?

I agree that to the above mainly because the Islamic concept is not understood by the general public. Therefore, the product structure seems complicated i.e. - Bai Bithamin Ajil (BBA) whereby there is selling of the non-existent item plus an "akad" that is an obligation to accept the agreement to sell and purchase. BBA is not a kind of sale rather it refers to the manner of payment via a deferred payment basis either in lump sum or instalment payment. The confusion arrives because often the concept is not explained to the customer thus, there was no transparency and transactions are done just as a procedure instead.

Meanwhile, there is no specific information to the public on the criteria needed for selection of the Shariah Supervisory Board. Though there are some criteria set, the selection is still based on discretion of the specific FI which can be influenced by internal or external factor for the benefit of the FI concerned. This could divert from the main purpose which is to uphold the Islamic concept.

Q: Would it improve the Islamic financial system to be more transparent?

Yes, definitely because once the public understood the Islamic concept and its benefits to their banking transaction, it would boost the growth and ultimately improve the Islamic financial system. It would eliminate the element of uncertainty and curiosity of the products and its enforcement. It would become one of the norms or way of life and will be treated as another choice of option for their banking preference.

Q: How do you think the Islamic financial system could be made more transparent?

The key factor to be more transparent is by educating the general public of anything with regards to Islamic financing – what, why, where and how. Example of Islamic concepts that are used to structure products are Mudharabah (Fixed Deposit), Musyarakah (Joint Venture) , Qard al Hassan (Interest free loan), Al-Rahn (collateralized borrowing), Al-Kafalah (guarantees), Al-Hiwalah (remittances),Al-Wakalah (agency), Bay al-Salam(purchased with deferred delivery) and Al-Ijarah Thumma al-Bay(AITAB)-hire purchase should be explain clearly to the consumers.

There should be easy access of information with regards to its concepts, product structure and governance. Only through understanding can the Islamic financial system prosper and grow in the banking industry.

Q: How do you think the lack of uniformity affects financial innovation and risk management in Islamic banking and finance?

Yes definitely. Lack of uniformity reflects non- synchronisation in implementing the Islamic concept. One example is the different view between Shariah scholars in Malaysia and the Middle East on debt trading- the Islamic concept known as Bay al-dayn. In Malaysia, it is considered as permissible if the debt is originated out of an asset financing transaction. Such a debt can be traded at market value while a debt based on loan could be traded at face value. This concept is used for Islamic Bankers Acceptance and is limited to the Malaysian market. The Malaysian Securities Commission Shariah Advisory Council has unanimously agreed to pass a resolution on 21.08.1996 to accept the principle of Bay al-dayn as one of the concepts for developing capital markets instruments based on the condition that there is a transparent regulatory system in the capital market to safeguard the maslahah (public interest) of the market participants. The Council held that in the context of the sales of securitised debt , the characteristics of securities differentiates it from currency. Thus, it is not a legal tender and therefore not bound by the conditions for exchanging of goods. It is in line with Shafi'i mazhab.

This distinction is not permitted in the Middle East as Bay al-dayn is simply means a sale and purchase transaction of a quality debt. The selling of debts is to avoid the occurrence of "riba" between two debts and avoid "gharar" and "makhatara" which may arise at the level of inability of a buyer from possessing what he has bought as it is not permitted that the buyer sold before actual receipt of the purchased item. The Hanafi mazhab are unanimously in not permitting Bay al-dayn with reason that the debt is in the form of mal hukmi (intangible property) and buyer takes great risks because he cannot own the item bought and the seller cannot deliver the item sold.

The above scenario reflects differences in opinion and interpretation of the mazhab which is the basis of the Islamic concept. The risk is purely in the implementation which could result in physical loss and whether it was implemented in accordance to Islamic concept or merely to suit the Islamic environment. In the end, the public is concerned whether the product is in accordance to the Islamic way of life-muamalat or otherwise.

Q: With reference to lender of last resort, the Islamic financial system doesn't really possess one per se. would it be beneficial to establish a lender of last resort?

Yes definitely it would be beneficial to establish lender of last resort if the Islamic financial system wants to establish itself as equivalent or even better than the conventional system. There is a large potential market for Islamic financial which would require the "assistance" when necessary, so it would be useful to establish a strong and stable lender of last resort whereby FI under Islamic financial system could rely on in case of contingencies arise . It would certainly add confidence to the general public knowing that their Islamic banking system has a secured back up and that means their physical investments are secured.

Q: What does one think about the current level of Islamic financial regulation?

In my opinion, the current level of Islamic financial regulation is sufficient to meet with the current level of Islamic financial system. However, moving forward some of the redundant regulation should be abolish to minimise stringency and more flexible and yet in compliance to the Islamic concept introduce to complement the existing regulation. A good governance is required to ensure that the Islamic financial are run on the right track in accordance to the Islamic rulings.

Q: What about central regulatory bodies such as the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB)?

The AAOIFI which was established in 1991 and based in Bahrain, has successfully met its objectives to determine the rights and obligations of all interested parties in accordance with principal of Shariah, to safeguard Islamic banks' assets – its rights and rights of others, to contribute to enhancement of managerial productive capacities of Islamic banks and to provide useful information to make legitimate decisions in dealings with Islamic banks. It has enhanced the confidence of users of the financial statements of Islamic Financial Institutions (IFI) and ultimately promotes IFIs. However, lack of Shariah consistency, comparability & consistency on accounting treatment on recognition, measurement and disclosure of Islamic based transactions and sound regulation on accounting gives room for improvement, thus to further develop accounting principles in the Islamic banking.

Whilst the IFSB which began operations in 2003 and based in Kuala Lumpur has achieved its goals to promote the awareness of issues that could have an impact on the Islamic financial services industry. Among IFSB initiatives are to issue Shariah compliant standards, hold conferences and seminars, provides guidance and supervision. Moving forward, it needs to build and enforce solid foundations as the industry transitions into a new era of growth and development in this post crisis world, competitive financial landscape, evolving international regulatory reforms, rising consumer expectations will hinge IFSB to keep raising the bar in pursuit of an effective functioning and sound Islamic financial system.

Thus, both bodies have managed to promote confidence and stability to the public of the Islamic financial services industry.

Q: What possible remedies (if it is felt like the system requires remedying) are there?

To summarise the above, some of the remedies are:

i) To be transparent to the users on the Islamic concepts, product structure, governance

ii) To synchronise in implementation of Islamic concepts so that it is acceptable by all

iii) To ensure sufficient level of understanding by all

iv) To enhance supervision level

v) To aggressively market and introduce the Islamic products and concepts to increase growth

Q: Do you think governance would affect the development of risk management under a Shariah framework?

Yes because it will be more stringent. However, it is also positive because it would help to ensure that the Islamic rulings are applied in accordance. Thus, good governance is essential to ensure that Islamic financial are on the right track which is to give an option for those who wish to conduct their way of life – muamalat, the Islamic way.

Q: Where do you see Islamic finance heading in the next few years?

Very positive. It is growing fast because the public is eager to try something new. Meanwhile, it is an avenue that the Muslims has been looking for and with benefits it gives, attracts the non- Muslims too. Again, bottom line is understanding of the product structure could lead to endless possibilities. Islamic finance is definitely a driving force in the near future.

Q: In the current economic climate what do you think is the scope for growth for Islamic finance? Why?

Probably to create as much investments as possible which could translate to gains during better economic climate? It would be wise for Islamic finance to get as much deposit as possible by offering attractive profit sharing percentage for deposits to increase its depositors and thus, the market base.

END

Practitioner 2

Q: How do you think mainstream finance views Islamic finance?

I think many mainstream financiers view Islamic financing as just a mere gimmick, a hoax. However due to various reasons, political, or perhaps out of professional courtesy, they do not openly made known this point of view. What you see in much of Islamic finance today is an artificial replication of conventional financial products. Islamic finance should focus of creating products and instruments that are more in line with Islamic principles.

Ethical banking and finance is just a mask to justify the existence of Islamic financing. They still charge "interest", but they now call it "profit". The substance is still the same, but just changes the form. Ethically, Islamic financing is not superior to mainstream financing. All types of financing require an element of ethics.

In fact, the way they repackage the essential principle of mainstream financing and diverting and misleading the element of opportunity cost of money to fit the Shariah concept does contain certain degree of misleading implications.

Money is money, when I take one dollar away from you contractually, no matter what you want to call it, "interest", "profit", "fees", etc., I actually deprive you the benefits of the dollar and the loss of use of that dollar (except for the case of charity when the money is not taken away under contractual obligation). If by calling the dollar taken away "profit" instead of "interest" will improve the transaction ethically, then we are all kidding ourselves.

Q: What do you think are the inherent risks of Islamic finance going into the 21st Century?

The inherent risks of Islamic financing would be its relevancy and cost effectiveness, going forward. In Islamic financing, the principle or substance is essentially the same as conventional financing, but they need to "repackage" the form, making it look like a buy/ sell activity with underlying assets hence increasing the cost of financing. If you are only repackaging the form of the product then fundamentally the problems that arise from the substance will still be the same. Changing the name of something does not make the problems go away. What you will be left with if Islamic finance continues in this direction would be the same problems of conventional finance such as the current financial crisis.

Q: What are your thoughts on the issues of transparency of the Islamic financial system?

