Epistemology of finance: Misreading Smith

Sufi Contribution to Islamic Economics

Interview with Mohammed Kateeb of Path Solutions

Equity screening in Islamic finance

Barrier to Entry: Shari’a Cost

Legal and Financial Mitigation Solutions for Sukuk Legal Risks

Datuk Noripah Kamso

A Humble Visionary
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As the Islamic finance industry grows, the need to support institutions and disseminate ideas becomes even more pressing. Competing effectively with conventional market institutions both in terms of profitability and ideology is undoubtedly difficult. The conventional markets have evolved over a period of 400 years; Islamic finance, only 40. The conventional markets are established in the psyche of the global population; Islamic finance is considered a peculiar substrate and not enough is known about it, its principles and its products.

Hence, it is necessary for those in the industry to promote Islamic finance to the masses. One way to do such is to galvanise market agents, to encourage them to think of the alternative perspective. In this regards, this publication by Edbiz Consulting of the Islamic Finance Review (ISFIRE) contains an exposition of ideas by those who wish to see Islamic finance develop as a dynamic, flourishing and unique system offering a tangible and real value proposition.

It therefore should come as no surprise that the first article in the ISFIRE starts by challenging the ideological principles of the current economic and financial system. Dr. Abbas Mirakhor, a leading Islamic economist and a shining light in the industry, challenges commonly held assumptions expounded by economists regarding Adam Smith’s ideas of the ‘invisible hand’ and ‘self interest’. While the current economic system has no room for the divine grand designer, Smith was much more accommodating. For Smith, the realisation of an efficient allocation of resources and consequently greater wealth for a nation, virtuous market agents were expedient. Rizwan Rahman takes this further focusing on how the general principles of Sufism can contribute to a change in thinking about conventional economics.

However, the power of ideas should not remain in abstraction, far from the events on the ground. The Islamic finance industry started from ideas but grew by the hands of practitioners. One leading figure in the industry, making strides in the Islamic asset management sector is Datuk Noripah Kamso, CEO of CIMB-Islamic Principal. A profile is provided showing how the focus and drive of a diminutive and humble Malaysian woman is changing Islamic asset management for the better.

One can compellingly argue that the strength of the conventional financial services industry owes itself to the explosive developments in technology over the last 30 years, which take into account the particularities of the products. Islamic finance products are different and require an alternative system. Path Solution can boast of a solution, having provided the first Shari’a compliant banking platform. Mr. Mohammed Kateeb, the charming CEO of Path Solutions and ex-Microsoft officer, sits with us to discuss the product, the industry, and the man himself.

The Islamic banking and finance industry is comparatively a young industry and is evolving slowly. The markets are constantly changing and one needs to be adrift of the current situation and the challenges that arise. Rizwan Malik looks at Shari’a stock screening, a constantly developing field. Asim Anwar Kamal focuses on the problem of Shari’a cost in the Islamic finance industry, which is proving to be a constant efficiency concern while Jhordy Kashoogie reflects on the conflicting law issue that confronts Islamic finance.

Following the Global Islamic Finance Report, Edbiz Consulting are proud to be publishers of another intelligence publication. Our commitment to thought leadership is staunch and we hope to encourage the development of ideas within the industry.

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Before the inception of the Islamic finance industry, there was what could be called a “market failure” in the conventional financial system. There was substantial unmet demand for Shari’a-compliant financial products. Islamic finance grew out of conventional finance to meet this demand. Muslim scholars writing mostly since the 1970s about Islamic finance focused on development of an Islamic finance system; they not only emphasised elimination of riba contracts but urged their replacement with risk-sharing contracts. The practitioners, most of whom had been operating in the conventional finance space, were however interested in developing ways and means of finance that, while Shari’a compatible, would be familiar to and accepted by market players in conventional finance. The former emphasised Profit-Loss sharing (PLS), the latter focused on traditional methods of conventional finance centred on risk transfer and risk shifting. In doing so, all financial instruments of conventional finance became subject to replicating, retrofitting and reverse engineering for Shari’a compatibility. This two part paper argues that there are two ideal financial systems based on risk sharing, conventional and Islamic, and one actual conventional system focussed on risk transfer. Part One discusses the epistemology of the conventional financial system and finds that there has been a subtle yet significant misunderstanding of Smith’s vision and closer inspection reveals similarities between the Smithian and Islamic conception of an economic system.

Adam Smith is commonly regarded as the father of modern economics and advocate of the free markets. However, as Dr. Abbas Mirakhor argues there has been a subtle yet significant misunderstanding of Smith’s vision and closer inspection reveals similarities between the Smithian and Islamic conception of an economic system.

Epistemology of Finance: Misreading Smith

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Despite Arrow’s attention to some important elements of the institutional structure that were integral to Smith’s vision of an economy, such as its value system, the economics profession developed its own vision of that economy focussing primarily on two concepts of “invisible hand” and “self interest”.

Could be regarded, in a well-defined sense, as superior to a large class of possible alternative dispositions …” (Arrow and Hahn, 1971, pp vi-vii). These attempts focussed primarily on Smith’s idea of a decentralized market economy but in the process it abstracted from much of the well-spring of his thoughts represented by the societal framework emphasizing moral-ethical values envisioned in The Theory of Moral Sentiments.

The work of Arrow-Debreu (1954) is fundamentally about optimal risk sharing in a decentralized market economy. It addresses the question of how best to allocate risk in an economy. The answer is that risk should be allocated to those who can best bear it. The work abstracted from the underlying institutional structure envisioned by Adam Smith in The Theory of Moral Sentiments and The Wealth of Nations. It appears that Arrow-Debreu took for granted the existence of such institutions as property rights, contracts, trust, rule of law, and moral-ethical values. Two key assumptions of this work were complete contracts and complete markets. By the former it was meant that it was possible to design contracts such that all contingencies were covered. The latter assumption meant that there was a market for every conceivable risk. Crucially, all future pay offs were contingent on specific outcomes. The Arrow-Debreu model did not include a fixed, predetermined rate of interest as pay offs to debt contracts. Subsequent to his seminal work with Debreu, Arrow made it clear that, while not stated explicitly in his work with Debreu and with Hahn, he envisioned it “possible that the process of exchange requires or at least is greatly facilitated by the presence of several … virtues (not only truth, but also trust, loyalty and justice in future dealings …). The virtue of truthfulness in fact contributes in a very significant way to the efficiency of the economic system … ethical behaviour can be regarded as socially desirable institution which facilitates the achievement of economic efficiency in a broad sense”. (Arrow, 1972, pp. 345-346). For example, if the institution of trust is strong in an economy, the universe of complete contracts can be replicated by simple contracts entered into by parties stipulating that terms and conditions of the contracts would be revised as contingencies arise. Arrow himself was to place emphasis on trust as the lubricant of the economy. Despite Arrow’s attention to some important elements of the institutional structure that were integral to Smith’s vision of an economy, such as its value system, the economics profession developed its own vision of that economy focussing primarily on two concepts of “invisible hand” and “self interest”. The first was mentioned only once in The Wealth of Nations and the manner in which the second was used by economists has been regarded by many as a misunderstanding of what Smith actually meant by “self interest”. Narrowing of Smith’s view has been subject to rather sharp criticism by Amartya Sen who suggests that the misrepresentation of the Smithian view has caused major deficiencies in contemporary economy theory which has widened the gap between economics and ethics.

A careful reading of Moral Sentiments and The Wealth of Nations provides immense support for Sen’s position. Even beyond Sen’s spirited criticism of economists’ misunderstanding of Smith’s self-interest motive is the latter’s insistence on the need to comply with “general rules of conduct” that align with the commands of a Deity who rewards for observance and punishes for breach in the life hereafter.

Three observations can be made of Smith’s view. First, this is the Smith that has been ignored by the economics profession. The Smith of economics is the author of the self-interest motive that is the basis of utility and profit maximization at any cost to the society, including the impoverishment and exploitation of fellow human beings. Even his most ardent of supporters, Amartya Sen, has ignored the Smith of the above quotation. Second, Smith makes clear in his Theory of Moral Sentiments that compliance with the rules prescribed by the Creator and with the rules of the market was essential to his vision. Third, it is also clear that Smith considers the internalization of rules – being consciously aware of ever-presence of the Creator and acting accordingly - as crucial to all human conduct, including economics. Smith succinctly and clearly shares some of the fundamental institutional scaffolding of Islam: belief in the One and Only Creator; belief in accountability on the Day of Judgement; belief in the necessity of compliance with the rules prescribed by the Creator; and belief that justice is achieved with full compliance of rules. To paraphrase Sen, no space need be made artificially for justice and fairness; it already exists in the rules prescribed by the Law Giver.

An economy in which there are contingent markets for all commodities
ilarities between the Smithian conception of an economic system and that propounded by Islamic economists. Part Two will focus on the Islamic system, the present state, the challenges it faces, and prospects for the future.

