



UNIT-14

Globalization of Islamic Banking

Learning Outcomes

By the end of this unit the learner will be able to:

- ✓ Explore the functions of International Islamic Financial Institutions
- ✓ Explain the Role of Islamic Corporations in Islamic Banking

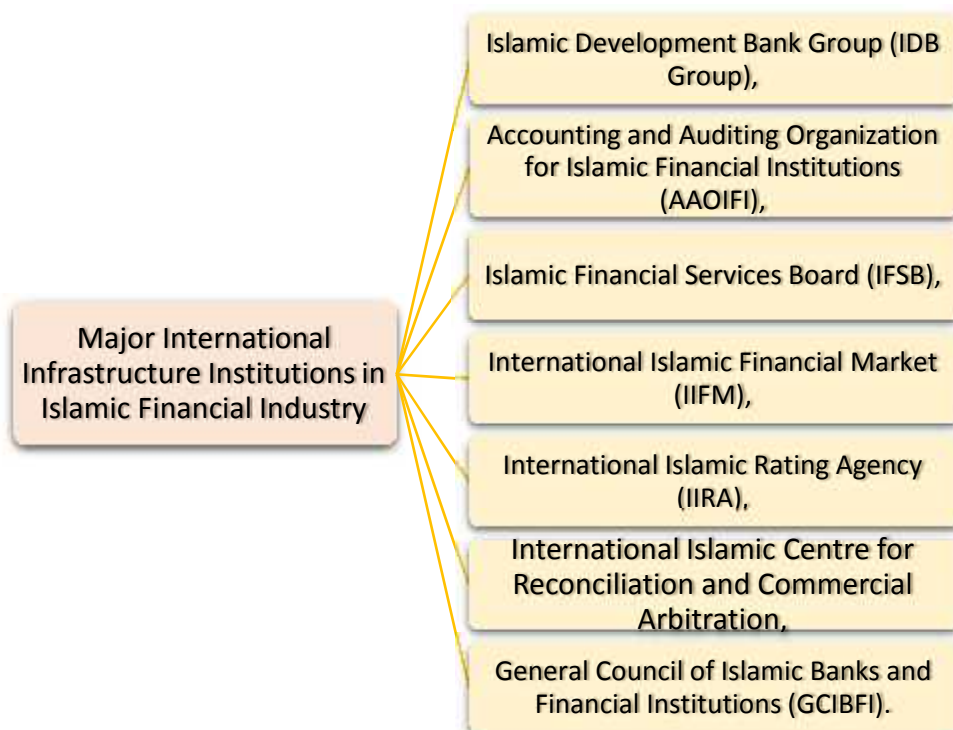
Unit 13

Globalization of Islamic Banking

International Islamic financial institutions

Every system has its institutional requirements. Islamic banks are no exception. They need a number of supporting institutions/arrangements to perform various functions. In the last 30 years, Islamic banking institutions all over the world have tried to benefit from the institutional framework that supports conventional banking which is not generally geared to meet their specific needs. Building a proper institutional set-up is perhaps the most serious challenge for Islamic finance in the coming years. Iqbal et al. (1998) and Jarhial- and Iqbal (2001) have identified some of the requirements for proper institutional arrangements. The process of institution building for the Islamic financial industry is already under way and has gained momentum in the last few years, yet a lot of ground still needs to be covered. In this chapter we provide a brief review of the emerging international financial architecture for the industry.

Major international infrastructure institutions established so far that support the Islamic financial industry include the following as shown in the figure below:



A brief overview of each of these is provided below.

Islamic Development Bank Group

The Islamic Development Bank Group (IDB Group) is a multilateral development finance institution comprising four entities: the Islamic Development Bank (IDB), the Islamic Corporation for the Insurance of Investment and Export Credit (ICIEC), the Islamic Corporation for the Development of the Private Sector (ICD), and the Islamic Research and Training Institute (IRTI). These entities, with IDB as the flagship, were established at different times in the history of the Group, each with its objectives and operational modalities but sharing common vision and mission. Headquartered in Jeddah (Saudi Arabia), the IDB Group has three regional offices in member countries: Almaty (Kazakhstan), Kuala Lumpur (Malaysia) and Rabat (Morocco). It also has eight field representatives in ten member countries: Bangladesh, Guinea, Guinea Bissau, Indonesia, Libya, Mauritania, Pakistan, Sierra Leone, Senegal and Sudan. Of the four members of the Group, IRTI is not a financial institution; the other three institutions are reviewed in the following sections.

Islamic Development Bank (IDB)

It was the establishment of the Islamic Development Bank (IDB) in 1975 that heralded the emergence of the Islamic financial industry. The IDB was established in pursuance of the Declaration of Intent issued at the Conference of Finance Ministers of Muslim Countries held in Jeddah in (December 1973). Following the inaugural meeting of the Board of Governors of the IDB in (July 1975), the IDB formally commenced operations on (20 October 1975).

Objectives: The main objective of the IDB is to foster the economic development and social progress of its member countries as well as Muslim communities in non-member countries either individually or jointly in accordance with the principles of *shari'a*. In pursuit of this aim, the IDB provides support to member countries in the form of project finance. It also establishes and operates special funds for specific purposes, including a fund for assistance to the Muslim communities in non-member countries.

Structure: The apex body of the IDB is the Board of Governors. Each member nominates one governor and one alternative governor to this Board (usually a finance/economic minister or the Central Bank governor of the country concerned). The Board meets once every year in a member country, by rotation. Among other things, the Board of Governors elects the president (chief executive) of the bank for a five-year term which is renewable.

All member countries of the OIC are eligible for membership of the IDB. However, to become a member, a country has to make a specified contribution to the capital of the IDB and undertake to accept terms and conditions to be decided upon by its Board of Governors.

Resources The main source of its financial resources is the member country funds.

Unlike other financial institutions, the bank does not receive interest-based deposits, nor does it augment its financial resources by borrowing funds from conventional world financial markets because this would involve payment of interest, which is not compatible with *shari'a*. Instead, the bank has developed new schemes and financial instruments which are in conformity with the principles of *shari'a*, with a view to supplementing its ordinary financial resources.