Yes, one thing good that come out of Islamic financing is that they tend to be more transparent, when compared to mainstream finance. This is in the economic sense. Theoretically speaking, the ways in which Islamic products are structure pays a lot of reference to the real economy, to real markets to ensure that everything exists. Everything must be known before contracts are undertaken. How much am I going to have to pay? How much will you receive? What is the cost? All these have to be made known to the parties before contracting and in this sense Islamic finance is more transparent than conventional finance. In theory only of course! Transparency should always be encouraged in all forms of financing and contracts.

As in all contracts, including Islamic finance, the terms of the contract are negotiated and finalised between financier and the customer. So it is up to the parties concerned to require the degree of transparency in the contract. Transparency is relative and to different people transparency could mean different things and everyone has a different requirement of transparency. We cannot just say that we need more transparency for the sake of it. It is not like conventional finance is fully transparent and people still get on fine with the financial products. I think to a certain extent it boils down to trust and because people are more familiar with conventional financial products they are less like to question transparency. With Islamic finance being relatively new and the reputation of Islam there are more questions being asked.

Q: How do you think the lack of uniformity affects financial innovation and risk management in Islamic banking and finance?

The lack of uniformity, in a way, does impede the development of Islamic financing into a global model. As I know, different regions of the world practices different variants of Islamic financing, for example the Middle East model contains differences when compared to the Malaysian version. Hence such differences may sometimes give rise to grey areas, subtleties in interpretation and ambiguities, and even confusions. In the case of Malaysia, this has made court rulings on Islamic financing in litigation matters extremely challenging, and often times with no clear cut directions. There is confusion between whether Islamic financial issues should be litigated in conventional or Islamic courts. There needs to be clearer distinction between where the rights of the customers lie.

This has clear implications on consumer confidence and the development of the Islamic financial system as a whole. Financial innovation would be difficult as practitioners do not know which set of rules to follow. You create a product that is valid in one country but not in another. This can only cause complications and confusion amongst customers and people in the industry.

Q: With reference to lender of last resort, the Islamic financial system doesn't really possess one per se. would it be beneficial to establish a lender of last resort?

As far as I know, countries with “mandated” support for Islamic financing extend the coverage of their central banks to Islamic financing. This is the case for Malaysia. The Malaysian central bank – Bank Negara Malaysia provides a viable outlet for funds for Islamic financial institutions. If I am not mistaken in the UK, with HSBC’s Islamic banking branch and Lloyds Islamic finance branch they have the Bank of England as a lender of last resort and in terms of regulation they are still governed by UK law. I am sure there have been amendments law to accommodate the needs of these Islamic financial institutions.

Current regulatory standards are still lacking of a strong and universally accepted body to regulate and provide guidelines and standards governing Islamic financing. The central bodies must be stronger and I think many Islamic institutions would like to see a set of uniform standards to follow.

Q: What about central regulatory bodies such as the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB)?

Yes, these are fragmented interim bodies set up to provide some guidelines and standards, but their acceptability globally is still something we need to see. For me there is very much a concern that while these central bodies have been selected to create or even unify the regulation of Islamic finance the do not have the power to enforce their work. A lot of the standards coming out of both are only informative and Islamic institutions can choose not to follow. As a regulatory body this is not acceptable.

Q: What possible remedies (if it is felt like the system requires remedying) are there?

Basically, Islamic finance needs to stay relevant, and innovate itself, instead of copying mainstream finance's model, and repackage them to fit the Shariah concept. By doing so , they inadvertently increase the cost of financing towards the customer, and of this is not remedied, they will be outdated and become obsolete in time to come. Currently, they are staying afloat because of "mandated" support from Islamic countries, and if these clutches are taken away, they will collapse owing to their non-competitiveness.

Q: Do you think governance would affect the development of risk management under a Shariah framework?

Good governance should be emphasised and enforced as part of risk management under Islamic financing. There is no Islamic framework for risk management. What we have are Islamic financing principles that have been adapted or we have Islamic products that replicate conventional financial instruments to manage risk.

Q: Where do you see Islamic finance heading in the next few years?

As I said earlier, they are staying afloat because of mandated support from certain nations . How far they will go without this support is rather uncertain.

I think the future of Islamic finance is quite uncertain as their structure is non-competitive and they are lacking innovation to propel them further. Essentially, they copy, and repackage and worse of all, they are non-competitive when compared to mainstream financing. They have to establish themselves as a viable alternative to conventional finance and not just copying. It should not be a case where Islamic finance is the same as conventional finance as this would then just mean that people would just use conventional finance. It is a tough balance between religious principles and meeting the financial needs of its customers.

END

Practitioner 3

Q: How do you think mainstream finance views Islamic finance?

Not much difference to that of that of conventional finance except for the fact that it (Islamic Banking and Finance) is using the profit sharing method. The interest that the borrower paid is in fact very much the same between conventional and Islamic finance. There cannot be too much of a difference as this would then lead to an uneven playing field.

Q: What do you think are the inherent risks of Islamic finance going into the 21st Century? Why?

Can't think of any. I strongly believe that both convention and Islamic finance will face the same risks in the fast changing economic environment. With the economy in its current state the notion that one financial system will be free from risk and not another cannot be true. The risks from the financial crisis will affect both Islamic and conventional banks.

Q: Islamic finance tends to be compared to ethical banking and finance. What are your views on this?

I do not share the view. Financial participants tend to suggest that Islamic finance is the same as ethical finance because there is a screening process for the selection on investments. What is not realized is that the screening criteria between Islamic and ethical financing are quite different with varying emphasis placed upon different social and moral aspects.

The Islamic view where Halal and Haram is very much questioned is very important to the Syariah financial system.

Q: What are your thoughts on the issues of transparency within the Islamic financial system? What do you think about the composition of Shariah Supervisory Boards?

For me it is very straight forward – Halal and Haram transaction. Since the committee in the Syariah Board is all consists of Muslims, I do not think there will be issue of lack of transparency. Moreover, it is not exactly an issue of transparency but rather one of marketing and knowledge. More has to be done to educate both conventional and Islamic financial participants about the ins and outs of the Syariah finance. There is a feeling that Islamic finance is not transparent because people do not know what the financial products mean and this is an issue for the Islamic financial institutions and central regulatory bodies. More has to be done to provide the public with information of Islamic finance. Maybe then there wouldn't be an issue or transparency.

Q: Would it improve the Islamic financial system to be more transparent?

As I mentioned above, lack of transparency should not exists but is rather a lack of information. Of course should more information be available that would definitely be beneficial to the Islamic financial system.

It all depends on individuals who is interested to opt for Islamic finance to know more the terms and conditions, the Shariah principle etc.

Q: How do you think the lack of uniformity affects financial innovation and risk management in Islamic banking and finance?

Minimal impact. Because I feel that different countries have different perspective. Leaders, CEO and all those Decision Makers definitely have different views in doing Business. For instance, even peer Muslim or peer Christian could have so much difference in Belief and understanding. However, this is not a major threat to the country as well as the Financial Institution or system.

As I've said different countries have different ways of doing things and if you look at conventional finance of different countries, even this is not entirely the same.

Q: With reference to lender of last resort, the Islamic financial system doesn't really possess one per se. would it be beneficial to establish a lender of last resort?

This is a difficult question to answer. We can see the benefits of having a lender of last resort. With Islamic finance this could be even more important with the questions regarding the liquidity of Islamic financial institutions but the main issue here would be not if Islamic finance needs a lender of last resort but who should take on this role. Should it be the central bank of the country? If so then would there be issues of haram financing should an Islamic bank require money from the country's central bank? Should there be an Islamic central bank? But then again this could create an uneven playing field with that of conventional finance.

This issue has to be explored further and I certainly cannot give you a definite answer. I would say that a lender of last resort could be beneficial but I cannot say who should undertake this role.

Q: What do you think about the current level of financial regulation is Shariah finance?

So far, I have no objection or grievances, as I believe it is outlined according to the Syariah Principles.

Whether good or not, I have not encountered any avenue to compare. We have been lucky thus far and the current standards of regulation in Islamic finance have not been put to the test just yet. Obviously, there is always room for evolution and development. The growth of Islamic finance in today's economy requires it to keep pace. Continuous development is always good.

I don't have much experience with AAOIFI and the IFSB but from my understanding they have been set up as central regulatory bodies that oversee the Islamic financial system as a whole. As with all financial systems, a point of reference is required in terms of regulatory standards.

Both institutions have a thankless job in trying to establish more understanding of the Islamic financial system. Not just understanding from within but also from outside the Islamic financial system.

Q: How do you think governance would affect the development of risk management

under a Shariah framework?

Definitely. They are the decision maker right? Governance under an Islamic financial framework is all about balance. Islamic financial institutions have to balance the religious and moral principles with financial principles and that is not an easy task. When it comes to risk management, Islamic finance has nothing against risk management. It is the tools that we have to be careful with and how these tools are used. There is a fine line between risk management and speculation. Moreover, should there ever be a breach of Syariah principles this would have a significant impact on the Islamic financial institution.

Q: Where do you see Islamic finance heading in the next few years?

Unless more advantages of using Islamic concept to be introduced such as stamp fee discount, people may opt to Islamic financing. People normally reluctant to take Islamic financing due to complicated Shariah compliance, terms and legal documentations. People reluctant to study or even to understand the concept.

This is where the central bodies must step in to make improvements. Setting up dialogue between Islamic financial institutions and governments to create a framework that accommodates Islamic finance. More also has to be done about the lack of information out there about Islamic finance.