An Ideal Conventional Financial System

An overall socio-political-economic system gives rise to an economic system out of which grows a system of financing to facilitate production, trade and exchange. The idea of the contemporary conventional economic system is usually traced to Adam Smith’s conception of an economy as envisioned in his book, the Wealth of Nations. What has been ignored until recently, however, is the fact that, from an epistemological point of view, Smith’s vision of the economy is embedded in his vision of a moral-ethical system that gives rise to the economy envisioned in the Wealth of Nations. That moral-ethical system was well-described in Smith’s book: The Theory of Moral Sentiments which preceded his Wealth of Nations by a decade.

Whereas conventional economics considered Smith’s notion of “invisible hand” as a coordinator of independent decisions of market participants, in both The Theory of Moral Sentiments and in the Wealth of Nations the metaphor refers to the design of the Supreme Creator, where market agents seeking their own advantage would produce the most efficient allocation of resources and consequently the greatest possible wealth for the nation. Smith contended that the objective of the Divine Design must have been the happiness of humans. A major contribution of Smith in his Theory of Moral Sentiments is to envision a coherent moral-ethical social system consistent with the Supreme Creator’s design and how each member of society would enforce ethical positions. Recognition of human frailties led Smith to recognise the need for an organic co-evolution of individual and society in a stage-wise process of accumulation of ethical system of values from one generation to next.

While it is possible for any given society to move forward or stagnate and even regress, the benevolence of the invisible hand of the “Author of nature” guides the totality of humanity in its movement toward the ideal human society. Compliance with and commitment to a set of values – virtues of prudence, concern for other people, justice and benevolence – would insure social order and cohesion.

Smith and Arrow

It was not until the second half of the last century that attempts were made to present a particular conception of Smith’s vision of the economy. This conception saw the economy as a market system guided by the “invisible hand” toward smooth functioning, coordinating independent individual choices in a connected world. Two such attempts were the works of Arrow and Debrau (1954) and Arrow and Hahn (1971) that sought to show “that a decentralized economy motivated by self-interest” would allocate resources, such that it
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...Had actual finance developed along the trajectory discernible from these works, i.e., steps taken toward completion of markets and of contracts, keeping in mind the overall institutional framework for the economy as envisioned by Adam Smith, the result might have been emergence of conventional finance different from the contemporary system.

meaning that there are buyers and sellers who promise to buy or sell given commodities “if any only if” a specified state of the world occurs – is called an Arrow-Debreu economy. In such an economy, it is the budget constraint of the participants that determines how much of each contingent commodity at prevailing market prices they can buy. Since these commodities are contingent on future states, they are risky. Therefore, the budget constraint of individuals determines the risk-bearing ability of each market participant. Arrow himself recognised such a market is unrealistic but opined that securities on the modern market serve as partial substitute. Such securities, referred to as Arrow Securities whose pay offs could be used to purchase commodities, would reduce the number of markets required while replicating the efficiency of risk allocation of complete contingent markets. Associated with complete markets are complete contracts. These are agreements contingent on all states of nature. In the real world, not all contracts can cover all future contingencies. Therefore, they are said to be incomplete contracts and may indicate inefficiencies in exchange. However optimal contracts can be devised provided there is mutual trust between the parties to the contract.

A compelling case can be made that in so far as the financial instruments are Arrow Securities, i.e., their pay off is contingent on the “state of nature”- that is, dependent on the outcome that is not fixed, predetermined, and represents risk sharing- this ideal system would have many characteristics of an ideal Islamic system. However, not all Arrow Securities would satisfy Shari’a requirements as some may well represent contingent debt contracts to deliver a fixed predetermined amount of money if a given state of the world occurs. These may not, therefore, represent an ownership claim either. Shares of common stock of open corporations do meet these requirements. They are residual ownership claims and receive a return contingent on future outcomes. Stock markets that are well-organized, regulated and supervised are efficient from an economic point of view because they allocate risks according to the risk-bearing ability of the participants. In essence, this is the contribution of Arrow-Debreu model of competitive equilibrium, according to which, efficient risk sharing requires that the risk of the economy are allocated to market participants in accordance with their respective degree of risk tolerance.

**From ideal to actual: conventional finance**

The spring that motivates the action of market agents in Smith’s story has been carried forward, but much of the rest of his insights has been forgotten. Smith’s vision of the institutional infrastructure (rules of behaviour) that is articulated in the Theory of Moral sentiments has not been correctly identified and executed, and, as such, abstracting from them would be unlikely to change the outcome of the mathematical analysis of Arrow-Debreu and/or Arrow-Hahn. Furthermore, had actual finance developed along the trajectory discernible from these works, i.e., steps taken toward completion of markets and of contracts, keeping in mind the overall institutional framework for the economy as envisioned by Adam Smith, the result might have been emergence of conventional finance different from the contemporary system. That system would instead be dominated by contingent, equity, risk-sharing financial instruments.

Perhaps the most influential factor in derailing that trajectory is the existence and the staying power of a fixed, predetermined rate of interest for which there has never been a rigorous theoretical explanation. All, so called, theories of interest from the classical economists to contemporary finance theories explain interest rate as the price that brings demand for and supply of finance into equilibrium. This clearly implies that interest rates emerge only after demand and supply forces have interacted in the market and not exante prices. In fact, in some theoretical models there is no room for a fixed, exante predetermined rate of interest.

Even though no satisfactory theory of a positive, exante fixed rate of interest exists, all financial theory development post Arrow-Debreu-Hahn assumed its existence in the form of a risk-free asset, usually Treasury Bills, as a benchmark against which the rates return of all other assets, importantly equity returns, were measured. These include theories such as the Capital Asset Pricing Model (CAPM), Modern Portfolio Theory (MPT); and the Black-Scholes option pricing formula for valuing options contracts and assessing risk. For all practical purposes, the assumption of a risk-free rate introduced an artificial floor into the pricing structure of the real sector of the economy, and into all financial decisions.
It can be argued that it is the existence of this exogenously imposed rate on the economy that transformed Arrow-Debreu vision of a risk-sharing economy and finance. The resulting system became one focused on transferring or shifting risk rather than sharing it. Such a system needed strong regulation to limit the extent of both. However, further developments in finance theory provided analytic rationale for ideologically aggressive deregulation. One was the Modigliani-Miller Theorem of neutrality of capital structure of firms. In essence this theorem asserted that the value of a firm is independent of its capital structure. This implied that since firms want to maximize their value and since Modiglian-Miller showed that the value of the firm is indifferent whether the firm debt finances or equity finances its capital structure, firms would prefer to incur higher debt levels for the firm rather than issue additional equity. Hence, the risk of additional debt would be shifted to other stakeholders.

Another was the development of the Efficient Market Hypothesis (EMH) that claimed that in an economy which is similar to that of Arrow-Debreu, prices prevailing in the market contained all relevant information such that there would be no opportunity for arbitrage. The implication was that if market efficiency is desirable, then markets should be allowed to move toward completion, through innovation and financial engineering, in order to create a financial instrument to allow insurance against all risks. For this to happen, it had to be demonstrated that it is possible to develop such a wide array of instruments, and that regulation had to become passive or even regressive to allow an incentive structure to induce innovation. The latter was initiated in almost all industrial countries in the 80s and continued with an accelerated pace until the 2007-2008 crisis. The former had already been demonstrated by the theory of spanning developed in late 1960s and early 1970s showing that one basic financial instrument can be spanned potentially into an infinite number of instruments. These developments coupled with the high magnitude of leverage available from money-credit creation process characteristic of a fractional reserve banking system represented an explosive mix that reduced the vision of Adam Smith to the rubble of post crisis 2007-2008. The Arrow-Debreu vision of an economy in which risk was shared was first transformed into an economy in which the focus became risk transfer but which quickly transformed into one in which risks were shifted, ultimately, to tax payers.

Conclusion

The economy-finance nexus defined by Arrow-Debreu-Hahn general equilibrium models were risk-sharing conceptualizations in which securities represented contingent financial claims on the real sector. Equity share claims represent first best instruments of risk sharing and satisfy characteristics required of Arrow Securities. It would appear that had the financial markets in industrial countries developed their financial sector along the lines suggested by Arrow-Debreu-Hahn model, they could have had much more efficient risk sharing and, perhaps, avoided the crises that have plagued conventional financial system. A number of post-mortem analyses of the recent crisis have developed constructive insights that may help steer the conventional system away from high credit, high leverage, and high debt which are the ultimate causes of all financial crises. Almost all of the many recommendations for reform of the conventional system – from the Stiglitz Report (2010), at one end, and The Squam Lake Report (2010), at the other end of the spectrum of thought among financial-economic scholars and practitioners – include some form of control, direct or indirect, on credit, debt, and leverage within the financial system, including higher capital adequacy requirement. Some have gone beyond these recommendations and have suggested reform of the fractional reserve banking system and deposit insurance. It is likely that if such reforms are implemented reliance on debt-creating flows within the conventional system will decline in favour of greater equity. Basel III has already taken steps – albeit not as significant as some scholars demanded – to enhance capital adequacy requirements, impose limits on leverage and curtail proprietary trading of the banks. Whether these changes are sufficient to induce the conventional system to move away from its overwhelming dominance by interest-based debt contracts, risk transfer and risk shifting or it will take a more severe bouts with crises before it does so remains to be seen.
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The overriding problem economics, as an intellectual endeavour, seeks to reconcile is how to fulfill unlimited demands in a world characterized by limited resources. If scarcity is the ab initio, economic theory then explores consumer choice when confronted by limited resources through the mechanics of supply and demand. Prices are then set by seeking an equilibrium through intersection of the upward sloping supply curve with the downward sloping demand curve. In theory, scarcity functions as an ever present reality of the supply, but when met with an exponentially increasing demand, the pliancy of economic theory is tested.