The capital base of the bank has witnessed significant expansion over the years. The authorized capital of IDB has increased over time from Islamic Dinar (ID)2 billion to ID15 billion (US \$22.56 billion). Similarly, the issued capital has increased to ID8.1 billion (\$12.18 billion). At the end of 1425H (2005), the paid-in capital of the bank stood at ID2.73 billion (\$5.42 billion) and the ordinary capital resources consisting of the member countries' funds (that is, the paid-in capital, reserves and retained earnings) stood at ID4.27 billion (\$6.42 billion) (Islamic Development Bank, 2005). In order to supplement its capital resources the bank has launched several *shari'a* compatible schemes at different times. The first such scheme, the Investment Deposit Scheme, was introduced in 1400H (1980). It provides investors with an option for making investments through participation in the financing operations of the bank. Under the scheme, the bank accepts deposits from investors and uses them to make short-term investment through participation in foreign trade financing operations. The Islamic Banks Portfolio (IBP) is another window through which the bank mobilizes liquidity available with the Islamic banks, financial institutions and individual investors, and channels it to finance beneficiaries in its member countries. The Unit Investment Fund (UIF) is a private sector window that raises additional resources for the bank from the market and, at the same time, provides investors with a profitable channel of investment in conformity with *shari'a*. The Export Financing Scheme (EFS) mobilizes funds to be used exclusively for promoting exports from the member countries. As of the end of 1425H, the funds raised through these schemes were \$138.96 million through the Investment Deposit Scheme, \$100 million through the IBP, \$325 million through the UIF and \$201.53 million through the EFS.

Recently IDB has started mobilizing resources from the international capital market on competitive rates through *sukuk*. The bank issued its first *sukuk* bond in 1424H, which generated \$400 million. In order to meet the growing needs for additional resources, the bank has recently launched (second quarter 2005) the second *sukuk* issue under the Euro

Medium Term Note (EMTN) Programme for \$1 billion with a 'benchmark issue'/first tranche of \$500 million. The remaining tranche of a smaller amount will be offered later, depending on the liquidity requirements of the bank.

Activities: IDB conducts its development assistance mainly through three types of financing operations, namely (i) ordinary operations comprising project financing and technical assistance operations; (ii) trade financing operations; and (iii) Waqf Fund operations.

The extent of the efforts made over the years is indicated by the assistance given by the bank to its member countries during the past 31 years. Up to the end of 1425H, financing approved by the bank for different operations amounted to ID28.8 billion (\$38.3 billion). All financing is provided through Islamic modes of finance. These modes of finance include interest-free loans, equity participation, leasing, instalment sale

and *istisnaa*. Among these modes of financing loan, instalment sale and leasing are the most important. Between 1396H (1976) and 1425H (2005), 84 per cent of the project financing was done through these modes. Over one-third (35 per cent) of the financing was provided in the form of loans – a concessionary mode of IDB financing. The shares of leasing and instalment sale were 26.4 and 22.7 per cent, respectively.

A brief description and salient features of these modes as used by IDB are given below.

Loans

1. Loans provide long-term financing for the implementation of development projects, mainly in agriculture (canals, rural water supply, etc.) and infrastructure (roads, social facilities such as schools, hospitals, etc.).
2. Currently loans are limited to a maximum of ID7 million per project. They are given interest-free and bear only a service fee to cover related administrative expenses incurred by IDB when formulating and processing the project. Repayment is made in equal semi-annual instalments and extends over a period varying between 15 and 25 years, with a grace period of three to five years, depending on the country and the project.
3. IDB financing usually covers (fully or partially) the foreign cost of specific components. In certain cases, particularly for least-developed countries, it may also cover part of the local cost.
4. The beneficiary is expected to contribute to the project financing. Co-financing with other institutions is also possible under certain conditions (usually parallel financing or, if procedures are similar to those of IDB, joint financing).
5. Loans are normally extended to governments or public institutions having the government guarantee. The private sector may benefit from loans only in special cases.
6. While loans are mainly for least developed countries, they may also be extended to other member countries, particularly in combination with other modes (leasing or instalment sale) when possible.
7. Regional operations as well as projects which promote complementarity between the economies of the member countries are given special consideration.

Instalment sale

1. Instalment sale is a medium-term mode of financing introduced by the Islamic Development Bank in 1405H (October 1984).
2. A request for financing by a government agency or a private entrepreneur under this mode has to be made to the IDB through the office of the governor, IDB of the relevant member country. The official request must be accompanied by a feasibility study or an appropriate project document.
3. This mode of financing calls for a contract between the IDB and the beneficiary entity for whom the bank procures tangible asset(s) and sells it at a mark-up allowing him to make the payment on a deferred basis.
4. The bank finances both locally fabricated as well as imported items of capital assets. Under special circumstances, however, IDB also finances special services associated with a project/operation and supervision during the construction. The minimum limit of financing provided directly by the bank under instalment sale is ID2.0 million and the upper limit is about ID20 million. Total IDB financing could be higher if combined with its other windows of financing such as IBP, UIF and so on.

5. The items eligible for financing under this mode generally include equipment under various economic sectors, such as infrastructure, industry, agriculture, education and health, and covers construction equipment and machinery, industrial equipment, transport equipment and so on. The main criterion for determining the eligibility of an equipment for financing under this mode is that its useful life should not be less than the period proposed for repayment of the IDB financing.
6. Payment is usually made by the beneficiary in semi-annual instalments. The maximum period allowed for instalment sale operations is generally ten years, including the gestation period. However, it could be extended to 12 years for infrastructure projects with a ceiling of ID10 million per project. IDB may also consider extending the period up to 12 years for countries with a Structural Adjustment Programme of the IMF and having no scope to obtain financing from other institutions for repayment in less than 12 years. On delivery of the asset(s) to the beneficiary, the ownership of the asset(s) is transferred from the IDB to the beneficiary.
7. The mark-up currently ranges between 7.5 and 8.5 per cent, depending on the nature of the project and the economic standing of the concerned member country. There is, however, a 15 per cent rebate on the mark-up if the payment is made on time by the beneficiary in accordance with the agreed schedule of payment.
8. For all projects/operations financed by the IDB under this mode, the beneficiary has to provide a guarantee. If it is a project sponsored by the government or its agencies, guarantee by the government is sufficient. In the case where it is a private sector project, it is necessary to provide a guarantee from a first-class commercial bank acceptable to IDB.
9. All purchases are to be undertaken by the beneficiary as an agent of the bank and in close coordination with and concurrence of the bank. The equipment is to be procured in conformity with the bank's procurement procedures, that is, by international competitive bidding. Procurement through local competitive bidding or restricted tendering may, however, be permitted only under special circumstances.
10. The IDB generally disburses funds only after the costs have been incurred. After the finalization of contract and award of bids, the bank asks the beneficiary to open a letter of credit in favour of a supplier and the payment is made directly to the supplier.