Q: In the current economic climate what do you think is the scope for growth for Islamic finance?

Unless the bank personnel as well as the consumer/customers are aware and fully educated in Islamic Finance, we can see the growth.

Otherwise, people may just opt for conventional banking without having to understand the Islamic concept, Shariah etc.

END

Practitioner 4

Q: How do you think mainstream finance views Islamic finance? Islamic finance tends to be compared to ethical banking and finance. What are your views on this?

Many main stream financiers view Islamic finance as a complement to them and is an integral part of finance eco-system. It is a financial system that exists and research has shown that it work so why shouldn't it be regarded as an alternative to conventional finance. Just because it is based upon religious principles does not mean that it does not fulfil the role as a financial system

I personally believe that all finance and banking matters should be conducted on an ethical ground, regardless of whether it is mainstream or Islamic finance. Just because we belong to a conventional financial system, it does not mean that we lose track of facets such as morality and integrity. Business and finance should be conducted ethically. Although this is probably ideological rather than practical if you consider the practices of banks during the recent financial crisis

Q: What do you think are the inherent risks of Islamic finance going into the 21st Century?

The inherent risks of would be those risks normally associated with providing credit facilities, and are in essence not much different from mainstream finance. In terms of risk associated to methods of financing there is some risk for the availability of products. At this point in time the financial instruments available to manage risk in Islamic finance are slightly limited and there is increased scope for financial innovation. The risks borne by Islamic finance are very similar to conventional finance but obviously there might be a separate importance placed upon different risks. In conventional finance this might be credit risk whilst in Islamic finance the emphasis will be on liquidity or default risk. Moreover, there is also the issue of Shariah-compliance and Islamic financial institutions have to take great care in ensuring that they adhere to Shariah principles. This however is easier said than done.

Q: What are your thoughts on the issues of transparency in Islamic finance? Would it be beneficial to be more transparent?

I believe one of the strong points in Shariah finance is its emphasis on transparency, wherein all terms and conditions should be clearly spelled out, and there should not be elements of uncertainty in the contract. In you think about it, the fact that there must be clear lines of ownership within Islamic financial transactions means that there looks like there is more transparency than many conventional transactions.

In terms of Shariah scholars and the boards that they sit on, I feel that this is an issue that is quickly diminishing. When Islamic finance first started there was very much a lack of expertise in terms of Shariah scholars. With the growth that Islamic finance has experienced over the past few years, there has been a lot of emphasis on developing a larger expertise base which would mean that you will see new faces on different boards. For me it is not a question of similar members on different boards for the sake of a salary but rather there were just not enough people who possessed the knowledge. The central bodies have been making an effort to try and improve the amount of expertise in the area and it would also be good to have individuals who possess not only an understanding of Islamic finance but conventional finance.

Definitely, increase transparency would be beneficial to all financing contracts, whether Islamic or mainstream. I am not saying that Islamic finance is fully transparent but the level of non-transparency that people talk about is not that bad and is quickly disappearing.

Q: How do you think the Islamic financial system could be made more transparent?

As it is, Islamic financing has a highly transparent structure wherein all elements of uncertainty in the contract are clearly clarified and all terms clearly defined. In fact, many have viewed Islamic finance to be even more transparent than main stream finance.

However, further attempts to increase transparency should be viewed positively. In light of the Shariah board members more can be published about the selection process. In light of transactions more information can be made know about the roles of parties. It is not like information about the structure conventional bond issuances are freely available.

Q: How do you think the lack of uniformity affects financial innovation and risk management in Islamic banking and finance?

Personally I think Islamic finance should not strive to come out a “one solution fit the world” model, as different regions of the world has its unique cultures and ways of doing business. Banking and financing solutions, Islamic and mainstream likewise, should try to customise the financing models to suit the local scenarios rather than shoving a “uniform or universal” model on a world with different cultures, and operating on different ways of going about their business

I fact, most successful global brands have adopted the approach of customising to local scenarios such as HSBC with the slogan “The world’s local bank”, even the menus of McDonalds has a twist of differences in different parts of the world

Q: With reference to lender of last resort, the Islamic financial system doesn't really possess one per se. would it be beneficial to establish a lender of last resort?

The central bank usually acts as the lender of last resort, and in the case of Malaysia, the central bank, i.e. Bank Negara Malaysia acts as the lender of last resort, which also covers Islamic finance. I suppose the Malaysian situation is easier as there are efforts by the Malaysian government to push the issue. With Bank Negara Malaysia, Islamic banks have a Shariah-compliant lender of last resort but this would be more difficult in countries such as the UK. Legal provisions must be made to clarify this issue further.

At the moment, the current regulation is deemed adequate to facilitate the operation of Islamic finance. But as business platforms and systems evolves, regular reviews should be done to monitor the adequacy of the regulations form time to time.

Q: What about central regulatory bodies such as the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB)?

They exist to provide guidance and standards on accountings related issues with regard to Islamic finance. I do not have much experience with AAOIFI or the IFSB but from what I gather, any attempts to further develop any regulatory standard for the betterment of a financial system should be embraced. They have a task that is not easily achieved.

Q: What possible remedies (if it is felt like the system requires remedying) are there?

As it is, business models, approaches and platforms in the world is constantly evolving and changes and part and parcel of surviving in modern business. As such, Islamic finance should also try to maintain its relevancy in the constantly changing business world by coming out with relevant and useful financing solutions and products. This in my view will be the main challenge going forward.

Q: Do you think governance would affect the development of risk management under a Shariah framework?

Yes good governance should always be the cornerstone of all financing structures. In developing a sound risk management structure for Islamic finance, good governance should always be an integral part in the framework.

Q: Where do you see Islamic finance heading in the next few years?

I believe it is gaining better understanding from the world which will result in higher acceptance and adoption.

The potential for further growth for Islamic finance is going to be robust given that it offers an alternative to the conventional mainstream finance and the scope will widen to cover more areas as it gains importance in the global stage of finance and commerce.

END

Practitioner 5

Q: How do you think Islamic finance is viewed by mainstream finance?

A: I think that there is a mix of views. Some people see it, especially in the western world, they see it as a real alternative to conventional financing, the conventional financial system and this view, I think, is becoming stronger with the waves of financial crises that we are receiving over the last 2-3 years. There is another group that has a view that it is something old-fashioned, it may not be adequate for the 21st century and they associate it to some terrorist activities or political agendas more than anything else. They do not consider it as a serious alternative; they see it as more of a threat to the western culture and society. I must say that the latter of the two groups is much, much smaller in number. The general view is that it is actually something that is considerable as an alternative and it requires more research in how and why it behaves. It leads towards something that is quite different from what you see as an output from conventional finance.

Q: How would you describe Islamic finance to someone who is new to the concept?

A: Islamic finance for us an alternative way of financing. There is another perception that maybe it is interest-free and therefore that means it's cost-free as well but of course we have to dispel this myth and you have to explain to people that being interest-free doesn't mean that it is totally cost free as well. Of course there will be costs involved. We explain to people and people (in this sense) doesn't mean that we deal with individuals and small business, we deal only with either institutional clients or big corporates and these are the people who are actually look for either some strategic benefit or alternative opportunities. So we advise them that this is an alternative financial system and you have to understand the nature of risk involved in this so do not think that it is completely risk free, do not think that it is immune to any shock or any hazard. Of course there is a possibility of having issues with this type of finance also but they need to understand the nature of risk involved with Islamic finance will be completely different. Say for example if a corporate seeks our advice and they want to raise some fund for their projects and they are trying to make a strategic decision between issuing a conventional bond and a sukuk, an Islamic bond. So we have to explain to them in this case the underlying asset of an Islamic bond will be completely different from the underlying asset of a conventional bond. In a conventional bound you can just use a financial asset or the receivables. You can handle them as an asset and you can issue a bond and the return of that bond will be actually based on the performance of the financial asset and the rating of the bond will be based on the solvency of the corporate, the issuer. Whereas, when you talk about Islamic bond or a sukuk then the underlying asset will be completely different because you may have many receivables but that will be considered as debt and you will not be able to repackage that debt and use it as a financial asset. Here you need tangible physical asset and you have to give a legal recourse to the subscriber or bond holder that in case of a default, they will actually have recourse through the asset that you are putting as the underlying instrument for your structuring. So the risk profile of this instrument will be completely different. The return on the investment, that the sukuk holders will make in to this bond will be very much dependant on the performance of the underlying asset, whether it is a production facility, it could be a set of equipment; it could be a portfolio of real estates. The remuneration of those bond holders will be coming from the performance of asset and it is variable. It could go up and it could go down and also on the rating side it is not going to be solvency of the corporate or how financially strong they are of what sort of backing that they have from any parent companies that they have. It is actually very much dependant on the underlying asset that is being used for structuring. So we have to advise them on these things and this is actually where the mains difference lies and they have to fully understand the dynamics of this risk and how they are going to manage this risk and how it have an impact on their overall business and their overall planning.

Q: What are the inherent risks faced by Islamic finance going into the 21st century?