Practically speaking, this scarcity of goods is not a consideration that governs the demands of the average consumer. Consumer choice is continuously saturated with the quantity and range on offer by the perpetual growth of suppliers. In this acquisition of goods, the tangible role of money is reduced as individuals are able to procure wanted and required goods on credit. Thus, rarely will an individual realize the multifaceted dimensions present behind the creation of a single good, as well as its effect on resources and the environment.

This modern age, characterized by its gross materialism and excessive consumption, has led to a number of problems including the gradual depletion of resources and poverty. Nature itself has fallen into disequilibrium as fossil fuels are being exhausted and the scarcity of natural resources has become a reality. Although this has forced governments to search and harness other forms of energy, viable alternatives have not yet been discovered, and in countries where natural resources are abundant, exploitation due to the constraint of the rule of law has led to war and civil unrest. Although the corporation has been maligned and fallen into disrepute for its less than ethical practices, in competitive markets, the incentive to build profits is paramount. The modus operandi has be-

In these times of excess and its effects on the global economy, there is a need to step back and consider a more prudential approach. Looking at the beliefs of the Sufis, Rizwan Rahman finds that their austere ways may act as a panacea to the current global ills.
come if there is demand, there needs to be an equivalent supply.

However, problems of unbridled consumption are not limited to the depletion of resources or the causation of sedition. In the developed world, crippling effects of debt accumulation both on a personal and institutional level have led to the dethronement of both the individual and industry. This profligate spending of individuals has been mirrored by government and has led to the paralyzing economic situations of many countries. The unweaned desires of the masses has set the global trajectory towards a recession. Thus, a more tempered, less indulgent approach to the procurement of goods is paramount. However, changing the utility function of both entities and focusing on prudence will be an arduous task when the internal economic culture is marked by prodigal consumption. Thus, external paradigms of those with alternative worldviews becomes indispensable when creating alternative notions of consumption. One such paradigm is provided by Sufism.

**Understanding the problem**

Western economists have created the economic man, homo economicus, who is motivated by his own self interest. His focus is on fulfilling his desires within a budget constraint. In order to have a sufficient budget, he will need to have employment to generate income. The quantum of pay will be dependent on the type of occupation undertook. Generally, for higher paying and more secure jobs, education up to a tertiary level is paramount. By going into higher education there is a sacrifice of immediate, lower wage packets, for an increased salary in the longer term. In order to ensure security or to generate increased wealth, individuals are likely to save a portion of their income or invest some of their income for profits in, for instance, pension schemes or in the stock markets. There is a hope that by doing so, idle money will beget a capital gain. To achieve a higher capital gain will be dependent on the risk profile of the individual. Homo economicus can be of three types: risk averse, risk neutral and risk taking. Each will have a certain expectation but the latter will have a greater propensity for taking risks in order to secure higher profits.

Therein is a simplified deconstruction of the life of the homo economicus, one which needs to be followed closely in order to understand the consumption problem. The main focus of the average man is to maintain and sustain himself. Anything above a certain amount becomes a luxury, which while not required are instead desired in order to gratify, maybe even gratuitously. The consumption problem is precisely borne from this gratuitous gratification. In the Western world, people generally have basic needs satisfied either through their own efforts or through social welfare. Individuals look for more material benefits and comfort and are desirous to spend more income to achieve this.

**Philosophy of Sufism**

Sufism is commonly thought of as being the mystical, where adherents seek to explore and experience transcendental delights. Perceptions vary with some looking at Sufism as a heretical sect of Islam while others see it as a bohemian cult advocating a saccharine outlook to life. Sufism is thus misunderstood, especially as there are differences in the acts and practices of the variegated Sufi groups. A closer inspection of the roots of Sufism reveals certain principles which would define a Sufi. A Sufi’s focus is to devote himself absolutely to the transcendent. They chose to forsake the world, looking instead to lead an aesthetic life. While the beginnings of Sufism are not altogether clear, it is agreed that some of the early Sufis used to lead solitary lives wearing woollen garments (suf). Being woollen, the garments were coarse and uncomfortable, especially in the scalding heat of the desert. To wear these garments was a deliberate means to scourge any love for the world. Indeed love for the transcendent was the raison d’etre for the Sufis; love for the world needed to be purged out.

For the purposes of this essay, we will only look at the first four principles.

**Seeking Guidance**

The first point for an aspirational Sufi was to find the right teacher who would help him ‘experience the transcendent’. The guide would provide him with the necessary instruction and tools to help him achieve this objective. Initially Sufis were simply individuals who adopted certain idiosyncratic practices in their desire to experience. Over time, certain Sufis gained repute. The scholar acted as a centrifugal force bringing in
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The consumption of the Sufis was small and limited in terms of choice. In economic terms, by consuming less, there is less need for just-in-time supply and over distributing products. On the other hand, the dynamism and creativity of the modern day economy would be negatively affected.

students who wished to follow his methodology. These students would then disseminate their knowledge to willing students; and so began the tariqa, the word “tariqa” in arabic meaning path. Mureeds would be trained by an expert (sheikh) who provided a regimented system in order for them to reach this transcendental goal. Each tariqa had a certain pedagogy and approach and often times mureeds would have to reside with their sheikh in institutions known as khanqaqs. Khanqaqs served as a college for the Sufis and was the epicentre for the development of the individual tariqas.

Analogically in the modern day, guidance is found in schools and colleges followed by university but the education is secular in its nature. Subjects are taught in relation to themselves rather than in relation to the divine. Following university, students are expected to go into salaried jobs and thus principally the education system is a means by which students can secure gainful employment. The grading system established from an early age serve to inform employers the quality of the candidates, though not in an absolute way. Students looking for higher salaries and a better quality of living aim for higher grades. For the majority of students, concern is material from the outset and the guidance from teachers is, broadly speaking, about achieving grades.

For the Sufis, the guidance was to help them ‘experience the transcendent’ and could be a lifelong process. It was not about achieving material benefits. There was a close relationship between the sheikh and the mureed, and the sheikh would be able to advise according to the needs of his student. The main purpose of the sheikh was to help the student refine his character in order to experience the transcendent’. Thus their focus was not on material gains; it was on personal development. Abstract, lifelong and uncertain, it had significant impact on the worldview of the mureed.

**Disavowing the World**

The focus on the inward meant a general aversion to the outward, manifest world. Sufis lived quite austere lives shunning luxury in favour of simple, almost monastic living. Metaphors in Sufi poetry alluded to the world as a prison, where escape was only possible through complete devotion to the transcendent. Their concerns were not worldly as they viewed the world as fleeting and thus they did not desire from the world. This psychology is contrary to the dominant one of any era, where securing material gain is encouraged and facilitated. Most individuals live to gain beneficially from the world and hence would like to consume the good things in life. The consumption of the Sufis was small and limited in terms of choice. In economic terms, by consuming less, there is less need for just-in-time supply and over distributing products. This diminishes the impact on resource extraction and counters the scarcity problem. On the other hand, the dynamism and creativity of the modern day economy would be negatively affected.

**Reliance on the divine**

Sufis had a strong belief on relying on the divine to meet their needs. One’s life was assumed to be dictated by the divine and therefore anything that happened to a person was part of the decree of the divine and to be accepted resignedly. They ascribed to the notion that all power came from the divine. Some Sufis took this to mean adopting a hermetic life, seldom expending effort to meet basic needs and assuming provision would be provided for by the heavens. This was roundly criticised by many other Sufis who, argued that reliance on the divine did not necessarily mean adopting an apathetic view to sustenance. They had to strive to meet their needs and not have to resort to begging. Yet by relying on the divine, they were less concerned about future security and were encouraged to have very few possessions. Additionally, with menial incomes, savings would be reduced. Pension schemes and developing ones financial portfolio would have been alien concepts. In the modern era, impetus has been placed on financial planning – ‘saving for a rainy day’. Savings in banks and investments in financial instruments have provided the financial sector with much needed liquidity to oil the mammoth machine. Reduced savings, less investments and a country is confronted with anemic financial markets. Conversely, it reduces the opportunity for unbridled speculation and inextricable dependence of a country’s economy on the financial sector.

