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Islamic Finance

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This article reviews selected developments in Islamic Finance during 2012.[1]

I. Introduction

The Islamic Finance industry has again faced controversy and struggles in its long-term development. Twenty-twelve was a year filled with discussions and review of regulations in the allowance of what is often termed as "Islamic Windows." Islamic Windows are a means in which a conventional financial institution may offer various Islamic products in the marketplace, in addition to its regular conventional products. This allows the financial institution to capitalize on multiple market segments. As the global financial markets continue to suffer, it is important for financial institutions to find ways to broaden their market base. The Islamic finance industry is reported to have been worth US $1.3 trillion at the end of 2011, with expected further growth throughout the coming years.[2] This is an industry filled with opportunity. The growth of Islamic finance may be attributed to many different reasons. Among those reasons is the entrance of conventional financial institutions into the Islamic finance market place. The debate was sparked when the Qatar Financial Services Authority issued a ban on Islamic Windows and expected compliance by December 31, 2011.[3] In response, the Malaysian Central Bank has advised that it currently holds no plans to institute the same ban as Qatar.[4]

There are many different viewpoints relating to this practice, among them is that Islamic Windows provide opportunities for conventional banks to broaden their market segments, introduce Islamic finance to conventional markets, and increase the awareness, understanding, and potential growth of the Islamic finance industry.

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1. For developments during 2011, see Dena H. Elkhatib & Pierre M. Gaunaurd, *Islamic Finance*, 46 INT'L LAW. 281 (2012). For developments during 2010, see Pierre M. Gaunaurd et al., *Islamic Finance*, 45 INT'L LAW. 271 (2011).

2. *See Islamic Finance*, THE ECONOMIST, (Apr. 10, 2012, 6:40 PM), http://www.economist.com/blogs/graphicdetail/2012/04/focus-2.

3. *See Conventional Banks Close Islamic Branches as Deadline Nears*, QATARISBOOMING.COM (Jan. 30, 2011), http://www.qatarisbooming.com/2011/12/30/conventional-banks-close-islamic-branches-as-deadline-nears/; *see also* Paul McNamara, *A Damp Squib in Doha*, ISLAMIC GLOBE, Jan. 12, 2012, *available at* 2012 WLNR 733873.

4. OXFORD BUSINESS GROUP, THE REPORT QATAR 2011, at 106 (2012).

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On the other hand, many are critical of conventional institutions opening Islamic finance windows. The concern is that the governance and regulatory scheme of this area is still undeveloped in many countries and may prove to have long-term consequences in the Islamic finance industry. As a result, several governments throughout the Gulf Region in the Middle East are reviewing the practice of Islamic Windows. Qatar's regulatory authority, the Qatar Financial Centre, has banned onshore banks to operate Islamic Windows in Qatar.[5]

The idea is that a financial institution should be either exclusively a conventional or an Islamic institution. There are several points to consider in relation to each perspective, however, this article will focus only on three key points: the Shariah obstacles, regulatory challenges, and the benefits to the industry and the bank.

II. Shariah Obstacles of Financial Institutions

To understand the perspective of each position, it is important to first understand what is the difference between a conventional and a Shariah compliant financial institution. These differences may be highlighted in the following areas: (1) Shariah compliance, (2) segregation of Islamic versus conventional funds, and (3) varying accounting standards.

A. Shariah compliance

Briefly, the Shariah forbids transactions that have interest (*riba*), contractual uncertainty (*gharar*), gambling (*maisir*), and prohibited industries (such as dealing in pork, pornography, or alcohol).[6] Because the application of Islamic finance uses jurisprudence, Islamic law, and fatwas (scholarly decrees), many Islamic financial institutions have a Shariah supervisory board that assists in the application of the Shariah principles to the activities of the financial institution.

There is no international supervisory board or agency that governs the overall market practice of Islamic finance.[7] Rather, financial institutions have internationally recognized institutional practices that issue guidelines for Islamic institutions (i.e., accounting standards). The guidelines are unofficial binding practices that assist in providing general market practice guidance but are not obligatory unless adopted by the respective regulatory authority.

Therefore, each Shariah compliant financial institution applies its own understanding of Islamic finance in accordance with consultation of its appointed Shariah board, unofficial international binding practices within the market place, and any laws or regulations issued by its local governance. Islamic financial institutions typically appoint a Shariah board to oversee the practices of the institution. The Shariah board assists in ensuring that the practices and business of the Islamic financial institution is acceptable.[8]

It is reasonable to say that the governance of a conventional model and that of an Islamic financial model are not symmetrical, they have conflicting concepts with each re-

5. *Id.*
6. Dena Elkhatib, The ABA Practical Guide to Drafting Basic Islamic Finance Contracts 13 (2012) [hereinafter Elkhatib].
7. *Id.* at 11.
8. *Id.* at 7.