A: Well the inherent risks for me, for Islamic financial institutions are I think probably two or three. First of all, I think the biggest risk that they are facing is the concentration of their asset class. As Islamic finance or modern Islamic finance is relatively new there is a lack of diversity of instruments and a lack of asset classes and as a result, due to the restrictions imposed by Shariah, the Islamic banks are more likely to invest into certain types of portfolios, certain type of asset classes and we have seen this happening in the gulf. There most of the bank or Islamic banks are actually investing heavily in real estate sector and with the financial crisis there was a knock-on effect on the estate market, the prices went down, the market crashed and so did many Islamic banks. So although none of them actually came to the point that they required a bailout, as many western banks did, but still there was a very serious dent in their financial stability because of the loss of value in their investments and this is a technical limitation and a risk that they are running because of the lack of instruments and this will continue into the 21st century because the sophistication and the innovation required to bring more instrument, to develop them and to bring them to the market will take time. It is not going to happen overnight so this is probably the first risk they are facing. Second risk that they are facing is actually, we have observed as practitioners in industry that there is actually a strong tendency of mimicking conventional products to make them fit into Shariah-compliance and to make them Islamic, at least to dress them as Islamic and this is, we believe that it is very risky process because first of all it killed the objectivity of Islamic finance so it is not really an alternative. It was just a dressing up of something else. Secondly thing is that when you mimic the conventional product basically firstly you stop your innovation and you will remain facing the first inherent risk that I described. Secondly the mimicking of the conventional products will first of all create a very big question mark on the integrity of Shariah-compliance within the institution, whoever is doing that and it will send politically incorrect messages to the market and to other players. Third it will also lead eventually to the same sort (10.57) as the conventional market will running and eventually it becomes useless because you not really diversifying and you are not really steering away. It is not really an alternative you are just following the same footsteps and you are going to the same destination. So it means that if somebody is trying to do the existing conventional derivatives for example and trying to make them fit somehow, one way or the other, to call them Islamic, but then the bottom line or the underlying structure of the derivative is the same as the conventional then obviously they are running the same risk as the conventional and that is no good for the industry. Third, is very much again a case in terms of risk management. As I said the risk in Islamic finance industry are different but the risk is still there. So this is a very important message to communicate to the industry and to anybody that is looking into Islamic finance that it is not a risk free business. It is very much based on the risk because Shariah does require a risk and reward link in any transaction. So the risk has to be there but the risk could be fundamentally from conventional finance. So when, for example, an Islamic bank is funding a house or a building that will be completely different, the risk involved with that will be completely different. However the financial outcome will be almost the same as a conventional mortgage or a conventional funding or leasing but the risk involved with that process will be completely different. Now what I am observing as a practitioner is that the risk managers currently working in the Islamic financial industry are not fully aware of this key difference and it is not their fault because the majority of them are coming from conventional background so they have their own education and qualification, their training and their experience will be all based on conventional finance. So their mind set is conventional and they see the risk in a conventional way whereas it could be dramatically different in Islamic and sometimes they are findings it really hard and difficult to fully understand and when you don't understand the risk then obviously when you don't understand the risk then you cannot mitigate or manage your risk effectively. So this is, from a risk point of view, I think this is one of the inherent risk any Islamic financial institution that if they fail to fully quantify their risk and to manage it adequately then they will be definitely a mistake somewhere and if things go well, they will go well, but the day there is an issue it could be very detrimental to the institution and also to the industry at large.

Q: Transparency is a big issue in Islamic finance. Transparency in the sense of the transactions, the composition of Shariah supervisory boards and in terms of product structures. How do you feel about that?

A: As a practitioner I don't think that there is any major issue with transparency. I think that it has been probably misinterpreted somewhere. All that you have mentioned is definitely a cause for concern within the industry and also within the consumer, if you refer to the retail market. It is not a lack of transparency, it is actually a lack of understanding and when people do not understand fully then it becomes a sort of mysterious way of doing things for them and that may eventually be interpreted as a lack of transparency. I'll tell you what happens. For example, you have mentioned here transparency in terms of transactions, so until you explain to me otherwise, I understand that when a transaction takes place people do not really understand why this process is used, why the bank has to purchase the asset before they sell and so on and so forth. So all these processes or procedures may seem a bit odd or out of place to many people but it has been actually developed on the basis of fulfilling certain Shariah requirements. So say for example in a murabaha transaction. That requires precisely, it is a Shariah requirement that the asset or the subject matter, when it is sold that the seller or the vendor has to have possession. So if the bank is financing an asset on murabaha basis then that asset is effectively a funding that the bank is providing but in order to provide that funding the bank has to use the procedure of murabaha that is acquiring the asset, paying an agree price to the vendor, taking over the ownership of the asset and then making an offer of sale to the customer or to the end user or the client who is seeking the funding. So effectively this procedure will be different and it will be different from any ordinary funding that the client will be expecting and the reason is that if the sequence of events in a murabaha is not respected then the contract actually becomes void from a Shariah point of view. So if the offer was made to the client or end user before the asset was actually taken into the ownership of the bank then from a Shariah point of view it is not a valid transaction. So when the process is working in a certain way, it is due to certain reasons and those reasons are for Shariah purposes and as the clients or the customer they do not have a full understanding of the background of the transaction then they find it quite hard to understand and they think it is too twisted or it is too long or it is too complicated. Why all this lengthy procedure and so on and so forth and they start calling it a lack of transparency and they think we don't know why they are doing all this, well it's for a purpose and I'll tell you where the failure is. The failure is actually on the part of the bank or the institution. It is their job to provide all this understanding and to provide the explanation. Either they have to print some explanatory material or they have to give the customer some advice and some background information which I believe is not there. The documents and agreements that I see, to be honest with you, if I read those agreements, about 50-100 page documents, if I am a lay man, if I don't really have the background knowledge I will not be able to make any sense of them and they don't even bother to give you the glossary of terminology at the beginning of the contract. So of course it will become very opaque and it will become a transparency issue. When it comes to the composition of the Shariah supervisory board, then there are the same issues over and over again. Always if you go to Islamic financial conferences, one of the hottest topics ever is only a handful of Shariah scholars are sitting on so many boards and conflicts of interest and all that debate will go on forever. I agree with most of these concerns for it can create conflicts of interest it can create governance issues but we also have to be realistic and we have to understand that this industry is going very fast. It is a double digit annual growth and it is very difficult and very hard for the industry to manage this growth by providing the resources that will be required including human and financial resources etc. etc. and this is something that you cannot develop overnight. You need time, you need to develop the knowledge, to grow your experience and to develop your resources accordingly so it will always be an issue to a certain point until there are enough scholars available who have the right experience, who have the right qualifications, who have the right understanding. So that's why all these things are happening. They have some sort of believity but again I don't think that there is a transparency issue. It is actually a lack of understanding and I'm not saying, I am not trying to defend the industry here. The industry has to do more, the industry has to invest in research and development they have to invest in developing their resources, their human capital is a big issue in this industry and that is why as there are no or almost any genuinely home-grown authentic indigenous Islamic bankers so the majority of them are actually coming from the conventional grounds and that's even further complicating things. So this is my view of that. I don't think it is a transparency issue but it is actually to do with the understanding and the industry has to provide you this awareness and this explanation. This is not going to happen on its own. We cannot expect the institutional clients, or we cannot expect the individual customers to seek knowledge and to go an Google everything such as what is an ijarah or what could I expect if I buy a car or if I want a $10 mil loan for a installing a new factory etc. etc. so how is that going to work. So all these things they aren't available on Google and they shouldn't be so this is the responsibility of the institution to provide all this background information and to provide a handholding to the client because it is a completely new concept. So given the non-Muslim clients and the non-Muslim people involved they don't have any background knowledge whatsoever and they are completely lost in this jungle of terminology. The majority of the terminology comes from Arabic which is very hard for people to pronounce and understand so it puts them off. The Muslims they have some background knowledge but again but none of them – the ordinary Muslim on the street does not have any significant understanding of Islamic finance. All of them they will know and they will agree that interest is haram, it is forbidden in Islam but it stops there. If you just stop anybody in Lime Street and ask them what they know about mudaraba, the answer will be a completely blank look and it is nobody else's responsibility. It is the industry's responsibility to make people aware of what mudaraba is and how it's going to work if they are interested in that. There is actually no transparency issue. The issue is a lack of understanding and that lack of understanding has to be address by creating more awareness and providing information by providing detailed information to the people.

Q: How do you think the lack of uniformity within the different Shariah financial hubs is affecting the Islamic financial system as a whole?