**Refinement of the Self**

Disavowing the world and relying on the divine provides the mental underpinnings for the aspirant Sufi and the basis for the refinement of the self. Under the
tutelage of the sheikh, the Sufi focus was upon improving their character, on removing egregious aspects of their personality. These aspects broadly converge to the seven cardinal sins of the Catholic Church: lust, gluttony, avarice, sloth, wrath, envy and pride. Each sin would need to be expunged by adopting certain practices. It would typically involve meditation, extra prayers over the canonical five, long periods of isolation, late night vigils, constant fasting and recitation of litanies.

The idea of refining the self is casually disregarded in the modern age. Many believe developing good character is abstract, personal and intuitive and any regimented system precisely for this purpose is obsolete. The Sufis, on the other hand, saw that the loci for the evils in the world was in the human individual and therefore ‘sinful’ aspects of his character had to be purged. This could only be accomplished by a long purification process overseen by a qualified sheikh who has undertook the purification process. He would be one who has an understanding of his student and the perspicacity of potential failings. Without his guidance, the aspirant may not be able to overcome his vices.

The credit crisis has been blamed on ‘greedy’ bankers and governments have been encouraged to pass laws to regulate their activities. However, regulation is a macro solution; there is little focus on the micro elements, ergo the individual. Economics starts off with the assumption that individuals are self-interested, and from this premise, economic theory has evolved. It is precisely the self interested individual that Sufism seeks to tackle as they see sins emanating from self interest. Working on sinful aspects of a character would therefore reduce self interest, not encourage it, leading to significant economic changes.

**Sufi Economics**

Sufism is regarded as being a peculiarity with extreme quietist and self immolative tendencies. It is considered impractical and removed from the practical needs of the world. Certainly, complete withdrawal from the world would be difficult for the majority but there are principles of Sufism that have the potential of tackling the worrying economic problems that are confronting the world today. Guidance on refining the character leads to more moral citizens and less of a focus on gaining material wealth reduces the scarcity problem. Undoubtedly, a wholesale adoption of Sufi practices would lead to a stagnant and less dynamic economy, but the Sufis were never concerned with the macro and more concerned with the individual. The purpose of their institutions was to provide the environment for the refinement of the individual. The focus was on the transcendent, and from a capitalist point of view, this overriding purpose is pointless. But for the value proposition of Islamic finance, Sufism offers a unique way of understanding the world and how to act in it.
To redefine the rules of the game requires a visionary, one capable of going beyond established boundaries and entering new frontiers of possibility. As Islamic finance grows, expands and flourishes, stakeholders in its future health cannot simply reinvent the wheel but must continually be seeking new opportunities, to achieve growth through a unique and nuanced foresight. It requires individuals and organizations with the perspicacity to push the boundaries. Datuk Noripah Kamso is such an individual: wise, insightful, sharp and committed to the development of the global Islamic asset management sector. Taking the helm of CIMB-Principal Islamic Asset Management Sdn Bhd (CIMB-Principal Islamic) in 2008, the global institutional house has successfully demonstrated a convincing Islamic investment track record via customised investment capabilities.

Headquartered in Kuala Lumpur, CIMB-Principal Islamic is strategically located in a prime location for Islamic finance. Malaysia has firmly established itself as a hub for Islamic finance, making strides in thought leadership, product development and institutional establishment. Its overall success in Islamic finance owes itself to the support of the government, who has taken gradual steps in creating the right infrastructure for Islamic finance to flourish. Today Malaysia is one of the world’s most developed Islamic finance jurisdictions and the world’s first country to have a complete Islamic financial system operating in parallel to the conventional system. This allows CIMB-Principal Islamic to leverage on Malaysia’s comprehensive Islamic financial legal and regulatory infrastructure.

Noripah, who was previously the Chief Executive of CIMB-Principal Asset Management Berhad from September 2004 to October 2008, has brought more than 25 years of experience in corporate credit and lending. Her commendable dedication in creating awareness and educating the industry has deemed her a two-time winner of the “Marketing Personality of the Year” award (for 2005 & 2006) by Asia Asset Management for the Asia Pacific region and CEO of The Year for Malaysia (2007). Due to her consistent thought leadership initiatives with global institutional investors, regulators and stakeholders, CIMB-Principal Islamic has won numerous prestigious awards – two time winner of the Best Asset Management Company awarded by Global Finance 2010 and 2011, Most Outstanding Islamic Fund Manager at the 7th KLIFF Islamic Finance Awards 2010. Previous awards also include the Islamic Fund House of The Year (2006, 2007, 2008 & 2009) awarded by Islamic Finance News. Her focus stems from a deep conviction that Islamic finance is more than just a capitalistic alternative. It is a complete system, one that expounds an ethical and profitable ethos; and one that needs to cohere in the markets. Noripah brings this belief to her work, advancing the cause of Islamic finance in Malaysia and the World.

Considering that CIMB-Principal Islamic aspires to be the most valued Islamic global institutional asset management house, Noripiah has ensured its global recognition. Datuk Noripah takes pride in this aspiration. Her primary functions are to market and build up the firm by securing institutional clients from around the world through offering global investment management capabilities. CIMB-Principal Islamic focuses on four investment capabilities: Global Equity, Global Sukuk, Regional Equity and Regional Sukuk. Whilst Noripah was based in London in the first half of 2009, ...
Datuk Noripah believes Islamic finance has only scratched the surface. There are still obstacles to overcome, doubters to be convinced but Noripah knows that only through dedication and commitment to the Islamic finance proposition will success result.

As of 31st March 2011, its shareholders group has a total combined Islamic Asset under Management of USD2.7 billion. A total of USD546 million worth of new mandates were awarded to CIMB-Principal Islamic since August 2009 from South East Asian Central Banks and Pension Houses.

As the framework of Islamic asset management is still taking shape, Datuk Noripah continues to play an aggressive role in educating and mitigating the misconceptions the mainstream investment community may hold with regards to Islamic investing. She has advanced the thinking revolving around Islamic investments and its role on the global landscape. She has contributed to a range of global publications including the London-based Euromoney, the Global Islamic Finance Report, Financial Times and Bloomberg. In the GCC, she has written for Dubai-based Islamic Business and Finance and The Saudi-based Middle East Insurance Review. Datuk Noripah has taken it as her responsibility to educate global investors by participating as a speaker in numerous international conferences and roundtable discussions in London, Edinburgh, Dubai, Abu Dhabi, Istanbul, Tokyo, Bahrain, Singapore, Hong Kong, Jakarta, Brunei, Sydney, USA and of course, Malaysia. In 2010, she chaired the Australian Business to Business Roundtable in Islamic Finance and also participated in the Istanbul Roundtable, a platform identified as a gateway to market players and policy makers from the Russian and CIS countries. Recently, in April 2011, she chaired a private roundtable with Bruneian Islamic banks and takaful operators, organized by CIMB-Principal Islamic itself.

Through assessing the large 2nd generation resident-Muslims in the UK, Germany and France and based on Europe’s strong conviction on ethical investing, Noripah has recognized that the best positioning for Shari’a investing to these jurisdictions is to promote socially responsible investments, values and ethical investing. To ensure an efficient cross-border global distribution model for its products, CIMB-Principal Islamic is planning to launch three Shari’a Equity Funds on a UCITS-compliant platform in Dublin and Ireland.

With the burgeoning interest in Shari’a investing and the comparable returns offered by conventional and Islamic funds over the last five years, Datuk Noripah believes Islamic finance has only scratched the surface. There are still obstacles to overcome, doubters to be convinced but Noripah knows that only through dedication and commitment to the Islamic finance proposition will success result. It will be a long and drawn out process, but Datuk Noripah is committed to setting the agenda for the global Islamic asset management landscape with her years of expertise and knowledge.
Noripah Kamso was born in Sepang, Selangor, Malaysia into a middle/rural-class neighborhood. The youngest of seven siblings, she was raised by her father who was a military-cum-police personnel.

She has four children; two of her daughters are currently working, the eldest as a doctor and the second as an investment banker. The third child is in the Australian National University, Canberra with the youngest still in secondary School.

**Honors Bestowed**

“Datuk” is a title awarded by Sultans/State Governors in Malaysia to personalities who have contributed to nation building through both the corporate/professional world and also through social contribution/causes. She was awarded her Datukship by the State of Malacca.

**Education Background**

Masters in Business Administration, 1980, Marshall University, Huntington, West Virginia, USA  
Bachelor of Business Administration, 1979, Northern Illinois University, Dekalb, Illinois, USA

**Brief Career Profile**

Prior to her appointment as Chief Executive Officer of CIMB-Principal Islamic Asset Management, Datuk Noripah was the CEO of both CIMB Principal Asset Management Berhad and CIMB Principal Islamic Asset Management. She eventually relinquished her role in the conventional space and now focuses entirely on the global Islamic space.