The standard disbursement procedure is as follows: (i) down-payment of 10 percent to the supplier on signature of contract and against an acceptable bank guarantee;(ii) disbursement of 80 per cent against shipping documents; (iii) disbursement of the balance on satisfactory completion of the supply of goods and services.

Leasing

1. As introduced and practised by IDB, leasing is a source of medium-term financing to meet the financing requirements of income-generating projects in industry and other important sectors for which the rental payment and lease period are determined in the light of the projected profitability and cash flow of the project.
2. Under leasing, IDB finances various items such as plant, machinery and equipment for industrial, agro industrial, infrastructural, transport and other projects, normally of an income-generating nature in both public and private sectors. Lease financing is also provided for ships, oil tankers, trawlers and other specialized cargo vessels either new or second-hand, up to five years old.

3. IDB normally finances the total cost of machinery and equipment which comprises the cost including freight (CIF) price, inland transportation, erection and installation.
4. The bank retains the ownership of the leased assets throughout the entire lease period which may extend up to 12 years, including a period of gestation that ranges between six and 36 months, depending on the envisaged implementation period of the project. The prevailing return to IDB is 7.5–8.5 per cent if calculated on a yearly basis.
5. After the end of the lease period and full payment of the rentals by the lessee, the IDB transfers the ownership of the equipment to the lessee as a gift.
6. The lessee should provide the bank (the lessor) with an irrevocable and unconditional guarantee from the government or a first-class commercial bank acceptable to IDB to cover all obligations of the lessee under the lease agreement to be signed between IDB and the lessee.

Lines of financing In addition to financing projects directly, IDB also extends lines of financing to the National Development Financing Institutions (NDFIs) in member countries especially to promote the growth and development of small and medium enterprises (SMEs) mainly in the private sector. The lines extended comprise, and under a line the

IDB approves, a certain amount of financing for a national development financing institution which can use the line to finance industrial/commercial projects identified and appraised by it. Under the line of equity, the IDB participates in the share capital of a company sponsoring technically and financially viable projects up to a maximum of one third of its equity capital while, under the lines of leasing and instalment sale, IDB finances the procurement of machinery, equipment and other capital assets for new or expansion projects. Under the line of leasing, the asset is acquired by the IDB and leased to the company until the lease period expires. The ownership of the leased asset is transferred to the lessee by the lessor (IDB) following the payment of the last instalment by the beneficiary. Under the line of instalment sale, the ownership of the asset which is procured by the IDB is transferred to the beneficiary on its delivery. The maximum repayment period allowed for projects under the line of instalment sale and leasing is generally 12 years, including a gestation period of up to a maximum of three years, depending mainly on the anticipated implementation and commissioning period. Under a line of leasing the maximum period may be extended to 15 years. The gestation period may be extended to 48 months or more, depending on the merits of each case.

For each project financed under the line of leasing/instalment sale, a bank guarantee is required for repayment of IDB dues. However, the NDFIs concerned generally provide the required guarantee. In some countries where the development banks are not authorized or are not willing to give guarantees, a commercial bank or a government guarantee is acceptable.

Priority areas Two areas have always been high on the agenda of the IDB: trade promotion among member countries and poverty alleviation. Its activities in these areas are summarized below.

Trade promotion activities IDB accords high priority to the promotion of trade amongst member countries, recognizing that trade contributes immensely to the development process. To this end, IDB has evolved several modes of financing to support and encourage trade.

An Import Trade Financing Operations (ITFO) scheme was launched in 1397H (1977) to finance the import of raw materials, intermediate and finished goods of member countries.

The scheme received an overwhelming response as it enabled the member countries to benefit from ITFO financing for imports of developmental raw materials and inputs.

The scheme also served as a vehicle for utilization of the bank's liquid funds in *ashari'a* compatible way.

The bank launched another scheme, the Export Financing Scheme (EFS), in 1408H.

As a suppliers' credit scheme, it aims to promote exports from the member countries through provision of short- and long-term financing for the exports destined for both the member and non-member countries. The mark-up charged on the EFS operations is generally kept below the market levels. The EFS has its own membership, capital, budget and resources, and its accounts are maintained separately. Currently, the scheme has 26 participating countries as its members, with a total contribution of ID170 million. This amount, together with the IDB's contribution of ID150 million, brings the total subscribed capital to ID320 million. The paid-up capital of the scheme is ID134 million, of which ID75 million was paid by the bank.

In addition to these two major schemes, trade financing is also conducted through the bank's other windows, namely the Islamic Banks' Portfolio (IBP), the Unit Investment

Fund (UIF), the Islamic Corporation for Private Sector Development (ICD) and the Awqaf Properties Investment Fund (APIF). The IDB also manages a special programme on behalf of the Arab Bank for Economic Development in Africa (BADEA) based in Khartoum, which is designed to finance exports originating from Arab member countries to non-Arab league member countries of the African Union.

The total net financing approved by the IDB under its trade financing schemes since its inception until the end of 1425H (2005) amounted to ID17.6 billion (\$23.3 billion). *Poverty alleviation programmes* Among the 55 member countries of the IDB, 26 are 'least developed', while four other member countries are treated as such. These countries are given priority in respect of concessionary (loan and technical assistance) financing of the bank. Loans are provided free of interest and the bank charges a modest service fee to enable it to recover only the administrative costs incurred in its financing. In addition, loans provided by the bank include a grace period of three to seven years and the repayment is spread over a period of 15–25 years. LDMCs are usually given the maximum grace and repayment periods. Loans are provided for projects with a significant socioeconomic developmental impact.