A: This is a major cause for concern but this issue is diminishing over time. If we were talking about the same issue a decade ago then it would have been a major cause for concern because of the regional schools of thought found in the Islamic world where Shariah is interpreted in slightly different ways. So this resulted in a situation where a certain type of transaction authorised by the Malaysian scholars or the scholars of that particular school of thought – the Shaffi school of thought – will not be acceptable for the Hanbali school of thought and that is mainly in the gulf region. So what happens is that if a Malaysian institution issues a paper and it was based on a certain type of underlying instrument that will be rejected by default by the GCC and they will not find any subscribers so basically they will then be confined to the regional investors of the far east where people follow the same school of thought and they will accept it as Shariah compliant and vice versa it could be completely the opposite way also. For example a bond or an instrument was issued from Saudi Arabia or from Bahrain and it was not accepted by the Malaysians. This was a very serious issue and it impeded the growth and development of the industry for a long long time but this issue is diminishing now, in my view, very rapidly and actually a lot more swiftly than anything else. First of all there are three organisations that I would name that have helped tremendously in addressing these standardization issues. First of all its AAOIFI based in Bahrain and with their Shariah standards and accounting standards they have actually made it really easy for people to structure their products and instruments in a way that are acceptable from the Muslims across the broad. OS those issues of schools of thought and interpretation etc. are no longer there if somebody wants to use AAOIFI Shariah standards which is the case in the majority of the industry now. It is very, very rare that you will find something outside those standards because it is in everybody's interest. You have to know that AAOIFI has its own Shariah board and that Shariah board is actually a lot bigger and more comprehensive and extensive than any other institutional board. In an institutional board you will usually have 3 scholars or sometimes 5 scholars or in exceptional cases like Al-Rajhi Bank in Saudi Arabia where you will have 7 or 9 scholars and these are just a few institutions that you could count on your fingertips otherwise the majority of these institutions are 3 scholars on a board. AAOIFI Shariah board is actually much bigger. I think they have around 20 odd scholars on their board and they have taken a representation from all the different regions of the world and all the schools of thought and they have taken a proportion so there is a minority of Shia scholars on their board and a majority of Sunni scholars from all over the region and the whole board works as a team and what is accepted as a Shariah standard by AAOIFI is actually a ratification or validation of that standard by all those scholars unanimously. It means that whatever is given to the market, it will acceptable for all the schools of thought and all the hubs. This should be the case in principal. That has made everybody's life very easy because now if you do structure an instrument that is based on AAOIFIF Shariah standards then it is almost acceptable in all the Shariah hubs. (Interview cuts off here…)

Q: Islamic finance doesn't have a lender of last resort. How do you think that would affect the Islamic financial system?

A: I do think that there should be a lender of last resort but I do not understand why and how we expect only having one lender of last resort for the whole financial industry. For me it doesn't work because in the conventional industry, every country or every market has its own lender of last resort which is usually the central bank of the country. So either we are saying that the Islamic financial industry as a whole is just one market and its dynamics are completely identical from one and to the other only then I think we can of having a central lender of last resort. If that is not the case, which it is definitely not in my view, then I think we cannot imagine having one lender of last resort for the whole industry. What I would suggest is we definitely need a lender of last resort but this is where the central banks have to be considered and they have to start moving towards a position where they will be able to act as the lender of last resort for Islamic institutions in an Islamic way. We have already seen this happening where for example in Malaysia or in Lebanon where by definition the central bank is actually accepting the reserves from Islamic institutions on Islamic principles. So it goes into an Islamic account held at the central bank and the reserves will be taken as a deposit on Islamic principles and it will be remunerated, if it is remunerated, in an Islamic way and similarly the central bank will act as a lender of last resort if required for an Islamic financial institution. Now it is still very early because it will be very difficult, for me, to imagine that the Bank of England or the Bank of France will start behaving in this way but in my view this is what is required and if the UK regulator, the FSA, has authorised 5 standalone Islamic banks in the country then I think this is one of the things that they should consider and , to some degree, is their responsibility to discuss it with the Bank of England and find a solution because at the moment these banks do not have any lenders of last resort and they are working in a complete vacuum but before we expect the bank of England or the FSA to do anything like this we would expect from the central bank in countries with a Muslim majority and where the Islamic financial industry is much stronger like the UAE and the Saudi Arabia and Pakistan, I think, this is what they have to do first. They have to set up the example as the Malaysian and the Lebanese have set and only then will we be able to see the national lenders of last resort for Islamic financial institutions. I think that more practical, sustainable and easy to implement than anything else.

Q: How do you think you could improve the standard of governance in Islamic finance?

A: Good question. I think there are two things that we need to consider what we talk about good governance. First of all it will be good governance in general for the institutions and part of that good governance will be Shariah governance. Now this is one of the arguments that I have had with some of the national regulators in the European countries where the regulators have taken a position steering themselves completely away from Shariah governance and saying that they are a secular organisation, we represent a secular country and we do not really want to interfere with the Shariah. Fine enough. I totally accept, as a practitioner I will accept and agree with this position that they have taken. However, I think that there is one point that is very serious and completely ignored by the regulators which is, one of the rules of the regulators is actually to protect the consumer of that market so when you authorise an Islamic bank to operate in the market as an Islamic bank then by definition I would expect as a consumer, from the regulator, to make sure that every measure has been put in place to ensure that what it says on the tin is what it contains as well and at the moment I do not see as a consumer, I am not fully satisfied, and this maybe one of the things that eventually translates into questions over transparency etc., that how Shariah governance is taking place, how the decisions of the Shariah supervisory board are taken, how the scholars are appointed, on what grounds they are appointed, how the scholars are making decisions, how those decisions are being implemented and when I go, for example to an Islamic Bank, I am told that the home finance that I am applying for is Islamic and they show me a fatwa or a signed paper by their Shariah supervisory board members, is that all I should have access to as a consumer of an Islamic bank. I am not naming any bank here; I am just giving you an example so please try to avoid naming any bank. So as a consumer what I would like to see that there is open communication where an annual report is published or there is at least something referring to a sort of annual approval report of Shariah compliance that is part of the group report for instance or the accounts. So as part of the accounts you have the chairman's report and the auditor's report and the managing director's report and another page by the chairman of the Shariah supervisory board that all of the business conducted by this bank is in accordance with the Shariah rulings and the rulings are provided by the Shariah supervisory board. So this is part of good governance for me. That is one side and this will not happen until there is more emphasis on Shariah audit. This is very important because everybody is putting a lot of emphasis on financial audits especially these days where certain practices of the banking industry have become very questionable and they have challenged the decisions etc. etc. So financial audit is extremely important and so is Shariah audit and there is not enough measures in place actually to ensure that there is an internal or ideally there is an external, independent Shariah audit being done and there is no sort of Shariah rating as well. On the other side the general good governance of Islamic financial institutions again, I think with what I have observed sometimes as a practitioner is that the individual who are sitting on the board of directors do not fully understand the implications of Shariah and they do not fully understand what will be required from them as the custodians of this institution and the custodians of the trust of the customers or the staff of the institution has placed in them, the board. In some markets, in Europe, I think it is quite stringent and people do understand but I have seen in some countries where corporate governance is treated as a secondary issue and not really something that is important. I have also seen interference going on as well with the day to day management of the business etc. So in my personal view this is something that has to be very strongly addressed and there should be very clear systems in place to ensure that good governance is actually good governance and people understand and they feel the responsibility that they are carrying in terms of providing they corporate governance or the direction to the institution and there is no chance of any interference or any malpractices between different layers of the governance including the Shariah governance. So I would not expect a Shariah scholar to intervene in an management decision or intervene into any headed decision of the financial institution regardless if it is the brother of the Shariah scholar or his father it should be completely indifferent for the person. I am not accusing anybody here; I am just thinking loudly that these are the things I would expect to see in theory and also in practice. They should be implemented. They (both Shariah and conventional governance) need to work together however I put more emphasis on Shariah governance. There should be a proper mechanism of external Shariah audit to make sure that what is being said is Shariah complaint is truly Shariah compliant.

Q: How do you see Shariah finance progressing in the future?

A: I think the overall perspective of Islamic finance is actually quite positive and very strong. There is big room for growth, I would say, internationally because it is not only the countries or the markets with the Muslim majority but it is also very relevant to the non-Muslim population as well. It will be just a matter of creating the awareness and maybe also providing some alternative terminology because, and this is another observation I have made as a practitioner, that the extensive use of Arabic terminology, which is understandable, but it is not helping a lot in propagating this alternative to a lot of people. So if all these issues are dealt with in a constructive way then I think that overall Islamic finance has a very bright future and it has the potential to appeal to Muslims and non-Muslims alike and to become a part of mainstream finance as a strong alternative channel. I was actually very delightfully surprised to see a photo sent by a friend and that photo was taken on Wall Street in New York and American lady was carrying a banner, and she was Caucasian, that was displaying something like 'maybe we should bank as the Muslims do…" or something like that. So what we have seen over the last two three years, how events are unfolding in the conventional financial industry and these issues of greed etc., I think they can be duly addressed with the implementation and introduction of Islamic finance but this will take time and it will require a lot of concerted effort of the industry to create this awareness and to make it a proper mainstream alternative channel but if they can do it and pull it together then I think that it has actually a very strong potential and the future will be very, very bright even if they continue doing what they are doing now, I think the future is still pretty bright for them (Islamic finance).

Q: What do you think about the development of new instruments such as the wa'ad in Islamic finance?

A: I think that the wa'ad is definitely one of the key instruments that could be developed and has a lot of potential but it will remain under very strict conditions and this is the unfortunate fact. When a murabaha is authorised by the scholars it came with a very strict set of rules and conditions to be respected. Unfortunately, over time people started feeling very lax about that and they started turning murabaha in to something else and eventually it came to the point where it became extremely controversial and many scholars who initially were happy with murabaha they declared that it was no longer acceptable in their view because the practices of murabaha today are far away from what they should be. If this is going to be done to the wa'ad then, of course, it will become very controversial and it will actually become another issue in the future. However, if it is managed correctly and when the conditions are provided or the set of rules are provided by the scholars then it has to be understood by the practitioners instead of arguing for the sake of arguing and trying to mould it to make it look more like a future than a wa'ad. That will be very detrimental and that will again put a dent in the confidence of the scholars, in the confidence of the consumers and it will become another joke like murabaha. However, if it is used, if it is implement and if it is research, and it will required a lot of research, and the Muslim scholars who will be taking the decisions and who will be providing the set of rules, they have to be fully informed as well of the implications of the future because they have to see both sides of the picture. So when they fully understand the future market and when they fully understand the Shariah implication of wa'ad then definitely they will be able, with the help of practitioners to come up with innovative structures where we can use wa'ad objectively while remaining true to Shariah and if we start going in the other direction then maybe we will damage this excellent tool and we will end up in a situation where a lot of people will be unhappy with the use of wa'ad.