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quiring unique oversight. Therefore a financial institution practicing both conventional lending as well as Shariah based lending would require separate compliance procedures for each practice as well as the costs of retaining a Shariah board to supervise and advise on the compliance of the Shariah practice. It is noteworthy to highlight that not all procedures or compliance aspects between a conventional and Islamic practice are different; however, the areas that are different would require both internal training and oversight. Although this is possible, on a practical note it is challenging for the financial institution operating the Islamic window in terms of cost, time, and training.

B. Segregation of Islamic Versus Conventional Funds

Shariah prohibits certain industries (such as gambling or alcohol), and therefore funds used by a conventional financial institution through the Islamic window are expected to be managed in accordance with Shariah. Therefore, it is reasonable to expect that the funds be segregated into conventional funds and Islamic funds. This is burdensome on the financial institution, as it will be required to maintain accurate records for both the conventional funds distributed as well as those under the Islamic window.

C. Varying Accounting Standards

As a separate business unit for the conventional financial institution, it is reasonable for the Islamic window to have separate financial statements. The accounting standards for Islamic lending are different than that of conventional lending and have different reporting requirements. Although there are not official global requirements for the reporting of financial statements for Islamic finance institutions, the Accounting and Auditing Organization for Islamic Finance Institutions (AAOIFI) has provided a non-binding set of rules and regulations that are internationally recognized and adopted by many in the Islamic finance community.[9] The relevant aspects of these guidelines, or those issued by similar institutions or the respective government regulator, would need to be adopted to report the financial activities of the Islamic window. This may seem cumbersome, but the functions of the Islamic Window may be treated as a separate business unit that, while incurring additional costs, funds itself.

III. Regulatory Challenges

The second important consideration relating to retaining Islamic Windows is that each jurisdiction independently regulates the Islamic financial marketplace.[10] In most instances such regulations are recent (as is the industry) and are continuously developed and refined. Generally, the Islamic window regulations are limited and have a tendency to be overlooked as the institution is categorized as a conventional financial institution and specific products are only authorized as Islamic products. The detailed oversight of such products and the results thereof are typically lightly regulated.

9. *Id.*
10. *See generally* Islamic Financial Services Board, Guiding Principles on Shariah Governance Systems for Institutions Offering Islamic Financial Services (2009), *available at* http://www.ifsb.org/standard/IFSB-10%20Shariah%20Governance.pdf.

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If this gap in the regulatory market is properly covered, and the respective government regulatory authorities tighten the requirements relating to Islamic Windows, then this challenge would be mitigated. The Malaysian Central Bank has taken this stance and has issued comprehensive regulations in all areas of Islamic banking.[11] Regulators throughout the Gulf Cooperation Council (GCC) and the Middle East and Northern Africa (MENA) region have also begun to review their regulations and question whether to follow in the direction proposed by the Qatar Financial Services Authority.[12]

IV. Benefits to the Banking industry

There are many benefits to the Islamic finance marketplace in retaining Islamic Windows. For instance, Islamic Windows provide conventional financial institutions the ability to leverage product risk and widen target markets.[13] The global financial crisis has strained many financial institutions, especially in the conventional marketplace.[14] It is no secret that the conventional financial markets have stagnated and in some instances declined significantly during the past several years. But the Islamic finance market is growing and continues to grow. Conventional financial institutions can use this additional market to stabilize, expand their product portfolios, increase the target market base, and leverage the financial institutions' assets. As previously noted, Islamic finance is an asset-based lending system, which aids financial institutions in strengthening their portfolios.

Islamic finance has proven to be a growing marketplace providing many new opportunities and market segments.[15] In any good industry healthy competition, regulation, and open markets always prove to strengthen the industry long-term. Retaining Islamic Windows in the Islamic financial marketplace can provide benefits to both conventional financial institutions as well as the Islamic finance industry.

11. THE REPORT QATAR 2011, *supra* note 4, at 106.
12. *Id.*
13. *See generally* ERNST & YOUNG, WORLD BANKING ISLAMIC COMPETITIVENESS REPORT 2011-12 (2012), *available at* http://www.ey.com/Publication/vwLUAssets/IBCR_Report/$FILE/IBCRReport2011(LR)%20Final.pdf.
14. *See* ARZUL AZWAR AHMAD TAJUDIN ET AL., ISLAMIC FINANCE: A SAFE HAVEN OF UNCERTAIN TIMES 5 (2012), *available at* http://online.thomsonreuters.com/assets/downloads/islamicRep_A4_brochure.pdf.
15. *See* ELKHATIB, *supra* note 6, at 1.

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