

**ISLAMIC CAPITAL MARKET
FACT FINDING REPORT**



OICJ-IOSCO

**REPORT OF THE
ISLAMIC CAPITAL MARKET TASK FORCE
OF THE INTERNATIONAL ORGANIZATION
OF SECURITIES COMMISSIONS**

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Chapter 1: Introduction

There is no doubt that securities markets and products continue to evolve and change. The challenge to regulators is to consistently be abreast of and track new market developments in order for there to be effective and timely formulation of standards, guidance or best practices where necessary. Numerous international initiatives completed in the last few years focused on assessing weaknesses in the international financial markets and analysing the operations of markets in order to develop global standards and benchmarks that have the ultimate aim of strengthening the international financial architecture. This report aims to contribute to the process of building knowledge with the goal of achieving the objectives of improving investor protection; ensuring that markets are fair, efficient and transparent; and reducing systemic risk, as set out in IOSCO's *Objectives and Principles of Securities Regulation*, which is one of the internationally accepted standards listed in the Financial Stability Forum's Compendium of Standards.

The Islamic financial services industry, comprising Islamic banking, Islamic insurance (takaful) and the Islamic capital market, is an area that has grown to become an increasingly substantial segment within the global financial market and has gained considerable interest as a viable and efficient alternative model of financial intermediation. Growing awareness of and demand for investing in accordance with *Shariah* principles on a global scale have been the catalyst towards making the Islamic financial services industry a flourishing industry. This is also a reflection of the increasing wealth and capacity of investors, both Muslim and non-Muslim, to seek and invest in new investment products that serve their needs.

Islamic financial products also represent a class of investment products, which may appeal to those looking for socially responsible or ethical investments, as these products must comply with strict *Shariah* rules that have religious as well as ethical underpinnings. Indeed, the pace of Islamic financial market development has gathered such momentum that various international Islamic organisations have been established with the view towards formulating appropriate standards for the Islamic financial services industry. These international bodies include the Islamic Financial

Services Board (IFSB)¹ and the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI).

In recognition of the increasing size of, and growing investor interest in the Islamic financial services industry, and the potential implications it may have on financial stability and investor protection, the IOSCO Executive Committee, at the 2002 IOSCO annual conference and meetings held in Istanbul, Turkey, mandated the formation of an Islamic Capital Market Task Force to assist relevant regulators in assessing the extent of the development and potential regulatory issues relating to the Islamic capital market, as well as to gather information on Islamic financial products and activities. The output expected from the Task Force is an information document that would detail the landscape of the Islamic financial services industry in general, and would highlight key issues concerning the Islamic capital market in particular. While Islamic banking is the most developed part of the Islamic financial system, there is great potential for the Islamic capital market as the industry matures and holdings of financial assets gradually transfer from the Islamic banking sector to the Islamic capital market. As has been the experience with nascent fast-growing markets, various regulatory issues need to be assessed on a timely basis. This mandate represents an important initiative taken by capital market regulators to study the area of the Islamic capital market in order to gain a better understanding of its specific attributes. This is to ensure that the Islamic capital market is appropriately regulated and that any gaps in regulation are identified early to safeguard investor interest and at the same time pave the way for the industry to evolve in an orderly manner.

The Task Force comprises 11 IOSCO members spread across 5 regions. The Task Force is chaired by the Securities Commission of Malaysia. (Please refer to Annex 1 for details of Task Force members).

The work of the Task Force is built on gathering information from among IOSCO members and external parties with expertise in the Islamic capital market, and to undertake an in-depth analysis of the information obtained. A survey questionnaire was formulated to seek information pertaining to the following broad issues – (i) the

¹ The establishment of the IFSB in November 2002 was supported by the International Monetary Fund.

overall availability of Islamic financial and capital market products and services; (ii) the regulatory framework applied to Islamic financial services and products, and issues pertaining to *Shariah* compliance and investor protection; (iii) the state of Islamic capital market development including an examination of growth factors and impediments; (iv) market foundations such as accounting standards and tax frameworks; and (v) international issues relating to cooperation and collaboration efforts among jurisdictions, as well as efforts to address differing *Shariah* interpretations among scholars. In the course of its work, the Task Force also conducted extensive research and teleconference interviews with selected industry participants in order to be able to present as wide a discussion on this topic as possible.

In this report, the Task Force presents the information collated from the surveys. In addition, the report also identifies key issues that affect the development and regulation of the Islamic capital market. These key issues were identified within the context of IOSCO's overarching objectives of investor protection; ensuring that markets are fair, efficient and transparent; and the reduction of systemic risk. In connection with this, the report has also discussed the application of the *IOSCO Objectives and Principles of Securities Regulation (IOSCO Principles)* in relation to the Islamic capital market. In this regard, it is important to bear in mind that IOSCO, as an organization with members from over 100 jurisdictions, is a secular organization. Each IOSCO member has committed to making best efforts to implement the IOSCO Principles within its jurisdiction whatever the religious or other precepts that may be observed there. Individual members are free, however, to implement the IOSCO Principles within the context of their own culture and society and IOSCO recognizes that many of its members have an interest in the development of Islamic capital markets. While IOSCO has no view regarding compliance with religious or other precepts beyond the matters of regulatory policy set out in its principles, IOSCO is the recognized international standard setter and places great importance on furthering the application of the IOSCO Principles in the context of the development of Islamic capital markets.

The report is structured as follows:

Chapter 1 introduces the background to the conception of the report and the establishment of the Task Force.

Chapter 2 explains the fundamentals and principles underlying Islamic finance. It discusses the philosophy and beliefs, which have led to the structuring of *Shariah* - compliant financial products and services.

Chapter 3 describes the landscape of the Islamic financial services industry with discussions on the individual components which make up the Islamic financial services industry – Islamic banking, Islamic insurance (takaful) and Islamic capital market. The discussions trace the history of the Islamic financial services industry and maps out the geographical spread of Islamic financial activities, discusses the product range as well as structures. The background of various international Islamic organisations and their respective roles and objectives are also discussed.

Chapter 4 discusses the developmental and regulatory issues that have arisen out of the Task Force’s survey and research. Among the key issues discussed are *Shariah* compliance, the applicability of the conventional regulatory framework to the Islamic capital market including the IOSCO Principles, accounting standards and international collaboration efforts.

Chapter 5 concludes the report. It recognizes the potential growth of the Islamic capital market, and discusses the importance of jurisdictions’ compliance with IOSCO’s Objectives and Principles in relation to the Islamic capital market.

The report has four annexes. Annex 1 lists the members of the Task Force while Annex 2 provides a glossary of Islamic terms. Annex 3 lists the respondents to the survey and the bibliography is contained in Annex 4.

Pursuant to its mandate, the Task Force has not formulated any specific recommendations within this report. The objective of this report has been to present factual and background information, and to raise concerns and issues arising from the survey and from the Task Force’s own extensive research. In addition, this report may perhaps serve as a useful document that could be utilized in future efforts.

Chapter 2: Fundamentals and principles of Islamic finance

2.1 Introduction

The Islamic financial system broadly refers to financial market transactions, operations and services that comply with Islamic rules, principles and codes of practices. The laws and rules of the religion require certain types of activities, risks or rewards to be either prohibited or promoted. While Muslims undertaking financial transactions are encouraged to use financial instruments that comply with these rules, other investors may find the appeal of these instruments from an ethical standpoint.

Islamic laws and rules are known as *Shariah* and are also referred to as Islamic jurisprudence. *Shariah* governs all aspects of Islamic matters including faith, worship, economic, social, political and cultural aspects of Islamic societies. The rules and laws are derived from three important sources, namely the Holy *Quran* (the holy book of the religion of Islam), *Sunnah* (the practice and tradition of the Prophet Muhammad s.a.w.) and *ijtihad* (the reasoning of qualified scholars). Further elaboration and interpretation of the rules dictated by the Holy *Quran* and *Sunnah* are provided by qualified scholars in Islamic jurisprudence via *ijtihad* or an interpretative process which is carried out within the framework of *Quran* and *Sunnah*.

Modern Islamic financial products and services are developed using two different approaches. The first approach is by identifying existing conventional products and services that are generally acceptable to Islam, and modifying as well as removing any prohibited elements so that they are able to comply with *Shariah* principles. The second approach involves the application of various *Shariah* principles to facilitate the origination and innovation of new products and services.

In order to provide a better understanding on the unique attributes of Islamic finance, this Chapter discusses the fundamentals and principles, which form the foundation of Islamic financial services.

2.2 Fundamentals of Islamic finance

Islamic law on commerce is known as *fiqh al-mu`amalat*. Much of the laws, rules and interpretations of *Shariah* takes into consideration issues of social justice, equitability, and fairness as well as practicality of financial transactions. In general, the *Shariah* legal maxim in relation to commercial transactions and contracts state, “they are permissible unless there is a clear prohibition.”² In a nutshell, prohibited elements of a commercial transaction must first be removed for it to be *Shariah*-compliant. The major prohibited elements under *Shariah* are *riba* (interest), *gharar* (uncertainty), *maisir* (gambling), non-*halal* (prohibited) food and drinks and immoral activities. These are elaborated further below.

a) *Prohibition of riba*

Riba has the literal meaning of “an excess” and is defined as an increase or excess which accrues to the owner in an exchange or sale of a commodity, or, by virtue of a loan arrangement, without providing equivalent value to the other party.

More precisely there are two categories of *riba* – *riba qurudh* and *riba buyu`*. *Riba qurudh*, in its application to modern financial transactions, occurs through loans. The prohibition of *riba qurudh* relates to any fixed or pre-determined rate of return tied to the maturity and the amount of principal (i.e., guaranteed regardless of the performance of the investment). The general consensus among *Shariah* scholars is that *riba* covers not only usury but also the charging of “interest” as widely practised.

However, the lending activities or loans are still allowed in Islam through the concept of *Qardh Hasan*. This type of lending is a contract of loan between two parties on the basis of social welfare or to fulfil a short-term financial need of the borrower. The amount of repayment must be equivalent to the

² Mohammad Hashim Kamali (Prof.Dr), *Islamic Commercial Law*, Cambridge: The Islamic Texts Society, 2000, p.66; Yusuf al-Qaradawi (Prof.Dr.), *The Lawful And The Prohibited In Islam*, Kuala Lumpur: Islamic Book Trust, 1985, p. 14

amount borrowed. It is however legitimate for a borrower to pay more than the amount borrowed as long as it is not stated or agreed at the point of contract.