Practitioner 6

Q: So the first question is, how do you think conventional finance views Islamic finance?

Right, you're talking about mainstream finance, the conventional ones right?

Yes.

Right. I'll talk here in the MENA region you know because we are based in the MENA region. They view it, you know, as it's very competitive kind of banking or financing tools being used here in the MENA region okay, they view that as ethical system more than the conventional one. Okay they find a lot of opportunities in this market as well as a lot of gaps you know because most of the banks are conventional so, and people are now trying, tend to go through the Islamic finance, Islamic institutions so there is a good gap in the market so in terms of view, as I said now conventional banks, they know exactly what Islamic banks are all about, they know the system, they know how it works. In Kuwait specifically most of the big banks, mega conventional banks are now having an Islamic bank under its umbrella so it's a must, so if I give you an example about National Bank of Kuwait, it's one of the biggest banks here in the region, the MENA region, just two, three years ago it acquired an Islamic bank, it's called Boubyan, Boubyan Bank, it's an Islamic bank so now this bank owns both a conventional as well as Islamic banks so, you know, it's now a must for any conventional bank to have an Islamic bank under its umbrella.

Q: Sure. You said people basically kind of see Islamic banking as a form of ethical financing, do you think that there is a difference between Islamic banking and ethical financing, say for example green investments, do you think there's a difference?

I'm not sure really, for the regular people they do not know the difference. However, you know, it's for us as Muslims here in the region, we more believe in Islamic related products and structures, etc. so if you offered me a green investment, a green investment from a conventional bank and I have any other structure or product from any Islamic bank here in the region, I will go for that Islamic product, I will not go with a product that came out of a conventional bank. Now I'm talking about maybe 50 or 60% of the population, you know, most of the people now tend to respect more or to go to such Islamic institutions.

Q: Is there a lot of competition between Islamic and conventional banks?

Yes in recent years, in recent years so I'll just give you a brief about, you know, here in Kuwait specifically 20 years ago they established a bank, it's called Kuwait Finance House, okay. Kuwait Finance House is the first Islamic bank established here in Kuwait and it was the only bank. On the other hand the conventional side there was around five banks, mega banks, okay 20 years ago, not far from now you know, only 20 years ago so since then now we are talking, we have almost the same number of Islamic banks same as the conventional banks so we have about six conventional banks and we have almost another six Islamic banks here in Kuwait so we can see how this picked up in the last 20 years only in Kuwait and as I said, you know, in recent years now they almost they have the same number, almost the same, talking about same size region you know so they are 50/50 in Kuwait which is, you know, it's something we cannot ignore, you know, Islamic finance here in Kuwait now it's picking up big time.

Q: As an investment banker, how do you feel about the products available within Islamic finance?

Right, to be very honest, in terms of investment products they are not as innovative as in conventional banks. As you know financial engineering is most in the other side which is the conventional banking, however for Islamic banking the products are a little bit limited and what we call they are more concerned with the commercial side of the banking, you know, the retail side, not the investment banking side, I'm talking here about investment. I'm talking here the investment side of the banks, okay, so if you notice you will see that conventional banks are having more sort of investment products than the other Islamic banks. Islamic banks, if we talk about investment they have direct investments, more direct investments than having Islamic products, structured products you know so I'll give you an example about Kuwait Finance House which is the biggest Islamic bank maybe in the region for now, one of the mega banks, Islamic banks in the region. They already have a lot of direct investments. There are a lot of subsidiaries, a lot of investments they directly, that we call private equity investments so they invest in companies, in a lot of companies, they do not invest in portfolios and money markets, etc., etc. because a lot of these products are not Sharia compliant you know so we're talking about Forex, etc., all these products are not Sharia compliant because of talking about, you know, Sharia sort of problem dealing with such products so what they do is they invest heavily in a lot of sectors so talking about healthcare, education, talking about investment so for example they own our company, the company I'm working for at the moment, the finance house, they own, well they partially own our company so they like to have their investments and companies not in investment products okay so this is the difference maybe between them and the conventional, across conventional, they have more free, they have a lot of options you know for the assets, you know, they have a lot of, you know, location wise they can put their monies among a lot of products regionally and globally but it is not the case for Islamic banks as you know.

Q: So that's from an investment perspective, what about a risk management prospective, do you think there needs to be more instruments for risk management in Islamic finance?

A very broad question, we're talking about risk management. Risk management has to be in every department. We are talking here about, if we are talking about investment banking department inside the bank, there has to be a risk management framework that govern the way people perceive the risk within an investment so we're talking about risk management, we're talking about risk management at the board level going down, you know, at the executive management level and then going down to the employees' level inside every department, okay, talking about asset management, we're talking about liquidity management, we're talking about, you know, there are a lot of risks out there that has to be managed from different layers within the institution within a bank, so we're talking about risk management, Islamic finance is very broad okay and it cannot be honestly here for example I've been given a task in this company, in this investment company to start making a governance, a corporate governance framework and the risk management framework. It's good to have it theoretically when we are talking theoretically, it's very easy to have them written and signed by the board and approved, etc. The problem lies with the implementation of such a framework and how you monitor it, how you really implement such a risk management. Okay we know that we have an investment, you have to make our risk management to analyse the risk, etc. to, you know, there are a lot of things you have to do within, you know, a criteria, specific criteria okay so, you know, this broad question cannot be answered at the bank level without, you know, going down to the bottom line of banks so what sort of bank is this? Is it only working as a commercial bank or, you know, it's working as an investment bank and, you know, the liquidity levels, is it a big, big massive bank that has a lot of market share or not, so the more the bank is, the bigger the bank is, you know, there are, the more risk here the bank is vulnerable for, you know, liquidity crisis so for example if people suddenly they call it bank run or whatever they go and just withdraw their monies and deposits, etc. How the bank will react to this, you know if, yeah so.

Q: I mean predominantly we're looking more at basically portfolio risk management so say for example using financial derivatives within Islamic finance to hedge against risk, do you think there is a lack of innovation in that aspect of Islamic finance?

Yes, yes there is, there is a lack of innovation maybe because Islamic finance is just what we call it? It's emerging, still emerging, it's not developed, you know, it's not like the conventional, there is no real system, you know, that is governed by, for example at the global level, not like the conventional. The conventional system is known and uniform, etc., but for the Islamic, it's not as uniform as the conventional yet. So there is lack of innovation definitely there is. In terms of risk management yes there is also still I think they are way beyond how other banks are managing their risk and liquidity also so yes they are still behind. Because it's newer than the conventional but it will pick up, it will pick up soon. It will have to pick up.

Q: How do you feel about new like how do you feel about the current level of innovation, say for example the new products such as the Wa'd. How you do you feel about them approximating let's say a conventional option, do you think that's the right way forward? Do you think that's not the right way forward?

It's in the very right way, the innovation is growing but as I said it's still lagging so we will find conventional banks are way, you know, they are more innovative than Islamic banks and this is not as bad as people might think. Because Islamic finance is very limited in terms of products, you know, there are a lot of investment products and derivatives that are not Sharia complaint, you know what I mean? So in terms, if we are talking about products and new products and innovative products, you know, you will find most of them are not compliant with the Sharia law and therefore you will not find a financial engineer, investment products that are Sharia compliant.

Sure.

Therefore you will find, yeah Islamic banks are a little bit behind but the reason is not because the people are working are not at the innovative level as the other banks, no it's about the Sharia law itself and how it limits the options we have in terms of investment products that we can offer within the bank.

Q: Sure. In terms of Sharia compliancy, one of the main criticisms of Sharia compliancy with the lack of transparency behind what is Sharia compliant and what isn't Sharia compliant, do you think there is an issue of transparency in Islamic finance?

Yes definitely. Look, transparency we always have problem with transparency. I'm talking we here, talking about, you know, the MENA region and maybe a few countries in the Far East, you know, transparency is a massive problem. We're talking here at all levels so talking about the government level, we're talking about companies of the corporate levels, there is no any transparency, all very minimal so the problem with data, you know, some people view it as very confidential and they do not want to disclose what they are doing sort of what is available for the public, you know, we don't have this what we call it this culture of just being very transparent with each other so people can learn, people can analyse, look what you have done and then you can improve, etc., as what is happening in the, we're talking here about, you know, the US, western Europe, you know, for us here it's, you know, transparency is just at the lowest ever level, you know, in compared to the more transparent markets.

Q: Do you think it would help Islamic finance if, say for example, the Fatwas issued by the Sharia supervisory boards were made available to the public, do you think it will help if, you know, basically product structures were made known to the public, do you think that will help Islamic finance immensely in the future?

Definitely, definitely because people will start understanding more what is Islamic finance, how it works, whether it's really, really hard to do or hard to implement or is just simple and have little principles here and there and can be implemented so it will help them grow faster, at a faster pace, you know. If there is transparency definitely such principles will grow more, you know, more quicker than a space at this level at these days, you know, so the more transparent institutions are, the more people will know, the more the people will analyse, the more the people will look at the data and transactions and all, as you said there, Sharia supervisory board if they issue a report so there is an understanding what's inside that report so here also about the product structure, how those products are structured, how they actually work, how they are Sharia compliant, all these data will help them to grow, you know, at a faster pace than the current pace they are having.