As a demonstration of the bank's concern for poverty alleviation, in 1413H (1992) the

Board of Executive Directors established a special window called 'Special Account for the LDMCs'. The objective of the window is to increase the total financial resources available to these countries to meet the basic and urgent needs. This account is used to finance projects or components of projects that would

not, normally, be financed by the bank under its regular programmes. Loans from this account are granted for a maximum period of 30 years, including a grace period of ten years, with a service fee not exceeding 0.75 percent per year. Special consideration is given to the needs of poor segments of the population.

The areas of support include primary services, such as basic schooling and healthcare, provision of adequate and safe drinking water, and micro projects in remote locations.

Following the full utilization of the initial amount of \$100 million, the LDMC

Account was replenished in 1420H and was supplemented with a second tranche of \$150million. An aggregate amount of ID13.29 million (\$19.04 million) was approved from this account until the end of 1425H.

The total amount of project and TA financing approved for the LDMCs so far has reached ID2.15 billion (\$2.83 billion), representing 41 per cent of the aggregate financing approved for all type of operations in LDMCs and 26 per cent of total ordinary resources approved by IDB. LDMCs share in cumulative loan approvals of the bank has reached 83.8 per cent (ID2.28 billion).

IDB also established a Special Assistance Account in 1399H (1979). The account is kept separate from its ordinary resources and is used, among others, for the following purposes: (a) provision of relief in the form of appropriate goods and services to member countries and Islamic communities afflicted by natural disasters and calamities, (b) provision of financial assistance to Muslim communities in non-member countries to improve their socioeconomic conditions, (c) provision of financial assistance to member countries for the promotion and furtherance of Islamic causes, and (d) training and research aimed at helping and guiding member countries to reorient their economies, financial and banking activities in conformity with *shari'a*.

Islamic Corporation for the Insurance of Investment and Export Credit (ICIEC)

As mentioned above, trade promotion among member countries is high on the agenda of the Islamic Development Bank. It was realized that provision of export insurance services could contribute significantly towards the achievement of that objective. Therefore, the

Board of the bank decided to establish a specialized institution for that purpose.

Accordingly, ICIEC was established on 24 Safar 1415H (1 August 1994).

Membership of ICIEC is open to the Islamic Development Bank and countries which are members of the Organization of the Islamic Conference (OIC). At the end of 1425H, there were 35 shareholders of ICIEC, comprising the IDB and 34 countries. Several other countries are in the process of completing the membership requirements.

The authorized capital of ICIEC is ID100 million (US\$150 million). The subscribed capital of the Corporation is ID96.99 million (US\$145.87 million). IDB contributed ID50 million (US\$75.20 million), which represents 50 per cent of authorized capital. Member countries subscribed ID46.99 million (US\$70.67 million) (Islamic Corporation for the Insurance of Investment and Export Credit, 2005).

Objectives The objectives of ICIEC are (a) to increase the scope of trade transactions from the member countries of the OIC, (b) to facilitate foreign direct investments into OIC member countries, and (c) to provide reinsurance facilities to Export Credit Agencies (ECAs) in member countries.

Activities ICIEC fulfils these objectives by providing appropriate Islamic *shari'a* compatible insurance instruments. It provides *shari'a*-compliant export credit insurance and reinsurance to cover the non-payment of export receivables resulting from commercial (buyer) and non-commercial (country) risks. It also provides investment insurance and reinsurance against country risk, emanating mainly from foreign exchange transfer restrictions, expropriation, war and civil disturbance and breach of contract by the host government. ICIEC commenced its business operations with three types of insurance policies. Since then, it has introduced new products, services and facilities. A brief description of these is given below.

Export Credit Insurance Programme The Export Credit Insurance Programme is the most active and readily recognized element of ICIEC's operations. It was launched in 1995 in tandem with the official start of ICIEC operations. The programme's main focus is to facilitate trade and project finance flows strictly between member countries. ICIEC provides different insurance instruments to address specific customer needs. It offers three types of insurance policies, viz. a Comprehensive Short Term Policy (CSTP), a Supplemental Medium Term Policy (SMTP) and a Bank Master Policy (BMP).

Recently, ICIEC has launched two new insurance products. The first is the Documentary Credit Insurance Policy (DCIP) which is an instrument available to commercial banks. The policyholder – the commercial bank – is protected against the risk of non-payment of an Import Letter of Credit issued by an importer's bank and confirmed by the policyholder on behalf of its exporting customer. The second new instrument launched is the Specific Transaction Policy (STP). The STP is designed to insure single short and medium export transactions, usually associated with project finance. It covers the same risks as the existing Supplemental Medium Term Policy (SMTP) which caters for medium-term whole-turnover business.

Foreign investment insurance services ICIEC introduced the Foreign Investment

Insurance Policy (FIIP) in 1419H (1998). The FIIP provides insurance cover against country risks to investors from member countries who intend to invest in other member countries. Such risks include war, civil disturbance, foreign exchange convertibility and transfer restrictions, nationalization and other forms of host country government interference which may deny the investor his rights to repatriate his investments and profits.

The policy cover can be for up to 20 years.

Reinsurance facility In 1425H, ICIEC developed and launched a new reinsurance product named a Reinsurance Facility Agreement (RFA). This agreement is a facultative reinsurance arrangement that could be developed into a quota share treaty. The Corporation can also participate in existing reinsurance treaties of the ECAs in member countries.

Investment promotion ICIEC is mandated to facilitate the flow of investments to its member countries. Many of the ICIEC member countries have not been successful in attracting investment flows

because of an unfavourable investment environment, lack of investment promotion capacity/capabilities, inability to articulate their competitive sectors and investment projects and the lack of a centralized investment information database.