On the other hand, *riba buyu`* occurs through the sale and purchase of six *riba`*s commodities (i.e., gold, silver, dates, wheat, barley and salt). The transaction of *riba`*s commodities is required to adhere to the following conditions:

- a) In trading commodities of the same group and kind, such as gold for gold or dates for dates; two conditions must be fulfilled, i.e., both commodities must be exactly equivalent and there must be prompt delivery
- b) In trading commodities of the same group but of different kinds, such as gold for silver, or wheat for barley, there is only one condition, i.e., the promptness in delivery is not a condition.
- c) In trading commodities of different groups and kinds, such as gold for wheat, or silver for barley; no condition is imposed and free trading can exist, whether there is equality, inequality, promptness or delay.

Thus, Islam encourages the earning of profits but forbids the charging of interest. Profit symbolises successful entrepreneurship and the creation of additional wealth through the utilisation of productive assets, whereas interest is deemed as a cost that is accrued irrespective of the outcome of business operations and may not create wealth if there are business losses. Social justice under *Shariah* requires borrowers and lenders to share rewards as well as losses equitably and that the process of wealth accumulation and distribution in the economy be fair and representative of true productivity.

b) *Prohibition of activities with elements of gharar (uncertainty)*

Gharar is defined as activities that have elements of uncertainty, ambiguity or deception. In a commercial transaction, it refers to either the uncertainty of the goods or price of goods, or deceiving the buyer on the price of goods.

An element of *gharar* is considered a normal phenomenon in the market if it is not excessive in the contracts and where the effect on the economy and society is considered minimal. This is accepted by *Shariah* as it would be practically impossible to eradicate this element completely from the market. A large element of *gharar* in a commercial transaction, on the other hand, is prohibited according to *Shariah* as it may affect the legality of a transaction.

One of the examples of *gharar* in the financial market is in conventional insurance. *Shariah* scholars are of the opinion that conventional insurance is not *Shariah* compliant due to the large element of *gharar*. This is because the policyholder enters into an agreement to pay a certain sum of premium and in turn the insurance company guarantees to pay a certain sum of compensation in the event of disaster. However, the amount of compensation that the company will pay to them is uncertain and it is also dependant on the occurrence of specific events in the future.

c) *Prohibition of maisir (gambling) activities*

Gambling is referred to as *qimar* or *maisir* in Arabic, which means any activity that involves an arrangement between two or more parties, each of whom undertakes the risk of a loss where a loss for one means a gain for the other, as it is common for gambling activities. The gain accruing from these games is unlawful in Islam, as it diverts the player's attention from productive occupation, and amassing wealth without effort. It is considered an immoral inducement by the person involved in expecting to make a profit at the expense of another party.

In relation to the above, Muslims are also prohibited from having any affiliation to gambling activities including participating, investing or financing any businesses related to, or associated with, the gambling industry.

d) Prohibition of the production and sale of goods and services that are prohibited in Islam

There are a number of drinks and foods that are prohibited in Islam such as alcoholic beverages and non-permissible food like pork. In addition, there are also prohibitions against immoral services such as pornography, prostitution, immoral entertainment and others. In this context, *Shariah* scholars are of the view that any activity relating to these products and services such as processing, producing, marketing, supplying and selling are also non-permissible.

Therefore, companies, which are involved in or accrue gains from business activities related to these non-permissible activities, would not be deemed as *Shariah* compliant.

2.3 Basic *Shariah* principles for Islamic financial products and services

The underlying fundamentals of Islamic financial transactions form the basis of the difference between conventional and Islamic financial instruments. Modern Islamic finance began with the emergence of Islamic banking, where products and services are not based on *riba* (interest). As the industry grew, many other financial products in the insurance and capital market sectors were adapted to incorporate *Shariah* compliant aspects. Product innovation has been significant in the Islamic financial services industry over the last decade, resulting in a wide array of Islamic instruments being introduced in the market. *Shariah* compliance rules have been developed for equity, debt and securitisation products and are in the process of being extended to structured products and examined for derivatives as well. Rules to determine Islamic-compliant operations have also been developed for the banking, broking, investment management and advisory services.

Islamic equity financing represents a component of the overall capital market activity. Typically, equity-financing is structured through profit-sharing contracts or *`uqud al-isytirak*. The two common types of equity financing instruments are *mudharabah* (profit-sharing) and *musharakah* (profit and loss sharing).

Significant differences, however, occur in the area of debt-financing due to the fact that conventional debt-financing is essentially structured upon interest-based lending. Islamic debt-financing is structured through contemporaneous underlying contracts of exchange such as sale and purchase contracts or *'uqud al-mu'awadat*. There must be an underlying asset which is made the subject matter of the contract in Islamic financing as opposed to a mere debt paper in conventional financing. Common *Shariah* principles that are used in Islamic debt instruments include *murabahah* (trade with mark up or cost plus), *ijarah* (lease financing), *bai` al-salam* (advance purchase), *istisna`* (purchase order) and others. Similarities with the conventional market also exist in *ijarah*, whereby *Shariah* recognises the different types of leasing such as an operating lease and a finance lease, as long as the aim of the lease is *Shariah*-compliant.

In developing these products, the basic elements of *Shariah* principles, as provided for in the section above, are applied. The following section will now consider the types of *Shariah* principles that are widely used in the Islamic finance currently. They have been used and developed in structuring various Islamic financial products and instruments for banking, capital market and insurance sectors.

a) *Mudharabah* (Profit-sharing)

One of the most important *Shariah* principles for investment activities is *mudharabah*, also known as *qirad* or *muqaradah*. It offers the owner of capital the opportunity to invest his capital in a certain project without becoming involved in managing that capital, and limits his liabilities to the capital committed. There is also an entrepreneur, who solely manages the projects. The most important feature of *mudharabah* is that the capital provider cannot claim a fixed profit and an assured return of his capital if the project is profitable, as the profit will be distributed based on a pre-agreed ratio between the capital provider and the entrepreneur. In the event of a business loss, it shall be borne solely by the capital provider and none on the part of the entrepreneur, unless the loss is due to negligence of the entrepreneur.

In addition, *Shariah* scholars have evolved the *mudharabah* principle further by introducing a “two-tier *mudharabah*.” The first tier *mudharabah* is created when the investor or capital provider places his capital with an Islamic financial institution which acts as the entrepreneur. The financial institution in turn invests the capital with another entrepreneur by means of a second-tier *mudharabah*. In other words, by using this type of *mudharabah*, an Islamic financial institution can act as an intermediary between investors and entrepreneurs.

b) *Musharakah* (Profit and Loss Sharing)

This is analogous to a joint venture. Both the entrepreneur and investor contribute to the capital (assets, technical and managerial expertise, working capital, etc.) of the operation in varying degrees and agree to share the returns, as well as the risks, in proportions agreed to in advance.

Shariah scholars have developed the *musharakah* principle further by introducing diminishing *musharakah* (or *musharakah mutanaqisah*), as a newly developed financial contract. Under this contract, the financial institution and client share the ownership of the financed asset. The periodic payment of the client contains two parts; a rental payment for the part of the property owned by the Islamic financial institution and a buy-out of part of that ownership. Over time, the portion of the asset owned by the client increases, until he owns the entire asset and the contract is eventually terminated.

c) *Murabahah* (Trade with mark up or cost-plus sale)

One of the most widely used instruments for short-term financing is based on the traditional notion of purchase finance. In this sale, the buyer (client) knows the price at which the seller obtains the object to be financed, and agrees to pay a premium over the initial price. It is an agreement that refers to the sale and purchase transaction for the financing of an asset or project, whereby the costs and profit margin (mark-up) are made known and agreed to by all parties

involved. As practised in the market for *murabahah* arrangements, the financier undertakes to buy the asset required by the client for resale to the client at a higher price as agreed upon by both parties and this can be settled in cash or in instalments as specified in the agreement.

d) *Bai` bithaman ajil* (Deferred-payment sale)

Bai` bithaman ajil has similar features as *murabahah* in term of the financier undertaking to buy the asset required for resale to the client at a higher price as agreed to by the parties involved. The difference with *murabahah* is that *bai` bithaman ajil* is used for long term financing and the seller is not required to disclose the profit margin which is included in the selling price.

e) *Bai` al- salam* (Advance purchase)

This is a sale and purchase transaction whereby the payment is made in cash at the point of the contract but the delivery of the asset purchased, as specified in the agreement, is deferred to a pre-determined date. In modern Islamic finance, *Shariah* scholars have allowed parallel *salam* or back to back *salam* contracts, whereby the financier will play a dual role. On one hand the financier is the seller in one *salam* purchase agreement and on the other hand he becomes a customer by entering into a separate independent *salam* agreement in order to acquire *salam* goods of a similar specification. The most important thing in the parallel *salam* is to distinguish the contracts as two separate deals of *salam*.

f) *Istisna`* (Purchase order)

This is a sale and purchase agreement whereby the seller undertakes to manufacture or construct according to the specifications given in the agreement. It is similar to *bai` salam*, the main distinction being the nature of the asset and method of payment. *Istisna`* generally covers those things which are customarily made to order and advance payment of money is not necessary as required in *bai` salam*. The method of payment in *istisna`* is flexible,

according to the terms as agreed to by the contracting parties. Parallel *istisna`* or back to back *istisna`* contracts is also permissible, similar to that of parallel *salam*, whereby the financier will play a dual role – i.e., he is the contractor in one *istisna`* purchase agreement but he becomes a customer in the other separate, independent *istisna`* sale agreement.

g) *Ijarah* (Lease financing)

Another popular instrument is leasing which is designed for financing an asset or equipment. It is a *manfaah* (benefit) or the right to use the asset or equipment. The lessor leases out an asset or equipment to the client at an agreed rental fee for a pre-determined period pursuant to the contract. Different forms of leasing are permissible, including leases where a portion of the instalment payment goes toward the final purchase at the end of the leasing period whereby the ownership of the asset or equipment will be transferred to the lessee through a sale and purchase contract. It is considered as Islamic hire-purchase or Islamic finance leasing and also known as *ijarah thumma bai`* or *ijarah wa iqtina`* or *ijarah muntahiyah bi tamlik*.

Chapter 3 : Landscape of Islamic financial services industry

3.1 Overview of the evolution of Islamic finance

3.1.1 Origins

Islamic finance has a long history and, in fact, some of the concepts and instruments commonly used today such as *mudharabah* and *musharakah* can be traced back to pre-Islamic days. After the establishment of Islam in the Middle East, Islamic principles were applied to trade financing practices then and were further formalised and institutionalised. Most of the early formal structures were developed in relation to state-based financing to aid and support business activities.

The increasing European influence during the period of colonialism resulted in the adoption of European-style financial institutions and products by most of the Islamic countries. However, by the 1960s, Islamic countries began to re-examine their financial services industry and establish financial systems compatible with *Shariah* principles. This eventually laid the ground for modern Islamic finance.