Q: Okay. Some people have said that the lack of transparency does not actually exist, it is in fact a marketing problem so for example Islamic finance does not market itself properly and people don't want to accept it and that's why people perceive there's a lack of transparency, would you agree with this?

I don't think so. It's not a lack of marketing. You know marketing is just to be very honest you know, people in the financial industry, they know each other, you know, we know, you know, what banks are there, what they are doing, who are the groups and those banks, what sort of exposure they have so talking here about people in the same industry, they know each other, we do not need the marketing, you know, Islamic finance do not need to be marketed by the institutions. Rather if some interested personnel or institutions would love to know more about Islamic financing and Islamic structures, Islamic product structures, they can just search for the data and start analysing them, you know, that's what we need. It's to have something like data centre or something that has a track record of transactions, supervisory, you know, Sharia supervisory board reports, annual, you know, AGMs for banks available, previous funds or previous portfolios invested within banks, you know, it's financial performance, all these data are very important to be analysed and then it can be used, you know, it can be used by researchers, can be used by, you know, other countries, you know. I think in America there is a huge potential for Islamic banks. Now in London there is Islamic banks started picking up in Malaysia already, you know, it's the financial centre for Islamic finance so I think those people who need to know more about how Islamic finance works and this will never happen unless those who are actually working in this industry start disclosing and being more transparent with others, sharing with them how such things work, you know. Once this is shared through a platform and then those data can be analysed and understood, I think it will be very interesting. It will be very interesting, I will have very interesting results, so for example for you as researchers, if you have a platform for data collection, you know, just you want to collect some data about banks, what sort of products they offer, what sort of, you know, we're talking about transactions, previous transactions, something they bought, something they sold, how things actually work, I think it will help, you know.

Q: I see what you mean, so it's basically not about being transparent, only within the financial industry about being transparent with basically everyone else so you can help Islamic finance grow in that respect.

Yes because transparent with the other in the same industry we already know, you know, when you are working in the same industry you know who are the key people, what they are doing, what are the products, you know what I mean so you don't need that transparently because you are already inside that market but for others who are outside and talking not outside only at the sector level, I'm talking about the geographical level, so in, for example, in Saudi Arabia they might not know who are the key players here in the Islamic finance arena. They don't know what sort of products and they are talking here about our neighbour so imagine, talking about Japan, if they want to know more about Islamic finance in Kuwait, they I think there is no way to know, if you know what I mean. So being transparent is being transparent at a global level at somewhere like, if you have somewhere like Thomson Reuters or something, Bloomberg, somewhere that you can share your transaction, your data your everything that can be analysed and then used, if you know what I mean.

Q: What do you think can be done to basically, you know, what mechanisms do you think should be put in place or could be put in place to basically make Islamic finance more transparent?

As I said, it has to be, first of all if you look at conventional banks, now how it spread all over the world at this pace, you know, and everybody knows how it works, because there is uniformity somewhere, there are some bodies or, you know, there are some, what we call them?

Central bodies.

Exactly, central bodies that they are sharing, you know, experiences from somewhere to the other and sharing the rules and regulations, etc. I think this is not the case. Yes there are a few bodies in the Islamic finance arena but they are not as active as in the conventional part, you know. So I think here are the bodies who have the connection, you know, if you start connecting people, using data, using information from one part of the world to the other part of the world, you will add value, you will definitely add value, you know, you will definitely add value and you will be like the bridge between the east and the west, between the second or third world and the first world as well call it, between Islamic finance and the people who doesn't know anything about Islamic finance you know so I think those bodies have to start, you know, being more active because to be very honest I have no clue of any of the Islamic finance rates but there might be, there might be two or three or five or ten but we cannot, we do not know them, you know, they are not on the ground if you know what I mean. They do not, they are not trying to approach, you know, Islamic banks, Islamic institutions like our company for example, an Islamic or Sharia compliant investment company. We have other, we have, you know, procedures for lending, procedures for investing, etc. so I think these experiences can be shared through those bodies to other investment companies in other parts of the world and this is where, this will help definitely growing very faster, you know, at a faster level than the pace we are having now.

Q: Sure. Going back to the Sharia supervisory boards, there's been a lot of criticism lately suggesting that you see the same Sharia scholars on similar boards with different companies and that companies are headhunting Sharia scholars for their judgements, how do you feel about this?

Right, now in Kuwait for example, I'll just, I'll give you something in Kuwait now, we have a CMA, something called Capital Market Authority okay that is obliging companies to have a supervisory board from a Sharia companies that are approved by the CMA, okay? So I'll just give you an example. If we have, you know, a Sharia consultancy in Kuwait say ten companies, they are all approved by the CMA okay so as a company, as an investment company licensed by this central, by the Capital Market Authority in Kuwait, we have to have them on board, one of those ten companies have them on our Sharia board, you know what I mean?

Sure.

Okay so it's not about just, you know before, that was before right you are, what you just said is picking up scholars from here and there, trying to have those three scholars from, you know, from the market and that's, but now recently just in the past three years, you know since 2010 all companies now are obliged to have those companies on board. One of those companies on board of our Sharia advisory board, you know, so it's more now regulated than before, so it's not a mega problem, it's not a problem for companies, it's not a problem for banks or Islamic banks because they are available and they are working under massive organisation structures that are really in the market and, you know, regulated by the Capital Market Authority of this market so it's regulated at the moment.

Q: So the problem, I mean it was a problem before but because there's more expertise and there's more regulation in the market now, it's no longer that big of a problem anymore.

Exactly.

Q: From our conversation so far I can kind of tell that you're very strong, you feel very strongly about the uniformity of the Islamic banking system. In terms of basically Islamic hubs, what you find is that Malaysia is a central Islamic hub, you have the Gulf region which is also a central Islamic hub and then you have the UK in the west. All three central hubs have, to a certain extent, different regulatory standards, different interpretations of Islamic law. How do you feel that impacts? So in essence it's the lack of uniformity there. How do you feel that impacts the overall Islamic financial system?

Yeah this is what I just said, you know because there is no uniformity between those hubs, you know, every bank is different, every, you know, at the operational level, you know, there will be a problem with the compliance, there will be a problem with being no better, you know because there is a lot of rules and regulations that are different, so I will give you an example for the Kuwait finance house, they are already in Malaysia, they are already in Dubai, they are already in Kuwait. Okay, they have different rules and regulations from Kuwait to Dubai to Malaysia. Imagine how you can just manage under the one umbrella, you know, those three massive banks, we're not talking only branches we're talking about banks, banks that are the same, under the same, you know, under the same umbrella of this bank so this is the problem in that you don't have uniformity, you don't have yet centralised place that give you direction and for each rule and regulation, you know what I mean, there is no one place that gives you clear cut, you know, rules and regulations, policies and procedures and how to just follow them and act as best practice Islamic bank, there is nothing, there is not such a thing.

Q: Sure. How do you feel about the large, how do you feel about AAOIFI and the IFSB?

As I said, I haven't heard of AAOIFI. I've heard of IFSB, I think it's Islamic Finance …

Services Board.

… Services Board.

Sure.

They are not active. From my perspective on the ground I haven't seen, I haven't heard may IFSB, I've read a few papers a few years ago about Islamic Finance but they are not on the ground my dear, and this is the problem, they are publishing, they are doing a lot of, you know, very high level, you know communications which, at the end of the day I think it will not add a lot of value. You have to be a real bridge or otherwise you should not, you know, take a lead on such and such as a sector, you know what I mean? You have to have more proactive role.

Q: Sure. There have been calls for a central bank to basically help Islamic support, to be a central regulatory standard for Islamic finance. Do you think this role can be taken on by say a sovereign central bank?

Yes why not but it has to be regulated somehow. I don't know how. I have no clue how it can be done but it has to be done because now it's not, I'm talking about 50% of the banking system in a country like Kuwait which is a very wealthy country and it's Islamic so it has to be regulated. It is regulated by central bank but it has to be, you know, also under the central bank and somehow especially, you know, bumping money, etc. in the financial system, there has to be a mechanism. I don't know how it's been done.

Q: How would you feel about an Islamic central bank, so say for example a central bank created just for Islamic finance, would that be preferable or would you rather have a conventional central bank?

Why not? No, I think an Islamic central bank is a very good idea at the moment, you know but the problem, how they are going to implement. On the ground it's a different case. It's a very different case especially, you know, just to let you know something. Now in Kuwait if a crisis happened, okay, how a conventional central bank will bail out an Islamic bank. There is no way, it can go insolvent without a helping if you know what I mean? You know what I mean so there is a lot of problems Islamic banks are facing. I am not sure how it can be solved to be very honest. Yes it's waking up, yes it's having a huge market share but it's still not supported by the government as should be supported.

Q: Sure. Well just a final few questions. In terms of Islamic banking and governance, what do you think are the main issues of governance within the Islamic banks?

Governance? I mean now talking about risk management and talking about having a framework, you know the board of those banks has to make sure they establish a proper risk management practices including also something we call it business continuity plan, you know, the board has also to make sure they control all the financial and non-financial risks so those in terms of governance are, I think it's to comply with all the other regulations with the central bank and capital market authority, etc., so those are I think this is the job of any board, you know, is to make sure they are governing the institution in a very robust way.