In order to address these critical issues, an IDB Technical Cooperation Programme in the field of investment promotion has been designed and is ready to be launched. The objective of the programme is to assist member countries in identifying and promoting promising investment opportunities which would encourage foreign investment flows in the member countries. This activity will be undertaken in partnership with relevant specialized multilateral agencies such as the Multilateral Investment Guarantee Agency

(MIGA), the United Nations Industrial Development Organization (UNIDO) and more importantly by leveraging IDB's own knowledge base and expertise in project development and finance in member countries.

Since inception, the Corporation has shown a robust growth in its operations. It has under written more than 1700 transactions, with an aggregate insurance commitment in excess of US\$1.2 billion. It has supported an aggregate of US\$650 million in insured business.

Islamic Corporation for the Development of the Private Sector (ICD)

The private sector is one of the most important engines of growth. A vibrant private sector enhances both savings and investment, which in turn lead to higher rates of growth. The private sector is also more dynamic as decision making is quicker. Unfortunately, in most member countries of the IDB, the public sector has dominated in the last four decades.

However, in the 1990s, active privatization programmes were initiated in many countries.

In the same period, financial sector reforms were also introduced in these countries. In order to support this process and help member countries build strong private sectors, the

Islamic Development Bank decided to establish the Islamic Corporation for the Development of the Private Sector (ICD), which became operational in November 1999.

ICD has an authorized capital of US\$1 billion, of which US\$500 million are currently open for subscription in the following proportions: 50 per cent for the IDB, 30 per cent for IDB's member countries, and 20 per cent for public financial institutions of ICD's member countries. By the end of 1425H, 44 member countries had joined ICD (Islamic Corporation for the Development of the Private Sector, 2005). In addition, five public financial institutions (three from Iran, one from Saudi Arabia, and one from Algeria) have subscribed to the ICD. Other member countries of IDB are also in the process of ratifying ICD's Articles of Agreement and will soon enjoy full membership. ICD is supervised by an independent Board of Directors.

Objectives The purpose of ICD is to promote, in accordance with the principles of the *shari'a*, the economic development of its member countries by encouraging the establishment, expansion and modernization of private enterprises producing goods and services in such a way as to supplement the activities of the IDB.

The objectives of ICD are (a) to identify opportunities in the private sector that could function as engines of growth, (b) to provide a wide range of productive financial products and services, (c) to mobilize additional resources for the private sector in member countries, and (d) to encourage the development of Islamic financial and capital markets.

Activities ICD finances private sector projects (projects in which the majority of the voting stock is held by private entities). Only projects that have a majority of the voting stock held by citizens of ICD member countries are eligible. The minimum investment required for a project to be considered by the ICD is US\$2 million and the ICD financing cannot exceed 50 per cent of the project's cost. The terms and conditions of ICD's financial products are determined according to the market conditions. Profit margins are set as a sum of the London Interbank Offered Rate (LIBOR) plus a spread. The latter is determined by the country and project-specific risks. Repayment periods are, in general, around five to eight years although, in exceptional cases, tenures can be up to 12 years.

These tenures are inclusive of grace periods, the duration of which is determined according to the nature of the project (usually around one year). ICD provides a wide variety of financial products and services. This enables ICD to offer a mix of financing that is tailored to meet the needs of each project. Some of these products are discussed below.

Direct financing ICD provides direct financing through equity participation, the purchase of assignable bonds or provision of term financing in productive and viable projects in member countries. As a general policy, ICD will not be the single largest shareholder in any project, nor will it acquire a majority or controlling interest in the share capital of a project or enterprise except when such acquisition is necessary to protect its interest.

Lines of financing ICD extends lines of financing to commercial banks and national development financing institutions. These lines represent a means to contribute in a cost effective manner to the financing of small and medium enterprises (SMEs). The modes of financing used within the framework of the lines are usually leasing and instalment sale.

Equity and quasi-equity may also be used in certain cases.

Corporate finance ICD extends short-term corporate finance to cover working capital or raw materials requirements of private sector entities through *murabaha* or purchase and lease-back for a period of (up to) 24 months.

Asset management ICD can act as a manager (*mudarib*) or sponsor for funds created by other institutional investors. It can create venture capital or sector funds for the financing of projects.

Structured finance ICD structures, arranges and manages syndications, underwrites and manages shares and securities issues, makes private placements and also carries out securitizations for its clients.

Advisory services ICD provides advisory services to governments, public and private companies on economic, financial, institutional and legal aspects relating inter alia, to creating a suitable environment

for private sector development, project financing, restructuring/rehabilitation of companies, privatization, securitization, Islamic finance and development of Islamic capital markets.

Priority sectors and project types All sectors other than tourism and recreation are eligible for ICD financing. However the priority sectors for ICD are telecommunications, power, technology and health. Furthermore special attention is given to the export potential of the project. In deciding to finance a project, ICD considers the project's developmental impact on the concerned country, in addition to its financial and technical merits.

Projects eligible for financing by ICD are the following.

Greenfield projects This refers to investment/financing of start-up companies/projects which will have some impact on the economy as a whole.

Expansion projects This refers to financing/investment in plant expansion or capacity enhancement.

Existing projects under restructuring/rehabilitation As most countries are restructuring their industries to reduce dependence on a particular sector, ICD has the opportunity to finance companies that are being restructured or rehabilitated.

Privatization operations ICD can finance state-owned enterprises which are being privatized as long as the remaining investment by the government in the company does not exceed 49 per cent. ICD will also structure and finance projects implemented through concession agreements (build-operate-transfer (BUT), build-own-operate-transfer (BOOT), build-own-operate (BOO) and so on) and finance the modernization of privatized companies to enhance their productivity and competitiveness.

The total value of approved projects by the ICD from its inception to the end of 1425H reached US\$298.8 million, while the total disbursed amount during the same period amounted to US\$146.4 million. Of the total approved amount leasing had the largest share (46 per cent), followed by instalment sale (20 per cent), equity (18 per cent), *murabaha* (7 per cent), line of finance (7 per cent) and *istisnaa* (2 per cent).