3.1.2 Modern Islamic Finance

Initial efforts to create a modern Islamic financial system took the route of replicating and adapting institutions and products in the existing conventional system. A major factor in choosing this approach was the fact that the existing legal, accounting and tax frameworks were often modelled after developed, non-Islamic financial centres.

The creation of modern Islamic financial institutions began with the establishment of Islamic banks. Its rapid growth was, to a large extent, aided by a period of prosperity for the Arab world, which benefited from rising oil prices. The huge amounts of wealth in the region provided a source of substantial liquidity for the nascent Islamic banks. As a result of its early head-start, Islamic banking is today the most developed

component in the Islamic financial system and Islamic banks represent the bulk of Islamic financial institutions worldwide.

The success in developing Islamic banking spurred efforts to extend Islamic practices into other market segments. The next significant development was the establishment of Takaful or Islamic insurance with the principles of compensation and shared responsibility among the community by using instruments that were in line with *Shariah*. In addition, Takaful also plays an important role in mobilising long-term funds, providing risk protection as well as supporting overall economic growth and development.

With the establishment of Islamic banks and takaful institutions, the management of balance sheet liquidity became a major challenge due to the scarcity of Islamic capital market instruments. Islamic banks had surplus funds to invest after providing for liquidity and statutory reserves, and financing for clients. Similarly, takaful operators faced a shortage of *Shariah*-compliant financial products in which to invest, particularly for long-term tenures. Some of these institutions' funds remained inactive because of limited investment opportunities.

It was clear that Islamic banking and takaful could not exist in isolation without the support of an Islamic capital market. Initial efforts to overcome this problem focused on creating short-term and long-term debt instruments that were in line with *Shariah* principles. This was evident, in some jurisdictions, through the issuance of diverse Islamic financial instruments ranging from short-term papers to long-term bonds to meet the liquidity and investment needs of Islamic banking and takaful institutions. It was also aimed at providing issuers with flexibility in structuring the instruments according to the specific financing requirements.

The strong growth of Islamic financing continues to be driven by increasing demand; not only by those who invest in such instruments in order to meet their religious obligations, but also by others, including non-Muslims, who find some of the risk-return features attractive, or investors who subscribe to ethical investment philosophies. Islamic finance is becoming a prominent segment of the global financial market with the most active global financial centres for Islamic financial activities

located in London and New York. Many of the global financial players such as Citigroup, HSBC and Standard Chartered, among others, have recognised the potential market demand for these products and have built their capacity and capabilities to originate, distribute and make markets in Islamic financial products.

The stages of evolution of the Islamic financial services industry are illustrated below:

Table 3.1.2-1: Stages of evolution of the Islamic financial services industry

1970s	1980s	1990s	2000s
<p>Institutions:</p> <ul style="list-style-type: none"> - Commercial Islamic banks 	<p>Institutions:</p> <ul style="list-style-type: none"> - Commercial Islamic banks - Takaful - Islamic investment companies 	<p>Institutions:</p> <ul style="list-style-type: none"> - Commercial Islamic banks - Takaful - Islamic investment companies - Asset management companies - Brokers/Dealers 	<p>Institutions:</p> <ul style="list-style-type: none"> - Commercial Islamic banks - Takaful - Islamic investment companies - Islamic investment banks - Asset management companies - E-commerce - Brokers/Dealers
<p>Products :</p> <ul style="list-style-type: none"> - Commercial Islamic banking products 	<p>Products:</p> <ul style="list-style-type: none"> - Commercial banking products - Takaful 	<p>Products:</p> <ul style="list-style-type: none"> - Commercial banking products - Takaful - Mutual Funds / Unit trust - Islamic bonds - <i>Shariah</i>-compliant stocks - Islamic stockbroking 	<p>Products :</p> <ul style="list-style-type: none"> - Commercial banking products - Takaful - Mutual Funds / Unit trust - Islamic bonds - <i>Shariah</i>-compliant stocks - Islamic stockbroking
<p>Area :</p> <ul style="list-style-type: none"> - Gulf / Middle East 	<p>Area :</p> <ul style="list-style-type: none"> - Gulf / Middle East - Asia Pacific 	<p>Area :</p> <ul style="list-style-type: none"> - Gulf / Middle East - Asia Pacific 	<p>Area :</p> <ul style="list-style-type: none"> - Gulf / Middle East - Asia Pacific - Europe / Americas - Global Offshore Market

3.2 Components of the Islamic financial services industry

3.2.1 Islamic banking

Islamic banks today represent the majority of Islamic financial institutions, which are spread worldwide. The emergence of Islamic banking was a result of a revival of interest to develop an Islamic economic system as well as the increasing demand from Muslims worldwide for products and modes of investment that are in compliance with *Shariah* principles. The pioneering establishment of Islamic banks had been the catalyst for growth and provided the foundation for the development of the Islamic financial services industry as a whole.

In general, Islamic banks are characterised by the following features:

- a. Transactions that are free from the payment and receipt of a fixed or predetermined rate of interest
- b. Transactions that are based on profit and loss sharing (PLS) arrangements where the rate of return is not fixed prior to the undertaking of the transactions
- c. Business activities and investments that are undertaken on the basis of permissible activities
- d. Transactions that are free from elements of *gharar* (unreasonable uncertainty)
- e. Payment of *Zakat* (alms or taxes) by the bank
- f. Transactions that operate through *Shariah*-compliant modes of financing

Another salient feature of Islamic banks is the requirement for the establishment of *Shariah* supervisory boards. These boards are responsible for reviewing, scrutinising and endorsing the activities and operations of Islamic banks to ensure that their activities are in line with *Shariah* principles.

The funding operations are broadly divided into four main types of Islamic bank accounts – current accounts, savings accounts, investment accounts and special investment accounts. These accounts are structured under various *Shariah* principles such as *mudharabah*, *wadi'ah yad dhamanah* (trust account), *musharakah* and others.

Apart from funding operations, Islamic banks provide financing facilities to their customers either on a short, medium or a long-term basis in accordance with the various *Shariah* principles. In general, Islamic banks' financing activities can be divided into several types, such as project financing under the principles of *mudharabah*, *musharakah*, *bai` bithaman ajil* and *ijarah*.

Early experimentation with Islamic banking took the form of a savings bank that operated on a profit sharing basis in the Egyptian town of Mit Ghamr in 1963. This bank functioned more as a savings institution rather than as a commercial bank. The first recognised interest-free commercial bank was Nasser Social Bank. It was established in Cairo in 1971 with the objective of developing a social security system in Egypt.

The next milestone was the founding of the Islamic Development Bank (IDB) in 1975 under the auspices of the Organization of the Islamic Conference (OIC).³ The main functions of the IDB was to provide assistance – in the form of equity capital and loans for *Shariah*-compliant projects – for the economic development and social progress of member countries as well as to promote Islamic banking worldwide.

The establishment of IDB was a catalyst for the establishment of Islamic banks in other Muslim countries. The Dubai Islamic Bank was incorporated immediately after the establishment of IDB in 1975. In 1977, three more Islamic banks, i.e., Faisal Islamic Bank of Egypt, Faisal Islamic Bank of Sudan and the Kuwait Finance House, commenced business. The list of Islamic banks that were incorporated in the late 1970s and early 1980s are shown in table 3.2.1-1.⁴

³ The Organization of the Islamic Conference (OIC) is an inter-governmental organization grouping 56 States. These States decided to pool their resources together and combine their efforts to ensure the progress and welfare of their members and those of other Muslims worldwide.

⁴ See "Islamic Banking System, Concept & Applications" by Sudin Haron and Bala Shanmugam, 1997

Table 3.2.1-1: Islamic banks incorporated in the late 1970s and early 1980s

Name	Country	Date of Establishment
Nasser Social Bank	Egypt	1971
Islamic Development Bank	Saudi Arabia	1975
Dubai Islamic Bank	United Arab Emirates	1975
Faisal Islamic Bank of Egypt	Egypt	1977
Faisal Islamic Bank of Sudan	Sudan	1977
Kuwait Finance House	Kuwait	1977
Islamic Banking System International Holdings	Luxembourg	1978
Jordan Islamic Bank	Jordan	1978
Bahrain Islamic Bank	Bahrain	1979
Dar al-Mal al-Islami	Switzerland	1981
Bahrain Islamic Inv. Company	Bahrain	1981
Islamic International Bank for Investment & Development	Egypt	1981
Islamic Investment House	Jordan	1981
Al-Baraka Investment and Development Company	Saudi Arabia	1982
Saudi-Philippine Islamic Development Bank	Saudi Arabia	1982
Faisal Islamic Bank Kirbis	Turkey	1982
Bank Islam Malaysia Bhd	Malaysia	1983
Islamic Bank Bangladesh Ltd	Bangladesh	1983
Islamic Bank International	Denmark	1983
Tamadon Islamic Bank	Sudan	1983
Qatar Islamic Bank	Qatar	1983
Beit Ettamouil Saudi Tounsi	Tunisia	1984
West Sudan Islamic Bank	Sudan	1985
Albaraka Turkish Finance House	Turkey	1985
Faisal Finance Institution	Turkey	1985
Al Rajhi Company for Currency	Saudi Arabia	1985

Name	Country	Date of Establishment
Exchange & Commerce		
Al-Ameen Islamic & Financial Investment Corp. India Ltd.	India	1985

Various approaches were used towards establishing an Islamic banking system by different countries. Some countries such as Iran and Sudan converted their entire financial systems to become an interest-free system. By contrast, in the majority of countries, the Islamic banking system developed in parallel with the conventional banking system. Malaysia, Egypt and Saudi Arabia have dedicated Islamic banks, as well as conventional banks that offer banking services based on *Shariah* principles. The Islamic units of conventional banks are commonly known as “Islamic windows.” These Islamic units are required to maintain separate current/ clearing accounts for their Islamic banking operations and, in some jurisdictions, they are required to appoint *Shariah* advisers to advise on the day-to-day operation of Islamic windows.

Currently, there are estimated to be over 265 Islamic banks with a market capitalisation in excess of USD 13 billion. Total assets are estimated at over USD 262 billion with financial investments above USD 400 billion. Deposits in Islamic banks are estimated to be over USD 202 billion worldwide and the average annual growth rate of the Islamic banking industry ranged between 10-20% over the past decade.⁵ Tables 3.2.1-2 and 3.2.1-3 show the size of assets, deposits and financing of Islamic banking in the most active Islamic banking centres, namely Bahrain and Malaysia.