Prior to this she was Executive Director of CIMB Futures Sdn Bhd from October 1996 to September 2004. She served as Deputy General Manager, General Manager, and then Director of Corporate Banking at Commerce International Merchant Bankers Berhad (CIMB) from January 1993 to August 2004.

From 1983 until 1993, Noripah rose through the ranks of Corporate Banking at Bank of Commerce (M) Berhad, starting off as a senior corporate banker and ending her service at the bank as Vice President of Corporate Banking.

**Articles/Books**

She authored a book titled “Credit Decision Making: The Qualitative Credit Approach” which was used by Institut Bank Bank Malaysia (“IBBM”) as a module for its Certified Credit Professional (“CCP”) exam. She writes articles for Euromoney, The Global Islamic Finance Report, Institutional Investors, Asia Asset Magazine, Malaysian Business, Asia Investors Magazine, Islamic Business and Finance Magazine, Middle East Insurance Review and others.

**Corporate Activities**

She has served on the Board of Directors for:  
- Malaysian Derivatives Clearing House, Malaysia.  
- CIMB Nominees Sdn. Bhd, Malaysia.  
- Flowmore Engineering Sdn. Bhd, Malaysia.  

She has also served on Bursa Malaysia’s Derivatives Consultative Committee, Malaysian Stock Exchange.

**Voluntary Organizations**

- Treasurer for the Association of Bukit Bintang Malay Women (Persatuan Wanita Melayu Bukit Bintang), Malaysia  
- Secretary for the Alumni Association of Northern Illinois University  
- Chairman of the women wing of UMNO Bukit Bintang Division, Malaysia.

**Professional and Association Membership**

President of the Malaysian Futures Brokers Association (“MFBA”) in 2003. Prior to that she served for four years as Vice President of the Association. She has been active in developing the domestic derivatives landscape for the past 6 years.

**Products**

- Institutional mandates: Islamic Global Equity, Islamic Asia Pacific ex-Japan, Equity, Global Sukuk and Regional (Ringgit) Sukuk mandates.  
- Retail products: 26 Islamic retail unit trust funds ranging from Malaysian domestic to Asia capabilities.
The importance of producing IT banking systems that accommodates the peculiarities of Islamic finance cannot be understated. The iMAL system created by Path Solutions is a welcome solution that is proving to be useful, efficient and economical. In this exclusive interview with CEO and Group Chairman, Mohammed Kateeb, we delve further into the man, the vision and the product.

What is the importance of technology in Islamic banking and finance? Is it any different from conventional banking?

In our current times, technology has become crucial for any industry to drive operational efficiency and enhance customer service. The Islamic financial industry is no different from its conventional counterpart. Importance has been magnified by the financial crisis where declines in the profitability of Islamic financial institutions and the tremendous increase of regulations have made IT solutions critical for this industry to continue its growth. The second point here is that Islamic financial institutions are in direct competition with conventional banks and they have to acquire the same if not better technology solutions than their counterparts in order to effectively compete. I say better because in addition to conventional banks basic operations that have Shari’a-compliant equivalents, there is the complexity of Shari’a-compliant products structures, profit calculations, etc.

Customers are becoming very demanding of their banks regardless of whether they are conventional or Islamic. The world is changing and customer experience is continuously being enhanced using technology. New delivery channels are putting customers in control through technology and banks have to provide the 24/7 access that customers’ need and the know-how that they demand.

What are your plans for Path Solutions for the next 12 months?

Path Solutions is completely focused on the Islamic financial industry. Based on our extensive research we believe this industry will continue to grow further over the next five years and the number of financial institutions will reach 1000. Path Solutions is in a great position to capitalize on this. In the next 12 months, we are focusing on perfecting execution and building more agility into our business. We will continue to expand our product line and geography coverage. We want to solidify our position as the undisputed IT solution leader in Islamic finance.

You are perhaps the only global technology firm that exclusively specialises in Islamic banking & finance. When did you realise that...
Islamic banking & finance was the niche you would like to tap into?

We started our company in 1992 and during the 90s we built Enterprise Resource Planning (ERP) class solutions, did IT consulting and provided professional services to many financial and non-financial companies. Some of these companies were Islamic financial institutions. It was in the late 1990s that we realized the importance of this segment and the tremendous growth expected. We decided to focus completely on this segment and drop everything else. It was a great decision. We decided to build a set of Shari’a-compliant fully integrated IT solutions that are designed to cater for all Islamic products, meet the increasing demand of this segment and be flexible enough to allow each bank to customize its own products based on its Shari’a board’s requirements. In addition to that, the system should provide state-of-the-art technology and should be comprehensive to cover all business needs. Many of our customers run their complete banking operations using our system with no need for any additional third-party products. In addition to a large portfolio of Islamic banking software solutions, we also offer other services, such as consulting, professional services, training and support.

I believe technology has changed all the rules regarding geographic. Almost all multinational companies have their operations offices spread across the globe and if we consider the outsourcing and off shoring and the makeup of a virtual company it gets much more complicated. Technology enables all of us to achieve integration. We believe in being close to our customers.

What are the IT-related challenges faced by the Islamic financial services industry?

One of the main challenges facing this industry is the masking of many conventional IT systems and positioning them to be Shari’a-compliant. These systems do not comply with the Shari’a financial regulatory requirements of the respective country. They are limited in flexibility and ease of use and don’t allow the building of customized Islamic financial products that can be bought to market in reasonable time. This industry still lacks many standards, as a single rigid solution will not meet Islamic institutions requirements. The solution should be designed to allow tremendous customization capabilities because this is critical for the success of the Islamic financial institution’s operations.

Ambition or talent: which matters more to success? In the case of Path Solutions, what has contributed most to the success of your business?
Hard work! Ambition and talent are important and required for success, but hard work is what brings it all together. We had the ambition to be the leader for the Islamic finance IT solutions segment; we brought in talented people to execute; but tremendous hard work on all stages of building these solutions is what brought us to where we are today. I subscribe to the theory that success is 95% hard work.

What is the size of the Islamic financial technology market? What are the driving factors in its further development and growth?

As per the Gartner February 2011 Report, the Islamic banking system market - that is, the market of the technologies that enable these financial products - is predicted to be a $1.2 billion market in 2011 and to grow at a 10.9% compound annual growth rate (CAGR) until 2014, while the external IT spending component will have a higher CAGR, at 18.1%. Thus, the total market size will grow from $1.2 billion in 2011 to about $1.6 billion in 2014. That is a phenomenal growth largely driven by some key market trends and the increasing demand for such banking systems.

In addition there is tremendous interest from conventional banks to offer Shari’a-compliant financial services in the form of Islamic windows which has given a boost to this industry. Of course the evolvement of a more robust regulatory framework has also pushed these financial institutions to deploy better IT systems and drive a huge replacement initiative of their existing systems to systems that can help them achieve their objectives.

Customers’ requirements are also a key factor for technology growth. Institutions are asking for more sophisticated peripheral systems, for example business intelligence, risk management, regulatory reporting and delivery channels: anything that helps them run more efficiently, control their business better and gives them insight into their business. IT solutions need to play as a differentiator; we have to keep up with the most sophisticated banking technologies, hence the need to continue to invest in R&D.

What is the cultural difference between leading the Middle Eastern operations of a giant like Microsoft and working at Path Solutions?

When I was at Microsoft, the company had an interesting model in running its operations based on geographies, which means the head of geography owns the complete Microsoft business in that geographic location and would be responsible for all decisions. In my last position at Microsoft I was responsible for 22 countries. This culture has created the spirit of entrepreneurship in many leaders who came out of Microsoft. Although it was a huge company, my experience at Microsoft in the USA and the Middle East has prepared me to run a company such as Path Solutions especially as they both develop great software. Of course Microsoft is a much larger company than Path Solutions and the support infrastructure in it for an executive is much stronger. The brand is also a strong brand and the company is a strategic partner to almost every business in the world. This of course opens many doors but at the same time, makes the job at Path Solutions more challenging and much harder. As a medium size company we have to work very hard to prove ourselves to a bank in London or Malaysia. It’s not only that we have to be much better than the multinationals we are competing with, but we also need to have a huge differentiator to even be considered.

Internally, I have tried to bring my value system, my work ethic and a personal vision of a corporate culture to Path Solutions and recreate the company to care about all the right things. I believe we have been building a great culture inside Path that is as good as any of the large multinationals. The size of the company of course allows me personally to know and influence directly most of the employees at Path Solutions.

How difficult is it to manage a company with global operations, headquartered in Kuwait, a Research & Development Centre in
Lebanon, and clients spread all over the world?