Accounting and Auditing Organization for Islamic Financial Institutions

Transparency and corporate governance issues are very important for financial institutions to gain the confidence of the clients. In this respect, preparation of financial statements in a way that provides sufficient and comparable information assumes critical importance. The shareholders, depositors, investors and regulators utilize the information provided in the financial statements to assess the health of the institution. Usually it is the central banks that lay down the rules and procedures of disclosure, but several specificities of the operations of Islamic financial institutions warrant some special treatment. If financial statements of these institutions were prepared on the basis of uniform standards, it would facilitate objective comparison between different financial institutions. It would also ensure better market discipline. Industry leaders realized this need and responded with the establishment of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). AAOIFI was established in accordance with the Agreement of Association which was signed by Islamic financial institutions on 26 February 1990 in Algiers. It was registered on 27 March 1991 in the Kingdom of Bahrain. AAOIFI is an international

autonomous non-profit corporate body that prepares accounting, auditing, governance, ethics and *shari'a* standards for Islamic financial institutions.

Objectives

AAOIFI has the following objectives:

- Develop accounting, auditing, governance and ethical standards relating to the activities of Islamic financial institutions which comply with Islamic *shari'a* taking into consideration the international standards and practices.
- Disseminate the accounting, auditing, governance and ethical thoughts relating to the activities of Islamic financial institutions and their application through training seminars, publication of newsletters, preparation of reports, research and any other means.
- Harmonize the accounting policies and procedures adopted by Islamic financial institutions through the preparation and issuance of accounting standards and the interpretations of the same to the said institutions.
- Improve the quality and uniformity of auditing and governance practices relating to Islamic financial institutions through the preparation and issuance of auditing and governance standards and the interpretation of the same to the said institutions.
- Promote good ethical practices relating to Islamic financial institutions through the preparation and issuance of codes of ethics to these institutions.
- Achieve conformity or similarity (to the extent possible) in concepts and applications among the *shari'a* supervisory boards of Islamic financial institutions to avoid contradiction and inconsistency between the fat was and the applications by these institutions, with a view to activating the role of the *shari'a* supervisory boards of Islamic financial institutions and central banks through the preparation, issuance and interpretations of *shari'a* standards and *shari'a* rules for investment, financing and insurance.
- Approach the concerned regulatory bodies, Islamic financial institutions, other financial institutions that offer Islamic financial services, and accounting and auditing firms in order to implement the standards, as well as the statements and guide lines that are published by AAOIFI.

Structure

The structure of the AAOIFI comprises the following.

General Assembly The supreme body of all the members of AAOIFI which consists of founding members, associate members, regulatory and supervisory authorities, observer members and supporting members. The total membership of AAOIFI under various categories stands at 115. Observer members and supporting members have the right to participate in the meetings of the General Assembly without a right to vote.

The founding members of AAOIFI include the Islamic Development Bank, Dar Al-Mal Al-Islami (represented by Shamil Bank of Bahrain), Al-Rajhi Banking and Investment Corporation, Dallah Albaraka Group, Kuwait Finance House, and Bukhary Capital (Malaysia).

Board of Trustees the **Board of Trustees of AAOIFI** is composed of 15 part-time members appointed by the General Assembly every three years. The members of the Board of Trustees are elected from among the following categories, taking into account their geographical distribution:

- regulatory and supervisory authorities,
- Islamic financial institutions,
- accounting and auditing firms whose professional work relates to Islamic financial institutions,
- *shari'a (fiqh)* scholars,
- users of financial statements of Islamic financial institutions.

Accounting and Auditing Standards Board The Standards Board is one of the two technical boards, the most important functional bodies of AAOIFI. It is composed of 155 part-time members who are appointed by the Board of Trustees for a four-year term.

Members of the Standards Board represent the following categories:

- regulatory and supervisory authorities,
- Islamic financial institutions,
- *shari'a (fiqh)* scholars,
- the accounting and auditing profession that relates to the work of Islamic financial institutions,
- users of financial statements of Islamic financial institutions,
- university professors in accounting and financial studies.

Shari'a board The *Shari'a* Board is the second technical body of the organization. It is composed of (up to) 15 members appointed by the Board of Trustees for a four-year term from among *fiqh* scholars who represent *shari'a* supervisory boards in the Islamic financial

institutions which are members of AAOIFI, and *shari'a* supervisory boards in central banks.

Activities

AAOIFI started producing standards in 1993. To date, it has issued 56 standards on accounting, auditing, governance, ethical and *shari'a* issues.

AAOIFI standards are not automatically mandatory. They are basically advisory in nature. However, over the years, AAOIFI has taken significant steps to encourage the application and enforcement of its standards throughout the world. These efforts have helped to increase the remit of AAOIFI standards. Now they are either mandatory or used as a guideline by the regulators in jurisdictions such as Bahrain, Sudan, Jordan, Malaysia, Qatar, Saudi Arabia, Dubai and Lebanon. Most recently, Syria has signed an agreement to mandate and adopt AAOIFI's standards.

Islamic Financial Services Board

Proper regulation and supervision of banks and financial institutions is also important for financial efficiency and stability. Some of the risks faced by the Islamic financial industry are unique because of the requirement of *shari'a* compliance. Bank supervisors utilizing the traditional standards cannot assess such risks. The need for special guide lines for the regulation and supervision of Islamic banks has long been felt.

With an active involvement of the International Monetary Fund (IMF), the IDB and support of the Bahrain Monetary Agency (BMA), Bank Negara Malaysia (BNM) and some other central banks, an Islamic Financial Services Board was established in Malaysia in November 2002 and has been in operation since March 2003. Its mandate is to serve as an international standard-setting body of the regulatory and supervisory agencies that have an interest in ensuring the soundness and stability of the Islamic financial services industry (defined broadly to include banking, capital market and insurance). In advancing this mission, the IFSB will promote the development of a prudent and transparent Islamic financial services industry through introducing new, or adapting existing, international standards consistent with Islamic principles, and recommend them for adoption. To this end the work of the IFSB complements that of the Basel Committee on Banking Supervision, International Organisation of Securities Commissions and the International Association of Insurance Supervisors.