⁵ See “Islamic Banking: Key Challenges Ahead” by Dr. Fouad Shaker, The World Islamic Banking Conference, 2003

Table 3.2.1-2 : Growth of Bahrain Islamic banking (1990 – 2001)

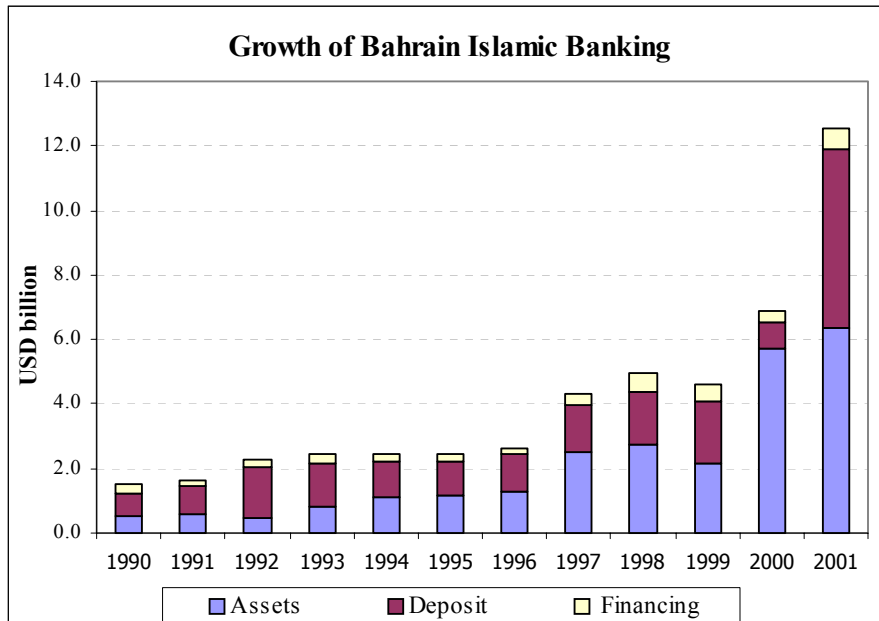
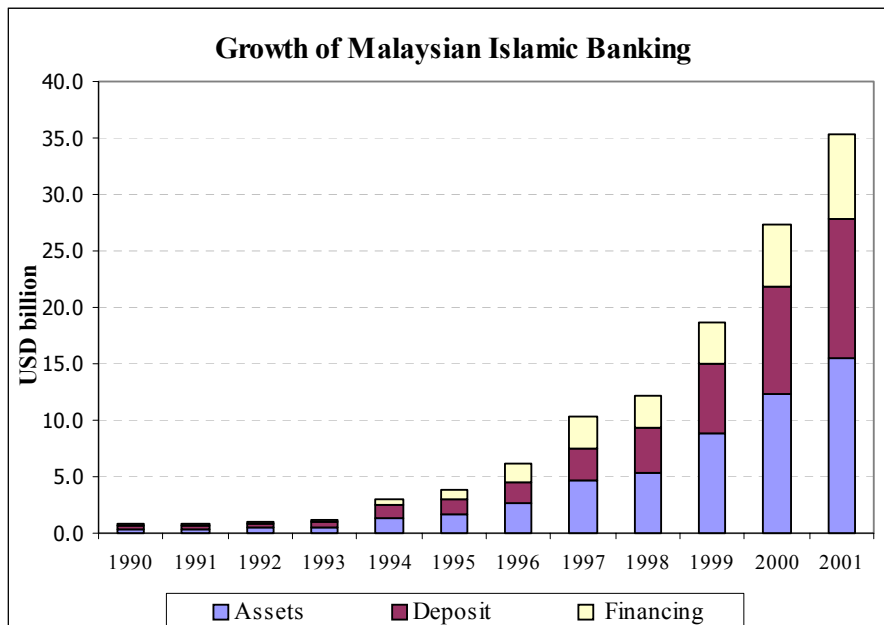


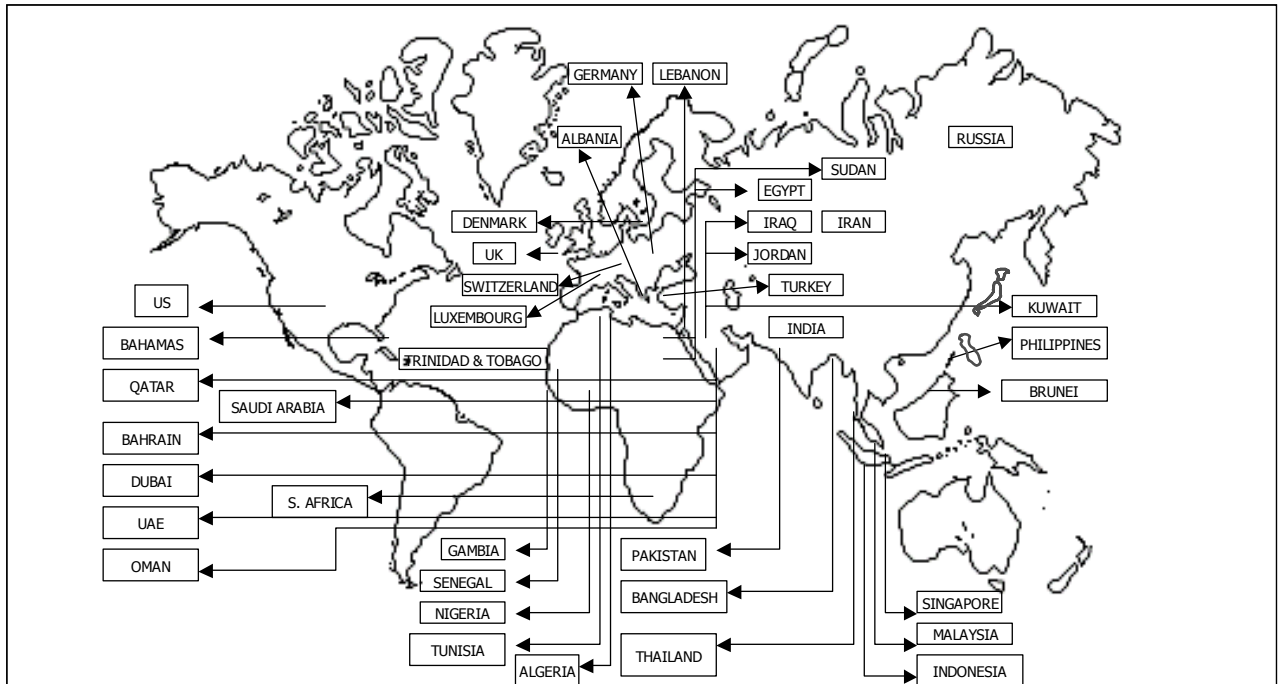
Table 3.2.1-3 : Growth of Malaysian Islamic banking (1990 – 2001)



In total, there are at least 39 countries that have already established or are offering Islamic banking products and services, as broadly illustrated in table 3.2.1-4. It is projected that the Islamic banking industry would account for at least 40 to 50 per

cent of the total savings of the Muslim population worldwide within an 8 to 10 year time-frame.⁶

Table 3.2.1-4 : Geographical spread of countries that offer Islamic banking products



3.2.2 Takaful

The term takaful literally means “shared responsibility or shared guarantee or assurance.” In practical terms, takaful means a mutual guarantee provided by a group of people in the community against a defined risk befalling one’s life, property or any form of valuable things. Unlike conventional insurance, takaful is free from elements of *gharar* (uncertainty) and *maisir* (gambling). The uncertainty element in a conventional insurance policy arises from the arrangement where the insurance company guarantees to pay a certain amount of compensation to the policyholder in the event of a disaster. However, the policy holder in the first instance does not know when such a disaster would occur or the amount of compensation that he will receive from the insurance company.

⁶ See “An Overview of Islamic Finance and the Growth of Islamic Funds” by Tariq Al Rifai, Islamic Funds World 2003

Takaful is based on definite terms, and requires a transparent and clear contract to avoid elements of uncertainty. Currently, two *Shariah* principles, namely *mudharabah* (profit sharing arrangement) or *wakalah* (fee-based arrangement) are used for takaful contracts. Syarikat Takaful Malaysia Berhad, which is Malaysia's first takaful operator, for instance, adopts the principle of *mudharabah* whilst Takaful Ta'awuni, which is based in Saudi Arabia, applies the principle of *wakalah*. While both principles involve embedding the sharing of profit between participants and takaful operators in the contract, there is, however, a difference in the profit determination process as explained in the following paragraphs.

Takaful operators incorporate the insurance scheme into the structure of the instrument via the concept of donation or *tabarru'* (gift) in their operations. In this respect, the participants to the takaful scheme agree to relinquish a certain portion of their takaful contributions as a donation to assist other participants who might suffer a loss or damage due to a disaster or catastrophe.

Under *mudharabah* principles, the takaful operator acts as an entrepreneur and accepts contributions from investors on a periodic basis. The takaful terms and conditions will state how profit from the operations managed by the takaful operator will be shared on a mutually-agreed ratio between the participants as the providers of capital and the takaful operator as the entrepreneur. However, the operator is not permitted to charge and deduct management expenses from the takaful fund.

In contrast, under the *wakalah* principle, the takaful operator is permitted to charge fees at the point the contract is signed in return for its role as the agent for the participants. The operators are also allowed to use part of the fund to cover its management costs.

Another distinguishing feature of takaful compared with conventional insurance can be found in its investment choices. Takaful operators must ensure that the avenues of investment of takaful funds must be in accordance with *Shariah* principles. Takaful funds are usually invested in long-term *Shariah* compliant products and services.

The engagement of *Shariah* advisors or *Shariah* supervisory boards is also important in the takaful business. This is to ensure that day-to-day operations of takaful companies comply with *Shariah* principles.

Generally there are three types of takaful products:

a) General takaful (Islamic general insurance)

This offers protection or coverage against risk of a general nature for companies or individuals (participants). Some of the products are motor insurance, fire and allied perils, worker compensation, marine cargo, property insurance, transportation insurance and others.

b) Family takaful (Islamic life insurance)

This provides coverage for individuals or corporate bodies on a long-term basis and the maturity period ranges from 10 to 40 years. Some of the products include medical and health plans, education, accident, marriage, as well as *hajj* and *umra* plans.

c) Retakaful coverage (Islamic reinsurance)

The retakaful companies offer coverage for takaful companies against risks, loss or dilution of its capital and reserves resulting from high-claim exposure. There are very few Retakaful companies and they are mainly located in the Bahamas, Malaysia, Saudi Arabia and Sudan.

Takaful began in the late 1970s when Islamic scholars started to permit takaful practices – on the basis that the relationship between takaful companies and its participants can be viewed as a *mudharabah* contract which entails profit sharing arrangements. Since then, there has been a gradual establishment of takaful companies in Muslim and non-Muslim countries.

The first recognised takaful operator was the Islamic Insurance Company, which was established in Sudan in 1979. This was followed by the establishment of the Islamic-

Arab Insurance Co. in two countries; namely Saudi Arabia and United Arab Emirates in 1979 and 1980 respectively.