I believe technology has changed all the rules regarding geographic distribution. Almost all multinational companies have their operations offices spread across the globe and if we consider the outsourcing and offshoring and the makeup of a virtual company it gets much more complicated. Technology enables all of us to achieve integration. We believe in being close to our customers and we believe in having a direct presence in their countries. We also believe in having R&D offices where affordable talent is. We have a R&D office in Beirut, one in Egypt and the third one is of course in our headquarters in Kuwait. The office in Kuwait allows us to mix many nationalities and bring talent from India, other Middle Eastern countries and even Europe and the USA. There are advantages in having a centralized model but we believe the advantages we are getting from the distribution model outweigh the disadvantages and we always have technology to make all this work!

If someone says that technology is technology, nothing is Islamic about it. What would you say?

We, of course, disagree on this, and we have built a very successful company because we disagree. We also have over 75 Islamic financial institutions worldwide who agree with our point of view. Actually, whenever we have a
chance to debate this point and present our solutions to any potential customer we usually win. Islamic finance has different processes governed by different regulations, different policies and procedures and unique documentations when compared with conventional finance. Profit and the way it is calculated is completely different to interest; investment and financing products are also different, and of course all these fundamental differences lead to the need to have an IT solution that is designed based on a comprehensive understanding of Islamic finance.

What distinguishes Path Solutions from its competitors?

The answer is execution on a vision, comprehensive solutions, fast deployment of these solutions and great support for our customers. This all translates to great total cost of ownership and tremendous value delivered to customers.

We realized early that Islamic finance is unique and different to conventional finance and we strove to be the IT leader for the segment. We designed and built our solutions to cater for Islamic finance needs. We partner with key organizations and thought leaders in the industry. We are the first AAOIFI-certified software firm. The certification covers all Islamic banking modules, business processes, contracts, Islamic accounting principles, implications and behavior.

We built our solutions to be comprehensive, modular, integrated set of solutions that offer functionality as good if not better than any conventional system out there. We offer modules that perform Core Banking, Investment, Financing, Treasury, Trade Finance, Retail and Corporate Banking in addition to Delivery Channels management and integration.

A very strong competitive advantage we have is the speed of our deployment and bringing our customers live. While many of our competitors struggle to bring their customers live, we had new banks live in two to three months and have existing large banks migrated off their legacy systems in just nine months. This is unparalleled in our industry.

Of course we have a great model for supporting our customers and continuously updating them to the newest version of our solutions at no additional cost. Customers continuously get the most updated solutions as part of their maintenance contract.

In your observation and opinion, what has been the impact of the on-going financial crisis on Islamic banking & finance?

I believe the financial crisis highlighted the strengths of Islamic finance concepts. Tying assets to transactions is of critical importance. Pure economies based on Islamic finance would never have had such a crisis, but we all know such economies don’t exist. The future impact of this crisis on the industry would be decided based on the behavior of market agents in the next few years. If the Islamic finance industry capitalized on this crisis by halting the translation of conventional products and financial instruments to Islamic products and by returning to the spirit of Islamic finance and addressing the shortcomings, I believe it would have had tremendous positive impact. If we continue to do what we have done in the past years, this segment will continue to grow, but also will continue to be a sub segment under conventional finance impacted by all the forces of conventional finance. It will never realize its full potential.

Which country is the most interesting from the viewpoint of your business?

We serve our segment in markets from as far as Malaysia in the East all the way to the United Kingdom in the West, and with Islamic finance emerging strongly in Africa, Central Asia and even China, we are excited by the new opportunities they bring.

We are in fact very enthusiastic about the development of Islamic finance worldwide. Malaysia continues to lead in Islamic finance with many interesting initiatives, e.g. The International Islamic Liquidity Management initiative and others are starting there. Similarly countries like Sudan where Islamic finance is the only form of finance; Oman announcing the opening up of Islamic banks to curb fund outflows, positive developments in Egypt as well, Qatar and the UAE leading different initiatives; seeing central banks representatives from countries like South Korea and Japan attending Islamic finance conferences is also a positive sign. Of course seeing Islamic finance reaching Moscow, Central Asia, and North America and further development in Europe is all very exciting stuff for us!

Where would you like to see yourself personally in the next 10 years?

The world is changing so fast, it’s so hard to see three years ahead, but I am a person with a very strong value system and professionally always focus on being a contributor who adds value to whatever I do. I would be happy if I continue to be just that in ten years and that I am not driven to irrelevance.

What do you do when you are not working?

I am a very hardworking person, so when I am not working I spend time with my family; I enjoy helping my kids with school work, traveling with them, and educating them about life. I also enjoy reading and research.
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Everything is permissible in Islam unless it is clearly prohibited, meaning unless something contradicts the guidelines of the Shari’a, it is deemed Shari’a compliant. Islam is a religion which guides its followers in every facet of life, be it how to pray, or how to invest your funds in accordance with guidelines set out in the Shari’a. The Islamic investor needs to consider not only the structure of the investment but also the type of organisation the investment is in.

When an investor gets involved in equity investment he technically becomes a part-owner of the company. As a result, in the case of equities traded on the stock exchange, an investor needs to consider whether the company is involved in non-Shari’a compliant activities. Some Shari’a scholars are of the view that a minimal amount of haram activity is acceptable, as long as the primary activities of the company remains Shari’a compliant. However, strict opinion states that even a small amount of Haram activity undertaken by the company is deemed as unacceptable. Shari’a scholars in the past had completely ruled out investing in listed companies; however with time this has changed and a more balanced approach is being adopted. More informed scholars have conceded that all companies in the market have to go through or transact with conventional finance and therefore, are affected by interest based financing.

Hence, consensus is moving towards accepting some degree of compromise. Shari’a boards of a number of Islamic banks and Islamic financial regulators like the Accounting and Auditing Organizations for Islamic Financial Institutions (AAOIFI) have agreed upon various criteria, which would ensure that...
the stock in question would be regarded as acceptable under the Shari'a. The norms or benchmarks set out by the likes of Dow Jones, S&P, AAOIFI, MSCI, Russell Jadwa are listed towards the end of the paper.

Guidelines underpinning the Shari'a assessment of stocks are provided by the Shari'a Scholars who have delved into Islamic legal principles and precedents to determine the boundaries of investment. These guidelines regarding the activities of the company are there to prevent an investor being part of something which is deemed Haram or impermissible. In assessing whether certain investment is Shari'a compliant or not, it needs to be examined from two different angles, namely:

- Business Screening
- Financial Screening

**Business Screening**

Business screens focus on the commercial activities of the business. If the business is involved in activity considered by the Shari'a as being forbidden, then the Shari'a sensitive investor is prohibited to invest. Non-Shari'a compliant activities (which differ from institution to institution) include alcohol, gambling, conventional financial institutions, adult entertainment (including cinema, music etc), pork-related products, weapons and defense. However, today’s companies sell a range of goods and services, mixing both what is considered under the Shari’a as acceptable and forbidden.

Shari’a scholars have elaborated upon on how the investor should approach this dichotomy. They have permitted investments in companies whose main product and/or service offerings are Shari’a compliant but contain only a small percentage of non-compliant activities. In value, if over 5% (the percentage differs amongst scholars but is generally quite low) of the firm’s revenue is derived from non-Shari’a compliant investments or activities deemed unacceptable, it is prohibited to invest in these companies. Question arises as to where the 5% figure comes from. The 5 per cent tolerance is not based on the Quran or Sunnah; instead it is based on the consensus made between contemporary Shari’a Scholars. This income received from the non-Shari’a compliant activities is subject to purification where 5 per cent of the revenue is donated to a charity or another similar good cause.

The threshold test may sound simple. However, in most cases, in depth analysis into the company activities is required in order to accurately decide whether the stock would be considered compliant or non-compliant. It is a difficult process and a few examples would suffice to explain the problems.

If we take an example of a company which produces alcohol and other beverages, or invests heavily in conventional financial activities, these types of companies will be immediately removed. This is a simple example but what about if there is a company producing IT software which is used by conventional financial institutions as well as others? What about a Compact Disc manufacturing company whose CDs is used for music production? The underlying concern over both these products is that they facilitate a non-Shari’a compliant activity. IT software is used by conventional banks for Riba transactions. The troubled dialectic that arises is that a riba transaction can only occur due to the utilisation of the software. If the software is facilitating a ribawi transaction, then its modus operandi is inextricably linked to that which is considered haram.

Shari’a scholars have proposed a broad based solution. In the case of the two companies mentioned above the companies are actually producing something which can be used for both Shari’a compliant and non-Shari’a compliant activities. So unless or until it is found that the software company or the CD manufacturing companies produces exclusively for non-Shari’a compliant activities then the company is deemed Shari’a compliant. A further problem is that business focus changes. It maybe that initial analysis of the company showed that the company had less than 5% of the income in Shari’a non compliant activities. However, over time, this percentage increases over the threshold. Consequently, Shari’a auditors have to be constantly vigilant as to the activities of the company.