Objectives

The objectives of the IFSB include:

- To promote the development of a prudent and transparent Islamic financial services industry through introducing new, or adapting existing, international standards consistent with *shari'a* principles, and recommending these for adoption.
- To provide guidance on the effective supervision and regulation of institutions offering Islamic financial products and developing for the Islamic financial services industry the criteria for identifying, measuring, managing and disclosing risks, taking into account international standards for valuation, income and expense calculation and disclosure.
- To liaise and cooperate with relevant organizations currently setting standards for the stability and the soundness of the international monetary and financial systems and those of the member countries.
- To enhance and coordinate initiatives to develop instruments and procedures for efficient operations and risk management.
- To encourage cooperation amongst member countries in developing the Islamic financial services industry.
- To facilitate training and personnel development in skills in areas relevant to the effective regulation of the Islamic financial services industry and related markets.
- To undertake research into, and publish studies and surveys on, the Islamic financial services industry.
- To establish a database of Islamic banks, financial institutions and industry experts.

Structure

The structure of the IFSB consists of the following elements.

General Assembly The representative body of all the members of the IFSB, including full members, associate members and observer members. Full membership is available to the leading financial supervisory authority of each sovereign country that recognizes

Islamic financial services, whether by legislation or regulation or by established practice, and to intergovernmental international organizations that have an explicit mandate for promoting Islamic finance and markets upon application for membership by that authority or organization. No country is permitted to have more than one full member. Associate membership is available to any central bank, monetary authority or financial supervisory or regulatory organization or international organization involved in setting or promoting standards for the stability and soundness of international and national monetary and financial systems, which does not qualify for full member status or which does not seek to become a full member upon application for membership by that central bank, authority or organization. Associate members can participate in the deliberations of the General

Assembly, but do not have voting rights. Observer status can be granted to any national, regional or international professional or industry association, any institution that offers

Islamic financial services or any firm or organization that provides professional services, including accounting, legal, rating, research or training services.

Council This is the highest executive and policy-making body of the IFSB. It consists of one representative for each full member who shall be the senior executive officer of that full member or such other senior person nominated to represent him from time to time.

Technical Committee This is the body responsible for advising the Council on technical issues within its terms of reference (as determined by the Council). It consists of ten persons selected by the Council and has a term of office of three years.

Working groups A working group is a committee that is established to be responsible for drafting standards and guidelines. It reports to the Technical Committee.

Secretariat The permanent administrative body of the IFSB. It is headed by a full-time secretary-general appointed by the Council.

Activities

The IFSB has begun the development of prudential standards for the Islamic financial services industry. The standards being prepared by the IFSB follow a lengthy process which involves, among other things, the issuance of an exposure draft and, where necessary, the holding of a public hearing. Through this process the IFSB expects to contribute to the development of a robust and resilient Islamic financial system that can effectively preserve financial stability and contribute to balanced growth and development. It is also expected to facilitate integration of the Islamic financial system as a viable component of the global financial system.

International Islamic Financial Market

Despite its remarkable growth and recognition, the Islamic banking industry is still in its infancy. Key challenges faced by it are product innovation, to meet the varying demands of investors in a fast-changing market environment; support infrastructure, which will address the critical need for liquidity management among Islamic financial institutions; and standardization and codification of laws and market practices. Financial authorities from several Islamic countries recognized the critical need for an organization to fill this gap and came together to create the International Islamic Financial Market (IIFM). Its founding members include the Islamic Development Bank, Bahrain Monetary Agency, Labuan Offshore Financial Services Authority, Central Bank of Sudan, Central Bank of Indonesia and Ministry of Finance Brunei Darussalam. IIFM is an independent, non profit organization headquartered in the Kingdom of Bahrain. The IIFM became operational on 1 April 2002.

Objectives

The chief objective of the IIFM is to facilitate international secondary market trading of Islamic financial instruments. This would considerably enhance cross-border acceptance of Islamic financial instruments and strengthen cooperation among Muslim countries.

Activities

IIFM faced some logistical problems after its establishment and did not have an active operational programme for some time. It has now become more active and is expected to increase its activities in the near future. It intends to achieve its objectives through the following:

- developing a market for independent *shari'a* enhancement of existing or new Islamic financial instruments through increasing the number of issuance and participants;
- providing guidelines for the issuance of new Islamic financial instruments;
- enhancing cooperation amongst market participants by encouraging product development and trading of instruments in the secondary market;
- undertaking research for the development of Islamic financial markets.

International Islamic Rating Agency

Market discipline is important for an efficient and stable financial system. In this regard, external rating systems and accounting standards play a vital role in improving the availability of information to investors, bankers and regulators. Obtaining a good rating is very important for any institution to attract funds from other institutions and investors. Islamic financial institutions mobilize funds on a profit-and-loss sharing basis. Funds are invested in these institutions with an expectation that all risks and rewards will be equitably shared between the investor and the IFI. Islamic financial institutions are no longer confined to the boundaries of Muslim countries. They are rapidly expanding into other countries and dealing with institutions and regulatory authorities which may not fully comprehend the specific characteristics or the

risk profile of Islamic financial institutions. Further, the development of a secondary market in Islamic products such as *sukuk* has increased the importance of credit assessment. In such a market, both issuers and their instruments need to be rated in terms of their inherent risks. This is a prerequisite if the market's products are to be accurately priced and actively traded. In order for Islamic financial institutions to compete in the global financial arena, it is critical that these institutions obtain a good rating. An institution/instrument whose creditworthiness has been positively rated will enhance the investors' confidence.

Existing conventional rating systems are primarily concerned with the financial strength of counterparties and ignore compliance with the *shari'a* requirements. Since non-compliance of even a financially sound Islamic bank with the *shari'a* requirement can be a serious cause of systemic instability, the need for an Islamic rating agency has always been felt. Keeping this need in mind, an International Islamic Rating Agency (IIRA) was incorporated in Bahrain in October 2002 with an authorized share capital of US\$10 million and a paid-up capital of US\$2 million. The main activities of the IIRA are to undertake research, analysis, rating of the obligations, dues, commitments, and other securities and to give an independent assessment of compliance by the concerned entity, or the financial instrument with the principles of *shari'a*. Although similar to conventional rating agencies, IIRA aims at developing a distinct market niche whereby it will, among other things, rate funds being raised for the Islamic market/investors as well as banks and insurance companies incorporated or operating in the IDB member countries.