Subsequently, Darul Mal Al-Islamic was incorporated in Geneva in 1981. In 1983, four more takaful operators commenced business, i.e., Syarikat Takaful Al-Islamiyah in Bahrain, Islamic Takaful and Re-Takaful Co. in Bahamas and Islamic Takaful Company in Luxembourg. The list of takaful operators that were incorporated in the late 1970s and late 1990s are shown in table 3.2.2-1.⁷

Table 3.2.2-1: Takaful operators incorporated in the late 1970s and late 1990s

Name	Country	Date of Establishment
The Islamic Insurance Company	Sudan	1979
The Islamic – Arab Insurance Co	Saudi Arabia	1979
The Islamic – Arab Insurance Co	United Arab Emirates	1980
Darul Mal Al-Islami	Geneva	1981
Syarikat Takaful Al-Islamiyah	Bahrain	1983
Islamic Takaful and Re-Takaful Co.	Bahamas	1983
Islamic Takaful Company	Luxembourg	1983
Al-Barakah Insurance Co.	Sudan	1984
Syarikat Takaful Malaysia Bhd	Malaysia	1984
Islamic Insurance and Re-Insurance Company	Bahrain	1985
The PT Syarikat Takaful Indonesia	Indonesia	1994
The Syarikat Takaful Singapura	Singapore	1995
Takaful Nasional Sdn. Bhd. (Formerly known as MNI Takaful)	Malaysia	1993
Islamic Insurance Co.	Qatar	1995
ASEAN Takaful Group	Malaysia	1996
ASEAN Re-Takaful International (Labuan) Ltd (ARIL)	Malaysia	1997

⁷ See “Principles & Practices of Takaful and Insurance Compared” by Mohd Ma’sum Billah, 2001

The global size of takaful premium contributions from 58 takaful operators is currently estimated at around USD 2 billion. It is reported that the takaful market in the Middle East is growing at 15-20 percent per year. There are also efforts underway to establish the world's first Global Takaful Company (GTC), headquartered in Brunei, by the IDB Fund with a market capitalisation of USD 250 to 300 million.⁸ The geographical distribution of takaful products is illustrated in figure 3.2.2-2 below.

Figure 3.2.2-2: Geographical spread of countries that offer takaful products

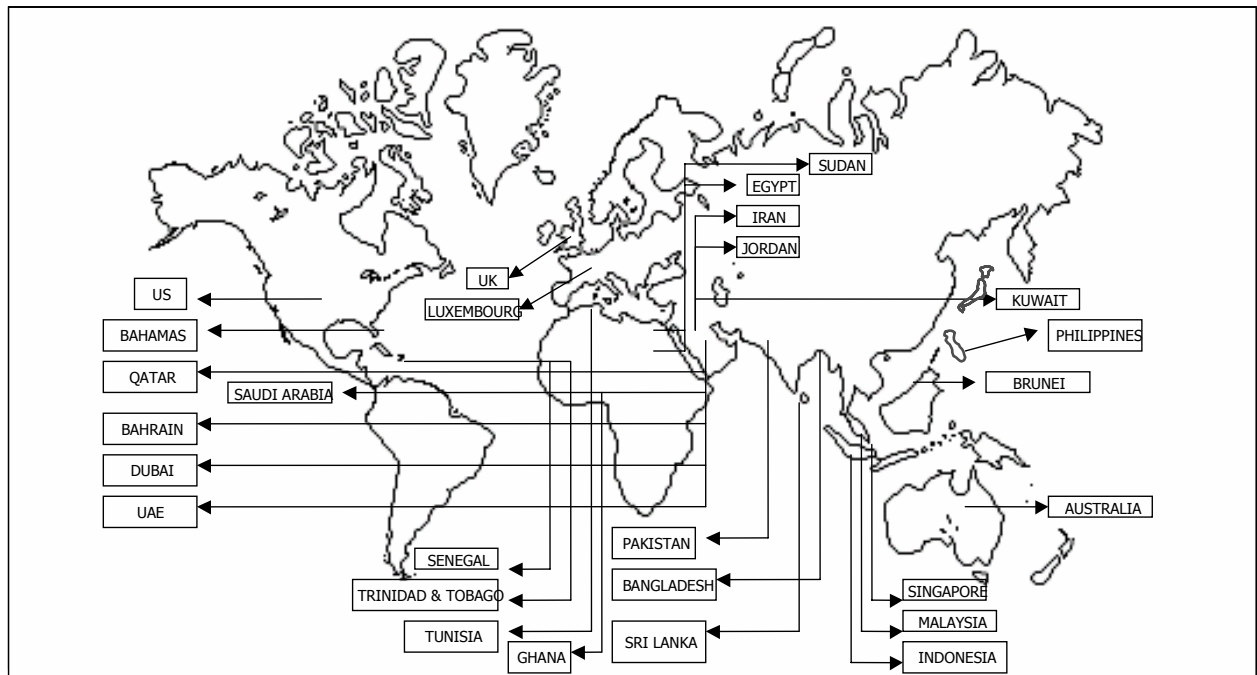


Figure 3.2.2-3: Premium contribution of takaful industry in selected Asian jurisdictions (USD Million)

Country	1999-2001	2002	Total	% Share
Malaysia (4 operators)	452.174	346.344	798.518	87.6
Brunei (3 operators)	44.894	14.787	59.681	6.5
Indonesia (3 operators + 4 branches)	26.057	12.886	38.943	4.3
Singapore (3 branches)	6.068	0.353	6.421	0.7
Bangladesh (6 operators)	2.8	4.5	7.3	0.8
Sri Lanka (1 operator)	0.223	0.321	0.544	0.1
Total	532.216	379.191	911.497	100

⁸ See "Islamic Development Bank Infrastructure Fund" by Mumtaz Khan, The World Islamic Banking Conference, 2003

⁹ See "Islamic Financial Services The Road Ahead" by Dato' Mohd Fadzli Yusof, OIC Business Forum 2003

3.2.3 Islamic capital markets

The emergence of a distinct Islamic capital market, where investment and financing activities and products are structured in accordance with *Shariah* principles, is therefore the outcome of a natural progression in the growth of the Islamic financial services industry. As outlined earlier, the pressing need to address liquidity management for Islamic banks and takaful operators prompted several countries – such as Malaysia, Bahrain, Kuwait, Sudan and Iran – to introduce Islamic bonds to facilitate the management of assets by Islamic financial institutions.

Whilst there had been earlier efforts by the Governments of Jordan and Pakistan¹⁰ to introduce a legal framework for Islamic bond issuance, the first successful issuance of Islamic bonds was initiated by the Malaysian Government in 1983 with the issuance of the Government Investment Issue or GII (formerly known as the Government Investment Certificate or GIC). The main objective of this issuance was to facilitate the management of assets in the Islamic banking system, which, by this time, was fairly mature. The issuance of GII is based on the Islamic concept of *qardh hasan* (benevolent loan) non-interest bearing loans. However, GII was not a tradable instrument under the concept of *qardh hasan*, which did not permit secondary trading. Recently, the underlying concept of GII was changed to *bai` al-`Inah* to allow it to be traded in the secondary market.

Similarly, the Central Bank of Kuwait issued interest-free bonds to finance the purchase of properties held by nationals other than Gulf Co-operation Council states. Iran has also introduced the concept of participation bonds on a *mudharabah* basis. The success of numerous Islamic bond issuances worldwide opened up an alternative source of funding, which is now tapped by many countries and corporations.

Another aspect of the early part of the development of the Islamic capital market was the need to establish clear guidance on the types of equities that comply with *Shariah*

¹⁰ The effort was undertaken by the Jordanian Government as stipulated by Law No. 13 of 1978, which allowed the Jordan Islamic Bank to issue Islamic bonds known as *Muqaradah* bond. This was followed with the introduction of the *Muqaradah* Bond Act (1981) by the Jordanian Government to develop *waqf* property. Similar efforts in Pakistan saw the introduction of a special law called the *Modaraba* Companies and *Modarabas* (Flotation and Control) Ordinance 1980. This law was supplemented by the *Modaraba* Companies and *Modaraba* Rules (1981). However, to date, no Islamic bonds have been issued in Jordan and Pakistan.

requirements. The review and identification of *Shariah*-compliant stocks are guided by specific criteria set out by *Shariah* scholars. In Malaysia, the initial efforts to provide a list of *Shariah*-compliant stocks were undertaken by Bank Islam Malaysia Bhd in 1983. This was later followed by the introduction of a list of *Shariah*-compliant stocks in June 1997 by the Securities Commission of Malaysia.

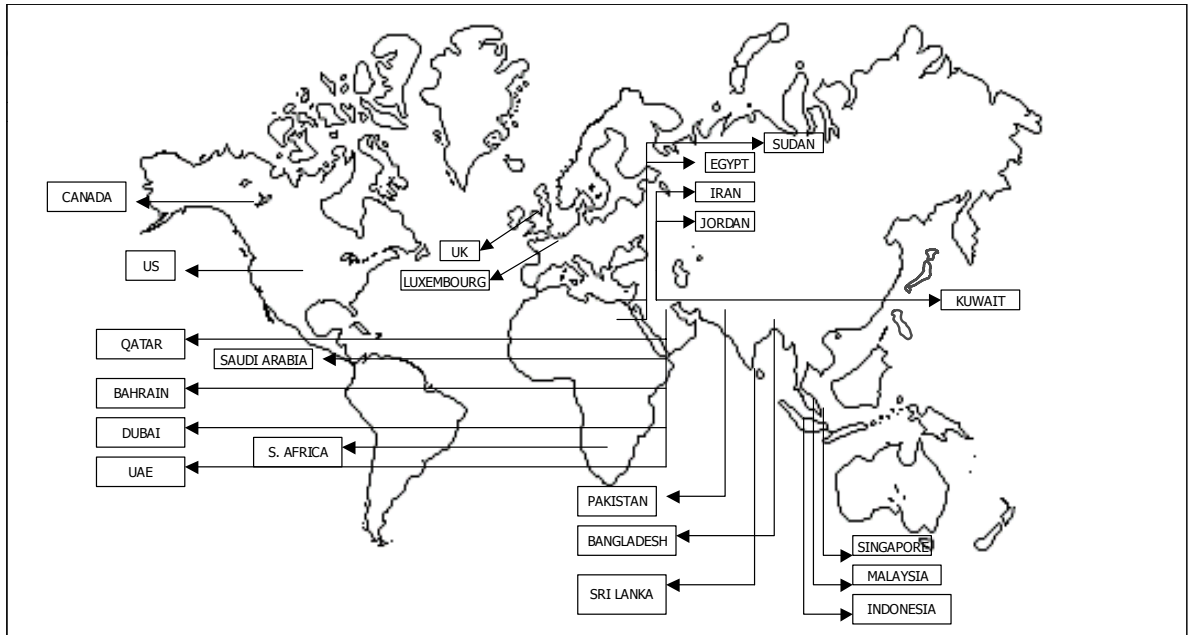
The implementation of a process to identify *Shariah*-compliant stocks facilitates the establishment of Islamic indices. The first Islamic equity index was introduced in Malaysia by RHB Unit Trust Management Bhd in May 1996. This was followed by the launching of the Dow Jones Islamic Market Index (DJIM) by Dow Jones & Company in February 1999, the Kuala Lumpur *Shariah* Index (KLSI) by Bursa Malaysia in April 1999 and the FTSE Global Islamic Index Series by the FTSE Group in October 1999.