An added problem is that in some cases information might not be available making the work of Shari’a auditor more challenging. Take for example a property developer that rents space out to businesses. Along with the Shari’a Compliant businesses renting, he has leased the property to non-Shari’a compliant businesses i.e conventional financial institu-
tions or pork-meat shops. Shari’a scholars are of the view that if the property developer generates more than 5 per cent of the rent revenue from these leasees than the stock of the property developer becomes prohibited to invest in. The problem is that sometimes the breakdown of revenue is not publically available, making it difficult for the auditor to assess the Shari’a compliancy of the company. In which case, the auditor would have to directly contact the company in order to request for the revenue breakdown.

Instead of independent research, it is easier to pick stocks that are from an Islamic index like Dow Jones Islamic, FTSE, S&P and MSCI etc, as these stocks are already screened for Shari’a compliancy. There is no added work required from the investor or fund manager. However, the ease comes at what we can call an opportunity cost of limiting the investments to that specific index portfolio and thus narrowing the Shari’a compliant stock universe.

Financial Screening
As mentioned above different Islamic banks and Islamic financial institutions including regulators have agreed for a certain criteria in assessing the Shari’a compliancy of the companies to invest in. Information is available on screening criteria used by AAOIFI, Dow Jones, MSCI, FTSE, Russell Jadwa and Nasdaq etc. The criteria used by these organizations are listed below:

AAOIFI
According to Shari’a standards listed in AAOIFI Standards book, the fundamental rule is that of prohibition of acquiring shares of and transactions in the shares of corporations that sometimes undertake transactions in riba and
other prohibited things even when their primary activity is lawful, but for this rule subscription and transactions are exempted with the following conditions:

• That the corporation does not state in its memorandum of association that one of its objectives is to deal in interest, or in prohibited goods or material like pork and the like.
• That the collective amount raised on loan as interest – whether long-term or short-term debt – does not exceed 30% of the market capitalization of the corporation.
• That the total amount of interest-taking deposits, whether short, medium or long-term shall not exceed 30% of the market capitalization of total equity, knowingly that interest-taking deposits are prohibited whatsoever the amount is.
• That the total amount of income generated from prohibited component does not exceed 5% of the total income of the corporation irrespective of the income being generated by undertaking a prohibited activity, by ownership of a prohibited asset or in some other way. If a source income is not properly disclosed then more effort is to be exerted for identification thereof giving due care and caution in this respect.
• For the determination of these percentages, recourse is to be had to the last budget or verified financial position.

**Dow Jones Islamic Index Screening Criteria (DJIMI):**

The DJIMI Shari’a Supervisory Board established the following broad categories in industries as inconsistent with Shari’a percepts and stocks are screened to ensure that each meets the standards set out in the methodology.

**Business Screening**
- Alcohol
- Pork-related products
- Conventional financial services
- Entertainment
- Tobacco
- Weapons and defense
- Financial Ratio Screens

- All of the following must be less than 33%:
  - Total debt divided by trailing 24-month average market capitalization.
  - The sum of a company’s cash and interest-bearing securities divided by trailing 24-month average market capitalization.
  - Accounts receivables divided by trailing 24-month average market capitalization.

- Sum of company’s cash and interest-bearing securities over total assets should not be more than 33.33%
- Sum of company’s accounts receivables and cash over total assets should not be part of 33.33%.

**FTSE Shari’a Global Equity Index Series:**

Companies involved in any of the following activities will be filtered out as non-Sharia compliant:

**Business Screening**
- Conventional Finance (non-Islamic Banking, Finance and Insurance, etc.)
- Alcohol
- Pork related products and non-halal production
- Entertainment including casinos and gambling
- Tobacco
- Weapons, arms and defense manufacturing

**Financial Screening**

The remaining companies are then further screened on a financial basis. The following financial ratios must be met for companies to be considered Shari’a compliant:

- Debt is less than 33% of total assets
- Sum of company’s cash and interest-bearing securities over total assets should not be more than 33.33%
- Accounts receivable and cash are less than 50% of total assets
- Total interest and non-compliant activities income should not exceed 5% of total revenue.

**Russell Jadwa Shari’a Index:**

**Business Screening**

The business activity screens eliminates companies whose activities are related to the following:

- Financial Institutions
- Alcohol, tobacco or weapons
- Production and distribution of meat not slaughtered according to Shari’a
Financial Screening

The financial based screens exclude companies with excessive exposure to interest and other forms of prohibited income, as well as prohibited investments. Companies are excluded if:

- Total cash, deposits, and receivables divided by the immediately preceding 12-month average total market capitalization, exceeds 70%.
- Interest bearing debt divided by the immediately preceding 12-month average total market capitalization, exceeds 33%.
- Total cash, deposits and interest bearing securities divided by the immediately preceding 12-month average total market capitalization, exceeds 33%.
- The sum of interest earned and revenue from prohibited activities divided by total income (defined as total revenue or sales) exceeds 5%.

Nasdaq 100 Shari’a:

Business Screening

- Conventional Finance (non-Islamic Banking, Finance and Insurance, etc)
- Alcohol
- Pork related products and non-halal production
- Entertainment including casinos and gambling
- Tobacco
- Weapons, arms and defense manufacturing

Financial Screening:

- The sum of company’s cash and short terms investments divided by the market cap should not be more than certain percent meaning the norm is to screen out companies do not have major portion of assets that are real and tangible.
- This gearing ratio screens out companies that excessively depend on the debt to finance their business activities compared to the total value of the company. The ratio used is total debt divided by market cap which should not be more than certain per cent (normally 30% or 33.33%), meaning that the total debt of the company should not be more than one third of the total company’s value. Total debt include: bank overdrafts, loans, credit facilities, finance lease and advance from suppliers etc.
- The ratio screens out companies that excessively invest in interest bearing assets as part of their business companies meaning all the investment that the company makes and the interest received on it. These normally include deposits, cash, loans given out, receivables, finance lease, advances to customers. The ratio uses to measure is interest income divided by Total revenue, which should not be more than certain per cent (normally 5 per cent).

As one can see, 33% seems to be an important proportion. The rationale for selecting or considering one third is partly based on the following hadith:

“It is narrated by Saad bin Abu Waqqas that The Prophet SAW came visiting me while I was sick in Mecca (‘Amir) HE said, “May Allah bestow His mercy on Ibn Afra”. I said, “Oh Allah’s apostle! May I will all my property (in charity)” He said, “No.” I said, “Then may I will half of it?” He said “No”. I said, “One third?” He said: “Yes, one third, yet even one third is too much. It is better for you leave your inheritors wealthy than leaving them poor begging others, and whatever you spend for Allah’s sake will be considered as a charitable deed even the handful of food you put in your wife’s mouth. Allah may lengthen your age so that people may benefit by you”.

In conclusion, different bodies have different interpretations of the parameters of Shari’a compliance. This is does not obviate the importance of ensuring Shari’a assessments of the stocks to ensure compliancy.

Purification

The profits are normally generated either through dividends distributed by the relevant companies or through appreciation in the prices of the shares known as Capital gain. If the profits are earned through dividends, a certain proportion of the dividend, which corresponds to the proportion of the interest earned must be donated to charity. This practice is derived from the following Qur’anic verse:

“O you who believe, fear Allah and give up what remains due to you of interest if you are indeed believers. And if you do not, then be warned of war (against you) by Allah and His Messenger, while if you repent you shall have your capital, Do not do wrong and you shall not be wronged. (2:278-279)”

So, it is through the purification process that the elements of non-permissible income are removed from the portfolio via dividend cleansing.

Shari’a screens agreed by different Shari’a boards or Shari’a scholars are very subjective and can change overtime. According to International Shari’ah scholar, Sheikh Yusuf Talal DeLorenzo, “four important points need to be kept in mind.”

Firstly, that the screens developed by scholars are preliminary attempts to deal with issues of interest and should in not be considered the final word on any of these matters.

Secondly, that these apply only to non-Muslim owned/operated companies.

Thirdly, that this is not to be understood as an endorsement of corporate practices.

And, fourthly, that all impermissible income must be calculated and cleansed.”
Barrier to entry

Shari’a Cost

There is growing need for affordable yet authentic Islamic finance advice in the industry. In an ever evolving Islamic finance system with more entrants to the market and technological developments, prices are indeed falling. Asim Anwar Kamal investigates further.
Islamic finance is expected to continue its rapid growth despite the recent unrest in the Middle East. New frontiers are currently being explored all over the world, from Europe through to the Far East. Governments facing political instability are turning to Islamic finance as a possible means for social & economic reform. In the West, Islamic finance has been viewed as a tool for the financial inclusion of the growing local Muslim populace. Furthermore for many countries Islamic finance is as a way to attract funds from the oil rich GCC and Far East.

One of the requirements for any institution looking to enter the Islamic finance space is the establishment of a reputable Shari’a board on which tier 1 Shari’a scholars sit. Names such as Sheikh Nizam Yaqubi and Dr. Mohamed Elgari serve an important function in the overall marketing of the Islamic financial service on offer. Scholars such as these are no doubt knowledgeable enough to offer advice and thus their services come with a premium.