The IIRA will scrutinize *shari'a* aspects of financial institutions and products, which will be of major importance to the Islamic financial industry, bearing in mind the global character/appeal of the new international agency. An internationally recognized rating will give these institutions the credibility and the transparency they need to deal with the international market. As a specialized rating agency, the IIRA will be complementary to the existing agencies, adding value to the market. By assessing fiduciary relationships and credit risk inherent in any instrument or issuer, the IIRA will help create a higher degree of confidence and acceptability of products among the players in the industry.

International Islamic Centre for Reconciliation and Commercial Arbitration for Islamic

Finance Industry

Islamic financial institutions work under different legal jurisdictions and, sometimes, because of their special nature, the legal basis in the ordinary laws of the country may not be very clear. This may result in disputes among contracting parties which may be difficult to resolve in courts. It is estimated that litigation, on average, costs nearly 20 per cent of the value of the disputed amount and, even if the decision of the court is in favour of the financial institution, only 80 per cent of the value of the disputed amount is recovered.

The cost of an out-of-court settlement is nearly 17 per cent of the disputed amount. The absence of institutions providing alternative dispute services to Islamic financial institutions

had been seriously felt for the past several years. In order to solve this problem, the Islamic Development Bank and the General Council of Islamic Banks and Financial Institutions took a joint initiative to establish an Arbitration Centre to resolve any possible disputes. The government of the United Arab Emirates welcomed the initiative and agreed to host such an institution. Accordingly, the International Islamic Centre for Reconciliation and Commercial Arbitration for Islamic Finance Industry was established on 19 April 2005. The centre is headquartered in Dubai, UAE.

Objective

The objective of the centre is to settle financial and commercial disputes between financial or commercial institutions that have chosen to accept the *shari'a* law to settle their disputes. It will also attempt to settle disputes between these institutions and third parties through reconciliation and arbitration.

Structure

The structure of the Centre comprises the following.

General body Central banks, Islamic financial institutions and conventional financial institutions offering Islamic financial services wishing to subscribe to the centre.

Board of Trustees Up to 15 members chosen by the general body for a period of three years, renewable once. The first Board of Trustees comprises Islamic Development Bank,

General Council of Islamic Banks and Financial Institutions, Abu Dhabi Islamic Bank

(UAE), Dubai Islamic Bank (UAE), Bahrain Islamic Bank (Bahrain), Al Jazeera Bank (Saudi Arabia), Kuwait Financial House (Kuwait), Qatar Islamic Bank (Qatar), EN

Bank (Iran), Family Finance Institution (Turkey), Bank Islam Malaysia (Malaysia), Saudi-Tunisian Finance House (Tunisia), Association of Sudanese Banks (Sudan), Jordan Islamic Bank (Jordan) and Bangladesh Islamic Bank (Bangladesh).

Executive Committee The Board of Trustees will select a seven-member Executive Committee for a period of three years. The members of the Executive Committee will be from amongst the members of the Board of Trustees or experts from outside.

Technical (Investigation) Committee The Technical or Investigation Committee will comprise five members appointed by the Board of Trustees from amongst the members of the Board of Trustees or experts from outside.

General Secretariat The General Secretariat will comprise a secretary general and such other staff as may be needed.

General Council of Islamic Banks and Financial Institutions

The General Council of Islamic Banks and Financial Institutions (GCIBFI) is an international autonomous non-profit corporate body that represents Islamic banks and financial institutions and the Islamic financial industry globally. It was incorporated into the

Kingdom of Bahrain on 16 May 2001. Its mission is to support and promote the Islamic financial services industry by being the organizational umbrella for the Islamic Financial Institutions (IFIs). It serves the industry through information, media, research and development, consultancy, and human resources development.

Objectives

The objectives of GCIBFI include the following:

- to provide the IFIs with the information needed for their development and growth;
- to promote the Islamic Financial Services Industry (IFSI) and enhance its image;
- to contribute to the growth of the IFSI by providing research and development services;
- to improve and enforce the growth of the IFIs by providing them with the needed advisory and consultancy services;
- to contribute to the human resources development required to face global challenges and meet growth opportunities.

Activities

The activities of GCIBFI are centred around four major areas, which are summarized below:

- 1) Media and awareness
 - Internet website and the e-newsletter,
 - conferences and seminars,
 - global awareness programmes,
 - local public awareness campaigns;
- 2) Information and research
 - administrative and financial directory for Islamic financial institutions,
 - series of Islamic banking applications,
 - monthly educational bulletin;
- 3) Policies and strategic planning
 - model law for Islamic banking,
 - International Islamic Bank;
- 4) Islamic financial products
 - Islamic QMS Certification for Islamic financial products.

Conclusion

In recent years a number of initiatives have been taken to strengthen the Islamic financial architecture. Under the leadership of the Islamic Development Bank and with active support from international

institutions such as the World Bank, IMF and the Basle Committee, several international Islamic financial institutions have been established. In addition, though many of the traditional infrastructure arrangements for conventional finance, such as payment systems, trading arrangements and information systems, are also available to IFIs, in most cases the operational modalities need to be adjusted in varying degrees to accommodate the specific requirements of IFIs. To make these adjustments, a 'functional approach' towards building the infrastructure of the Islamic financial industry is needed. The functions being performed by various institutions in the conventional framework should be examined and attempts should be made to modify the existing institutions in a way that enables them to provide better support, or establish new ones as needed.

While there is no doubt that the emerging Islamic financial architecture requires further strengthening, two other requirements are also urgent. One is the need to consolidate the emerging set-up and to coordinate the activities of the newly established institutions so as to avoid duplication. The other is the need to integrate the Islamic financial architecture in to the global institutional framework without losing its specificities. In this respect the impact of the current trend towards globalization as well as the technological developments which are changing the shape of financial firms need to be seriously considered and responded to. The Islamic financial industry has a bright future, but it will be achieved only if the past achievement on the one hand and the floodlight of imminent changes on the other do not blind its active players.

Further Reading:

- ✓ *The Law of Globalization: An Introduction By Laurence Boule*
- ✓ *The Globalization of Business and the Middle East: Opportunities and Constraints By Masoud Kavoossi*