With *Shariah* investment guidance in place, the establishment of Islamic investment funds gained momentum. The Amana Income Fund, the first Islamic equity fund to be established in the United States, was formed in June 1986 by members of the North American Islamic Trust (NAIT), an organisation in Indiana, which oversees the funding of mosques in the United States.¹¹ In 1987, Dallah AlBaraka Group established two companies, namely Al-Tawfeek and Al-Amin, which were specifically dedicated to the development of Islamic equity funds. These companies have successfully launched a number of Islamic funds focusing on such diverse sectors such as real estate as well as international equities.

Today, there is a wide array of Islamic capital market products and services to meet the needs of those who seek to invest in compliance with *Shariah* principles. These include *Shariah*-compliant stocks, Islamic bonds, Islamic funds and Islamic risk management products. The Islamic capital market has grown in sophistication and Islamic forms of product structuring, project financing, stockbroking, asset management and venture capital services are becoming increasingly widely available.

¹¹ See "Islamic Banking" by Mervyn K. Lewis and Latifa M. Algaoud, 2001

The distribution of countries that offer Islamic capital market products and services is illustrated in chart 3.2.3-1.



A. *Shariah*-compliant stocks

In general, the *Shariah*-based principle of equity participation is essentially the same as that for conventional companies. It is based on a form of equity partnership investing called *musharakah*. However, from an Islamic perspective, corporate stocks can only be classified as *Shariah*-compliant if their business activities are not related to prohibited activities as outlined by *Shariah* scholars. The prohibited business activities include:

- a) Alcohol
- b) Gambling
- c) Pork-related products
- d) Pornography
- e) Conventional financial services
- f) Conventional insurance.

Within this context, there may be other activities or enterprises that are prohibited such as tobacco, weapons, hotels or entertainment depending on the methodology or

interpretation used by *Shariah* scholars in different jurisdictions. In addition to the business activities criteria, certain jurisdictions use financial ratios as additional criteria in classifying *Shariah* stocks. The main financial ratios applied are:

- debt-to-equity ratio
- cash and interest bearing securities-to-equity ratio
- cash-to-asset ratio.

Other than business and financial criteria, some jurisdictions are known to also apply a cleansing mechanism to purify investments that are tainted by prohibited activities. The cleansing process is normally performed by the individual investors, although in some cases, the Islamic funds would perform the task on behalf of their investors. For instance, if some part of the income from interest-bearing accounts (prohibited by *Shariah*) is included in the income of the company, the proportion of such income in the dividend paid to the shareholder must be given to charity, and must not be retained by the shareholder. This is called purification or dividend cleansing.

In Malaysia, for example, the screening of listed stocks for *Shariah* compliance is undertaken by a centralised body. The review and identification of stocks that are considered to be *Shariah*-compliant is undertaken by the *Shariah* Advisory Council (SAC) of the Securities Commission. The Securities Commission then compiles the decisions of the SAC and publishes the list of *Shariah*-compliant stocks twice a year.

In other countries, screening services are commonly performed by the private sector rather than by the regulatory authorities. In India for instance, Parsoli Corporation and IBF Net jointly launched India's first Islamic equity index comprising *Shariah*-compliant stocks, the Parsoli IBF-Net Equity (PIE).¹² In the Middle East, private financial institutions and investment companies produce their own lists of *Shariah*-compliant stocks. As mentioned earlier, both Dow Jones and FTSE have introduced global Islamic indices, which track the performance of securities approved by their *Shariah* boards.¹³ Table 3.2.3-2 shows the market capitalisation of Malaysian and

¹² Source : www.parsoli.com

¹³ Dow Jones; FTSE International

Bahrain *Shariah*-compliant stocks, while table 3.2.3-3 illustrates the size of stock exchanges in selected Islamic countries.

Table 3.2.3-2: Market Capitalisation of Malaysian and Bahrain *Shariah*-compliant stocks (USD Million)

Year	Bahrain		Malaysia	
	M-cap of <i>Shariah</i> -compliant stocks	% of total market capitalisation	M-cap of <i>Shariah</i> -compliant stocks	% of total market capitalisation
1998	411.8	6.13%	55,982.8	56.00%
1999	462.7	6.46%	70,082.4	48.00%
2000	647.3	9.77%	65,129.3	54.70%
2001	612.9	9.30%	75,131.60	59.20%
2002	603.2	7.98%	76,426.32	57.55%
2003	621.2	6.40%	102,926.32	57.70%

Table 3.2.3-3: Market Capitalisation of stock exchanges in selected Islamic countries¹⁴

As at Dec 2003	Malaysia	Bahrain	Oman	Kuwait	Saudi Arabia	Qatar	Jordan	UAE	Egypt
Number of listed companies	906	43	130	112	70	29	178	15	157
Market capitalisation (USD billion)	165.0	28.7	4.7	57.8	151.7	25.7	10.7	13.5	21.0

B. Islamic funds

Islamic mutual funds or Islamic unit trust funds are funds, which are managed in compliance with *Shariah* principles. Islamic mutual funds typically engage *Shariah* boards to advise and ensure that investment operations and portfolios are managed in compliance with *Shariah* principles. In some jurisdictions, the retention of *Shariah* boards for Islamic funds is required under the law.

Globally, there are different categories of Islamic funds with the most common product being funds that invest in *Shariah*-compliant stocks. Examples of Islamic equity funds being launched recently include the Alfanar US Equity Hedge Fund,

¹⁴ Sources : www.zawya.com and www.bursamalaysia.com

which was launched in 2003 as the world's first Islamic hedge fund by the Saudi Economic and Development Company (SEDCO) and the Permal Group.

Apart from Islamic equity funds, there are other categories of Islamic funds such as realty and property funds, investment and *murabahah* funds, commodity funds and leasing (*ijarah*) funds. Investment and *murabahah* funds operate with the fund manager purchasing commodities from third parties (typically through a bank as an agent of the fund) and reselling the same commodities to the bank on deferred payment terms. The bank, as an agent, ensures that transactions are based on physical commodities. The profit for each transaction is agreed to as between the bank and the fund at the time it purchases the goods and is generally set as levels comparable with the returns from money market instruments or *murabahah* fund transactions.

Realty and property funds involve the acquisition and management of a portfolio in real estate. Property funds have recently gained popularity and interest among investors in the Middle East and Europe. In addition, there are also Islamic real estate investment trusts (REIT) funds which invest their portfolios in listed real estate securities that own and operate real estate such as residential, commercial, and retail properties, storage facilities, warehouses and car parks. Islamic property funds and Islamic REITs differ from conventional property funds and REITs only in terms of the requirement to observe Islamic investment guidelines and *Shariah* principles. The *Shariah* principles, in this case, would extend to the activities and businesses undertaken by the tenants of the properties of the fund.

Islamic commodity funds invest in commodities, which are permissible according to *Shariah*. Among the popular commodities are metals such as aluminium, copper, nickel, palladium and platinum. Other types of Islamic funds include the leasing (*ijarah*) fund, which invests in leasing transactions that satisfy *Shariah* requirements.

In general, the categories of Islamic funds are reflected in figure 3.2.3-4.

Figure 3.2.3-4: Categories of Islamic funds¹⁵

Type of funds	Funds name
Global funds	Al-Rajhi Global Equity, NCB Global Trading Equity, Wellington Hegira, Al Sawfa, Al Baraka, Al Fanar Investment Holdings, Al-Dar World Equities, Riyadh Equity Fund, Oasis International Equity
Regional funds	Mendaki Growth, Al Rajhi Middle East, TII Ibn. Majid, Al-Nukhba
Sector funds	TII Small-Capital, Amana Income, Hi Tech Fund
European funds	Al-Dar European Equities, European Trading Equity Fund
Domestic funds	Most Malaysian funds, Saudi Trading Equity, Al Rajhi Egypt, US equity funds
Hedge funds	Alfanar US Equity Hedge Fund
Index funds	Dow Jones Islamic Market Index Fund
Leasing (<i>ijarah</i>) funds	GCC Leasing, Al Kawthar Ijara Fund
Realty & property funds	Al-Deera Real Estate Fund, Badr Property Fund, First Industrial Fund
Commodity funds	Commodity fund (Euro), commodity Mudaraba, Al-Rajhi Commodity Mudaraba
Investment & <i>Murabaha</i> funds	Alfanar Murabaha Ltd, Noriba Murabaha Fund, Murabaha Fund
Trade finance funds	Al-Bard fund, AIF Trade, Al-Ahli International Trade, SAR Trade Finance

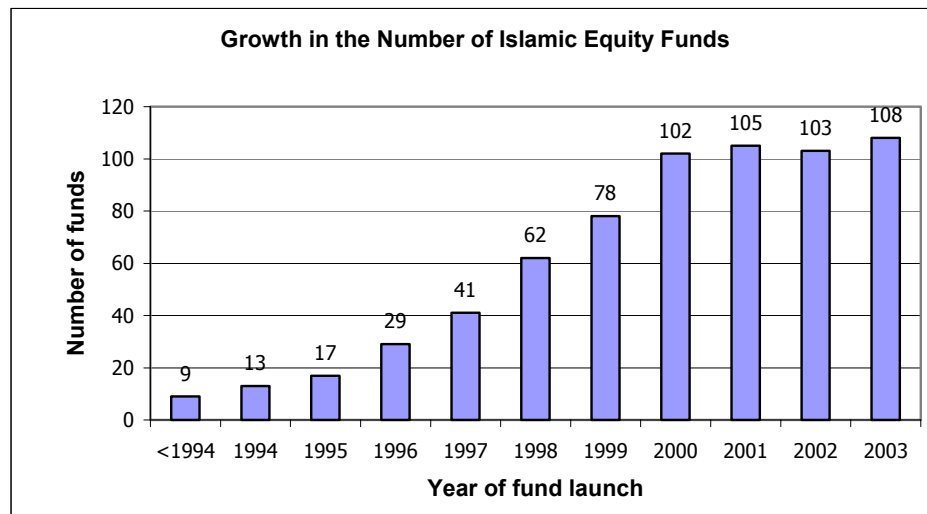
Between 1994 and the end of 2001, approximately 120 Islamic funds have been launched by both Islamic and conventional institutions. Of these, over 60 percent of these funds were established to invest in international equities. Although most Islamic

¹⁵ See "Islamic Banking" by Mervyn K. Lewis and Latifa M. Algaoud, 2001

funds have targeted institutional and professional investors, some of the international Islamic equity funds have been distributed at the retail level as well. Amongst them are Al Rajhi Banking and Investment Corporation that have moved on from trade and commodity *mudharabah* to offer its clients several *Shariah*-compliant global and regional equity funds. In Malaysia, Islamic funds have been in existence since the launch of the first Islamic equity fund by Arab-Malaysian Unit Trust Berhad in 1993. Since then, 55 Islamic funds have been launched, representing approximately a quarter of the total of 226 funds in the country.¹⁶

Currently, the size of Islamic equity funds is estimated to be approximately USD 3.3 billion and it has been growing at over 25 per cent over the past seven years. There are estimated to be over 100 Islamic equity funds worldwide.¹⁷ The rapid growth of the number of Islamic equity funds and its assets is expected to continue as new players enter the market due to enhanced awareness and familiarity with the products.