In the nascent stages of the Islamic finance industry, the high cost of Shari’a advice was attributed to demand and supply factors. This means that there were high levels of demand for Shari’a advice and very few well versed Shari’a scholars on the supply side. It was expected that as the industry grew and matured, the supply of skilled Shari’a scholars would increase which in turn would cause a reduction in the Shari’a costs facing institutions.

Over a decade has passed and Shari’a costs continue to remain high even though the number of Shari’a scholars in the industry has increased. One of the reasons for this is that established financial institutions want established names and therefore the premium for their services has remained. For these established institutions paying this premium is justifiable as there is no doubt that tier 1 scholars deserve the fees they receive for their high quality service.

However it cannot be denied that there is a growing need for affordable Shari’a advice for new players looking to enter the Islamic finance space, especially less established institutions. Many of these institutions, particularly in the west, are reluctant to take the plunge due to the high initial Shari’a cost and thus have decided to avoid Islamic finance.

There is a growing need for affordable Shari’a advice for new players looking to enter the Islamic finance space. Many of these institutions, particularly in the west, are reluctant to take the plunge due to the high initial Shari’a cost and thus have decided to avoid Islamic finance.

Notwithstanding this constraint, demand and clamour for cheaper Shari’a advice has been steadily increasing as seen by developments in the industry. For Fund managers looking to cut down on Shari’a costs, there are now software providers who for an annual or monthly subscription, pre-screen a universe of stocks and then allow fund managers to have access to the results enabling them to form a Shari’a compliant portfolio. This saves the fund manager from having to hire external parties to conduct the Shari’a screening on their behalf and thus reduces its costs.

Another way of saving on the Shari’a cost for some institutions offering Islamic financial services has been the appointment of a Shari’a advisory firm. These particular firms can substantially reduce Shari’a costs for an institution. Instead of the new player setting up their own Shari’a board, the firm can represent them and present the service to the end client’s Shari’a board. The reason that this is sometime more viable and efficient is that if for example an institution sets up their own Shari’a board for a particular service it is offering, whilst its own Shari’a board may approve the service, when they go to the end client to market it, the end client’s Shari’a board will also need to approve it and may even pass the service as Shari’a repugnant. In such a scenario the initial Shari’a cost of setting up the institutions Shari’a board is a huge sunk cost.

Whilst the appointment of Shari’a advisory firms may save an institution some Shari’a cost, it is still a fairly costly option for a player who is still unsure about Islamic finance and is just dipping its toe in the water.

A recent initiative by Edbiz Consulting, a London based firm, seems to be the way forward. For a nominal fee, small institutions looking at entering Islamic finance can have access to quality Shari’a advice on a daily basis. This would be appreciated by clients who need initial Shari’a advice with regards to an Islamic financial service they are looking into. This would be helpful for institutions looking at plain vanilla products that have become standard in the market such as commodity Murabaha for example. Instead of undergoing a high Shari’a cost the institution can have an informal opinion as to whether their proposed offering meets Shari’a standards such as AAOIFI’s and whether or not the service is likely to be approved by a Shari’a scholar.

Initiatives such as this would enable more institutions to have access to affordable Shari’a advice and this in turn would help the industry grow in future.
Legal and Financial Mitigation Solutions for Sukuk Legal Risks

With the combination of both the Shari’a and conventional law in Sukuk contracts, there were always going to be conflicts. This increases the risk facing potential investors. However, as Jhordy Kashoogie opines, there can be a harmonious relationship between the two systems of law.

There have been 21 sukuk defaults recently in the Islamic capital market space, with the Nakheel sukuk and the East Cameron Gas sukuk among the most publicized. These sukuk defaults reveal severe legal risks which are inherent in the sukuk contract. Specifically, the risk with regards to a sukuk contract’s enforceability i.e. whether or not the sukuk can be enforced in order to protect the rights of the sukuk holders in the event of a default.

Sukuk default cases are increasing with adverse impacts on the legal rights, and compensation of the sukuk holders. Therefore, in this article, the issues surrounding the enforceability of sukuk contracts are discussed in an attempt to give possible legal and financial mitigations to the problem of sukuk legal risks in the Islamic capital market. Before assessing issues surrounding the enforceability of sukuk, it is imperative to highlight the kind of conflicts occurring in the Islamic finance sphere due to the dual law system that governs sukuk transactions.

Common law and civil law each present distinctive problems when they collide with the Shari’a. The national law always prevails over Shari’a law when there are disputes. In the case of Shamil Islamic Bank of Bahrain VS Pharmaceutical Company, the defendant was unable to repay his loan to the bank, and the court judged based on English law instead of Islamic law. The defendants argued that the contract was so worded with Shari’a principles as not to clash with English law. However, the judge ruled that there cannot be two separate law systems governing a contract, and that English law will prevail especially since the parties had stated that the governing law of the contract was English law. The Courts will only look at the Shari’a so far as it adheres to the commercial purpose of the contract and will not look at it as the governing law. Furthermore, the conflict between common law and Shari’a leads to paradoxes. In the aforementioned case, the verdict was decided based on sale contract law, while the substance of the contract was actually a conventional debt contract.

With respect to sukuk structures in jurisdictions where Shari’a concepts are followed, this is, to a certain degree, more straightforward from a legal perspective, although the process does compose more layers since it requires compliance with Shari’a as well as local law. Realising that in most sukuk issuances there are cross-border transactions, there is a problem with which law would be enforced. This enforceability issue causes legal impediments due to the inability to obtain satisfactory legal opinions, which emanate from the sale of assets between the originator and investors through the SPV, and also due to various bankruptcy law matters. Hence, there is a confusion about which law can be enforced and to what extent that law can be enforced in some sukuk issuances.

There are two crucial aspects of sukuk operations that affects the enforceability of a sukuk contract. Firstly, true sale execution. Executing a true sale is a crucial element in a sukuk operation, as it constitutes a real transfer of ownership from the originator to the sukuk holders via the SPV (a trustee) with good faith. Therefore, trust law plays an important
role in governing the SPV’s establishment. These two aspects indicate that property law, bankruptcy law, and trust law are pivotal in governing rules to facilitate a true sale transaction in the eyes of both western law and the Shari’a.

True sale execution and an independent SPV, however, are not in existence in most sukuk structures, which eventually leads to a lack of legal protection for the sukuk holders. There are two identifiable legal mitigations arising from these sukuk enforceability issues. Firstly, the rating agency should incorporate additional proxies for sukuk rating, which take into account compliance as well as legal uncertainties of sukuk. Secondly, sukuk urgently need to be standardised and streamlined in terms of legal documentation and Shari’a standards. AAOIFI Shari’a standards for sukuk have been set properly, but the problem is that the standards are not binding among key players in the Islamic financial industry. Therefore, enforcement of the standards is critical to having Shari’a compliant and jurisdictionally accepted sukuk in the market. Besides this, there should be uniformity of methods in resolving the issue of conflicting legal systems that govern sukuk issuances across. The goal would be that, in a case of default, the case could be resolved in pursuant to a standardised legal documentation. Hence, there would be predictability, certainties, and Shari’a convergence through sukuk standardisation.

Alternatively, possible Shari’a compliant financial innovations can be suggested in order to give financial protection to the sukuk holders from legal uncertainties. The following are suggestions made by scholars such as Mohammed Khnifer. Firstly, sukuk maturity extension in which the sukuk contract is extended until the issuer’s legal dispute is resolved by compensating sukuk holders through higher rental payments in the case of ijarah sukuk, and increasing the agreed profit sharing ratio in the case of musharakah sukuk. Secondly, sukuk refinancing in which sukuk are refinanced with another sukuk, which have lower financing costs, in order to settle the sukuk holders’ residual payments. These two suggestions can be done only if the sukuk was in a strong financial position. Lastly, convertible equity sukuk in which sukuk’s assets values are converted into the issuer’s equity value based on a pre-determined formula in the event of default. These innovations would give assurances to the sukuk holders before the purchase undertaking is executed, and hence their financial rights would be fully protected from legal uncertainties.

Realising that in most sukuk issuances there are cross-border transactions, there is a problem with which law would be enforced. This enforceability issue causes legal impediments due to the inability to obtain satisfactory legal opinions, which emanate from the sale of assets between the originator and investors through the SPV, and also due to various bankruptcy law matters.

If key players in the Islamic capital market seriously consider these legal and financial mitigation tools, sukuk issuances can become more transparent and predictable enough so that sukuk can be enforced to protect the sukuk holders’ rights. Sukuk holders would have more valuable information as well as financial assurances in order to make an informed decision for sukuk investment. Thus, closer engagement between key players, regulators, Shari’a advisers, and scholars in the industry is urgently needed to discuss and improve the feasibility of these legal and financial mitigation tools.
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