Q: Going into the 21st century, what do you think are the main areas of risk within Islamic finance? Say for example we had the current financial crisis, we saw a few problems with Sukuk structures and so on and so forth, where do you think are the main areas of risk for Islamic finance going into the future?

To be very honest, now we are having in our region we have political risk you know. Political risk is very high, you know. If any of those countries are not, you know, supported and the finances are supported, you know, properly so I give you an example is Egypt. These days they have …

Sorry Salem you're breaking up.

As you might know there's a co-op by, yeah this is such a problem, in fact the financial situation, the balance sheet of Egypt, you know, so they will need to pump in some money. These monies might be got from, you know, from some countries like the US or other countries like Saudi or Kuwait as we've seen, you know, so we're talking here about political risk. The political risk will definitely, definitely impact the Islamic financing institutions, you know. There is also religious related risks I think. Religious related risks, now these days also because Islam, I'm not sure what's happening to it, you know, there are a lot of problems happening and people are being more afraid of the idea of Islam. We are all Muslims, etc. but you know what we call it, something I have to speak about which is, you know … okay so there is also religious risks I think so talking here about unreligious and political I think, financial also could be if there is a crisis or something, okay another crisis happened there might be a bank run which might impact the liquidity of the Islamic banks and a leap to solvency. In those I think financial, political, religious, those three things, that's what I think.

Q: Sure. Okay final question. Do you see Islamic finance competing with conventional finance for the future, I mean in terms of, as opposed to an alternative, as opposed to basically being a niche product, do you think Islamic finance would be on a level playing field with conventional finance?

Not now. Maybe not before, you know, 10 to 20 years. I'm not exaggerating but it will need a lot of time.

Sure.

Because there is you know, as we said, no uniformity, a lot of things are still missing, it's a long way for them to … it's now competing but at certain regions, certain countries, as I said Kuwait, Saudi Arabia, etc. so in this region only, okay, the competition is but to go beyond these regions I think it will need a lot of time and effort so not now, not now at all.

Q: Sure. As a practitioner as well, as a person that's underground as an investment banker in Islamic finance, how do you think Islamic finance performed during the financial crisis? Do you think it did well? Do you think it rode it better than conventional finance?

It is better, surprisingly better. Surprisingly better than conventional finance because why? I tell you why, because the basic idea of the Islamic Sharia structure is not to take a lot of risk, okay, not to be exposed to a lot of derivatives, you know to try to be conservative as much as possible and those banks all survived the most you know, the banks who do not carry a lot of risk, the banks who are not exposed to a lot of derivatives and a lot of risky investments and therefore they perform better because they are very conservative based on the Sharia laws, you know, the Sharia laws try always to, what to say, to save or to make sure no harm for anybody, you know what I mean?

Sure.

So to protect investors and to protect others so that's it, that's it I think. That's why they perform better.

END

Appendix 5 – Interview Access Documents

Interview Cover Letter

Dear Sir/Madam

The purpose of this e-mail is to request a brief interview with you regarding your thoughts on several aspects of Islamic banking and finance.

My name is Seng Kiong, Kok and I am a postgraduate research student at University of Liverpool Management School. I am currently undertaking research with regards to "The Evolution of Islamic Finance in the World Today: A Study of Risk Management and Governance". This research essentially focuses on the development risk management concepts within the Islamic financial system and the continual evolution of its governance. Recent studies have shown that whilst Islamic finance does provide a source of diversification to the traditional western investor, risk management strategies are still very rigid and lack the dynamic nature of their western counterparts. Moreover, the lack of a central, uniform set of rules to govern the financial system as a whole has resulted in many a grey area. This research aims explore the various available risk management instruments presented by Islamic finance and the scope for the development of more proactive strategies. Additionally, this research also seeks to determine if the lack of a single regulatory standard is detrimental towards the continual development of Islamic Finance.

An important element of the research requires critical discussion and dialogue in the form of interviews with a well-informed respondent group with in-depth knowledge and experience in the subject area. The interview should last a maximum of 1 hour where a number of issues within the area of Islamic Finance will be discussed. The interview process will include individuals from both an academic and professional background within the field of Islamic banking and finance, allowing for a well-rounded group of respondents to provide their views and opinions on the research area.

I hope you would be able to provide your time as well as insight, which will be greatly beneficial to my research. I would be more than happy to provide you with a draft copy of interview questions in advance, if you require and would, of course, work around your availability and schedules. All information supplied will be treated with strict confidentiality and kept at the University of Liverpool Management School Campus. Information collected will be used solely for the purposes of this study and no other.

Access to interview transcripts is restricted to me as principal researcher and my supervisory team. Participation in this interview is entirely voluntary and you are free to withdraw from this study at any time. If you wish to withdraw your participation, please contact me at the email address provided below and all informational related to you will be destroyed. If you would like a summary of the results of this research, I would be happy to send you copies of future publications.

Please feel free to contact me via email at S.Kok2@liv.ac.uk with regards to any queries you may have, or my director of studies G.Giorgioni@liv.ac.uk or through telephone at +44 151 795 0560.

Thank you for considering my request and I look forward to hearing from you soon.

Yours respectfully,
Seng Kiong, Kok
Postgraduate Research Student

UNIVERSITY OF LIVERPOOL

PARTICIPANT INFORMATION SHEET

The Evolution of Islamic Finance in the World Today: A Study of Risk Management and Governance

Name of Researcher and School/Faculty

My name is Seng Kiong, Kok and I am a postgraduate research student at University of Liverpool Management School. I am currently undertaking research in the field of “The Evolution of Islamic Finance in the World Today: A Study of Risk Management and Governance”.

1. What is the purpose of the study?

This research essentially focuses on the development risk management concepts within the Islamic financial system and the continual evolution of its governance. Recent studies have shown that whilst Islamic finance does provide a source of diversification to the traditional western investor, risk management strategies are still very rigid and lack the dynamic nature of their western counterparts. Moreover, the lack of a central, uniform set of rules to govern the financial system as a whole has resulted in many a grey area. This research aims explore the various available risk management instruments presented by Islamic finance and the scope for the development of more proactive strategies. Additionally, this research also seeks to determine if the lack of a single regulatory standard is detrimental towards the continual development of Islamic Finance.

2. Do I have to take part?

Participation in this interview is entirely voluntary and you are free to withdraw from this study at any time. If you wish to withdraw your participation, please contact me at the email address provided below and all informational related to you will be destroyed. If you would like a summary of the results of this research, I would be happy to send you copies of future publications.

3. What will happen to me if I take part?

An integral part of this research is to collect information through the use of interviews from both academics and professionals within the field of business and finance, allowing for a well-rounded group of respondents to provide their views and opinions on the research area. Each interview should last no more than 45 minutes.

Interviews will be transcribed for analysis and access to interview transcripts is restricted to me, as principal researcher, and my supervisory team. Information collected will only be used for the period of this research and no more.

4. **Are there any risks / benefits involved?**

As principle researcher I do not foresee any risks or discomforts that would arise in conducting this research as all information will be kept confidential.

5. Will my taking part in the study be kept confidential?

All information supplied will be treated with strict confidentiality and kept at the University of Liverpool Management School Campus. Information collected will be used solely for the purposes of this study and no other. Information, once collected will be encrypted and stored in password protected folders.

Contact Details of Researcher

Please feel free to contact me via email at S.Kok2@liv.ac.uk with regards to any queries you may have, or my director of studies G.Giorgioni@liv.ac.uk or through telephone at +44 151 795 0560.

Once again thank you for your time.
Yours respectfully,

Seng Kiong, Kok
Postgraduate Research Student
University of Liverpool

Interview Consent Form

UNIVERSITY OF LIVERPOOL

CONSENT FORM

The Evolution of Islamic Finance in the World Today: A Study of Risk Management and Governance

By: Seng Kiong, Kok
Faculty: University of Liverpool Management School

1. I confirm that I have read and understand the information provided for the above study. I have had the opportunity to consider the information, ask questions and have had these answered satisfactorily ☐

2. I understand that my participation is voluntary and that I am free to withdraw at any time, without giving a reason and that this will not affect my legal rights. ☐

3. I understand that any personal information collected during the study will be anonymised and remain confidential ☐

4. I agree to take part in the above study ☐

Name of Participant	Date	Signature
Name of Researcher	Date	Signature
Name of Person taking consent	Date	Signature

(if different from researcher)

UNIVERSITY OF LIVERPOOL

ASSENT FORM FOR CHILDREN / OTHER DEPENDENTS

The Evolution of Islamic Finance in the World Today: A Study of Risk Management and Governance

By: Seng Kiong, Kok

Faculty: University of Liverpool Management School

Child (or if unable, parent/guardian on their behalf) / young person to circle all they agree with

Have you read (or had read to you) information about this project?	Yes/No
Has somebody else explained this project to you?	Yes/No
Do you understand what this project is about?	Yes/No
Have you asked all the questions you want?	Yes/No
Have you had your questions answered in a way you understand?	Yes/No
Do you understand it's OK to stop taking part at any time?	Yes/No
Are you happy to take part?	Yes/No

If any answers are 'no' or you **don't** want to take part, don't sign your name!

If you **do** want to take part, you can write your name below

Your name ____________________________
Date ____________________________

Your parent or guardian must write their name here if they are happy for you to do the project.
Print Name ____________________________
Sign ____________________________
Date ____________________________

The researcher who explained this project to you needs to sign too.
Print Name ____________________________
Sign ____________________________
Date ____________________________