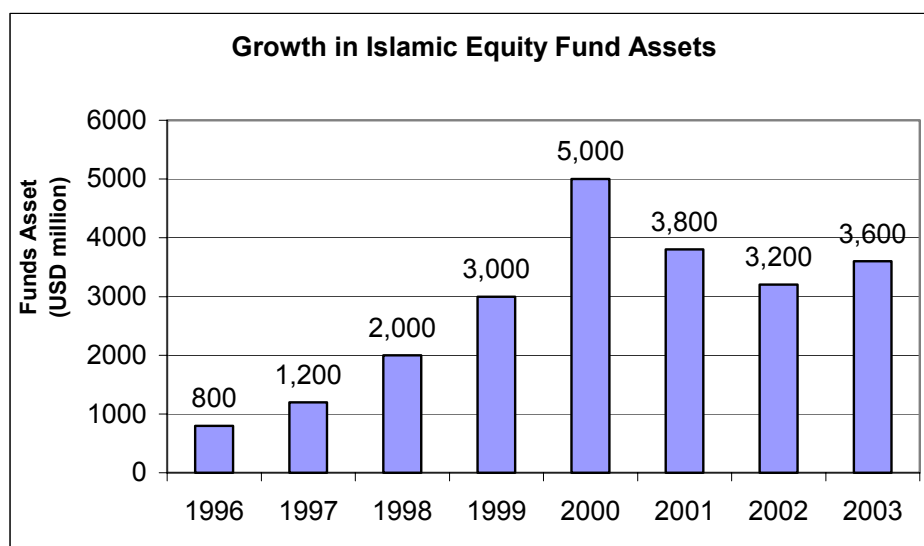
Figure 3.2.3-5: Statistics on the growth in the number of Islamic equity funds



¹⁶ As of December 2003

¹⁷ See “An Overview of Islamic Finance and the Growth of Islamic Funds” by Tariq Al Rifai, Islamic Funds World 2003

Figure 3.2.3-6: Statistics on the growth in Islamic equity funds assets



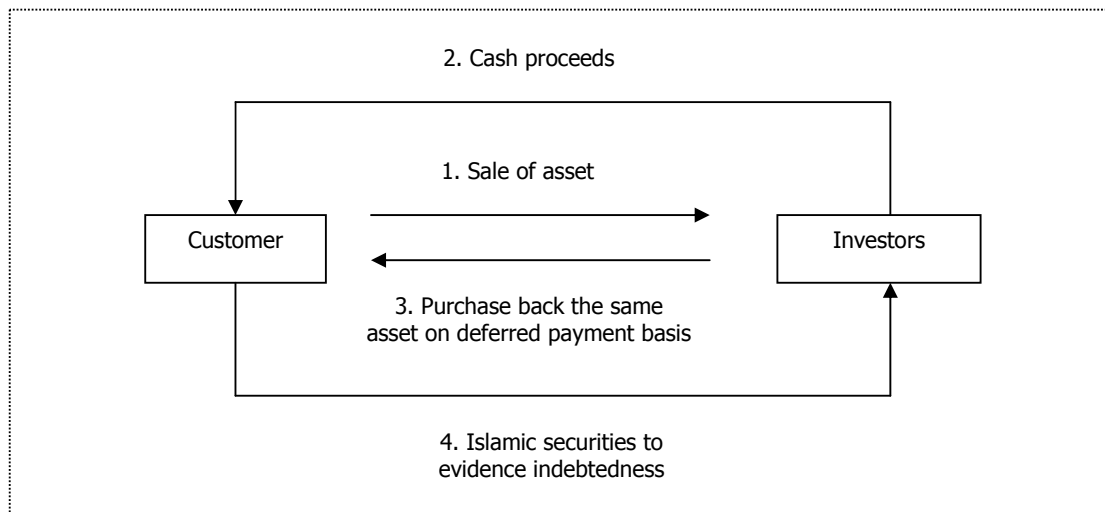
C. Islamic bonds

The origination of Islamic bonds typically involves the packaging or structuring of pools of *Shariah*-compliant assets with or without credit enhancement into securities. It is structured based on a specific contract of exchange that can be made through the sale and purchase of an asset based on deferred payment, leasing of specific assets or participation in joint-venture businesses. Unlike conventional bonds, the issuance of Islamic bonds requires an exchange of a *Shariah*-compliant underlying asset for a financial consideration through the application of various *Shariah* principles such as *ijarah*, *mudharabah*, *musharakah*, *bai` bithaman ajil* and others. The structure of Islamic bonds has to be reviewed and approved by *Shariah* advisers to ensure that the structures are in compliance. In addition, the structuring process may also involve the provision of additional protection for investors against late payment, pre-payments, potential write-offs and others. Such protection is often provided in the form of credit and/or liquidity enhancement schemes.¹⁸

A simplified structure of Islamic bonds using *bai` bithaman ajil* is shown below in figure 3.2.3-7.

¹⁸ See "Islamic Securitisation : Practical Aspects" by Suleiman Abdi Dualeh

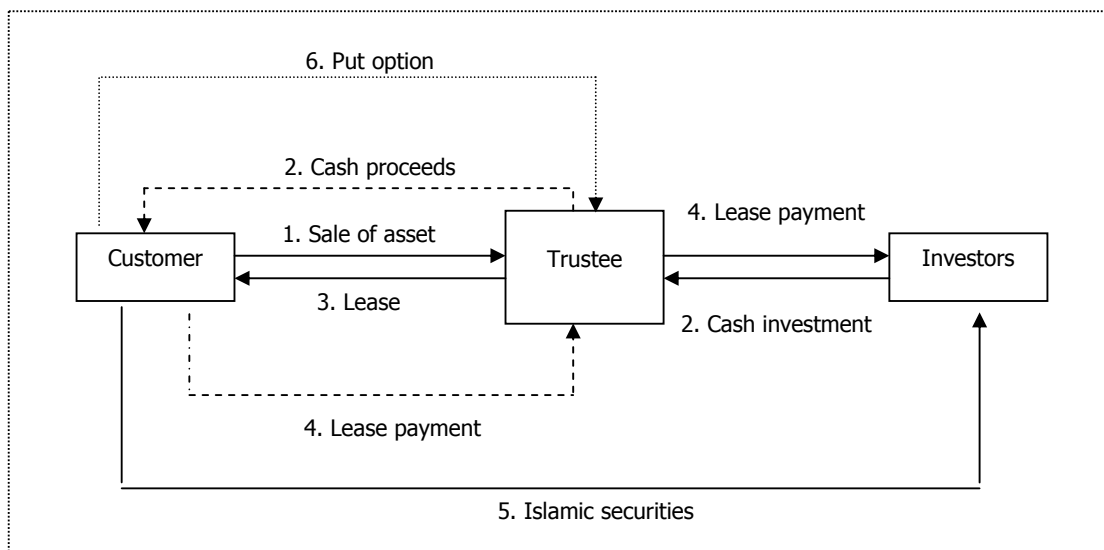
Figure 3.2.3-7 Islamic bonds based on *bai` bithaman ajil* structure



- The customer and investors identify certain customer's asset. The customer enters into an agreement to sell an asset, for example, a building to the investors. The title to the asset passes to the investors immediately upon the sale of the asset. In return the customer will receive cash proceeds from the transaction.
- The customer will then buy back immediately from the investors the same asset at an agreed price on a deferred payment basis (purchase price plus margin of profit). The title to the assets reverts back to the customer who, as a result of transactions will be indebted to the investors. The repayment of this debt, comprising the purchase price and profit will then be deferred and subsequently executed over an agreed period.
- Subsequently, the customer issues Islamic securities (which can be traded) to the investors to reflect the above financing arrangement and as evidence of the customer's obligation to pay the purchase price and profit to the investors.

In trade finance, Islamic institutions use the *murabahah* contract, which enables the Islamic institutions to purchase certain goods and re-sell the same to the client. In project financing, Islamic institutions use the *ijarah* form of contract to buy equipment and lease it to a project-promoter. A simplified structure of an asset-backed securitisation based on *ijarah* is shown in figure 3.2.3-8

Figure 3.2.3-8 Asset-backed structure based on *ijarah* structure



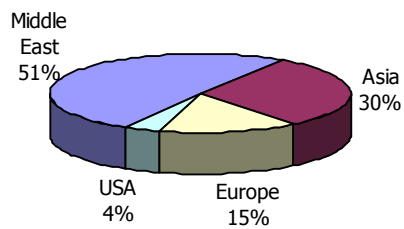
- The customer enters into an agreement to sell an asset, for example, a machine to a third party. In this case, the third party can be a trustee [or special purpose vehicle (SPV)]. The trustee acts on behalf of investors who provide the funds for the purchase of the machine. The title to the machine passes to the trustee as an agent and trustee for the investors immediately upon the sale of machine. The trustee, on behalf of the investors, then leases the machine to the customer under the *Shariah* principles of *ijarah* where the customer will make lease payments to the trustee throughout the leasing period.
- Subsequently, the customer issues Islamic securities to the investors to reflect the above financing arrangement. The returns to the investors are in the form of leasing profits and the principal amount (face value of the securities) will be paid to the investors at maturity of the securities. The customer grants a put option to the trustee where at the end of the *ijarah* facility period, the trustee can exercise the put option which requires the customer to purchase the machine back from the trustee.

The *ijarah* concept is one of the more popular concepts among issuers of global Islamic bonds. This is reflected by the strong reception and success of global Islamic bonds issued by sovereigns (Malaysia and Qatar); corporations (Guthrie Berhad – a

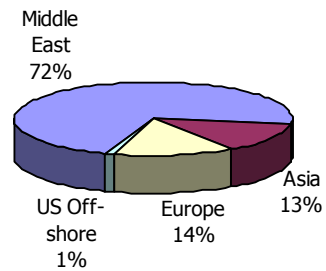
Malaysian public listed company); and multilateral organisations like the Islamic Development Bank (IDB). All these bonds were reviewed and endorsed by the Global *Shariah* Supervisory Committee (SSC) of the International Islamic Financial Market (IIFM) Board.

A geographical breakdown of the international investors who subscribed to the Malaysian, Qatar and IDB Global Islamic Bonds is provided below:¹⁹

Analysis of distribution of Malaysian Global Bond by geographical location:

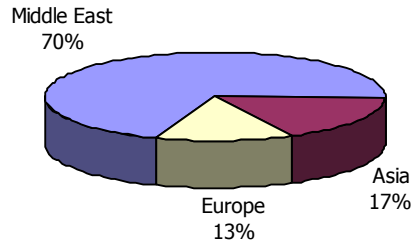


Analysis of distribution of Qatar Global Bond by geographical location:



¹⁹ Source: HSBC

Analysis of distribution of Islamic Development Bank Bond by geographical location:



Currently, the value of Islamic bonds issued globally is estimated at USD 25.8 billion. (see figure 3.2.3-9).

Figure 3.2.3-9: Size of Islamic bonds issued by selected jurisdictions as of 31 December 2003

No.	Issuing Country	Size (USD million)
1.	Qatar (Global)	700
2.	Islamic Development Bank (Global)	400
3.	Bahrain	1,000
4.	Malaysia	22,680
5.	Malaysia (Global)	600
6.	Guthrie Bhd (Global)	150
7.	Indonesia	119
8.	Singapore	35
9.	Sudan	148
	Total	25,832

TERMS

DEFINITION

the goods, the price, or through faulty description of the goods, in which one or both parties stand to be deceived through ignorance of an essential element of exchange. As an example, gambling is a form of *Gharar* because the gambler is ignorant of the result of the gamble.

Gharar is divided into three types, namely *gharar fahish* (excessive), which vitiates the transaction, *gharar yasir* (minor), which is tolerated and *gharar mutawassit* (moderate), which falls between the other two categories. Any transaction can be classified as forbidden activity because of excessive *gharar*.

Haq Maliy	<i>Haq maliy</i> are rights on the financial assets. Examples of such rights are <i>haq dayn</i> (debt rights) and <i>haq tamalluk</i> (ownership rights).
Hibah	A gift awarded to a person.
Hiwalah	A contract that allows a debtor to transfer his debt obligation to a third party.
Ibra'	An act by a person to withdraw his rights, i.e., his rights to collect payment from a person who has the obligation to repay the amount borrowed from him.
Ijarah	A <i>manfaah</i> (usufruct) type of contract whereby a lessor (owner) leases out an asset or equipment to his client at an agreed rental fee and pre-determined lease period upon the <i>aqad</i> (contract). The ownership of the leased equipment remains in the hands of a lessor.
Ijarah Thumma Bai'	A contract which begins with an <i>Ijarah</i> contract for the purpose of leasing the lessor's asset to the lessee. Consequently, at the end of the lease period, a lessee will purchase the asset at an agreed price from a lessor by executing a purchase (<i>Bai'</i>) contract.
Istisna'	A purchase order contract of assets whereby a buyer will place an order to purchase an asset that will be delivered in the future. In other words a buyer will require a seller or a contractor to deliver or construct the asset that will be completed in the future according to the specifications given in the sale and purchase contract. Both parties to the contract will decide on the sale and purchase prices as they wish and the settlement can be delayed or arranged based on the schedule of the work completed.
Ittifaq Dhimni	This is an external agreement, which must be reached before the contract can be concluded to allow for the bidding process (<i>Bai' al-Muzayadah</i>) to take place.

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Ji`alah	Contract of reward; a unilateral contract promising a reward for a specific act or accomplishment.
Kafalah	It has the same meaning as <i>Dhaman</i> .
Khilabah	A form of fraud, either in word or deed by a party to the trading contracts with the intention of inducing the other party into making a contract. This is prohibited according to <i>Shariah</i> .
Khiyanah	Refers to deception by not disclosing the truth or breaching an agreement in a hidden way. This is prohibited according to <i>Shariah</i> .
Mal	Something that has value and can be gainfully used according to <i>Shariah</i> .
Maisir	Any activity that involves betting whereby the winner will take all the bets and the loser will lose his bet. This is prohibited according to <i>Shariah</i> .
Mudharabah	A contract, which is made between two parties to finance a business venture. The parties are a <i>rabb al-mal</i> or an investor who solely provides the capital and a <i>mudarib</i> or an entrepreneur who solely manages the project. If the venture is profitable, the profit will be distributed based on a pre-agreed ratio. In the event of a business loss, the loss shall be borne solely by the provider of the capital.
Murabahah	A contract that refers to the sale and purchase transaction for the financing of an asset whereby the cost and profit margin (mark-up) are made known and agreed by all parties involved. The settlement for the purchase can be settled either on a deferred lump sum basis or on an instalment basis, and is specified in the agreement.
Musharakah	A partnership arrangement between two parties or more to finance a business venture whereby all parties contribute capital either in the form of cash or in kind for the purpose of financing the business venture. Any profit derived from the venture will be distributed based on a pre-agreed profit sharing ratio, but a loss will be shared on the basis of equity participation.
Muqasah	Debt settlement by a contra transaction.
Qabdh	<i>Qabdh</i> means possession, which refers to a contract of exchange. Generally, <i>qabdh</i> depends on the perception of ' <i>urf</i> ' or the common practices of the local community in recognising that the

TERMS	DEFINITION
	possession of a good has taken place.
Qardh Hasan	A contract of loan between two parties on the basis of social welfare or to fulfil a short-term financial need of the borrower. The amount of repayment must be equivalent to the amount borrowed. It is however legitimate for a borrower to pay more than the amount borrowed as long as it is not stated or agreed at the point of contract.
Rahn	An act whereby a valuable asset is used as collateral for a debt. The collateral will be utilised to settle the debt when a debtor is in default.
Riba	An increase, which in a loan transaction or in exchange of a commodity, accrues to the owner (lender) without giving an equivalent counter value or recompense in return to the other party. It covers interest both on commercial and consumer loans, and is prohibited according to <i>Shariah</i> .
Sarf	A buying and selling of currencies.
Suftajah	A credit instrument issued to a creditor to enable him to use or cash it at another predetermined venue and at the future date.
Sukuk	A document or certificate, which evidences the undivided pro-rata ownership of underlying assets - the <i>Sak</i> (singular of <i>Sukuk</i>) is freely tradable at par, premium or discount.
Shariah	Islamic law, originating from the <i>Qur'an</i> (the holy book of Islam), as well as practices and explanations rendered by the prophet Muhammad (<i>pbuh</i>) and <i>ijtihad</i> of ulamak (personal effort by qualified <i>Shariah</i> scholars to determine the true ruling of the divine law in a subject matter on which the revelation is not explicit).
Tadlis al-'aib	Refers to the activity of a seller intentionally hiding the defects of goods. This activity is prohibited according to <i>Shariah</i> principles.
Takaful	This is a form of Islamic insurance based on the principle of <i>ta'awun</i> or mutual assistance. It provides mutual protection of assets and property and offers joint risk sharing in the event of a loss by one of its members. Takaful is similar to mutual insurance in that members are the insurers as well as the insured.
Tanajush	Refers to a conspiracy between a seller and a buyer wherein the buyer is willing to purchase the goods at a higher price. This is done so that others would rush to buy the goods at a higher

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	price, resulting in the seller obtaining a huge profit. This transaction is not permissible in Islam.
Ta`widh	Penalty agreed upon by the contracting parties as compensation that can rightfully be claimed by the creditor when the debtor fails or is late in meeting his obligation to pay back the debt.
Ujrah	Financial payment for the utilisation of services or <i>manfaat</i> . In the context of today's economy, it can be in the form of salary, wage, allowance, commission and the like.
`Urbun	A deposit or earnest money which forms part payment of the price of goods or services paid in advance, but will be forfeited in the event the transaction is cancelled. The forfeited money is considered as <i>hibah</i> (gift).
'Uqud al-Mu'awadat	Contracts of exchange.
'Uqud al-Tabarruat	Charitable contract.
'Uqud al-Ishtirak	Contract of partnership
Wakalah	A contract, which gives the power to a person to nominate another person to act on his behalf as long as he is alive based on the agreed terms and conditions.
Wadiyah Yad Dhamanah	Goods or deposits, which have been deposited with another person, who is not the owner, for safekeeping. As <i>wadiyah</i> is a trust, the depository becomes the guarantor and, therefore guarantees repayment of the whole amount of the deposits, or any part thereof, outstanding in the account of depositors, when demanded. The depositors are not entitled to any share of the profits but the depository may provide returns to the depositors as a token of appreciation.
Zakat	A tax, which is prescribed by Islam on all persons having wealth above a certain amount and that is fixed by the <i>Shariah</i> . According to the Islamic belief Zakat purifies wealth and souls. The objective is to take away a part of the wealth of the well-to-do and to distribute it among the 8 categorises stated in the Quran.

Annex 3

Respondents to the IOSCO Islamic Capital Market Task Force survey

No.	Respondent
1.	Comision Nacional de Valores, Argentina
2.	Australian Securities and Investments Commission
3.	Bahrain Monetary Agency
4.	Securities and Exchange Commission, Bangladesh
5.	Securities Commission of the Federation of Bosnia & Herzegovina
6.	Ontario Securities Commission, Canada
7.	Dubai International Financial Centre
8.	Securities and Exchange Board of India
9.	International Monetary Fund
10.	Indonesian Capital Market Supervisory Agency
11.	Commissione Nazionale per le Societa e la Borsa, Italy
12.	Jordan Securities Commission
13.	Financial Supervisory Service, Korea
14.	Labuan Offshore Financial Services Authority
15.	Securities Commission, Malaysia
16.	Securities and Exchange Commission, Nigeria
17.	Securities and Exchange Commission, Pakistan
18.	Commissao do Mercado de Valores Mobiliarios, Portugal
19.	Qatar Central Bank
20.	Monetary Authority of Singapore
21.	Financial Services Board, South Africa
22.	Amana Investment Ltd, Sri Lanka
23.	Bank of Sudan
24.	Securities and Exchange Commission, Thailand
25.	Capital Markets Board, Turkey
26.	Central Bank, United Arab Emirates
27.	Financial Services Authority, United Kingdom
28.	Securities and Exchange Commission, United States
29.	Dow Jones
30.	HSBC Amanah Finance, Dubai

Annex 4

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